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WHAT WENT WRONG WITH CAPITALISM



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What Went Wrong with Capitalism



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PROLOGUE

WHY I FELL FOR CAPITALISM

The young often rebel against the systemic injustices of their time and place. Today, in America and many wealthy countries, they are agitating against the excesses of modern capitalism: widening inequality, dominant monopolies, big corporate bailouts. They are drawn in their frustration to more government intervention or socialism as the answer, but they need to beware what they wish for.

I was born in the mid-1970s, when India was staggering under the burden of a homespun socialism heavily influenced by the Soviet Union. The government had nationalized any business that was big, thrown out many that were foreign, and started building a welfare state—before generating the revenue to pay for it. Shortages were routine; the economy grew at a painfully slow rate. Per capita income was falling behind the global average. I was drawn, during my early travels outside India, to capitalism as the answer.

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My father had followed the path of opportunity in India at the time, which steered him into the government and a naval career. His postings kept us on the move, and I became the perennial new kid in town. In 1985 he was transferred to Singapore, which was developing a small and efficient state, with light taxes, simple regulations, and open doors, under the unchallenged rule of Prime Minister Lee Kuan Yew. Most Singaporeans did not seem to mind that elections were carefully managed, because with economic freedoms so well established, average incomes were rising by more than 10 percent a year—better than double the global average.

After the stagnation of India, Singapore was a liberating breath of fresh air. Lee's successes had earned him close ties to America and its president, Ronald Reagan, who seemed to go one better: loosening economic controls in a wide-open democracy. In my youthful exuberance, it seemed to me you could have it all—economic and political freedom. While in the West capitalism had already come to be synonymous in the eyes of many with greed and inequality, to me capitalism evoked endless possibility, not only for individuals but for my beloved home country. I became a passionate reader of classic economic texts.

When we returned to India, I was in my final years of high school. In May 1990, my teacher at Delhi Public School R.K. Puram assigned a debating topic for which I was, as luck would have it, well prepared: the relative merits of socialism and capitalism. The Soviet Empire was in its death throes, and many Indians were questioning the old socialist faith of the Congress Party, which had ruled the country almost without break since independence in 1947. I took the side of the questioners.

Why, I asked, was a democracy like India, so fiercely proud of its political freedoms, so unwilling to grant its people economic freedom as well? Surely citizens who could be trusted to vote and speak their minds could also be trusted to open businesses, set prices, and exercise the eco-

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nomic rights granted in other democracies as a matter of course. Wealth was rising and social welfare was improving faster in capitalist societies than in their socialist rivals.

The following year, 1991, would turn out to be one of the darkest in India's post-independence history. Decades of overspending had driven the country to the verge of default on its foreign debts. Prime Minister Rajiv Gandhi, a scion of the Congress Party's leading family, had taken tentative steps to open up India's economy. I admired Gandhi as a modernizer and was rooting for him in the upcoming national elections. But his life and his plans for India were cut short by a suicide bomber in May of that grim year.

Just out of high school, I went to work for a leading financial paper, writing a column on global markets—a beat no one else in India seemed to want at the time. Two months after Gandhi's assassination, my press credential got me in to see the maiden parliamentary address of the finance minister, Manmohan Singh, who captured all the pathos and promise of that moment. "As I rise, I am overpowered by a strange feeling of loneliness," said Singh, honoring the tragedy of Gandhi's assassination, before promising to push forward his economic agenda in a series of big-bang reforms.

I listened with so much excitement that it is surprising to look back at the speech now and find that the first flash of poetry was followed by thirty pages of jargon, dwelling on "credible fiscal adjustment and macroeconomic stabilization," which is to say budget restraint. Such was the tenor of the early nineties. The allure of socialism was fading, and pragmatic technocrats were in the ascendant. "Liberalization" was cool. Singh along with his Oxbridge and Ivy League team became the toast of the Davos crowd, praised for imposing budget discipline, thinning the regulatory thicket known as the "license raj," and opening India to the world.

Within a few years, India's economy pulled out of crisis. Under pres-

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sure from the old political establishment, still overwhelmingly socialist in its instincts, Singh slowed the pace of economic reform. I took a job at a global investment bank in 1996, and travel again gave me new points of comparison. East Asian nations like South Korea and Taiwan were, like Singapore, giving people far greater economic freedom and were seeing fast gains in income, alongside rapid declines in poverty and infant mortality. China was leaving India behind. In 1990, the two had similar average incomes: since then, China's has risen fortyfold to $12,500, while India's rose just sevenfold to $2,400.

To this day the standard Indian excuse is that the world's largest democracy can't force march development the way Communist China once did. But democracy is not the problem; many democracies have grown much richer than India. It is India's lingering attachment to a state that overpromises and under-delivers.

