

# **Capitalism, Socialism and Democracy in the Twenty First Century**

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**9 October 2014**

**A joint LSE-University of Melbourne public lecture delivered at the  
London School of Economics and Political Science**

Note: All of the ideas in this lecture which are neither trivial nor commonplace have been discussed with my colleagues in the Reading Group on International Economics at the University of Melbourne. I thank them all.

Three weeks ago I caught the train from Beijing to Shanghai. My ambition to re-read Karl Popper's "Open Society and its Enemies" in preparation for this lecture was disappointed by the speed with which the 1300 odd kilometres of abundant countryside flashed past.

A week ago I entered a new freeway for the 115 kilometres from Surabaya to the East Java city of Bojonegoro. The time to my destination was enough for the full Popper text. There was a crawl for ten kilometres as we approached a bottleneck created by the refusal of the owner of a small shop to accept the Government's terms of compensation.

At home in Australia between China and Indonesia we were arguing about whether to build 13 kilometres of slow rail between the Sydney suburbs of Parramatta and Epping—as we had been doing through all of the years in which China was building 13,000 kilometres of fast rail joining the large cities.

The preoccupations of political discourse were closer than the progress on public transport systems.

Indonesian discussion of politics last week was consumed by popular reaction to a decision of the parliament that was dominated by supporters of the losing candidate in the Presidential election—General Prabowo, who was intimately connected to the old Soeharto military regime. The new law ended direct elections for Provincial and local governments. It would block the repetition of the success of Jokowi, the charismatic president-elect who had risen from being Mayor of Jakarta through his popular appeal over the heads of the large established parties and the business elites which funded them. The cartoon in Kompas captures the mood.



Source: Kompas newspaper (Indonesia), 1 October 2014 ([www.kompas.com](http://www.kompas.com)).

Chinese in Beijing who talked about politics three weeks ago were absorbed by the arrest for corruption of yet another top leader of state-owned business. The General Secretary of the Communist Party was striking out to correct a fundamental weakness in the capacity of his Party and government to deal with the challenges of the twenty first century.

Australia was absorbed by the consequences of a new balance of power in the Senate. Decisions on the future of carbon pricing, a mining tax and many fiscal measures were hanging on the votes of a new party that had funded a massive election campaign from wealth created recently by its founder's privileged participation in Australia's China resources boom.

Melbourne provides two standpoints distinctively different from London for observing the evolution of economic and political systems.

First, antipodean economic and political systems have evolved differently from those of the other old, developed democracies. Many of the modern institutions of democracy and economic inclusion emerged first or early in the antipodean offshoots of industrializing Britain (Keane, 2009). Democratic evolution in the colonies that became Australia and New Zealand was less constrained by inherited wealth and privilege than in Europe. In that, it was similar to the United States. It was different from the United States because it was not constrained by the pervasive influence of slavery and its social legacy. Labour was scarce and economically valuable and therefore the democratic polity assertive and self confident earlier than in the North Atlantic.

Australians used their early democracy to modify the distribution of income that emerged from the untrammelled workings of the market economy. William Pember Reeves' description of these innovations in "State Experiments in Australia and New Zealand" set up his long foundational leadership of the London School of Economics.

Metin's description more than a century ago of the social and economic order of Australia and New Zealand as "Le Socialisme Sans Doctrines" (1901) evokes a reality that has helped to shape today's political culture and institutions. Australian and New Zealand democracy has avoided the articulation of policy within an elaborate and consistent set of ideas. Popper's "Open Society and its Enemies" (1945) with its praise for pragmatic democracy was influenced by being written during his antipodean exile immediately before joining the staff of this School.

Those roots contributed to the distinctive character of market-oriented policy in a remarkable period of reform from 1983 to the end of the century. After a deep recession in 1990-91 which was partly a consequence of taking time to learn how to manage the deregulated financial system, Australia has enjoyed the longest economic expansion unbroken by recession in its history—or, for that matter, the history of any developed country except by a small margin the Netherlands during the North Sea gas boom. Life has been harder since the China resources boom came off its peak in 2011. It will get harder still over the next few years as Australia grapples with economic challenges within a less suitable political culture. That is the story of my recent book, "Dog Days: Australia After the Boom".

The Australian reforms coincided in the beginning with the deregulatory initiatives of Thatcher and Reagan and from a distance were conflated with them. But Australia's market-oriented reform was within a social democratic framework.

