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Economic insecurity and the institutional prerequisites for successful capitalism

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; public investment and human resource development were 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 brought a reversal of fortune. We have avoided another depression but suffer from a return of financial instability. Economic growth has been sustained for the near term, but public infrastructure is neglected and family earnings are stagnant. Corporate profits have been stabilized, but inequality has increased considerably and economic insecurity now pervades the work force.

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 twenty-first-century capitalism. But first we must ask: What accounts for the split in the United States' economic experience during the post–World War II era?

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Money-manager capitalism

Numerous explanations have been proposed to account for the falling worker incomes and rising instability, inequality, and insecurity of the past two decades. Increases in taxes, government spending, and regulation are not to blame. The United States' income problems can be traced to pretax earnings; government shares of total employment and expenditure have not been growing since 1979; and regulatory costs have declined (Mishel, 1995).[1]

Other explanations focus on one or more of the following developments: the shift of jobs from goods-producing sectors to the service sector; a long period of slow overall productivity growth, despite significant technological change (especially in the realm of information processing); 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 as in Agatha Christie's *Murder on 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. In the initial era of *commercial* capitalism, external finance was used primarily to facilitate commerce by financing goods in process or in transit. The present period, in contrast, is one of *money-manager* capitalism, where financial markets and arrangements are dominated by institutional investors.[2]

Three financial stages, *industrial*, *financial*, and *managerial* capitalism, were dominant between the eras of commercial and money-manager capitalism. The shift away from commercial capitalism came as financing for production and trade purposes became dwarfed by the

[1] While there is little evidence linking contemporary economic problems to tax *increases*, Wolfson (1993) identifies a number of business tax breaks enacted since the 1980s that have provided strong incentives for corporate restructuring.

[2] As the name "commercial" capitalism suggests, merchant and commercial banks were the dominant financial institutions of this early capitalist era.

reliance on external funds to finance long-term capital development. Thus, industrial capitalism was characterized by the rise of industries that required vast resources for projects such as railroads, utilities, mills, and mines. This created a market for the services of investment banks that not only arranged to finance such investments but also financed the rise of trusts and cartels. The largely unregulated era of financial capitalism that emerged was brought to an end by the United States' economic contraction and eventual financial-system collapse in the period 1929–33.

The managerial era was ushered in by the economic policies and reforms of the New Deal. Important aspects of the managerial period's financial system included:

- Countercyclical fiscal policy, which sustained profits when the economy faltered;[3]
- Low interest rates and interventions by the Federal Reserve unconstrained by gold-standard considerations;
- Deposit insurance for banks and thrifts;
- An infusion of government equity into transportation, industry, and finance through the Reconstruction Finance Corporation (a temporary, national investment bank);
- Restrictions on competition (including geographic barriers to market entry, compartmentalization of financial institutions by function, and interest-rate regulation); and
- Interventions by specialized organizations (such as the Agricultural Adjustment Administration and the Federal Housing Administration) created to address sectoral concerns.

Another important aspect of the managerial period was the nature of indebtedness. 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 that were in turn largely offset by government debts. Business and household indebtedness was minimal; many of the great corporations had large net positions in government debts and bank deposits—and many working-class households held substantially larger net financial asset positions than hitherto.

[3] For a discussion of how the National Labor Relations ("Wagner") Act was also designed to contribute to macroeconomic stabilization, see Kaufman (1996).

Money-manager capitalism emerged out of this initial postwar position. In part, it was the result of the evolution of financial practices toward more speculative endeavors. But money-manager capitalism was also a consequence of institutional innovations and the growth of private pensions that supplemented social security. 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 of economic prosperity began to lengthen, margins of safety in indebtedness decreased and the system evolved: not only toward a greater reliance on debt relative to internal finance but also toward short-term financing and the increased use of debt to acquire existing assets. There was also an explosion of activity by finance companies and other non-bank financial institutions—as well as a steady stream of bank innovations such as the securitization of loans and the creative use of off-balance-sheet commitments.[4] 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 existed. Since the "credit crunch" of 1966, however, the amplitude of the business cycle has increased and financial crises have become regular occurrences.[5] Another Great Depression has been prevented, but many actions that stabilized the economy also validated speculative financial practices. In addition, financial fragility and instability have often been exacerbated by the Federal Reserve's fight against inflation (Minsky, 1986).[6]

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 only contractually restricted in their holdings.[7] Money-manager capital-

[4] The growth of finance companies is discussed by D'Arista and Schlesinger in Dymski et al. (1993); bank innovations are examined in Wray (1990).

