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“Competing Models of Capitalism and the Reorganization of World Economy after the Financial Crisis”^{*}

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Abstract: The international economic system is threatened, not only by the economic effects of the financial crisis, but also by the different interpretations on how the system should be reorganized. The different views are based on divergent models of capitalism and pose various ways of formulating state intervention in the market economy. We consider three models of capitalism as relevant in current discussion: "deregulated market economy", "state capitalism", and "social market economy". The main objective of the article is to evaluate these systems and their impact on the debate on the reorganization of the international economic system.

I. Present context and the revival of the debate on models of capitalism

After the fall of the Berlin wall, during the nineties and early 2000s, a world that could be characterized as unipolar unfold, where an extreme interpretation of the free market –the idea of a completely self-regulated market and therefore an economic policy based on deregulation– and candid confidence in a automatic advance to the western style of democracy flourished.¹

The international financial and economic crisis, triggered in 2007-2008, contributed positively in the decline of this vision that relied on the belief in social determinisms in history.

The financial crisis, which was originated in the collapse of a speculative bubble in mortgage markets, has led to what has been called the "great recession" of the international economy,

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¹ Francis Fukuyama’s “*El fin de la historia y el último hombre*” (Planeta, México, 1992) gave impulse to this vision.

drawing attention to deficiencies in a model based on "deregulated markets". Under this paradigm the regulations of the economy were significantly relaxed (in particular those on financial markets and antitrust law), concentration of economic property and wealth spread, and as a result the global financial system became more vulnerable to recurring and systemic crises.² Consequently, we witness today the deterioration of the social situation –in particular in the developed world– and the weakening of civic and democratic values in some countries.

Moreover, these phenomena have uncovered a long-term process of emergence of a multipolar world, where competition of national or socio-cultural models of capitalism takes place. Models of capitalism are originated in combinations of certain economic policies, a definite set of institutions and a given socio-cultural fabric. These combinations unfold in real historical specific cases in the context of a definite strategic view –usually at the national level– which tries to adapt these elements to address economic situations and geopolitical circumstances in the short and medium term.

The still present international economic crisis has marked, in general terms, the need for the return of State intervention in the economy, which has been implemented by the vast majority of countries, to a greater or lesser extent, (including policies such as the support of financial institutions and companies through the participation of the State, unemployment financial support and social policies, and the impulse to public spending in infrastructure, among others). A debate also started about how to reformulate the national regulations, and international institutions. The anti-cyclical policies, with fostered by the state contained the worst effects of the crisis, although "the end of the tunnel" is still not in sight, because the likelihood of a recession consisting of two drops, i.e. with a "W" pattern –at the time this paper is being written– still remains.

At the present time, on the other hand, different ways of interpreting "state intervention" in the economy arise. In most of the developed world this intervention is conceived as an exceptional and timely intervention, oriented towards the recovery of the private sector economy, understood as the primary engine of growth. In several countries of the developing world, extended intervention gives rise to a new model in which the state aims to manage the economy for an unlimited period of time.³ The leaders of many countries are adopting pragmatically a new model of "state capitalism", which some believe may help overcome the financial crisis and replace the "de-regulated markets" consensus, granting economic stability and growth. Other countries are in an intermediate situation, on the lookout. In the context of these trends, which have been taking shape recently, it seems to us that the debate on the economic systems and their accompanying policies will be redefined from here on.

² See Marcelo Resico, (2002) "Crisis en la nueva economía", *Revista Valores*, FCSE-UCA, December, No. 55.; and "La crisis financiera y el debate sobre las regulaciones," *Diario El Economista*, October 3, 2008.

³ Ian Bremmer, (2009). "State Capitalism Comes of Age", *Foreign Affairs*, May/Jun, Vol.88, Issue3.

