Have Capitalism and Democracy been Captured by the Elite?



Raghuram Rajan



Capitalism and democracy in crisis

- Crisis and bail out.
- Technocratic governments in Greece and Italy, central banks around the world.
- Enormous levels of youth unemployment, foreclosure crisis.
- Meanwhile the "one percent" have received much of the gains.
- What happened to equal opportunity and justice? Have the capitalists captured policy? Is "labor" powerless? Is democracy dead?

Troubling notes...

- Economies are in trouble, in part because of short sighted populist policies.
 - Government hiring and spending in Southern Europe (local governments in Spain, federal government in Greece)
 - Easy credit and low interest rates
 - Affordable housing push in the United States
 - Irish and Spanish housing boom
- Technology has made it easier for small groups to make themselves heard, to organize, and to raise funding.
 - Arab Spring, Occupy Movement
 - President Obama's first presidential campaign
- The world is awash in capital, while talented human capital is scarce.
 - Capital is not the source of power it was

Outline of talk

- The crisis was not caused by elitist or corporatist policies, at least in Anglo-American economies.
- But the elite is in disrepute because the consequences of the crisis have been broadly felt, even while the elite have escaped.
- We need to link the macro with the micro to understand past policies and their consequences, as well as what to do.

Macroeconomic underpinnings of the crisis: An outline

- Today's problems have been a long time building.
- Massive increase in societal promises (to the elderly, the poor) in the high growth 1960s.
- Fall off in growth in the 1970s, impervious to Keynesian policies.
- Deregulation, financial liberalization, and more competition in Anglo-American economies in the 1980s to revive growth.
 - Growing inequality because education does not keep pace with need for skills
 - Easy credit to keep up consumption
- Much less reform in Continental, especially Southern, Europe.
 - Rising unemployment
 - Accession to Euro => fall in real interest rates, and relaxed government spending constraints => real estate and government spending boom
- Crisis

Macro: Growth slowed

- Strong growth post war, especially in Europe.
 - Reconstruction
 - Resumption of trade
 - Spread of new technologies
 - Spread of education
- Rents shared, labor peace
- Expansion of welfare state
- But then low hanging fruit plucked, oil shock, growth slowed.

Growth Rate and Level of GDP per Hour Worked, U. S. vs. Europe, 1870-2003

	Annual Average Growth Rate			Europe Level, U. S. =100	
	U. S.	Europe	U.S Europe	Europe / U. S.	
				1870	71
4070 4040	4.00	4.55	0.07		
1870-1913	1.92	1.55	0.37	1913	61
1913-1950	2.48	1.56	0.92	1950	44
1950-1973	2.77	4.77	-2.00	1973	79
1973-1995	1.48	2.25	-0.77	1995	94
1995-2003	2.33	1.15	1.18	2003	85

Source: 1870-1990, Maddison (2001, Tables E-8 and E-9, pp. 352-3) 1990-2003, OECD Economic Outlook, December 2003, Table 13

Robert Gordon, NBER WP 2004

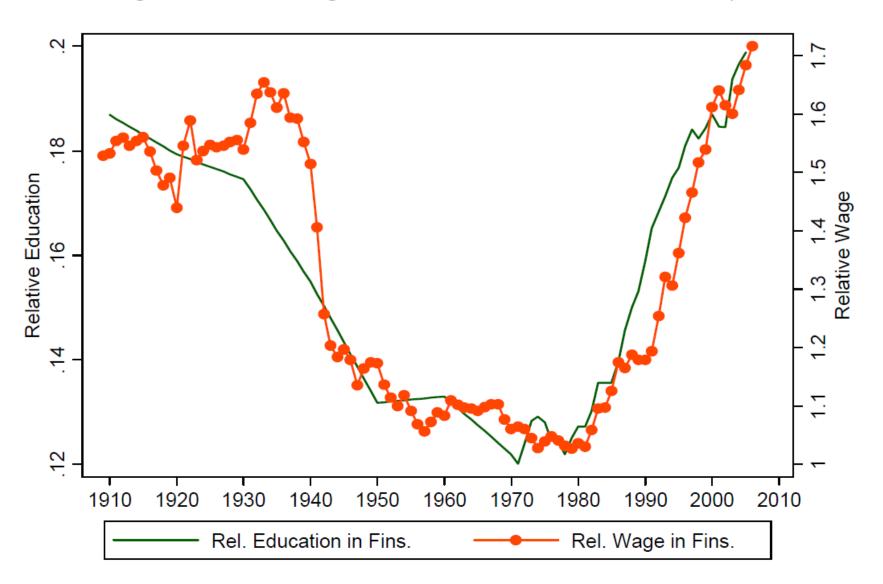
Reactions

- Keynesian stimulus stagflation
 - Monetary rigor Volcker disinflation
- United States: focus on supply side
 - Deregulation started under Jimmy Carter, continued by Ronald Reagan
- United Kingdom
 - Margaret Thatcher
- Continental Europe
 - Reforms slower, some push by European Commission for integrated market

