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THE CRISES OF DEMOCRATIC CAPITALISM

THE COLLAPSE OF the American financial system that occurred in 2008 has since turned into an economic and political crisis of global dimensions.¹ How should this world-shaking event be conceptualized? Mainstream economics has tended to conceive society as governed by a general tendency toward equilibrium, where crises and change are no more than temporary deviations from the steady state of a normally well-integrated system. A sociologist, however, is under no such compunction. Rather than construe our present affliction as a one-off disturbance to a fundamental condition of stability, I will consider the ‘Great Recession’² and the subsequent near-collapse of public finances as a manifestation of a basic underlying tension in the political-economic configuration of advanced-capitalist societies; a tension which makes disequilibrium and instability the rule rather than the exception, and which has found expression in a historical succession of disturbances within the socio-economic order. More specifically, I will argue that the present crisis can only be fully understood in terms of the ongoing, inherently conflictual transformation of the social formation we call ‘democratic capitalism’.

Democratic capitalism was fully established only after the Second World War and then only in the ‘Western’ parts of the world, North America and Western Europe. There it functioned extraordinarily well for the next two decades—so well, in fact, that this period of uninterrupted economic growth still dominates our ideas and expectations of what modern capitalism is, or could and should be. This is in spite of the fact that, in the light of the turbulence that followed, the quarter century immediately after the war should be recognizable as truly exceptional. Indeed I suggest that it is not the *trente glorieuses* but the series of crises

which followed that represents the normal condition of democratic capitalism—a condition ruled by an endemic conflict between capitalist markets and democratic politics, which forcefully reasserted itself when high economic growth came to an end in the 1970s. In what follows I will first discuss the nature of that conflict and then turn to the sequence of political-economic disturbances that it produced, which both preceded and shaped the present global crisis.

I. MARKETS VERSUS VOTERS?

Suspicions that capitalism and democracy may not sit easily together are far from new. From the nineteenth century and well into the twentieth, the bourgeoisie and the political Right expressed fears that majority rule, inevitably implying 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, warned that capitalists might ally themselves with the forces of reaction to abolish democracy, in order to protect themselves from being governed by a permanent majority dedicated to economic and social redistribution. I will not discuss the relative merits of the two positions, although history suggests that, 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 there was a widely shared assumption that for capitalism to be compatible with democracy, it would have to be subjected to extensive political control—for example, nationalization of key firms and sectors, or workers' 'co-determination', as in Germany—in order to protect democracy itself from being restrained in the name of free markets. While Keynes and, to some extent, Kalecki and Polanyi carried the day, Hayek withdrew into temporary exile.

Since then, however, mainstream economics has become obsessed with the 'irresponsibility' of opportunistic politicians who cater to an economically uneducated electorate by interfering with otherwise efficient

¹ This paper was given as the 2011 Max Weber Lecture at the European University Institute, Florence. I am grateful to Daniel Mertens for his research assistance.

² For the term 'Great Recession', see Carmen Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton 2009.

markets, 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 theories of ‘public choice’, essentially stem from market-distorting political interventions for social objectives.³ In this view, the right kind of intervention sets markets free from political interference; the wrong, market-distorting kind derives from an excess of democracy; more precisely, from democracy being carried over by irresponsible politicians into the economy, where it has no business. Not many today would go as far as Hayek, who in his later years advocated abolishing democracy as we know it in defence of economic freedom and civil liberty. Still, the *cantus firmus* of current neo-institutionalist economic theory is thoroughly Hayekian. To work properly, capitalism requires a rule-bound economic policy, with protection of markets and property rights constitutionally enshrined against 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 re-election. Such theories studiously avoid the crucial question of how to get there from here, however; very likely because they have no answer, or at least none that can be made public.

