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Reforming Capitalist Democracies: Which Way?

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Reforming Capitalist Democracies: Which Way?

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Abstract

The debate about how to reconcile political with economic democracy is translated in the framework of wage- and profit-led growth in this paper. The inherent tension between providing sufficient profit incentive to motivate investment by the capitalist class and maintaining electoral accountability to the economically less privileged majority is examined through an analysis of policies towards raising the social wage. The paper shows how wider circumstances characterising a regime as wage- or profit-led is of consequence for determining the possibility of combining a higher profit share with a higher social wage through the effectiveness of such policies.

JEL Classification Codes: E11, E12, H30, P16, H40

Key words: Profit and wage led, social wage, investment, disinvestment, ideology

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1. Introduction

A higher real wage plays a two-sided role in a capitalist economy closed to international trade. While it increases consumption demand (C) through distribution of income in favour of the working class with a higher propensity to consume, it depresses private investment expenditure (I) due to its unfavourable effect on the profitability of investment. Assuming constant marginal and average labour productivity which ensures that a higher real wage means both a lower profit share (h) and margin, a skeleton Kalecki-type model was presented in Bhaduri and Marglin (1990) and in Marglin and Bhaduri (1990). The model has predecessors in the under-consumptionist tradition (Steindl 1952; Rowthorn 1981), which fails to capture this more general two-sided effect of the real wage due to the specific form of the investment function used. It should be made clear that the model of Bhaduri and Marglin (1990) is not about justifying a particular version of the investment function but rather about capturing transparently the more general result. This may also be useful for clarifying the logical basis of contesting ideologies about the types of economic reforms needed in capitalist democracies under different circumstances.

2. Mechanics of the model with modifications

The essential mechanics of the Bhaduri-Marglin model (1990) can be derived by writing the expenditure-income, or investment-saving equality in the form:

$$I \ = \ I\ (z, h) = \ S = shz\ , \qquad 1 \ > s, z, h \ > 0 \tag{1}$$

where $s =$ propensity to save out of profit with no saving out of wage; $z = Y/Ymax \ =$ degree of capacity utilisation and $h = P/Y =$ share of profit. From (1) the direction of change of capacity utilisation driven by change in aggregate demand due to the share of profit can be derived as the slope of the locus of investment saving (IS) equilibria, i.e.:

$$(dz/dh) = \ (I_h - sz)/(sh - I_z\ ) \tag{2}$$

with subscripts denoting partial derivatives of the relevant variables.

Assuming the demand driven income generation process to be stable, i.e. $sh - I_z > 0$ (Bhaduri 2008), the condition for profit-led expansion is $dz/dh > 0$. From (2) this requires a stronger positive impact of the profit share on investment than on saving, i.e. $I_h > sz$. The opposite case of wage-led expansion with a higher profit share reducing capacity utilisation, i.e.$(dz/dh) < 0$, requires $I_h < sz$. These conditions are local properties as long as the partial derivatives obey the required inequalities.

A linear investment function has global properties as the partial derivatives, I_z and I_h, remain constant over the relevant domain. In this case the investment saving equality takes the form which can be written for easy comparison with the Bhaduri-Marglin model as (Rowthorn, 2018):

$$I = I_z z + I_h h + I_0 = S = shz \tag{3}$$

and the level of capacity utilisation is given by:

$$z = (I_h h + I_0)/(sh - I_z) \tag{4}$$

The denominator of (2) and (4) are the same. Assuming the Keynesian stability condition, (4) points to two different ways in which the level of capacity utilisation (z) can be raised. The first is to increase the profit share (h) through direct fiscal measures, or less direct measures known as structural reforms aimed at restraining growth of wages relative to labour productivity. These reforms are euphemistically referred to as labour market flexibility and involve easier hire and fire policies, lowering employment benefits through casualisation of labour, reform of the pension system etc. All such reform policies are meant to work broadly through the profit incentive, and would increase $I_h h$ in (4). However, since a higher profit share (h) will impact negatively on capacity utilisation (z) by raising the saving ratio (sh) in the denominator of (4), such policies would work only if the positive impact of higher investment due to a higher profit share is sufficiently large to outweigh the negative impact.

