

CAPITALISM, SOCIALISM AND DEMOCRACY 80 YEARS LATER

Looking at capitalism today in light of its past and possible future

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Trends in Capitalism, Socialism and Democracy: Revisiting Schumpeter

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In the first half of twentieth century, Schumpeter predicted certain trends in our social systems, relating to capitalism, socialism and democracy. This note looks at some of the changes and evolutions witnessed in these systems globally, in the last three quarters of a century. On capitalism, it observes few 'odd' trends in 'creative destructions' by entrepreneurs, in their search for super profits. It briefly evaluates the status of the widely published, much awaited transition of capitalism into socialism, and tries to analyse the efficacy of current day democracy. An attempt is then made to understand the overall systemic impact of the above trends on critical social aspects like human welfare, equality, justice, etc., and to suggest some potential strategies to correct the imbalances.

Creative Destruction: As per Schumpeter, creative destructions or innovations by entrepreneurs are critical drivers of capitalism. Schumpeterian theory focusses on breaking up of routine, circular business flows with innovations in terms of products and services by entrepreneurs, requiring higher levels of investments. Such competitive capitalism, as per him, leads to faster economic growth and capital accumulation, improving living standards of all people. When the effects of innovation vanish over time, super profits decline, warranting new cycles of innovation. This is not in line with the Marxian view, where capital accumulation is assumed to be driven by generation of surplus value, which in turn is assumed to be derived from exploitation of workers. Marx did not distinguish between a capitalist and an entrepreneur.

The above Schumpeterian theory is based on an unreal assumption that the state of economy would be in perfect competitive equilibrium. In the real world, excess profits are made not just by innovators, but also by their imitators, and even by traditional businesses. Super profits are currently determined world over, more by enabling regulations than by consumer choices. Monopolies and oligopolies make super profits at the cost of consumers, aided by friendly regulations.

No government is fully transparent or autonomous in the policy sphere, as there are pressures from corporates both within and outside the country. In addition, there are geopolitical

pressures, and influences from international affiliations, military pacts, strategic tie ups, cultural-religious groups, etc., which dilute the power of rulers. Big corporates are too powerful and they have a decisive say in policies and programmes in most nations. Firms get awarded major government contracts, mining rights, access to other natural resources, etc., involving negotiations that are many times not very transparent. The unholy nexus between businesses and politicians in nations, especially in democracies, is well documented. The role of money in elections has become too overwhelming. Unlike kings or autocrats, the politicians under democracies need to win elections, which requires huge spending of money. Funding from corporates is therefore critical for political parties and it is natural to expect a quid pro quo arrangement between the winners and funders, post elections.

Markets in general have asymmetric information, which also lead to higher profit generation by those with timely private information. Nations are being governed by power-based, rather than responsibility-based governments, which facilitate this trend. Employees in the top layer of firms are therefore increasingly engaged in 'managing the rules of the game' in the firms' favour, instead of concentrating on product or service innovations. While the 'odd' innovations make consumers pay the price for regulatory 'gifts' to corporates, real technological innovations create challenges for ordinary workers, whose value additions get eroded. Thus, both odd and real innovations end up creating huge social inequalities. Creative destructions have shifted from consumer welfare to producer welfare, which is a major deviation from what Schumpeter imagined: "the fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumer goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise create." (Schumpeter, 1975 P 83).

There are sham innovations for the sake of innovation, with very little value additions, and innovations that contribute negatively to societies. In the latter category, we can find innovations in creating and sustaining monopolies and tax havens. Another sham innovation is in the nature of 'creative' accounting practices. Labour rights get violated in many 'innovations.' 'Gig' workers are being 'legally' exploited using state of the art technological platforms. 'Creative positioning' of products using fake or unverified claims is also widely prevalent. The whole idea is to make profits by any means.

End of Capitalism: Capitalism as a system arguably goes back to 16th century, though it started getting serious attention of both supporters and opponents only in the past two centuries. In this period, many economists and political thinkers foresaw the end of capitalism while many others prophesised that capitalism will co-terminate with mankind.

