

REDEFINING CAPITALISM

An article by J.Pozuelo-Monfort¹

I. OUTLINE

Redefining capitalism to reduce the poverty gap between the first and third world, suggesting mechanisms to redistribute income through regulation in the financial markets in particular, and changing the overall financial system through alternative thinking such as ethical ratings.

II. AN UNEQUAL WORLD

Today's world is a world of increasing differences. There are objections to the previous statement, but the World Bank's figures are self-explaining. They point to a scenario in which extreme poverty of the world's poorest would have dramatically increased in the past 20 years in Sub-Saharan Africa, whereas South and East Asia would have benefited from the phenomenal growth of China and India. Xavier Sala i Martin at Columbia University provides a different approach and argues accordingly that the Millennium Development Goals, led by Columbia economist Jeffrey Sachs, have already been accomplished. However other reputed economist at Harvard, Lant Pritchett, states in different terms:

Well, forget convergence – the overwhelming feature of modern economic history is a massive divergence in per capita incomes between rich and poor countries, a gap which is continuing to grow today.

Jeffrey Sachs, who currently heads the Commission in charge of UN's millennium

development goals cannot make it more clear:

The extreme poor and the poor make around 40 percent of humanity. [...] Our generation's challenge is to help the poorest of the poor to escape the misery of extreme poverty so that they may begin their own ascent up the ladder of economic development.

Anti-globalists like Susan George, who heads the anti-money-laundering, Europe-based organisation ATTAC, are pessimistic about the system as a whole. She criticizes the Washington Consensus and the Bretton Woods Institutions that Keynes suggested as a way to take off economically speaking after World World II.

Economist and Nobel prize winner Joseph Stiglitz, who during the Clinton administration headed as chief economist both the Council for Economic Advisors at the White House, and the World Bank, argues that the IMF and its policies have done everything but good to developing economies in the past 20 years.

The difference between the rich and the poor is there, whether or not one may argue that it is actually widening. Many would support the argument that there exists a gap, a gap that stops many emerging economies from departing in the appropriate direction for good.

Debt relief, migration flows, war against hunger -as Lula da Silva, Brazil's prime minister, fights- are all hot topics that most of us hear everyday on the media. President Jimmy Carter wrote in 2004 an interesting set of words about his view on the situation of the world:

The worst and most spread problem the current world faces is the growing abyss between the richest and the poorest on planet

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Earth. However, our political candidates and current leaders do not deal with this question neither from a dimension of morality nor in national security terms. War against terrorism cannot be won, unless we devote more effort to fairly share the available resources, and give some kind of response to the world's economic and social needs.

President Carter, through the Carter Foundation, is an active leader in the promotion of global equality between countries as well as supportive of policies that lead to poverty reduction.

There is overconfidence and a lack of realism in the first world as to how to tackle the situation that worsens day after day. Many individuals in the rich world that are not directly involved with the difficulties that emerging economies face, do not realize the deepness and severity of the problems they encounter, and how much the latter affect the daily lives of millions of people.

No easy solution seems feasible or applicable. There have been, and there are interesting initiatives that, provided their success, could bring first and third world closer together in terms of income, growth opportunities and share of the pie. However and although straightforward, it's about proposals simplistic and hard to implement within the present regulatory frame, or that may be implementable only on the long run. All this is exacerbated by the fact that the individual is greedy by axiom.

III. THE ROLE OF FINANCIAL ECONOMICS

Finance drives the economy in the developed world. The economic policies of the rich economies determine the fate of the emerging countries. It seems plausible to find implementable alternatives through regulation in the

financial markets of the developed countries, and to change some of the basics that permit their existence and operation. Capitalism has always been revisited after major crisis or crashes. The Great Depression in the 1930s, the crash of the stock market in 1987 or the burst of the Internet bubble in the late 1990s, are all examples of situations in which the major players of the game have redefined their roles and repositioned themselves. Many in the first world may not see a crisis in the current environment. Many may be too optimistic, overconfident, true believers in a process we all label globalization that brings good to everyone we know of, to everyone around us. Some could have misunderstood what globalization really brings to many, wrongly taking for granted that those living in the developing world can access the same sort of opportunities and resources as we do in the rich world.

