Economic Insecurity and the Institutional Prerequisites for Successful Capitalism

by

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Fifty years ago President Truman signed into law the Employment Act that committed the U.S. government to the goal of employment opportunities for all Americans. The Act represented a pledge to avoid another Great Depression. It acknowledged that government has a vital role to play in establishing national economic stability and prosperity.

U.S. economic performance during the past fifty years can be divided into two periods of roughly equal duration. The first was characterized by a successful economy: cyclical instability was controlled; resource creation was supported; and flaws in selected markets were corrected. It was a period of robust economic growth, rising worker incomes and falling inequality.

The second period has brought a reversal of fortune. We have avoided another depression, but suffer from a return of financial instability. Economic growth has been sustained but family earnings are stagnant. Corporate profits have been stabilized but economic insecurity has grown considerably and now pervades the workforce.

Our current difficulties make it necessary to consider not only how we measure the success of an economy but also the institutional prerequisites for a successful 21st-Century capitalism. But first we must ask: what accounts for the split in America's economic experience during the post-world War II era?

Money-Manager Capitalism

Numerous explanations have been put forth to account for the phenomena of falling worker incomes and rising instability and inequality experienced during the past two decades. Increases in government taxes, spending and regulation are not to blame. Income and distribution problems can be traced to pre-tax earnings, not tax changes. Government shares of total employment and expenditure have not been growing since 1979, and regulatory costs have declined (Mishel 1995).

Other recent explanations focus on one or more of the following developments: the shift of jobs from goods-producing sectors to the service sector; an acceleration of technological change (especially in the realm of information technologies); public-sector privatization and corporate downsizing and outsourcing; increased immigration; the erosion of the minimum wage and the decline of unions; the growth of contingent work; the appearance of persistent trade deficits; and increased capital mobility, trade liberalization, and global competition. While some have sought to calculate the relative impact of these developments, Barry Bluestone (1995) seems to emphasize the most essential aspect of the matter when he suggests that the solution to this mystery is the same is in Agatha Christie's Murder OR the Orient *Express* -- they all did it.

Despite the relevance of the aforementioned factors, one crucial element has been left out -- the evolution of the financial structure. Capitalism is a dynamic, evolving system that comes in

many forms. Nowhere is this dynamism more evident than in its financial structure. The financial structure of the American economy has undergone significant evolution over the history of the republic. From its initial stage of "commercial" capitalism, during which external finance was used mainly for trade, this structure has evolved into its present stage of "money-manager" capitalism, where financial markets and arrangements are dominated by managers of funds.

Two financial stages, "industrial" capitalism and "paternalistic" capitalism, were dominant between the eras of commercial and money-manager capitalism. The shift away from commercial capitalism came as financing for trade purposes became dwarfed by reliance on external funds to finance long-term capital development. The economic contraction and eventual collapse in the period 1929-1933 brought this second stage to an end and led to the New Deal restructuring that ushered in the paternalistic era.

Important aspects of the financial system in the era of paternalistic capitalism included: countercyclical fiscal policy, which sustained profits when the economy faltered: low interest rates and interventions by the Federal Reserve unconstrained by gold-standard considerations; deposit insurance for banks and thrifts; establishment of a temporary, national investment bank (the Reconstruction Finance Corporation) to infuse government equity into transportation, industry and finance; and interventions by specialized organizations created to address sectoral concerns (such as those in housing and agriculture).

From 1933 through the end of World War II, government represented the main source of external financing for the economy. By 1946, a broad set of households owned financial assets mainly in the form of government debt or as interests in insurance policies and bank deposits which were in turn largely offset by government debts. Business indebtedness was minimal -- indeed, many of the great corporations had large net positions in government debts -- as was household indebtedness.

Money-manager capitalism emerged out of this initial post-World war II position. In part it was the result of the evolution of financial practices toward more speculative endeavors. But money-manager capitalism was also partly a consequence of the emergence of plans that supplemented social security with private pensions. As the label "money-manager" capitalism suggests, central to this new stage are institutions that manage large portfolios of financial instruments.

Economic activity in the early postwar setting began with a cautious use of debt. But as the period over which the economy did well began to lengthen, margins of safety in indebtedness decreased and the system evolved toward a greater reliance on debt relative to internal finance, as well as toward the use of debt to acquire existing assets. As a result, the once robust financial system became increasingly fragile (Minsky 1986).