On the other hand at the global level we can see that the international system is threatened, not only by the economic effects of the crisis, but by the different interpretations of how it should be organized. We share the view that these differences are based on differing models of capitalism.⁴ The changes in the balance of economic and political power at the international level, as shown by contemporary evolution of the G-7 to G-20, make it unavoidable to assume this topic for the resolution of the form that a new international architecture must take. The central argument of this article is that there is a third alternative, between the "deregulated market" and the "state capitalism" models: the "social market economy", consisting in an adequate response to national challenges as well as a sound contribution to the debate on the reconstitution of the international system.

II. State Capitalism and its limits.

State capitalism is a system in which the government acts as the dominant economic player and uses markets mainly for its political benefit. In order to do this it can combine political authoritarianism with state control of the key sectors of the economy. Governments that practice "state capitalism" know, after the experience of Soviet communism, that sustaining economic growth is essential to maintain the monopoly of political power.

The economy in these countries can maintain "theoretically" private property and a pragmatic opening to foreign trade, but in the service of the state and its leaders. The government uses the state-owned companies or those controlled by the state, and other social partners (trade unions and social movements, as is the case in Latin America), to move forward their policies. In state capitalism the success in the business depends on the close relations between entrepreneurs and political officials. At the same time, the policy of expansion of the activities and powers of the state provide more opportunities to condition the economic and social actors.

According to analysts of the phenomenon, state capitalism has three main actors: state-owned companies (oil industry and other relevant sectors), allied national private corporations, and public financial funds.⁵ Large state-owned enterprises are usually monopolies in their sectors, enjoy better conditions and receive funding from the state. The government also uses selected private companies, called "national champions", to dominate key industries.⁶ The state-owned or state-controlled companies often enjoy a dominant role in the domestic economy and in export markets.

Public financial funds aim to achieve a tight control of the most relevant investment projects through the power of long-term state financing. The latter, in turn, gets the capital by capturing

⁴ Bremmer, I., Roubini, N., (2011). "A G-Zero World", *Foreign Affairs*, Mar/Apr, Vol.90, Issue 2.

⁵ Adapted from Ian Bremmer, (2008) "The Return of State Capitalism", *Survival*, vol. 50, no. 3, June–July, pp. 55–64., who mentions 4 elements.

⁶ Great private businesses depend on state patronage in form of legal restrictions to eliminate competition, differential access to government contracts, subsidies, long-term investment financing, etc.

foreign exchange reserves accumulated thanks to exports, taking over natural resource rents and the revenues from the operations of the controlled large businesses. The motivations behind investment decisions are political as well as economic.

The government controls the economy by acting as a “capitalist” (in the sense stated by Karl Marx), that is to say, by appropriating surplus from the private economy. The "surplus appropriation" policy presupposes and requires a production system capable of creating wealth. In this conception, the optimal strategy is not short-term return maximization, but to encourage the productive system as much as possible, consistent to the preservation of the dominant position in the system.

In the Latin-American case, for example, the cultural characteristics of the region make our predominant form of "state capitalism" to be colored by charismatic authoritarianism and the clientelism of a demagogic state that distributes resources to win elections and adepts. This policy is becoming entrenched in some countries of the region that currently benefit from extremely good international commodity prices and have abundance of natural resources. However, this scheme wastes valuable resources in investments of dubious economic rationality and poorly designed social policies, without interest in encouraging self-improvement and independence of the people to whom they are addressed. The fate of this model will depend on the permanence of the international conditions that make it possible (commodity prices) and on a clearer awareness by the population on the level of inefficiency and contradictions that generates.

From a broader point of view, “state capitalism”, as such, is a system that has serious limitations that tend to increase over time. Economic decisions, taken by politicians and bureaucrats add in inefficiencies making economies less competitive, efficient and productive. The higher administrative costs, inefficiency, and growing public corruption burden the functioning of markets. The mixture of business with government impairs competition, and more grave indeed “state capitalism” –as well as "de-regulated market economy"– does not believe in laws against monopolies. The distortions of competition, such as imbalances, bottlenecks, etc., lead to misallocation of resources, which in “state capitalism” usually involves new interventions, causing a vicious circle.