There are various ways to conceptualize the underlying causes 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 based on social need or entitlement, as certified by the collective choices of democratic politics. Under democratic capitalism, governments are theoretically required to honour both principles simultaneously, although substantively the two almost never align. In practice they may for a time neglect one in favour of the other, until they are punished by the consequences: governments that fail to attend to democratic claims for protection and redistribution risk losing their majority, while those that disregard the claims for compensation from the owners of productive resources, as expressed in the language of marginal productivity, cause economic dysfunctions that

³ The classic statement is James Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy*, Ann Arbor, MI 1962.

will become increasingly unsustainable and 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 turning the theory into what Marx would have called a material force. In this view, economics as ‘scientific knowledge’ teaches citizens and politicians that true justice is market justice, under which everybody is rewarded according to their contribution, rather than their needs redefined as rights. To the extent that economic theory became accepted as a social theory, it would ‘come true’ in the sense of being performative—thus revealing its essentially rhetorical nature as an instrument of social construction by persuasion. In the real world, however, it did not prove so easy to talk people out of their ‘irrational’ beliefs in social and political rights, as distinct from the law of the market and the right of property. To date, non-market notions of social justice have resisted efforts at economic rationalization, forceful as the latter may have become in the leaden age of advancing neoliberalism. People stubbornly refused to give up on the idea of a moral economy under which they have rights that take precedence over the outcomes of market exchanges.⁴ In fact where they have a chance—as they inevitably do in a working democracy—they tend in one way or another 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 honouring human expectations of a life outside the dictatorship of ever-fluctuating ‘market signals’. This is arguably what Polanyi described as a ‘counter-movement’ against the commodification of labour in *The Great Transformation*.

For the economic mainstream, disorders like inflation, public deficits and excessive private or public debt result from insufficient knowledge of the laws governing the economy as a wealth-creation machine, or from disregard of such laws in selfish pursuit of political power. By contrast, theories of political economy—to the extent that they take the political seriously and are not just functionalist efficiency theories—recognize

⁴ See Edward Thompson, ‘The Moral Economy of the English Crowd in the Eighteenth Century’, *Past & Present*, vol. 50, no. 1, 1971; and James Scott, *The Moral Economy of the Peasant: Rebellion and Subsistence in Southeast Asia*, New Haven, CT 1976. The exact content of such rights obviously varies between different social and historical locations.

market allocation as just one type of political-economic regime, governed by the interests of those owning scarce productive resources and thus in a strong market position. An alternative regime, political allocation, is preferred by those with little economic weight but potentially extensive political power. From this perspective, standard economics is basically the theoretical exaltation of a political-economic social order serving those well-endowed with market power, in that it equates their interests with the general interest. It represents the distributional claims of the owners of productive capital as technical imperatives of good, in the sense of scientifically sound, economic management. For political economy, mainstream economics' account of dysfunctions in the economy as being the result of a cleavage between traditionalist principles of moral economy and rational-modern principles amounts to a tendentious misrepresentation, for it hides the fact that the 'economic' economy is *also* a moral economy, for those with commanding powers in the market.

In the language of mainstream economics, crises 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 perceives crises as manifestations of the 'Kaleckian reactions' of the owners of productive resources to democratic politics penetrating into 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.⁵ Standard economic theory treats social structure and the distribution of interests

⁵ In a seminal essay, Michał Kalecki identified the 'confidence' of investors as a crucial factor determining economic performance: 'Political Aspects of Full Employment', *Political Quarterly*, vol. 14, no. 4, 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 in what would amount to an investment strike of 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. In this perspective, the point at which capitalists react adversely to non-market allocation by withdrawing investment need not be seen as fixed and mathematically predictable but may be negotiable. For example, it may be set by a 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 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 involves opportunistic or, at best, incompetent attempts to bend economic laws. Good economic policy is non-political by definition. The problem is that this view is 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, their political demands as democratically expressed will differ from the prescriptions of standard economic theory. The implication is that while an economy, if sufficiently conceptually disembodied, may be modelled as tending toward equilibrium, a political economy may not, unless it is devoid of democracy and run by a Platonic dictatorship of economist-kings. Capitalist politics, as will be seen, has done its best to lead us out of the desert of corrupt democratic opportunism into the promised land of self-regulating markets. Up to now, however, democratic resistance continues, and with it the dislocations in our market economies to which it continuously gives rise.

2. POST-WAR SETTLEMENTS

Post-war democratic capitalism underwent its first crisis in the decade following the late 1960s, when inflation began to rise rapidly throughout the Western world as declining economic growth made it difficult to sustain the political-economic peace formula between capital and labour 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, which enabled them to achieve social security and a steadily rising standard of living. More than two decades of uninterrupted growth resulted in deeply rooted popular perceptions of continuous economic progress as a right of democratic citizenship—perceptions that translated into political expectations, which governments felt constrained to honour but were less and less able to, as growth began to slow.