Even Congress's successors in the right-wing Bharatiya Janata Party (BJP) are steeped in the same ideals. BJP prime minister Narendra Modi campaigned for the job in 2014 promising "minimum government, maximum governance" and sounding like the Reagan of India. He criticized Congress for "welfarism" and said the poor want "work not handouts." Then Modi took power and, rather than restrain Congress's welfare programs, he topped them, offering every Indian family a "pucca" (concrete) home with gas and electricity.

India's critical mistakes included doing too little to expand economic freedom, and too much to build a welfare state, too soon. The government didn't spend more heavily than its Asian rivals, but it did spend less wisely, having introduced free social programs at a much earlier stage of development, before building the roads and schools that could generate incomes high enough to pay for those programs.

The imperious Indian state was quick to regulate, officiate, and pick winners, overconfident that its priorities were correct. Though Modi has

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in recent years tried to restrain welfare overspending, the central government remains notorious for its questionable choices, leaving critical services underfunded and understaffed. My grandfather died, after suffering a heart attack, when an unqualified aide in a public hospital tried to install a pacemaker.

Too often, Indian politicians sell aid to select businesses or industries as economic reform, when the measures in fact retard competition and growth. Pro-business is not the same as pro-capitalism, and the distinction continues to elude us.

The result: despite all of India's inherent strengths, from a strong entrepreneurial culture to world-class human capital, it will take longer to become a developed nation than it could have. In pursuit of the unreachable socialist ideal—equality of outcomes—India long denied itself the very real promise of capitalism: equality of opportunity.

Today the developed capitalist societies are turning onto the path that slowed progress in India, speeding the expansion of welfare and regulatory states. In its size and its reach into our economic lives, the U.S. government has, like its peers in Europe and Japan, grown steadily since the 1930s, when Franklin Delano Roosevelt launched New Deal spending programs to stop the Great Depression.

In 1980 Reagan had set out to reverse the New Deal and the growth of the state but ended up slowing its growth only in some respects, and temporarily. Now in the name of reversing the Reagan revolution, which never really happened, President Joe Biden is promising to fix the crises of capitalism by enlarging a government that never shrank. Biden aides call this recommitment to big government "the new Washington consensus," and they're not wrong.

Political and popular support for a larger state is higher now than it has been in at least half a century. Republicans are campaigning against Biden more on social issues than on his willingness to wield

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state power, since they are in many cases equally willing to impose government control on flows of people, money, or goods. Like populists on the left, many of those on the right share a sense that decades of free market ideology are behind today's economic ills.

This increasingly bipartisan and conventional wisdom is, I think, based on a fundamental misreading of economic history. Flaws that economists blame on "market failures," including inequality and inordinate corporate power, often flow more from government excesses. In particular, constant government support and intervention in financial markets has crippled the competition that would break up concentrations of personal and corporate power, were capitalism allowed to function properly. If frustrated young generations want to correct the growing ills of capitalism, the first step is to get the diagnosis right. This book reexamines the causes of those ills, and the possible way out.

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INTRODUCTION

WHAT WENT WRONG

I've spoken of the shining city all my political life, but I don't know if I ever quite communicated what I saw when I said it. . . . In my mind it was a tall, proud city built on rocks stronger than oceans, wind-swept, God-blessed, and teeming with people of all kinds living in harmony and peace; a city with free ports that hummed with commerce and creativity. And if there had to be city walls, the walls had doors and the doors were open to anyone with the will and the heart to get here. That's how I saw it, and see it still.

—Ronald Reagan, Farewell Address, January 11, 1989

Love or hate him, few observers today would say Ronald Reagan was wrong when he declared victory for his revolution. Recalling why he had entered politics in the 1960s, Reagan said he was moved by concern for the direction of the country in a decade when regulators and tax collectors were taking a growing share of citizens' money, options, and freedom. His aim was to reenact, in a way, the American Revolution of 1776, which he described as "the first

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revolution in the history of mankind that truly reversed the course of government."

Reagan said his presidency had "stopped a lot of what needed stopping." His efforts to roll back government had unleashed the longest economic recovery since World War II—seven years and counting as he spoke, accompanied by a flowering of entrepreneurship and innovation. Aiming to change a nation, "we changed a world," inspiring other countries to abandon socialism and communism—"the ideologies of the past." Eleven months later, in November 1989, the Berlin Wall fell.

Looking back at the Reagan revolution, we can see where it worked and how it went wrong. The United States has had an astonishing run in the last four decades, losing nothing of its 25 percent share of the global economy over that time, while China was expanding its share rapidly—and entirely at the expense of Europe and Japan. As a financial superpower, the United States remains as strong as ever, the dollar by far the dominant currency in global trade, the U.S. stock and bond markets bigger than ever, relative to the rest of the world. And that also is where the flaws start to appear.