Deregulation

- Increases competition
- Increases returns to innovators, the skilled, and the creative
- When accompanied by financial sector deregulation, increases returns to/power of talented human capital vs returns to financial or physical capital.
- Consider the financial sector in the United States

Figure 1: Relative Wage and Education in the Financial Industry



Source: Philippon and Reshef (2009)



Technology and globalization further exacerbate the demand for talent

Routine

Non-Routine

Skilled

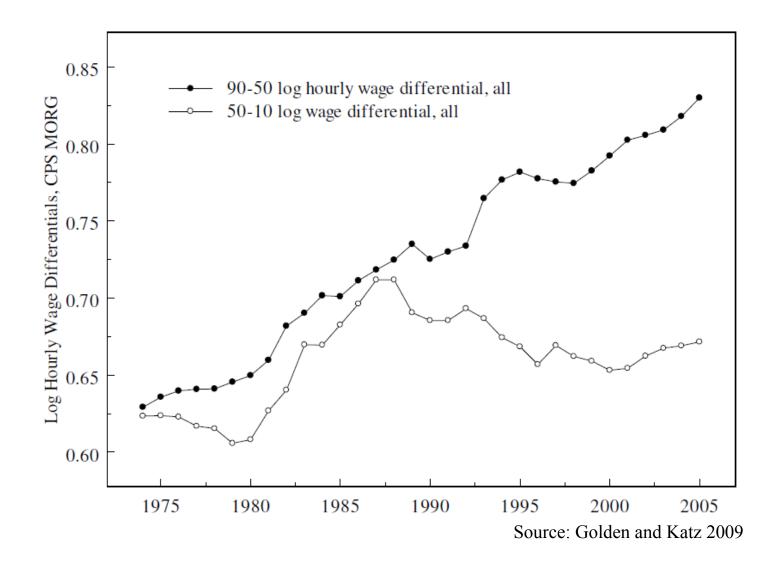
Unskilled

Clerk: Analyst; Discovery	Consultant, Corporate		
Replaced by program/	Lawyer, Doctor, Engineer,		
machine, Outsourced	Medical technician		
Textile worker	Gardener, McCook,		
Globalized	construction		

But education (and skill building) has not kept up in the United States.

- Race between technology and education (Golden and Katz (2009))
- 35% of 25-54 year olds with no high school diploma have no job
- Those aged 25 to 34 are less likely to have a degree than 45-54 year olds.
- Skill mismatch: STEM vs social sciences.
- Probably due to inadequacies in families, communities, pre-school preparation, and K-12 schooling experience.
- Caveat: New elite based on educational attainment and capabilities (and luck) rather than primarily race, gender, or even university.
- CEO background and tenure
- But entrenchment nevertheless— children of rich much more likely to complete college than children of poor, and difference increasing.

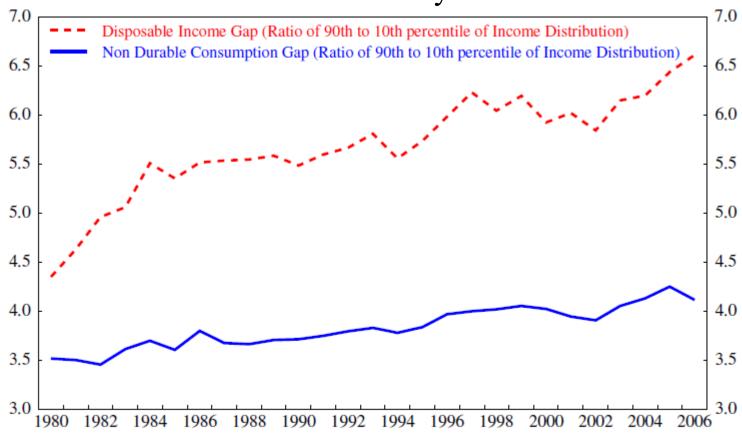
Consequence – stagnating middle in the United States



Let them eat credit

- As more Americans left behind in perception if not in fact, increasing polarization.
- Rising inequality and political pressure to do something.
- But education difficult to tackle
 - Redistribution? No political support + huge costs
 - But people care about consumption. So what if they don't have income growth.
 - Consumption growth through credit growth
 - Better still, home ownership: stake in the future as well as means to borrow
- Affordable housing (Clinton), ownership society (Bush)
 - Instruments: FHA, Fannie, Freddie

Consumption inequality has not increased commensurately...



