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Seven ways to fix the system's flaws

By Martin Wolf

The shocks inflicted on the world by the upheavals of the past few years make a thoroughgoing overhaul urgent

Three years ago, when the worst financial and economic crisis since the 1930s gripped the global economy, the Financial Times published a series on "the future of capitalism". Now, after a feeble recovery in the high-income countries, it has run a series on "capitalism in crisis". Things seem to be worse. How is this to be explained?

In 2009, the world was in a state of shock. Now, despite successful efforts at stabilising economies, people are closer to despair. Something seems to be wrong with the system. But what, and what needs to be done?

Capitalism has always changed. That is its genius. Today's shocks make the case for reform urgent. Let us consider seven challenges. Some relate to capitalism itself, others to the context in which it operates.

Managing macro instability

One of the biggest debates in economics is whether a modern capitalist economy is inherently stable. Before the crisis, the orthodox view was that it would be if one had a competitive economy and a central bank that anchored inflation expectations. Events have disproved this view.

The late Hyman Minsky, in his masterpiece, *Stabilizing an Unstable Economy*, provided incomparably the best account of why this theory is wrong. Periods of stability and prosperity sow the seeds of their downfall. The leveraging of returns, principally by borrowing, is then viewed as a certain route to wealth. Those engaged in the financial system create – and profit greatly from – such leverage. When people underestimate perils, as they do in good times, leverage explodes.

Finance then progresses from what Minsky called "hedge", in which interest and principal is repaid out of expected cash flow, to "speculative", in which interest is paid out of cash flow but debt needs to be rolled over, and finally to "Ponzi", in which both interest and principal is to be paid out of capital gains. Does this sound familiar? It certainly should.

What is the answer? We can see three elements if one puts to one side the notion that we should return to the 19th-century gold standard or eliminate banking.

The first is to recognise that, as critics have long noted, crises are inherent in free-market capitalism. This is partly because of the way capitalism itself behaves. It is also because all participants, including regulators and even economists, act and think pro-cyclically.

Second, so-called "macroprudential" policy – oversight over the financial system as a whole – matters. Regulators need to watch the build-up of leverage. They also need to ensure adequate levels of loss-absorbing capital in financial institutions and among the ultimate borrowers.

Finally, the government and its agencies, including the central bank, have a big role. They acted as stabilising forces during the crisis. But they also acted as destabilising forces before the crisis: central banks responded too aggressively to incipient recessions in previous decades and governments were too willing to encourage excessive leverage in the household sector. These serious mistakes must not be repeated.

Fixing finance

The financial system is an essential part of any market economy. But it is based on a complex and fragile network of trust. The lesson of the crisis is that such networks are prone to abuse and then to collapse.

Again, what is the answer? It is to protect finance from the economy and the economy from finance. This requires bigger shock absorbers. If that change is made, the normal disciplines of the market can operate, as they should: no more "too big and connected to fail". Yet mistakes will still be made. People are always influenced by the fads and fashions of the moment. But if the financial system is more robust, it will be in a better position to survive such errors.

What are the elements of the shock absorbers? The most important is far more capital. The core financial institutions should not in the long run have leverage of more than 10 to one. An additional requirement is a resolution regime that lets the authorities act promptly once institutions are on the brink of losing funding. Moreover, as the UK's Independent Commission on Banking (of which the writer was a member) has also recommended, managing the payments system and providing credit to households and small and medium-sized businesses should be separated from investment banking, to strip away implicit subsidies.

Finally, too often, consumers cannot understand what they are buying. The principle of "caveat emptor" – let the buyer beware – does not work. People need protection from the predatory practices seen so egregiously in US subprime lending before 2008.

Addressing inequality and jobs

As the Organisation for Economic Co-operation and Development, the Paris-based think-tank, showed in a recent report, high-income countries have seen large rises in inequality over the past three decades. This is captured in the slogan of the Occupy Wall Street protest movement: "We are the 99 per cent". The rise in inequality is the result of complex forces: globalisation, technological change, "winner-take-all" markets, the birth of new and dynamic industries, changes in social norms over pay, the rise of finance, and shifts in taxation.

Many of these changes were irresistible and are irreversible. But the level and increase in inequality does vary across countries, which suggests that economic structure and policies do alter outcomes. The US and UK, for example, have seen far faster rises in the real incomes of the top decile than of the bottom decile of household income distribution since the 1980s. In France, this went the opposite way.

