The Weekend Essay Life & Arts

What went wrong with capitalism

America has become unhealthily dependent on loose money and big government, argues Ruchir Sharma

Ruchir Sharma 9 HOURS AGO

In his farewell address, Ronald Reagan described America as the "shining city on a hill", open to "anyone with the will and heart to get here". I was one of those inspired to try, and today the dynamic mix of academics and entrepreneurs who energise the world's technology leader still strikes me as a marvel. Of the top 100 US companies, 10 now have chief executives who were born in my home country, India, a breakthrough that could have happened only in a capitalist meritocracy.

Nonetheless, I worry about where the US is leading the world now. Faith in American capitalism, which was built on limited government that leaves room for individual freedom and initiative, has plummeted. Most Americans don't expect to be "better off in five years" — a record low since the Edelman Trust Barometer first asked this question more than two decades ago. Four in five doubt that life will be better for their children's generation than it has been for theirs, also a new low. According to the latest Pew polls, support for capitalism has fallen among all Americans, particularly Democrats and the young. In fact, among Democrats under 30, 58 per cent now have a "positive impression" of socialism; only 29 per cent say the same thing of capitalism.

That's not surprising, given what we've all been told. When Joe Biden won in 2020, op-eds in newspapers around the world hailed his presidency as a death knell for "the era of small government", which they dated to the "neoliberal" rebellion against the welfare state launched by Reagan and Margaret Thatcher. Recent histories of capitalism sketch the same arc, arguing that those two leaders ended three "glorious" postwar decades for social democracy, when ambitious governments worked with corporate and union leaders to generate faster growth and distribute the proceeds more fairly. In short, these thinkers cast Biden's plans for new spending and regulation as a welcome break from small, penny-pinching government and a plausible fix for popular frustration with capitalism.

Just one problem: the era of small government never happened. Government has been expanding for nearly a century in virtually all measurable respects, as a spender, borrower and regulator; the one brief retreat, under Bill Clinton, proves the trend. In the US, government spending has risen eight-fold since 1930 from under 4 per cent to 24 per cent of GDP — and 36 per cent including state and local spending. What changed under Reagan was that as spending rose, tax collections remained steady, so government started paying for its own expansion by borrowing. Deficits went from rare to routine and as a result public debt has quadrupled in the US to more than 120 per cent of GDP today.

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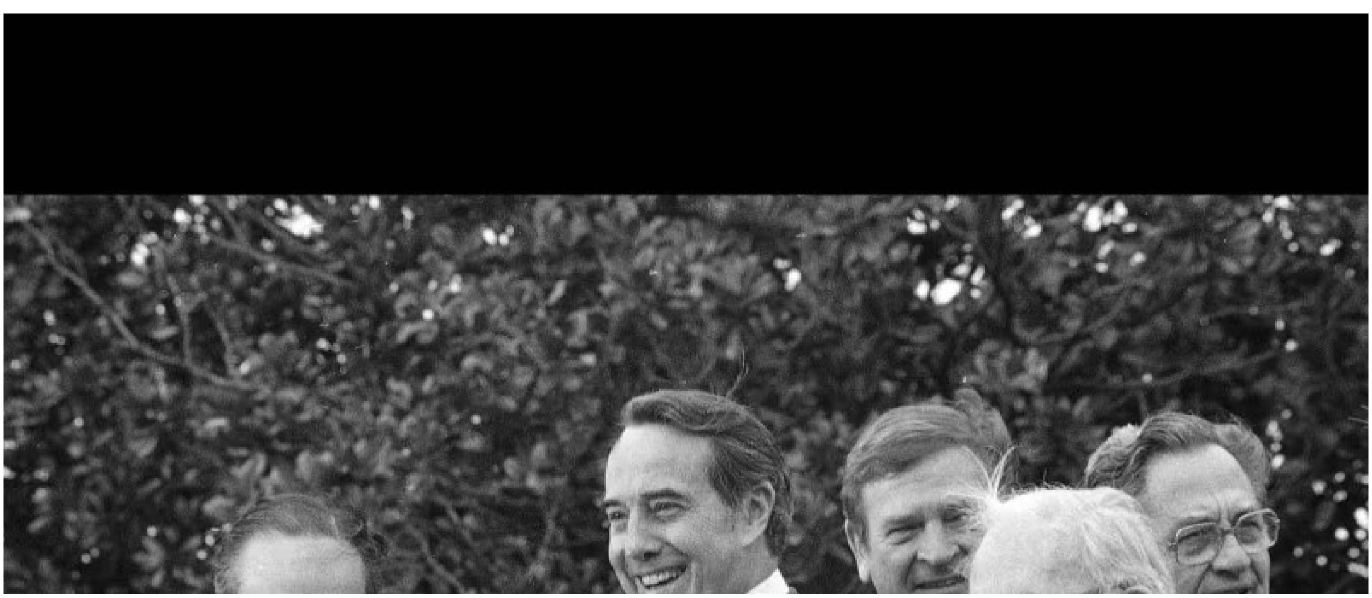
Reagan changed the conversation, which did often focus on a neoliberal agenda of cuts to taxes or deficits or regulation. But even when governments attempted to deregulate, the result was more complex and costly rules, which the rich and powerful were best equipped to navigate. By the 1980s, fearful that mounting debts could end in another 1930s-style depression, central banks started working alongside governments to prop up big corporations, banks, even foreign countries, every time the financial markets wobbled.