There was a downside to the absence of doctrine in the late twentieth century reforms. Critics who disliked the larger role for markets were able to set up a caricature of policy as if it had no social democratic content, and to condemn the application to policy-making of economic analysis as “economic rationalism”. That opened the way for people who favoured the market orientation but not the social democracy to claim the success of the reforms over the next quarter century as their own, and to present economically irrational deregulation as a continuation of the policy approach of the reform era. This is a hugely important development in the twenty first century world of uninhibited engagement of business interests in the policy process, as independent application of economic analysis to policy choice is crucial in the defence of the public interest against sectional claims.

The absence of doctrine in early state policy in Australia contributed to the avoidance of extremes. Or almost avoided them. There was doctrine in the early twentieth century antipodean insistence that the good life being built within a young democracy was for a small part and not the whole of humanity.

The exclusion of most of humanity from early concerns for equity was part of a more general exclusion from conceptions of economic development. This is a fundamental flaw in almost everything written about economic growth and the distribution of income until the last half century (Australian economist Colin Clark is an admirable exception). The discussion of the distribution of income in the developed countries today is still sometimes conducted as if it could be separated from the plight of the rest of humanity.

Prosperity has helped to delay Australians’ curiosity about weaknesses in modern democratic capitalism. We have been late to ask the questions that have attracted interest elsewhere in the developed world about where our political and economic systems are taking us—questions that were last so prominent in the 1930s and 1940s.

#### Questions From the Thirties and Forties

Seventy and eighty years ago we were challenged by economic decline and hopelessly high unemployment and then by the capitulation of continental Europe to Nazism.

While Keynes in the 1930s and Hayek, Schumpeter and Popper in the 1940s were all strongly committed to personal freedom and the advantages of the market economy, they had different hopes and fears about what was possible for the future, and about the greatest dangers to our civilisation.

Keynes’ essay “Economics for Our Grandchildren” as well as the concluding chapter of the General Theory saw the inexorable accumulation of capital and increases in productivity as leading over a hundred years to material abundance. The continual accumulation of capital would eventually reduce the rate of return on low-risk investment to negligible levels, bringing about “the euthanasia of the rentier”. Some income differentials would remain to ensure that the wheels of the economy kept turning, but taxation could safely be more progressive, as the jobs would be done well enough for less. The remaining inequality was unimportant, as everyone with the capacity to enjoy the good life would be living well. Far from leading to the plutocracy anticipated

in Picketty's recent work, the abundance of capital would make its owners less influential and important, just as abundance would make economists as boring as dentists.

Skidelsky and Skidelsky (2012) have recently examined some of Keynes' prognosis against what is now historical experience. The expectation of productivity and incomes growth has been met more or less precisely. But people have chosen to take much less of the new abundance as leisure than Keynes had anticipated.

Hayek at this School once remarked that Keynes lacked curiosity about anything that had not been written in English. The most important gap in Keynes curiosity, however, was the consequences of extending modern economic development to the whole of humanity.

Hayek's warning against central planning was justified by the subsequent evolution of Soviet central planning and its echo in China from 1949. Both had been confined to the dustbin of history by the early 1990s.

While Hayek's "Road to Serfdom" became a revered text for those who sought to push back the boundaries of the democratic capitalist state in the late twentieth century, its actual content is helpful today to people seeking to preserve the role of the mixed economy that had been so successful in the postwar decades. Of relevance to contemporary debates, Hayek acknowledges roles amongst much else for a social security safety net including provision of health care and for systematic intervention to avoid external environmental costs from private economic decisions. As Keynes noted at the time, once the case for intervention has been made in principle, the question is where to draw the line. The answer is not found in doctrine, but in analysis case by case.

Schumpeter in "Capitalism, Socialism and Democracy" was at once convinced of the great merits of traditional, unrestrained capitalism, and doubtful about its survival in a democratic polity.

Schumpeter used Napoleonic examples to show that good non-democratic leadership could produce Government for the people. He could as easily have referred to Bismarck's Germany. But in the end, effective leadership for important change required an appeal to the people that pushed a society towards government acceptable to the people, and by implication in the end by the people.

Of special interest to the twenty first century discussion, Schumpeter thought that the means at the disposal of private interests in a democracy "are often used to thwart the will of the people", and "to interfere with the working of the mechanisms of competitive leadership".

Popper was less impressed than Schumpeter both by the pure form of traditional capitalism and by Marxist logic, and more comfortable with the messy reality of democracy and its inevitable tendency towards social democracy. The open society might get many things wrong, but it had a capacity for self-correction and for improvement over time that was more valuable than the occasionally more precise correctness of its enemies.