Many would argue that inequality is unimportant. To this, there are two powerful responses. The first is that it is important if it is politically salient. It is. The second is that inequality of outcome has a strong bearing on equality of opportunity, about which many more do care. It is harder for children who grow up in deprivation to obtain a decent start in life than those brought up in happier conditions. The effort becomes harder still if parents cannot find remunerative jobs and young people cannot hope to do so when entering the job market.

What are the answers? Among them must be explicit fiscal redistribution from the winners to the losers and particularly to the children of the losers; subsidisation or direct provision of jobs; big efforts to improve the quality of education and childcare for all, including public financing of access to higher education; and a determination to sustain demand more effectively in severe downturns.

Changing corporate governance

The core institution of contemporary capitalism is the limited liability corporation. It is a brilliant social invention. But it has inherent failings, the most important of which are that companies are not effectively owned. That makes them vulnerable to looting. Incentives allegedly provided to align the interests of top employees with those of shareholders, such as share options, create incentives to manipulate corporate earnings, at the expense of the long-term health of the company. Shareholder control is too often an illusion and shareholder value maximisation a snare, or worse.

What is the answer? Unfortunately, no simple remedy exists. The corporation is the best institution we know of for running large, complex and dynamic businesses. It is surely important to ensure that taxation and regulation do not obstruct other forms of ownership, including partnerships and mutuals. It is vital to encourage the creation of genuinely independent, diverse and well-informed boards. It is sensible to ensure that pay packages are transparent and any incentives for destructive forms of remuneration are removed. But except in banks, where the public interest demands intervention in the incentives of management, governments should not intervene directly.

Tinkering with taxation

The general thrust of political discussion, outstandingly so in the US, is against any and all taxation. Yet taxes play a decisive role in determining how the market economy operates, for good and ill. They determine the resources available for the supply of essential public goods and services. Finally, they can make a big difference to the outcome on inequality.

What are the answers? Among the most important tasks is to remove the incentives for leverage embedded in personal and corporate taxation. On the latter, treating equity and debt equally might significantly reduce fragility. Another sensible idea is to shift the tax burden from incomes on to consumption and wealth. Yet another objective is to ensure richer people pay tax. At present a host of loopholes protect them, including the ability to turn income into capital gains. Some of this demands global co-operation, which is horribly difficult to obtain.

Curbs to purchasing politics

Among the biggest concerns must be the relationship between wealth and democratic politics. Politics and markets each have their proper spheres. The market is based on the roles of people as producers and consumers. Politics is based on their roles as citizens. In the absence of protection for politics, the outcome is plutocracy. Plutocrats like closed political and economic systems. But if they succeed, they undermine the open access on which democratic politics and a competitive market economy depend. Protecting democratic politics from plutocracy is among the biggest challenge to the health of democracies.

What is to be done? The protection of politics from the market comes by regulating the use of money in elections and by the supply of public resources to those engaged in them. At least partial public financing of parties and elections is inescapable.

Globalising public goods

Last but not least, today's capitalism is global. This creates a host of both challenges and constraints.

One issue is how to regulate businesses that operate on a vast global scale. This has turned out to be particularly difficult in finance. There is a choice: align support in times of trouble with regulation at the national level and so break up the integrated global financial system, or align support with regulation at higher levels and move towards a more integrated European or global politics.

More broadly, the disjunction between the level at which politics operates and the levels at which business and the economy function is a concern. Among the issues it raises is how to provide a host of global public goods by agreement among a range of very different states. Those include open markets, monetary and financial stability, security and, above all, protection of the environment.

What are the answers? The long-term one is likely to be more global governance. Will that be feasible? Not in the near future, in many areas.

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A crisis, it has been said, "is a terrible thing to waste". Capitalism has always changed. It needs to change right now if it is to survive and thrive. We need to find specific practical reforms within capitalism and to review the framework within which it operates.

But capitalism must still be capitalism. It is highly imperfect. Yet so are we. It is still a uniquely flexible, responsive and innovative economic system. It may be "in crisis" right now. But it is still among humanity's most brilliant inventions. It is the basis for the prosperity that so many now enjoy and far more aspire to. It is transforming the lives of billions of people. Let us strive to make it better.