

# DJB Quarterly *Jan-Mar 2011*

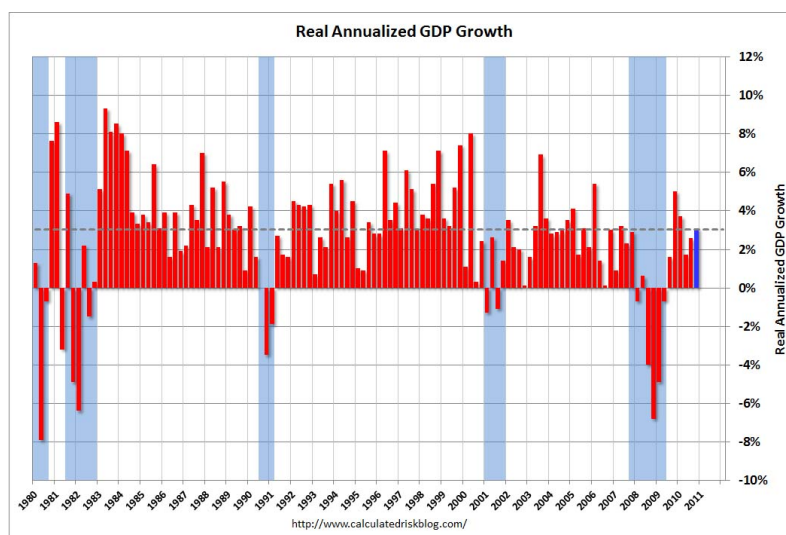
Global economic trends from a Public Interest Capitalism perspective

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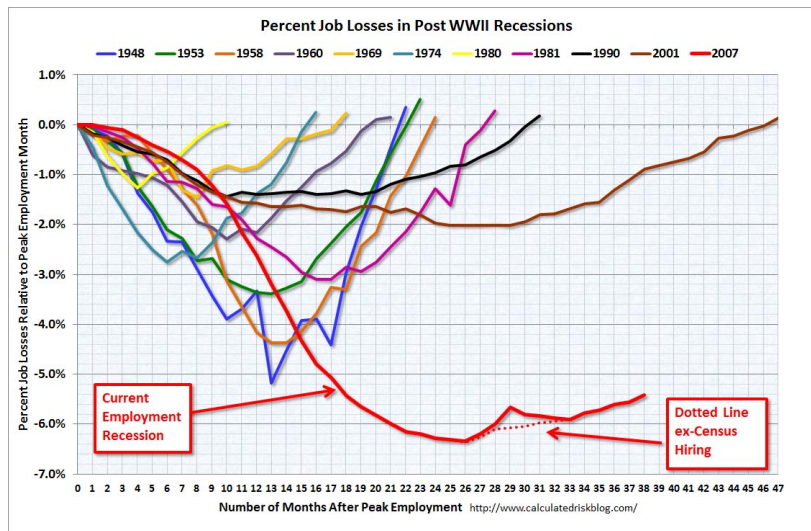
This letter, made possible by generous support from the James Abegglen Scholarship Fund, provides a quarterly review of global economic trends related to capitalism and the public interest. In any given three month period, there are more trends and signs of emerging trends than I can cover in a single short letter. For example, in this issue I do not address the still unresolved Euro-zone crisis or the increasingly fragile China Bubble. Nor will I address social and political topics that do not have a clear bearing on capitalism and the public interest, such as the tragic aftermath of the recent earthquake and tsunami in Japan. I hope my readers will forgive these glaring omissions. The letter concludes with acknowledgements and some background on Public Interest Capitalism.

## US recovery continues, weakly

The best place to go for an update on the US economy is the Calculated Risk blog: <http://www.calculatedriskblog.com/>. In fact, it's so good that John Campbell, chair of the Department of Economics at Harvard, started off a recent lecture with a series of graphs from Calculated Risk. Bookmark it or, better yet, sign up for a free daily email of posts: <http://www.calculatedriskblog.com/p/email-subscription.html>. So, courtesy of Calculated Risk, here are two graphs that pretty well sum up the economic situation in the US:



This graph shows real annualized GDP growth, which has now been positive for six quarters. These growth rates are too low, however, to utilize fully the productive capacity of the economy. This underutilization is evidenced by the still very bad employment situation, as captured in the next graph.