The first twenty years after World War II were characterized by financial tranquility. No serious threat of a financial crisis took place. Since the "credit crunch" of 1966, however, the

amplitude of the business cycle has increased and financial crises have become regular occurrences.[1] Another Great Depression has been prevented, but the same actions that stabilize the economy also validate speculative financial practices. In addition, instability has been exacerbated by the Federal Reserve's fight against inflation (Minsky 1986).

In the current era, the largest proportion of the liabilities of corporations are held either by financial institutions such as bank trust departments and insurance companies or by pension or mutual funds that are restricted in their holdings only by contract. Money-manager capitalism introduces a new layer of intermediation into the financial structure. The stated aim of these money-managers -- and the sole criterion by which they are judged -- is the maximization of the value of the investments made by the fund holders. This is measured by the total return on assets: the combination of dividends and interest received and the appreciation in per share value.

A consequence of the rise of these funds is that business leaders have become increasingly sensitive to the stock-market valuation of their firm. In the early postwar period widespread caution in finance, combined with America's dominance in the global economy, allowed managers a degree of freedom from stockholder influence. Today, however, top management is often subject to relentless shareholder pressure.

When one considers the pressures due to both the rapidly evolving financial system and the economy's other structural

changes, it is no surprise that economic insecurity is widespread. With the passing of the paternalistic financial structure, *corporate* paternalism has also faded. Workers at nearly all levels are insecure, as entire divisions are bought and sold and as corporate boards exhibit a chronic need to downsize overhead and to seek out the least expensive set of variable inputs.

Economic Success

In the early postwar period, American policymakers measured economic success primarily by two aggregate statistics -- the Gross National Product (the Gross Domestic Product, more recently) and the unemployment rate. Price stability and greater income equality were additional objectives, but inflation was not a significant problem until the late-1960s and a direct assault on inequality seemed of little necessity since the trend was toward a more equitable distribution of income. There appeared to be much truth to the expression "a rising tide lifts all boats."

Reliance upon these particular measures of success was partly a product of history: the main economic difficulty of the century's early decades was considered to be capitalism's tendency to generate severe depressions. These were also measures that required only a minor reconsideration of standard economics. Countercyclical fiscal and monetary policies could be easily reconciled with traditional theory through the "neoclassical synthesis;" a focus on aggregates made it possible to ignore the need for an institutional foundation for evolving economic structures. These gauges of success were also pragmatic. For the

first two decades of the postwar era -- despite valid concerns about perennial matters such as how national output ignores environmental costs and how the unemployment rate ignores discouraged job seekers (persons counted as not in the labor force) -- overall output and employment functioned as useful indicators of citizen well-being.

Today's economy is different. Many families cannot distinguish recession from recovery. Despite strong profits and recent productivity gains, chief economist Stephen Roach of Morgan Stanley summarizes the view of most Americans when he writes, "Recovery or not, the 1990s are still all about downsizing, longer workdays, white-collar shock and relatively limited opportunities for new employment" (Roach 1995).

Today's widespread insecurity requires economists and policymakers to look beyond a few aggregate statistics. The aggregates conceal not just income stagnation and other difficulties mentioned above but also longer employment searches, increased family dependence on multiple job holdings, and an explosive growth in part-time and contingent work. Also concealed is the anxiety that accompanies the fact that since early 1994 private firms have announced plans to cut more than a half-million jobs, many in companies (AT&T, for example) that once referred to their workforce as "family" (Challenger, Gray and Christmas 1996).

Polls released in early 1996 indicate approximately one-third of America's families fears job loss in the near future (Herbert 1996; Montague 1996). Perhaps even more striking are findings from

a late-1994 survey conducted for U.S. News *and World Report,* findings that indicate "a major shift" from America's historic optimism. According to the survey, 57 percent of those asked said the American Dream is out of reach for most families, while more than two thirds were worried that their children will not live as well as they do (Roberts 1994, 32).

In the current era, economic success requires more than economic growth, low unemployment, and minimal inflation. It requires that every citizen has the opportunity to develop and utilize his or her talents and capacities, an economy that rewards workers with rising standards of living and the prospect of an even better life for their children. It requires that economic insecurity be reduced and that prosperity be available to the whole of society. Without these, American capitalism will not be successful by any measure for very long in the 21st Century.