Like Karl Marx, Schumpeter believed that capitalism has self-destructive genes in it and that these factors could lead to the demise of capitalism and emergence of socialist systems. Some economists indeed feel that Schumpeter actually did not believe in capitalism transitioning into socialism, and that it was just his way of overcoming the intellectuals' resistance to the concept of capitalism prevailing then.

Though many agree on the terminal nature of capitalism, they widely differ on the processes of such a transformation. Some believe that capitalism will get imploded by its own inherent contradictions like over accumulation. Some others foresee it getting mutated and transformed into some form of socialism. The Marxian view is that capitalism cannot survive because of economic failures. Schumpeter argues that capitalism, with its internal contradictions, will be destroyed by its own success. According to him, "Capitalism, being essentially an evolutionary

process, would become atrophic. Profits ... would converge toward zero. Socialism of a very sober type would almost automatically come into being.” (Schumpeter, 1975 P 131). Opposition to capitalism, as per Schumpeter, arises not because of material impoverishment, but because “its very success undermines the social institutions which protect it, and inevitably creates conditions in which it will not be able to live” (Schumpeter, 1975 P 61). The very psychological resentment created by entrepreneurial dynamism will destroy it. He argues that creative destructions under capitalism will lead to huge and powerful corporates. As these corporations grow, they will become increasingly bureaucratized, necessitating more mechanizations, and ultimately eliminating the entrepreneurs themselves. The bureaucracy led by anti-capitalist intellectual class will then push for a socialistic economic system. Interventionist state policies, and anti-entrepreneurial sentiments that are inherent in any capitalist society, will accelerate the process. The management of firms would shift away from familial ownership to wider shareholders and professional managers, leading to the demise of capitalism. “The perfectly bureaucratized giant industrial unit not only ousts the small or medium-sized firm and expropriates its owners, but in the end, it also ousts the entrepreneur and expropriates the bourgeoisie as a class” (Schumpeter, 1975 P 134).

This projection has not come true as yet. As per Visual Capitalist, an online publisher, globally, 90% of enterprises are today run by families. According to the 2023 EY and University of St. Gallen Family Business Index, the largest 500 family businesses are growing faster than the global economy, at nearly twice the rate of advanced economies and around 1.5 times the rate of emerging market and developing economies. In such a situation, capitalism is unlikely to end anytime soon. The belief that ‘command economies are both unviable and unstable and only capitalism can co-exist with the natural human greed, selfishness, and competitiveness’ is not fading away.

Is Socialism a mirage? Schumpeter thought that the success of capitalism would result in a type of corporatism which will give rise to values hostile to capitalism, and that such values would be encouraged by intellectuals. In advanced capitalism, such hostility was expected to lead to socialism in some form. This, he thought, would be by way of orderly parliamentary processes, as democratic nations were logically expected to vote for welfare states. However, no major socialistic nations have taken birth globally, in the last many decades.

Why are economies not embracing socialism? Reasons could be many. It is often said that socialism does not incentivise people for good work. It ignores the fact that human beings, by their very nature, are selfish and greedy. People want to have unbridled property rights and pricing power for their products and services, which is not possible under perfect socialism. Today, under political capitalism, rules are more often created and interpreted in favour of the elite. Value systems have shifted towards social rankings, which emanate from material wealth and political power. Some of our values have become ‘*value delusions*’ or ‘*maverick*’ values for the so-called winners in society, who get ranked based on the material resources they hold, skill sets or intellect they possess, formal educational levels they have achieved, celebrity status they enjoy, wealth they amass, leadership positions they are in, powers they use, etc. The ethical, conventional social values have become ‘*herd*’ values which do not count much today, in most societies. In contrast, maverick values are on a non-stop, on-stage performance. They try to mesmerise the masses by creating and sustaining sensational perceptions of social rankings. These values are highly noticeable, thereby generating, promoting, and perpetuating mad races in societies. Under this value system, the paths and byways used for the achievements are irrelevant. The concept of using clean, ethical or ‘instrumental values’ is not invoked. Only end results matter in the scheme of things.