The level of capacity utilisation in the linear model also presents a second option in (4), if the value of the intercept I_0 is treated not as a constant given by initial conditions but as a policy variable introducing in effect an additional parameter. However, this assumption has to be interpreted for it to make economic sense.

3. Institutional setting of social wage

It would be plausible in many circumstances to think of a part of total investment as autonomous in the sense that it is not directly guided either by profitability or by the degree of capacity utilisation specified in the investment function in (3). It might be investment undertaken by the local community for non-market distributive or other objectives, or by private corporations as their 'social responsibility'. In so far as the government is concerned usually as the major player, such expenditure may be funded from the current (including regular expenditure of social welfare and other subsidy items, see later equation 9) or the capital account (investment items) of the budget for expanding the capacity and delivery of welfare services. These expenditures affect the level of the 'social wage' available in the society. If universal, it affects the public in general, if targeted to workers it affects their living standard. The role of the private wage affecting living standards has to be judged as wage net of tax minus subsidy received by the working class if the access to a higher social wage is targeted exclusively at workers. When the benefit is universal, the working class is either subsidising or, is being subsidised by a wider scheme involving taxes and subsidies for the general public.

The level of social wage has historically evolved in different ways in various capitalist democracies as the outcome of interactions among social actors, usually with converging as well as conflictive interests. They involve industrialists, trade unions, NGOs, community based religious and non-religious organisations etc. The evolution in this complex process is naturally both country and time specific. However, the ruling ideology has usually played a dominant role. Generally speaking, while the welfare state and social democratic ideology played an important role in increasing the level of the social wage, neo-liberal ideology tried to reverse it by emphasising the role of the private profit motive. The intensity of the tension between the two varied historically over time, often shaped by broader geo-political considerations. The 'systems competition' between western capitalist democracies and Soviet style socialism during the period of the Cold War tended to raise markedly the level of the social wage in capitalist democracies (Hobsbawm, 1993). With the end of the Cold War and increasing globalisation the scope of market forces expanded globally in trade, investment and finance beyond the reach of the nation state, placing transnational corporations in an advantageous position. The private profit motive and rolling back government economic activities became the priority through various pro-corporate policies. This tendency is clearly witnessed in pressures on governments for competitive corporate tax benefits, as well as for liberalisation, deregulation and privatisation even in areas of public utilities, like water, transport systems, welfare services, health care, education, pension reform etc.

However, the mode of operation of the social wage need not always be through the government. Typically the result is not a universal but targeted increase in the social wage for some segment of the working population. For instance, expenditures may be incurred by a private corporation to increase the company wage with subsidised food, education, housing, health care etc. Its main purpose is often to gain workers' dependence and loyalty to the company. This connects with the view that labour discipline may be enforced by a 'carrot and stick' policy, either by gaining the loyalty of workers or by creating the fear of job loss through functional unemployment in the absence of direct supervision (Shapiro and Stiglitz, 1984; Akerlof and Yellen, 1990). This echoes the explanation of political trade cycles suggested by Kalecki (1943) which fit in well in turn with Marx's notion of the reserve army of labour, and even with the mainstream notion of a 'natural' or 'non-accelerating inflation rate of unemployment' (NAIRU).

Most former socialist countries institutionalised such measures of augmented 'company wage'. In contrast to many social democracies, the production of most 'public goods' remained in the domain of a centralised state bureaucracy, but it became an institutional aspect of those socialist countries to provide access to their employees to such public goods as social wage through employment in the state enterprises. Privatisation of these corporations during the period of transition to the market economy depressed violently the standard of living of the suddenly unemployed workers who lost the security of the social wage along with their private wage. This remains perhaps the clearest example of how the social wage can be reduced drastically through privatisation and disinvestment.

4. Formal representation of the social wage

In the formal model, the evolution of the social wage amounts to a shift of the intercept I_0 of the linear investment function (3). These are various types of public or community investments aimed at expanding, rationalising or modernising social welfare benefits. In so far as the government is concerned, they are placed in the capital account of a government budget. On the other hand, expenditures related to regular maintenance and delivery of these welfare services would be classified under the current account of the budget, while expansion of such welfare services is usually a current account item, but can also be treated as a capital account item if it is meant as a temporary expansion for instance to cope with a disaster.