Institutional Prerequisites for Successful Capitalism

Economies evolve, and so too must economic policy. The institutional innovations of the New Deal were valuable in their time but have become insufficient in the present. The task before today's economists and policymakers is to meet the challenges of the coming millennium without forgetting the valuable lessons of the past, lessons that include: 1) capitalism comes in many varieties; 2) the institutions established through public policy play a vital role in determining what form capitalism takes; and 3) laissez-faire is a prescription for economic disaster.

It is easy to envision two alternate futures for American capitalism. The pessimistic future involves a hostile and uncivilized "fortress" capitalism; the optimistic future is an open and humane "shared-prosperity" capitalism. Fortress capitalism -- a system with declining fortunes for all but a few who must seek protection behind walled and gated communities -- is the result of a return to laissez-faire.[2] Institutional prerequisites for a successful, shared-prosperity capitalism are outlined below. A conceptual starting point is provided by a brief discussion of the relationship between economic security and progress.

I. Security and Progress

Capitalism can be successful only if economists and policymakers recognize that people have a limited tolerance for uncertainty and insecurity. Evidence of this limited tolerance is provided by insurance, which is purchased to provide protection against large contingent losses. When deleterious consequences mount for uncertainty outside the reach of private insurance, society must respond through public action.

Many have long maintained that the reduction of economic insecurity is inconsistent with economic progress under capitalism. But as John Kenneth Galbraith observed decades ago, insecurity is cherished "almost exclusively in the second person or in the abstract" (Galbraith 1958,98). Reducing economic uncertainty has been a central objective of corporations, labor unions, and associations of farmers since their inception.

Economic progress may be threatened by private or collective efforts to reduce insecurity. The central lesson of the era of paternalistic capitalism, however, is that security and progress can also be mutually reinforcing. Indeed, when one takes off the blinders of conventional economics it becomes clear that countercyclical stabilization policy was only one element in the strengthening of capitalism by reducing insecurity.

New Deal agricultural programs, by setting minimum prices and by providing crop insurance, had the effect of setting floors to farmers' incomes. These stabilized incomes made it possible for farmers to finance investment in new technology. Furthermore, agricultural extension services and experiment stations served to socialize research costs and disseminate information on scientific breakthroughs. What followed was a period of unparalleled advance and productivity growth in agriculture.

Conventional economists often worry that security will reduce economic "efficiency." But the experience of U.S. agriculture demonstrates that security can ignite an advantageous dynamic -- one that permanently improves the technological conditions which determine the very meaning of "efficient."

Moreover, as Henry Simons suggested long ago, economic efficiency -- even when considered from a dynamic perspective -- should not be the sole aim of economic policy. Rather, policy should strive to assure the civilized standards of an open and democratic society. A humane society should not be sacrificed on the altar of narrow economic efficiency (Simons 1948).

II. Employment

The Employment Act of 1946 committed the federal government to promote maximum employment, production and purchasing power. The **Full** Employment and Balanced Growth Act of 1978 reiterated these objectives and put greater emphasis on employment by identifying a particular goal, four percent, for the overall unemployment rate. Today it is necessary to go beyond a statement of objectives and goals. It is time to fulfill President Franklin Roosevelt's call for employment to be not merely a responsibility of the able-bodied but also as a *right,* one guaranteed by a public-sector employer of last resort.

The economic and human costs of unemployment -- to individuals and to the nation -- are too great to be tolerated in a society replete with unmet needs. Using the Depression era's Works Progress Administration (WPA), National Youth Administration (NYA), and Civilian Conservation Corps (CCC) as prototypes, federal, state and local officials could easily design programs that would enable unemployed citizens to support themselves by making useful contributions to their communities.

III. Economic and Social Progress

In the short run, societies can choose between two routes to competitiveness: a "high-performance" path and a "low-wage" path. The former involves encouraging firms to compete on the basis of innovation, product quality, and the development of new markets. In the United States a policy vacuum has caused most firms to follow the low-wage path -- a strategy that ultimately leads to an

economic disaster as firms engage in a "race to the bottom." Instead of the unsustainable vicious cycle of the low-wage path, America's public policies and institutions must support a *virtuous* cycle that leads to economic and social progress (Marshall 1995; Harrison 1995).

