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MPIfG Discussion Paper 11/15

**The Crisis in Context**

Democratic Capitalism and Its Contradictions

Wolfgang Streeck



Wolfgang Streeck  
**The Crisis in Context: Democratic Capitalism and Its Contradictions**

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## Abstract

The “financial crisis” and its sequel, the current sovereign debt crisis, appear to be the latest permutations of an old conflict between capitalism and democracy that forcefully reasserted itself after the end of the postwar growth period. Today’s calamities were preceded by high inflation in the late 1960s and 1970s, rising public deficits in the 1980s, and growing private indebtedness in the 1990s and 2000s. In each case, governments were faced with popular demands for prosperity and security that were incompatible with market allocation. Inflation, deficits and financial under-regulation should not be understood as results of faulty economic management but rather as temporary stop-gaps to simultaneously satisfy democratic-political claims for social justice and economic claims for profitability. As the site of distributional conflict moved with time from the labor market and industrial relations to the politics of public spending, then to the provision of credit to private households, and from there to international fiscal diplomacy, it became increasingly insulated against popular democratic pressures. At the same time, the political and economic risks associated with the contradictions of democratic capitalism have increased, with potentially disruptive consequences for the social integration of democratic polities as well as for the system integration of advanced market economies.

## Zusammenfassung

Die sogenannte Finanzkrise von 2008 und die anschließende Krise der Staatsfinanzen müssen als jüngste Manifestation eines alten Konflikts zwischen Kapitalismus und Demokratie gesehen werden, der mit dem Ende der Wachstumsperiode der Nachkriegszeit neu aufgelebt ist. Vorläufer der heutigen politisch-ökonomischen Verwerfungen waren die Inflation der späten 1960er und der 1970er Jahre, die steigenden Haushaltsdefizite der 1980er Jahre und die zunehmende Privatverschuldung seit Mitte der 1990er Jahre. In allen Fällen waren demokratische Regierungen mit Forderungen nach steigenden Einkommen und sozialer Sicherheit konfrontiert, die mit einer Allokation von Ressourcen nach den Spielregeln freier Märkte unvereinbar waren. Inflation, Haushaltsdefizite und Unter-Regulierung der Finanzmärkte waren im Kern nicht Folgen fehlerhafter Wirtschaftspolitik, sondern dienten der zeitweiligen Zufriedenstellung demokratisch-politischer Forderungen nach sozialer Gerechtigkeit, die mit wirtschaftlichen Forderungen nach Profitabilität und Verteilung nach Maßgabe marginaler Produktivität unvereinbar waren. In dem Maße, wie die Auseinandersetzung sich vom Arbeitsmarkt und den Arbeitsbeziehungen auf die öffentliche Haushaltspolitik, anschließend auf die Politik der Regulierung des Finanzsektors und von da auf die internationale Geldpolitik verlagerte, wurde der demokratisch-kapitalistische Verteilungskonflikt zunehmend gegen demokratischen Druck von unten isoliert. Gleichzeitig nahmen die den Widersprüchen des demokratischen Kapitalismus inhärenten Risiken zu, mit potenziell schwerwiegenden Folgen sowohl für die soziale Integration demokratischer Gesellschaften als auch die Systemintegration fortgeschrittener Marktwirtschaften.



## The Crisis in Context: Democratic Capitalism and Its Contradictions

What can a social scientist contribute to our understanding of that world-shaking event, the collapse of the American financial system, that occurred in 2008 and has since turned into an economic and political crisis of global dimensions? Nobody expects a sociologist to offer practical advice on to how to repair the damage and prevent similar disasters in the future: what “stress tests” to apply to banks; what capital reserves to require them to hold; or whether to create and how to design a bailout mechanism for bankrupt states belonging to a currency union. In one sense, of course, this is unfortunate as there are obviously no consulting fees to collect here. On the other hand, however, regrettable as this may be, it may actually be an advantage as it makes it unnecessary for sociologists or political scientists to believe, or pretend to believe, that in principle at least there does exist a fix for the problem and that one only needs to find it.

Unlike the economic mainstream, sociology in particular, unless it has given in to fashionable pressures to convert to a “rational choice” model of social order, or alternatively has failed to leave behind the Parsonian functionalism of the 1950s, is in no way compelled to conceive of society as governed by a general tendency toward equilibrium, where crises and change are no more than temporary deviations from what is for most of the time the steady state of a normally well-integrated social system. Rather than having to construe our present affliction as a singular disturbance to a fundamental condition of stability, a sociological, i.e. not an efficiency-theoretical approach to political economy can afford to try out a historical perspective relating today’s crisis to earlier, similar events, and explore the possibility of them being systematically related, both by historical sequence and by common causes. In fact this is what I will do in this lecture, in which I will suggest considering the Great Recession (Reinhart/Rogoff 2009) and the subsequent near-collapse of the modern tax state’s public finances as a manifestation of an underlying basic tension in the political-economic configuration of advanced capitalist societies, a tension that makes disequilibrium and instability the rule rather than the exception, and that has found expression in a historical succession of different but cognate disturbances of the socio-economic order.

More specifically, I will argue that the present crisis can be fully understood only when considered as one more stage in an ongoing, inherently conflictual evolution and transformation of that very particular social formation that we call *democratic capitalism*. Democratic capitalism came to be more or less safely established only after the Second World War and only in the Western part of the world. There it functioned extraordinarily

well for the next two to three decades – so well in fact that this period, which was one of uninterrupted economic growth, still dominates our ideas and expectations of what modern capitalism (Shonfield 1965) is or should and could be. This is true in spite of the fact that looked at with hindsight and in the light of the turbulences that followed, the quarter century immediately after the war should without difficulty be recognizable as truly exceptional. Indeed I suggest that it is not the *trente glorieuses* (Judt 2005) but the series of crises that followed that is representative of the normal condition of democratic capitalism. That condition, I maintain, is ruled by an endemic and essentially irreconcilable conflict between capitalist markets and democratic politics that, having been temporarily suspended for the historically short period immediately following the war, forcefully reasserted itself when high economic growth came to an end in the 1970s. I will now in general terms discuss the nature of that conflict before I turn to the sequence of political-economic disturbances produced by it that preceded as well as shaped the present global crisis.

# I

Suspensions that capitalism and democracy may not easily go together are far from new. Beginning in the nineteenth and well into the twentieth century, the bourgeoisie and the political Right were afraid that majority rule, being inevitably the rule of the poor over the rich, would ultimately do away with private property and free markets. The rising working class and the political Left, for their part, were fearful of capitalists allying themselves with the forces of reaction to abolish democracy, in a search for protection from being governed by a permanent majority dedicated to the redistribution of economic advantage and social status. I will not discuss here the relative merits of the two positions, although I believe that, unfortunately, at least in the industrialized world, the Left had more reason to fear the Right overthrowing democracy in order to save capitalism, than the Right had to fear the Left abolishing capitalism for the sake of democracy. However that may be, in the years immediately after the Second World War it was a widely shared assumption that for capitalism to be compatible with democracy, it had to be subjected to extensive political control<sup>1</sup> so as to protect democracy from having to be restrained in the name of free markets. While Keynes and, to an extent, Kalecki and Polanyi carried the day, Hayek had to withdraw into temporary exile.