Shifts in I_0 may also signify changes in the private 'investment climate' due to changes in the level of the social wage. At contrasting extremes, a higher social wage may be brought about by a larger positive intercept as workers are better trained as a consequence of a higher social wage, while a drastic decrease in the social wage, say through large scale privatisation, may turn the intercept negative. The latter typically occurred during the period of transition in former socialist countries through large disinvestment and privatisation of public enterprises. Formally, a negative intercept raises problems about the existence of meaningful economic solution in (4) which requires,

$$\text{for } z > 0, \ (I_h h + I_0) > 0, \quad i.e. \quad h > -(I_0/I_h) \tag{5}$$

So long as I_0 is positive inequality (5) is always true, but when it is negative, the profit share has to be higher than a minimum positive number for a positive z to exist. Since $1 \geq h \geq 0$, (5) allows a meaningful solution, if $I_h > |I_0|$, the absolute value of I_0 setting a lower limit to the level of disinvestment for a solution to exist.

5. Social wage and profit incentive

In the electoral politics of a capitalist democracy an increase in the profit share with income distribution moving against the poorer working classes raises questions about the legitimacy and acceptability of these policies to the electorate. Ideologies differ. Social democratic policies would generally try to mitigate the effects of a higher profit share (after tax) through a higher social wage. However, this would be resisted by those who would like to rely solely on the effectiveness of the profit motive to stimulate private investment. The analytics of this political divide can be most starkly schematised when the level of capacity utilisation is held constant. In that case no additional output is forthcoming, and capacity utilisation is fixed at some arbitrary level $z = z^*$ with parameters s, I_z and I_h held constant. The problem boils down to examining how an increase in the profit share h affects the social wage through its impact on I_0. Rewriting (4) as $z^*(sh - I_z) = I_h h + I_0$ and differentiating (4) with respect to h yields:

$$dI_0/dh = (sz^* - I_h) \tag{6}$$

It follows from the right hand side of (6) that in the wage-led case specified by the numerator of (2), the social wage denoted by I_0 would have to increase to maintain the same level of capacity utilisation z^* at a higher profit share. Conversely, the social wage has to decrease in the profit-led case. More intuitively, in a wage-led regime a higher profit share decreases capacity utilisation which has to be compensated by a rise in social wage investment I_0 to restore effective demand and capacity utilisation to its constant level z^*. However, in the profit-led regime a higher h stimulates investment through higher profitability, and I_0 can be reduced to keep the level of capacity utilisation constant at z^*.

A more extreme form of conservative argument often suggests that a rising profit share is not the problem, but part of the solution in so far as a higher profit share would strengthen further the profit incentive. This may be represented by replacing the constant I_h, which has so far been treated as a given parameter, by the assumption of I_h being an increasing function of h, with all the other parameters held constant. In this case, differentiating (4) yields:

$$\frac{dI_0}{dh} = -[(I_h - sz^*) + mI_h] < 0 \tag{7}$$

Let m represent the elasticity of I_h with respect to h, i.e. $m = \frac{dI_h/I_h}{dh/h} > 0$.

If m is treated as a constant for simplicity of exposition, in the profit-led case, the right-hand side of (7) is unambiguously negative implying that the extent of reduction in the level of I_0 with respect to h would have to be larger, the larger is the elasticity m. However, the situation is more ambiguous in the wage led case, as rearrangement of (7) shows:

$$\left(\frac{dI_0}{dh}\right) > 0 \quad \text{if} \quad [(sz^* - I_h)/m] > I_h \tag{8}$$

The square bracketed term on the left-hand side in (8) remains positive in the wage-led case, but decreases in magnitude as m becomes larger, and violates the inequality for a sufficiently high value of m. Therefore, the wage-led regime is able to accommodate a higher social wage with higher profit share for relatively small values of m. In other words, only a relatively weak profit incentive of investment (I_h) to a higher profit share (h) is compatible with an increase in investment in social wage.