Pursuit of a high-performance path requires incentives for private investment, but it also requires public investment in education and training, science and technology, and infrastructure. Taxes and subsidies should be used to encourage individuals and firms to enhance productivity through training and the upgrading of skills. In addition, we must develop national business-assistance networks modeled after our agricultural extension service. Public investment, a crucial complement to private investment, must be revitalized as well.

The U.S. budget is not structured to engender rational investment decisions. Although there have been periods during which Washington officials committed themselves to improving public capital, federal non-defense investments as both a share of budget outlays and as a share of GDP peaked in the mid-1960s. Today our nation has the lowest ratio of public-capital investment to GDP of any of our major industrial competitors (Joint Economic Committee 1994, 62).

Investments in education can be improved not merely by more money (to upgrade facilities, provide supplies, and reduce class sizes, for example) but also by closer collaboration both across levels of government and among business, government and the

educational community. Vouchers redeemable at private schools are not what's needed; rather, we must have high educational-performance standards, national certificates of mastery, and improvements in apprenticeship programs and other organizations and services that facilitate the transition from school to work (Marshall and Tucker 1992; Marshall 1996).

Science and technology policies and institutions are also required. A role for government has always existed here due to the social benefits, large-scale risks, and long time horizons associated with research and development. But today this role is more important than ever due to the rise of "brain-power" industries -- industries such as microelectronics and biotechnology that can be located wherever the necessary talents are coordinated. As in Europe, consortiums for particular projects should be established not by government alone but through public-private partnerships that require matching funds from participating firms (Thurow 1996).

According to Wallace Peterson, America's neglect of public infrastructure has left us with more than a trillion dollars in necessary construction, repairs and renovations (Peterson 1994, 200-201). A study just released by the Manhattan-based Regional Plan Association indicates that the New York metropolitan region alone requires $75 billion in transportation and other improvements over 25 years to save it from outright decline (Johnson 1996). Institutions and policies that renew the nation's commitment to infrastructure investment cannot be avoided if America is to

prosper in the 21st Century.

Perhaps the most significant obstacle to greater public investment is an approach to budgeting that treats biotechnology research no differently than a White House dinner party. To enable policymakers and the public to make sound judgments on budget matters, America needs more useful accounting techniques. A full balance-sheet approach -- listing, as do private organizations, both assets and liabilities -- is worth exploring. At the very least, federal officials should follow the lead of the states and establish a capital budget for tangible investments in public facilities and in civilian systems such as communications and transportation.

IV. The Good Financial Society

An essential prerequisite for establishment of a "good financial society" (the term was used first by Henry Simons) in the early 21st Century is a Federal Reserve that continues to prevent debt deflations through its lender-of-last-resort powers. In addition, the Federal Reserve needs to focus more attention on *qualitative* credit controls (i.e., refusing to guarantee or prohibiting purchase of certain types of assets, particularly those likely to experience speculative price swings) than on quantitative controls. Levels of central bank supervision and regulatory requirements should vary according to the types of assets purchased.' These steps provide an opportunity not only to reduce the riskiness of bank lending but also to encourage credit to be directed toward socially-desirable activities (Wray 1996).

During the 1992 election campaign Bill Clinton advocated a national network of Community Development Banks, designed to meet the needs of communities and citizens not well served by existing banks. The idea takes on increasing import because of the heightened uncertainty associated with money-manager capitalism. The attractiveness of investment in small businesses increases with the uncertainty attached to jobs in firms whose future is dependent on the vagaries of money-manager evaluations. Community development banks should evolve into full-service community financial institutions (Minsky et al. 1993; Papadimitriou et al. 1993; Minsky 1993).

The sole focus on inflation by the Federal Reserve is misguided. Contemporary wage-setting patterns and institutional structures have created an environment in which low unemployment has not brought on the threat of high inflation (London 1995; Rissman 1988; Bennett 1995). Moreover, the consumer price index is a flawed tool for those seeking to control inflation (Papadimitriou and Wray 1996). Shared-prosperity capitalism requires that the current monetary-policy goal of "zero inflation" be replaced by a return to the early postwar policy of low and stable interest rates (Papadimitriou and Wray 1994).

