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CURRENT TRAVAILS OF GLOBALIZAING CAPITALISM

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I first met Gottfried Haberler when I was a young official at the World Bank in Washington, on leave from University College, London, in the late 1970s. He and his wife became close friends, and I looked forward to our lunches at the American Enterprise Institute (which included William Fellner) as a classical liberal antidote to the daily *dirigiste* discourse at the World Bank. In 1983 I returned to the World Bank as the Research Administrator in Anne Krueger's new research vice-presidency, seeking to steer the Bank's thinking into more market oriented lines. This was the time when the 80s Third World debt crisis was in full flow. I was asked to do the first part of the 1984 World Development Report with Martin Wolf, on the global economy. We commissioned a number of background papers, one of them by Gottfried on "The slowdown of the world economy and the problem of stagflation", which were published in a book Lal and Wolf (1986). Reading these papers and looking back at that first global financial crisis today, with the world embroiled in another crisis, the parallels are more striking than the differences.

First, both in the 1980's and in today's sub-prime mortgage triggered financial crisis, the crisis arose because there was a surplus of savings in a number of countries which was recycled through the international banking system, to maintain world aggregate demand. Second, highly liquid banks funneled cheap credit to borrowers who were not creditworthy by any prudential standards: the fiscally challenged and inflation prone countries of Latin America and Africa in the 1970s, the *ninja* (those with no income, no jobs, no assets) sub prime mortgagees of the current crisis. Third, there was a rise in commodity prices and a worsening of the terms of trade of the OECD. This posed the dilemma of stagflation for their central banks, having aided and abetted the earlier asset boom. Fourth, the imprudent banks sought bail outs from taxpayers, claiming their demise would fatally damage the world's financial system. *Plus ca change*.

So, in this conference to honor Gottfried, I thought it best to outline the lineaments of the current global financial crisis (part 1), to show how many of the purported cures are likely to be worse than the disease (part 2), and then in the final section (part 3) show how these are part of a continuing covert attack on globalizing capitalism, when the overt attacks in favor of full blooded *dirigisme* have become unpersuasive, with the implosion of the countries of 'really existing socialism'. .

I

THE CREDIT CRUNCH

There are ominous parallels between the US of the 1920's and today. A Gilded Age, with a boom in house prices and the stock market, followed by a threat of bank collapses associated with a softening in the housing market, pressure on the dollar and a rise in protectionist and isolationist sentiments. Are we on the verge of another Great Depression?

The origins of the current crisis in credit markets lie in the "Greenspan put" after the stock market dotcom crash in 2000 and the terrorist attack of Sept. 2001. The rising trade surpluses and foreign exchange reserves of many Asian countries trying to self-insure against a repeat of the 1990's Asian crisis, as well as of the oil exporting countries following the recent rise in oil prices, were recycled -primarily to a US running historically unprecedented trade deficits- resulting in low real interest rates.. These, in turn, led to booming asset prices, particularly for real estate, and to financial innovations which are the proximate cause of the current crisis.

Structural changes in the financial system have also contributed. These entailed the conversion or absorption of non-bank financial institutions specializing in financing mortgages (savings and loan (S&L) associations in the US and building societies in the UK) by commercial clearing banks, which in turn had absorbed or taken on the roles of specialized investment banks. The effect was to blur the distinction between what were previously non-bank financial institutions and banks. This distinction is important because it is only clearing banks which can add to (or reduce) the stock of money.

A clearing bank holds deposits in cash (legal tender base money) from non-banks, repaying deposits in notes, and making payments for depositors by settlements in cash through an account in the central bank. When a clearing bank extends a loan it adds to its assets and simultaneously creates deposit liabilities against itself, increasing the broad money supply at 'the stroke of a pen'. This ability to create money 'out of thin air' is limited by the bank's capital and cash. As cash can be borrowed from the central bank, the ultimate constraint on its ability to create money is its capital. But it is only because banks take in cash deposits - Keynes' 'widow's cruse' - that they can create money.

By contrast, a non-bank financial intermediary, say a mortgage lender, when it takes deposits or makes a mortgage loan has to 'clear' these through deposits held at the clearing banks. Thus when someone deposits 'cash' at an S&L this comes out of the depositor's bank account with a clearing bank. Similarly when the S&L makes a loan to a mortgagee this comes from the S&L's bank account with a clearing bank.
Thus the essential difference between non bank financial institutions and clearing banks is that the former cannot create the bank deposit component of broad money (M2 or M4).

With the blurring of the historical and institutional distinction between mortgage lenders, investment banking and clearing banks, and the loosening of monetary policy following the 'Greenspan put' which led to large increase in house prices, bank absorbed mortgage lenders went on a lending spree. In California they were in caravan parks extending loans to the *ninja* (those with no income, no job, no assets) at low 2 year teaser rates which even members of the 'underclass' could pay, with the high hope of getting enough equity in their new homes with rising house prices to sell before the teaser rate ended. These sub prime loans were then repackaged by the financial wizards in the investment banking parts of the clearing banks into opaque financial products, which were then sold off to financial institutions and other banks around the world. This Ponzi scheme depended upon a continued rise in house prices and low interest rates..