The greedy men have marched even further. Traditional values have become powerless, as they are no more strong or useful in generating top-of-the-table material gains. Instead, power is believed to be emanating from and resting with material wealth and comforts. Pursuing common goals by cooperation and team work has been replaced by ever expanding personal goals in terms of authority and resources. The moral, ethical, and qualitative attributes of 'herd' values like honesty, integrity, compassion, etc., have got marginalized, and relegated to the background. The noble concept of being a 'good human being,' first and foremost, is virtually confined to rhetoric. The prime determinants of value under this phenomenon have got changed to harvesting and accumulating wealth and achieving positions of power and fame. Markets and communities are seen by these wealth and fame seekers as instruments to achieve their personal targets, not as platforms to offer a range of services to communities and consumers for a living, or for a reasonable return. Monetary values are replacing and destroying humane values. As a result, the humane values have gone underground and genuine humanists have become an endangered species. A maverick's solo performance is always lauded. But when such an achievement is made possible by exploiting some, or by pushing down or subjugating others using unfair means, it is a different story altogether. The German historical economist Werner Sombart's 'late capitalism' (*Der Moderne Kapitalismus*) refers specifically to economic, political and social deprivations associated with the aftermath of the first world war. Today, social deprivations are no more linked to wars. They are being created by the spread of above 'maverick values.'

The message from the elite rich to the rest of mankind is simple. Welfare measures using our resources are limited for you; but we will use your resources for unlimited gains for us. The labour class is generally lazy, and therefore deserves and gets less; the top layer represented by us deserves and gets unlimited. The interest on savers' deposits must be low or preferably negative; the equity returns for us must be unlimited. We may inflate away the interest cost, if any, in any case. Your values are invaluable and heavenly; our values are material, ordinary, measurable, and earthly. The public is dear to us; but our wealth, friends, and relatives are a lot dearer. The roots of current day inequality lie in the very consciousness of societies that is rooted in the quest and worship of money power.

Schumpeter envisaged a transition from capitalism to socialism in the early 1940s. In his words, socialism is that organization of society in which the means of production are controlled, and the decision on how and what to produce and on who is to get what, are made by public authority instead of by privately-owned and privately-managed firms. He further assumed that a central planning system with access to perfect information could control the entire economy, thereby eliminating economic downturns and eradicating unemployment. However, he could not anticipate a situation where misuse of power would be rampant. In reality, the probability of misuse of power by power-centres, including governments, is seen directly proportionate to the degree of power such centres exercise. Greater the power, greater the misuse.

Socialism is yet to be a reality in almost all capitalist nations. Though capitalism continues to flourish, it is not leading to higher levels of equality or socialism. The 'trickle down' effect of economic growth is too insignificant. There is no convergence of economic growth between nations either. State socialism has virtually collapsed. Many believe that the major reason for such a situation is the lack of competent and creative political leadership which competitive markets were expected to produce, as anticipated by Schumpeter. This in turn, is mainly due to lack of economic accountability for elected political leaders and bureaucrats. Schumpeter did not envisage an 'undemocratic' or unprincipled leadership in 'flawed' democracies.

Firms and shareholders are today more focussed on wealth maximising strategies involving tax avoidance, benefitting from regulatory arbitrages, excessive leveraging, speculation, etc. The basic causes for current day inequalities in societies are assumed to be linked to factors like technological progress, increased mechanization, globalization, outsourcing, weakened power of trade unions, regressive tax policies, access to global tax evasion mechanisms, higher savings by high income groups, etc. No meaningful interventions are planned or made by governments to tackle these. A significant factor driving inequality is the way wealth is created in modern economies by speculators. The capital invested in productive and commercial activities creates new wealth that gets widely distributed to different players like the investors of capital, workers engaged to produce and distribute goods and services, suppliers of raw materials, as tax to Government, etc. In contrast, capital multiplied using speculative financial markets create no new wealth. Instead, there is either an increase in the notional wealth or a net transfer of existing wealth to those who made correct speculative market calls. About 85% of global financial transactions today are speculative. Speculation has reached a stage where well-functioning, productive companies are bought and sold just like equity portfolios, by cash rich financial giants and conglomerates. In addition, there are incidents of rampant accounting manipulations, insider trading and various other types of unfair practices, that lead to astronomical and unjustified share prices that inflate the wealth of shareholders. The speculators are also being helped by investment of public money in the financial markets. Governments are indirectly aligning the interests of public with the speculative private investors. After the financial crisis of 2008, global central banks bought stocks, bonds, and other financial assets in very large quantities. Post Covid 19, they repeated it. These passive wealth creators have reduced the purchasing power of poor by the inflationary impact they produce.