Journalist David Brooks at The New York Times wrote not long ago:

Rapid improvements at the bottom of the income ladder are contributing to and correlating with declines in illiteracy, child labor rates and fertility rates. The growth in the world's poorer regions also supports the argument that we are seeing a drop in global inequality.

However, a rich world's invention may not be necessarily good news for everyone. Joseph Stiglitz talks about globalization in the following terms:

The critics of globalization accuse Western countries of hypocrisy, and the critics are right. The Western countries have pushed poor countries to eliminate trade barriers, but kept up their own barriers, preventing developing countries from exporting their agricultural products and so depriving them of desperately needed export income.

As it has happened in the past, capitalism may need to be revisited. The current trend does not serve the goals set by the UN, that given the current state of the world, will be unlikely accomplished by the year 2025, as Jeffrey Sachs points out:

We can realistically envision a world without extreme poverty by the year 2025 because technological progress enables us to meet basic human needs on a global scale and to achieve a margin above basic needs unprecedented in history.

Jeffrey Sachs is right in the end but perhaps may not be so in the means. Vandana Shiva, a writer connected to the participatory economics movement, led by Michael Albert, makes an interesting argument:

To make poverty history, we first need to elaborate a real history of poverty. And Sachs has totally misunderstood it.

The trend of present capitalism will be that of increasing differences. Inequality tends to increase not only worldwide, but also within developed nations. The system is heading off the wrong direction, but yet has the virtue to redefine itself. However this will not happen automatically.

There are mechanisms in the financial industry to address many of the issues covered so far. Departing from some of the suggestions presented in this section, the author proposes a set of initiatives that may contribute to (a) improving the working conditions of the poor and as a result their quality of life and dignity; and (b) increase the available funds for development aid.

IV. REDEFINING CAPITALISM

The reflections of this section are nothing else than practical ideas to redefine the

current system in place. Simple to understand and implementable on the long run, the approach tries to delve into the current system and its anomalies to change it from the inside, maintaining its structure, although redefining and strengthening it at the same time.

The strong connection between financial markets and the opportunities available to emerging economies plays a key role in the approach, and manifests the importance of financial economics in the development of this research. As stated in the previous section, the author views finance as the main driver of the first world's economies. Finance has a daily impact on the stability and growth of an economy.

The Columbia economist Sanjay Reddy, and sociologist Thomas Pogge question the methodologies used by the World Bank to count the poor. They argue that the current methods are flawed to such degree that their results cannot be trusted, and that as a result they should be replaced:

Our conclusion is that in effect, we do not know how many poor people there are in the world, how poor they are, where they live, or how their number has been changing over time. [...] A widely held belief is that the issue does not much matter because we already know all that we need to know: that there are many poor people in the world, and that their number is too large. A significant part of the case that we have had to make, therefore, is that it does matter a great deal how many people in the world are poor, how poor they are, where they live, and how their number has been changing over time. These numbers matter because they play a crucial role in evaluating policies and allocating resources.

In the opening section of this essay confronted views on the questions above have been presented, which reflect contradiction and not a unique truth on

what the world's income distribution actually looks like. Jeffrey Sachs, through his clinical economics, knows the kind of intervention needed in third world countries to overcome the current situation of extreme poverty, which he denotes as differential diagnosis for poverty reduction. Nevertheless, no feasible, durable, credible, and sustainable approach to provide with the funding required has been accomplished yet.

This section will elaborate mainly on four parts. The first will redefine the financial system through alternative thinking such as ethical ratings. The second will explain how this new approach will redistribute income and increase the funds available for development aid. Subsequently a development fund that approaches the idea of ethical funds -defined in the previous section- is proposed, and the mechanism to allocate the funds in a competitive bidding, and execute the follow-up is described. Last, the effects that the above mechanisms will have on poverty reduction and its causes are explained.