With monetary tightening in 2006-07 and the softening of the US housing market, the Ponzi scheme collapsed. The *ninja* could no longer pay and walked away from their sub prime mortgages. This would not have mattered, as the *ninja* never expected to own a home, and some probably got some equity from sales before the housing market collapsed. If the sub prime assets had been held by the specialist S&L of yore, their shareholders would have taken the necessary hit. But the financial 'masters of the universe' had packaged them with various other financial assets, and these were now spread through the world financial system. It was like a piece of infected meat having been processed with healthy meat into infected meat pies which could not be distinguished from the wholesome. Many of these infected meat pies were held in off balance sheet structured investment vehicles (SIVs) by the banks.

When credit market conditions tightened in May 2007 and the sub prime mortgage market collapsed, the opacity of many of the financial assets in these SIV's meant that they could not be sold on, and had to be taken on to the bank's balance sheets. To balance their books the banks had to find liabilities to balance these new found assets. The liabilities of banks' comprise their shareholder capital and deposits. With their share prices falling and economies slowing, capital is hard to get, except for those like Citigroup and UBS able to 'touch' rich emerging market investors.

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The final element in the crisis is Basle II. This requires banks to maintain a capital ratio of 8 per cent (of assets). With limited hope of raising capital this cannot be done without cutting back on their lending, and thence a contraction in the broad money supply- the major cause of the Great Depression. Central Banks have tried to avert this by the coordinated addition of massive liquidity into credit markets. This has failed to increase inter bank lending or to substantially reduce the spread of LIBOR over their lowered discount rates. The banks are still hoarding cash and refusing to lend to each other. Their problem is to continue to achieve the Basle II capital ratios, which requires a massive contraction in lending and thence broad money. As many commentators are now urging, and as the Bank of England has hinted, these Basle requirements need to be reformulated to alleviate the credit crisis of Western banks. This should avoid another Great Depression.

But, why did Western banks, particularly those in the US, undertake this imprudent lending? An anecdote might help. In the run up to the Asian financial crisis, a former student (not by any means the brightest) who had joined a Wall Street investment bank in the 1990's, rang me to thank me for having given him a reference for what had turned out to be an excellent job. He said he had just received a very large bonus for doing one of the simplest jobs imaginable. He had been put on the Thai desk to trade in the country's bonds. This job he said was a no-brainer. Given the interest differential between Thai bonds and US interest rates all he had to do was to buy Thai bonds and earn a tidy arbitraging profit for the firm. When I asked him if there wasn't a risk that the *baht* might be devalued, he said that was a minor risk as the Thai government (and with implicit IMF support) was committed to a fixed exchange rate. Of course, the *baht* was devalued. I only hope he unwound his Thai bond positions before then, but I have not heard from him since!

This example illustrates the problem of perverse incentives in the current global banking system, which has led to a number of global financial crises caused by imprudent bank lending. The 1980's debt crisis was due to the imprudent sovereign lending by offshore branches of Western money centre banks (of their deposits of OPEC surpluses) to fiscally imprudent Third World countries, at negative floating interest rates. The Asian crisis of the 1990's and the linked LTMC crisis were caused by imprudent lending based on bankers gambles on the non -occurrence of low probability events (changes in exchange rates and/or interest rates). The current sub prime mortgage crisis which resembles the Third World debt crisis of the 1980s, in so far as in both cases abnormally liquid banks funneled cheap credit to borrowers who would never have been considered to be credit worthy by any standard of prudence. In all cases this imprudence ended in tears, particularly for the many innocents caught by the subsequent real adjustments that had to take place in the effected economies. But most bankers, like my former student, in the good years when the money was being shoveled out had received large bonuses which more than made up for any temporary loss they may have suffered when their gambles turned sour and they were sacked- only to be rehired by someone else when the next manic banking spree started. Clearly there is some systemic fault running through the world's banking systems.

The former economic counselor at the IMF, Raghuram Rajan, has suggested (in *Financial Times*, 9 Jan 2008) that the system of annual bonuses by which traders are compensated needs to be changed. For these rewards provide an incentive for traders to gamble on events in the tail of the probability distribution of risks. Until these low likelihood events occur, their gambles seem to pay off, allowing them to show higher returns than the market average, and thereby earn large annual bonuses. By the time the low probability event occurs, leading to losses, they have already taken their bonuses and run. Regulation of traders' remuneration packages is then recommended. But this form of 'incomes policy' only makes sense if the high risk trading activities actually damage the financial system. Currently there is a danger. But only because the previously separated activities of commercial and investment banking are now combined along with mortgage lending in 'universal' banks. As the traders' activities can effect the balance sheets and thereby the 'money creating' (or destroying) activities of the 'clearing bank' bit of the consolidated 'universal' bank, they can effect the overall monetary system.

This could be avoided even in universal banks, if the depositors in their 'clearing' component had to bear the risks of the gambles being taken by the 'investment' or 'mortgage' components of the bank. But though this discipline on reckless lending did exist in the free banking period in Scotland and the US in the 19th century, today the deposit insurance which is ubiquitous, and politically impossible to rescind, precludes this method of avoiding moral hazard.