Popper is interesting also for his vilification of Plato as the original source of ideological opposition to the open society. This was ethno-centric in Popper's time: Confucian political philosophy had said as much about the advantages of leadership by an elite that was aware of its responsibilities to the wider community.

The case for Plato's general importance in global political thought is stronger now than in the 1940s: the current leaders of the Chinese Communist Party were taught at University and the Party School that their version of socialist thought had beginnings in Plato. General Secretary Xi Jinping's Herculean (or Sisyphian) efforts to purge corruption from the Chinese Communist Party can be seen as seeking longevity of Party rule through government by Platonic guardians.

The cautionary words from the troubled years assisted the developed world to avoid some traps. This and the favourable experience of the postwar decades focused the spotlight on more mundane questions. The best of modern economics has much that is valuable to say about the boundaries between activities that are most usefully undertaken through unrestrained market exchange, those that require regulated markets for good outcomes in the public interest, and those that are best provided directly by the State. It was influential in the North Atlantic in the golden postwar years and in Australia in the reform period 1983-2000.

### The Return to Big Questions

The stagnation and in the United States the decline of labour incomes and more generally the large increase in the dispersions of the distribution of incomes and wealth in the late twentieth and early twenty first century have renewed discussion of where our political and economic systems are taking us. Mainstream economists in the United States (Stiglitz, Krugman, Sachs) became critics of the way the democratic system was working and came to focus especially on the role of corporate money in the policy-making process.

Picketty's recent book has become the focus of much of the recent discussion. Picketty highlights a challenge to the future of democracy from widening dispersion of the distribution of incomes and wealth. He presents in an engaging way immense information on the distribution of income and wealth at various times since the eighteenth century, focusing most intensively on France, the United Kingdom and the United States. He touches upon other countries, mostly developed and mainly in Europe. He describes a simple economic model within which we can understand part of the change in the distribution of incomes over time—the part that derives from changes in the distribution between labour and capital. He discusses eclectically a range of other influences on the distribution of income and wealth. He applies insights from the model and the eclectic discussion to suggest that in the absence of political upheaval or new policies, inequality will widen to and perhaps beyond levels known in Europe before World War I. He comments that this is likely to be inconsistent with the ethos, good health and perhaps survival of democratic institutions and societies. Finally, he suggests policy reform that could avoid the excesses of growing inequality and preserve democracy. While wealth will seek to use its influence in the democratic process to block the implementation of reforms to secure a democratic future, Picketty, like Keynes, optimistically thinks that ideas will turn out to be more powerful than vested interests.

Picketty catches our interest by observing how the novels of Austen in Britain and Balzac in France describe how a young person may find the material foundations for a satisfactory life in theft or in marriage into a large inheritance, but not in the application of youthful intelligence and energy to study and professional achievement. His data establish that inequality in the distribution of wealth and income in France, the United Kingdom and the United States tended to grow wider in the early stages of modern economic growth; shrink decisively from the outbreak of War a century ago until the 1970s; and grow wider again over recent decades. There was once much less inequality in the

United States than in Europe, but now much more—as wide in the United States now as in Europe in the Belle Epoch.

The economic model that Picketty uses to explain growing inequality is built on the simple reality that when the return on capital exceeds the growth rate of the economy, income from capital tends to increase over time relative to income from labour. He expects the rate of return on capital to remain more or less steady over future time as it has done in the past, and the rate of economic growth to fall over time with the slowing of growth in both population and productivity. It follows that he expects the share of capital in national income to rise over time, probably at a faster rate than in the recent past, leading to vastly increased inequality.

The book makes strong points about the relationship between the distribution of income and wealth on the one hand, and democratic policy-making and political stability on the other. Picketty notes that policy—progressive income and capital taxes and expenditure policies—was important in the lessening of inequality in the mid-twentieth century; that wealth is highly influential in the policy process, and has become more so as disparities have increased; and that inequality of the dimension that is likely to emerge over the twenty first century is inconsistent with the ethos that underpins democracy and is likely to generate great tension and probably political instability.

Picketty's preferred policy response to preserve democracy and a market economy is for all countries to introduce a progressive annual global wealth tax. He acknowledges that for the time being international agreement on introduction of a progressive wealth tax is "utopian". Pending global agreement, worthwhile results could be achieved for the distribution of income within Europe from two achievable steps: international sharing of information on capital flows and other financial transactions; and the introduction of a progressive European annual wealth tax.

I see merit in the Picketty eclectic discussion of sources of inequality, in his views about the effects of inequality on the health of and prospects for democracy, and in his main suggestion for policy. But there is a big problem in the central analysis of the prospects for inequality.

