CAN CAPITALIST DEMOCRACY SURVIVE?

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CAMBRIDGE – Once again, the developed world is feeling the inherent tension between market capitalism and representative democracy. Each institution provides its own mechanisms for allocating society's resources and distributing the income and wealth generated by their use. Each offers procedures for legitimating the distribution of power, be it in the form of "one dollar, one vote" or "one person, one vote." Critically, power accumulated in one domain can be exercised in the other, either to redress or reinforce outcomes across the political economy.

This interplay has been crucial to accommodating successive waves of technological innovation that have transformed human existence. But the march of technology has never been neutral in either origin or effect. It can yield new public goods for broad social benefit; it can also create new forms of exploitation and sources of private rents.

For two generations after World War II, the constructive coexistence of capitalism and democracy was largely taken for granted in developed countries – including the former Axis powers. This deep-seated complacency was reinforced by the collapse of the Soviet Union. But the 2008 global financial crisis put an end to faith in the supposed inevitability of liberal economics and democratic politics.

To those who were paying attention, signs of an emerging discontinuity between market capitalism and representative democracy were already evident in the later decades of the twentieth-century. The digital revolution had ushered in another wave of globalization, opening and expanding markets in capital, goods, and services – including labor services – while also incrementally transforming the nature of work (like every wave of technological innovation before it). At the same time, China, after 1979, began to demonstrate the effectiveness of an alternative system of authoritarian capitalism.

Fatal Attraction

Looking back, we must acknowledge that capitalist democracy is a rather recent and fragile phenomenon. The dynamics generated from within each pillar of the system tend to conflict. As the French Revolution made clear, elites had ample reason to worry that expanding the franchise could lead to a radical redistribution of income and wealth. At the same time, economic inequalities clearly have the potential to override the nominal political equality upon which representative democracy is based.

Moreover, as Harvard University's Dani Rodrik has argued, capitalism in a globalized world can threaten the autonomy of nation-states, undermining their ability to respond to their citizens' needs, desires, and demands. And as Thorstein Veblen (and Max Weber) recognized more than 100 years ago, the ever-increasing complexity of modern political economy has given rise to an

administrative technocracy whose authority derives only indirectly from either the franchise or the marketplace.

As a historical matter, the tension between capitalism and representative democracy must be considered through the lens of the Anglo-American experience, given the leading roles played by the United Kingdom and the United States in the Industrial Revolution and the creation of the modern international order.

But capitalist democracies of course differ widely, reflecting countries' distinctive historical experiences and cultural attributes. The conflicts over economic policy between EU member states, most obviously, exemplify such distinctions. So, too, does the recent imbroglio between Japan and South Korea over the latter's demand for further compensation for the former's wartime atrocities. And for its own idiosyncratic reasons, Argentina has once again highlighted the fragility of democratic political systems that coexist with market or capitalist institutions.

Shotgun Wedding

The basic fact at the heart of capitalist democracy is that markets have always depended on state authority to enforce contracts, underwrite the rules of the game, and provide the currency needed to play. "The idea of a self-regulated market," Columbia University's Bernard Harcourt points out, "is preposterous."

In the pre-modern era, the state was controlled by elites whose power rested on the armed authority of feudal or royal entitlement, as in Europe and Japan, or on religious authority, as in colonial New England. The result was a highly concentrated distribution of power, along with entrenched, nonnegotiable social and economic roles for individuals across both political and economic domains. These were the conditions that corresponded with the "Malthusian Trap," whereby any increase in the production of material essentials was dissipated in increased population growth.

Then came the first Industrial Revolution, which increased productivity and vastly expanded the scope and scale of markets, starting in Britain. The winners in those markets – merchants and industrialists – soon challenged the established elites. In Britain and across Europe, a succession of "bourgeois revolutions" in newly emerging nation-states forced a haphazard opening of the political system from the late eighteenth century onward, albeit with property qualifications restricting access to the ballot box.

As the twentieth-century economic historian Karl Polanyi explained in his seminal book *The Great Transformation*, the primary task of the early democratic-capitalist state – following the insights of classical economists such as Adam Smith and David Ricardo – was to eliminate traditional barriers to commercial activity, while providing some degree of protection to the poor. Mercantilism yielded to free trade and the pursuit of comparative advantage. Entirely new forms of private property were legally codified. Through enclosure, land that had been entailed from generation to generation became a tradable commodity, as did labor. The poor, no longer the charges of local parishes, were forced into workhouses under England's new Poor Law of 1834.

