

# The Dawn of a New Era: Social Democracy after the Financial Crisis



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**A** NEW ERA IS dawning. The financial crisis of 2008 is not the end of capitalism. Capitalism dates back to the Medici revolution, which invented modern banking, but since then it has gone through many different regimes and articulations. The 2008 crisis marks the end of the Reagan-Thatcher counter-revolution. Neoliberalism and monetarism are dead. Even Nicolas Sarkozy now calls for the re-foundation of capitalism.<sup>1</sup> This does not mean that thousands of policy-makers are not continuing to implement old recipes, helplessly watching their loss of control over events. Antonio Gramsci once said a crisis is when the old is dead, but the new not yet born. With the election of Barack Obama new paradigms in policy-making become possible. Yes, we can reconcile markets and social justice; we can invent a new social model for

Europe. We can integrate the real and financial economy. But how? European social democrats were able to shape various epochs to different degrees. How can they adapt to the new situation? Those who are in government or wish to form it will have to become the architects of the new Europe after having served as fire brigade in the crisis.

A new perspective for Europe's left needs to integrate economic and political norms and values into a coherent project for society. Since World War II, three paradigms have dominated political and economic thinking in the world. In the East, Marxism rejected markets and democracy; in the West, Keynesianism laid the foundations for social democracy and political liberalism, while Friedman's counter-revolution developed a neoliberal ideology from the theories of monetarism.

Friedman's anti-Keynesian revolution was not primarily directed against the welfare state, although he did think that 'most hardship and misery in the United States today reflect government's interference'.<sup>2</sup> His more fundamental attack sought to establish the superiority of the market economy over centralised planning. In this he was right. Today, after Deng

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Xiaoping and the fall of the Berlin Wall, we are in one sense, all Friedmanians.<sup>3</sup>

But this concession does not warrant the adoption of the erroneous monetarist paradigm. Friedman did understand that money was crucial to the functioning of a market economy. So did Marx. But they both remained confined to the classical economic paradigm, whereby markets are places for exchange of 'real' goods, while money was simply a veil that covered the reality. Until today socialists all too often keep making the same mistake. Marx drew the radical conclusion that capital and therefore money must be abolished. Not surprisingly, the 'new' economy of communism resembled the old: resources were allocated by hierarchy, and not by contracts between free and equal individuals; markets and consumer choice were suppressed.

Friedman and his followers took another track: if money was a veil, it could distort. Inflation was the main cause of distortions. Monetary policy therefore had to ensure price stability so that markets remained transparent and efficient. Only in the absence of inflation would prices send out the right signals to firms and consumers. Perfect competition would push profit maximising entrepreneurs to provide optimal welfare. Markets' 'invisible hand' (Adam Smith) would then yield a unique equilibrium towards which the economy would naturally gravitate. There was no role for governments or regulation.

This paradigm did not recognise the important role that money has in *creating* markets

and in ensuring that the promises stipulated by financial contracts are fulfilled. It ignored that our real economy was characterised by oligopolistic and not by perfect competition. The problem with neoliberalism was less that it advocated unfettered markets; it was that it did not understand how markets work in reality. The truly alternative economic paradigm of a monetary economy was first elaborated by John Maynard Keynes; it has subsequently been fine-tuned by Joseph Stiglitz and others<sup>4</sup>: money is credit, a bridge to the future, and not a veil. Tomorrow's reality is determined by today's promises. Because the human condition is characterised by fundamental uncertainty, money is a precautionary instrument to secure access to goods, services and resources in a risky world. Therefore money is a constraint to our actions in the present and in the future. And competition means striving for money, income and profit. It is frequently distorted by information asymmetries and does not necessarily lead to the unique equilibrium of welfare where everyone is better off.<sup>5</sup> In this perspective, economic policy must aim at reducing uncertainty and insecurity. The financial crisis has reminded us all: without financial stability markets collapse. But more importantly, the generalised uncertainty in the economy as a whole, including prospects for effective demand and employment, will reduce growth, jobs, income and wealth.

The legitimacy of Keynesian macroeconomic policies and the modern welfare state were derived from this insight. But

they became dysfunctional when the neoclassical-Keynesian synthesis started using fiscal policy as if money did not matter. The vulgarisation of Keynes opened the gate for Friedman. A misguided view of markets led to the deregulation of financial institutions. Believing that money served mainly as means of exchange in goods markets rather than as the ultimate asset for the extinction of debt justified the creation of liquidity, which has fuelled the enormous financial bubble in the American economy. Fortunately, the European Central Bank has been more careful, but does it operate from different intellectual foundations? Today, we need a new paradigm for economic policies that links markets to security, that renews the promise of modernity and progress; a paradigm that marries economic freedom to social justice, equality to solidarity. After having extinguished the fire of the present crisis, we need to build a house that is fireproof.