Is Keynes or Picketty Wrong About the Rate of Return?

Picketty's conclusions depend on his view that the rate of return on capital will not fall much from past levels, and certainly will not fall below a falling aggregate rate of economic growth. He makes a great deal of the historical tendency for the pre-tax rate of return on capital to hold up at 4-5% per annum in real terms. He calculates rates of return in a particular way and concludes by implication that Keynes was wrong.

Not so fast.

Picketty's calculations on returns depend on the continuing boost that falling interest rates has given to capital values of assets since the turn of the century. The fall has been surprisingly persistent over a period that includes the Great Crash of 2008. Sovereign bond rates are now extraordinarily low by historical standards—last Friday in London 2.39% for 10-year sovereign bonds, Melbourne 3.43% (with higher currency risk and inflation expectations), New York 2.43%, Frankfurt 0.92% and Tokyo 0.52%. These rates are all near or below zero after deducting inflation and taxation.

That was last weekend. This afternoon the UK rates were another 17 basis points lower, New York 14 points and Germany 3 points.

The contemporary real rate of return on low-risk investment in the developed countries is substantially lower than it has ever been. The fall to these levels through the twenty first century has spurred the twenty first century boom in real asset values.

Long term interest rates cannot fall much lower now that they are near zero in nominal terms, and so will soon cease to be a source of rising asset values.

The general presumption is that the low bond yields are a temporary phenomenon associated with the aftermath of the Great Crash of 2008. If the presumption were correct, we could expect a fall in asset values as interest rates rise.

But there is another possibility—that historically low interest rates are the new norm for the twenty first century. This is suggested by the persistence of low rates through the (admittedly weak) recovery that is currently proceeding in the United States.

If so, we are already out of Austen's and Balzac's worlds of comfortable rentiers, beyond Picketty's fears of yields on investment persisting near the levels of the nineteenth and twentieth centuries, and into one dimension of the world that Keynes' envisaged for the twenty first century.

The insipid business investment in the developed world since the financial crisis may reflect the low returns on investment available in contemporary circumstances, and the slow adjustment of business expectations of returns on investment to the new realities. The reduction in opportunities for profitable investment associated with the tendency to lower productivity growth in developed countries in the twenty first century, the effects of the ageing of populations in successful economies on savings rates, the tendency for savings rates in the rapidly growing developing countries to be high by world standards, and the fiscal consolidation that is preferred in all developed countries since the financial crisis all help to hold returns on investment at historically low levels for a long time. To this we can add the historic economic transition in China away from investment led growth, which is likely for a while to see investment fall more rapidly than savings from 2014 levels in the country that is already bigger absolutely as a source of savings than the United States and Europe together.

#### They Are All Wrong About Global Development

If the Keynesian euthanasia of the rentier is with us already in the early twenty first century, it has arrived surprisingly early given the globalization of economic activity. Incorporation of the developing countries into the world economy can be expected to hold up both the rate of return on investment and the global rate of economic growth until the maturation of global development—the time when living standards become high for people everywhere.

Let us reflect for a while on the implications of global development for inequality.

I find it useful to distinguish among three sets of countries: the DEVELOPED countries, whose populations mostly already enjoy high living standards; the DEVELOPING countries that are firmly on a path of rising productivity and incomes and falling fertility; and the UNDERDEVELOPED



countries, where productivity and incomes of most people are low and stagnant and fertility and population growth high.

The developed countries already enjoy average living standards that all earlier generations of our species would have regarded as an abundance.

That few see it that way reflects in part the importance of “positional goods”, which by their nature can never be supplied to everyone who aspires to their consumption. It also owes something to the proliferation of new goods and services that are soon taken for granted—for example, the many delights of information technology and mass communications, and the positive benefits of much new medical knowledge. The contributions of the new goods and services are undervalued in the standard statistical measures of output and real incomes.

Skidelsky and Skidelsky’s recent book “How Much is Enough?” emphasises the insatiability of human desires. Keynes would say that most of us will grow and educate ourselves out of it in a world of abundance.

The tough old mover of economic reform in China, Deng Xiaoping, would be disappointed by the insatiability of Chinese desires. He said to me in 1986 that he looked forward to the Chinese people on the mainland enjoying by the middle of the twenty first century the superior living standards then experienced by people in Taiwan and Korea. Then, he said, they should be satisfied. Chinese on the mainland are already enjoying living standards in excess of those of the smaller East Asian economies in 1986, and want much more. Deng could at least take comfort that they express happiness with their current lot to pollsters in higher proportions than people elsewhere.

