

The case for capitalism

Two new books explore the drivers of prosperity and their impact on democracy, writes Martin Wolf

Martin Wolf

Is capitalism the best economic system? Does capitalism conflict with democracy? Rainer Zitelmann, a German former journalist, former businessman, investor and prolific author, addresses the first of these questions: his answer is a resounding “yes”. Torben Iversen, a Danish political scientist and professor at Harvard, and David Soskice, a British economist and professor at the London School of Economics, address the second: their answer is a resounding “no”. Zitelmann provides a lively polemic against the denigrators of free-market capitalism. Iversen and Soskice argue for the symbiosis of capitalism and democracy in the “advanced capitalist democracies”.

Not only does capitalism work, it is also the only economic system that works. This is Zitelmann’s core point in *The Power of Capitalism*. He justifies this controversial proposition by an appeal to historical experience, not abstract theory. Readers are taken through extraordinary stories of market-driven success: China’s journey from the catastrophe of the Great Leap Forward in the late 1950s, to the four decades that followed Deng Xiaoping’s “reform and opening up” — the biggest anti-poverty triumph in human history; the contrast between the prosperity of capitalist West Germany and South Korea and the poverty of their socialist twins, East Germany and North Korea; and the economic success of Chile, against the dismal failure of socialist Venezuela.

Zitelmann, a committed ideologue, pushes his view too far. He argues, for example, that the economic reforms of Margaret Thatcher and Ronald Reagan were an astonishing success. Yet that is debatable. In both cases, one consequence was a big rise in inequality. Zitelmann insists this is insignificant. Yet high inequality results in a decline in social mobility, as well as the rise of destructive populism.

More egregiously, Zitelmann says the financial crisis was “triggered by developments on the American residential property market, which had their roots in political interventions and the policies of the US Federal Reserve”. These are standard rightwing talking points but are hugely exaggerated. Similarly, his view that the correct thing to have done post-crisis was to allow mass bankruptcy and risk a severe depression was what discredited the Austrian school of economics in the 1930s. Such policies also led to the election of Adolf Hitler.

Yet, for all the exaggeration and oversimplification, a good part of what Zitelmann argues is right. He is right, too, that too many intellectuals, out of some combination of envy, distaste and arrogance, wrongly detest capitalism and capitalists. Post-second world war experience has indeed repeatedly vindicated the view that the single most powerful driver of prosperity is profit-seeking businesses operating within a law-governed and competitive market economy, overseen by an honest judiciary.

Zitelmann views democracy mainly as a source of demands for excessive public spending and intervention in the market. Thus, for him, democracy is a threat to capitalism. A large group of people on the left hold the opposite view, namely, that capitalism makes the tax base too mobile and the economy too unequal for stable democracy. Thus capitalism threatens democracy.

Iversen and Soskice insist both views are wrong: democracy and the advanced market economy are symbiotic. This combination has, they argue in *Democracy and Prosperity*, proved astonishingly successful over the past century and, in all probability, will continue to be so. Their thought-provoking thesis has three core elements.

First, the state is central. In an advanced economy, government needs to ensure companies are subject to competition, workers are co-operative, the population is adequately educated and trained, the research that drives technological advance is funded and the infrastructure on which the economy depends is built. It has not been the market against the state, as many believe, but the market with the state.

Second, in an advanced economy, the educated and the aspirational are a large and highly politically engaged element in the population. Such people will tend to vote for parties and people they consider economically competent.

Finally, the skills on which advanced businesses (and so advanced economies) depend are embedded in networks of people who live in specific locations. Companies are, as a result, quite immobile. Only the less skilled parts of their operations are footloose.

These arguments have radical implications. They imply that capital is far less footloose than some suppose: core activities are geographically specific, with each advanced democracy gaining from the skills of the others, via globalisation. The authors also suggest that democratic governments are compelled to provide businesses with what they need to succeed, while businesses are, in turn, unable to escape the taxes and regulations democratically elected governments choose to impose, despite the conventional wisdom to the contrary.

Democracy then is stable, so long as governing parties are able to satisfy the bulk of the middle classes. The latter will insist they gain a good share of rising prosperity. That is, however, quite consistent with persistent indifference to the fate of the relatively poor.

This analytical framework illuminates five puzzles, the authors argue: the so-called “middle-income trap”; the coexistence of integrated economies with durable differences among them; the marriage of democracy with advanced modern capitalism; the existence of distinct paths to democracy; and the contemporary rise of populism.

“For more than a century, entry into the advanced group has only occurred in the instances of Singapore, South Korea, Taiwan, Israel, Ireland and Hong Kong,” write Iversen and Soskice. These are small countries with exceptional characteristics — strong, determined governments and unusual human resources. China may also achieve this. But now it is still a middle-income country. The main obstacle to success has been the difficulty of creating “large knowledge-intensive sectors sustained by internally driven innovation”.