The structure of the post-war settlement between labour and capital was fundamentally the same across the otherwise widely different countries where democratic capitalism had come to be instituted. It included

an expanding welfare state, the right of workers to free collective bargaining and a political guarantee of full employment, underwritten by governments making extensive use of the Keynesian economic toolkit. When growth began to falter in the late 1960s, however, this combination became difficult to maintain. While free collective bargaining enabled workers through their unions to act on what had 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 policy thus leveraged the bargaining power of trade unions beyond what a free labour market would have sustained. In the late 1960s this found expression in a worldwide wave of labour militancy, fuelled by a strong sense of political entitlement to a rising standard of living and unchecked by fear 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 full employment. In countries where the institutional structure of the collective-bargaining system was not conducive to the negotiation of tripartite 'social pacts', most 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 which, while allowing free collective bargaining and full employment to continue to coexist, did so at the expense of raising the rate of inflation to levels that accelerated over time.

In its early stages, inflation was not much of a problem for workers represented by strong trade unions and politically powerful enough to achieve *de facto* wage indexation. Inflation comes primarily at the expense of creditors and holders of financial assets, 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 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

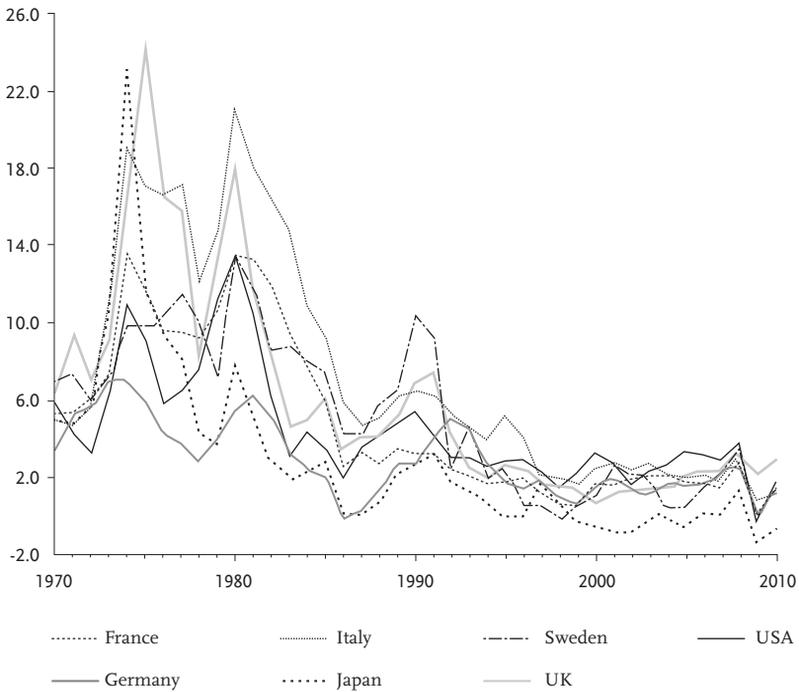
property and market power, inflation may also be considered an expression of anomie in a society which, for structural reasons, cannot agree on common criteria of social justice. It was in this sense that the British sociologist, John Goldthorpe, suggested in the late 1970s that high inflation was ineradicable in a democratic-capitalist market economy that allowed workers and citizens to correct market outcomes through collective political action.⁶

For governments facing conflicting demands from workers and capital 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 post-war years, economic growth had provided governments struggling with incompatible concepts of economic justice with additional goods and services by which to defuse class antagonisms. Now governments had to make do with additional money, as yet uncovered by the real economy, as a way of pulling forward future resources into present consumption and distribution. This mode of conflict pacification, effective as it at first was, could not continue indefinitely. As Hayek never tired of pointing out, accelerating inflation is bound to give rise to ultimately unmanageable economic distortions in relative prices, in the relation between contingent and fixed incomes, and in what economists refer to as 'economic incentives'. In the end, by calling forth Kaleckian reactions from increasingly suspicious capital owners, inflation will 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 restore monetary discipline.

3. LOW INFLATION, HIGHER UNEMPLOYMENT

Inflation was conquered after 1979 (Figure 1) when Paul Volcker, newly appointed by President Carter as chairman of the Federal Reserve Bank, raised interest rates to an unprecedented height, causing unemployment to jump to levels not seen since the Great Depression. The Volcker 'putsch' was sealed when President Reagan, said to have initially been afraid of the political fallout of Volcker's aggressive disinflation policies,

⁶ John Goldthorpe, 'The Current Inflation: Towards a Sociological Account', in Fred Hirsch and Goldthorpe, eds, *The Political Economy of Inflation*, Cambridge, MA 1978.