With good reason, progressives deride this new version of capitalism as "socialism for the very rich", but governments were doling out relief for the poor and middle class too. More than socialism for the rich, this is "socialised risk", a campaign to inoculate an entire society against economic downturns. Although still widely criticised as the land of "raw" Reaganite capitalism, America is displacing Europe as the society least tolerant of financial distress for anyone, up to and including the super-rich.

Something has been changing in the culture. Just as the American "revolution in pain management", which insisted on treating even moderate injuries with powerful opiates, was hooking the nation on OxyContin, its approach to economic pain management was addicting the system to a drip feed of government support. During the past two decades, the US fell from fourth to 25th in the Heritage Foundation rankings for economic freedom as both regulation and debt increased.

If the era of small government was a myth, then the majority who want government to "do more" would be wise to think twice. An even bigger government is more likely to magnify than ease their frustration with the dysfunctions of modern capitalism.



History bends towards big government

Reagan did not gut the welfare state. Since 1980, welfare spending has risen in most of the developed economies tracked by the OECD — and has risen faster than the average in the US. Even liberals who favour more welfare spending don't dispute this trend. Matthew Desmond, the scholar of American poverty, has written that he expected to find that US spending on the poor had grown "stingier over time", because that is the standard story, but found instead that "the opposite is true".

The original Keynesian idea was that government should save during recoveries, so that it could spend heavily to ease recessions. By the 1960s, the saving part was dead: a Democrat, John F Kennedy, had launched the first big stimulus to speed up a recovery. Soon the US government was running significant deficits in good times and bad, averaging 4 per cent of GDP in recessions, and 3 per cent in recoveries between 1980 and the end of 2019. This oft-criticised age of fiscal "austerity" is more aptly described as an era of constant stimulus.

The omnipresent state became a bipartisan joint venture of the Treasury and the Federal Reserve. Following the stock market crash of 1987, the Fed under a Republican appointee, Alan Greenspan, delivered its first public promise of support to troubled financial markets, and the next decade joined the constant stimulus project with the first rate cuts to speed up — and later prolong — a recovery. By 2008, the Fed could not lower its own rates much further, so it tried lowering borrowing costs a new way, by buying bonds and other debt in the public markets, in multitrillion-dollar bulk.

Gradually, by running up debts, authorities were making the system more fragile, putting pressure on themselves to offer more support in each crisis. Caught in this doom loop, governments expanded bailouts — which were rare and small before the 1980s — into the multibillion-dollar rescues of 2008 and the multitrillion-dollar excesses of the pandemic, when the US scattered relief like rain: unsolicited offers of help for companies large and small, distressed or not, hundreds of billions in cash to more than half the country, 170mn Americans, jobless or not, a good chunk of it to people making more than $100,000 a year.

The tale about shrinking government was based on talk not data. High-profile tax cuts were counterbalanced even under Reagan with lower-profile rises, so tax collections have remained steady as a share of GDP since the 1950s. Campaigns of "deregulation" ended up rewriting old rules at greater length but with "deregulatory intent" — creating a thicket of loopholes that favour the biggest banks with the most lawyers. During the past three decades, the bureaucracy eliminated a total of just 20 rules, while adding new ones at an almost metronomic pace of about 3,000 a year, under both parties.