Economic paradigms shape political norms and values. The French revolution has defined modernity by the twin values of *liberté* and *égalité*; later, the Commune de Paris added *fraternité*. With the Declaration of Human and Civil Rights it enshrined individual rights as a protection against authoritarian rule and the tyranny of majority. Emancipated citizens became the sovereign in the modern state. Free and equal individuals would conclude the 'social contract' of the republic by which they determined the laws that were applicable to themselves. The political division into a 'liberal right' and an 'egalitarian

left' follows different interpretations of the modern world: Liberalism gives priority to individual freedom, socialism to equality. Both are children of modernity. But let us understand that how we interpret the world is how we change it.<sup>6</sup>

The modern vision of society serving individuals stands in clear contrast to the conservative, anti-enlightenment view,<sup>7</sup> whereby society is a hierarchically structured whole in which each individual has a pre-assigned role and status and to which they have to surrender. The conflict between these three political paradigms has dominated European history for over 200 years. At times, *liberalism* entered into an alliance with conservatism and became 'neoliberal' and nationalistic; modernity was preserved in 'political liberalism', which recognised the equality of citizens as democratic right holders. On the other side, socialists fell for communitarian conservatism when equality did no longer mean recognition of the other as an equal in all her or his diversity, but rather the surrender to conformism and hierarchy. But true *social democracy* is a modern and progressive force: it embraces individualism by fighting for human and civic *rights*; it breaks up the barriers of traditions and customs; it seeks the emancipation from community by developing the freedom of individuals; and it recognises that individual freedom is only possible when the formal equality of legal rights has a material substance in wealth. This is why individuals need the state not only as a set of rules and regulations, but as a system of rights. Access to food, clothing, shelter,

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and medical care have become human rights that can only be realised through the democratic use of power in a state of law (*Rechtsstaat*). Regulating financial markets today may be necessary to overcome the economic crisis, but it is not sufficient as a new paradigm for a Social Europe.

The emergence of modern social democracy cannot be separated from the existence of market economies and therefore from the institutions of money and finance. Modern social democracy has gone beyond Marxism, without forgetting that capitalism endogenously produces injustice. For the political norms of modernity will only be recognised as valid and legitimate in a society where contracts are concluded by market participants who interact as free and equal partners. These political norms give priority to freedom and equality over fraternity, to contractual relations of solidarity over the patriarchal hierarchy of community and they emphasise democracy as the only system which allows individuals to control the collective as free and equal citizens. Thus, the modern state is democratic and not authoritarian, because it returns power and sovereignty to citizens who are the collective owners of public goods, of the *res publica*. No doubt, reality often looks different. Power relations over-

rule norms of freedom and equality. But norms may be valid even when they are not facts. Indeed, the never-ending struggle for freedom and equality, which has defined social democracy for 150 years, draws its legitimacy from the discrepancy between modern norms and values and their non-realisation in the real world. It was this insight that led Eduard Bernstein 100 years ago to call for the pursuit of a more practical, piecemeal movement towards a socialist state within the context of a parliamentary democracy. And Jean Jaurès acknowledged it by saying: 'The Republic is the humus of socialism'. Today a European democracy must become the humus of Social Europe.

The financial crisis of 2008 is an opportunity to rethink the shortcomings of the neoliberal paradigm. The financial problems were not caused by 'excessive greed', as moralistic conservatives would argue. Instead, the romanticised version of markets and money that Friedman and his followers adhered to did not allow policies to deal with the systematic interaction between the monetary and 'real' economy. They deregulated markets and pushed structural reform agendas that slowed down productivity growth instead of raising it. They did bring inflation down, but then flooded the world with

liquidity that fueled asset price bubbles. Keynes would have taught them long ago that production depends on credit, and credit on trust, and trust on reputation. This world of beliefs becomes a house of cards, when reputation sustains speculation, a fickle lightning in the darkness of uncertainty. The crisis has taught us painfully what happens, when trust disappears. Ordinary workers lose their jobs because bankers are scared. Financial stability requires rules and regulations that focus bankers' minds on assessing the validity of investment projects and whether they can yield profits to service debt.

