

Democracy

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Modern democracy and modern economic development have grown together over the past couple of centuries. They enjoyed great success together in the third quarter of the twentieth century. Success was more uneven after that, but generally continued through to the century's end. By the late twentieth century, modern economic development and democracy were inseparable in many minds in the high income countries.

Many in the developed countries in the late twentieth century saw modern economic development as capitalist development, and competitive democracy as the partner of market capitalism. When Deng Xiaoping committed the Chinese Communist Party and China to massive enlargement of the role of market exchange and Time magazine described him as Man of the Year, many Americans including people of official and scholarly prominence, thought that democracy must be part at least of Deng's long term thoughts for his country. When the collapse of the Soviet Union brought the Cold War to an end and Fukuyama wrote of the End of History, he had in mind the whole world having competitive voting democracies with capitalist market economies.

The reality then, now and always is more complex. Both competitive democracy and market capitalism change in their content and their outcomes over time. Both are part of restless modern development. Neither travels for long in straight lines.

Both competitive democracy and the capitalist economy had their best days so far through much of the second half of the twentieth century.

The better times and the worse have an international context. These notes explore some of the interactions between domestic performance of democracy and capitalism, and international competition amongst national polities, political and economic ideas and political and economic systems.

The defeat of fascism in Europe and Japan raised the status of and reinforced democratic institutions and values—in the post-war period infused with social democratic values. Far from reaching their greatest heights of achievement after the removal of the competitive threat of Soviet communism, as anticipated by Fukuyama, democratic institutions and values and the capitalist market economy have run into hard times in the early twenty first century.

Interaction amongst people, societies, polities and economies across Eurasia and North Africa was important in the development of human civilization from the introduction of agriculture about a dozen millennia ago. Developments that can be described more accurately as international have been centrally important since the emergence of modern economic development in Britain a quarter of a millennium ago.

We should not forget the circumstances that preceded democracy's and capitalism's good half century after the second world war. In the 1930s, German Nazism and Japanese militarized Imperialism presided over rising and in the end high employment and strong output growth. At the time, these were compared favourably by elites and many citizens with underperformance in the democratic market economies of the English speaking five. Melbourne University Press's recent republishing of Christina Stead's *House of All Nations* reminds us of the attractions of

Nazism's apparent certainty to what is in retrospect a surprising range of owners of capital. Collaboration by business elites was part of the background to the early capitulation of much of continental Europe to Nazism—as Piketty in *Capital in the Twenty-First Century* highlights in explaining French commitment to redistribution of incomes and wealth in the early post-war period. Roosevelt had to overcome substantial sympathy for Nazism in preparing the United States for war with Germany.

The defeat of Nazism and militarism was a close run thing. The effectiveness of Soviet resistance to Germany and Chinese to Japan was surprising to the Axis and to what became the Allied powers alike. They were crucial to Britain hanging on long enough for Roosevelt's intervention to be straightforwardly decisive. Victory by the United States and the British allies reinforced democratic values and social democratic economic policies at home, and enhanced the attractions of those values and policies elsewhere. Cold War competition from Soviet Communism deepened the reinforcement. One consequence was sensitivity in the policy-making process to levels and changes in living standards of ordinary people.

The enrichment of democracy and the extension of social democracy turned out to be highly beneficial for domestic economic performance amongst the victors. For a quarter of a century after the world settled down after the war, growth in economic output and incomes in the democracies exceeded anything before or since. Full employment with low inflation became the norm. Fiscal policies contributed to more even distribution of incomes and wealth. Democracy and market capitalism, substantially influenced by social democratic concern for the welfare of ordinary citizens, turned out to be overwhelmingly more attractive than authoritarian government with a centrally planned economy.

The declining moral legacy of wartime commitments to democracy and social democracy and the demise of the centrally planned authoritarian systems have changed constraints on policy-making since the early 1990s. This has given freer rein to tendencies inherent in the logic of contemporary global development towards policies that generate wider dispersion of the distribution of incomes and wealth in the developed countries.

Deeper integration of global markets for goods, services, capital and skilled labour has tended to widen income disparities within the developed countries, but not in the world as a whole.

Globalisation of production of goods and services has tended to raise incomes of relatively unskilled workers in the developing and to lower them in the developed countries. Greater mobility of capital and skilled labour but not of unskilled labour has placed constraints on taxation of some but not all high incomes.

The Gini coefficient (a statistical measure of inequality) has increased in the developed countries but fallen in the world as a whole over recent decades. In the three decades to the Great Crash of 2008, the big global winners from rising incomes were people in the middle deciles of the global distribution of income—corresponding to ordinary people in China and some other successful developing countries—and the top one percent (Garnaut 2015). The least favoured were those around the eightieth and ninetieth deciles, corresponding to

ordinary people in the developed countries, and the lowest decile of all—the world's poorest people, mainly in Africa and a few other countries.

The widening dispersion of income and wealth distribution in the developed countries has occurred alongside slower growth in overall output and incomes. The overall outcome includes stagnation and decline in living standards of ordinary people in the developed countries—since the 1970s in the United States, since the early twenty first century in Europe, since the end of the China resources boom in 2011 in Australia, and everywhere more emphatically since the Great Crash of 2008.

Stagnation and decline of the living standards of ordinary people over long periods outside war and civil disorder is a new phenomenon in the capitalist democracies. It takes these countries into new political and social as well as economic territory.

These diminished economic outcomes have emerged alongside increased, less inhibited and more effective pressure on the policy-making process from vested interests in the developed democracies.