[5] At the center of the 1966 "credit crunch" was a run on bank-negotiable certificates of deposit (see Minsky, 1986, pp. 87–91, and Wolfson, 1994, pp. 31–39).

[6] Other factors contributing to increased fragility include the deregulation and globalization of financial markets (Wolfson, 1994; Wray, 1994).

[7] Between 1950 and 1990, money managers saw the fraction of U.S. corporate equities under their control grow from 8 percent to 60 percent (Porter, 1992, p. 69). Over the same period, pension funds increased their share of total business equities from less than 1 percent to almost 39 percent, while their fraction of corporate debt rose from 13 percent to 50 percent (Ghilarducci, 1992, p. 117).

ism 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 paid out and the appreciation in per-share value.

A consequence of the rise of such funds is that business leaders have become increasingly sensitive to the stock-market valuation of their firm. In the early postwar period, managers were allowed some freedom from stockholder influence due to widespread caution in finance, the United States' dominance in the global economy, and less financial intermediation. Today, however, top management is often subject to relentless shareholder pressure via these funds.

Another consequence of the rise of such funds is that they help generate an environment conducive to mergers, acquisitions, breakups, leveraged buyouts, and stock buybacks. Fund managers have a powerful incentive to support all takeovers and buybacks that will at least temporarily boost portfolio value. Their funds often provide the resources that raiders need to secure corporate control.[8]

When one considers the pressures on corporation managers 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 end of the managerial financial era, stability in U.S. industrial relations has also ended. 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, economic success was measured primarily by two aggregate statistics—the gross national product (more recently, the gross domestic product) 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 unnecessary since the trend was toward a more

[8] These funds have also contributed to financial-system evolution by providing a ready pool of buyers for securitized loans, the commercial paper of finance companies, and other innovations.

equitable distribution of income. There appeared to be much truth to the expression, "a rising tide lifts all boats."

Reliance upon these 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 evolving institutional underpinning for economic activity. 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 economic well-being.

Today's economy is different. Many families cannot distinguish recession from recovery. Despite strong profits and some evidence of very 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 policy makers to look beyond a few aggregate statistics. The aggregates conceal not just income stagnation for many (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.[9] 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 work force as "family" (Challenger, Gray and Christmas, 1996). Polls released in early 1996 indicate approximately one-third of America's families fear 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*, that indicate "a major shift" from America's historic optimism. According

[9] Details on these and other dimensions of U.S. economic insecurity can be found in Whalen (1996).

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, p. 32).

In the current era, economic success requires more than economic growth, low unemployment, and minimal inflation. It requires that every citizen have the opportunity to develop and utilize his or her talents and capacities, and that workers are rewarded with rising standards of living and the prospect of an even better life for their children. It requires that economic insecurity is diminished and that prosperity is available to the whole of society. Without these, American capitalism will not be successful *by any measure* for very long in the twenty-first century.

Institutional prerequisites for successful capitalism

Economies evolve, and so, too, must economic policy. The institutional innovations of the New Deal, which remain the foundation of much of the current institutional structure, have become insufficient. The task today 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) institutions established through public policy play a vital role in determining the performance of capitalism; and (3) laissez-faire is a prescription for economic disaster.

Two alternate futures for U.S. capitalism can be envisioned. 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 minority who seek protection behind walled and gated communities—would be the unavoidable product of a return to laissez-faire.[10] 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.

Security and progress

Capitalism can be successful only if the institutional structure reflects an understanding that people have a limited tolerance for uncertainty and insecurity. Evidence of this limited tolerance is provided by the widespread reliance on private insurance, which is purchased to provide protection against large contingent losses. When deleterious conse-

[10] For more on fortress capitalism, see Thurow (1995).

quences arise from uncertainty, which cannot be covered by 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, p. 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 managerial 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 of many arrangements that strengthened capitalism by reducing insecurity.

Consider, for example, the case of farm policies. New Deal agricultural programs, by setting minimum prices and 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 improves the technological conditions that 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).