Reagan's farewell speech is remembered for the image of the "shining city." But there was a throwaway line, a caveat to his normally unshakable optimism that rings loudly now: "I've been asked if I have any regrets. Well, I do. The deficit is one."

Contrary to the narrative that prevails today, Reagan did not "reverse the course of government." The welfare state, the regulatory state, the national security state, all held steady or continued to grow, and government deepened its influence on our economic lives. What changed, starting in the late seventies and accelerating under Reagan, was the way government pays for itself—by borrowing to cover the perennial deficit. Four decades later capitalism is addicted to debt. While Donald Trump got mocked for calling himself the "king of debt," he

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captured in a phrase the rulers of a system who came to run on rolling over credit.

Capitalism is, to adapt a line from Winston Churchill, the worst system for allocating a nation's economic resources, "except for all the others that have been tried." When capitalism is working, it gives people freedom to vote in the marketplace, by investing in new ideas and growing companies. Their choices determine prices, and those prices reflect the public's best bet on which ideas and companies are poised to thrive in the future. The collective wisdom of millions of individuals, scrutinizing every deal closely, cannot be matched by the lone mind of the state, trying to steer capital from on high.

Capitalism is the economic soulmate of democracy, equally fair and flawed. With the partial exception of tiny Singapore, no wealthy, developed economy is not a fully formed democracy. And no centralized autocracy has ever grown rich in the modern era. China may never make it into the developed class, in part because it is in the process of bringing back big government.

Governments of the leading developed nations have played a more active role in allocating capital since the Depression of the 1930s, whether by rescuing and regulating, or spending and borrowing. Fear that the resulting debt bubbles will blow up and take down the economy has come to haunt policymakers, and has grown more acute since the crisis of 2008, when we witnessed the most damaging collapse of a debt bubble since the Depression. Today governments watch for jitters in the markets and rush in to support them with easy money and bailouts at the first sign of trouble.

When government becomes the dominant buyer and seller in the market—as it has in recent decades—it distorts the price signals that normally guide capital. Money starts to flow down the paths of least regulatory resistance, or most government support. Each crisis brings big-

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ger bailouts, leaving capitalism more mired in debt, more dysfunctional and fragile. In the 2000s, and even more in the 2010s, the governments of advanced countries began injecting money into economies that were not in crisis. They were in recovery. Disappointingly slow recovery, but still. Intended to boost the pace of growth in these economies, these experiments had the opposite effect. By flooding the engines of capitalism with easy credit, they created more kings of debt, more excesses in the financial markets.

These distortions reached fun house mirror proportions amid the pandemic, with its record bailouts. Governments offered trillions of dollars in support to companies large and small, solvent or not, so investors no longer looked for companies with bright prospects. They looked to buy whatever assets the central bank was buying, or whatever companies the Treasury supported. That is what Ray Dalio, founder of the world's largest hedge fund, had in mind when he said in July 2020: "The capital markets are not free." Wealthy capitalists are now often as critical of "financialized" capitalism as socialists are.

The periodic financial crises—erupting in 2001, 2008, and 2020—now unfold against the background of a permanent, daily crisis of colossal capital misallocation. Its most visible symptoms are the big economic players who have the resources to thrive in a system awash in complex debt products. That is a major and overlooked reason why most American and European industries are concentrating in the hands of fewer companies, and the individuals who founded and lead those companies now measure their wealth in hundreds of billions, not mere billions.

Every big player on Wall Street knows in his or her heart that Bernie Sanders has a point when he calls modern capitalism "socialism for the very rich." Concentrating wealth in the hands of oligopolies and the billionaire class is a critical symptom of capitalism gone wrong, both inefficient and grossly unfair. I agree with Sanders, but my diagnosis of how it went wrong could not be more different.

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In the Sanders view, the story begins with leaders like Reagan shrinking government. Over the next four decades they gutted regulations, which left rich capitalists free to run wild, and downsized the welfare state, which left the poor to get poorer. Sanders always pairs his critique of "socialism for the very rich" with "rugged individualism for the poor." The problem is a shrinking government, he says, so the answer must be more regulation and welfare spending—a view that captivates many Americans, especially the young.

In 2016, the youth vote helped turn Sanders from a Vermont sideshow in American political life to the first socialist ever to make a serious run for the presidency from one of the major parties. By 2020, only half of American adults under forty approved of capitalism, a third were willing to try communism as an alternative, and 70 percent said they were likely or extremely likely to vote for a socialist. For the first time since the Pew polling agency started posing the question in the early 1990s, a majority of under-forties said yes when asked if the government should "do more to solve problems."

They did not get an avowed socialist in 2021, but they did get Joe Biden, who saw himself as a throwback to Franklin Delano Roosevelt. The original big-government president, FDR launched the New Deal spending programs to counter the Great Depression. The prospect that Biden would launch a second New Deal inspired headlines from the *New York Times* to the *Washington Post* and the *Guardian* heralding the end of "the era of small government" or the "age of neoliberalism," which is to say the free market reforms that began with Reagan and Margaret Thatcher in the United Kingdom. Even conservative publications like the *Wall Street Journal* accepted the basic premise—that big government had disappeared—by warning that it was "back."

