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Profits, banks, and the state: How to get investment going again

by Engelbert Stockhammer

The world is still experiencing the worst economic crisis since the 1930s. While the economic forecasts have brightened up recently, the overall picture is still gloomy. The collapse has been stopped, but the recovery is likely to be muted. This is for three reasons. First, US households, which have been the most dynamic source of demand in the past decade, are deeply in debt – and their houses, the biggest part of their wealth, are worth a lot less. Thus they are not likely to resume spending in the near future. Second, the banks are still in a lot of trouble. The big bank crash after Lehman Brothers has been avoided, but their balance sheets are still loaded with dubious assets and most make their money from trading, i.e. speculating, rather than from extending credit to businesses . It will be hard to get credit for a while. Thirdly, government expenditures that have prevented the meltdown are being rolled back. After the panic of late 2008, normalcy has returned to economic policy making. And in a neoliberal world it is considered normal that states have to balance their books, rather than help the economy or the poor. In short, while the worst is over, the bad is still to come. In particular, unemployment is still rising and will continue to do so.

So how could we get the economy going again? The key component of growth in a healthy economy is investment. Investment is an important source of demand, but it also provides the capital stock needed for future production. There are two types of investment: private and public. Private investment depends on business expectations about demand and profitability and on the availability of credit. Given the extent of the present crisis, it's unsurprising that businesses are reluctant to invest. Academic research has clearly identified demand as the single most important determinant of investment. Indeed, who would invest if they think they can't sell the output? The lesson for policymakers is clear: stabilise demand or the private sector won't invest.

Obviously capitalism is about making money, so firms are unlikely to invest unless they expect to make a profit. However, the importance of profits for investment is often overstated. Indeed, one of the great puzzles of the past decades is why firms (at least outside China) have not invested more, given their abundant profits. Looking at the USA and the EU, in 1980 around two thirds of profits were reinvested, while in 2007 only half were reinvested. Why don't firms invest when they are sitting on all this cash? The short answer is shareholder value orientation and globalisation. Firms now distribute a lot more money to their shareholders through dividend payments or through share buy-backs. Firms are run to the benefit of shareholders. Globalisation means that a lot of firms outsource production, reducing investment at home. This has mixed effects in the countries of the South and the East: it increases production there, but this is often in enclaves that are badly connected to the local economies and it often increases inequality .

The take-home from this is that the problem is not a lack of profits. Profits have been buoyant in the past without much investment taking place. Wage moderation will thus not help investment. Indeed, it will make matters worse. In particular, in countries with a large enough domestic market, such as Germany, wage moderation will depress domestic (consumption) demand further, creating an environment that is detrimental to investment. In a recent study (with Özlem Onaran and Stefan Ederer) we found that in Europe a redistribution of 1000 € from wages to profits will lead to about 100 € more of investment, but to 35 € less consumption. (Stockhammer et al 2009)

Access to credit is a more legitimate cause to worry about for businesses. Banks with problems on their balance sheets will be reluctant to lend. Monetary policy has so far helped to restore bank profitability, but has not been effective in ensuring that banks lend. Simply put, banks can earn a lot of money now, taking credit

from the central banks and buying government bonds. There is no need to bother with old-fashioned business credit. Perversely, governments in many industrial countries now own substantial parts of the banks. But they are reluctant to interfere with their policy. Instead they have provided capital for the big banks in need and now watch how they are run in the interest of shareholders again.

All this may sound like there is little that governments can do to stimulate investment. But this is far from the truth. There is not only private, but also public investment. In the 1930s, public investment projects were used on a massive scale to revitalise the economy. However, today there is great reluctance to do so. Indeed, the IMF and the OECD are eager to push governments to turn to a more restrictive policy. Now with the shock of the imminent collapse over, business is returning to normal – and this means a small state. As if nothing had happened in the past two years! Much of this approach is a legacy of the neoliberal domination that has preached the superiority of private investment over public activity. But the near-meltdown of the financial sector in the 2008 should have made it clear that the private capitalist sector does not possess the miraculous properties of efficiency. Sure, governments often fall prey to corruption and may serve petty interests, but so does the private sector. Remember Bernard Madoff? Or Enron?

How should public investment be financed? Of course the largest demand effect will arise if government expenditures are credit financed. However this will also increase public debt. If expenditures are financed by raising taxes, ways to do so in a progressive manner include closing tax havens, establishing wealth taxes and a financial transactions tax. All of these could raise substantial amounts without negative effects on demand. Closing overseas tax havens has been estimated to have the capacity to generate global additional revenues of US$100-billion (Cavanagh et al 2009). A recent study found that a (worldwide) financial transactions tax of 0.1% would raise about 1.5% of world GDP (Schulmeister et al 2008).

Thus the pragmatic question should be whether there is a material need for investment projects in public infrastructure that the private sector is unlikely to provide. And the answer is a clear yes. From modernising (or building) public transportation to investing in energy-saving technology and from spending on education to housing projects, there are plenty of areas where the social return to public investment is large enough to justify spending. Now is the time.

Further readings and references:

Cavanagh, J, Collins, C, Goldberg, A, Pizzigati S. (2009): Reversing the Great Tax Shift: Seven Steps to Finance Our Economic Recovery Fairly (http://www.ips-dc.org/getfile.php?id=356)

Jetin, B, Denys, L, 2005. Ready for implementation. Technical and legal aspects of a currency transaction tax and its implementation in the EU. Berlin: WEED (http://www2.weed-online.org/uploads/CTT_Ready_for_Implementation.pdf)

Pollin, Robert, Heintz, James, Garrett-Peltier, Heidi, 2009. The Economic Benefits of Investing in Clean Energy. June 2009. (http://www.americanprogress.org/issues/2009/06/pdf/peri_report.pdf)

Schulmeister, Stephan, Schratzenstaller, Margit, Picek, Oliver, 2008. A General Financial Transaction Tax: Source of Finance and Enhancement of Financial Stability. Presentation at the European Parliament in Brussels on April 16, 2008 (http://www.greens-efa.org/cms/default/dok-bin/231/231075.a_general_financial_transaction_tax_sour@en.pdf)

Stockhammer, E, Onaran, Ö, Ederer, S. 2009. Functional income distribution and aggregate demand in the Euro area. Cambridge Journal of Economics 33 (1): 139-159. The working paper version can be downloaded at (http://www.wu-wien.ac.at/inst/vw1/papers/wu-wp102.pdf)

Engelbert Stockhammer is working at the Vienna University of Economics and Business. His research interests include macroeconomics, income distribution, financial systems. He recently wrote "The Rise of Unemployment in Europe" (Elgar 2004) and "Wither Mainstream Economics?" (co-editor, Metropolis 2009).