FIGURE I. *Inflation Rates, 1970–2010*

Source: OECD Economic Outlook Database No. 87

was re-elected in 1984. Thatcher, who had followed the American lead, had won a second term in 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 determined attacks on trade unions by governments and employers, 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 unemployment went more or less steadily up (Figure 2, overleaf). In parallel, unionization declined almost everywhere, and strikes became so infrequent that some countries ceased to keep strike statistics (Figure 3, overleaf).

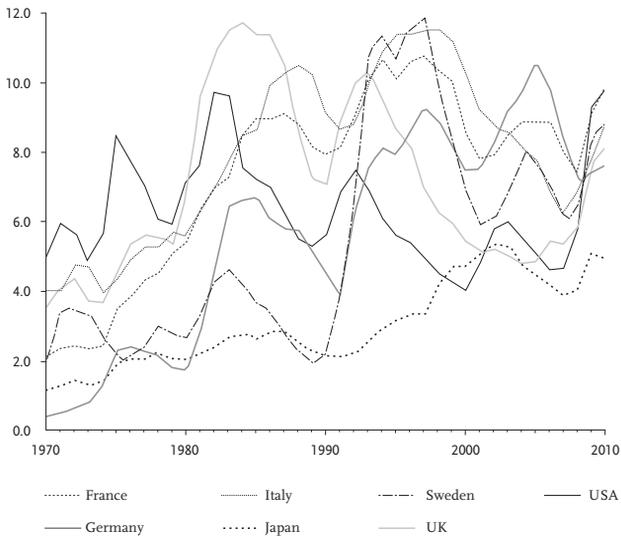
The neoliberal era began with Anglo-American governments casting aside the received wisdom of post-war democratic capitalism, which

held that unemployment would undermine political support, not just for the government of the day but also for democratic capitalism itself. The experiments conducted by Reagan and Thatcher on their electorates were observed with great attention by policy-makers worldwide. Those who may have hoped that the end of inflation would mean an end to economic disorder were soon to be disappointed, however. As inflation receded, public debt began to increase, and not entirely unexpectedly.⁷ 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 through weakening national currencies, a process that had first complemented economic growth, and then increasingly substituted for it, 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 become due, increasingly burdening public finances.

With inflation no longer available for closing the gap between the demands of citizens and those of ‘the markets’, the burden of securing social peace fell on the state. Public debt turned out, for a while, to be a convenient functional equivalent of inflation. As with inflation, public debt made it possible to introduce resources into the distributional conflicts of the time that had not yet in fact been produced, enabling governments to draw on future resources in addition to those already on hand. As the struggle between market and social distribution moved from the labour market to the political arena, electoral pressure replaced trade-union demands. Instead of inflating the currency, governments began to borrow on an increasing scale to accommodate demands for benefits and services as a citizen’s right, together with competing claims for incomes to reflect the judgement of the market and thereby help maximize the profitable use of productive resources. Low inflation was

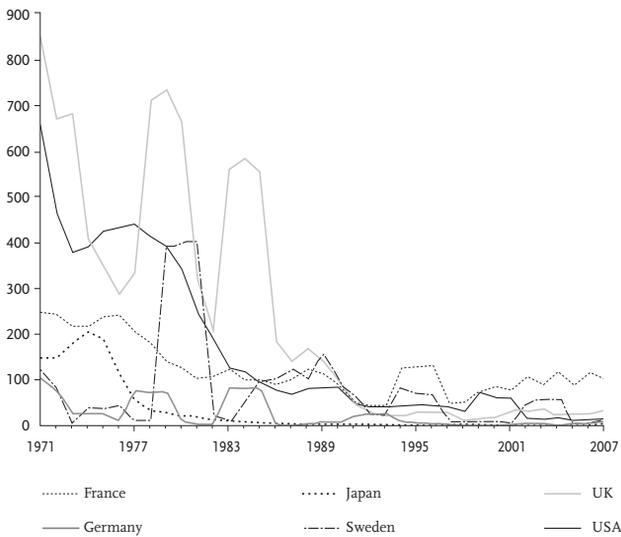
⁷Already in the 1950s Anthony Downs had noted that in a democracy the demands from citizens for public services tended to exceed the supply of resources available to government; see for example, ‘Why the Government Budget Is Too Small in a Democracy’, *World Politics*, vol. 12, no. 4, 1960. See also James O’Connor, ‘The Fiscal Crisis of the State’, *Socialist Revolution*, vol. 1, nos 1 and 2, 1970.