One of the complementary laws, passed along with the creation of the FDIC in the US during the New Deal, was the Glass-Steagall Act of 1933. This separated the investment and commercial halves of the banking industry, to prevent the speculation by the former 'universal' banks which had contributed to the collapse of broad money during the Great Depression. With the financial 'Big Bang' in London in the early 1980's and the repeal of the Glass-Steagall Act in the US in 1999, the banking industry reverted to the universal banking of the earlier era.

This 'deregulation' was justified by monetary theorists, beginning with Gurley and Shaw and culminating with Eugene Fama, who argued that there was no real distinction between clearing banks and non-bank financial intermediaries. This, illegitimately removes the crucial distinction between deposit taking banks which can create money out of 'thin air' and deposit taking non- bank financial intermediaries like mortgage lenders, which can't.[1]

The collapse of Bear Sterns and the US Fed's bail out in March, has been followed by the Fed acquiring the authority to regulate investment banks in the same way as it does commercial banks, thus placing US taxpayers resources behind investment banks in the same way as it does through its lender of last resort facilities behind deposit taking commercial banks. As many commentators have pointed out this is misguided. Alan Meltzer, the historian of the Fed, has noted the institution's sorry record as a supervisor and regulator. The Fed ignored warnings about the risky housing loans banks were keeping off their balance sheets. In both the savings and loan crisis in the 1970s, and the Latin American debt crisis of the 1980's, the US Fed has connived with banks to hide their losses until virtually all their capital disappeared. The FDICIA passed by Congress in 1991 to regulate commercial banks, argues Meltzer, should be extended to investment banks. "Since investment banks mark their portfolio to market every night, all Congress has to do to keep them in line is set a minimum capital standard. If an investment bank is unable to borrow enough to balance daily with its capital intact, it should become subject to the FDICIA rules…These require reduction or elimination of dividend payments when capital is impaired, followed by a temporary takeover by a regulator if capital continues to fall. Management would be replaced and stockholders would bear the loss. This rule goes a long way to discourage excessive risk-taking and moral hazard".[2]

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[1] See T. Congdon (2007) for an elaboration and discussion of the baneful effects of dethroning the pivotal role of broad money- including bank deposits- in determining macro-economic outcomes.
[2] A. H. Meltzer (2008).

But, I wonder if this will be enough. What is needed is to go back to the future: the commercial deposit taking role of banks which effects broad money, once again, needs to be separated from the investment banking and mortgage lending of the financial system. True banks and hence the macro-economy can then be protected from the imprudent gambles which no doubt will continue to be taken by the masters of the universe in the newly restored and distinct non-bank financial intermediaries- but they will then be gambling with their own and their clients' money and not those of taxpayers.

II

FALSE REMEDIES

With the recent actual or near collapse of many Western banks and companies as a result of the credit crunch, the massive severance packages that the failed executives have nevertheless walked off with (eg. most recently the sacked CEO of AIG got $35 million having overseen $30 billion credit-related write downs and losses), added to the scandals following the dotcom boom (of which Enron was emblematic) seems to have led many to question the very basis of Anglo-American capitalism. Instead of being agents creating shareholder wealth, the corporations at the heart of this form of capitalism seem to have become instruments for enriching their managers by bilking their owners- shareholders. How has this come to pass, and does it mark the beginning of the end of this form of capitalism, as governments bring in new regulations to stem growing public anger? Do these travails provide a justification for the alternative stakeholder form of capitalism pioneered by Germany and Japan?

In the Anglo-American model of managerial capitalism, the separation of ownership (by a large number of shareholders) and control (by a small group of managers) leads to the "agency" problem. The former are interested in maximizing the returns to their investment which arise from the firm's profits. The larger these profits, the higher the dividends paid out, the higher the return to the shareholders. Managers, though not indifferent to profits, would be more interested in using them for their own ends: paying themselves higher salaries and reinvesting profits in expanding the firm to acquire greater power and status.

Given their large numbers and the attendant problem of 'free riding', the principals (shareholders) will be collectively unable to monitor the actions of their agents (managers) to see they are maximizing shareholder value. It was the threat of hostile takeovers by 'outsiders' - hostile to the 'insider' managers of the company but friendly to its shareholders- which prevented mangers from bilking shareholders. A company not maximizing shareholder value would be in danger of being taken over by a corporate raider who offered to buy the company's shares at a premium. The existing management would be sacked. It is this market for corporate control in which 'outsiders' could challenge the incumbent 'insider managers' which controlled bad managers. Despite his malign depiction by Hollywood, Gordon Gekko is good for the market!

