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DAVID MAYER

Democratic Economics and Improved Governance:
Development Policies for the G20

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Fax: 5727•9800 ext. 6314
Correo electrónico: publicaciones@cide.edu
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Abstract

Democratic economics and improved governance can be guiding principles for the newly formed G20, representing two thirds of the world's population and 88% of the world's economy.

To get economies to work for the majorities it is necessary to balance free market policies with global and national governance. Huge corporate profits –based on huge market power– produced a savings glut that could not be invested and led to the 2008 crisis. Investment needed publically provided complements that were not available, such as health, education, infrastructure, urban development and technological, including green, innovation. In 2010, investment demand continues to be low (witness the low level of long-term interest rates). Neither stimulating consumption nor lowering interest rates work to increase global corporate investment. Instead, what is needed is funding indispensable public investments. Meanwhile, on paper, one quarter of FDI inflows and stocks were held in small island tax havens in 2009. Effective taxation of multinational corporations, in proportion to value added at point of final sale, can finance economic development, eliminating distortions between domestic and international production, and democratize and revitalize the economy.

Global governance capable of regulating transnational corporations is essential, for example, to reduce non-communicable chronic disease health risks whose costs are projected to rise above retirement costs: cardiovascular disease, cancer, chronic respiratory disease and diabetes, mainly caused by transnational promotion of poor nutrition, alcohol and tobacco.

Improving global governance is impossible without promoting national governance quality as well. For example, infrastructure investments could be paid for directly by firms as a form of tax payment, reducing government administrative costs and corruption.

* Background contribution to October 2010 G20 Finance Ministers and Central Bank Governors meeting preceding G20 summit in November.

Resumen

Democratizar la economía y mejorar la gobernanza pueden ser los principios rectores de las políticas de desarrollo del recién formado G20, que representa dos tercios de la población mundial y 88% de su producto.

Para obtener economías que funcionen para las mayorías, es necesario equilibrar las políticas de libre mercado con gobernanza nacional y global. Las enormes ganancias de las grandes corporaciones– basadas en su poder de mercado –produjeron un exceso de ahorro que no pudo ser invertido y condujo a la crisis de 2008. La inversión requería complementos públicos indispensables que no estaban disponibles, como salud, educación, infraestructura y desarrollo urbano y tecnológico, incluida la innovación verde. Para 2010, sigue baja la demanda de inversión (como muestra el bajo nivel de las tasas de interés de largo plazo). Ni el estímulo del consumo, ni las tasas de interés bajas lograrán incrementar la inversión global. Lo que se requiere es financiar las inversiones mencionadas. Mientras tanto, en papel, en 2009 una cuarta parte de los flujos y stocks de IED se situaban en pequeños paraísos fiscales insulares. La tasación efectiva de las corporaciones multinacionales, en proporción al valor añadido en el punto de venta final, puede financiar el desarrollo económico, eliminar las distorsiones entre la producción nacional e internacional y democratizar y revitalizar la economía.

Gobernanza mundial capaz de regular las empresas transnacionales es esencial, por ejemplo, para reducir riesgos de salud como las enfermedades crónicas no transmisibles, cuyos costes se prevé crecerán por encima de los costes de jubilación: enfermedades cardiovasculares, respiratorias crónicas, cáncer, diabetes, causadas principalmente por la promoción transnacional de nutrición deficiente, alcohol y tabaco.

Mejorar la gobernanza global es imposible sin la promoción de la calidad de la gobernanza nacional. Por ejemplo, las inversiones en infraestructura podrían ser pagadas directamente por las empresas como una forma de pago de impuestos, reduciendo los costos administrativos y la corrupción del gobierno.

* Capítulo de libro presentado a la reunión de octubre de 2010 de Ministros de Finanzas y Gobernadores de Bancos Centrales del G-20, preparativa de la reunión cumbre de noviembre.

Introduction

The main challenge facing global development policy is to promote democratic economics: to ensure that economies function and grow for the benefit of majorities everywhere. Yet the current policy mix is indistinguishable from what a syndicate of the very rich and powerful would recommend. What can the role of the G20 be in the current circumstances of globalization and crisis?