FIGURE 2. *Unemployment Rates, 1970–2010*



Source: OECD Economic Outlook Database No. 87

FIGURE 3. *Strike Days per 1,000 Employees, 1971–2007*



Source: Author's calculations of three-year moving averages based on ILO Labour Statistics Database and OECD Labour Force Statistics

helpful in this, since it assured creditors that government bonds would keep their value over the long haul; so were the low interest rates that followed when inflation had been stamped out.

Just like inflation, however, accumulation of public debt cannot go on forever. Economists had long 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 practice, it turned out to be possible, at least for a while, to keep interest rates low by deregulating financial markets while containing inflation through continued union-busting.⁸ Still, the US in particular, with its exceptionally low national savings rate, was soon selling its government bonds not just to citizens but also to foreign investors, including sovereign wealth funds of various sorts.⁹ Moreover, as debt burdens rose, a growing share of public spending had to be devoted to debt service, even with interest rates remaining low. 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. By then at the latest, pressures would begin to mount from ‘financial markets’ for consolidation of public budgets and a return to fiscal discipline.

4. DEREGULATION AND PRIVATE DEBT

The 1992 presidential election in the United States was dominated by the question of the two deficits: that of the Federal Government and that 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.¹⁰ But once the Democrats lost their Congressional majority in the 1994 midterm elections, Clinton turned to a policy of austerity involving deep cuts in public spending and

⁸ Greta Krippner, *Capitalizing on Crisis: The Political Origins of the Rise of Finance*, Cambridge, MA 2011.

⁹ David Spiro, *The Hidden Hand of American Hegemony: Petrodollar Recycling and International Markets*, Ithaca, NY 1999.

¹⁰ Robert Reich, *Locked in the Cabinet*, New York 1997.

changes in social policy which, in the words of the President, were to put an end to 'welfare as we know it'. 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.¹¹ 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 indebted themselves. The felicitous term, 'privatized Keynesianism', was coined to describe what was, in effect, the replacement of public with private debt.¹² Instead of 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 sometimes compelled, to take out loans at their own risk with which to pay for their education or their advancement to a less destitute urban neighbourhood.

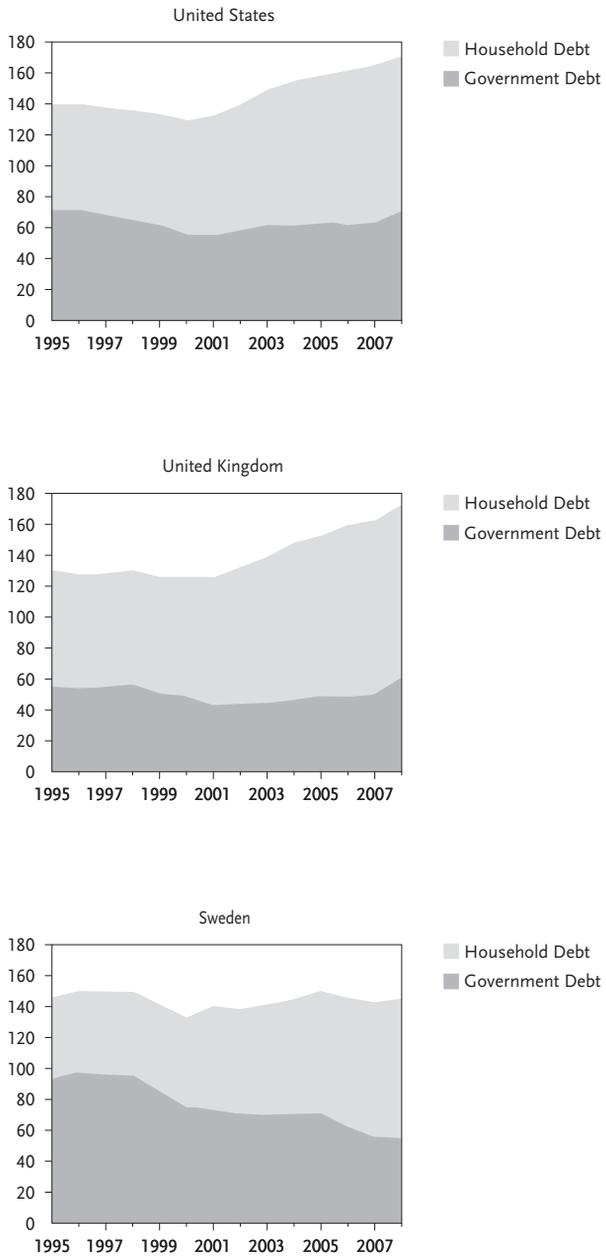
The Clinton policy of fiscal consolidation and economic revitalization through financial deregulation had many beneficiaries. The rich were spared higher taxes, while those among them wise enough to move their interests into the financial sector made huge profits on the ever-more complicated 'financial services' which 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 'flexibilized' labour market. For African-Americans in particular, owning a home was not just the 'American dream' come true but also a much-needed substitute for the old-age pensions that many were unable to earn in the labour markets of the day and which they had no reason to expect from a government pledged to permanent austerity.