The public response to these trends led to what Polanyi calls the "double movement." Over the following generations, successively broader categories of citizens were granted the vote. In the US – exceptional for the absence of an aristocracy, the existence of land for the taking from the indigenous peoples, and the entrenchment of chattel slavery – universal suffrage for white males happened shockingly fast, owing to developments in the 1820s and 1830s, when a populist revolt targeting coastal merchant and banking elites swept President Andrew Jackson to power. And in the 1860s, the power and prerogatives of southern slaveholders brought the tension between the economic and political realms well past the breaking point.

Seven-Year Itch

In the first half of the twentieth century, the power of industrialization and new technologies were underscored by the sheer destructiveness of two world wars. But the implications of expanding representative democracy were also revealed, as mass movements emerged to address the destabilizing levels of income and wealth inequality that had been generated by the hyper-capitalism of the late nineteenth century. (Economist Thomas Piketty and his collaborators on the World Inequality Database team have compiled invaluable statistics for this period.)

Total war, sky-high inequality, and the Great Depression were the horrific antecedents to the post-1945 Golden Age of capitalist democracy. In the postwar decades, the economically disadvantaged in the US exercised their political power to continue the work started during the Progressive and New Deal eras. More broadly, governments across the West pursued redistributive taxation, stronger social-safety nets, and legal initiatives to challenge monopolies and strengthen trade unions. And in the US, the franchise was finally extended to all voting-age citizens. The other capitalist democracies enjoyed enlightened US support and benefited from America's technological, economic, and military dominance. The postwar liberal international order insulated them from any competitive threat to their own domestic arrangements.

Between the end of WWII and the 1970s, labor's share of income grew across Western capitalist democracies. Yet, as economist Mark Blyth of Brown University has documented, increased protections for labor eventually provoked a reaction from capital, following the same interplay that Polanyi had documented for the nineteenth century. "The contemporary neoliberal economic order," Blyth writes, "can be seen as merely the latest iteration of Polanyi's double movement."

Neoliberalism, signaling the renewed primacy of the market over society, triumphed decisively in the 1970s. Thenceforth, it was the state that would be constrained. The postwar consensus –quasi-Keynesian macroeconomic management complemented by an extended microeconomic social-safety net – foundered in the face of rising inflation and stagnant economic growth ("stagflation").

This crisis of the established order – expressed economically in squeezed corporate-profit margins, and financially in an extended bear market – was amplified to the breaking point by OPEC oil shocks and a dramatic increase in energy prices. Ironically, the Western state during this period was declared impotent in the face of economic conditions largely caused by other (nondemocratic) states exercising their market power.

An Open Relationship

In the decades thereafter, neoliberalism became deeply entrenched in the Anglo-American democracies, but also reached as far as Germany's social-democratic economy, most obviously in the 2002 Hartz labor-market reforms. It was underwritten intellectually, with putative universal application, by the neoclassical efficient-market hypothesis.

This new theoretical framework, underpinned by the so-called rational-expectations approach building economic models, made the efficiency of the resource allocation the sole focus of analysis, and presented the market economy as a self-regulating system. As such, whatever distributional outcomes it generated were "fair" by definition, because they supposedly represented the marginal contribution of each factor of production to output. Once again, theory and practice co-evolved, as they had 150 years ago.

The practical results of this theoretical (in fact, ideological) sea change were far-reaching. Labor unions, particularly in the Anglo-American world, faced political and legal challenges like never before; many social programs were cut and/or privatized. In the US private sector, union membership is now under 7%, down from a peak of about 35% in 1950; in the UK, private-sector union membership has fallen to 13.2%, from 52% in 1980.

Neoliberalism also led to the deregulation of virtually all markets, domestic and international. The resulting globalization of trade in goods, services, and capital was accompanied by an unprecedented increase in the value, variety, and volume of financial instruments. Meanwhile, the reforms of the period were amplified by a maturing digital revolution that eliminated technical frictions in trading activities and introduced a new wave of automation. The balance of power, along with the share of total income, steadily shifted toward capital once again. Inequality duly returned to the extreme levels of a century ago.

Finding Fault

Throughout the two centuries since America's Jacksonian period, a demon has lurked in the shadows of democratic capitalism: the inherent instability of financial markets. In 1825 – when expansion of the franchise was just beginning to climb the British political agenda – a banking crisis forced the Bank of England to intervene aggressively in the economy to save the capitalists from themselves. A private institution that had been established 131 years earlier to assist the state in financing war was suddenly transformed into the world's first "lender of last resort."

Around the same time, Jackson rejected the idea of a national central bank for the US, a decision that reflected the populist sentiment that had brought him to power. But the Jacksonian era was followed by recurrent financial crises, culminating in the radical agrarian populism – along with the brutal suppression of labor activism – of the *fin de siècle* period. As had been the case in Jackson's time, the populist agitation of the late nineteenth century was a revolt against dominant financial institutions, with the gold standard becoming the key focus for three-time Democratic Party presidential nominee William Jennings Bryan.