Finally, the good financial society also requires institutional adjustment in the sphere of international finance. The current flexible exchange-rate system discourages forward contracts, encourages speculation, and exerts a stagnationist influence on the world economy (as nations impose austerity

measures to deal with trade imbalances). Essential features of a more secure and prosperous international-finance system include: stable exchange rates; an accommodative mono-reserve setup; and an international lender of last resort. A starting point for the development of this type of world-wide financial structure can be found in the writings of John Maynard Keynes (Keynes 1980; Davidson 1992; Wray 1996).

V. Shared Prosperity

While the arrangements identified so far provide a foundation for an affluent future, ensuring shared prosperity requires additional institutional elements. These include an enhanced minimum wage; stronger trade unions and employee associations; an expanded Earned Income Tax Credit; portable pensions; and a health-care system that provides basic care to all Americans. Also needed are tax incentives and other inducements that lead firms to: share productivity and profitability gains with their workers; offer family-friendly employment benefits and work arrangements; and foster employee participation from the workplace to the boardroom.

Private money incomes -- such as wages, salaries, dividends, interest, and transfer payments -- are not the sole source of personal and family income. Some of our "income" is independent of these private sources and is the result of publicly-provided goods and services. It is *ambience* income -- public consumption. Just as both rich and poor were once free to sleep under the bridges of Paris, today's rich and poor are equally free to "enjoy" safe streets. Public investments that promote economic growth and

enhance the efficiency of privately-owned capital are certainly important, but improvements in public consumption -- in urban parks and other public spaces, and in public health and safety, for example -- are also essential in a civilized society. Moreover, such endeavors can easily be made compatible with the full-employment objective discussed earlier.

Finally, the public sector needs a tax system adequate to support its various operational, employment, resource-creation, consumption, and debt-validation needs. The explosion of federal debt relative to GDP during the Reagan-Bush era was due largely to an irresponsible fiscal policy that undermined the revenue system while increasing defense spending and failing to control rising transfer costs, particularly in health care. As America prepares for the 21st Century, tax and spending policies should be used to reduce the ratio of federal debt to GDP from its current level of 70 percent to approximately 50 percent. While there are a wide range of revenue alternatives -- including income, consumption, inheritance, wealth, and value-added taxes -- some element of progressivity is warranted due to the increased income inequality produced by today's capitalism.[4]

Conclusion

Capitalism was a failed economic order in the winter of 1933. The Employment Act symbolizes a change in national outlook, one that produced an institutional structure for successful capitalism in the wake of the 1929-1933 disaster. Perhaps the first two decades following enactment of that legislation were not a "Golden

Age" but they stand as a historical and practical best.

Capitalism evolves and so too must the legislated institutional structure. The evolution of the private sector's institutional structure is market driven -- driven by agents acting in their own self interest. This evolution can undermine the barriers to instability and dynamic inefficiency. Such undermining has to be offset from time to time by changes in the government's institutional structure. These dynamic institutional changes preserve the dynamic efficiency of capitalism.

The institutional structure of paternalistic capitalism reduced economic insecurity and enhanced the performance of the economy so that a failed economic system was transformed into a successful order. Similarly apt institutional changes are needed to transform the insecurity-breeding money-manager capitalism into a new structure conducive to successful capitalism.

The fiftieth anniversary of the Employment Act should be celebrated by looking back and congratulating ourselves for many accomplishments. But we should also commemorate the occasion by looking ahead -- toward a new era of institution building. Economic systems are not natural systems. It is possible not only to reduce present-day economic insecurity without sacrificing economic progress but also to frame and establish the institutional prerequisites for a successful 21st Century capitalism. The goals of the Employment Act are best honored by working to achieve a new age of shared prosperity.

Notes

1. At the center of the 1966 "credit crunch" was a "run" on bank-negotiable certificates of deposit (Wolfson 1994, 31-39).

2. For more on fortress capitalism, see Thurow (1995).

3. The need to vary bank supervision according to the types of assets purchased is especially true in the case of institutions deemed "too big to fail." As L. Randall Wray suggested recently, such an institution "should be subject to increasingly close supervision as it engages in activities thought to be risky" (Wray 1996, 143).

4. For one approach to the revenue system, see Minsky (1996).

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