For all the insatiability of desires, the developed countries are having difficulty in maintaining effective demand at levels that secure high employment. For the developed world as a whole, investment intentions of citizens fall short of their intentions on saving. Government deficits make up some of the shortfall in demand, but not enough to secure full employment. This is the background to the exceptional monetary policies of the European, UK, US and Japanese central banks.

It is doubtful whether private sector savings and investment decisions would be consistent with high levels of employment after the withdrawal of exceptional monetary policies in the foreseeable future—or ever—in the absence of other sources of stimulus to demand. What might provide an additional stimulus? Direct public sector expenditures with larger budget deficits would satisfy the requirement in the short term, and if expenditure were directed well would have much more positive effects than unconventional monetary expansion on future living standards. However, Governments are wary about expenditure following the financial crisis and its recessionary aftermath.

Another approach would be for developed countries deliberately to increase income-earning investment in the developing countries in ways that accelerate incomes growth in developing countries. A substantial part of the increase would need to be public investment—the private sector can be expected already to be investing abroad most of what seems to be justified by its perception of commercial opportunity. But we could expect some increase in private investment as well, encouraged by higher rates of economic growth, improved infrastructure and confidence in

stability of commercial arrangements. The capital outflow would be associated with lower real exchange rates, larger net exports, and higher production of tradeable goods and services. The income-earning investments abroad would reconcile high savings in anticipation of retirement requirements of an ageing population with high employment in the developed countries. Income from or sale of the assets would provide resources when required to support expenditure in an old population.

These considerations support high levels of contemporary investment abroad by Chinese official agencies and the recent Chinese efforts to lead the building of a “BRICs Bank” and an Asian Infrastructure Bank.

Many developing countries, including the most populous after China, India and Indonesia, are in a good position to absorb higher levels of investment from abroad, especially if it is long term investment in infrastructure and other assets contributing to rising living standards.

China is moving so swiftly through the middle income range of development that only a political cataclysm would block its attainment of developed status within a decade or so

Incidentally, the graduation of China to developed status without transformation of its political system would change the political complexion of the developed world. The addition of China with its present political and economic systems would make a substantial majority of the developed world’s people citizens of a Platonic market economy.

The underdeveloped countries roughly correspond to Collier’s “Bottom Billion”. Today they include all of Australia’s island neighbours in an arc of instability, intensifying poverty and high fertility and population growth through Papua New Guinea at least to Fiji. Collier didn’t include Papua New Guinea in his Bottom Billion in 2007, and the persistence then of the struggle for good governance within the leadership justified his hesitation at that time. There is a Gresham’s Law of corruption in a country with weak institutions. When the currency has been debased beyond some threshold, bad money drives out good. The good is forced out of circulation until there has been transformational institutional change. The struggle is now over for the time being in Papua New Guinea and the categorization unambiguous.

My observations from experience of development in the island countries of the Southwest Pacific correspond to those of Collier in Africa, and support his main conclusions. Underdevelopment has its origins in problems of governance, which are far-reaching and intractable. Making headway on the problems of governance sets a path to development, but is hard to get started. Democracy is often an illusion until institutional weaknesses have been removed by education and drawing on external institutions.

The magnitude of the challenge does not mean that progress is impossible. Just difficult, requiring institutional stability, wisely directed institution-building over long periods and often intrusive external support. A number of Bottom Billion African countries are making headway in the twenty first century so far, led by Ethiopia with its remnant Leninist State and large Chinese support for infrastructure and agricultural and industrial development.

The Bottom Billion are more important than their current numbers suggest, because much higher fertility makes them a rapidly increasing proportion of humanity. We could be confident that the

global population would be on a downward path within a few decades despite increasing longevity, with all of its benefits for global living standards, environmental amenity and stability, security, and inequality of income distribution within all countries as well as in the world as a whole, if and only if a large proportion of the Bottom Billion were headed towards entry into the ranks of the developing countries.

International support for development in the Bottom Billion must take the form of transfers rather than income earning investments, and be justified on development and security grounds. It can contribute to lower real exchange rates and net exports and therefore employment in the developed countries, but not to future income for an older population.

#### Global Development and Inequality

The outlook for income inequality for all of humanity differs from the main Picketty story, which is based on data from the old developed countries

Let us look first at global income distribution as it has changed in recent years, and then at how it might be affected as the world moves towards the maturation of modern economic development.

For inequality inside developed countries, Picketty's inclusion of capital gains in incomes and augmentation of wealth leads to faster growth of inequality temporarily, but doesn't immediately change the direction of movement.