This was not to remain so, however. Today's political economy literature, to the extent that it comes out of mainstream economics, is obsessed with the figure of the opportunistic or myopic, in any event irresponsible, politician who caters to an economically uneducated electorate by fiddling with otherwise efficient markets and thereby prevent-

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1 For example through nationalization of key firms and sectors or, as in Germany, through "economic democracy" in the form of worker rights of "co-determination" in large companies.

ing them from achieving equilibrium – all in pursuit of objectives, such as full employment and social justice, that truly free markets would in the long run deliver anyway but must fail to deliver when distorted by politics. Economic crises, according to standard economic theories of “public choice” (Buchanan/Tullock 1962), essentially stem from political intervention, in particular from market-distorting intervention for “social” objectives. While the right kind of intervention is one that sets markets free from political interference, market-distorting intervention derives from an excess of democracy, or more precisely, from democracy being carried over, by irresponsible politicians, into the economy where it has no business.

Today, not many go as far as the formidable Friedrich von Hayek, who in his later years advocated abolishing democracy as we know it in defense of economic freedom and civil liberty. Still, the *cantus firmus* of current neo-institutionalist economic theory sounds very Hayekian indeed. For capitalism to work, it requires a rule-bound economic policy; constitutionally enshrined protection of markets and property rights from discretionary political interference; independent regulatory authorities; central banks firmly protected from electoral pressures; and international institutions such as the European Commission or the European Court of Justice that do not have to worry about popular reelection. Ideal, of course, would be some sort of assurance that government will always be in the hands of the likes of a Thatcher or Reagan, leaders with the courage and the muscle to shield the economy from the immodest demands of short-sighted citizens for protection and redistribution. It is not by chance, however, that such theories studiously avoid the crucial question of how to get from here to there, very likely because they have no answer, or at least none that can be made public.

There are various ways to conceive of what is at the bottom of the friction between capitalism and democracy. For present purposes, I will characterize democratic capitalism as a political economy ruled by two conflicting principles, or regimes, of resource allocation: one operating according to marginal productivity, or what is revealed as *merit* by a “free play of market forces,” and the other following social need, or *entitlement*, as certified by the collective choices of democratic politics. Governments under democratic capitalism are under pressure to honor both principles simultaneously although substantively the two almost never agree – or they can afford to neglect one in favor of the other only for a short time until they are punished by the consequences, political in the one case and economic in the other. Governments that fail to attend to democratic claims for protection and redistribution risk losing their majority while governments that disregard the claims for compensation from the owners of productive resources, as expressed in the language of marginal productivity, cause economic dysfunctions and distortions that will be increasingly unsustainable and will thereby also undermine political support.

In the liberal utopia of standard economic theory, the tension in democratic capitalism between its two principles of allocation is overcome by the theory turning into what Marx had expected *his* theory to become: a material force (*materielle Gewalt*). Economics as a “science” instructs citizens and politicians that markets are better for them than politics,



and that *real* justice is *market* justice under which everybody is rewarded according to contribution rather than to needs redefined as rights. To the extent that *economic* theory became in this sense accepted as a social theory, it also *would come true* in the sense of becoming *performative* – which reveals its essentially rhetorical nature as an instrument of social construction by persuasion. In the real world, however, it is not all that easy to talk people out of their “irrational” beliefs in social and political rights, as distinguished from the law of the market and the right of property. Up to now at least, non-market notions of social justice have resisted all efforts at economic rationalization, forceful as they may have become especially in the *bleierne Zeit* of advancing neoliberalism. Apparently people stubbornly refuse to give up on the idea of a moral economy (Thompson 1971; Scott 1976) under which they have rights as people or as citizens that take precedence over the outcomes of market exchanges.<sup>2</sup> In fact where they have a chance, as they inevitably do as long as there is democracy, they tend in one way or other to insist on the primacy of the social over the economic; on social commitments and obligations being protected from market pressures for “flexibility;” and on society honoring human expectations of a life outside of the dictatorship of ever fluctuating “market signals.”<sup>3</sup>

In the economic mainstream, that there should be a conflict in a market economy between rivaling principles of allocation can be explained only by a deplorable lack of economic education of citizens, or by demagoguery on the part of irresponsible politicians. Economic disorders, like inflation, public deficits, and excessive private or public debt result from insufficient knowledge of the economic laws that govern the functioning of the economy as a wealth creation machine, or from a frivolous disregard of such laws in selfish pursuit of political power. This is quite different in theories of *political economy*, to the extent that they take the political seriously.<sup>4</sup> Such theories recognize market allocation as one political-economic regime among others, one that is governed by the special interests of those owning scarce productive resources that put them in a strong market position, while its alternative, political allocation, is preferred by those with little economic but potentially high political power. From this perspective, standard economics is basically the theoretical exaltation of a political-economic social order that serves the interests of those well-endowed with market power, in that it equates *their* interests with the *general* interest and represents the *distributional claims* of the owners of productive capital as *technical imperatives* of good, in the sense of scientifically sound, economic management. In fact, for political economy, if standard economists account for economic dysfunctions by a cleavage between *traditionalist* principles of

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2 The exact content of such rights may change and obviously differs between social and geographical locations. But certain elements seem universal, for example that someone who puts in a “good day’s work” should not be poor, meaning that his income should enable him and his family to participate fully in the life of his community. Other common principles of moral economy include the insistence on attributions of social worth different from economic worth, and on values and entitlements that cannot be expressed in terms of market prices.

3 This, to me, is the essence of what Polanyi ([1944]1957) means when he writes of a “counter-movement” against the commodification of labor (Streeck 2009: 246 ff.).

4 That is, that they are not just functionalist efficiency theories.

*moral* economy and *rational-modern* principles of *economic* economy, this amounts to a tendentious misrepresentation of the nature of the problem as it hides the fact that the economic economy is *also* a moral economy, namely that of those commanding strong power in markets for indispensable productive resources.

In the language of mainstream economics, economic disturbances, as caused by market allocation being interfered with by politics, appear as punishment for governments failing to respect the natural laws that are the true governors of “the economy.” By contrast, a theory of political economy worth its name accounts for crises as manifestations of what one could call the *Kaleckian reactions*<sup>5</sup> of the owners of productive resources to democratic politics, penetrating into what they consider their exclusive domain, trying to prevent them from exploiting their market power to the fullest, and thereby violating their expectations of being justly rewarded for their astute risk-taking.<sup>6</sup> Unlike political economy, standard economic theory treats social structure and the distribution of interests and power vested in it as exogenous, holding them constant and thereby making them both invisible and, for the purposes of economic “science,” naturally given. The only politics such a theory can envisage are the inevitably counterproductive efforts by opportunistic or, at best, incompetent politicians to bend economic laws. Good economic policy is nonpolitical by definition. This view is, of course, not shared by the many for whom politics is a much needed recourse against markets whose unfettered operation interferes with what they happen to feel is right. Unless they are somehow persuaded to adopt neoclassical economics as a self-evident model of what social life is and should be – unless, in other words, they are turned into practicing life-world economizers – their political demands as democratically expressed will differ from the prescriptions of standard economic theory. The implication is that while an *economy*, if

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5 In a seminal essay in 1943, Michal Kalecki identified the “confidence” of investors as a crucial factor determining economic performance (Kalecki 1943). Investor confidence, according to Kalecki, depends on the extent to which current profit expectations of capital owners are reliably sanctioned by the distribution of political power and the policies to which it gives rise. Economic dysfunctions – unemployment in Kalecki’s case – ensue when business sees its profit expectations threatened by political interference. “Wrong” policies in this sense result in a loss of business confidence, which in turn may result eventually in what would amount to an investment strike by capital owners. Kalecki’s perspective makes it possible to model a capitalist economy as an interactive game, as distinguished from a natural or machine-like mechanism. If the economy is in a Kaleckian way conceived as interactive, the point at which capitalists react adversely to non-market allocation by withdrawing investment need not be seen as once and for all fixed and mathematically predictable but may be negotiable. For example, it may be set by a historically evolved and historically changeable level of aspiration or by strategic calculation. This is why predictions based on universalistic, i.e. historically and culturally indifferent, economic models so often fail: they assume fixed parameters where in reality these are socially determined and historically flexible.