Companies that maximize political objectives do not tend to be innovative and productive, since the political criteria often hinder efficiency and entrepreneurship. The investments made based on political calculations in general neglect the economic criteria, putting at risk the growth of the favored companies themselves. Also state's credit aimed to reduce risks is channeled to large companies, but does not reach the small. Corruption is higher as the state grows, weakening

the operation of public administration itself, public services and infrastructure. Eventually, systems operating under "state capitalism" erode its own capacity.⁷

Besides, the politicization of economic relations could easily lead to disharmony of interests, which is manifest in a constant and growing tension between parties and groups. The appropriation of surplus expands the "zero-sum" logic to other parts of society. By this logic an individual or group wins at the expense of another, stimulating the escalation of conflict between interest groups. In this fashion it is probable that tension rises within the ruling class, or between the ruling class and the rest of society.⁸ Finally, the model, which contains growing contradictions, becomes inherently unstable over time.

III. Contemporary alternative systems of economic organization

The "de-regulated market" capitalism has led to the current "great recession", on the basis of growing economic concentration, capture of regulatory agencies by special interest groups, and a thoughtless deregulation, which caused a great financial instability later. However, its present replacement in many emerging economies by systems of "state capitalism" only deepens these deficiencies, generating an inefficient and concentrated economy. Moreover they depend on political systems that are generally of an authoritarian sign and opaque to citizen participation, increasing the incentives for corruption.

As we could see in the last few decades serious economic abuses have been committed in the name of the decentralized systems of market capitalism, and the vitality and controls of a democracy under the rule of law have been greatly weakened. Nevertheless this form of organization, when the state establishes a strong institutional framework, economic results are oriented towards social ends, and the civil society recovers an active engagement, remains a system that has proved to prevent abuses generating both legitimacy and economic growth in many places of the world and across different times.

Even though democratic regimes are not immune to certain elements of "state capitalism", institutionalized and participatory democracy, with its rule of law, alternation of government, active civil society, free and pluralistic press, and other controls on power –provided they are supported by wide consensus to be effective– hinder their growth. An example of this type of system is what has been called the Social Market Economy, which is a third alternative between "de-regulated market economy" that collapsed recently and "state capitalism" that arises in the present.

⁷ Walter E. Grinder, John Hagel III, "Toward a Theory of State Capitalism: Ultimate Decision-Making and Class Structure", *Journal of Libertarian Studies*, Vr.1. I. No. I, pp. 59-79.

⁸ Ibid.

IV. Social Market Economy as an organizing economic system.

The social market economy is a system based on a free market economy, which cannot be conceived without the existence, at the same time, of a strong institutional framework, and an emphasis on the socialization of the results of economic growth in an equitable manner through society. This last point is achieved through an active decentralization policy (for example antimonopoly law, local and regional development policies, etc.), and in the form of a subsidiary social policy that promote self-improvement of individuals and communities (empowering civil society associations for social aid, and complementary public policies).

The institutional framework in this system is based on the rules of a market economy, the defense against concentrations of economic power or the protection against restraints to competition, sound market regulation (in order to avoid behavior that may violate justice and a fair competition) and rules for the use of macroeconomic policies that open up a space for its prudent use in cases of exceptional situations, such as active macro policies during the current crisis.

Social policy as a whole is conceived in a "subsidiary" function, supporting self-help, and based on the promotion and strengthening of civil society initiatives, with a State that intervenes in cases where these efforts are not sufficient. This socio-economic model harmonizes inherently with a participatory democracy political system based on the recognition of individual and social rights, with government alternation and the division of powers to guarantee them.⁹

The SME emerged from the search for an economic and institutional framework on the medium and long term that could be explicit, respected and stable as a basis for the organization of an economic system.¹⁰ The different actors in the economy, such as consumers, investors, savers, trade unions, employers, require a clear and reliable framework for their decision-making on the medium and long term.

The Social Market Economy is based on the organization of markets as the best system for allocation of resources, while it tries to correct its flaws and to grant the institutional, ethical and social conditions to its efficient and equitable operation. When required it doesn't abstain from

⁹ Resico Marcelo, (2011). *Introducción a la Economía Social de mercado. Edición Latinoamericana*, Río de Janeiro, SOPLA-KAS.