Furthermore, each advanced democracy has different clusters of skills connected to different clusters of businesses, with most of the relevant knowledge tacitly embedded in the labour force, rather than in the companies. To replicate another country’s clusters requires the movement of many people simultaneously, or overcoming the chicken-and-egg problem of creating a cluster: the skilled people are not present, because the businesses are not, and the businesses are not present, because the skilled people are not.

Again, the connection of democracy with advanced capitalism, the authors say, comes from the fact that the “decisive voters” will insist on their country’s economic success. This is the basis of their earnings and the prospective earnings of their children, as well as of the funding of desired public services. So, far from being an obstacle to economic success, democracy propels it forward. Moreover, the authors argue, in most advanced democracies, the disposable incomes of working-age people in the middle of the distribution did not fall relative to their country’s average between 1985 and 2010. So people in the middle did share in economic growth.

Industrialisation and democracy were intimately linked, because industrialisation required a more educated population and the latter, in turn, demanded a political say. But there were two distinct paths to this outcome. In “proto-corporatist” countries, such as Germany, an organised working class compelled elites to recognise their political claims. In “proto-liberal” countries, such as the UK, where trade unions were weak, the enfranchisement of workers was largely due to the desire of capitalists for a better educated workforce.

Finally, populism rises when important groups of people feel their interests are no longer represented within the established party system. A crucial element in its contemporary emergence is the replacement of the old industrial system (which the authors call “Fordism”), on which the economic prosperity of the advanced democracies had been based in the mid-20th century, by the very different “knowledge economy”, on which it is based today.

In the Fordist economy of old, skilled and unskilled workers were complementary and mutually interdependent. In the globalised knowledge economies of today, that is no longer true. This economy is concentrated in clusters of people with tertiary education, often in large cities. Meanwhile, the former industrial workers and their children are left behind in declining towns. These downwardly mobile members of the old middle class resent those who have abandoned them, the culture of the new elites and the foreigners who, they believe, are competitors for jobs and the resources of a threadbare welfare state.

As a set of values, Iversen and Soskice also note, populism is much more widespread in “majoritarian systems” such as the US and UK, “as powerfully illustrated by Brexit and Trump’s election”. An important driving force behind populism is the educational system “and the extent to which it offers the losers of the transition to a knowledge economy opportunities to restore their status: not through monetary compensation but through acquisition of new skills and, above all, better educational opportunities for their children. Where such opportunities are few, losers feel trapped and turn away from established parties and towards new populist ones.”

The fundamental conclusion of this important book is, nonetheless, optimistic. The authors argue that the knowledge economy will continue to rely on immobile clusters of human beings with the right skills. The latter, in turn, will be large enough in number to sustain democracy and subordinate companies to the will of the enabling state. The unhappy classes of today are, in the authors’ view, a problem for democracy, rather than a threat to it.

This analysis deepens understanding of what a successful modern economy is and how it relates to democracy. But it also raises three big questions.

The first is whether the advanced countries are able to bind their populations together. At present, the chances seem poor, not least because the populist politics that the left-behind favour tends to make their actual plight worse, in a vicious spiral of anger, bad political choices (such as Brexit or the election of Trump), a still worsening economic plight and then yet more anger.

The second question is whether artificial intelligence might destroy the economic advantages of today’s localised networks of skilled human beings. In such a world, “Silicon Valley” or the “City of London” might become a network of machines that could be located anywhere. This may not be what we are seeing now. But the authors’ confidence that the position of today’s clusters of knowledge-workers is secure for the future seems startlingly overconfident.

The third question is whether the people at the top of the income distribution might pull away decisively from everybody else. One risk is that they will be able to poison the competitive wellspring of advanced capitalism, through their ability to fund populist campaigns in the name of the “left behind”. Will they replace open and competitive capitalism with oligarchic, anti-competitive and rentier capitalism in which low productivity growth combines with inherited wealth to create a new aristocracy?

Capitalism is indeed the best economic system, just as democracy is the best political one. The two have worked well together in advanced capitalist democracies for a long time, with each tempering the weaknesses and buttressing the strengths of the other. But an economy of perpetual growth is a fragile plant. In a world of environment constraints, it may even be an impossible one. We cannot take the future of capitalist democracy for granted.

Democracy and Prosperity: Reinventing Capitalism through a Turbulent Century, by Torben Iversen and David Soskice, Princeton, RRP \$29.95/£24, 360 pages

The Power of Capitalism: A Journey Through Recent History Across Five Continents, by Rainer Zitelmann, LID Publishing, RRP £22.49/\$33.42, 256 pages