This graph shows the employment impact of all US recessions since the end of World War II in 1945. Each colored line traces the employment level relative to the peak level of employment before the recession. From this graph, we can see that US recessions in the post-war period through 2000 were generally painful but short. The economy lost jobs quickly, and then added them back quickly. For example, consider the dark green line corresponding to the 1953 recession. 13 months of job losses eliminated about 3.4% of the jobs that had existed before the recession began to bite. Within another 9 months, all these lost jobs had been recovered, and the economy surpassed its pre-recession employment level.

Now, look at the brown line (the 2001 recession) and the red line (the 2007 recession). Job losses continued for 25 to 26 months, far longer than in earlier post-war recessions. The 2001 recession was relatively mild, however, with net job losses reaching only 2% of the pre-recession peak and all lost jobs recovered within 47 months (a very long time!). By comparison, the 2007 recession is much more serious. Net job losses continued for 26 months and reached almost 6.4% of the pre-recession peak. To put this in perspective, in every recession through 1980, net job losses were *eliminated* within 24 months, and total net job losses never exceeded 5.2%.

So where are we now? 38 months since job losses began, we still have more than 5% fewer jobs in the US than we did before the recession, and job recovery is proceeding at a very slow pace. At the current rate of recovery, it could take more than 5 years to recover all the lost jobs. Of course, during that time the labor force will continue to grow, so even recovering all the lost jobs won't get us back to pre-recession employment rates. Jobs distribute wealth through the economy, so reduced employment means that fewer people share in the nation's wealth. That said, the economy is clearly recovering.

I've presented data on net job losses instead of unemployment rate data because the unemployment rate is influenced by the participation rate, so changes in the unemployment rate may not accurately reflect changes in actual economic activity. The unemployment rate has decreased, however, from a peak of over 10% to slightly under 9%.

Perhaps the most remarkable feature of the national political scene is the utter lack of concern for the jobless. Paul Krugman writes:

More than three years after we entered the worst economic slump since the 1930s, a strange and disturbing thing has happened to our political discourse: Washington has lost interest in the unemployed.

Jobs do get mentioned now and then — and a few political figures, notably Nancy Pelosi, the Democratic leader in the House, are still trying to get some kind of action. But no jobs bills have been introduced in Congress, no job-creation plans have been advanced by the White House and all the policy focus seems to be on spending cuts.

So one-sixth of America's workers — all those who can't find any job or are stuck with part-time work when they want a full-time job — have, in effect, been abandoned.<sup>1</sup>

## Austerity threatens economic growth and social welfare

Despite elevated levels of employment and a relatively weak recovery, policy-makers in the US are embracing austerity (i.e., budget cuts) at the federal, state, and local levels. At the state and local levels, these cuts are primarily a result of reduced tax revenue, a public mood generally hostile toward tax increases, and the withdrawal of temporary aid from the federal government. Also, under intense financial pressure, states are cutting aid to local governments.

At the national level, the push for austerity comes primarily from the Republicans, which are now significantly influenced by the smaller government, lower taxes ideology of the Tea Party faction. However, President Obama has also embraced austerity for reasons that are not entirely clear, at least to me (or, for that matter, to Paul Krugman<sup>2</sup>). The US does not face a fiscal crisis in the short term, so it is difficult to understand this push for austerity at a time when the economy is weak and employment is depressed. In any case, budget cuts at the federal level are still being debated, so I'll focus for the time being on cuts at the state and local levels.

The push for austerity at the state level crosses party lines. According to the *New York Times*:

The dismal fiscal situation in many states is forcing governors, despite their party affiliation, toward a consensus on what medicine is needed going forward. The prescription? Slash spending. Avoid tax increases. Tear up regulations that might drive away business and jobs. Shrink government, even if that means tackling the thorny issues of public employees and their pensions.<sup>3</sup>

State budget deficits expected to total over \$100 billion in the coming financial year. A few of the states facing serious deficits are California (\$25 billion), Illinois (\$15 billion), New Jersey (\$10.5 billion) and Texas (\$10 billion).<sup>4</sup> Although some states, such as California, are trying to cover their deficits partly through taxes, cuts in the tens of billions of dollars are probably unavoidable. These cuts will eliminate jobs and reduce economic activity, as well as decreasing the quantity and quality of public services.