The pre-Depression instinct to 'liquidate' weak companies in a crisis gave way to the opposite

Although some financial sector deregulation did open new opportunities for big investors, the spring from which their capital flowed was governments and central banks. Including equity and debt, the size of financial markets grew from slightly larger than the global

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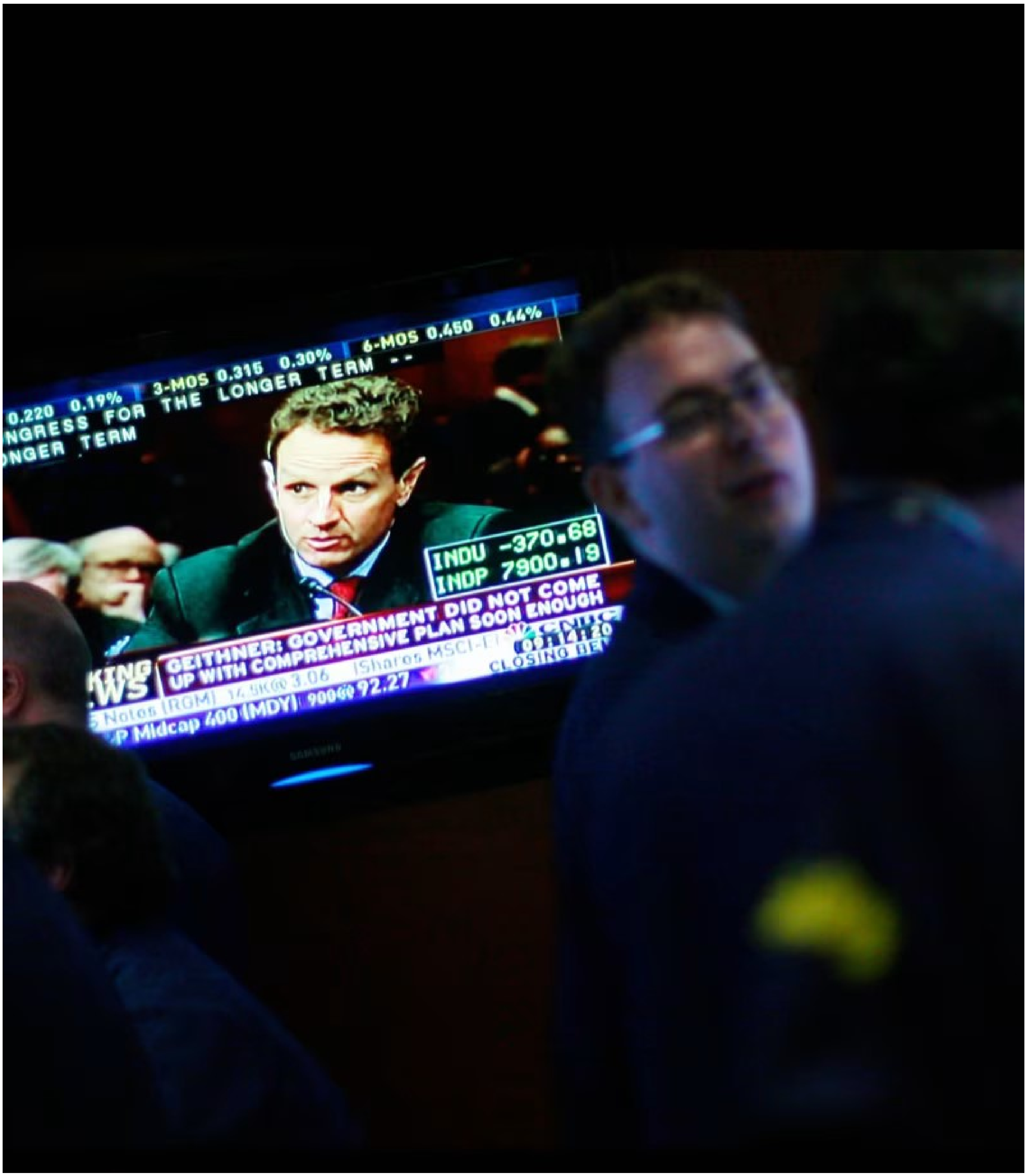
grew from slightly larger than the global economy in 1980 to almost four times larger today. This worldwide boom fed the illusion that markets were running free and wild as governments retreated, when in fact the driving force behind the runaway “financialisation” of capitalism was easy money flowing from the government.