6 In other words, standard economic accounts of economic crises are essentially representations, in the form of sets of simultaneous equations, of the strategic reactions of the owners of indispensable productive resources, making what are the particularistic claims of a social group appear like the laws of gravity driving the motions of the stars in a Newtonian universe.

sufficiently conceptually disembedded, may be modeled as tending toward equilibrium, a *political* economy may not, unless it is one devoid of democracy and run by a Platonic dictatorship of economist-kings.

As long as capitalist politics fails to lead democratic societies out of the desert of corrupt democratic opportunism into the promised land of self-regulating markets, governments must fear their societies being torn apart by conflicts over distributional claims the sum total of which considerably exceeds what is at any point in time available for distribution. Outside of the, as we now know, exceptional and short periods when strong economic growth makes it possible for all parties to improve their positions simultaneously, democratic governments find themselves under pressure to convert, by whatever means, zero-sum into positive-sum distributional games. In democratic capitalism after the end of postwar growth, this was done essentially by moving additional, not yet existing resources into the pool out of which current distributional claims were settled. As we will see, different methods were successively employed to pull forward resources that were still to be produced for present distribution and consumption. None of these lasted long as all of them were bound ultimately to result in economic crisis by provoking the resistance – what we have called the Kaleckian reactions – of those interested in an allocation of rewards according to the laws of the market.

## II

Postwar democratic capitalism underwent its first crisis in the decade following the late 1960s when inflation rates began rapidly to rise throughout the Western world. Accelerating inflation resulted when declining economic growth made it difficult to sustain the political-economic peace formula between capital and labor that had ended domestic strife after the devastations of the Second World War. Essentially that formula entailed the organized working classes accepting capitalist markets and property rights in exchange for political democracy enabling them to achieve social security and a steadily rising standard of living. When the 1960s came to a close, more than two decades of uninterrupted economic growth had resulted in deeply rooted popular perceptions of continuous economic progress as a right of democratic citizenship – perceptions that translated into political expectations that governments felt constrained but were increasingly unable to honor when growth began to slow down.

The structure of the “postwar settlement” between labor and capital was fundamentally the same across those otherwise widely different countries where democratic capitalism had come to be instituted. In addition to an expanding welfare state, it included a right of workers to free collective bargaining through independent trade unions, together with a political guarantee of full employment underwritten by governments liberally applying the toolkit of Keynesian economic policy. When growth began to falter, how-

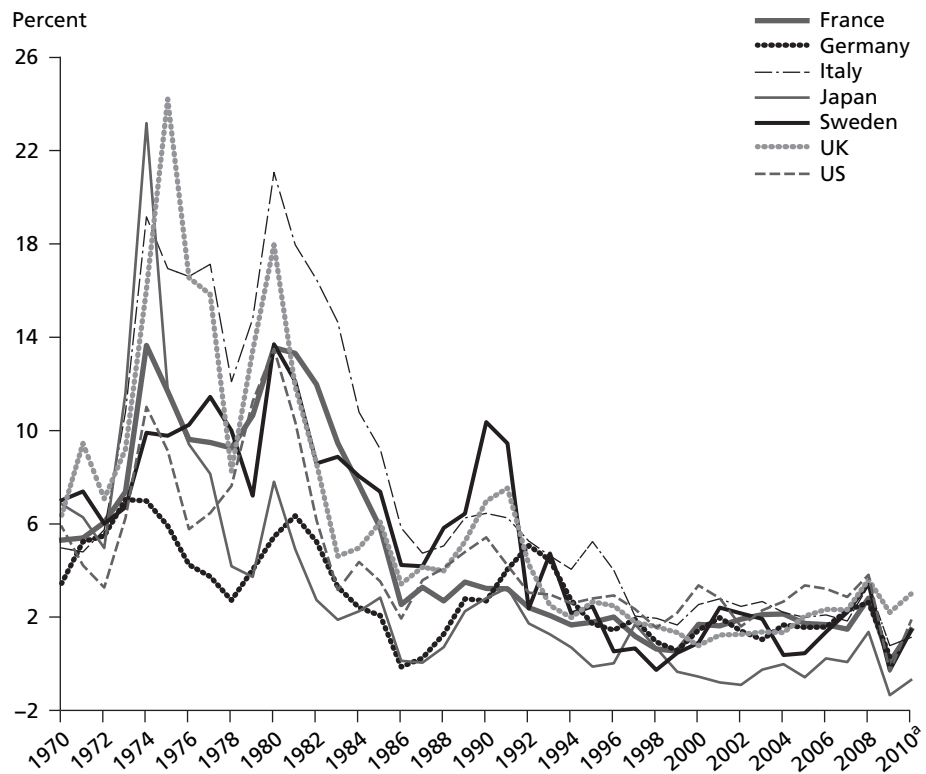
ever, the latter two in particular became difficult to maintain alongside each other. While free collective bargaining enabled workers through their unions to act effectively on what had meanwhile become firmly ingrained expectations of regular yearly wage increases, governments' commitment to full employment, together with a growing welfare state, protected unions from potential employment losses caused by wage settlements in excess of productivity growth. Government economic policy thus increased the bargaining power of trade unions far beyond what a free labor market would have sustained. In the late 1960s this found expression in a worldwide wave of labor militancy fueled by a strong sense of political entitlement to a continuously rising standard of living unchecked by fears of unemployment.

In subsequent years governments all over the Western world faced the question of how to make trade unions moderate their members' wage demands without having to rescind the Keynesian promise of secure full employment. In countries where the institutional structure of the collective bargaining system was not conducive to the negotiation of tripartite "social pacts," governments remained convinced throughout the 1970s that allowing unemployment to rise in order to contain real wage increases was too risky for their own survival, if not for the stability of capitalist democracy as such. Their only way out was an accommodating monetary policy that, while allowing free collective bargaining and politically-provided full employment to continue to coexist, did so at the expense of raising the going rate of inflation, with the risk of inflation accelerating over time.

Initially, and for a limited period, inflation is not much of a problem for workers represented by strong trade unions and politically powerful enough to achieve *de jure* or *de facto* wage indexation. Inflation comes at the expense primarily of holders of financial assets and of creditors, groups that do not as a rule include workers, or at least did not do so in the 1960s and 1970s. This is why inflation can be, and has been, described as a monetary reflection of distributional conflict between a working class demanding both employment security and a higher share in their country's income, and a capitalist class striving to maximize the return on its capital. As the two sides act on mutually incompatible ideas of what is theirs by right, one emphasizing the entitlements of citizenship and the other those of property and productive achievement, inflation may also be considered an expression of anomy in a society which for structural reasons cannot agree on common criteria of social justice. It was in this sense that the eminent British sociologist John Goldthorpe, in the late 1970s, suggested that high and indeed accelerating inflation was ineradicable in a democratic-capitalist market economy that allowed workers and citizens to organize politically to correct market outcomes through collective action (Goldthorpe 1978; Hirsch/Goldthorpe 1978).

