Corporatism not capitalism is to blame for inequality
By Edmund Phelps

Values such as solidarity, security and stability contribute to stifling policies, says Edmund Phelps

Lethargic growth, depressed employment, widespread job dissatisfaction and staggering debt – such is life in a western world that seems to have lost the habit of innovation that energised it for more than a century.

After a major loss of dynamism in the 1960s, productivity growth rates began dropping in most countries, falling by half in the US in the 1970s and more or less ceasing altogether in France, Germany and Britain in the late 1990s. It is urgent that these nations find a way back to their past dynamism.

But some prominent voices would change the subject. The important issue is inequality, they say. In Europe, it is estimated that one-quarter of private wealth is held by the richest 1 per cent; in America, the richest 1 per cent hold one-third. This wealth has ballooned, relative to national income, in countries where growth is slow; and the share held by the rich has risen in most nations over recent decades.

“Egalitarians” who complain about inequality view the wealth of the wealthiest as bad in itself: it disfigures society. They would enact a wealth tax to extirpate the offending wealth.

“Progressives” say the rich use their wealth for further gain – in particular, to obtain a tax system that favours them. The consequences include a demoralised middle class and myriad inefficiencies that result in a loss of “productivity”. These critics would repeal low tax rates on capital gains to roll back the gains of the super-rich, in contradiction to the idea that low rates whet appetites for starting up companies and help them to grow.

The complaint is not that wealth inequality causes reduced innovation. No one could argue that historical rises in inequality in the west caused past losses in dynamism, since productivity began falling before the rich began their recent winning streak. Innovation tailed off between 1940 and about 1970, while the top decile’s share of wealth and income began rising in the 1970s.

The causation runs the other way: losses of dynamism have tended to sharpen wealth inequality because it hits workers of modest means more than it hurts the wealthy. Developing new products is labour-intensive. So is producing the capital goods needed to make them. These jobs disappear when innovation stalls.

In western Europe, annual growth in capital investment slid from almost 7 per cent in 1961-65 to about 2 per cent in 1971-90. The trend in the US was similar. Profits slid, too, but the rich had investments overseas where returns remained high.

The productivity slowdowns that resulted pushed real interest rates to levels so low that most people could not become better off the old-fashioned way – by saving. And for westerners, success in business is now hard to come by. So large numbers are driven to Wall Street and the City of London, where they seek profits from arbitrage and speculation. With so many people rolling the dice in hopes of a big score, there are bound to be some winners – and their rich rewards raise wealth inequality even further.

The blame for the losses of innovation behind slowdowns in productivity lies with the spread of corporatist values, particularly solidarity, security and stability. Politicians have introduced regulation that stifles competition; patronised interest groups through pork-barrel contracts; and lent direction to the economy through industrial policy.

In the process, they have impeded those who would innovate, or reduced their incentive to try. With less competition to fear, companies are emboldened to raise their mark-ups and profits. That lifts share prices and thus the wealth of already wealthy shareholders.

Standard economic theory predicts people will save out of their wages to earn a return that will enable them to buy more than they could have done if they had spent their money earlier. Misers accumulate wealth merely for its own sake, but they are rare.
But the resurgence of another corporatist value, materialism, has brought just such a fixation on becoming rich. Statistics show that many now save even in retirement – especially the rich.

Materialism has also led to short-termism. It tempts chief executives to pump up share prices, and fund managers to demand that managers hit their quarterly earnings targets. This stifles innovation and buoys wealth inequality. Since the weakening in productivity growth that was recorded in the US from 1965 to 1975, profits as a share of the gross domestic product have climbed to record highs.

The egalitarians are profoundly wrong about the sources of wealth inequality. It is the corporatist maladies deep in western societies, more than “capitalism” or tax laws, that have brought abnormal wealth inequality since 1970. If we can cure ourselves of these maladies, dynamism will return and the abnormal wealth inequality will wane.

The writer is winner of the 2006 Nobel Prize for Economics and author of 'Mass Flourishing'