Inequality is getting widened due to inherited wealth as well, not envisaged by Schumpeter. Thomas Piketty observed that while there is moderate inequality of income from labour, there is extreme inequality of income from capital. As one goes up in the income hierarchy, the income from capital goes up. The lower strata generally cannot, in their lifetime, catch up with the increased income generated by the rich from their capital inherited and accumulated. Reports by Oxfam and other economists confirm the same and show that the people at the top of the wealth scale are not dropping from the list. The top layer is in some manner economically protected and it is a sort of an elite club, membership of which is almost stable. It is difficult to get into it if one is starting as a laggard. The distance to be covered for an upwardly mobile person remains more-or-less same or it increases. The wealthy status appears to be persistent across generations. Property inheritance is still a reality, though arguably an unfair one. Given this situation, creating a bright future for an ordinary person is like creating one's shadow. It is yours, but its creation, shape and direction are all decided by external factors, including the 'unearned' privileges or disadvantages handed down by heritage.

Democracy at Crossroads: Democracy is considered to be a system based on a logical extension or formalisation of the self-managing, self-correcting groups, on a national basis. Schumpeter had disputed the idea of democracy as a system where voters identified the agenda for common good, and then elected politicians to execute them. His argument was that politicians set their own agenda and then manipulated the electorates to vote for them. His model considers democracy as a mechanism where leaders compete, like in any market. Voters select leaders based on their policies and programmes. As per this logic, the scope of people's

participation in the welfare programmes or policies of a nation, in the real sense, is dubious and extremely limited. It appears that voters are also realising this limitation, as evidenced by the decline in voter turnout. As per the Institute for Democracy and Electoral Assistance (IDEA), despite an increase in both global voter population and the number of countries that hold elections, global average voter turnout has fallen. It was stable between the 1940s to 1980s, in the range of 78 percent to 76%, and then fell to 70 percent in the 1990s, and to 66 per cent in the period 2011-15.

Creative political leadership focussed on human welfare is conspicuously absent in most democracies. There is a general trust deficit in democratic systems where self-rule has virtually become a myth. Democracies are seen as ineffective systems in providing acceptable solutions to the expanding aspirations of common man. Democracies have arguably become systems for the privileged, of the privileged and by the privileged. Key participants in the system have neither achievable targets nor any form of accountability. It is a dichotomy of sorts in the sense that while national resources can be appropriated by the political leadership, welfare activities like poverty reduction are not considered as their responsibility. It has become a convenient structure that incentivises political leaders to promote their careers. Achieving and maintaining power has therefore become the main goal of political leaders. Consequently, in the modern democracies, politicians tend to make legislations that help them keep their power positions. Common good is no more the prime mover of such legislations.

As explained by the 'Public Choice Theory,' though there are 'government failures,' an individual voter has virtually no ability to control them. They cannot determine the outcome of an election, spending time on key issues is not personally useful to them, and many of them do not understand either the ideologies of major political parties or the people behind them. A voter therefore, is indifferent to policies and their impact on citizens. Except for a few highly publicized narratives or issues, they do not pay attention to what legislators do. Schumpeter does not claim that democracy is a necessary or sufficient condition for good governance. Since people do not analyse good governance, the incentives for good management in the public interest is understandably missing. Voters seem to be fine with the notion that a country of many uncertainties and complexities can be run by anyone including uneducated persons. This is not a rational assumption. Legislators can tax and extract resources by force. Since the voters do not monitor the resource allocations effectively, as per Public Choice Theory, legislators tend to behave in ways that are costly to society.