In the fairly unregulated market for corporate control in the 1950s-mid 60's, in hostile takeovers, U.S. share-holders received 40% over the pre-bid price for their shares. But, with the howl of protests from threatened insiders (managers) the US passed the 1968 Williams Act which removed the highly profitable element of surprise in hostile takeovers by making it more expensive for outsiders to mount a successful bid. But this did not kill hostile takeovers. A wave of them restructured US business in the 1980s. This led managements of the largest US corporations to petition State governments for protection from corporate 'raiders'. The legislatures and courts obliged, by allowing 'poison-pill' defenses against hostile takeovers, which declined from 14 % of all mergers in the 1980's to 4% in the 1990's. As friendly mergers began to predominate, the incumbent managers agreed to cede control in exchange for lucrative consulting arrangements, stock or stock options in the acquiring company, generous severance packages, and other bonuses. Unsurprisingly, executive compensation soared, as the costs of ousting incumbent managers rose with the restrictions on hostile takeovers. "Dollar for dollar, every increase in these costs could be claimed by the incumbent managers, either in greater rewards for themselves or in inefficient management policies." [3]

The rise in executive compensation from the attenuation of the market for corporate control was exacerbated by the double taxation of dividends. In both the US and UK, shareholder profits were first taxed through the corporation tax, and those paid as dividends were further taxed as part of the shareholder's income, reducing the post- tax return from holding shares in corporations. Most of shareholder returns were based on rises in share prices which in turn depended on reinvesting the company's profits in (hopefully) profitable investments. To motivate managers to take account of shareholders interests, their remuneration was linked to stock options. This gave both shareholders and managers a common interest in rising share prices, providing managers an incentive to manipulate their share priced through fraudulent practices (as shown up by the Enron and other scandals in the 1990's) and through taking high risk gambles with shareholder and depositor's money by the new 'universal' banks' in the current credit crisis.

The perceived ills of Anglo-American shareholder capitalism shown up by the dotcom bubble in the 1990's and the recent credit crunch- with their explosion of managerial remuneration at the expense of shareholder value- are not therefore a sign of some decrease in corporate morality, but due to the perverse incentives created for managerial 'rent-seeking' by regulations limiting 'hostile' takeovers, the unintended effects of fiscal policy through the double taxation of dividends, and the promotion of universal banking ,where deposit taking 'commercial' banking part of these institutions -which can 'create money'- is conjoined with the -gambling- 'investment' part. Removing these perverse incentives requires restoring the market for corporate control, removing the double taxation of dividends, and creating not merely a 'Chinese' but an actual wall between the commercial banks (with access to the lender of last resort facilities of the Central Bank) and investment banks. These would restore the Anglo-American model of capitalism which in its unfettered form has been a major engine of prosperity.

[3] H. Manne (2002)

One of the consequences of the excessive executive compensation, at the expense of the shareholder owners of corporations, is the worsening of income distribution. It has also meant the attenuation of an important feature of the Anglo-American form of capitalism. It has provided economic opportunities even for those without their own resources. It has enabled outsiders to challenge insiders, imparting the dynamism of the creative destruction involved in the most efficient deployment of an economy's resources. The US search funds which allow those without collateral or connections to finance their new ideas, are emblematic of the Anglo-American capitalist model. As the 'insiders' succeed in keeping 'outsiders' out through the political process, not only the efficiency but also the 'progressive' justification for this form of capitalism is threatened.

For, since the late 19th century it has faced competition from the corporatist 'stakeholder' model pioneered by Germany after its unification in 1871, and adopted by the reformers of the Meiji revolution in Japan. The major differences with the Anglo-American variety were, first, the toleration of cartels, as (following Fredric List) the nation rather than individuals was considered the basic economic unit, with industry required to serve the national weal. Second, there were incestuous relations between the industrial corporations and commercial banks. Third, German corporations had a two level system of corporate control: a management board for day to day management and a supervisory board consisting of various stakeholders: shareholders, banks, cartel members, local politicians and trade unions. Fourth, companies had to provide social insurance to their employees as well as 'co-determination', by giving them a formal voice on company boards.

The Japanese chose a variant of this stakeholder capitalism through the *zaibatsu.* These were conglomerates, which included banks and insurance companies, at whose center was a family-owned holding company, with other associated firms linked by cross-shareholdings and interlocking directorships.

After the war, the US tried to introduce more features of Anglo-American capitalism in the two countries. But both reverted to their older corporatist forms. The German 'social market' recreated Bismarckian corporatism, while Japan saw the *zaibatsu* reborn as the *keiretsu*. This model was exported to other Asian countries, most notably South Korea, whose *chaebol* was another form of corporatist capitalism. This is the so-called Asian model of capitalism. Variants are being adopted in the new form of 'authoritarian capitalism' evolving in both China and Russia.

Stakeholder capitalism was successful, as the countries adopting it were latecomers to industrialization, catching up with the industrial leaders in the UK and the US. Late developers with abundant labor can easily discern the initial industrial structure in line with their comparative advantage. It will consist of small-scale labor intensive industries which can be financed through the extended family or small partnerships, run by owner-managers. With growth and the shift of comparative advantage to progressively more capital intensive industries, families would not have the large amounts of capital required to establish such businesses and retain control, avoiding the 'agency' problems of managerial capitalism. This problem can be overcome by creating large concentrations of wealth or finding ways for some concentrated wealth holders- like rich families- to indirectly control enterprises run by managers.[4] The Indian managing agency system is an example of the latter path. It has resurfaced in a slightly altered from since the 1991 economic reforms.

In the countries of stakeholder capitalism, the financial institutions of the family owned conglomerates channeled the savings of the general public to their enterprises. This process was directed by the State as a major stakeholder, creating immense moral hazard. Neither the controlling family members, whose financial stake was diluted over time, nor the mangers or bankers found it necessary to undertake prudent investments. After the easy 'catch-up' stage of capitalist development, many bad investments were made leading to financial crises.