¹¹ Joseph Stiglitz, *The Roaring Nineties: A New History of the World's Most Prosperous Decade*, New York 2003.

¹² Colin Crouch, 'Privatized Keynesianism: An Unacknowledged Policy Regime', *British Journal of Politics and International Relations*, vol. 11, no. 3, 2009.

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, never have been able to buy a home, 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 uncommon for home owners to use their new credit to buy a second or third dwelling, in the hope of cashing in on what was somehow expected to be an open-ended increase in the 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, 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 liked.

Financial liberalization thus compensated for 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 state-governed collective demand in supporting employment and profits in construction and other sectors (Figure 4). These dynamics accelerated after 2001, when the Federal Reserve switched to very low interest rates to prevent an economic slump and the return of high unemployment this implied. In addition to unprecedented profits in the financial sector, privatized Keynesianism sustained a booming economy that became the envy not least of European labour movements. 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-union leaders, who noted with great excitement 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 in 2008 when 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, as % of GDP 1995–2008*

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

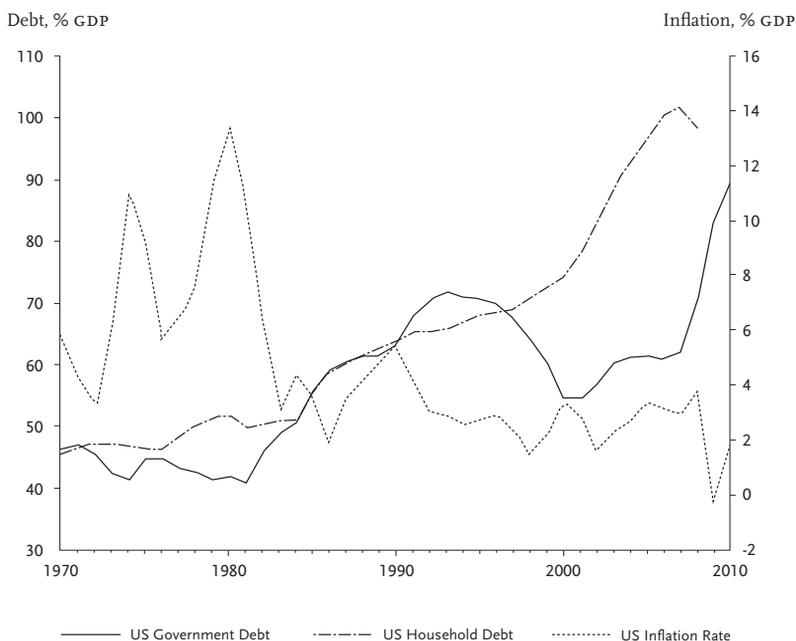
5. SOVEREIGN INDEBTEDNESS

With the crash of privatized Keynesianism in 2008, the crisis of post-war democratic capitalism entered its fourth and latest stage, after the successive eras of inflation, public deficits and private indebtedness (Figure 5).¹³ With the global financial system poised to disintegrate, nation-states sought 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 the 'real economy', 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 or misconceived public institutions, as implied by theories of 'public choice' and the large institutional-economics literature produced in the 1990s under the auspices of, among others, the World Bank and the IMF.¹⁴

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 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 financial sector. 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 private-sector creditors. But while this effectively shored up the financial industry's money factories, quickly reinstating their extraordinary profits, salaries and bonuses, it could not prevent rising suspicions on the part of the same 'financial markets' that, in the process of rescuing them, national governments might have over-extended themselves. Even with the global economic crisis far from over, creditors began

¹³ 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; Fritz Scharpf, *Crisis and Choice in European Social Democracy*, Ithaca, NY 1991.