Modern economic theory emphasises the role of information and uncertainty. A new political paradigm must integrate these insights when it defines a framework for market regulation. And the modern rules for monetary policy lay the base. Inflation is dysfunctional for efficient market economies. As Friedman saw correctly, it makes 'noise', meaning that producers and consumers cannot easily identify the significance of price signals. The Maastricht Treaty has therefore correctly assigned the objective of maintaining price stability to monetary policy in Europe. But this is only a necessary requirement for the existence of efficient markets; it is not sufficient. Access to information is at least as important. If information is asymmetric and non-transparent, because some people know and others do not, markets cannot operate optimally. Adverse selection and moral hazard, which may be rational at the level of individual decisions, will produce

outcomes that *reduce* welfare for everyone. These informational asymmetries also dominate monopolistic competition, which may yield many market equilibria and not only one optimal solution as Adam Smith believed.

A modern paradigm for social democracy must use the intellectual advances of recent years. The theory of monopolistic competition has shown that 'market failures' are virtually all-pervasive in ordinary market transactions.<sup>8</sup> The reasons are multiple, some related to information asymmetries, some to the existence of externalities. The former have dominated the financial sector. The latter are particularly relevant for political decision-making in Europe. The more decisions are decentralised, the higher the likelihood that 'coordination failure' will prevent individual actions to achieve social welfare. For example, while relocating jobs may be good for one company, it can devastate a region. These market failures justify government interventions. Socialists have known this for over 150 years. They have claimed the nationalisation of the means of production, they have taken strategic participations in companies, and they have regulated markets. But unfortunately, the logic of information economics also applies to governments and can cause 'government failure'. Thus, the traditional interventionism of 'market socialism'<sup>9</sup> has not necessarily produced better results than the neoclassical economics of liberal-conservatives. In fact, both camps frequently use the same analytical tools. This has undermined the confidence in the ability of

social democratic governments to correct market and government failures. A modern social democratic paradigm must rethink government action in informational terms: How can governments structure incentives for individuals and firms? How can information become more accessible? How can inequalities (asymmetries) in access to information be overcome for workers at the workplace, for consumers in markets, for citizens in the public sphere?

A new social democratic paradigm must start with the recognition that freedom and equality is founded in market economies. In modern societies wealth is created by the strength, creativity and dynamism of free and equal individuals who are guided in their behaviour by information and trust. Markets are the institution that can facilitate the flow of information, provided there are rules that maintain trust. But once wealth is created, it is not necessarily distributed in a way that people will consider as fair. This may justify corrections. As manifested in the recent financial crisis, rules for transparency and regulations that minimise informational asymmetries can be remedies for market failure. But which rules are acceptable? Standards of fairness and justice, which apply to everyone, can only emerge from free and open public debates about what is in the collective interest. They require an institutional framework within which each citizen has an equal right to make a contribution. Once that is in place, citizens can deliberate together about the objectives they wish to achieve collectively. They do

not have to agree about concrete policies, but they need to achieve a consensus that the democratic institutions are fair by offering equal rights to every citizen.

The aspect of democracy is of particular importance for a new social democratic paradigm in Europe. For decades, governments have behaved as if they were benevolent planners that were implementing 'the right policies' in order to make people happy. But few questions were asked *what* it is that made people happy. This does no longer work. The debate about a European Social Model is also a debate about the content of happiness, about how people want to live: how much personal comfort are we ready to sacrifice for saving the planet? Do the rich not feel happier when 'wealth is spread around' (Barack Obama)? Do they not live more secure lives when crime rates are lower? And are crime and poverty not correlated? Does fairness not affect the subjective quality of everyone's lives? These and many other questions will only find an answer after long drawn out debates and public deliberation. We increasingly find that citizens' input into the policy-making process is a value in itself that raises individual happiness.