Thus in Japan, Aldo Ando[5]has calculated that, from 1970 to 1990, because of these bad investments, the Japanese corporate sector incurred capital losses of $405 trillion, with non financial corporations earning a rate of return of about 2.5 and financial ones 1.6 per cent. Japanese households having cumulatively saved $1250 trillion (in 1990 prices), found they had suffered a real capital loss of $389 trillion. Thus an ageing population found that its stakeholder capitalism lost 31% of its lifetime savings over 30 years. No wonder the aged Mrs. Watanabe continues to save rather than spend to see her through an uncertain old age. A generation which propelled the Japanese miracle, after war time destruction, finds its hopes along its savings turning to ashes.

What then explains the undoubted economic success of the countries adopting corporatist, stakeholder capitalism? A neglected study of the comparative growth experience of OECD countries by Maurice Scott [6]shows that the Japanese growth rate of 9% between 1960 and 1973, and the German rate of 6% between 1955 and 1962, can be explained entirely by the investment rate, the growth of the quality adjusted labor force, and a catch up variable. The stakeholder model of capitalism had little to do with it. But their subsequent decline in growth and their continuing economic stagnation is due to the rigidities and inefficiencies in their labor and capital markets caused by the stakeholder model. Reluctantly, along with other adherents of the "Asian model", they are moving towards the shareholder model of the Anglo-Americans.

India has combined 'owner-managers' in its large business houses, with its legacy of the institutions of Anglo-American capitalism. But the post Independence financial repression with the nationalization of banks, prevented the free entry into the capital market that is the hallmark of Anglo-American capitalism. Today, by allowing hostile takeovers, completing the privatization of banks, and ignoring the proponents of stake-holder capitalism, India can repeat the dynamic capitalist growth which has been a hallmark of the Anglo-American capitalism over the last 200 year

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[4] See Lal and Myint (1994).
[5] A. Ando (2000). A. Ando (2000) : "On the Japanese Economy and the Japanese National Accounts" *NBER* wp. 8033, 2000 .
[6] M.Fg. Scott (1989)..

III

"CAPITALISM WITH A HUMAN FACE"

There is another movement which I label the *New Dirigisme*, which seeks to reform Anglo-American capitalism, in the name of freedom and justice: to create 'capitalism with a human face'. This has created many clouds on the horizon.

The first is 'corporate social responsibility'. Various activists have been successful in persuading many people and corporations in the previous citadels of Anglo-American capitalism that corporations have a social responsibility to pursue “sustainable development”. Others no doubt at this conference will address the vacuous notion of 'sustainable development'[7]. Though this corporate social responsibility is not as yet being legislated in the bastions of Anglo-American capitalism there are clearly pressures to do so. This would create a moral version of stakeholder capitalism with dire results. For, as David Henderson (2001) has shown in his devastating critique of this program of what he labels the “global salvationists,” the objectives to be subserved are unclear, the means to do so and judge their success even more so. As long as the pursuit of this moral agenda is not made compulsory in the Anglo-American share holding countries -- as the stakeholder form of capitalism was in Germany and Japan -- then, as this form of capitalism is compatible with a thousand flowers blooming, companies which favor the corporate social responsibility agenda will have to compete with those interested in the traditional objective of maximizing shareholder value. If shareholders prefer “ethical” companies irrespective of their relatively poorer earnings (as they serve many other gods besides profits), they will bid up their share price relative to their earnings. If not, their share price will decline compared to their more politically incorrect peers, with the consequent threat to their future survival. This has already happened to some of the firms and funds which have adopted this moral stance. Thus in the recent stock market bear market, the ethical mutual funds which eschewed holdings of tobacco stocks on ethical grounds have found that their performance has been worse than their more economically hard headed peers, as tobacco shares proved more resilient to the downturn than other stocks. Similarly Levi Strauss which created the denim jeans, embarked under its CEO Robert Haas on what has been described as “a failed utopian management experiment” in which it “was intent on showing that a company driven by social values could outperform a company hostage to profits alone”. The outcome was declining sales, profits and share value. As Nina Munk (1999) entitled her article this was “How Levi’s Trashed a Great American Brand”.

The second form the 'new dirigisme' has taken is adopting various forms of moral paternalism. This has a long lineage in social democratic thought. One clear exposition was by the distinguished Oxford legal theorist and philosopher Herbert Hart (1963). .

[7] My discussion in in Lal (2006), chp.8.

Whilst upholding Mill's principle of liberty that, an individual is at liberty to undertake feasible actions if they do not harm others, allowing him to favor every consensual private sexual activity, Hart abjures the classical liberal case against moral paternalism, on the specious grounds that individuals are not really free to choose. So while permissiveness is legitimate, all forms of paternalistic supervision or coercion are needed to ensure that individual choices are in fact freely made. As these choices are supposed to be psychologically determined it also becomes imperative to exercise thought control: to make "windows into men's souls". This is not classical liberalism but the route to 1984 and Big Brother, and classical liberals would eschew this moral paternalism however politically correct it is currently.