That narrative was misleading. Government had been growing steadily since the 1930s, and during the pandemic matched peaks of

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spending and debt reached in World War II. Capitalism has been twisted into an unfair and inefficient form, but not mainly by rules stacked in favor of big companies and tycoons. It has been distorted above all by governments and central banks pumping more money into the economy than the markets can possibly invest effectively. More than just socialism for the very rich, the underlying issue is socialized risk for everyone—the government extending the safety net beyond the poor to the middle class and the rich, at a pace and scale that have corrupted capitalism with debt. Bigger government will only magnify the distortions.

A Turn of the Mind

In 2022 and 2023, a series of landmark histories of capitalism hit the bookstores and bestseller lists, and all tell the story of the Reagan revolution in the same basic way. In Gary Gerstle's taxonomy of capitalist orders, the "New Deal order" begins to erode under President Jimmy Carter in the 1970s, and the ascent of the "neoliberal order" begins in earnest with the 1980 election. In Jonathan Levy's account of capitalist ages, the postwar "Age of Control," in which big government and big corporations control flows of capital, gives way in 1980 to the "Age of Chaos," in which the unleashed markets steer capital to chaotic ends. In *Slouching Towards Utopia*, Berkeley economist Brad DeLong describes how "thirty glorious years of social democracy" fell apart in "the neoliberal turn," starting in the 1970s and accelerating under Reagan.

In these "grand narratives," as DeLong calls them, the implication is that big government rose to new heights in the 1950s, '60s, and '70s, then fell back sharply under one aggressively capitalist leader after another, starting with Reagan and Thatcher.

There is wonderful depth in these books, which take readers inside

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the culture wars and the change in corporate mindsets that defined this shift from the early to late postwar eras. All of this happened. The public conversation did often attribute to free markets a kind of magic and focused on ways to push government out of the way by cutting regulations and deficits. The "neoliberal turn" was very real, but it was, for the most part, a turn of the mind.

The neoliberals resurrected the ideas of classic liberal thinkers like Adam Smith and John Stuart Mill, who were the original apostles of small government and free market capitalism. The neos rejected the way the word "liberal" had been repurposed, starting in the New Deal and continuing through Lyndon Johnson's Great Society in the 1960s, to describe people in favor of a larger welfare state. Starting in the fifties, the neoliberals had been plotting to overthrow the New Deal and much that followed. Clustered around economists and political scientists at the University of Chicago, they developed the agenda of cutting—taxes, spending, and regulation—that Reagan brought to the White House in 1980.

In practice, however, neoliberalism did not slow the momentum of big government. There was some slowdown at least in spending under Reagan, even a brief and isolated retreat under Bill Clinton in the 1990s, but not to the degree talk of new ages and orders implies. After 2000, government was booming again. By selectively stitching together the many episodes in which neoliberal thinking did shape policy over the last four decades, under both parties, commentators create what appears to be a persuasive picture of government retreating, leaving big companies and tycoons free to take over the economy.

Any leader who at any time followed any piece or pieces of the neoliberal agenda—from tax cuts to deregulation, privatization of state companies, free trade deals, or a rhetorical concern with containing public deficits and debt—is cast as one of them. From Bill Clinton to Barack

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Obama in the United States, Tony Blair in Britain to Gerhard Schroeder in Germany, and Emmanuel Macron in France—all populate these narratives as neoliberal descendants of Reagan and Thatcher.

Follow the data, not the debate, and the story reads differently: government grew steadily bigger everywhere in the capitalist world, with a few surprising exceptions, including the Nordic welfare states so beloved of the American left. On many measures, they are less socialist than most people think.

The "Era of Small Government" Ended Long Ago

There was an era of small government, but it ended in the United States with the Depression. Washington circa 1930, before FDR was first elected to the White House, would be entirely unrecognizable today. Half the government departments had yet to be created, and those that did exist were a sliver of what they would become. Half of all federal government employees worked for the post office. The Capitol, the citadel of democracy, would soon be dwarfed in scale by the temples of New Deal bureaucracy, first the headquarters of the Commerce Department and then in 1936 of the Agriculture Department—the world's largest office building at the time. Income taxes, introduced in 1913, were still relatively light, so Washington raised revenue largely through tariffs and tolls. Federal government spending was so low, less than 4 percent of GDP, even a large deficit would not have had much impact on the economy. Deficits were not only rare, they were a breach of the prevailing post-Victorian ethos, which saw debt as a moral failing and bankruptcy as a criminal offense. Compared to the capitals of Europe, Washington was like a small company town.