We have been trying so far to tell the story of Hamlet without the Prince of Denmark by keeping out the role of government fiscal policy. This was necessary for expositional simplicity, and may now be modified to introduce some complications due to government fiscal policies. However, for exposition compatibility with the earlier analysis, we assume all wages as well as dividend incomes are consumed making s the fraction of gross profit retained by firms. Assuming the revenue of the government comes entirely from corporate taxes on profit (T), and spending is on subsidy and transfers to the public (U), net government budgetary expenditure on goods and services at $z = z^*$ is,

$$B = T - U = \ t_p h z^* - \ U \tag{9}$$

where $1 > t_p > 0$ is the corporate tax rate on gross profits. Assuming U as constant for simplicity, $B_h = t_p z^* > 0$, providing budgetary support at the margin from tax on gross profit earned by corporations by raising the profit share. While it increases the budget surplus, the opposite holds when profit share is reduced, i.e. $B_h < 0$.

Equation (4) modified for accommodating budgetary expenditure as,

$$z \ = \frac{I_h h + I_0 + B}{sh - I_z} \tag{10}$$

With corporate retention rate out of gross profit s as well as I_z and I_h held constant, at an arbitrarily given level of capacity utilisation $z = z^*$, we obtain by differentiating (10) with respect to h,

$$\frac{dI_0}{dh} = [(sz^* - I_h) - B_h] \tag{11}$$

In a wage-led regime if $B_h = t_p z^* > (sz^* - I_h) > \ 0$, implying $dI_0/dh \ < 0$, it points to the retrogressive aspect of surplus centred fiscal policy which is brought about by an increased profit share with a given corporate tax rate. Such higher profit share induced budgetary surplus might even encourage disinvestment in welfare related public utilities for reducing the social wage. In the profit led regime, with $(sz^* - I_h) < \ 0$, a budget surplus at a higher profit share only strengthens further this tendency for reducing the social wage. It is easy to see from (11) that these conclusions are reversed with $B_h < 0$, i.e. a government budget deficit at higher profit share.

Two points left out in the schematised formalism need mention. First, without any change in the tax structure, the composition of budgetary expenditure can be changed to raise the level of the social wage, e.g. providing better schooling, health care facilities, greening of working-class areas etc., at the expense of military expenditure. Conversely, the opposite might also be argued that defence expenditure for enhancing national security, like maintenance of law and order is a part of the universal social wage. Ultimately it depends on the point of view of what public good contributes to the social wage, and how to prioritise among them. It is not an issue where logic can be of great help.

Second, interest payment on accumulated public debt has become an important item of the budget of most countries which has not yet been considered. Financing social wage through issuing bond impacts adversely on income distribution in so far as the interest income mostly goes not to poorer pensioners but to a richer section of bond holding public. From this point of view, monetary policy affecting the bond rate raises the issue of borrowing from the bond market versus borrowing from the central bank (i.e. monetising budget deficit). Since the choice between bond financing versus printing money might impact significantly on income distribution, it has implications for how the expenditure for a higher social wage is to be financed, and the desired degree of independence of the central bank in this respect.

6. Output expansion and the social wage

The assumption of keeping capacity utilisation arbitrarily constant at some level, $z = z^*$ was made for expositional simplicity. This assumption may now be relaxed. A change in capacity utilisation in response to increased share of profit is examined through logarithmic differentiation of equation (4) which yields on simplification:

$$dz/dh = \frac{[(I_h - sz) + (dI_0/dh)]}{[sh - I_z]} \tag{12}$$

The denominator of (12) is positive for a stable Keynesian income generation process. In view of classification of regimes in (2), it follows from (12) that a sufficient increase in the social wage, i.e. $(dI_0/dh) > 0$ at a higher profit share can compensate for the decrease in aggregate demand brought by a rise in profit share to make $dz/dh > 0$. In contrast, in a profit led regime capacity utilisation increases with the profit share, i.e. $(dz/dh) > 0$ in (12) despite a reduction in the social wage, i.e. $\left(\frac{dI_0}{dh}\right) < 0$ up to a point. Therefore, if the variation in the level of expenditure on the social wage is allowed, local properties derived in equation (2) become insufficient to characterise regimes. This also means a change of regime is possible through sustained fiscal policies directed towards changing the level of the social wage. Not surprisingly, budgetary measures affecting the social wage are a fiercely fought ideological territory.