As early as the 1980s, an increasingly isolated band of conservatives started warning that bigger government would bring on a crisis of melting debts or rising inflation — which never came. Globalisation brought more competition, keeping a lid on inflation in consumer prices, and solidified a conviction that government deficits and debt don’t matter. The pre-Depression instinct to “liquidate” weak companies in a crisis gave way to the opposite excess: “liquefy, liquefy, liquefy”. Why not rescue everyone, all the time, when governments can borrow for free?

Many observers think the era of easy money ended with the recent return of inflation, because it forced central banks to raise interest rates. But this era was not defined only by low rates and did not begin only in 2008; it encompasses the suite of habits — borrow, bail out, regulate, stimulate — that have been building for a century. It is not over until old habits change.

Biden's new spending and Donald Trump's tax cuts both set records for government stimulus in a recovery. Their administrations jointly devised the something-for-everyone pandemic rescues, which will be revived in future crises as nothing new.



What's wrong with government relief?

The crisis of capitalism is not speculative or distant, it is clear and present in the insidious ways overactive government is widening the key flaws of modern capitalism — slower growth, less fairly distributed.

Around the turn of the millennium, the impact of easy money started to show up in the flattening business cycle. Recessions were fewer and farther between, which no one minds.

Frustrations arose because mounting debt was prolonging but slowing recoveries. The recovery of the 2010s was the longest and weakest ever. On a chart, swings in US growth look like the flatlining ECG of a dying patient.

Behind the slowing recoveries was the central mystery of modern capitalism: a collapse in the rate of growth in productivity, or output per worker. By the outset of the pandemic, it had fallen by more than half since the 1960s. And a growing body of evidence points the finger of blame at a business environment thick with government regulation and debt, in which mega-companies thrive and more corporate deadwood survives each crisis.

If every entrenched billionaire is a 'policy failure', as the slogan says, the essential mistake is too much state support, not too little

Although mega-companies in the tech industry get all the attention, three of every four US industries have ossified into oligopolies, dominated by three or four names. Worse, these oligopolies are more and more often the "bad kind", prospering by lobbying regulators and killing off competitors, not by innovating.

Easy money also spawned the "zombies", a class of companies that don't earn enough to cover even interest payments on their debt, and survive by taking on new debt. They are hard to identify and track, and estimates vary, but zombies barely existed outside Japan before 2000, and now account for as many as one in five public companies in the US. Zombies tend to be weak and unprofitable themselves, and to hobble the performance of rivals in the same industry by sucking up talent and financing.