¹⁴ For a representative collection see James Poterba and Jürgen von Hagen, eds, *Institutions, Politics and Fiscal Policy*, Chicago 1999.

FIGURE 5. *Four Crises of Democratic Capitalism in the US, 1970–2010*

Source: OECD Economic Outlook Database No. 87

vociferously to demand a return to sound money through fiscal austerity, in search for reassurance that their vastly increased investment in government debt would not be lost.

In the three years since 2008, distributional conflict under democratic capitalism has turned into a complicated tug-of-war between global financial investors and sovereign nation-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 very states that they had only recently blackmailed into saving them. But the underlying configuration of power and interests is far more complex and still awaits systematic exploration. For example, since the crisis financial markets have returned to charging different states widely varying interest rates, thereby differentiating the pressure they apply on governments to make their citizens acquiesce in unprecedented spending cuts—in line, again, with a basically unmodified market logic

of distribution. Given the amount of debt carried by most states today, even minor increases in the rate of interest on government bonds can cause fiscal disaster.¹⁵ At the same time, markets must avoid pushing states into declaring sovereign bankruptcy, always an option for governments 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 that the first default would cause. A similar type of ‘solidarity’ between states in the interest of investors is 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 ways in which the tension in democratic capitalism between demands for social rights and the workings of free markets expresses itself today. Some governments, including the Obama administration, have attempted to generate renewed economic growth through even more debt—in the hope that future consolidation policies will be assisted by a 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 may be looking forward to a promising fight against political interference, 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 need government debt for safe investment; pressing too hard for balanced budgets may deprive them of highly desirable investment opportunities. The middle classes of the advanced-capitalist countries have put a good part of their savings into government bonds, while many workers are now heavily invested in supplementary pensions. Balanced budgets would likely involve states having to take from their middle classes, in the form of higher taxes, what these classes now 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

¹⁵ For a state with public debt equalling 100 per cent of GDP, an increase by 2 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 4 per cent of GDP would as a result increase by half.

to their children. However, while this should make them interested in states being, if not debt-free, then reliably able to fulfil their obligations to their creditors, it may also mean that they 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.

However complicated the cross-cutting cleavages in the emerging international politics of public debt, 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; 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 necessary, for another rescue of national and international banks—with his or her private savings, cuts in public entitlements, reduced public services and higher taxation.

6. SEQUENTIAL DISPLACEMENTS

In the four decades since the end of post-war growth, the epicentre of the tectonic tension within democratic capitalism has migrated from one institutional location to the next, 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, or 'economic justice', played itself out primarily in national labour 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 to put an end to it at high political risk, the conflict re-emerged 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'.¹⁶

¹⁶ Joseph Schumpeter, 'The Crisis of the Tax State' [1918], in Richard Swedberg, ed., *The Economics and Sociology of Capitalism*, Princeton, NJ 1991.

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 and politically 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 between financial institutions and electorates, governments, states and international organizations. Now the issue is how far states can go in imposing the property rights and profit expectations of the markets on their citizens, while avoiding having to declare bankruptcy and protecting 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 evaluated by the market, on the other. Each of the three worked for a while, but then began to cause more problems than they solved, indicating that a lasting reconciliation between social and economic stability in capitalist democracies is a utopian project. 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 this process—the successive manifestation of democratic capitalism’s contradictions, in ever new varieties of economic disorder—should have ended.

7. POLITICAL DISORDER

At this point, it seems clear that the political manageability of democratic capitalism has sharply declined in recent years, more in some countries than in others, but also overall, in the emerging global political-economic system. As a result the risks seem to be growing, both for democracy and

for the economy. Since the Great Depression policy-makers 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 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 programme appeared so strict that it would make economic recovery impossible.¹⁷ Moreover, there is 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 favourite clients and, of course, themselves. After all, with regulatory reform in the financial sector having failed in almost all respects, capital requirements are little higher than 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 skilfully 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 to the limit.