For governments facing conflicting demands from workers and capital owners in a world of declining growth rates, an accommodating monetary policy was a convenient *ersatz* method for avoiding zero-sum social conflict. In the immediate postwar years it had been economic growth that had provided governments, struggling with incompatible concepts of economic justice, with additional *goods and services* by which

Figure 1 Inflation rates, seven countries, 1970–2010

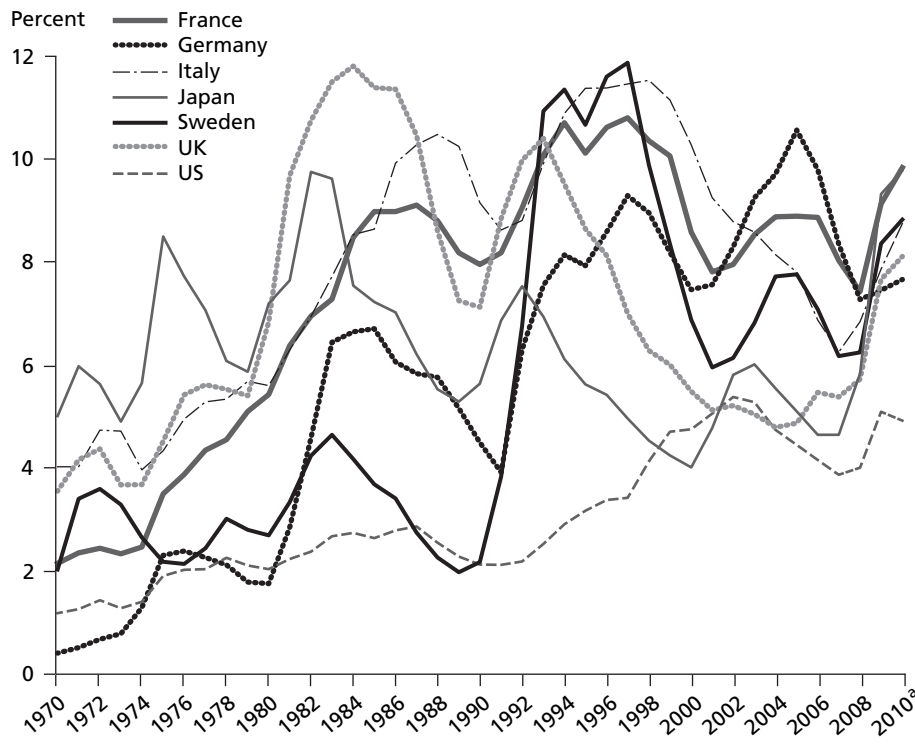


a Estimate.

Source: OECD Economic Outlook Database No. 87.

to defuse class antagonisms. Now governments had to make do with additional *money* as yet uncovered by the real economy, as a means of pulling forward future resources into present consumption and distribution. This mode of conflict pacification, effective as it at first was, could not however continue indefinitely. As Friedrich von Hayek ([1950]1967) never tired pointing out, sustained and in all likelihood over time accelerating inflation is bound to give rise to all sorts of ultimately unmanageable economic distortions: among other things in relative prices, in the relation between contingent and fixed incomes, and especially in what economists refer to as *economic incentives*. In the end, by calling forth Kaleckian reactions from increasingly suspicious capital owners, inflation will even produce unemployment, punishing the very workers whose interests it may initially have served. At this point at the latest, governments under democratic capitalism will come under pressure to cease accommodating redistributive wage settlements and to restore monetary stability.

Figure 2 Unemployment rates, seven countries, 1970–2010



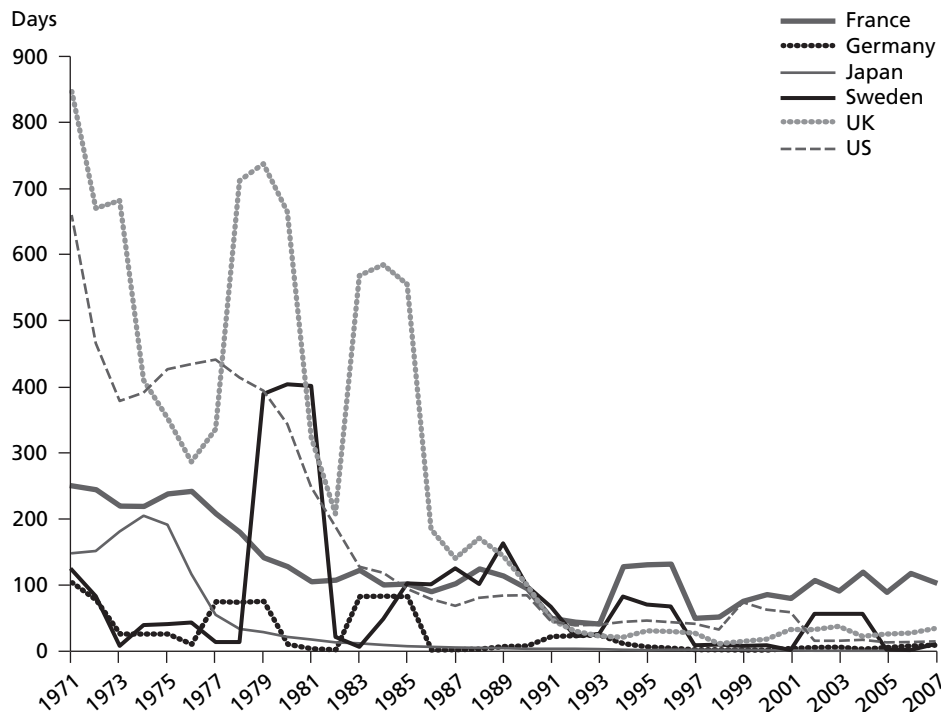
a Estimate.

Source: OECD Economic Outlook Database No. 87.

### III

Inflation was conquered in the early 1980s (Figure 1) when the Federal Reserve Bank of the United States under its new chairman, Paul Volcker, who had been appointed in 1979, still during the Carter presidency, raised interest rates to an unprecedented height causing unemployment to jump to levels never seen since the Great Depression.<sup>7</sup> The Volcker revolution, or one might also speak of the Volcker putsch, was sealed when President Reagan, who is said to have initially been afraid of the political fallout of Volcker's aggressive disinflation policies, was re-elected in 1984. Before him, Margaret Thatcher, who had followed the American lead, had won a second term in June, 1983, also in spite of high unemployment and rapid de-industrialization caused, among other things, by a restrictive monetary policy. In both the US and the UK, disinflation was accompanied by fierce and in the end highly successful attacks by governments and employers on trade unions, epitomized by Reagan's victory over the Air Traffic Controllers and Thatcher's breaking of the National Union of Mineworkers. In subsequent years, inflation rates throughout the capitalist world remained continuously low while

7 On the following see Samuelson (2010) among others.

Figure 3 Strike volume, seven countries, 1971–2007<sup>a</sup>

a Days not worked per 1,000 employees, three-year moving averages.  
Source: ILO Labour Statistics Database, OECD Labour Force Statistics; own calculations.

unemployment went more or less steadily up (Figure 2). In parallel, unionization declined almost everywhere, and strikes became so infrequent that some countries ceased to keep strike statistics (Figure 3).

The neoliberal era began with Anglo-American governments casting aside the political orthodoxy of postwar democratic capitalism. It was founded on the belief that inflation was always preferable to unemployment as unemployment would be certain to undermine political support, not just for the government of the day but also for the democratic-capitalist political-economic regime. The experiments conducted by Reagan and Thatcher on their electorates were observed closely by policy-makers worldwide. Those, however, who may have hoped that the end of inflation would mean an end to economic disorder were soon to be disappointed. As inflation receded, public debt began to increase, and not entirely unexpectedly so. Already in the 1950s Anthony Downs (see for example Downs 1960) had noted that in a democracy the demands from citizens for public services tended to exceed the supply of resources available to government, and as early as the late 1960s the Marxist scholar James O'Connor sympathetically commented upon by none other than Daniel Bell (1976), had seen emerging on the horizon of contemporary capitalism an endemic “fiscal crisis of the state” (O'Connor 1970a, 1970b, 1972, 1973).