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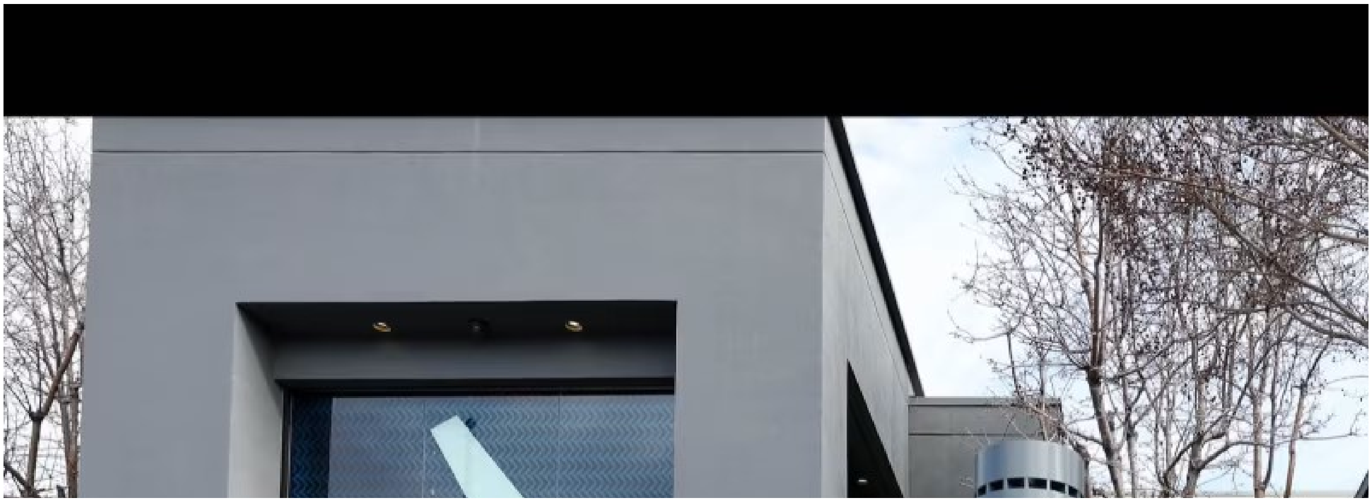
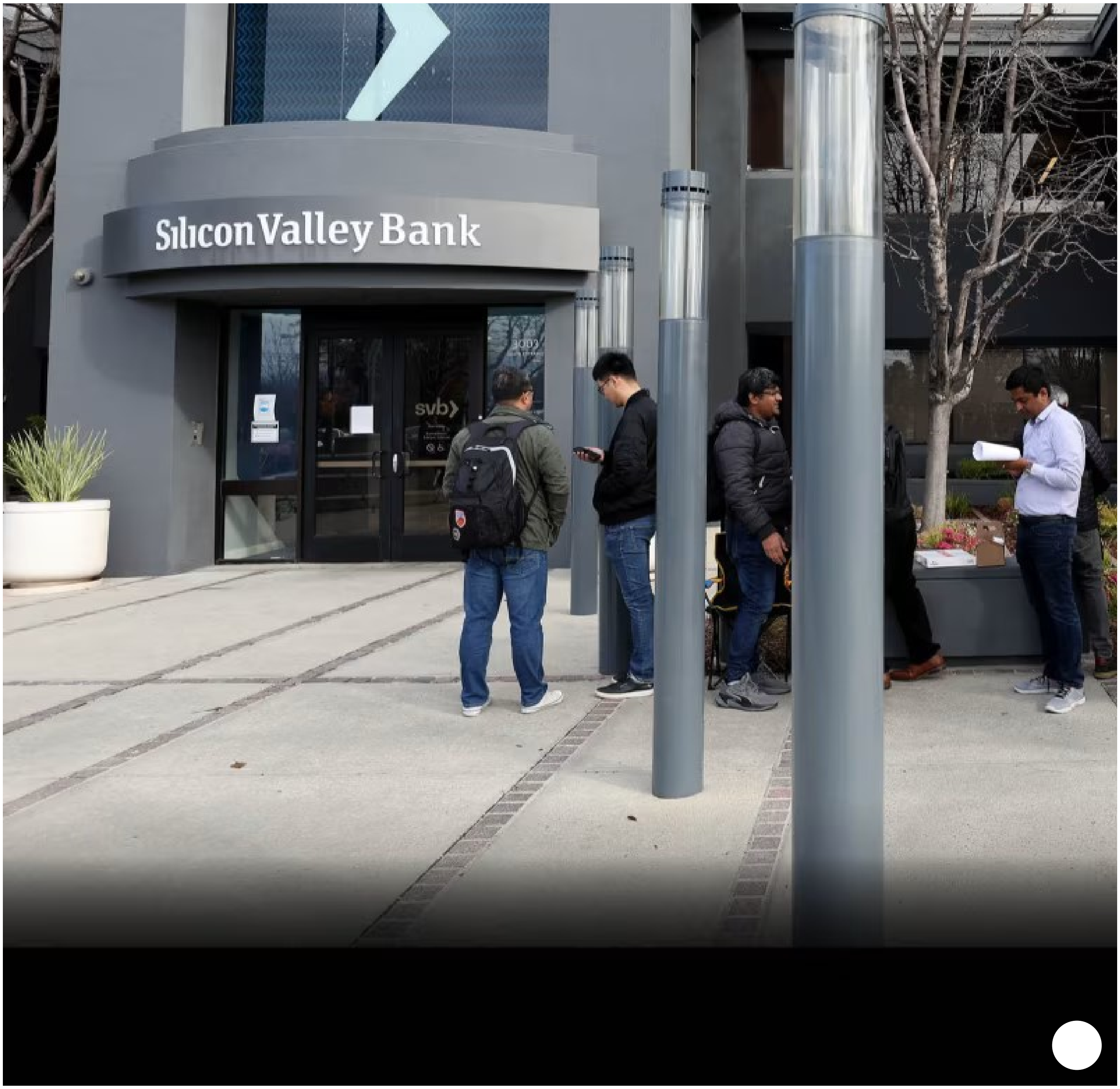
Squeezed from the top by oligopolies and from the bottom by zombies, the corporate middle has stagnated. Before the upheavals of the pandemic, the US was generating new companies at a little over half the rate and shutting old ones at just two-thirds the rate of the early 1980s.