This brings us to the issue of policy-making in Europe. For years Europe stood for peace and prosperity. But this association is increasingly put into question. Peace is taken for granted and neoliberal policies are proclaimed to be the only road to prosperity. But many citizens only find that their income is stagnating, real wages falling, jobs insecure, new employment nowhere to be

found, while top executives make fortunes. These citizens have no choice over policies. They have to accept what governments and their bureaucracies negotiate on their behalf. Not surprisingly, the approval rate of the European Union has slowly and gradually been falling. It stands today around 50%, while it was closer to 75% twenty years ago. The recent referenda in France, Netherlands, and Ireland all have signaled discontent with the way the European Union is run. Some political leaders may wish to argue it away and blame their predecessors for negative votes, but they are missing a simple fact: if citizens in the European Union are dissatisfied with a particular set of practical policies, the only means they have to oppose them is to turn against the European Leviathan 'in Brussels'. Europe's institutions stifle political controversy and partisanship. Citizens have little to no choice between alternative policy packages. Yes, every five years they can vote for the European Parliament; but who believes seriously that it makes a fundamental difference to *their* lives? The Commission President is selected like the pope: in smoke-free secretive meetings between chiefs who are not accountable

to the people. The assembled heads of governments have all kinds of interests but cannot, by definition, represent the *general* interest of the European Union. This Europe is the opposite of what the founding fathers had in mind when they embarked on European unification.

Without doubt, the continuous interaction between 'community method' and intergovernmentalism has contributed to the rapid progress in European integration. Governments have delegated crucial national policy competencies to the European level, such as the European Commission or the European Central Bank, because they were aware of the benefits this produced for their citizens. They often were right. But European policy-making has now reached a degree of depth and interdependence where nation states alone can no longer sufficiently legitimise policies that do not grant citizens their ultimate right of sovereign. As long as democracy remains confined to the nation state, European institutions will not be able to muster support for the policies they pursue. Europe must 'dare more democracy', to take up Willy Brandt's famous formula. But here again, new thinking for the new age is required.

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The growing conservative creed in Europe is that a European democracy is not possible because there is no European *demos*. What the advocates of this belief really mean is that national collective identities prime over the concrete interests of individual citizens. Instead of being able of pondering reasonable arguments whether a particular policy is in their interests and then making a decision all together, citizens are assumed to fulfill the stereotypes of 'their countries' and they must surrender to what governments decide in their name. At best it is democracy *for* the people, but not *by* the people. The conservative policy consensus that emphasises cultural identities of communities may help governments to legitimise their policies *at home* ('we are defending you'), but it prevents consensus and legitimacy at the European level. It is the opposite of what Jean Monnet described as the purpose of European integration: 'We do not create coalitions of governments, we unite human beings'.

The renewed awakening of nationalism is a direct consequence of the dominance of neoliberalism. It has become a barrier to democracy in Europe. By shrinking the public sector, neoliberal policies have broadened the scope for private and reduced the space for democratic decision-making. But many privatising decisions and actions have direct or indirect consequences for all. These unintended consequences arise in the form of negative spillovers and externalities, because, as we have seen, markets frequently fail to coordinate behaviour optimally. What is

done by one group of companies or individuals may be seen as a welfare loss by many others. So what to do? The conservative response is to appeal to morality, customs and communitarian identity. They argue, individuals should conform to ~~what~~ the prevailing and conventional sense of 'proper' behaviour. Deviation is sanctioned. But in Europe, communitarian identity means national identity and national interest. This confinement prevents minority dissent from crossing borders and forming majorities. Pan-European alliances are blocked because individuals are identified with their country and have to surrender to their governments' interest. Jacques Delors once gave a beautiful example when monetary union was hotly debated: 'Few Germans believe in God, he said, but all believe in the *Bundesbank*'. Yet, Germany's former chancellor Helmut Schmidt had always been a vocal critique of the *Bundesbank*, just like the German trade unions. Thus, according to the communitarian logic, Helmut Schmidt was not a German.

In a modern democracy citizens are the *demos*, the sovereign. Together individuals make up their minds, about what policies they consider as optimal. They have an interest in doing so, *because they are all affected by the policy decisions*. Hence, the question of which policies should be decided at the European level will be answered by looking at who is affected and by measuring the scope of the externalities. With democratic institutions, public deliberation will lead to policy solutions for what citizens consider best for themselves.

Citizens will accept the chosen solution, even if in minority, because they had an opportunity to participate and contribute to the preference-building process. But Europe does not have democratic institutions in this sense. Policy decisions reflect a consensus among governments and their bureaucracies, not among citizens. Public debates do not usually take place across the European Union, but only in the isolated honey combs of nation states. Nor is there any public choice by citizens. Like in pre-modern monarchies, governments negotiate policies with governments and states are the sovereign, not citizens. Of course, exceptions exist. The European Parliament has responded to public criticism of the so-called Bolkestein Directive on services. But as a rule, citizens are treated as spectators in a football match: they are supposed to support the local club with applause, but certainly not as owners of public goods that they all own jointly.