This moral paternalism is also being fed by the so-called "communitarians" whose leader is the sociologist Amitai Etzioni. His themes have been taken up by politicians of the "Third Way" like Tony Blair and Bill Clinton. The notion of "social capital" has also been developed in support of these views, most famously by the political scientist Robert Putnam. The third way politicians were searching for floating voters "who liked lower taxes and limited government but were put off by the celebration of egoism in the Thatcher-Reagan years. Community and its attendant watchwords -- voluntarism, civic virtue and neighborly responsibility -- arrived like a gift to politicians trying to "redefine" government."[8] Social ills from poverty, street crime, vandalized urban housing, and urban anomie -- epitomized by the title of Putnam's article and book *Bowling Alone* -- were seen as the results of an" erosion of community and the running down of social capital.

Communitarinism is a broad church, which in part recognizes the demoralization of Western society. But unlike classical liberals, instead of emphasizing the role of tradition in socializing the young in a morality which provides the cement of society, communitarians want the State to enforce a form of moral paternalism. "A skeptic about the movement once joked that communitarians want us to live in a Puritan Salem but not believe in witches."[9] Having eschewed a morality based on religion or tradition, and also -- with the rise of Freudianism -- the use of the moral emotions of shame and guilt in the socialization of children, the only instruments left to communitarians to reverse the demoralization of Western society are exhortations or the enforcement of morality by the State.

Not surprisingly, therefore, it is the proponents of the Oakeshottian "enterprise" view of the State [10]-- Fascism and Catholic corporatism -- which have upheld the claims of the "community" against the individual .For communitarinism is a philosophy which believes that there is a common good which resides in the national community. The State can override individual liberties to subserve this common good. Moral paternalism by the State is therefore justified. For, on this view, the community is indivisible, needs to speak with a single voice, and adopt a uniform line of conduct. Dissenters must be silenced or

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[8] Fawcett (2004), p. 23

[9] ibid

[10] See Oakeshott (1993), who distinguishes between the two views of the state: the state as an 'enterprise' association and that as a 'civil' association. The former view, which has its roots in the Judaeo-Christian tradition, sees the state as the manager of an enterprise seeking to use the law for its own substantive purposes, and in particular the legislation of morality. The civil association view of the State which goes back to ancient Greece sees it as a custodian of laws that do not seek to impose any preferred patterns of ends, but which merely allows individual's to pursue their own ends.

"reeducated" to conform to the views and behavior of the community. It is Mao's Cultural Revolution. It is a profoundly illiberal philosophy which seeks to extend State power into numerous private spheres where on classical liberal principles the State has no right to tread. This does not mean that communitarians are not right to diagnose the disease as the demoralization of society. It is the proposed means -- a further extension of the State into what were hitherto private spheres -- which are in question.

Nor is the notion of "social capital", which provides a technocratic gloss to this illiberal creed, any more cogent. As, both the economist Nobel Laureates, Kenneth Arrow and Robert Solow have argued, an essential element in the notion of capital is that it implies the deliberate sacrifice in the present (usually designated as "consumption foregone" by economists) for future benefits (consumption). The type of "social networks" emphasized by theorists of "social capital" as its main component, are often built up for non-economic reasons and may not involve any foregone consumption. "People may get jobs through networks of friendship or acquaintance, but they do not, in many cases, join the networks for that purpose."[11] What the proponents of "social capital" seem to be after are good behavior patterns which lead to trust and thence the lowering of the policing type of transactions costs which effect economic performance. But this was precisely the role of cosmological beliefs or "morality". To put this into a meaningless concept of "social capital" shows at the least a certain maladroitness, but even more importantly the reluctance to face up to the factors which have led to the demoralization of the West.

The romantic critique of capitalism has also had one other refrain. Capitalism breeds unhappiness. Many, from Marx to Etzioni, have seen this leading to immanent trends for capitalism's self-destruction.[12] But as Robert Lane has rightly noted "Given the thriving economic success of the U.S. version of individualist capitalism at the end of the twentieth century, there is an anachronistic quality to these accounts of capitalism's tendency to destroy itself. It is the theories of immanence and not capitalism that seem to destroy themselves."[13]

Recently many economists and politicians embraced this "happiness economics". In the UK, Tony Blair's Policy Unit took it up , and David Cameron the Tory leader has proclaimed that "gross national well being" (GWB) should replace GDP as the policy

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[11] Arrow (2000), p. 3. Solow (2000) also asks pertinently: "Just what is social capital a stock of? Any stock of capital is an accumulation of past flows of investment, with past flows of depreciation netted out. What are those past investments in social capital? How could an accountant measure them and calculate them in principle? I am not worrying about where the numbers would come from, I am wondering about what instructions you would give a search party." (p. 7)

[12] Thus Etzioni (1988) states: "The more people accept the neoclassical paradigm as a guide for their behavior, the more the ability to sustain a market economy is undermined." (p. 251) While in their Communist Manifesto, Marx and Engels (1848) maintain: "What the bourgeoisie, therefore, produces above all are its own grave diggers." (p. 12).