Two forms of governance rule human affairs, governments and markets. Each can promote equality and welfare, or concentrate power and wealth. When capitalism arose in the 18th Century, the question was, how can the pursuit of self-interest lead to the public weal? Adam Smith's reply was, through competition, whose "invisible hand" would allocate resources efficiently and make public action unnecessary. However, markets do not correct inequality or generate public goods and under substantial market power are inefficient and concentrate wealth.

Likewise, government only promotes the interests of the majority under special circumstances. Government can promote equality and welfare only when the majority controls the powerful. This initially occurred through revolution in the US, France and England, ensuring democracy through property rights and the rule of law. What mattered most were the rights of the weak and many.

The tools government and markets provide for promoting equality and welfare complement each other. What competitive markets can do, they do more efficiently than government. What markets cannot do, only some other form of governance can.

Globalization, corporate power and current economic policy

A prominent feature of globalization is foreign direct investment (FDI). While exports reached US \$17 trillion dollars in 2007, sales of foreign affiliates of transnational corporations (TNCs) reached US \$31 trillion, 43.7% of US GDP.

Globalization strongly increased the concentration of production. 89.3% of global FDI inflows were mergers and acquisitions. The world's top 100 non-financial TNCs produced 14.1% of 2008 output. Only 23 countries are not smaller than some corporation, while 69 corporations are larger than 100 countries or more¹.

Industrial concentration is a standard feature of production. In the US, from 1935 to 1992, the four largest firms in 459 industries produced 38.4% of

¹ All data sources are mentioned in Mayer-Foulkes 2009a, to which are added UNCTAD's World Investment Report 2010, US economic censuses and the World Bank's database.

shipments, while from 1992 to 2002, 40% of manufacturing value was added in the 200 largest manufacturing companies.

The risk is that global economic concentration could continue to rise towards US levels.

US corporations increased their economic power and reduced their accountability through globalization. Consider this. On average, between 1983 and 2005 US foreign affiliate profits equaled 90.7% of the US trade deficit. To the extent head corporations control their affiliates, these profits were nominally in (untaxed) foreign but actually in US hands, implying the US trade imbalance was much smaller than thought.

Increased corporate power has deeply affected US politics. Overturning a century-old restriction, the Supreme Court allowed corporations unlimited spending in federal elections (Savage, 2010). This is the result of long-term concerted political action involving the history of Supreme Court nominations. Weakening the control of the powerful by the majority, US corporate power has weakened US democracy to better pursue its own interests.

It is astonishing that the dominant economic viewpoint is that perfect competition is a good approximation to reality, when in fact market concentration is the norm. Concentration distorts prices, efficiency, distribution and politics. An objective, democratic choice of development policies would complement free market policies with public policies. Instead we see a highly selective policy choice that coincides with the interests of the staunchest supporters of free markets: big corporations with market power. This choice supports free markets and reduces to minimum levels policies addressing inequality, public goods, market power, health, education, urban development, infrastructure and technological innovation.

Successful economic development requires a balance between markets and governance at the global level. The challenge is to achieve governance without a global government, and without the inefficiencies of government. Such governance must include the regulation and taxation of TNCs.

Impact of globalized corporate power

The 2008 economic crisis

It is generally thought that the economic crisis of 2008 consisted of a combined collapse of the housing and financial market bubbles. However, paradoxically, the crisis originated in the huge FDI profit flows. These generated a global savings glut-or investment shortfall-that dramatically lowered long-term real interest rates, originating the international housing bubble that finally destabilized the financial system (Mayer-Foulkes, 2009a).

At present the financial and housing markets have regained some stability, but long-term interest rates continue to be low, in an effect mostly independent of the short-term interest rates controlled by the Fed (Figure 1). TNCs continue to generate high enough profits to supply the global financial system with more funding than is demanded for investment. Yet the global incentives for investment continue to be low.

Lowering interest rates or increasing spending to increase consumption does not raise TNC investment incentives very much.

Global investment slowed down over the last *decade* for structural, not cyclical reasons. These consist mainly of investment shortfalls in publicly provided complements to private investment, such as infrastructure, education, health and technology.