Another trend seen in some democracies is the promotion of a group's interest, based on religion, race, caste, etc. Even regulatory agencies appear to be in the hands of vested interest groups. Many politicians are just representatives of certain collective faiths, which are themselves not founded on any convincing logic. Such leaders will keep furthering the interests of their aligned groups and cannot be expected to work for the benefit of common good. The end result is that democratic systems are not delivering what they were expected to. Buchanan and Tullock, in their book 'The Calculus of Consent: Logical Foundations of Constitutional Democracy,' has a view that a collective decision that is truly just or a decision in the public interest, would be one that all voters would support unanimously. While unanimity is largely unworkable in practice, the book challenges the widespread assumption that majority decisions are inherently fair.

It may be worth recalling here the observation in the Nobel Prize-winning economist Kenneth Arrow's 1951 book, '*Social Choice and Individual Values.*' It attempted to figure out through

logic whether people who have different goals can use voting to make collective decisions that please everyone. He concluded that they cannot (the 'impossibility theorem'.)

Can societies be more socialistic? One of the ways to deal with inequality is to open-up the governance systems more. In such an environment, abuse of power would be limited, for fear of public criticism. The concerns about misuse of power are extremely serious when we consider the fact that the commercial rights on natural, national resources like minerals, coal, oil, etc., in many nations are not with their current or future generations. They have already been sold off to rich private entities by past governments at prices considered good by them then. The nation's future generations will have no rights on them. Thus, the playing level is highly unequal, to begin with. This dangerous network of politicians, bureaucrats and business men has to be kept under check. For that to happen, more and relevant disclosures on their economic decisions and activities must be made, on an on-going basis.

A critical question that arises is whether ordinary people can create their own future by hard work or using their imagination. Doubtful, in most cases, given the historical trends. Societies therefore have the responsibility to take care of those born under challenging conditions, for no fault of theirs. It is unfair to assume that they are destined to struggle themselves with no light at the end of the tunnel.

Chathur Varna: The world is apparently recreating a scenario that prevailed in ancient India under its much maligned 'Chathur Varna' (four castes) system. We have 'Kshatriyas' or rulers in various designations at the top, followed by 'Brahmins' or religious heads who play critical advisory role in many countries. Then comes the 'Vaishyas' or business men, who are rich and highly powerful, and at the very bottom, the largest number of 'Shudras' or people who are labourers and ordinary workers, who get least respect in society.

Another application of the principles of 'Chathur Varna' is visible in the global tax collection system¹. An efficient tax collection system presupposes elimination of, or effective control on, tax evasion. Such a system is critical for reduction in inequality. But there is a serious issue with the system now. It is widely known that huge multinational corporates typically pay very low tax on their global income. An average billionaire also pays tax at lower rates, while for the common man, the rates are much higher. Addressing tax evasion is a difficult task, as there is a virtual competition to facilitate and even promote tax evasion in various places globally, using structures that legally allow tax avoidance by individuals and corporates. This is done by creating and maintaining shell companies in so called tax havens. Some countries also allow dual citizenships which make tracking of an individual's income almost impossible, thereby indirectly helping avoid payment of due taxes.

Countries that lose tax incomes in the process have not been able to stop this phenomenon. There is no global agreement on how to address this. Governments across the globe lose billions of dollars of tax revenue every year due to these smart financial structures set up by large corporates and ultra-high net worth individuals in tax havens. Most governments are reluctant to formally publish the information on corporates using tax havens.

There is an argument that the jurisdictions with lower income tax rates cannot increase their tax rates as their very economic survival depends on large number of these entities operating out of their locations. But such locations or territories cannot be allowed prosper at the cost of

other nations. In a technologically enabled world, tracking and tackling big corporate tax evaders should not be a serious problem, if major nations are willing. In the recent past, governments got reasonable success in tracking terrorism funding. So, tracking tax haven related transactions may not be too difficult, if countries have a common objective and they sincerely, collectively go for it.