Then came the panic of 1907, which finally galvanized support for a central bank. A quasi-state institution, the US Federal Reserve, established in 1913, would assume from private interests the duty of providing seasonal liquidity and (potentially) engaging in crisis management. A generation later, however, the Great Depression represented a collective failure on the part of all the world's central banks. The failure to reverse a radical contraction of the market economy brought representative democracy to the breaking point in much of Europe, and threatened to do so in the US.

The question is whether this was a failure of will or of economic power. In arguing for active state spending and borrowing to reverse a systemic collapse in aggregate demand, John Maynard Keynes concluded that all central banks could do in such circumstances was equivalent to pushing on a string. That is the basic problem with a "liquidity trap": all of the available cash is hoarded rather than invested.

Yet the popular history that came down to us was written by Milton Friedman, who argued in *A Monetary History of the United States* that it had been within the Fed's power to prevent financial and economic collapse in the late 1920s. It is Friedman, not Keynes, whose message eventually resonated the loudest after the 2008 crash. Today, the prevailing macroeconomic models impute to the central bank the power to set rates of real economic growth and inflation at whatever targets it chooses. Never mind that these models have now failed spectacularly in the run-up to the global financial crisis.

Arbitration and Mediation

To be sure, the 2008 global financial crisis did trigger a transient return to Keynesian fiscal stimulus, even in Germany. But while the Fed and the US Treasury served as liquidity providers of last resort for the entire Western world, all of the advanced economies had by 2010 retreated toward austerity, leaving the central banks as "the only game in town," to invoke Allianz Chief Economic Adviser Mohamed A. El-Erian's memorable phrase.

Under the new normal of risk-free real interest rates, around $17 trillion worth of debt securities are trading with negative nominal yields. Savers now must pay the German government for the privilege of purchasing its debt. Moreover, a critical component of this unprecedented phenomenon is that regulators now require financial institutions – banks and insurance companies – to hold "risk-free" assets at elevated levels, creating a captive market for buyers of what appear to be rather unattractive securities.

These economic and financial conditions will have far-reaching implications for democratic societies, not least because they favor some cohorts at the expense of others. Low interest rates increase the present value of future cash flows (be they the contractual payments specified in bond contracts or the speculative ones represented by stock prices), and have translated into extraordinarily high valuations for financial assets. This, in turn, has increased wealth inequality, because it is the rich who tend to own equities; and wealth inequality is already significantly more extreme than income inequality: in the US, the top 1% receive about 22% of all income but own almost 40% of all wealth. Worse, high asset valuations make it even more difficult for wage

workers – already facing the twin challenge of globalized labor markets and automation – to earn their way to property ownership.

Moreover, in financial terms, low interest rates inflate valuations at the speculative frontier, where private unicorns – firms with a valuation of at least $1 billion – are burning through cash at unprecedented rates. Those funds are coming from institutional investors – particularly pension funds – that are desperate for positive returns to offset their own liabilities, which are also inflated as a result of low interest rates.

Walter Bagehot, the great Victorian-era editor of The Economist, famously summarized this search for yield. "A period of a low rate of return on investments inexorably leads towards irresponsible investment," he observed. "People won't take 2 per cent; they won't bear a loss of income. Instead of that dreadful event, they invest their careful savings in something impossible – a canal to Kamchatka, a railway to Watchet, a plan for animating the Dead Sea, a corporation for shipping skates to the Torrid Zone."

Who Gets What?

In the advanced economies, central banks have struggled, and largely failed, to generate a post-crisis recovery strong enough to forestall political discontent. And in any case, it is entirely beyond their remit to address the deepening inequalities of both outcome and opportunity that neoliberalism and the digital revolution have wrought. The following chart from the 2018 *World Inequality Report* shows the extraordinary difference between the experience of the top 10% in the US – especially the top 1% – and everyone else.

Consider the minimal discrepancy between post- and pre-tax income growth for the top 10% during the past generation. This indicates that while central banks have had only a limited impact on the real economy, they have driven the valuation of financial assets to extraordinary levels. It is little wonder that investors have been able to ignore the growing stress between market capitalism and representative democracy.

They cannot ignore the latest wave of political backlash, though. In the UK, Brexit campaigners have fought a successful battle on the brilliant slogan: "Take Back Control." And across continental Europe and in the US, right-wing populist movements have made unprecedented electoral gains by exploiting the gap between voter expectations and economic realities.