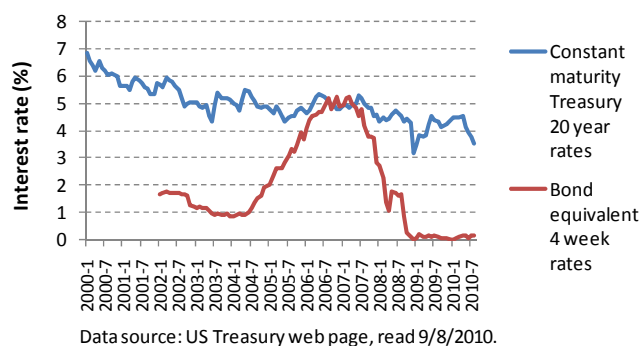
In short, the global imbalance between markets and governance led to an investment slowdown. Transnational corporations are mostly behaving as free-riders in the provision of essential publically provided investment. Harmonizing taxes for TNCs is an inevitable requirement of global integration.

Global public goods

The importance of global governance is illustrated in the following (Mayer-Foulkes, 2009a).

Non-communicable chronic diseases (NCDs), mainly cardiovascular disease, cancer, chronic respiratory disease and diabetes are amongst the principal burdens of disease in both developed and underdeveloped countries. These diseases share modifiable and preventable risk factors, mainly physical inactivity, tobacco use, unhealthy diet, and the harmful use of alcohol. NCD-attributable costs are projected to rise *above retirement costs*. NCD risk factors are directly related to TNCs. For example, TV advertising exacerbates child obesity (Kelly *et al.*, 2010). Nestle and Coca Cola each have advertising budgets approximating the World Health Organization's or the Gates foundation's budget. Holding TNCs responsible, for example by charging a health insurance tax associated with their product risks, and regulating them to promote cooperation for better outcomes, requires national and international institutional frameworks. This problem has not been fully addressed in the US, as its obesity epidemic shows.

Figure 1. Long- and Short-Term Treasury Interest Rates, 2000-2010



Taxing TNC's, global governance and the G20

Taxing and regulating TNCs faces three main obstacles as an idea.

- Tampering with markets is counterproductive.

A global balance between markets and governance is essential for democratizing the economy and achieving development. The main objection to taxes will come from TNCs. Why does the World Bank (2010) say infrastructure is badly needed but never suggests harmonizing TNC taxes to fund it? Should the countries providing TNCs with cheap labor *borrow* for infrastructure investment?

- TNCs represent the national interest of their country of origin, and should be protected.

This posture is undemocratic in the concert of nations, and works against the global common interest. The national interests of the weaker G20 countries include democratizing their own economies, and this requires a level playing field with global corporations. These contrasts in interests make the G20 an excellent forum for advancing global economic governance and development. There is enough representation from weaker countries to make a difference, and they in turn have enough in common with other LDCs for improvements to benefit all.

- A time of crisis is the wrong time to raise TNC taxes.

However, while TNCs continue to generate oligopoly and technology profits, investment incentives remain low. Investment requires its public complements. Also, TNC tax loopholes (small island tax havens held, on paper, *one quarter* of FDI inflows and stocks in 2009) penalize domestic producers, especially in developed countries, reducing employment and investment. Finally, healthy public finances are an urgent requirement for stability.

The risk of rising economic concentration, combined with the low reach of international law creates an unprecedented threat to democracy, arising from capitalism itself. This threatens the US as well, as the Supreme Court ruling and the US obesity epidemic illustrate.

Countries compete for FDI lowering taxes and regulation, racing to the bottom in governance. What is needed instead is a race to the top. This requires international agreement and international accounting. An important point relating to transfer pricing is to measure value added according to point

of final sale, guaranteeing progressive taxation will compensate for low wages, generating funds for development. International initiatives raising governance quality, such as cash transfer programs, have been successful. Much more governance innovation is needed. For example, governments could issue lists of desired goods, such as roads, hospitals and schools, together with a tax equivalence. Tax payment would consist of building these facilities. This would generate pricing competition between the different goods to provide and between different providers, and reduce administrative costs and corruption in government.

Conclusion

The current economic and political juncture requires looking beyond a distorted conception of free market policies that supports the interests of the very rich. Concentration of production is an inescapable feature of contemporary capitalism that requires a strong capacity for global governance to establish necessary regulation and taxation, and to generate indispensable public investments that will democratize and revitalize the economy.

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