IV.1 Redefining the game in financial markets

Another world is possible if... is the title of one of Susan George's books. And I believe this is feasible but only through an overview of the current system and a determined approach to tune the aspects that are not fully working, or alternatively seen, that are causing the already large disparities to become even larger. Some of the alternatives presented in the first section (fair trade, ethical ratings, increase of development aid through income taxation) serve as a suggestion for future action.

There is already regulation in the financial markets that, through taxation, raises

public funds for public spending. If corporations were asked whether to pay corporate or dividend tax, they would definitely choose not to do so, based on the maximization of the present value of their future cash flows, which certainly equals the company's equity value. Or equivalently, they would adopt the one strategy that most benefits their shareholders.

Similarly, corporations in today's world tend to respect the current regulation, but are able to skip ethical codes of conduct, always aiming at maximizing their profits, since there is no such regulation set in place.

One of the key strengths of the current financial markets is the financing possibilities it opens to public corporations through the issuance of stock or corporate debt.

The concept of financial rating is key to a public corporation, because it determines the cost of capital it will incur on whatever funds are borrowed from investors. The rating agencies impose strong constraints to assign certain ratings that are indicative of the financial strength of a corporation, or alternatively seen, the financial policies set in place. In addition, auditors make sure a public corporation's financial statements fulfill international standards and are trustworthy.

Hence there is a system in place with which the modern corporation has to comply. This system has suffered much evolution over the years, and yet has not reached perfection. A corporation's unique approach is to adapt to the regulation and the set of rules established by regulators and rating agencies. Top executives at large corporations work hard to be transparent, to not use confidential information to their own advantage, to

immediately communicate the financial community whatever news may arise, either good or bad. This has enabled the well functioning of the so-called three principles of financial economics.

There is a growing trend in the corporate world to adopt a code of ethical conduct that includes respect to the environment, flexible working conditions, trade-off between work and family, et cetera. However a firm is absolutely free to adopt such code, or can avoid it, having this no repercussion from a financial point of view. Briefly stated, a firm's financial rating will not change whether or not the company is ethically responsible. Today's financial markets only reward the financial manners of a corporation, the ethical manners being certainly unimportant.

We cannot live in a world governed by multinational corporations that do not have strong codes of conduct, that invest and divest huge amounts of funds as they wish, that outsource the majority of operations to third-world economies with deplorable working conditions for their inhabitants, and that have no strong ethical regulations set in place. The rich world has succeeded at building up a system that works for us, but that does not work globally. The system needs to be revisited, and this time the ethical component needs to be addressed.

Along the financial rating, a company should have an ethical rating of similar nature, that will affect its financing and its success in the consumer market, as much as it does its financial rating in the financial markets.

Rating agencies will determine the ethical actions of a corporation, whether or not it outsources, how it invests its money, the working conditions of its employees, whether its operating policies respect the

environment, what part of their corporate tax is devoted to social action and so on. And there will be auditors that confirm whether the corporation complies with the set of ethical criteria established. A globalized economy characterized by the immediate diffusion of information should not tolerate unethical policies on behalf of corporations.

The statements are strong, since they touch every potential corporation that participates in the financial markets. But if a corporation currently does its homework financially speaking, simply because this is the way to operate in the system, a corporation will similarly do its homework from an ethical point of view, if this is a requirement to remain in the system.

Every potential investor looks at a corporation's financial rating prior to purchasing stock, corporate debt or derivatives that have the corporation's stock as underlying asset. The financial rating has become a guarantee for an investor because it is a definite proxy for the firm's probability of default. The ethical rating will play the same role for the consumer. Investor versus consumer, that is the key of this story.