Education is one target for spending cuts. New Jersey cut education by \$1 billion, laying off thousands of teachers.<sup>5</sup> New York State is seeking to cut “a record \$1.5 billion from the \$23 billion budget for grades K-12.”<sup>6</sup> State governments are also cutting essential welfare services for the poor:

Pennsylvania is one of several destitute states seeking to help balance budgets by removing adults from government health insurance programs. Gov. Christine Gregoire of Washington, a Democrat, recently removed 17,500 adults covered under Basic Health, a state-financed plan for the working poor. In Arizona, Gov. Jan Brewer, a Republican, proposes to remove up to 250,000 childless adults who have been insured by her state's Medicaid program under a decade-long agreement with the federal government.<sup>7</sup>

Local governments are also under pressure. Major cities facing deficits in the coming fiscal year include New York City (\$2 billion), Washington DC (\$688 million), Los Angeles (\$438 million) and San Francisco (\$380 million)<sup>8</sup>. Mayors are responding with budget cuts:

Many mayors have already raised taxes, cut services and laid off workers, even police and firefighters. Now they are girding themselves for more tough times, as falling home values are belatedly showing up in property tax assessments, and struggling states are threatening to cut aid to cities.<sup>9</sup>

They have serious implications for public safety:

Despite having one of the highest crime rates in the nation, Camden, N.J., laid off nearly half its police force this week after failing to win concessions from its unions."<sup>10</sup>

Newark, New Jersey experienced a crime wave after laying off police officers:

Three weeks after New Jersey's largest city had to lay off more than 150 cops, crime spikes up significantly in Newark, leaving residents on edge. Cops are on the hunt for who[m]ever killed a teen execution style Sunday night. ... The rest of the city of 280,000 has reports of carjackings and shootings in every ward over the past weekend. Since Friday evening, Newark cops have investigated nine carjackings, almost all of which remain unsolved cases.<sup>11</sup>

Some local governments are headed for bankruptcy. The city of Vallejo, in northern California not far from San Francisco, has already arrived. Social services have been curtailed:

The police force has shrunk from 153 officers to 92. Calls for any but the most serious crimes go unanswered. Residents who complain about prostitutes or vandals are told to fill out a form. Three of the city's firehouses were closed. Last summer, a fire ravaged a house in one of the city's better neighborhoods; one of the firetrucks came from another town, 15 miles away.<sup>12</sup>

At this point, austerity probably represents the greatest threat to economic recovery in the US.

## Labor loses its voice

In the fight over how to divide up the nation's wealth, labor unions have long been a powerful weapon for the working classes. At some times and in some situations, this weapon has stifled productivity and hindered economic development, but it would be unreasonable to criticize unions while ignoring the economic destruction wrought by profiteering managers and irresponsible financial institutions. In any case, one cannot deny that labor unions helped maintain a balance of power between workers on the one hand, and managerial and financial interests on the other. In recent years, labor unions have diminished in size and strength, shifting the balance of power toward managers and financiers.

Hendrik Hertzberg describes this transformation in a recent article:

Organized labor was powerful and, for the most part, respected. Its economic and political muscle had played an indispensable role in insuring that the benefits of postwar prosperity were widely shared . . . .

Labor has come a long way since then—a long way down. At the outset of the nineteen-sixties, one in four workers had the protection of a union. By the early eighties, after President Reagan destroyed the air-traffic controllers' union, the proportion was down to one in five. Now it's one in eight. . . .

Organized labor's catastrophic decline has paralleled—and, to a disputed but indisputably substantial degree, precipitated—an equally dramatic rise in economic inequality. In 1980, the best-off tenth of American families collected about a third of the nation's income. Now they're getting close to half. The top one per cent is getting a full fifth, double what it got in 1980. The super-rich—the top one-tenth of the top one per cent, which is to say the top one-thousandth—have been the biggest winners of all.<sup>13</sup>

Union membership has declined from a peak of 35% in the mid 1950s to 11.9% in 2010. The decline of unions is particularly pronounced in the private sector, where only 6.9% of workers are now unionized—the lowest level in over one hundred years.<sup>14</sup> Recently, public sector unions are coming under attack in Wisconsin, Ohio, and Indiana<sup>15</sup>. Surprisingly, the American public has an increasingly negative view of labor unions. James Surowiecki writes:

In the recent midterm elections, voters in several states passed initiatives making it harder for unions to organize. Across the country, governors and mayors wrestling with budget shortfalls are blaming public-sector unions for the problems. And in polls public support for labor has fallen to historic lows.<sup>16</sup>

Surowiecki attributes the public antagonism toward unions to the resentment felt by non-union workers toward the perks enjoyed by union workers:

Even though unions remain the loudest political voice for workers' interests, resentment has replaced solidarity, which helps explain why the bailout of General Motors was almost as unpopular as the bailouts of Wall Street banks. And, at a time when labor is already struggling to organize new workers, this is grim news. In a landmark 1984 study, the economists Richard Freeman and James Medoff showed that there was a strong connection between the public image of unions and how workers voted in union elections: the less popular unions were generally, the harder it was for them to organize. Labor, in other words, may be caught in a vicious cycle, becoming progressively less influential and more unpopular.<sup>17</sup>

The decline of unions probably helps explain why corporate profits have recovered from the recession while jobs have not:

This jobless recovery, after all, is the third straight recovery since 1991 to begin with months and months of little job growth.