Yet democracy is as much at risk as the economy in the current crisis, if not more. Not only has the 'system integration' of contemporary societies—that is, the efficient functioning of their capitalist economies—become precarious, but so has their 'social integration'.¹⁸ With the arrival of a new age of austerity, the capacity of national states to mediate between the rights of citizens and the requirements of capital accumulation has been severely affected. Governments everywhere face stronger resistance to tax increases, particularly in highly indebted countries where

¹⁷ 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.

¹⁸ The concepts were laid out by David Lockwood in 'Social Integration and System Integration', in George Zollschan and Walter Hirsch, eds, *Explorations in Social Change*, London 1964.

fresh public money will have to be spent for many years to pay for goods that have long been consumed. Moreover, with ever-tighter global interdependence, it is no longer possible to pretend that the tensions between economy and society, between capitalism and democracy, can be handled inside national political communities. No government today can govern without paying close attention to international constraints and obligations, including those of the financial markets forcing the state 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, in combinations and permutations as yet unexplored.

As we now read almost every day in the papers, ‘the markets’ have begun to dictate in unprecedented ways what presumably sovereign and democratic states may still do for their citizens and what they must refuse them. The same Manhattan-based ratings agencies that were instrumental in bringing about the disaster of the global money industry are now threatening to downgrade the bonds of states that accepted 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 organizational capacities of normal people: the US, armed to the teeth not just with aircraft carriers but also with an unlimited supply of credit cards, still gets China to buy its mounting debt. All others have to listen to what ‘the markets’ tell them. As a result citizens increasingly perceive their governments, not as *their* agents, but as those of other states or of international organizations, such as the IMF or the European Union, immeasurably more insulated from electoral pressure than was the traditional nation-state. In countries like Greece and Ireland, anything resembling democracy will be effectively suspended for many years; in order to behave ‘responsibly’, as defined by international markets and institutions, national governments will have to impose strict austerity, at the price of becoming increasingly unresponsive to their citizens.¹⁹

Democracy is not just being pre-empted in those countries that are currently under attack by ‘the markets’. Germany, which is still doing relatively well economically, has committed itself to decades of

¹⁹ Peter Mair, ‘Representative versus Responsible Government’, Max Planck Institute for the Study of Societies Working Paper 09/8, Cologne 2009.

public-expenditure cuts. In addition, the German government 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 to occur in the case of the first country collapsing. The high political cost of this can be measured in the progressive decay of the Merkel government's electoral capital, resulting in a series of defeats in major regional elections over the past year. 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 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.²⁰

The political expectations that democratic states are now facing from their new principals may be impossible to meet. International markets and institutions 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 publicly pledged to 'sound finance', or else the cost of debt service will 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.

One factor here is that the arenas of distributional conflict have become ever more remote from popular politics. The national labour markets of the 1970s, with the manifold opportunities they offered for corporatist political mobilization and inter-class coalitions, or the politics of public

²⁰ According to Wolfgang Schäuble: 'We need new forms of international governance, global governance and European governance.' *Financial Times*, 5 December 2010. Schäuble acknowledged that if the German parliament was asked to forfeit its jurisdiction over the budget immediately, 'you would not get a Yes vote'—'[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.

spending in the 1980s, were not necessarily beyond 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 the political and financial elites to recognize the underlying interests and identify their own.²¹ While this may generate apathy at the mass level and thereby make life easier for the elites, there is no relying on it, in a world in which blind compliance with financial investors is propounded as the only rational and responsible behaviour. To those who refuse to be talked out of other social rationalities and responsibilities, such a world may appear simply absurd—at which point the only rational and responsible conduct would be 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 may 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 more 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 be fully understood. It also can—and 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's 'power elite' appears a

²¹ 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 against each other nations that are each subject to the same financial market pressures for public austerity. Ordinary people are told to demand 'sacrifices' from other ordinary people, who happen to be citizens of other states, rather than from those who have long resumed collecting their 'bonuses'.

shining example of liberal pluralism.²² More than ever, economic power seems today to have become political power, while citizens appear to be almost entirely stripped of their democratic defences and their capacity to impress upon the political economy interests and demands that are incommensurable with those of capital owners. In fact, looking back at the democratic-capitalist crisis sequence since the 1970s, there seems a real possibility of a new, if temporary, settlement of social conflict in advanced capitalism, this time entirely in favour of the propertied classes now firmly entrenched in their politically unassailable stronghold, the international financial industry.

²² C. Wright Mills, *The Power Elite*, Oxford 1956.