If Europe's social democracy wants to meet the challenge of moving into a new era, it needs to become the advocate, the carrier and the implementer of a proper European democracy.<sup>10</sup> From the beginning, social democracy was internationalist, treating citizens as the sovereign, while conservatives thought of them as cattle.<sup>11</sup> Today, European social democracy must fight for individuals' freedom to take political decisions at the European level. They must acknowledge that European citizens are *equal citizens* with equal *rights to decide what they consider their best interests*. European democracy

means, European citizens will be able to elect a European government that will make laws that are applicable to all citizens because they are all affected by them. This is the opposite of the conservative approach to policy-making, which was recently articulated by the French president suggesting that France should assume the presidency of the European Union for a number of years. By contrast, the German Social Democratic Party (SPD) has

made an important step in the right direction when it adopted the *Grundsatzprogramm* in Hamburg in 2007, which states: 'Our model is a political union granting all European citizens democratic rights of participation. The democratic Europe needs a government answerable to parliament on the foundation of a European constitution.'<sup>12</sup> The SPD clearly understood that there will be no Social Europe without a proper European democracy. It is now

necessary that all democratic parties in Europe unite behind this project.

A new era of human fulfillment, social justice and democratic progress is within reach, if social democrats in Europe draw the conclusions from the failures of the previous economic and political paradigm. But it is also clear that this redefinition of aims and purposes is necessarily a European venture. Europe remains the most exciting project of our times.

## Endnotes

<sup>1</sup> European Parliament (2008), 'L'Europe doit porter l'idée d'une refondation du capitalisme mondial. Ce qui s'est passé, c'est la trahison des valeurs du capitalisme, ce n'est pas la remise en cause de l'économie de marché', 21 October, <http://www.euractiv.com/fr/services-financiers/sarkozy-presente-refondation-capitalisme/article-176573>.

<sup>2</sup> Friedman, Milton (1997), 'Is Welfare a Human Right?', in, Leube, K.R., *The Essence of Friedman*, Hoover Press Publication, Stanford.

<sup>3</sup> On 31 December 1965, *Time* magazine put John Maynard Keynes on the cover and quoted Friedman as saying, 'We are all Keynesians now'. Later, Friedman said he was quoted out of context. 'In one sense, we are all Keynesians now; in another, no one is a Keynesian any longer. We all use the Keynesian language and apparatus, none of us any longer accepts the initial Keynesian conclusions'. (See <http://eh.net/pipermail/hes/2002-July/002319.html>).

<sup>4</sup> Stiglitz, Joseph, Bruce Greenwald (2003), *Towards a New Paradigm in Monetary Economics*, Cambridge University Press, Cambridge.

<sup>5</sup> The European Constitutional Treaty has recognised this reality by stipulating (Art. 1-3): 'The Union shall offer its citizens an area of freedom, security and justice without internal frontiers, and an internal market where competition is free and undistorted'. President Sarkozy subsequently eliminated it from the Lisbon Treaty. Should Europe seek unfree and distorted competition? Should it favour one country or interest over another? This is surely not compatible with a modern left-wing policy agenda.

<sup>6</sup> In his 'Theses on Feuerbach', Marx proclaimed: 'The philosophers have only interpreted the world in various ways; the point, however, is to change it.' This separation between a world of thought and a real world echoes the classical economic paradigm, whereby goods and services are the 'real economy' and money is a veil.

<sup>7</sup> For an excellent analysis of anti-enlightenment philosophy and its drift to fascism, see Sternhell, Z. (2006), *Les Anti-Lumières. Du XVIIIe siècle à la guerre froide*, Fayard, Paris.

<sup>8</sup> Cowen, Tyler, Eric Crampton (2002), *Market Failure or Success. The New Debate*, Edward Elgar, Cheltenham.

<sup>9</sup> I borrow the term from Stiglitz, Joseph (1990), *Whither Socialism?*, MIT Press, Cambridge MA.

<sup>10</sup> For detailed analysis and proposals see Collignon, Stefan, Christian Paul (2008), *Pour la République européenne*, Odile Jacob, Paris.

<sup>11</sup> Charles de Gaulle famously once said: 'Les français sont des veaux.' But *quod licet bovi, non licet jovi*: A conservative, authoritarian politician may think that way, a political philosophy that claims the equality of men cannot be.

<sup>12</sup> <http://www.parteitag.spd.de/servlet/PB/show/1734195/Hamburger%20Programm%20engl.pdf>