Products and services will be labeled with a company's ethical rating. The consumer will at all times know whether a company is ethically responsible, and in the end, consumers will reward or penalize a firm for not complying with the rules of the system. There is research available that links a consumer's ethical values to his or her consumption habits. Therefore and provided that a consumer does have ethical values, he or she will likely purchase products or services that align with their values ethically speaking. This is why the proposed system is sustainable. In order to be successful in the marketplace a

firm will have to be ethically responsible. The better ethical rating, the better opinion a consumer will have on the corporation, and the more likely he or she will be to purchase a certain product or service.

Multinational corporations will not determine a consumer's choice. Consumers will rather determine a corporation's set of operating policies.. It's about reversing the rules of the game. It's about giving the consumer the power to believe that his or her actions truly affect the state of the world. It's about only allowing those players that fulfill the rules to participate in the game. It's about consumers pushing out of the market those corporations that are not ethically responsible.

There is a success story in certain European savings banks, that by regulation, are required to devote a high percentage of their net income to social action. And these banks do so because they have to, in order to comply with the regulation. And the effects of their social policies are noticed locally.

In these lines and in order to reach the maximum ethical rating, a corporation will have to give away a certain percentage of its net income, funds that will end up in a development fund. A company may choose not to do so, although by doing so it may obtain the maximum ethical rating and the corresponding consumer reward. It is a trade-off, since what a firm loses by giving away part of its funds is earned through consumer reward.

The money accumulated in the development fund will be managed by a public entity, that will only invest in companies that are ethically responsible. Companies that are ethically sound, besides being financially driven, will see

their financing opportunities increased. This idea follows from the ethical ratings presented in the first section.

It is not unlikely to picture a world with strong multinational corporations that are ethically responsible. It is not impossible to imagine a development fund converted into the largest fund of human history, that only invests in companies with strong ethical codes of conduct, that devotes the rates of return of its investment strategies to development aid, and by doing so foment ethical operating policies within corporations.

The development fund's investment strategies will support firms with strong ethical policies. Furthermore, it would be interesting to see what effect this investment philosophy would have in the investment strategies of other large funds. The contagion effect may well have positive consequences for the system as a whole, since large funds with large stakes in public corporations may force the top executives to adopt the ethical constraints suggested by the ethical ratings. Should a firm's top management refuse to comply with certain ethical constraints, a certain fund may communicate it may sell the equity stake it holds, with the corresponding drop in the stock price. Managers will be certainly careful, because a drop in the stock price may have disastrous consequences vis à vis their variable compensation and permanence in the firm.

Everything is intricately connected in the new conception of capitalism. It is a more social capitalism, far from approaching socialism. It's about ethical ratings that improve a corporation's operating policies. It's about a system that sets up a fund that only invests in companies with strong ethical principles and destines its profits to development aid.

IV.2 Raising funds through regulation

Within a century, society will look back and will not understand the extreme inequality of personal wealth that currently exists in the world. It is cumbersome how the wealthiest fortunes of planet Earth represent the net income of millions of people in the poor world. This extreme asymmetry only proves that the current system has produced enormous disparities. We are eyewitnesses of this phenomenon, yet many of us are convinced nothing can be done. So are the regulators. The situation is taken as is, inequality has always existed, it is an intrinsic attribute of the human kind.

In a simple exercise, let's suppose that by regulation, the wealthiest are required to devote a tenth of their total wealth to a development fund. If this fund's principal was compared with other large funds, it would be the largest of any funds in the history of financial markets.

Personal wealth over a certain amount should be taxed. The current regulation taxes income and gains on assets, but does not tax personal wealth. Somehow the more a person owns, the greater is his or her social compromise is with the current state of the world. In the end nobody should be eligible to have above a certain amount of money and not be taxed for the monetary resources held. From a global sense of justice, it is simply not sustainable. And this can and should be accomplished through regulation with changes in the tax code.

Corporations will be entitled to invest ten percent of their net incomes in a development fund over a certain time horizon, say 5 years. After this period expires the corporation will get the money invested back, and this will be done on a yearly basis. The fund will keep the profits

linked to the investment strategies and devote them to development aid.