¹⁰ SME comprises a complete political economic theory and a proved economic policy system applied in real economy experiences. This approach was developed in Germany and was applied successfully after the Second World War. The results have influenced similar decisions in neighboring countries at the time. It also contributed to the reunification of Germany in 1989 and it influenced the economic system adopted by the European Union as well as in the developing and transitioning countries, including Latin America. In some way the economic system of the USA (and Anglo-Saxon world) has a similar structure but depends on political consensus between different political parties through time, instead of on a broad and common explicit economic concept. It could be argued that both approaches are useful in different cases depending on cultural backgrounds. (For an study of the American economy case close to this argument see Luttwak, Edward, *Turbo Capitalism*, Harper Perennial, New York, 1999; and McCraw Thomas, *Creating Modern Capitalism*, Harvard University Press, Cambridge, 1998.

compensating or correcting possible excesses or imbalances that a modern economic system based on free markets –characterized by a thorough and extensive division of labor– that, in certain areas and under certain circumstances, can get away from a fair and effective competition may present.

The ESM system arises from the conscious attempt to synthesize the advantages of a market economic system: stimulation of individual initiative, productivity, efficiency, tendency to self-regulation, with the fundamental contributions of the social tradition of solidarity and cooperation based on equity and justice in a given society.¹¹ The representatives of this concept work in a synthesis of the liberal political-economic tradition in regard to the "individual rights," "republicanism," and the "market," with the tradition of social -Christian thought that emphasizes "human dignity," "social justice" and "fraternity".

In order to take the economic socio-political principles listed thus far to the concrete reality, the social market economy is based on a series of economic principles that are derived from them. The first listing of them is due to the contribution made by the economist Walter Eucken, one of the leaders of the Freiburg School of Law and Economics, who classified them into two groups: the so-called "structural principles", which are dedicated to ensure the field of economic freedom, and the "regulatory principles", which are the ones that prevent the potential abuse of that freedom and guarantee that the profits generated in the market will be widely distributed in a socially equitable manner.¹²

The structural principles involve the development of a market economy which provides, if properly designed, the most efficient system known for the encouragement of production and of economic organization. In regards to the regulatory principles, they are related to the institutional framework and economic policy that the state provides, and are needed for a market economy to produce the benefits of its high productivity in the service of people in a given society.

All this set of economic principles presupposes the existence, in contrast with extreme economic liberalism and with the authoritarian statism, of a "strong and limited" state. "Strong" to promote and implement the principles set forth, and even punish individuals or pressure groups that seek to violate them by imposing their own interests; and "limited" so that it does not exceed its functions beyond those principles, nor in the design nor its application. In addition the

¹¹ This definition of the ESM as a socio-economic model comes from the ideas developed by Alfred Muller-Armack, who coined the concept as an open idea and not as a closed theory. In his work *Wirtschaftslenkung und Marktwirtschaft* (Economic management and market economy), 1946, based on the article "Economía Social de Mercado, Introducción" (Social Market Economy. Introduction) by Friedrun Quaas, in Hasse Rolf H., Schneider Hermann, Weigelt Klaus (ed.), (2008). *Diccionario de Economía Social de Mercado, Política Económica de la A a la Z*, 3ra. Ed., Buenos Aires, Konrad Adenauer Stiftung.

¹² See Eucken Walter, *Fundamentals of Economic Policy* (Grundlagen der Wirtschaftspolitik), Rialp, Madrid, 1956; and Karsten Siegfried, Eucken's Social Market Economy and its Test in Post War West Germany, *American Journal of Economics and Sociology*, Vol. 44, No 2, April 1985.

operation of this kind of state is conceived from the point of view of “subsidiarity”, that is to say, in total coincidence with the delegation of functions and the promotion of individual, organized, or civil participation.