Rising public debt in the 1980s had many causes. Stagnant growth had made taxpayers more averse than ever to taxation, and with the end of inflation, automatic tax increases through what was called “bracket creep” also came to an end. The same held for the continuous devaluation of public debt in the course of the devaluation of national currencies, a process that had first complemented economic growth, and then increasingly substituted for it, in reducing a country’s accumulated debt relative to its nominal income. On the expenditure side, rising unemployment, caused by monetary stabilization, required rising expenditures on social assistance. Also the various social entitlements created in the 1970s in return for trade union wage moderation – as it were, deferred wages from the neo-corporatist era – began to mature and became due, increasingly burdening public households.

With inflation no longer available for closing the gap between the demands of citizens on the one hand and of “the markets” on the other, the burden of securing social peace fell on the state and on public finance. Public debt turned out, for a while, to be a convenient functional equivalent of inflation. Like inflation, public debt made it possible to introduce resources into the distributional conflicts of the time that had not yet been in fact produced, enabling governments to draw on future resources in addition to those already on hand. What had changed was the method by which resources were pulled forward in time to satisfy politically irresistible or economically irrefutable demands that could not be simultaneously satisfied with existing economic resources alone. As the struggle between market and social distribution moved from the labor market to the political arena, electoral pressure took the place of trade union pressure. Governments, instead of inflating the currency, began to borrow on an increasing scale to accommodate demands for benefits and services as a citizen’s right, as well as competing claims for incomes to reflect as closely as possible the judgment of the market and thereby provide opportunities for a maximally profitable use of productive resources. Low inflation was helpful in this since it assured creditors that government bonds would keep their value, even over the long haul; and so were the low interest rates that had resulted when inflation had been stamped out.

Just like inflation, however, accumulation of public debt cannot go on forever. Economists have always warned of public deficit spending “crowding out” private investment, causing high interest rates and low growth. But they were never able to specify where exactly the critical threshold was. In actual practice, it turned out to be possible, at least for a while, to keep interest rates low by deregulating financial markets (Krippner 2011) while containing inflation through continued union-busting. Still, the US in particular, with its exceptionally low national savings rate, soon had to sell its government bonds not just to citizens but also to foreign investors, including sovereign wealth funds of various sorts (Spiro 1999). Moreover, as debt burdens rose, a growing share of public spending had to be devoted to debt service, even with interest rates remaining low – which could, however, not forever be taken for granted. Above all, there had to be a point, although apparently unknowable beforehand, at which creditors, foreign and



domestic alike, would begin to worry about getting their money back eventually. By then at the latest, pressures would begin to mount from “financial markets” for consolidation of public budgets and a return to fiscal discipline.

#### IV

The dominant theme of the 1992 Presidential election in the United States was the two deficits, the one of the Federal Government and the other of the country as a whole in foreign trade. The victory of Bill Clinton, who had campaigned above all on the “double deficit,” set off worldwide attempts at fiscal consolidation, aggressively promoted under American leadership by international organizations such as the OECD and the IMF. Initially the Clinton administration seems to have envisaged closing the public deficit by accelerated economic growth brought about by social reform, such as increased public investment in education (Reich 1997). However, when in the midterm elections of 1994 the Democrats lost their majority in both houses of Congress, Clinton soon turned to a policy of austerity involving deep cuts in public spending, including changes in social policy which, in the words of the President, were to put an end to “welfare as we know it.”<sup>8</sup> Indeed in the three final years of the Clinton Presidency, from 1998 to 2000, the US Federal Government for the first time in decades was running a budget surplus.

This is not to say, however, that the Clinton administration had somehow found a way of pacifying a democratic-capitalist political economy without recourse to additional, yet-to-be-produced economic resources. The Clinton strategy of social conflict management drew heavily on the deregulation of the financial sector that had already started under Reagan and was now driven further than ever before (Stiglitz 2003). Rapidly rising income inequality caused by continuing de-unionization and sharp cuts in social spending, as well as the reduction in aggregate demand caused by fiscal consolidation, were counterbalanced by unprecedented new opportunities for citizens and firms to indebt themselves. It was Colin Crouch who coined the fortuitous term, “privatized Keynesianism,” for what was in effect the replacement of public with private debt (2009). What this amounted to was that rather than the government borrowing money to fund equal access to decent housing or the formation of marketable work skills, it was now individual citizens who, under a debt regime of extreme generosity, were allowed, and in fact compelled, to take out loans at their own risk with which to pay for their education or their advancement to a less destitute urban neighborhood.

The Clinton policy of fiscal consolidation and economic revitalization through financial deregulation had many beneficiaries. The rich were spared higher taxes while those among them – a fast-growing number – who had been wise enough to move their in-

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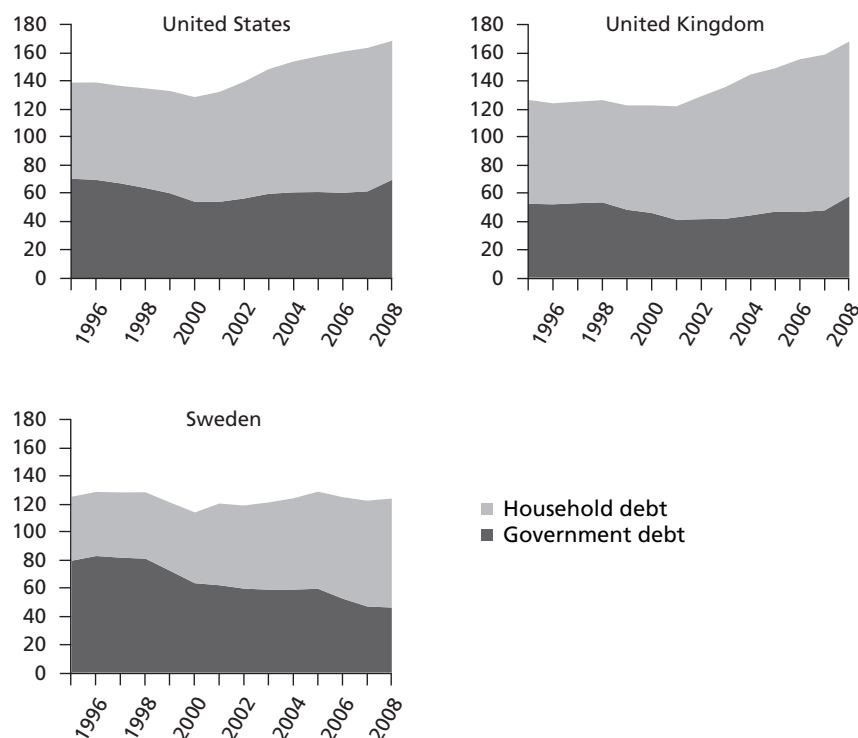
8 With the “Personal Responsibility and Work Opportunity Reconciliation Act” of 1996.

terests into the financial sector, were making huge profits on the ever more complicated so-called “financial services” that they now had an almost unlimited license to sell. But the poor also prospered, at least some of them and for a while. Subprime mortgages became a substitute, however illusory in the end, for the social policy that was simultaneously being scrapped, as well as for the wage increases that were no longer forthcoming at the lower end of a more and more flexible labor market. For African-Americans in particular, owning their home was not just the “American dream” come true but also a much-needed substitute for the old-age pensions that they were unable to earn in the labor markets of the day and that they had no reason to expect from a government pledged to a policy of permanent austerity.