Since the 1930s, public spending has grown steadily as a share of

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every large capitalist economy, punctuated by two upward spikes during World War II and the pandemic of 2020. There was never a sustained retreat anywhere in the leading capitalist economies, which I'll call the LCEs. Owing to limited historical data for others, I include in this group the United States, Japan, the United Kingdom, and the four major members of the European Union: Germany, France, Italy, and Spain. Since 1930, spending by government—including state and local—has quadrupled on average to 48 percent of GDP in the LCEs, but within a broad range, rising from 4 percent to 36 percent in the United States and from 19 percent to 58 percent in France.

While free market ideology spread worldwide after 1980, and shaped policy episodically, governments in the western world were extending their reach into economic lives. In the United States and Europe alike, parties of the center right and left launched bouts of deregulation, which generally entailed rewriting and replacing regulations with longer ones. Overall, the regulatory state grew dramatically—more rules, more restrictive rules, more rule-makers, and more rule-making agencies with bigger budgets.

The legislators cut some taxes, raised others, and overall the government's tax take didn't change much. "Hauser's law," really just a factual observation, states that while the sources of tax revenue shift constantly, the total tax burden hasn't changed for decades. Including state and local government, it has hovered slightly above 20 percent of GDP on average in the LCEs, and slightly under 20 percent in the United States. If revenues are so steady over time, how can it be that government is growing more expansive?

The big change was that the large capitalist countries began running significant deficits (larger than 1 percent of GDP) virtually every year starting in the late 1970s. Under Reagan, the spending choices shifted from welfare to defense, butter to guns, and the deficits grew. Rather

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than pay for the growing edifice of state agencies by raising taxes, or making cuts elsewhere in the budget, governments borrowed more. Central government debt in the LCEs crept up from 21 percent of GDP in 1970 to 30 percent in 1980, surging to almost 120 percent on the eve of the pandemic and 140 percent during the pandemic.

The Reagan revolution spawned a conviction, which soon spanned the capitalist world, that deficits and debt don't matter. From 1980 on, Republicans would propose tax cuts as the solution to every problem, claiming they would pay for themselves by generating more economic growth. Even if public debt rose, the economy would grow faster, easing the burden. Democrats would make the same case for spending on schools, health, or subsidies for manufacturing, arguing that social spending is "an investment" in the future. Either way, growth in the economy never kept up. The burden of public debt—measured as a share of GDP—mostly kept climbing. The two main exceptions—public debt receded a bit in the United Kingdom under Thatcher in the 1980s, and in the United States under Clinton in the 1990s—prove the general rule.

Slowly the developed world became addicted to debt, and to constant support from governments that had come to define their jobs as ensuring stable expansion of the economy. The Keynesian idea, born in the Depression, that governments should run deficits to create jobs in hard times, and surpluses in good times, had given way to running deficits all the time. Democracies were losing the capacity to make hard choices.

Elected legislatures were fracturing along partisan lines, often over issues of race, immigration, and other social conflicts not directly related to the economy. Divided lawmakers found it difficult to come to spending decisions, even during crises. Voters had come to expect the government to keep the economy growing, but responsibility for that task was passing by default to unelected central bankers, who came to

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see themselves as the last institutions standing between the world and the next Great Depression.

This fearful, backward-looking mindset is destructive for all countries, and a particularly odd fit for the United States, which sees itself as younger, bolder, tougher, and more "future-oriented" than soft Europe or aging Japan. Yet for much of this century, the mantra of officials facing a crisis has been variations on "better to be early and overreact," or "err on the side of being generous," or the "risks of doing too little are far greater than the risks of doing too much."

This shift mirrors exactly the "revolution in pain management" that, also over the last two decades, helped hook America on opioids. Accepting any pain is seen as a legacy of crude, nineteenth-century medicine, so modern doctors should dose their patients with OxyContin even for moderate injuries. The public—particularly homeowners, stockholders, and bondholders—came to expect more help in every crisis; they put more pressure on politicians and central bankers to deliver more relief, culminating in the shockingly large doses of government aid in 2020. Though inspired by a kind of paternalistic fear, these rescues are delivered with growing certainty that the cure is not worse than the disease.

Gradually, a safety net once meant to catch the poor at the precipice of hunger was extended under the financial markets, where the big beneficiaries are far from hungry. In the seven largest capitalist economies, cited above, the combined stimulus from governments and central banks rose from about 1 percent of GDP in the recessions of the early 1980s and 1990, to nearly 3 percent in 2001, to more than 12 percent in 2008 and 35 percent in 2020.

As governments and central banks flushed more money into the economy with each crisis, they inflated the size of the financial markets. Liberal critics cast the post-Reagan boom in financial markets as a result

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mainly of deregulation, which did play a big role—but only in widening the options for investors. Their capital came mainly from governments and central banks, and their overconfidence was built on the promise of public bailouts.