Australia until recently was an exception to the general tendency towards increasing inequality within developed countries, once taxation, transfer payments and public services are taken into account. The pressures for growing inequality in the market place have increased since the peak of Australia's China resources boom in 2011 and some of the policies which secured more equitable outcomes are in the process of being modified or withdrawn.

Let us define the pure Picketty framework as the tendency for the rate of economic growth to fall while the rate of return on investment stays high. Two influences from outside that pure framework on the distribution of income in the developed countries have been influential. First, while the reduction of transactions costs and official barriers to international trade—the globalization of the market for goods and services—raised labour incomes in successful developing countries, and raised total incomes in developed countries, it lowered market incomes of labour in the developed countries. Some countries, notably Australia, offset this negative effect on labour incomes by transfers from the higher incomes generated through globalisation.

Second, the lowering of taxes on capital and higher incomes in the developed countries reduced the capacity of the state to fund transfers and services. In the big developed countries, these changes in the tax regimes emerged from the interaction of business interests with deregulatory ideology. In the smaller countries, some of the reduction was an attempt to increase capital inflow and so to raise domestic incomes at the expense of others.

The actual effect of reductions in taxation on capital incomes in the smaller countries was complex and not always in the direction of raising incomes of residents of the host country.

Part of the reduction in taxation on capital and high personal income represented a loss into tax havens, which increased in number and ease of access.

Within each of the developing countries with an initial abundance of labour, including all of Northeast and South and much of Southeast Asia, the dispersion of income distribution expands in the early stages of economic growth, until labour becomes scarce and wages start to increase as or more rapidly than output. The possibilities are wider in resource rich countries with the potential to capture resource rents for public purposes: some countries have been successful in supporting widely based development in this way (Botswana is a clear example), but the political economy of resource development has more often generated a “resource curse”.

China has seen different tendencies in income distribution over time. The first steps in market-oriented reform were concentrated in rural areas, and early success led to falling inequality from 1978 to 1984. A long period of investment-led growth followed, leading to massive increases in inequality well into the twenty first century. Labour began to be scarce and real wages to rise rapidly from about 2005, and since the shift to the new model of economic growth in 2011 the standard private as well as official measures have revealed reductions in inequality.

The Indonesian story is also complex. Through the 1990s until the collapse in the Asian financial crisis in 1997-8 wages rose strongly and inequality declined moderately. Slower growth since the Asian financial crisis has seen a return to widening inequality, although the democratic governments, like their authoritarian predecessor before the financial crash of 1998, have been effective in reducing poverty. Interestingly, the largesse of election campaigns has been directed overwhelmingly towards the poor and Resodusomo and Yusuf (2009) have noted a decline in inequality in election years.

The slower growth in living standards since 1998 encouraged the bumper stickers carried on a few of the cars stuck with me half way between Surabaya and Bojonegoro: “Better with Soeharto”. Democratic memories are short.

Income distribution is generally extremely unequal and getting more so within the Bottom Billion, with little prospect of major improvement without reform of the governance structures that are blocking entry into modern economic development.

Whatever is happening to income distribution within individual countries, a global measure of inequality would show declining inequality through the early years of the twenty first century and especially since wages started to rise strongly in China in about 2005. The incomes of ordinary people in the big Asian developing countries accounting for about half of the world’s people have been growing substantially more rapidly than the incomes of all but the elites of the developed countries.

How might this change over time? The favourable developments in global income distribution in the twenty first century so far are likely to continue for as long as the developing world continues to “catch up” with the developed in average incomes and productivity. Rapid economic growth in the world as a whole, associated with an increasing global capital stock and sooner rather than later a falling global labour force, would see wage rates rising relative to returns to capital. This would accelerate sharply with a global “turning point in economic development”, when stocks of

surplus labour in developing (by then encompassing underdeveloped) countries were exhausted. The turning point in the global labour market would accelerate the euthanasia of the rentier if it had not already occurred.

This emergence of abundance and increased equity in income distribution is now no less certain and no more distant for the world as a whole than it was in the 1930s for the developed countries alone.

Of course, anything that blocks the maturation of modern economic development also blocks the decline in returns to capital and increase in returns to labour. There are many candidates. A failure of the political systems of developed countries to adjust to the changing challenges of modern government would destabilize the whole structure of modern economic development. The miring of major developing economies in a “middle income trap” would halt the process.