To work, capitalism needs a playing field on which the small and new have a chance to challenge — creatively destroy — old concentrations of wealth and power. Today, as industries increasingly concentrate and decay, more and more US towns and counties rely on one big employer. Before 1980, Americans were two times more likely to move between states, and 25 per cent more likely to switch jobs in the same industry, than they are today.

Throughout, income inequality has been widening, but since 2000 this trend is no longer explained mainly by the rise of chief executives, making multiples more than their own employees. It flows from the rise of superstar companies such as Google, where all employees are making more than all their peers at weaker companies.

Immobility is stifling the American dream. Other than the British, Americans are the people least likely to earn much more than their parents. Amid the record pandemic bailouts, the leading US tycoons saw their fortunes grow by tens of billions within 12 months. But if every entrenched billionaire is a “policy failure”, as the slogan says, the essential mistake is too much state support, not too little.




Silicon Valley Bank
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The way out

Building on overbuilt foundations, government leaders are trying to please everyone but are more likely to further undermine growth, widen inequality and deepen popular distrust. Still, if only to avoid fashionable pessimism, it's worth pondering what a reinvigorated capitalism would look like.

There is no clear threshold beyond which government has grown too big, but leaders need to be aware of where their nation stands, relative to its own past and its peers.

Those nostalgic for the optimism of America in the 1960s should keep in mind that government was smaller and less missionary then. Bringing back the "glorious" era of social democracy would require less government, not more. In recent crises, authorities have vowed quite openly to err on the side of doing too much too quickly in order to prevent another Depression, even if the threat is minor (such as in the case of the Silicon Valley Bank failure last year).

To date, capitalism has arguably gone more wrong in Europe, where the state has been quicker to rescue and regulate, and growth in productivity and average incomes has slowed more than in the US. Now, however, the two sides of the Atlantic may be swapping places. Under Biden, the US has become an extreme outlier, with deficits and debt on track to set records, and to grow much faster than those of its peers.

Today's policymakers are status quoists, indulging the same old impulse to rescue, regulate and spend, and hoping for better results. Instead, they are likely to get the same results: gravy days for markets and billionaires, not society as a whole. Capitalism's premise, that limited government is a necessary condition for individual liberty and opportunity, has not been put into practice for decades.

A genuine departure would require restraint, finding a middle ground between 19thcentury liquidationists and today's liquefactionists. During recessions, authorities need to extend relief to the unemployed, and to keep capital and credit flowing through the financial markets when they are frozen by fear. But their recent, experimental quest for endless growth is utopian, a counterproductive step too far. They need to stop stimulating during recoveries, and to leave financial markets free enough to falter, on occasion.

Although our leaders often speak of the economy as an "engine" subject to "fine tuning", it is more like a natural ecosystem in which humans meddle at great risk to the system and themselves. Authorities would no longer dare try to reshape forests and oceans in the name of progress, as they did a century ago — the protests would be deafening — but they can count on applause when they experiment on the economy. This thinking needs to change. Economics is not as hard a science as many imagine.

The real sciences explain life as a cycle of transformation, ashes to ashes, yet political leaders still listen to advisers claiming they know how to generate constant growth. Their overconfidence needs to be contained before it does more damage. Capitalism is still the best hope for human progress, but only if it has enough room to work.

Ruchir Sharma is chair of Rockefeller International. His book 'What Went Wrong with Capitalism' is published on June 11 by Simon & Schuster in the US and Allen Lane in the UK

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