Since easy money inflates the prices of all financial assets—equity and debt, stocks and bonds—the financial markets grew even more bloated than the debts alone. From slightly larger on average than the large capitalist economies in the 1970s, the financial markets had grown to nearly four times larger by the eve of the pandemic, when they rose even higher. In the United States, where the "everything bubble" was the most extreme, the financial markets are now worth $120 trillion, four and a half times U.S. GDP.

Though stocks comprise roughly 30 percent of global financial markets, the rest is in debts of all kinds, from simple government and corporate bonds to increasingly exotic packages of loans—for cars, college, consumer credit, mortgages, anything. The markets are the big city street corners where debt addiction plays out.

Central banks used to be conservative institutions that bought only short-term government bonds to push money into a troubled economy, but in the crises of 2008 and 2020 they turned radical and experimental, expanding what kinds of bonds they would buy and from whom, to the point that in 2020 they were buying the junk debt of failing companies known as "sinking demons" and purchasing those debts from "shadow banks" like hedge funds and other private investors.

They pushed easy money straight into the hands of the biggest players on Wall Street, which, despite their scale, can't steer that many trillions efficiently. By the time the pandemic hit, capitalist economies were already being overtaken by monopolies and oligopolies, by the billionaires who own them, by firms that make no profit, and by a growing class of "zombie companies" that make too little profit to cover even the

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interest on their debt and survive by taking out new debt. All these creatures of credit thrived in the bailouts of 2020, which were seen by many as a creative emergency response to a hundred-year storm. Yet each new rescue built on those that came before, pushing the century-long expansion of the bailout culture to a risky new height, and setting a higher bar for the future.

How Big Government Slows Growth

Economies began to slow in the 2010s, not only in the LCEs but worldwide, in part for a reason beyond government control. The social revolutions of the 1960s and '70s gave women the freedom to have fewer children. Birth rates started to fall, which meant fewer young adults entering the workforce in subsequent decades. Many governments would try to counter the population slowdown—for example, by giving families bonuses for having more children—but to little or no avail.

Economic growth is a simple function of how many people are working, and how much each worker is producing. To boost economic growth in an era when fewer adults are entering the workforce, governments need to raise productivity—output per worker. Productivity growth allows companies to raise worker pay without increasing prices—generating higher economic growth without inflation. It has been called the magic key to prosperity, which it is. But like population growth, productivity growth has slowed sharply since 1980. Despite a recent uptick, productivity growth is down by more than half in the United States to an average barely over 1 percent a year since 2010, and down even more sharply in the United Kingdom, Japan and the four largest European economies, where it averaged just one quarter of a percent.

The productivity slump is the most important mystery of modern

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capitalism, and mounting evidence suggests that a widely overlooked piece of the puzzle is bigger government and its by-products: ballooning debt and metastasizing capital misallocation. To revive capitalist economies, the most essential thing governments need to do is boost productivity. Instead, their efforts are backfiring. It is likely no accident that productivity has fallen more sharply to even lower levels in Europe than in the United States, at a time when the European Union is building what scholar Anu Bradford calls a global "empire of laws and regulations."

When capitalism works, it does so through what the Austrian-born economist Joseph Schumpeter called "creative destruction." Competition in the markets allows new firms to rise up and destroy the complacent ones, making the economy ever more productive over time. This process generates vast pools of wealth, personal and corporate, but *only temporarily*, as cut-rate competitors raze monopoly profits and concentrations of power. The downsides of this rough cyclical justice are more downturns in the economy and churn in the markets. The upside is human progress.

This is what capitalism is losing, daily. Government rescues made recessions few and far between, and less deep than they otherwise would have been. As more old and weak firms survived each downturn, America ceased to be the land of second chances, because so few established businesses were allowed to fail in the first place. As what researchers have called "the cleansing effect" of recessions disappeared, recoveries started to last longer but at a slower pace of growth, particularly after the dot-com crash of 2000.

The rhythm of the markets started to change, too, calmer and steadier but less discriminating. Investors came to assume that good economic news was good for the markets yet so was bad news—because it would trigger more government support. As a growing government stifled competition and crippled the prospects of creative destruction, the

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largest firms kept getting bigger. And markets with no downside were a boon to the super-rich. Billionaires barely existed worldwide before 2000, but have since surged in number to more than 2,600, rising with the financial markets.

All of this—the bloated markets, weaker recoveries, and shorter recessions with fewer bankruptcies, the general stupefaction of a business culture pickled in debt—might be of less social consequence were it not conspiring to slow economic growth. Who, after all, wants harsher or more frequent recessions, more bankruptcies, or a scarier ride in the stock markets? By smothering capitalism's competitive fire, big government is slowing productivity growth, which is lowering economic growth in the long run, thus shrinking the pie and concentrating what's left in fewer hands.