In fact for a time home ownership offered the middle class and even some of the poor an attractive opportunity to participate in the speculative craze that was making the rich so much richer in the 1990s and early 2000s, treacherous as that opportunity would later turn out to have been. As house prices escalated under rising demand from people who would in normal circumstances have never been able to buy a house, it became common practice to use the new financial instruments to extract part or all of one’s home equity to finance the – rapidly rising – costs of the next generation’s college education, or simply for personal consumption to offset stagnant or declining wages. Nor was it entirely uncommon for home owners to use their new credit to buy a second or third house, in the hope to cash in on what was somehow expected to be an open-ended increase in the market value of real estate. In this way, unlike the era of public debt when future resources were procured for present use by government borrowing, now such resources were made available by a myriad of individuals selling in liberalized financial markets more or less solemn commitments to pay a significant share of their expected future earnings to creditors who in return provided them with the instant power to purchase whatever they needed or liked. Financial liberalization thus compensated for social policy being cut in an era of fiscal consolidation and public austerity. Individual debt replaced public debt, and individual demand, constructed for high fees by a rapidly growing money-making industry, took the place of collective demand governed by the state in supporting employment and profits in industries far beyond “financial services,” such as construction (Figure 4).

Especially after 2001 when the Federal Reserve switched to very low interest rates to prevent an economic slump, and with the return of high employment this implied, the new financial freedoms that had made the privatization of Keynesianism possible, sustained, in addition to unprecedented profits in the financial sector, a booming economy that became the envy not least of the European Left. In fact Alan Greenspan’s policy of easy money supporting the rapidly growing indebtedness of American society was held up as a model by European trade unions, which never tired of noting that unlike the European Central Bank, the Federal Reserve was bound by law not just to provide monetary stability but also high levels of employment. All of this, of course, ended when in 2008 the international credit pyramid on which the prosperity of the late 1990s and early 2000s had rested suddenly collapsed.

Figure 4 Fiscal consolidation and private debt in percent of GDP, three countries, 1995–2008



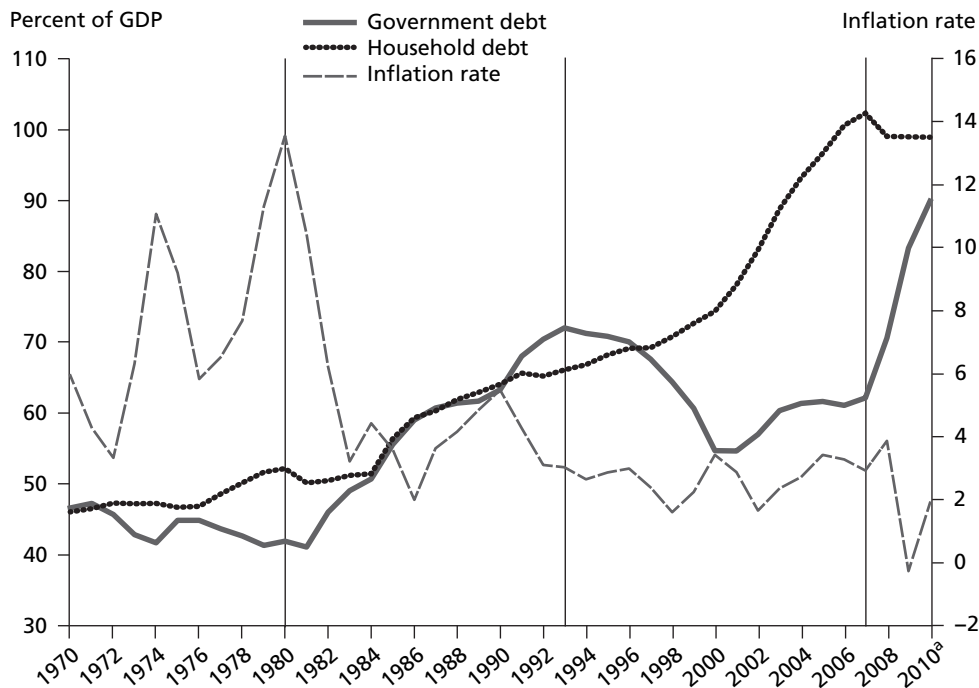
Source: OECD Economic Outlook Database No. 87, OECD National Accounts Database.

## V

With the crash of privatized Keynesianism, the crisis of postwar democratic capitalism entered its fourth and, up to now, latest stage, after the successive eras of inflation, public deficits, and private indebtedness (Figure 5)<sup>9</sup>. As the global financial system was about to disintegrate, nation-states had to restore economic confidence by socializing the bad loans licensed in compensation for fiscal consolidation. Together with the fiscal expansion necessary to prevent a breakdown of what the Germans call the *Realökonomie*, this resulted in a dramatic new increase in public deficits and public debt – a development that, it may be noted, was not at all due to frivolous overspending by opportunistic politicians as implied by public choice theories, or to misconceived public institutions

9 The diagram shows the development in the lead capitalist country, the United States, where the four stages unfold in ideal-typical fashion. For other countries it is necessary to make allowances reflecting their particular circumstances, including their position in the global political economy. In Germany, for example, public debt already began to rise sharply in the 1970s. This corresponds to the fact that German inflation was low long before Volcker, due to the independence of the Bundesbank and the monetarist policies it adopted as early as 1974 (Scharpf 1991).

Figure 5 The United States: Four crises of democratic capitalism, 1970–2010



a Estimate.

Source: OECD Economic Outlook Database No. 87.

as suggested by a broad institutional economics literature produced in the 1990s under the auspices of, among others, the World Bank and the IMF (for a representative collection see Poterba/von Hagen 1999).

The quantum leap in public indebtedness after 2008, which completely undid whatever fiscal consolidation might have been achieved in the preceding decade, reflected the fact that no democratic state could have dared to impose on its society another economic crisis of the dimension of the Great Depression of the 1930s, as punishment for the excesses of a deregulated global money industry. Once again, political power was deployed to make future resources available for securing present social peace, in that states more or less voluntarily took upon themselves a significant share of the new debt originally created in the private sector, so as to reassure creditors. But while this effectively rescued the financial industry's money factories, reinstating in very short time their extraordinary profits, salaries and bonuses, it did not and could not prevent rising suspicions, on the part of the very same "financial markets" that had just been saved by national governments from the consequences of their own indiscretion, that in the process governments might have overextended themselves. Even with the global economic crisis far from over, creditors began vociferously to demand a return to sound money through fiscal austerity, in search for reassurance that their vastly increased investment in government debt will not be lost.

In the years after 2008, distributional conflict under democratic capitalism has turned into a complicated tug-of-war between global financial investors and sovereign national states. Where in the past workers struggled with employers, citizens with finance ministers, and private debtors with private banks, it is now financial institutions wrestling with the same states that they had only recently successfully blackmailed into saving them from themselves. While this is what we see on the surface, the underlying configuration of power and interests is, however, far more complex and still awaits systematic exploration. For example, financial markets have since the crisis returned to charging different states widely different interest rates, thereby differentiating the pressure they apply on governments to make their citizens acquiesce with unprecedented spending cuts in line, again, with a basically unmodified market logic of distribution. In fact, given the amount of debt carried by most states today, even minor increases in the rate of interest on government bonds could cause fiscal disaster.<sup>10</sup> At the same time, markets must avoid states declaring sovereign bankruptcy, which states always can do if market pressures become too strong. This is why other states have to be found that are willing to bail out those most at risk, in order to protect themselves from a general increase in interest rates on government bonds once the first state has defaulted. Solidarity, if one can call it this, between states in the interest of investors is also fostered where sovereign default would hit banks located outside the defaulting country, which might force the banks' home countries once again to nationalize huge amounts of bad debt in order to stabilize their economies.