[13] Lane (2000), p.327

goal. Whilst the Labour peer Richard Layard has written an influential book *Happiness: Lessons from a New Science.*

Ever since Bentham sought a happiness meter to measure the pleasures and pain which would allow his Utilitarian calculus to be put to use for public policy, many economists of a *dirigiste* disposition have sought to create a quantitatively informed Brave New World. But lacking a happiness meter they had to fall back on basing 'happiness' on the satisfaction of individual desires, as revealed in actual choices in the market place. Hating the recent victory of the market over the plan and the great material prosperity it has engendered, the new *dirigisme* is seeking to replace the quantitative measures of this prosperity provided by GDP, by purportedly 'hard' measures of subjective well being, provided by the cross-country and cross-cultural data from the *World Values Survey*.

There are serious methodological problems with this data and the inferences that some happiness researchers have drawn, which Helen Johns, and Paul Omerod[14] show are far from robust. Many variables like longevity, crime, and unemployment, which would commonly be expected to increase a country's well being do not seem to effect the happiness indices. What the happiness research finds is that, on its measures of *reported* subjective happiness there is a moderate positive correlation with per capita income (in PPP $), which is strongest with countries with a per capita GNP up to $10,000 (in 1995). “There are no rich countries where people’s happiness, on average is low. But, for the rich countries, it does not seem that higher per capita income has any marked effect on happiness.”[15]. This is hardly surprising, because real income is likely to be only one element in a person’s happiness, and as economic theory postulates diminishing marginal utility from increased income (consumption) we would expect rich countries to have reached what Frank Ramsey postulated as the “Bliss” level of utility. But, as the data refer to 'reported' rather than 'actual' happiness, even this inference is insecure. Happiness economics has also tried to econometrically estimate the determinants of “happiness”, and to argue that the standard microeconomics of utility theory need to be revised. These byways need not detain us.

More serious are the implications various dirigistes have drawn from this line of research. Some[16] have argued that the estimated “happiness functions” provide an approximation to the social welfare function- which hitherto had been a merely theoretical construct of modern welfare economics- yielding the optimal values of its determinants which public policy is then expected to implement. But this raises Arrow’s famous Impossibility Theorem, which showed that under a set of “reasonable assumptions” it was not possible to aggregate individual preferences into a social welfare function which consistently ranked outcomes: something which a dictator would obviously be able to do, and a role these social planners hope to fill!

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[14] Johns and Omerod (2007).
[15] Frey and Stutzer (2002).
[16] See Di Tella, McCulloch and Oswald (2001)

The other implications are more disturbing. The rat race for social status is deemed to increase unhappiness requiring heavy taxation of the winners. As working too hard is a source of unhappiness, work should be taxed more heavily. So that people substitute leisure for work at the margin -- something the French government has imposed by fiat with its statutory reduction of the working week with no apparent improvement in happiness to offset the obvious losses in economic output.

These complaints about the psychologically dysfunctional effects of capitalism confuse questions about how best to make a living (material beliefs), with those concerning, in Plato's words, "how one should live" (cosmological beliefs)[17]. Capitalism provides a new and highly productive way of making a living. Whilst the social ills adduced to capitalism, like the decline in family values and companionship, have less to do with capitalism than individualism. It is the demoralization of their societies rather than the instrument of their prosperity -- capitalism -- which is to be blamed for the social ills cited by the "happiness researchers".

This would not have come as a surprise to the sages of the Scottish Enlightenment. Discussing happiness in his *Theory of Moral Sentiments*, Adam Smith wrote: "Happiness consists in tranquility and enjoyment. Without tranquility, there can be no enjoyment; and where there is perfect tranquility there is scarce any thing that is not capable of amusing. But in every permanent situation, where there is no expectation of change, the mind of every man, in a longer or shorter time, returns to its natural and usual state of tranquility. ...The great source of both the misery and disorders of human life, seems to arise from overrating the difference between one permanent situation and another. Consider the ... conduct of almost all the greatly unfortunate, either in private or public life, ... and you will find that the misfortunes of by far the greater part of them have arisen from their not knowing when they were well, when it was proper for them to sit still and be contented. The inscription upon the tombstone of the man who had endeavored to mend a tolerable constitution by taking physic; "*I was well, I wished to be better; here I am"*; may generally be applied with great justness to the distress of disappointed avarice and ambition."[18]

Thus it is the pursuit of the classical virtues that led to happiness. The Scottish sages never believed, not should their classical liberal followers, that material prosperity is necessarily the route to happiness. This is of course the truth recognized by the various Eurasian religions, for whom their respective codes of conduct and the virtues they propagated were the very cements of their society that were assumed to promote happiness. Thus my conclusion that the complaints about the unhappiness that capitalism has caused are better addressed to the causes of the West's demoralization (the course of its individualism) than the instruments of its prosperity (capitalism).

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The final, and most recent strand has been labeled 'libertarian paternalism' by its progenitors, the behavioral economists, Richard H. Thaler and Cass R. Sustein (2008).

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[17] See Lal (1998) for a fuller discussion and cross- civilizational application of this distinction in explaining the role of 'culture' in economic outcomes.

[18] Smith (1759/1982) pp. 149-50.

Based on the findings of psychology, behavioral economists have found many anomalies in the standard economic model of individual's maximizing utility subject to the usual budget constraints. The centre piece of these findings is the problem of self control, or *akrasia*, as the Greeks called it. A divided self is postulated with the short term myopic self being tempted not to act in the interests of its longer term rational self. Just as Ulysses tied himself to the mast to prevent his destruction by the voices of the Sirens, it is suggested that 'nudges' can help the far sighted Planner self "to promote your long term welfare…[which] must cope with the feelings, mischief, and strong will of the Doer [self], who is exposed to the temptations of arousal". (p.42).