Why? One obvious possibility is the balance of power between employers and employees.

Relative to the situation in most other countries — or in this country for most of the last century — American employers operate with few restraints. Unions have withered, at least in the private sector, and courts have grown friendlier to business. Many companies can now

come much closer to setting the terms of their relationship with employees, letting them go when they become a drag on profits and relying on remaining workers or temporary ones when business picks up.

Just consider the main measure of corporate health: profits. In Canada, Japan and most of Europe, corporate profits have still not recovered to precrisis levels. In the United States, profits have more than recovered, rising 12 percent since late 2007.<sup>18</sup>

Indeed, the interests of large US corporations seem to be diverging further and further from the interest of the American public.

## What's good for GE is bad for America

General Electric illustrates the growing conflict between American business and the public interest. GE is one of America's largest and most valuable companies, with a market capitalization in excess of \$200 billion. The company is very politically influential: Obama appointed the CEO of GE, Jeffrey Immelt, to chair his council of economic advisors. So does GE serve the public interest?

Consider job creation. From 2000 to 2010, the number of GE employees decreased from 313,000 to 304,000. The share of US-based employees decreased more, from 54% (168,000) to 44% (134,000).<sup>19</sup> The decrease in US employees may be due in whole or in part to divestitures, but it's striking that one of America's leading corporations, whose CEO is now the president's chief economic advisor, has shed 20% of its US jobs in the last ten years.

The conflict between public and corporate interest comes into sharper focus when we examine GE's aggressive tax avoidance, described in detail in a recent *New York Times* article:

General Electric, the nation's largest corporation, had a very good year in 2010. The company reported worldwide profits of \$14.2 billion, and said \$5.1 billion of the total came from its operations in the United States. Its American tax bill? None. In fact, G.E. claimed a tax benefit of \$3.2 billion. ...

Its extraordinary success is based on an aggressive strategy that mixes fierce lobbying for tax breaks and innovative accounting that enables it to concentrate its profits offshore. G.E.'s giant tax department, led by a bow-tied former Treasury official named John Samuels, is often referred to as the world's best tax law firm. ... The team includes former officials not just from the Treasury, but also from the I.R.S. and virtually all the tax-writing committees in Congress. ...

regulatory filings show that in the last five years, G.E. has accumulated \$26 billion in American profits, and received a net tax benefit from the I.R.S. of \$4.1 billion.<sup>20</sup>

According to the article, GE's tax department has 975 employees who are charged with dividing their time evenly between compliance and finding opportunities to avoid taxes. This is particularly galling in light of the support that GE received from the US government during the financial crisis, which included government guarantees for \$74 billion in debt. The *Washington Post* describes how GE exploited a loophole to obtain the guarantees:

General Electric, the world's largest industrial company, has quietly become the biggest beneficiary of one of the government's key rescue programs for banks.

At the same time, GE has avoided many of the restrictions facing other financial giants getting help from the government.

The company did not initially qualify for the program, under which the government sought to unfreeze credit markets by guaranteeing debt sold by banking firms. But regulators soon loosened the eligibility requirements, in part because of behind-the-scenes appeals from GE.<sup>21</sup>

Of course, aggressive tax avoidance by corporations is not limited to GE:

Such strategies, as well as changes in tax laws that encouraged some businesses and professionals to file as individuals, have pushed down the corporate share of the nation's tax receipts — from 30 percent of all federal revenue in the mid-1950s to 6.6 percent in 2009.<sup>22</sup>

So the budget crises at the federal, state, and local level can be attributed, at least in part, to businesses pursuing private profits at the expense of the public interest: Greedy Capitalism.

Meanwhile, the money game plays on

Thanks to government bailouts, the financial crisis in 2008 has had little lasting impact on the financial industry at the heart of the US economy. Financial firms and individual speculators are reaping greater profits than ever. From the *Wall Street Journal*:

In 2010, total compensation and benefits at publicly traded Wall Street banks and securities firms hit a record of \$135 billion, according to an analysis by The Wall Street Journal. The total is up 5.7% from \$128 billion in combined compensation and benefits by the same companies in 2009.