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, 4 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 Roosevelt's call for employment to be not merely a responsibility of the able-bodied but also 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.[11]

High-performance competition

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 and social disaster as firms engage in a "race to the bottom." Instead of the unsustainable vicious cycle of the low-wage path, the United States' public policies and institutions must support a *virtuous* cycle of economic and social advancement (Harrison, 1995; Marshall, 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. The incentives must include taxes and subsidies that encourage individuals and firms to enhance productivity through training and the upgrading of skills. Public investment, a crucial complement to private investment, can and should take many forms—ranging from participation in public–private partnerships to direct expenditures on public goods.

The U.S. budget is not structured to engender rational investment

[11] Community-service employment is certain to receive much attention in the years ahead if the current Wisconsin approach to welfare reform is to be fully implemented in that state and elsewhere.

decisions. Although there have been periods during which Washington officials committed themselves to improving public capital, federal nondefense investments—as both a share of budget outlays and a share of gross domestic product (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, p. 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 with the business community and across levels of government. 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, 1996; Marshall and Tucker, 1992).

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).[12]

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, pp. 200–201). A study released recently by the Manhattan-based Regional Plan Association indicates that the New York metropolitan region alone requires $75 billion in transportation and other improvements over twenty-five 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 the United States is to prosper in the twenty-first century.

Perhaps the most significant obstacle to greater public investment is

[12] Consideration should also be given to the idea of a national business-assistance network modeled after the U.S. agricultural extension system.

an approach to budgeting that treats biotechnology research no differently from a White House dinner party. To enable policy makers and the public to make sound judgments on budget matters, the United States 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, the U.S. government should follow the lead of the states and establish a federal capital budget for tangible investments in public facilities, communications, and transportation.

The good financial society

An essential prerequisite for establishment of a "good financial society" (the term was used first by Simons) in the early twenty-first century is a Federal Reserve (Fed) that continues to prevent debt deflations through its lender-of-last-resort powers. In addition, Fed officials need to focus more on *qualitative* credit controls (i.e., refusing to guarantee or prohibiting purchase of assets likely to experience speculative price swings by organizations whose liabilities enjoy central bank protection) than on quantitative controls. Central-bank supervision and regulatory requirements should vary according to the types of assets purchased.[13] These steps would not only reduce the riskiness of bank lending but also enable credit to be directed toward socially desirable activities (Wray, 1996).

During the 1992 national 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 financial institutions. The idea takes on increasing importance 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, 1993; Minsky et al., 1993; Papadimitriou et al., 1993).

The Fed's focus on inflation is misguided. Contemporary wage-setting patterns and international competition have created an environment in which low unemployment has not brought on the threat of high inflation (Bennett, 1995; London, 1995; Rissman, 1988). Moreover, the con-

[13] The need to vary bank supervision according to the types of assets purchased is especially strong 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" (1996, p. 143).

sumer 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 worldwide financial structure can be found in the writings of John Maynard Keynes (Keynes, 1980; Davidson, 1992; Wray, 1996).[14]

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 (at this writing, an increase is under consideration in Congress); 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 cer-

[14] Additional recommendations for financial-system reform that are worth consideration can be found in Dymski et al. (1993).

tainly important, but expenditures on public consumption—in urban parks and other public spaces, and in public health and safety, for example—are also required for a civilized society. Moreover, such undertakings 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 the United States prepares for the twenty-first 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 as a result of the increased income inequality produced by today's capitalism.[15]

Conclusion

Capitalism was a failed economic order in the winter of 1933. The Employment Act reflected a national outlook that produced an institutional structure for successful capitalism after World War II. Perhaps the first two decades following enactment of the 1946 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 institutional structure of the private sector is primarily market-driven—its evolution is driven by agents acting in their own interest. This evolution can undermine the barriers to instability and dynamic inefficiency. Such undermining has to be offset from time to time by legislated changes in the institutional structure. The aim of such institutional changes is to preserve the dynamic efficiency of capitalism.

The institutional structure of managerial 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.

[15] For one approach to the revenue system, see Minsky (1996).

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 twenty-first-century capitalism. The goals of the Employment Act are best honored by working to achieve a new age of shared prosperity.

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