Most damaging of all, the failure of most of the Bottom Billion to join modern economic growth could trap humanity in a Malthusian bog, with success in developing countries not being reflected in a reduction in the number or even the proportion of humans living in poverty. Developed world dreams of isolation from the health, security and economic consequences of failure of a major part of humanity would be illusory. In the modern world of intense global interaction, international cooperation on securing order and establishing foundations for development in the Bottom Billion is one of several international public goods that are essential to the maturation of global development.

None of this is to say that the current period of growing inequality in the old democracies does not matter. For ordinary people in developed countries, the prospect of waiting several generations for the reversal of recent declines in income shares and in some cases real living standards is an unattractive prospect—whatever the prospects for their grandchildren. The prospects of democracy everywhere will be damaged if it is discredited in its early homes.

Making the most of the substantial opportunities allowed by the modern global economy to raise living standards of ordinary citizens in developed countries without damaging global development itself will be important for the maturation of modern economic development as well as for political and economic success in the developed countries themselves. Success in the open societies requires the application of sound economic analysis—economic rationalism—to policy choice. It requires the shifting back of the balance of influence in policy-making to a strong centre of the polity, independent of vested interests and partisan politics. The closed societies seeking to implement policies for the people have other options.

Application of rational economic analysis to policy choice will be contested by established business interests. The rentier will not quietly accept modifications to currently highly favourable arrangements. Indeed, she and he will be exerting all of their considerable influence against policy reform.

The larger owners of capital will seek to change policies to hold up the return on capital after tax in the face of powerful tendencies for it to fall. This is where Picketty's story of money distorting democratic processes in the late twentieth and early twenty first centuries assumes great practical relevance. Falling returns to capital encourage pressures for lower tax rates on capital and high

incomes; for privatization of community and public assets whether or not there is economic justification in particular cases; for resisting regulation of business in the public interest; for turning competitive markets into monopolies; and for extension of changes in law and culture that have led to the explosion of executive remuneration in the early twenty century.

The continuation of modern economic development to its maturation also requires effective provision of a range of other international public goods. In the world of global capital markets, international cooperation on the taxation of capital income will be necessary for maintaining a domestic distribution of income that is consistent with democratic success. The sharing of tax information is a first step. That protection of the historical national tax base is an important focus of the G20 meeting in Brisbane in November shows that there is at least growing awareness of the issue.

The large countries working together against avoidance of taxation on internationally mobile capital could fundamentally change the outlook for inequality in the developed countries. Working together would involve use of political and economic weight against free-riding smaller countries—Luxembourg, Ireland, Switzerland and Singapore all come to mind. The biggest barrier to success will be the influence on domestic policy-making processes of business interests everywhere that stand to lose from effective action.

Our Chair this evening will support my contention that effective cooperation in avoiding dangerous climate change is a necessary condition for the maturation of economic development.

We have learned a great deal about international cooperation on the mitigation of climate change since the disappointment at Copenhagen five years ago. Assessments of the costs of reducing emissions are now much lower than they were in 2009, principally as a result of large-scale Chinese manufacturing of capital goods for all of the low-emissions technologies. More sophisticated understanding of the relationship between economic growth and reduction of emissions is recognizing more completely the costs of fossil energy systems.

The world's two largest emitters of greenhouse gases are taking strong action after sitting on the sidelines until 2009. China is now leading the world in deployment of low-emissions energy technologies and seeking to do as much with transport. The United States is making headway towards meeting ambitious emissions reduction targets for 2020.

There has been a realistic downgrading of the prospects for a single, legally binding climate treaty. In its place is what I call “concerted unilateral mitigation”, within which each country makes strong domestic political commitments in support of undertakings to the international community. This can be effective if all substantial countries participate strongly. Most but not all substantial economies are raising their efforts. A couple, notably Canada and Australia, are going backwards. Australia was taking effective action to reduce emissions until the past year, but is now in disorderly retreat.

#### Concluding Remarks From the Western Pacific

Many of the questions about where our political and economic systems are taking us that were discussed by Keynes, Hayek, Schumpeter and Popper seventy and eighty years ago have been answered by experience. The central planning that Hayek thought would be the road to serfdom,

that Schumpeter thought might possibly be made to work within a democratic framework and that Keynes never took seriously is dead and gone.

So is the traditional capitalism and associated business-dominated democracy that Schumpeter liked but thought would die. However, grotesque mutations of Schumpeterian ideas on democratic capitalism live on. Their revival in the late twentieth and early twenty first centuries as libertarian ideas for deregulation, especially of finance, and lower taxation, have created large problems for managing modern economic systems. The mutations turn Schumpeter's support for unbridled competition and creative destruction on its head by preserving and extending monopoly. Schumpeter always saw the potential for money corrupting democratic policy-making and he would recognize his fears in recent developments.