There are still more facets to the way in which the tension in democratic capitalism between demands for social rights and the workings of free markets currently expresses itself today. Some governments, foremost among them the Obama administration, are making desperate attempts to generate renewed economic growth through even more debt – in the hope of future consolidation policies, should they become inevitable, being assisted by a sizeable growth dividend. Others may be secretly hoping for a return to inflation melting down accumulated debt by softly expropriating creditors – which would, like economic growth, mitigate the political tensions to be expected from austerity. At the same time, financial markets as well as academic economists may be looking forward to a, given the nature of the new battlefield, more than ever promising fight against political interference with the forces of the market, once and for all reinstating market discipline and putting an end to all political attempts to subvert it.

Further complications arise from the fact that financial “markets,” whoever they may be, need government debt for safe investment, and pressing too hard for balanced budgets may deprive them of highly desirable investment opportunities. The middle classes of the rich countries in particular have put a good part of their savings into government bonds, not to mention workers now heavily invested in supplementary

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10 For a state with public debt equaling 100 percent of GDP, an increase by two percentage points in the average rate of interest it has to pay to its creditors would raise its yearly deficit by the same amount. A current budget deficit of four percent of GDP would as a result increase by half.

pensions. Balanced budgets would likely mean that states would have to take from their middle classes, in the form of higher taxes, what these now can save and invest, among other things in public debt. Not only would citizens no longer collect interest, but they would also cease to be able to pass their savings on to their children. However, while this should make them interested in states being, if not debt-free, then reliably able to fulfill their obligations to their creditors, it may mean that they would have to pay for their government's liquidity in the form of deep cuts in public benefits and services on which they also, in part, depend.

At the end of the day, however complicated the cross-cutting cleavages between the various interests in the emerging new field of the international politics of public debt may be, the price for financial stabilization is likely to be paid by those other than the owners of money, or at least of real money. For example, public pension reform will be accelerated by fiscal pressures at home and abroad, and to the extent that governments default anywhere in the world, private pensions will be hit as well. The average citizen will pay – for the consolidation of public finances, the bankruptcy of foreign states, the rising rates of interest on the public debt and, if eventually necessary and still possible, for another rescue of national and international banks – with his or her private savings, with cuts in public entitlements, with reduced public services and, one way or other, with higher taxes.

## VI

In the four decades since the end of postwar growth, the epicenter of the tectonic tension inside the political economy of democratic capitalism has migrated from one institutional location to the next, in the course giving rise to a sequence of different but systematically related economic disturbances. In the 1970s the conflict between democratic claims for social justice and capitalist demands for distribution by marginal productivity played itself out primarily in national labor markets where trade union wage pressure under politically guaranteed full employment caused accelerating inflation. When what was in effect redistribution by debasement of the currency became economically unsustainable, forcing governments under high political risks to put an end to it, the conflict reemerged in the electoral arena. Here it gave rise to growing disparity between public spending and public revenues and, as a consequence, to rapidly rising public debt, in response to voter demands for benefits and services in excess of what a democratic-capitalist economy could be made to hand over to its “tax state” (Schumpeter [1918]1991).

Just like inflation, conflict management by deficit spending could not continue forever. When efforts to rein in public debt became unavoidable, however, they had to be accompanied, for the sake of social peace, by financial deregulation easing access to private credit as an alternative route to accommodating normatively popular and po-

litically powerful demands of citizens for security and prosperity. This, too, lasted not much longer than a decade until the global economy almost faltered under the burden of unrealistic promises of future payment for present consumption and investment, licensed by governments in compensation for fiscal austerity. Since then, the clash between popular ideas of *social justice* and economic insistence on *market justice* has once again changed sites, re-emerging this time in international capital markets and the complex contests currently taking place there between financial institutions and electorates, governments, states and international organizations. Now the issue is how far states can and must go in enforcing on their citizens the property rights and profit expectations of those that call themselves “the markets,” so as to avoid having to declare bankruptcy while protecting as best they can what may still remain of their democratic legitimacy.

Toleration of inflation, acceptance of public debt, and deregulation of private credit were no more than temporary stopgaps for governments confronted with an apparently irrepressible conflict between the two contradictory principles of allocation under democratic capitalism: social rights on the one hand and marginal productivity, as determined by the relationship between supply and demand, on the other. Each of the three worked for a while until they began to cause more problems than they solved, indicating that a lasting reconciliation of social and economic stability in capitalist democracies is no more than a utopian project. Eventually, all that governments were able to achieve in dealing with the crises of their day was to move them to new arenas where they reappeared in new forms. There is no reason to believe that the successive manifestation of the contradictions inherent in democratic capitalism in ever new varieties of economic disorder should today be at an end.

## VII

The capacity of the social sciences to make predictions is limited if it exists at all. Like evolutionary biology, social science may, if it does its work well, provide plausible interpretations of the past in the form of systematically comparable historical reconstructions of chains of events that at first glance may appear nothing but chaotic. Looking forward, however, the social scientist faces the same open future as anybody else. Nevertheless, it appears to me that one can say with some certainty that the political manageability of democratic capitalism has in recent years sharply declined, obviously in some countries more than in others, but also and more importantly overall in the emerging global political-economic system. As a result the risks seem to be growing, both for democracy and for the economy.

Beginning with the economy, it would seem that economic policy-makers since the Great Depression have rarely, if ever, been faced with as much uncertainty as today. One example among many is that “the markets” expect not just fiscal consolidation but



also, and at the same time, a reasonable prospect of future economic growth. How the two may be combined, however, is not at all clear. Although the risk premium on Irish government debt fell when the country pledged itself to aggressive deficit reduction, a few weeks later it rose again, allegedly because the country's consolidation program suddenly appeared so strict that it would make economic recovery impossible.<sup>11</sup> Moreover, among those who must know, one finds a widely shared conviction that the next bubble is already building somewhere in a world that is more than ever flooded with cheap money. Subprime mortgages may no longer offer themselves for investment, at least not for the time being. But there are the markets for raw materials, or the new internet economy. Nothing prevents financial firms from using the surplus of money provided by the central banks to enter whatever appear to be the new growth sectors, on behalf of their favorite clients and, of course, of themselves. After all, with regulatory reform in the financial sector having failed in almost all respects, capital requirements are still as low as they were, and the banks that were too big to fail in 2008 can count on being so also in 2012 or 2013. This leaves them with the same capacity for blackmailing the public that they were able to deploy so skillfully three years ago. But now the public bailout of private capitalism on the model of 2008 may be impossible to repeat, if only because public finances are already stretched beyond their limit.