Vulnerability to pressure from vested interests was highlighted in early critiques of democracy in the nineteenth and early twentieth centuries. Democracy performed better than the critique through the twentieth century. However, the old critique is more resonant today. The struggle to debate and settle policy on national interest grounds, rather than having policy settled as the resultant of sectional pressures, has become more difficult in all of the established democracies in the early twenty first century. Some democracies, especially in Europe, have responded with far-reaching legal restrictions on funding of political parties and campaigns. The United States and Australia amongst others have few introduced constraints, and have experienced an explosion of vested interest pressures on the policy process.

Why the change?

Part of the story is simply learning by doing. Potentially powerful interests now invest more effectively in the political process. Vested interests have become better at buying influence.

Structural change in the developed economies has reduced the power of trade unions and other institutions which once exerted countervailing power against corporate influences.

The apparent absence of competition for the hearts and minds of citizens from alternative political systems has played some role. A closely related influence for the time being has been the apparent decline in the importance of a state and polity winning the strong allegiance of most its citizens for large-scale mobilization of national human and other resources for war.

I have already mentioned the declining moral legacy of the war against fascism. There is also a declining moral legacy from the pre-modern religious systems that once inhibited behaviour that advanced private at the expense of public interests.

Recent discussion of taxation policy in Australia provides an example of the new political culture at work. Arguments for taxation changes may still be presented on national interest

grounds, but in practice are much more likely to be favoured if they distribute income from the general run of citizens to powerful and vocal corporate interests. A wide-ranging review of the Australian taxation system led by the then Secretary of the Treasury Ken Henry in 2010 recommended a range of measures. Henry's report contained a consistent theme being the importance of taxing more heavily external environmental costs (carbon and congestion externalities), that there were public benefits from taxing more heavily income derived from geographically fixed resources (eg resource rents); and taxing less heavily income derived from mobile factors of production (capital in industries with competitive entry). After various false starts, the continuing debate on tax reform has excluded from the Henry recommendations those changes that are mainly progressive in their impact (resource rents) or beneficial for society as a whole while imposing short term costs on corporate interests (environmental externalities). The continuing debate favours changes that are mainly regressive (substitution of taxes on corporate income whether or not there is competitive entry, by taxes on household consumption).

I discussed the increasing role of vested interests in the policy process and provided recent examples in my book *Dog Days: Australia After the Boom* (2013). I had the opportunity to discuss these observations with former Prime Minister Malcolm Fraser shortly before his death earlier this year. Fraser expanded on my comments in *Dog Days*, noting the contrast between political fund-raising today with practices when he was active in party politics. When Fraser was a young member for the Victorian House of Representative seat of Wannon, his campaigns were well furnished financially by a committee of the local party. However, under rules established by Liberal Party founder Robert Menzies, Fraser did not know and was not allowed to know the identity of donors. By contrast, he noted, it is customary today to achieve access to Ministers or influential party figures by making financial contributions.

Does this distortion of the political process, leading to less equitable distribution of income in the developed countries, matter in an era of successful global development in which inequality is steady or falling in the world as a whole? A case might be made that less equitable distribution of incomes in the rich countries is incidental to a larger process that is favourable to incomes growth in the world as a whole, to more equitable global distribution of income now, and eventually to more equitable distribution everywhere.

This case favours the early 1930s views of the future of John Maynard Keynes against the contemporary views of Thomas Picketty. Keynes thought that in a hundred years from the time at which he was writing—that is, about 15 years from now—capital would be abundant and cheap, labour would support high living standards for ordinary people, and uneven distribution of incomes and wealth relatively unimportant. I have considerable sympathy with that view as the likely if uncertain long-term prospect for humanity (Garnaut 2015).

But Keynes also gave us the antidote to complacency about contemporary conditions with his comment that in the long run we are all dead. The long run is a succession of short runs, and what happens next is influenced by what happens now.

A continuation of the current underperformance of the developed countries will shape global perceptions of the value of democracy. If the democratic polities continue to find it difficult to take decisions in the broader public interest, the prospects are for the continuation of low rates of productivity and incomes growth, to fiscal policy decisions that are unfavourable to the income shares of ordinary people and to continued stagnation or decline in the standards of living of the general run of citizens. These outcomes will feed back into problems of governing in the public interest.

Globalisation makes the present a time when international cooperation is necessary for good outcomes in a widening range of policy areas: taxation for efficiency and equity; the promotion of global development; the reconciliation of continued economic growth with climate stability; countering terrorism; stopping the spread of pestilence from areas of failed governance; and of course and still, the avoidance of international conflict in the presence of weapons of mass destruction. Confident, effective governments in the developed world are essential to good outcomes in all of these areas.

Success with economic development and rising living standards in major countries with predominantly market economies and undemocratic political systems would be influential in shaping global views about the relative merits of competitive democracy. The influence would be greater if this success were juxtaposed against the continuation of stagnant or falling incomes of ordinary people in the old democracies.

Most importantly, China is embarked upon far-reaching political and economic reforms designed to raise average incomes into the ranks of the developed countries, to reduce inequality in the distribution of income, and to secure government for but decidedly not by the people. The leadership of the Chinese Communist Party and State has set itself a challenging task. The task may be impossible. The leaders at critical times may not be up to the task

But the Chinese leadership may succeed. If the Chinese leadership succeeds, within a decade or two, a majority of the world's high income people will live within an authoritarian political system. That would turn upside down today's world, in which all or nearly all people in high income countries are governed within competitive democracies.

The people of the developing countries—the many who are making up their minds about government for and by the people—will be influenced by the performance of democracy in its original homes.

The good news is that there is now increasing awareness and concern in the developed countries of the extent of underperformance of their political systems. There is now increasing awareness of the importance of fundamental reform to allow government and policy to work more effectively for the people. In Australia at least, an independent centre of the polity is stirring in response to recognition that great damage will be done if the political system is allowed to set in the shape of recent times.

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