They advocate paternalism because "of the false assumption that almost all people, almost all of the time, make choices that are in their best interest or at the least better than the choices that would be made by some one else. We claim this assumption is false" (p. 9). They are libertarian because instead of using coercion to force people to serve the long term Planner self, the public and private "choice architects" would merely use nudges to point people in the right direction as in the male urinals at Schipol airport in Amsterdam. These bear etchings of a black housefly, and an economist's "fly-in-urinal trials found that etchings reduced spillage by 80 per cent". (p.4). But as the economic journalist Tim Harford rightly remarked :" I am no more in favor of spillage than the man standing at the urinal beside me, but how is this libertarian paternalism? 'We recognize your right to wet your shoes, but in case that is not your objective we will structure your choice environment to help you"[19]

Some moral paternalists have even invoked Mill in their justification of paternalism in aiding the Planner of the divided self (eg Amartya Sen in defending the recent UK ban on smoking in public places). basing themselves on Mill's correct argument against a person's freedom to sell himself into slavery.[20] It has been argued, (eg. by Amartya Sen about smoking tobacco) that prohibition is justified on Mill's principles of liberty "as habit forming behaviour today restricts the freedom of the same person in the future".[21] But as I and others pointed out subsequently, this is a complete misuse of Mill's argument against slavery.[22] Mill's robust defense against bans on addictive substances like alcohol and opium, does not mention his argument against slavery as being relevant in any way.

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[19] T. Harford: " It is markets that nudge, not states", *Financial Times*, 22 August 2008

[20] namely that "the principle of freedom cannot require that the person be free not to be free. It is not freedom to be allowed to alienate his freedom" Ibid, p. 158

[21] Sen (2007).

[22] See D. Lal, "Mill would have been appalled at tax on risky, pleasurable activities", Letters, *Financial Times*, 15 February 2007. The best response to Sen's article was from Stuart Simpson, who as a heavy smoker since his teens wrote that "So strong is Prof. Sen's commitment to liberty that he feels we must now go beyond the traditional assumption of individual free will and seek to liberate the individual from himself or herself. I have myself been in a state of bondage for over 15 years and I was entirely unaware of this state until two weeks ago. This has left me feeling uneasy. Perhaps Prof. Sen can be given a regular column to enlighten us to other states of bondage we may find ourselves in. Each week he may identify for us a personal behaviour from which we require to be liberated with the aid of state sanctions. In time the government maybe persuaded to set up a new ministry to deal with the required legislation. I suggest we call this ministry the Ministry of Liberty". ("Liberate us from all our states of bondage", Letters, *Financial Times*, 2 March 2007) .

The argument for prohibiting addictive substances, based on assuming a divided self, postulates a negative inter-temporal consumption externality facing potential addicts. In the resulting myopic models[23] the current consumption of addictive substances depends on the 'stock of habits' which is given by the depreciated sum of all past consumption.[24] Hence, current consumption depends on past consumption but not future consumption. This omission is repaired in the rational addiction models of Becker and Murphy. They show how even with inter-temporally inconsistent preferences, consumers maximize utility over their life cycle taking account of the future consequences of their actions in consuming addictive substances.[25]

More seriously, as the economic theorist Dew Fudenberg (2006)'s, critical review of behavioral economics, including its theoretical limitations, rightly notes: "in thinking about these ideas, it is helpful to distinguish between welfare economics as political economy-how we think the government should make decisions- and welfare economics as moral philosophy- how we would advise others to behave. Even if we believe people do make systematic errors in evaluating how various choices will influence the appropriately defined measure of their 'welfare', we might not trust that the government or policy anaysts would make better evaluations. For this reason, it is consistent to believe both that people make mistakes and that government policy should be based on the assumption people's actions and ex-ante predictions are the best guide to what is in their own interests". (p.707). Quite![26]

But, this does not mean that in teaching our children 'how to live' they should not be encouraged to exercise self-control, and think of long term consequences. But this is the domain of preachers. There is nothing libertarian about 'libertarian paternalism'. It *is* paternalism which should on Mill's principle of liberty play no part in the public policy of the good society.

As I have argued at length elsewhere (Lal (1998), (2006)), the demoralization of Western society[27] has led its politician's to seek various ruses, in which they wrongly see globalizing capitalism as the root of the evil, instead of the means of their prosperity. This has more to do with the consequences of the loss of faith in the Christian God which had hitherto underwritten their private morality and the undermining of the customs and traditions which as Hume saw clearly are the only basis of morality in a Godless world. The continuing attacks on globalizing capitalism discussed in this essay, will merely destroy the only know basis for generating global prosperity, without in any way repairing Western souls.

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[23] See Schelling (1978)
[24] See Houthakker and Taylor (1966)
[25] See Becker and Murphy (1988), Becker et al (1991).
[26] Also see Levitt and List (2007), why the empirical findings of behavioral economics based on laboratory experiments based on playing games with graduate students cannot be readily generalized to the real world.
[27] Also see Himmelfarb (1994)

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