As I said, it is not for the social scientist to make predictions, for example on where the next bubble may burst; on whether the United States will continue to find creditors willing to finance their apparently ineradicable double deficit; whether it will be possible or not to impose the costs of consolidation entirely on pensioners and public sector workers, so as to spare "the markets" from economic hardship; or to what extent economic growth or inflation will be forthcoming to ease countries' debt burdens. What we do know, however, is that democracy is as much at risk in the current crisis as the economy. Using concepts developed long ago by the British sociologist David Lockwood (1964), not only has the *system integration* of contemporary societies – that is, the efficient functioning of their capitalist economies – become precarious, but also their *social integration*. With the arrival of a new age of austerity, the capacity of national states to mediate between what in the past were the rights of citizens on the one hand and the evolving requirements of capital accumulation on the other has profoundly suffered. For example, governments everywhere face stronger resistance to tax increases than ever, in particular in highly indebted countries where fresh public money would have to be spent for many years to pay for goods that have long been consumed. Even more importantly, with continuously increasing global interdependence the times are over when it was still possible to pretend that the tensions between economy and society, and indeed between capitalism and democracy, could be handled inside national political communities. No government can today govern without paying very close attention to international constraints and obligations, in particular to obligations in financial

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11 In other words, not even "the markets" are willing to put their money on the supply-side mantra according to which growth is stimulated by cuts in public spending. On the other hand, who can say how much new debt is enough, and how much too much, for a country to outgrow its old debt.



markets forcing it to impose sacrifices on its population. The crises and contradictions of democratic capitalism have finally become internationalized, playing themselves out not just within states but also between them, and simultaneously at both levels in as yet unexplored combinations and permutations.

As we now read in the papers almost every day, “the markets” have begun in unprecedented ways to dictate what presumably sovereign and democratic states may still do for their citizens and what they must refuse them. Moreover, the very same ratings agencies that were instrumental in bringing about the disaster of the global money industry are now threatening to downgrade the bonds of the very same states that had to accept a previously unimaginable level of new debt to rescue that industry and the capitalist economy as a whole. Politics still contains and distorts markets, but only, it seems, at a level far remote from the daily experience and the political and organizational capacities of normal people: the US, armed to its teeth not just with aircraft carriers but also with an unlimited supply of credit cards for the most militant shoppers in human history, still gets China to buy its mounting debt and manages to muscle the three global ratings firms, all based at the southern tip of Manhattan, into awarding its government bonds the triple A to which it feels forever entitled. All others, however, have to listen to what “the markets” tell them. As a result citizens increasingly perceive their national governments, not as *their* agents, but as those of other states or of international organizations, such as the IMF or the European Union, that are immeasurably more insulated from electoral pressure than was the traditional nation-state. In countries like Greece and Ireland in particular, anything resembling democracy will be effectively suspended for many years as national governments of whatever political color, forced to behave *responsibly* as defined by international markets and organizations, will have to impose strict austerity on their societies, at the price of becoming increasingly *unresponsive* to their citizens (Mair 2009).

Democracy is being preempted not just in those countries, however, that are currently under attack by “the markets.” Germany, which is still doing relatively well economically, is doing so not least because it has committed itself to decades of public expenditure cuts. In addition, the German government had, and will again have, to get its citizens to provide liquidity to countries at risk of defaulting, not just to save German banks, but also to stabilize the common European currency and prevent a general increase in the rate of interest on public debt, as is likely occur in the case of the first country collapsing. The high political cost of this is documented by the progressive decay of the electoral capital of the Merkel government, culminating up to now<sup>12</sup> in two crushing defeats in major regional elections. Populist rhetoric to the effect that perhaps creditors should also pay a share of the costs, as vented by the Chancellor in early 2010, was quickly abandoned when “the markets” expressed shock by slightly raising the rate of interest on new public debt. Now the talk is about the need to shift, in the words of the German

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12 April 2011.

Finance Minister, from old-fashioned “government,” which is no longer up to the new challenges of globalization, to “governance,” meaning in particular a lasting curtailment of the budgetary authority of the Bundestag.<sup>13</sup>

In several ways, the political expectations democratic states are today facing from their new principals are such that they may be impossible to meet. International markets and organizations require that not just governments but also citizens credibly commit themselves to fiscal consolidation. Political parties that oppose austerity must be resoundingly defeated in national elections, and both government and opposition must be equally pledged to “sound finance,” or else the cost of debt service will inexorably rise. Elections in which voters have no effective choice, however, may be perceived by them as inauthentic, which may cause all sorts of political disorder, from declining turnout to a rise of populist parties to riots in the streets. What may at first sight help is that the arenas of distributional conflict have with time become ever more remote from popular politics. Compared to the fiscal diplomacy and the international capital markets of today, the national labor markets of the 1970s, with the manifold opportunities they offered for corporatist political mobilization and inter-class coalitions, and the politics of public spending of the 1980s were not necessarily beyond either the grasp or the strategic reach of the “man in the street.” Since then, the battlefields on which the contradictions of democratic capitalism are fought out have become ever more complex, making it exceedingly difficult for anyone outside of the political and financial elites to recognize the underlying interests and identify their own.<sup>14</sup> While this may generate apathy at the mass level and thereby make life easier at the elite level, there is, however, no relying on it in a world in which blind compliance with the demands of financial investors is made to appear the only institutionally rational and responsible behavior.

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13 Wolfgang Schäuble, in an interview with the Financial Times, December 5, 2010: “We need new forms of international governance, global governance and European governance ...” As summarized by the FT: “If the German parliament were asked for a vote today on giving up national budgetary authority, ‘you would not get a Yes vote,’ he added. But ‘if you would give us some months to work on this, and if you give us the hope that other member states will agree as well, I would see a chance.” Schäuble was, fittingly, “speaking as winner of the FT competition for European finance minister of the year.”

14 For example, political appeals for redistributive “solidarity” are now directed at entire nations asked by international organizations to support other entire nations, such as Slovenia being urged to help Ireland, Greece and Portugal. This hides the fact that those being supported by this sort of “international solidarity” are not the people in the streets but the banks, domestic and foreign, that would otherwise have to accept losses, or lower profits. It also neglects differences in national income. While Germans are on average richer than Greeks (although some Greeks are much richer than almost all Germans), Slovenians are on average much poorer than the Irish, who have statistically a higher per capita income than nearly all Euro countries, including Germany. Essentially the new conflict alignment translates class conflicts into international conflicts, pitting nations against each other that are all subject to the same financial market pressures for public austerity. Rather than from those who have long resumed collecting their “bonuses,” ordinary people “on the streets” are told to demand “sacrifices” from other ordinary people, who happen to be citizens of other states, to somehow make less painful the “sacrifices” they themselves are asked to make.

To those who refuse to be talked out of other, social rationalities and responsibilities, such a world may at some point seem nothing but absurd, making it the only rational and responsible conduct to throw as many wrenches as possible into the works of *haute finance*. Where democracy as we know it is effectively suspended, as it already is in countries like Greece, Ireland and Portugal, street riots and popular insurrection could be the last remaining mode of political expression for those devoid of market power. Should we hope in the name of democracy that we will soon have the opportunity to observe a few examples?

Social science can do little if anything to help resolve the structural tensions and contradictions underlying the economic and social disorders of the day. What it can do, however, is bring them to light and identify the historical continuities in which present crises can only be fully understood. It also can – and indeed I believe it must – point out the drama of democratic states being turned into debt collecting agencies on behalf of a global oligarchy of investors compared to which C. Wright Mills’ “power elite” (1956) must appear like a shining example of liberal pluralism. More than ever, economic power seems today to have become political power while citizens appear to be almost entirely stripped of their democratic defenses and their capacity to impress on the political economy interests and demands incommensurable with those of capital owners. In fact, looking back at the democratic-capitalist crisis sequence since the 1970s, one cannot but be afraid of the possibility of a new, however temporary, settlement of social conflict in advanced capitalism, this time entirely in favor of the propertied classes now firmly entrenched in their politically unconquerable institutional stronghold, the international financial industry.

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