In the US, President Donald Trump successfully appropriated the battle cry of the populist left: "The system is rigged." That message has had sustained relevance in a country where millions lost their jobs and homes to a financial crisis caused by bankers who faced no punishment, and where the average net worth of the people's elected representatives has grown much faster than that of the people. While the "swamp" of corruption in Washington, DC, has grown ever deeper, Trump has remained on message.

For almost three years now, the Trump administration has pursued an incoherent mix of neoliberalism – deregulation and deficit-financed tax cuts for the wealthy – and economic nationalism in the form of a trade war against China. (Needless to say, when the world's leading economic power resorts to protectionism in the face of a rising challenger, it is signaling its own loss of competitive dynamism.)

In recent months, Trump has been browbeating the Fed to loosen monetary policy and ensure a strong economy before his 2020 re-election bid. The electoral battle next year will reflect the tug-of-war in financial markets globally. The continued ability of central banks to underwrite the value of financial assets is eroding, along with the rest of the political foundation upon which contemporary capitalism rests. While global markets careen between "risk-off" and "risk-on" scenarios in response to wayward presidential tweets, the public is quickly losing trust in the integrity and competence of those in charge (if anyone can be said to be in charge at all).

Surveying the Options

As I note in my book *Doing Capitalism in the Innovation Economy*, "Loss of authority by those charged with directing the state will always undermine the confidence of participants in the markets of financial capitalism." With confidence in the political underwriting of economic and financial life quickly disappearing, the obvious response is to take out self-insurance.

During my 35 years as a venture capitalist, I discovered an effective form of self-insurance in the unique double-hedge of "cash and control." One must maintain unequivocal access to enough cash to buy the time needed to evaluate an adverse, unexpected outcome; and enough control to shift the parameters of the problem as needed. With proper foresight, a private investor, major bank, or emerging-market economy can, in principle, accumulate enough reserves to meet the

first requirement. That is what JPMorgan did in the descent into the global financial crisis, and it is what East Asia did after being subjected to the International Monetary Fund's liquidation policies 20 years ago.

But for the vast majority of participants in both markets and governance, the means to buy time are unavailable. And even for those with the market power to accumulate protective cash at will, sufficient power to navigate a crisis is a different matter entirely. Beyond the narrow, microeconomic world wherein a dominant investor can force a change of leadership or direction of a company, maintaining sufficient control is utter fantasy.

In fact, there now may be only one player in the global game of markets, nation-states, and financial capitalism that has the means and power to self-insure. China's unprecedented, two-generation-long period of growth has brought it to the technological frontier, and forced it to confront the inherent conflicts of rampant capitalism (albeit with Chinese characteristics): corruption, inequality, environmental degradation, and the distributional and sectoral costs of responding to climate change.

As in the West, China has developed its own political counterweight to market capitalism: a party-directed, not-so-benevolent "surveillance state." Having mobilized digital technologies to identify popular expressions of outrage against exploitation, the authorities can punish either the bad market actors or the protesters. Needless to say, it would be deeply ironic – if not a historical turning point – if the world's representative democracies were to look to the Communist Party of China for stable, responsible leadership through this time of trouble.

One More Shot?

The excessive reliance on the world's central banks has begun to generate frustration in unexpected places. Christine Lagarde, the newly named head of the European Central Bank, recently warned that monetary policy may be reaching its limits ("I'm not a fairy"), and called for greater public spending to boost demand. In the UK, Prime Minister Boris Johnson and the other Brexiteers are proclaiming the end of a decade of austerity. The government's recent reversal of some of the past decade's devastating cuts to public services are doubtless politically motivated, with an eye toward an expected general election; but they nonetheless signal a shift in the broader policy discussion.

Indeed, even in Germany, one can hear talk of the need for deficit spending to marshal a response to climate change – which may be the legitimizing mission that democracy needs. And in the US, the muted economic response to Trump and congressional Republicans' regressive tax cut offers a double lesson: reducing taxes for those who are not inclined to increase consumption generates limited stimulus; and lower taxes alone do not induce increased investment and employment when the proceeds can simply be returned to stockholders through dividends and buybacks.

But even if we do escape from the constraints imposed on macroeconomic policy by the dead hand of discredited economic theory, the tensions between representative democracy and market capitalism will remain. As J. Bradford DeLong of the University of California at Berkeley has

argued, the structural instabilities we are experiencing predate Trump and his peer group of destructive populists.

Can climate change be a pretext for the kind of restructuring Western democracies need, serving as both the economic and moral equivalent of a just war? As Ernest Hemingway put it in *The Sun Also Rises*, "It would be pretty to think so."