Keynes and Popper would not be surprised or terribly uncomfortable with the rather messy social democracy which has emerged in all of the open societies. Keynes would be telling us that we were wasting a lot of our state intervention on matters that could be left alone, and neglecting other interventions with the potential to contribute more to the public interest.

Hayek would think that government had strayed too far. But he would have to acknowledge that the path to which the developed countries had strayed was not towards serfdom—on this matter, at least.

All of the big minds on Capitalism, Socialism and Democracy from the thirties and forties would have been amazed by the successful emergence of China as the largest economy in the world, and of Indonesia as a democracy with a dynamic economy. The extension of modern economic development to the large countries of Asia in the last quarter of the twentieth century is the most important development in the global economy since the beginning on this island a quarter of a millennium ago.

Where does China's Platonic market economy go next? If Ji Xinpeng succeeds in cleaning the Augean stables, a barrier will have been removed from the emergence of China as a developed economy. That must be the more likely if not certain outcome. If he fails, we can expect disorder that is deeply disruptive outside as well as inside China.

There is a widespread view in the West that the emergence of a developed market economy will be accompanied by movement towards democratic capitalism. A successful China will be home to continuing change in political structure that brings wider personal freedoms that are valued by the people. But will it be change in the political superstructure that people in the West would call "democratic"? Continued success in raising material standards of living, continuing the reversal of the early twenty first century increase in inequality, allowing people to travel across and between the great cities rapidly and in comfort, cleaning the air and leading the world's mitigation of climate change will all give the Guardians more time and options.

But the large numbers of young people on the Hong Kong streets over recent weeks tell us that these are not the only things that will count. The young people's slogans were directed against a power elite that encompassed the Communist Party leadership in Beijing and the business leaders of Hong Kong. Their elders urged caution. The young people who have been on the streets will still be here tomorrow but their elders will not.

Events will force responses to pressures for political change from time to time and the ideas of the Guardians at those times will be one of the influences on events.

Continued success in China as a Platonic market economy will be influential in the developing countries in which political structures remain open to debate and transformation. So will success in the democratic capitalist countries in cleaning out their own Augean stables and restoring the inclusive growth that won the Cold War in the second half of the twentieth century.

Large numbers of Indonesians are deeply committed to their democracy and excited by their choice of a new President from outside the old elites. But they fear that money and the forces of the closed society will find common cause and take it away. Current discussion of limits on campaign funding and introduction of public funding of election campaigns are on the front line of the defence of the open society in Indonesia.

Australia is also at an historic point on the future of capitalist democracy.

Corporate money has played a direct role in Australian policy-making and electoral competition over the past half dozen years in a way and on a scale that has no precedent. Climate change mitigation is simply the most important of the issues on which this has had important effects.

In the 2013 election, the Palmer United Party took the new political culture to new depths. Of deepest concern, the general polity accepted with little demur the party's deciding votes on carbon pricing, with little regard for the most naked of conflicts of interest.

There is one source of hope. The most populous state, New South Wales, has an Independent Commission Against Corruption with considerable powers and capacities. It began an investigation into corruption in allocation of coal mining leases a couple of years ago. One piece of information led to another, until a vast web of dubious including some probably illegal transactions and relationships had been revealed across the partisan political divide.

The good news for Australian democracy is that what had become common practice amongst major parts of the political and business elites of Sydney was rejected powerfully by the community as soon as it was brought into the public view. The elected Premier and several Ministers have resigned, and a dozen members of the governing parties have moved to the cross benches. The new Premier, himself clear of any allegations of foul practice, has announced his intention to legislate to ban corporate and trade union and to limit personal donations to political parties and to fill part of the void by increasing public funding of parties.

The success of Premier Baird's proposed reforms would be an important step towards reviving a democratic political culture in Australia after a difficult period. It will be resisted strongly by the established power elites which have done well out of the deteriorating status quo.

So in Australia as well as Indonesia and China, the influence of vested interests in the policy-making process has emerged as the most important battleground over which the future of Capitalism, Socialism and Democracy will be fought. This seems less grand than the clash of ideas involving Keynes, Hayek, Schumpeter and Popper, or before that of Reeves and Shaw and the Webbs, or earlier still of Lincoln at Gettysburg.



Maybe it is less grand. But it will be no easier to win than old battles for democracy. And what is at stake is as grand as anything ever was. Such simple things will determine whether Government by as well as of and for the people will be the main vehicle on which we travel to the maturation of modern economic development, or perishes from this earth.

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