The increase was fueled by a revenue rebound as the financial crisis recedes in the rearview mirror. At 25 large financial firms that have reported full-year results, revenue rose to \$417 billion, another all-time high, even though last year's 1% increase was just a fraction of the industry's revenue jolt from 2008 to 2009 as trading and investment banking sprang back to life.

"Things are shifting back to where they were before," said J. Robert Brown, a law professor at the University of Denver who studies compensation and corporate-governance issues.<sup>23</sup>

The most spectacular payout, at \$5 billion, went to hedge fund manager John Paulson. At least three other hedge fund managers reportedly made personal profits of \$2 billion to \$3 billion.<sup>24</sup> To put this in perspective, Paulson could pay his taxes (presumably only \$750 million since his gains will be taxed at the lower capital gains rate), pay off the collective deficits of New York City, Washington DC, Los Angeles and San Francisco (about \$3.5 billion), and still have about \$750 million left for himself.

So what lasting effect has the financial crisis had on the financial sector? According to John Campbell, chair of the Department of Economics at Harvard, the too big to fail banks have been emboldened.<sup>25</sup> They know that the government will bail them out to prevent a meltdown of the financial system, so they can take aggressive risks, pocket the profits or pay them out through dividends or share buybacks, and stick taxpayers with the bill when things go bad. Simon Johnson, formerly chief economist at the IMF and now a professor at MIT, writes:

The financial system poses a major risk to our fiscal outlook over the next few years. Unless you think that the Dodd-Frank reform bill really ended “too big to fail” and the associated excessive risk-taking culture, you should worry a great deal about the boom-bust-bailout-fiscal damage scenario that the Bank of England now refers to routinely as the “doom loop”.<sup>26</sup>

## Public Interest Capitalism

In closing, and after painting this decidedly depressing portrait of the US economy, I’d like to write briefly about Public Interest Capitalism, an economic technology which could help address some of these problems. Public Interest Capitalism is a concept that I began developing as a doctoral student at Harvard, first under the mentorship of Jim Abegglen and then together with a team of researchers supported by the Tokyo Foundation and the Alliance Forum Foundation. The concept is quite simple:

**Public Interest Capitalism:** A form of capitalism where companies pursue private profit in ways that also serve the public interest.

This contrasts with another form of capitalism advocated forcefully, albeit not under this label, by the late Milton Friedman:

**Greedy Capitalism:** A form of capitalism where companies seek to maximize private profit even at the expense of the public interest.

Some scholars, including former Secretary of Labor Robert Reich, argue that Greedy Capitalism is the only possible form of capitalism, but I believe there is ample evidence to the contrary, including many US and Japanese companies with solid values and a strong sense of social purpose. Fortunately, I’m in good company: Michael Porter, the eminent scholar of business strategy at the Harvard Business School, published an article in the January issue of the *Harvard Business Review* arguing that businesses should seek to create “shared value”. He writes:

In recent years business increasingly has been viewed as a major cause of social, environmental, and economic problems. Companies are widely perceived to be prospering at the expense of the broader community. ...

A big part of the problem lies with companies themselves, which remain trapped in an outdated approach to value creation that has emerged over the past few decades. They continue to view value creation narrowly, optimizing short-term financial performance in a bubble while missing the most important customer needs and ignoring the broader influences that determine their longer-term success. ...

Companies must take the lead in bringing business and society back together. ...

The solution lies in the principle of shared value, which involves creating economic value in a way that *also* creates value for society by addressing its needs and challenges. Businesses must reconnect company success with social progress. Shared value is not social responsibility, philanthropy, or even sustainability, but a new way to achieve economic success. It is not on the margin of what companies do but at the center. We believe that it can give rise to the next major transformation of business thinking.<sup>27</sup>

Importantly, Porter points out that seeking to create shared value can drive innovation in ways that traditional profit-maximizing management techniques cannot. In the long term, it’s

possible, and perhaps probable, that creating shared value may result in greater total profits for everyone. The article is well worth reading in full; it can be found online here: <http://hbr.org/2011/01/the-big-idea-creating-shared-value/ar/1>.

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Please send comments, questions, or subscription inquiries to me at [djb@davidjamesbrunner.org](mailto:djb@davidjamesbrunner.org). If I receive comments or questions that may be of interest to other readers, I'll publish excerpts in the next issue. Excerpts will be published anonymously unless you give me explicit permission to include your name.

More information about me and about Public Interest Capitalism, as well as my blogs in English and Japanese, can be found on my web page, <http://davidjamesbrunner.org>. You can also follow me on Twitter: <http://twitter.com/davidjbrunner>.

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