Rich economies will issue as much as the equivalent of 10% of their GDP in public debt and devote this money to the investment fund. Again, only the profits from the investment strategies will be used as development aid. Therefore the fund will have a principal to invest in securities that will not decrease over time.

Surpluses of the rich economies of the world will feed the development fund covered in the previous subsection, which rate of return will become development aid for third-world economies. Personal wealths over \$1 billion will be initially suggested to devote 10% to the development fund.

And last but not least, individual investors will be welcome to allocate part of their savings to the fund over a certain time horizon, after which they will get the principal invested back.

Many of today's individual investors with certain savings on their accounts, either do not invest them and hence keep them in a checking account with either no return or very low return, or invest them in funds that yield small returns that are mostly kept by the investment managers for actively managing the funds (management fees).

These individuals could alternatively invest their savings in the development fund that could have indexed investment strategies in exchange, and would not charge management fees. The individuals would get back the principal invested after the time horizon they chose, the rates of return being kept by the fund, and devoted to investment aid.

IV.3 The development fund

The fund will become a redistribution instrument, from the rich to the poor. With an annual budget equal to the profits of its investment strategies, the fund will distribute the profits competitively among projects proposed to a central committee. The committee will be in charge of allocating the funds. Proposals will be submitted and analysed by the committee year round. In an annual summit the committee will announce which proposals get funding. The projects that get funded will be monitored and audited by the development fund's auditors, that will travel to emerging countries to follow up the development of a project.

The process above guarantees that the development aid is used as efficiently as possible, that through bidding only strong proposals get funding. Furthermore, the audits will also make certain that an organisation does not receive funding again if it has previously been declared corrupt by auditors.

It's about a global mechanism that departs from accumulating resources by means of a development fund. The mechanism does not only raise the funds needed, but it also allocates the money from a global perspective of fairness. The process is transparent, and every project is given the chance to get funding. Projects are not only funded, but a follow-up audit makes sure the money allocated is properly used for the purpose in hands.

Within a time horizon since inception of five years, the development fund would represent annual funds exceeding the aggregate budget of four of the most representative non-profit organizations worldwide, such as Unicef or American Red Cross. If, as previously claimed, we assume that the 500 wealthiest individuals

devote 10% of their wealth to the fund, total annual profits of the investment strategies would yield \$20 billion per annum.

Similarly, let's consider a national economy like that of Spain, issuing the equivalent of 10% of its GDP in public debt. Spain's economy has a current public debt level as a percentage of GDP of 44% and a GDP (2004) of roughly \$891 billions. The principal of the development fund would accordingly increase by \$89 billion and the profits from the investment strategies devoted to development aid would rise by approximately \$13 billion if we apply the two basic investment strategies mentioned beforehand.

The development fund will be able to influence, with its equity investment policy, the corporate strategy of numerous multinational corporations, clearly aiming at investing only in those that defend and effectively apply ethical management principles.

IV.4 Effects of the suggestions proposed on poverty reduction and its causes.

Ethical ratings will affect a corporation's financials, from the sales figures to the market share, mainly because ethical ratings will directly impact consumer behaviour and the choices made when purchasing products and services. By adapting to a set of ethical constraints a firm will directly or indirectly influence third world economies where the firm or one of its suppliers may conduct operations. This will affect, among others, a poor country's workforce and its quality of life. Furthermore it will encourage policies that promote the stability of a poor country's economy, such as the fight

against money laundering and illegal money transfers.

A development fund, conceived the way presented above, will substantially increase the amount of funding available for development aid in third world countries and therefore have a direct influence on the causes of poverty.

Wealth redistribution has enabled the modern economic societies of the twentieth and twenty-first centuries to reach qualities of life unthought of after the two world wars. The progressivity of the tax code is certainly something that those who earn most dislike. A wealthy individual would be better off managing that part of his or her wealth on his or her own. The progressivity of the tax code benefits many low incomes in expense of a lesser number of higher incomes. This represents the concept of solidarity in countries with advanced economic systems established.