Millennials, the next ruling generation, have embraced a narrative that is clear on the problems of capitalism and way too certain of the causes. Like the media establishment, many Americans seem to assume that the story of shrinking government is true. They juxtapose it against the stark facts of giant corporations dominating the economy: the stock market value of the largest company skyrocketing above $3 trillion, the fortunes of the richest tycoons breaking $200 billion, CEO pay topping four hundred times the average staffer's pay. If these distortions arose in a period of shrinking government, they figure, then bigger government must be the answer. But if the era of shrinking government never happened, that is exactly the wrong answer.

America Is Now "Exceptional" in the Wrong Ways

Since its earliest stirring in the seventeenth century, the term "American exceptionalism" has described the unique culture of a country in which

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individual freedoms flourished because government was too young and small to be entrenched or overbearing. Reagan's "shining city on a hill" was a metaphor for this origin story. And though the American style of democratic capitalism continued to outperform its rivals into the late 2010s, at least in economic competition, the U.S. intelligentsia did not recognize, much less boast of, its achievements. Perhaps the establishment was reluctant to highlight American successes when Donald Trump, a man it despised as a rogue populist, occupied the White House.

Then Trump lost, and "American exceptionalism" made a comeback. Even writers who normally avoid a patriotic tone began to laud "the power of American capitalism," or the "marvel" of how it had held its ground against China, and the lessons this "astonishing economic record" have for Old Europe and Japan. What impressed establishment publications from the *Economist* to the *New York Times* and the *Washington Post* was U.S. dominance in financial markets, the might of the dollar, and the fact that the biggest American companies were growing even bigger. While U.S. tech giants accounted for most of the world's ten largest companies, and had for more than a decade, many investors thought they would remain on top for another decade.

Most Americans, however, were not joining in this round of applause and awe. Riding the back of what was still the fastest-growing economy in the developed world, Biden was said to be perplexed by why he was so unpopular, and why voters were still so frustrated. Late in his first term, Biden's approval ratings were the lowest since Jimmy Carter in the 1970s; only two in ten Americans thought life in this country was "better" than fifty years ago, and one in ten expressed confidence in their economic future.

Make no mistake, America has had an exceptional run, relative to other developed countries, for the past decade in particular. But it has been outrunning a field of competitors who have all slowed dramati-

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cally. The weaknesses of modern capitalism are increasingly clear to the majority, and not only in the United States. They see that the system is unfair, out of balance, less and less capable of lifting all boats. In many ways, the economic crisis is not merely brewing, it is here. The debate over how to fix capitalism needs to start with a clear understanding of what went wrong in the first place.

Bidenomics

By 2023 the White House was pitching "Bidenomics" as a geopolitical masterstroke and a historic turning point. Its premise, as outlined by national security adviser Jake Sullivan, was that after World War II, the United States had built a global economic order that lifted millions out of poverty and "sustained thrilling technological revolutions." In recent decades, however, this order had faltered on an "oversimplified" faith that "markets always allocate productively and efficiently." Left to their own devices, it was the markets that had allocated capital to the rich over the middle class, to finance not manufacturing, and to China not the United States, leaving the construction of a green economy to Beijing. Thus the first pillar of Bidenomics was an "economic mentality that champions building."

It put government in charge of allocating capital—through spending and subsidies, regulations and trade barriers—to where the executive branch thinks it is needed most. Denying any intent to "pick winners," the administration would aim instead to "unlock the power and ingenuity of private markets" through financial incentives, said Sullivan. And yet it had already picked three very specific winners indeed: advanced semiconductors, green technology, and precious minerals required in many green technologies, such as lithium, cobalt, nickel, and graphite.

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This "modern American industrial strategy" was part of "the new Washington consensus," in which "like-minded" Western countries would rally to fight climate change and compete with China. Sullivan's speech was titled "Renewing American Economic Leadership."

The muscular nationalism inherent in Bidenomics might rally support at home, but it was inherently divisive abroad, pitting capitalist countries against China—and against one another. After complaining that a modern American industrial policy would hurt them as much as China, American allies began racing to match it, barrier for barrier, subsidy for subsidy. The European Union rolled out a "Green Deal Industrial Plan," including schemes to match U.S. clean energy subsidies. The head of the European Central Bank touted the plan, and so did French president Macron, who was once a champion of free markets. Japan launched $150 billion in green tech subsidies of its own. German officials warned German companies in unusually blunt terms to reduce ties to China.

The leader of the capitalist world was leading its peers toward a bigger, more active government. Biden had campaigned for the presidency on promises of a "cradle-to-grave" expansion of the welfare state, from childcare to community college to health and pension benefits for retirees. By 2022, after some defeats for his social spending agenda in Congress, the Biden team had shifted focus, emphasizing the "modern American industrial strategy" more than the social spending. None of its speeches failed to mention China, the rival supposedly provoking this strategic response.