Source: Heathcote, Perri and Violante (2010), based on micro-level data from the U.S. Consumer Population Survey. Income corresponds to disposable income, and consumption to non-durable consumption expenditures.

Was deregulation a failure?

- No, helped household as consumer
 - Walmart effect
- Would have helped household as producer if skill-building had responded.
- Financial deregulation helped, but financial sector went off track.
- Not a failure of capitalism but a failure of financial capitalism.
 - Can we tame finance?

Turning to the Euro Area

- Milder reforms prior to Euro accession
- Southern Europe: Insider vs Outsider economies
 - High unemployment before Euro accession
- After Euro accession booms
 - Housing (Spain)
 - Local government spending
 - Federal government spending (Greece)
- Unit labor costs rise => competitiveness falls

Unemployment in Periphery

Country	Unemployment (1999)	Unemployment (2007)	Unemployment (2010)
Greece	12.1	8.3	12.6
Italy	11	5.9	8.4
Spain	15.6	8.3	20.1

In sum, have the capitalists subverted democracy?

- Populist policies produced fast-working but unsustainable solution
 - Easy credit
 - Government spending
- Private financiers were neither blameless nor unwilling tools.
 - Convergence between business and politics
- But to argue that policy was solely elitist in origin and intent is a total misreading of what happened.

Did policies post crash favor the elite?

- Bank bailouts could have imposed more costs on shareholders and bondholders
 - Dividend restrictions
 - Capital raising rather than asset shrinkage
 - Moratorium on bonuses
- Cognitive capture rather than crony capitalism.
- But large deficits and sovereign debts are typically not because of bank bailouts (Ireland apart).
- Deficits are large for the usual reasons
 - Lower revenues
 - Automatic stabilizers unemployment insurance
 - Stimulus

Have capitalists/corporations captured the political process?

- Hard to argue corporations have become more influential individually=> Competition for influence
- Costs to public of organizing, and disseminating information, have fallen tremendously.

Has the power of capital over labor increased?

- Capitalist ownership of key assets and lack of alternatives for worker => source of power
- Lower entry barriers, easier finance -- make physical assets less important => more alternatives for worker
- Intellectual property not same as physical capital
 - Can be eroded quickly
- Creativity, differentiation, rather than monopoly position are the continuing sources of value
- Human capital now has power of its own
 - Diminished role of unions as countering capitalist power
 - Resistance to egalitarian solutions
 - The working rich rather than the idle rich

Real issue is not power but capabilities

- Undifferentiated low skilled commodity labor, largely found in the service industries
 - Gardeners, restaurant workers, home aides for elderly
 - Not held down by capital but by competitive markets, automation, and trade
 - Organizing across industry to extract higher rents
 - Minimum wage
- How can they get a "living" wage? How can they move up?

Difficulties in reforming

- Policies will pay clear dividends only in the long run.
 - Education and skills
 - Innovation
- Need to address distress in short run
 - How to get the unemployed, especially the young, into the labor force?
 - How to retrain those in sunset industries?
 - How to engage the unemployable?
- How to draw on the vibrancy of finance while reducing its destabilizing tendencies.

Political difficulties

- Political environment difficult: Distrust of elites
 - In US Wall Street vs Main Street
 - Tea Party and Occupy identify same problems
 - In Euro area elite for greater integration vs skeptical people
- Will all this turn against the foreigner?
 - Excess focus on household as producer rather than consumer

Bottom line

- Our problems are not elite capture (at least not any more than in the past).
- Industrial democracies are facing up to developmental problems (how to energize growth) that they thought they never would have to face again.
- Electorates are impatient and divided, so politicians respond with short term policies that don't get at the real problem.
- The future of the West lies in the rest, so this is the worst time for protectionism (aka insourcing).
- Hopefully, we will get it right ... eventually.



THANK YOU