V. The debate on economic organization systems on a global stage.

Apart from being a sustainable response at the national level, the model of the Social Market Economy may be a relevant framework of reference as a contribution to the reorganization of the international economic system. The international system is seriously threatened, not only by the economic effects of the current “great recession” crisis, but by a critical dissent in terms of what form this reorganization should take due to divergent models of capitalism, together with the values to institutions that compose them.

The global economy has always needed common values and institutions, in addition to the leadership of certain countries that guaranteed specific institutional and infrastructure requirements as a safety net for markets, trade, and capital flows.¹³ Present day international organizations were created to resolve conflicts through accepted rules, created democratically by members, instead of using bare force. However, the structure of representation of this International Organizations refers to the geopolitical landscape at the end of the Second World War, a scenario that today has clearly changed, weakening their representativeness.

In the present day the geopolitical and geo-economic picture is rapidly evolving. We are witnessing a certain relative decline of leadership of the USA and Europe as a providers of global public goods, in addition to the fact that China, and other emerging powers, are focused on their own development, currently postponing the assumption of greater global responsibilities. This transitional scenario is dangerous, especially in face of substantial differences in the referred “models of capitalism” between developed and emerging countries, which menace the creation of a vacuum in the needed international leadership and organization.

The changes in the balance of economic and political power at the international level, illustrated by the evolution of the G-7 to the G-20 of the present time, make taking into serious account this topic inescapable to the resolution of the form that a new international architecture must take. Until the mid-90s, the G-7 led an international environment based on core of values such as democracy and market economy.

¹³ As the economist Wilhelm Röpke stated during the aftermath of the Great Depression: “Under the system of the competitive market economy, as well as under any other economic system, economic integration cannot, in the end, go further than the socio-political integration based on laws, institutions and psycho-moral forces. The latter is the indispensable condition of the former, whereas it is highly doubtful that economic integration can be sufficiently relied upon to produce the integration it requires... [International economic integration] is a highly sensitive artifact of Occidental civilization, with all the latter's ingredients of Christian and pre-Christian morality and its secularized forms...” Wilhelm Röpke, *International Economic Disintegration*. London 1942, p.68.

In the present the attempt to provide a broader institution with greater representation, including prominent developed and emerging countries, by creating a G-20 is not leading to a so clear list of shared values and institutions. Although the G-20 has acted in a relatively coordinated manner in the view of the recent severe crisis, it has revealed from then on difficulties to reach a certain consensus on philosophical topics as visions on democracy, the role of government in the economy and the way to address the reorganization of the international agencies.¹⁴

This weakness occurs precisely at a time when it is of utmost importance to tackle several issues of the current agenda that are serious and urgent. The detaching of China through its change towards a strategy of development of its domestic market, the clash between different models of capitalism, and the competition for resources and markets could bring more frictions. Already the increase of trade conflicts in the context of the permanence of global imbalances is a symptom of this.

In this scenario it is increasingly clear that there is a need to establish agreements with guarantees to govern the global economy from here onwards. This requires a common framework to set limits on the involvement of the states in view of trade and international environment.¹⁵

The differences between “market capitalism” and “state capitalism”, that to some extent are representative of USA and China economic models of organization, will need other possibilities to play the role of third parties. In this situation there is an important space for the model of the Social Market Economy and for Europe and other countries (some in Latin America) which are applying using this model.¹⁶

Many consequences could arise if this path is taken. From an economic policy point of view for example more emphasis in social policy, both at national and international level, stronger regulations for financial markets, for laws and institutions who could foster competition, a renewal of efforts to bring closer differences in labor and ecological standards between regions and countries.

¹⁴ WEF, (2012). “Global Agenda Council on Geopolitical Risk”, Davos-Klosters, Switzerland 25-29 January.

¹⁵ Lehmann Jean-Pierre and Appleton Arthur, (2011). “Only the Rule of Law can Prevent a US-China Conflict”, IMD, Lausanne, Switzerland, January.

¹⁶ Takenaka Heizo, “The Chinese Mirror”, *Project Syndicate*, 03-02-2011

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