The timing was odd. Biden was said by aides to harbor a "burning sense of competition to prove that democratic capitalism can work," yet he was, in rough outline, following the lead of China, where the state still plays the guiding role in investing capital—with increasingly disastrous results. As paramount leader Xi Jinping reimposed state control in the 2010s, China's GDP growth rate slowed from well over 10 percent a year

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in nominal dollar terms to less than 5 percent by 2023. At that pace, China was no longer growing fast enough to surpass the United States as the world's largest economy in the coming decades, if ever. Why follow the lead of a faltering rival? Former U.S. trade representative Robert Zoellick called Biden's vision a "Washington Ordered Economy," and warned that its barriers, rules, and subsidies, once embedded, would be "hard to reverse."

By mid-2023, Biden had launched nearly $8 trillion in new spending, the largest surge ever, outside a world war or depression. Of that sum, roughly $2.3 trillion did go to the kind of investment in research and infrastructure that could be called "industrial policy." But some $1.7 trillion went to Covid relief, $2 trillion to the military, and more than $2 trillion to new welfare benefits, including Medicare subsidies, disability benefits, and student loan forgiveness.

As Biden rolled out new spending, the governments of Europe and Japan were exercising more restraint, particularly after the return of higher interest rates started pushing borrowing costs upward in 2022. Though U.S. spending habits were once pretty typical for an advanced economy, the United States was turning into an outlier, exceptional in self-defeating ways, the biggest deficit spender in the capitalist world. It was putting its competitive advantages at risk.

In early 2024, the Congressional Budget Office estimated that federal government spending would remain near 25 percent of GDP through the 2020s, higher than at any point in the prior century. The deficit thereafter would remain at record levels—close to 6 percent of GDP, roughly double the average of recent decades. The scale of this shift is hard to overstate. Before the pandemic, the U.S. deficit was only slightly larger than average for a developed economy. In the coming years, it is on track to be six times larger, because rivals are cutting back while the United States ramps up.

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And deficits mean more debt. Already third highest in the developed world after Italy and Japan, the U.S. government debt (including state and local) is expected to rise between 2023 and 2028 by 14 points, to 137 percent of GDP. It was growing nearly twice as fast as the public debt of the United Kingdom, more than five times faster than that of Japan and ten times faster than the average for the four largest European states. Meanwhile, public debt was poised to decline through 2028 as a share of smaller European economies, including the Nordic states, such as Denmark and Sweden.

To date, capitalism has arguably gone more wrong in Europe, where the state has been even more inclined to rescue, bail out, and regulate, and growth in productivity and average incomes has slowed more than in the United States over the last two decades. Now, however, the two sides of the Atlantic may be swapping places, as big government grows faster in the United States.

Part I of this book will retell the story of the last century, showing how government has evolved from limited before the Depression to omnipresent in this century. Part II will explain the cumulative effect of expanding government, and how it has distorted the capitalist system, as the symptoms of dysfunction became clear after the year 2000. Fueled by easy money and rising debt, those distortions include, most prominently, the increase in income and wealth inequality, the spread of zombie firms that live on fresh infusions of debt, and the rise of "bad" monopolies and oligopolies—the kind that thrive less on innovation than on strangling competition. Part II will end with a new explanation for the mystery of the global productivity slowdown, which can be traced, in good part, to these symptoms of debt addiction, enabled by government.

There is no returning to the nineteenth century, when the government barely existed as a provider of welfare services or a regulator of economic behavior, much less the major player in the financial markets,

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the way it does now. No rational person would imagine it possible to return to an era when the federal government didn't do much more than deliver mail and wage war. The intellectual consensus today, however, assumes that there is plenty of room for government to grow bigger, and more active, because it has been shrinking since the Reagan presidency. Flawed history will lead to misguided solutions. Expanding government from this new base—many times larger than it was in 1980—is likely to make the ongoing crisis of capitalism that much worse.

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PART I

THE RISE AND RISE AGAIN OF BIG GOVERNMENT

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ONE

THERE WAS NO GOLDEN AGE

Government as Americans know it is traceable to one of the founding fathers, Alexander Hamilton. He wanted to establish a strong government to develop the young country, anchored by a central bank that would serve as the foundation for a private credit system, which in turn would fund the spread of commerce and industry, and the rise of cities.

A financial visionary, Hamilton was ahead of his time. He tried to persuade his skeptical peers, steeped in Puritan values of self-reliance, that issuing public debt would be good for the economy. Only the interest would have to be repaid, while the principal would serve in essence as collateral for private lending, over time greatly expanding the credit supply—and the economy. "A national debt if it is not excessive will be to us a national blessing; it will be a powerful cement of our union," he said. Hamilton would prevail, but only long after he was dead.

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