Globalization cannot serve one goal and deny others. Globalization is not only about destroying trade barriers to sell internationally. It is also about redistribution from the rich to the poor. And if we think of the world as a common and integrated economic system where everybody is interconnected, there should be income redistribution from the rich to the poor globally, just as it happens at a national level.

Many wealthy that probably represent a small percentage of the total, have set foundations that devote monetary resources to development aid and the like. The effect is, in the author's opinion, unnoticeable, because there is not a global view of how to administer that funding. The wealthy invest part of their wealth according to their vision of the world. To be more precise, it would be as if the rich

in a national economy decided to not pay their contribution of income tax and invest part of their wealths in improving the living conditions of the low incomes in their neighborhoods, but as they wished and when they wished. Not every wealthy person would do so. Regulation forces every individual to contribute and uses the synergies of a larger reach.

Therefore it is fundamental that there exist a central allocation and administration of the funds coming from taxation of personal wealth, understood as the direct consequence of a progressive tax code having a global scope.

V. ALLOCATION OF THE FUNDING

In principle large amounts of development aid will be available every year out of the development fund. That represents already a great accomplishment.

The funding being provided, a fair allocation system needs to be defined and implemented. An allocation system will allocate the money to development projects in third world economies, to humanitarian aid and the like. Susan George makes an interesting remark regarding the allocation of the funds raised through her taxation proposal:

Suppose that international taxation of international transactions, corporate mergers and acquisitions and industrial pollution are accepted; that genuine debt relief is granted and a pool of fresh funds is thereby constituted. Is that the end of the story? The most important part remains to be invented and it concerns managing and using the money. [...] Probably the best option would be a new, small UN body made up of personnel chosen from the UN specialised agencies

plus a corps of roving auditors. [...] After forty-plus years of largely unsatisfactory development aid, we've had an opportunity to learn at least one thing: you can't just hand over funds to a government and hope for the best.

Ramon Baker adds some color in the same line of reasoning above:

By comparison, if the Marshall Plan merits an A+, 50 years of development assistance merits a D or lower.

In the previous section I suggested an annual summit that would allocate the funds to development projects submitted to a central committee year round. The process would be competitive, in the sense that every project would be considered. In this respect, NYU Economist William Easterly states that:

Aid agencies face a peculiar incentive problem: they spend one group of people's money on a different group of people. The intended beneficiaries have almost no voice in how the money is spent. There has been surprisingly little research thinking about how to design proper incentives for aid agencies to achieve results in this situation, as well as how the aid agencies can design contracts to create good incentives for recipients.

Susan George's previous comments regarding the auditing and monitoring of the projects that receive funding are fundamental. Every dollar spent on development aid is important and the contracts proposed by William Easterly are a way for recipients of the funding to get serious and accomplish the development plans for which the funds were meant.

VI. CONCLUSION

The developed world has set in place a system that through complex mechanisms, serves to increase the welfare of its population. Today's capitalism paradigm lies in the center of the individual. It is competitive, rather than cooperative. The western society can progress towards individualistic cooperation or cooperative individualism. A new concept in which the individual is no longer in the center, but what matters is the society as a whole, not only that in the developed world, but also that in third world countries. It's about a different approach, an approach in which personal satisfaction or personal utility boosts by being aware there is global improvement. That is what, in the end, globalization should bring, a global perspective (as opposed to local).

Economics and finance are the basis of modern capitalism, that so far, is designed to increase the aggregate wealth of those in the developed world. However these tools (economics and finance) are good, are available, and have not been used in everybody's interest. They can and have to be used with the sole goal of making the poor better off doing the least harm to the rich.

There are already initiatives with which ethical ratings or the taxation of personal wealth could integrate, to reduce the extreme poverty, to give everyone the opportunity to move forward. The world will then observe the rise of a redefined, stronger capitalism, that after all, as F.A. Hayek properly said, is the only mechanism that has ever been discovered for achieving participatory democracy.

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