Here we revisit 'Chatur Varna' system. There were well planned and recorded economic concepts and doctrines in ancient India, in the Hindu *Vedas*, *Upanishads*, *Dharma Shastras*, *Neeti Shastras*, and similar books. The most celebrated and arguably the first systematic set of economic policies written in the 4th century BC, is in Kautilya's '*Arthashastra*.' Kautilya, also known as Chanakya, was the minister of Chandra Gupta Maurya. '*Arthashastra*' was written for streamlining economic and financial administration of Chandra Gupta Maurya (Maurya Dynasty). In the document, Kautilya advised that those who perform sacrifices, the spiritual masters, priests, and others well - versed in Vedas shall be granted lands, yielding sufficient produce. They were then considered productive on account of their land ownership, and it was suggested that as productive people, they should be exempted from taxation and fines. This is exactly what is happening now. In the name of productivity, business firms are protected, they are given land either free or at subsidized price, and their incomes are either not taxed at all or taxed less.

The rich and powerful do not and need not pay tax, again. We are going back to the millennia old 'Chatur Varna,' globally.

What Next? The focus on welfare that began post World War II got abandoned in mid-seventies, due to large scale state interventions, which allegedly damaged economic systems. Neo liberalism that followed allowed markets to regulate businesses. Welfare responsibilities were transferred to non-profit organizations, and private sector. The higher levels of national debts today keep countries' future resources significantly pre committed, making governments unresponsive to the welfare needs of people. Thus, it is doubtful whether social equality will happen anytime soon. If inequality grows unbridled, there is a high probability of social unrest and revolts against governments in future.

Under these circumstances, can we chart out a middle path which can promote the positive aspects of capitalism while effectively bridling its 'excesses'? Can such a system also embrace the major positives of socialism? Can a partial conversion of capitalism into soft socialism be politically feasible? May be yes. We can make a beginning by forcing the national governments (starting with say, the G20 nations) to formulate alternate social structures, policies, and a set of few hard decisions, which can include the following:

1. **Philanthropy:** Some countries already have rules mandating corporate social responsibility. Its scope may be increased. The top 500 business firms in terms of profitability globally may be forced to identify and adopt say, 500 poorest districts or identified locations and offer their entire population below an economic level, free education, and healthcare for say, ten years.
2. **Removal of '*limited liability*':** Once a company, including its subsidiaries, exceeds a market capitalization of say, USD 50 billion, its limited liability condition may be legally removed. After exceeding that limit, all shareholders must have unlimited liability.

1. **Abolishing Tax havens, Special Economic Zones, (SEZ) etc.:** All tax havens could be abolished. SEZs may be allowed to be set up in a nation for promoting smaller firms only.
2. **Phasing out shell companies:** This could be implemented if big nations cooperate. New ones must not be allowed to be created.
3. **No inorganic growth:** Private, for profit, commercial entities with a net worth of over say, USD 75 billion must not be allowed to acquire other companies. Such large corporations may be allowed to grow only organically.
4. **Banning sovereign funds from speculating:** Government money must not be used for purchase of private company equity shares from the secondary market.
5. **Ownership of natural resources:** Private firms that have long term rights to exploit natural resources like mines, oil fields, etc., may be forced to share wind fall gains with their governments, over and above normal taxes. There should be an assumed private public partnership when such situations arise.
6. **Cap returns on equity:** Any returns on equity or equity linked instruments or derivatives for any holding period, above a cap of say, 5 times the ten-year government bond rate in that country might be forcibly transferred to a Universal Basic Income Fund or similar fund, to discourage market manipulations and speculations.
7. **Opaqueness in Political decisions:** Political decisions will have to be made fully transparent, as politicians in power can otherwise be tempted to make personal gains in the name of national security, etc. All political actions must be supported by logical explanations.

References

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