7. Concluding Observations

An academic paper cannot do what is needed for transformative politics of either the Right or the Left, but it can help to clarify the economic logic behind ideologies. The paper shows how in keeping with the logic of their ideology, conservative economic reformers rely on raising the profit share to strengthen the profit motive as the 'life blood of capitalism' without bothering about its negative impact on the poor. And yet, even in a capitalist democracy the holders of this view become accountable to the electorate when various fiscal and non-fiscal distributive measures in favour of profits do not lead to sufficient investment within a specified period of time. Moderate social democrats who also believe in encouraging the profit motive become accountable in the same way, but might try to mitigate the situation by raising the social wage, typically through extending the 'safety net' for the poor. Thus even when the two sides of the political divide agree on the importance of stimulating private investment though the profit motive, the time period within which the impact of the higher profit incentive on private investment must materialise becomes crucial in determining the political feasibility of a higher social wage.

Democracy imposes institutionally that time horizon for political accountability, thus forcing some degree of convergence among contesting ideologies. In this respect, demand management by the state has an advantage in so far as its impact on capacity utilisation and employment are more immediate, although precisely this short-termism might affect the quality of public investment. In contrast, building private investors' confidence through the profit motive involves an uncertain and usually longer time horizon. Our static framework of analysis can merely emphasise the crucial importance of the time horizon in influencing accountability in electoral democracies.

A broader theme emerges from this discussion. It shows the same macroeconomic policy need not produce similar outcomes because wider circumstances differ. A case in point is the broad characterisation economic regimes as wage- or profit-led. The paper shows how social wage policies differ due to different natures of the regime despite a common policy towards raising the profit share. In a wage-led regime a higher profit share depresses the level of economic activity, and the level of capacity utilisation can be maintained only through higher expenditure aimed at raising the level of the social wage. In this sense, a higher social wage and a higher profit share complement one another in a wage-led regime. However, a higher profit share is expected to stimulate investment sufficiently to maintain aggregate demand without raising, or even lowering the social wage, in a profit-led regime. As a result, a higher profit share and a higher social wage tend to become competitive rather than complementary in a profit-led regime. While economic logic might help in understanding the implication of these broader circumstances defining the nature of a regime, but any attempt at changing it belongs to the realm of transformative politics.

The ideology of classical social democracy relied heavily on the concept of the social, not merely the private wage. It was summed up perceptively by the Swedish economist Ohlin as a shift 'from nationalisation of the means of production to nationalisation of consumption' (Ohlin, 1938, 4-5). This proposition is somewhat ambiguous in so far as it leaves open the issue of private profitability of production of goods for social consumption with serious inequality of income. A higher profit share and a higher social wage might create a growing tension between the objective of socialisation of consumption and sufficient profitability of the compatible pattern of mass consumption goods like public transport, water supply, health care, schooling etc. This tension between social consumption and private production is all the more visible in poorer capitalist democracies where the masses with insufficient purchasing power cannot ensure sufficient profitability for private production of these goods. Despite its initial success over several decades, it is clear on hindsight why nationalisation of consumption through a higher social wage faced increasing opposition from large private corporations while a large section of the population suffered increasingly the hurdle of over-bureaucratisation and tax burden. As a result, the balance of power shifted in favour of large private corporations, helped to no small extent by the corporate fed media shaping public opinion. Privatisation became the buzz word even for producing public utilities like public transport, water supply, health care, education, old age pension etc which are essential for raising 'socialised consumption'. With the shift in the focus from a higher social wage to widening the scope for deregulation and privatisation, social democracy retreated from its original conception. It undoubtedly has to reinvent itself in many ways if it wants to remain relevant perhaps through lesser reliance on corporations to produce the pattern of goods and services needed for raising the social wage while avoiding over-bureaucratisation for the delivery of essential economic and social services through more community-based decentralised services. This is the transformative politics of a time when income inequality is being allowed to increase in the name of nurturing the profit incentive. Capitalist democracies need to be held accountable not to the market but to the electoral majority by bringing back into the focus the role of the social wage. Many false narratives would no doubt be created to resist this transformation, but they would merely hollow out the content of an electoral democracy further, leaving only its populist shell. To recognise the importance of the social wage is to recognise the importance of genuine accountability in a democracy.

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