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Capitalism and the Future of Democracy

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Introduction

America is a mess. So are many other Western nations. Populism is on the rise because our existing system of a market-based liberal democracy is falling short of producing what citizens need and want.¹

The argument made by Francis Fukayama in 1993 that liberal democracy has won in the competition for ideas now seems quaint. History has by no means ended. Its next phase is, to many people, extremely worrying.

Some of the problems are economic: rising inequality, stagnant wages, lack of employment, lower intergenerational mobility, disappointing levels of health and education in the U.S. despite their large costs, rising levels of public and private debt, growing place-based disparities.

Some are political: hyper partisanship, influence-buying and corruption at the highest levels, paralysis, and declining trust in government.

Some are cultural: resentment of migrants and growing tensions over race and gender in America.

These problems are interrelated. We can no longer address them in isolation from one another. A failure in one domain creates failures in the others. Economic and cultural anxieties elected Trump. Trump and his ilk in other countries are using these anxieties to gain and maintain power and further erode confidence in our institutions. Government paralysis is undermining efforts to deal with economic disparities and those left behind.

Underlying these discontents at a deeper level is a mindset that has treated markets as the ultimate arbiter of human worth – a mindset I will label “capitalism” or “market fundamentalism” for short. The basic idea is that markets work, governments don’t. This ideology has been especially strong in the U.S. in recent decades.

This essay argues that this mindset has led to ever-rising inequality and a government that has been captured by business interests and the wealthy. It is creating a spiral that can only end in crisis unless the intellectual foundations of the current system are better understood and challenged.

Three Types of Societies

Most modern societies are made up of three sectors: the state, the market, and civil society. Most political philosophies contain an implicit bias toward one of these three sectors.

Socialists tilt toward the state. They believe that government bears primary responsibility for improving the lives of its citizens. To this end, state ownership of the means of production is favored. A softer version of this model, which I will call democratic socialism, sees some role for markets given the past failure of planned economies, but a bigger role for government than currently exists in many European countries and especially in the U.S. The Nordic countries come closest to embodying this philosophy and left-leaning politicians in other countries point to their example as one that is worth copying.

Capitalists believe that free markets are the best way to organize a society. Markets, they argue, are not only the most efficient way to allocate resources but also preserve individual freedom in the process. Markets produce good outcomes precisely because, when unfettered, they optimize growth, efficiency, and a distribution of income that is acceptable because it is assumed to reflect each person's contributions to the economy. ²

A softer version of capitalism, that we might call liberal democracy or the mixed-economy model, accepts the importance of markets but recognizes the need for government to correct market failures and address distributional questions. This type of a "mixed economy" prevailed in the three decades following World War II in the U.S. and was championed in a weaker way by Third Way leaders such as Tony Blair and Bill Clinton in the 1990s and Obama in the 2000's.

Social capitalists believe that the good society is built on a foundation of respect for tradition and authority, and for the civic virtues or morals that enable us to fulfill various responsibilities to one another. That society is based on private property but also on "the little platoons" of family, church, and voluntary associations. It celebrates virtuous social norms and habits that shape how people behave. I call this social capitalism, not because of its emphasis on private property (although that institution is celebrated) but because of its emphasis on the little platoons that in the aggregate create "social capital."

These three models are archetypes. In most societies all three of these sectors – the state, the market, and civil society – play a role. The question is not whether there is a role for each. The question is what's the right balance or mix. If we got the mix right we might have a Goldilocks economy and a well-woven society – one in which all three sectors play a prominent role but in which they complement each other and provide a kind of checks and balances against the weaknesses of each.

Right now, the predominant paradigm in the U.S. is market fundamentalism. But it is being challenged on both the left and the right, by both left-leaning Democrats (e.g., Elizabeth Warren and Bernie Sanders) and some conservative intellectuals (e.g. David Brooks and Yuval Levin).

How Market Fundamentalism Became an Ideology³

Advocates of the mixed economy model argue that we don't need to disparage the market; we just need a more capacious understanding of its strengths and weaknesses, of where government needs to intervene to improve overall welfare. As taught in most upper-level university courses, we can rely on markets to allocate resources, but that won't resolve distributional questions or a variety of market failures. As Paul Collier puts it, "capitalism needs to be managed, not defeated." ⁴

In practice, most ordinary citizens are never exposed to this more sophisticated and nuanced version of capitalism. Instead, conservatives have transformed it into a caricature of its academic self. ⁵ They have created a narrative about markets that supports tax cuts, deregulation, and limited government. They argue that safety nets create hammocks when what we need is trampolines. They have celebrated free trade with little concern for its adverse effects on local workers and communities.

I will argue that the ideological mindset that the capitalist model has engendered, the attitudes it has fostered among well-intentioned leaders and citizens, and the kind of policy regimes it supports have damaged the social fabric, and with it, the strength of democracy – especially in the U.S. The free market model has had an outsized influence on the policy debate and has produced such progeny as supply-side economics that has dominated policy-making at least since the Reagan-Thatcher years. Supply-side economics has spawned supply-side (donor-dominated) politics with very troubling consequences for the survival of democracy.

I am not the first or only person to voice these concerns. Larry Kramer, the President of the Hewlett Foundation, has called for a longer-term effort to create a new paradigm to replace what he calls neoliberalism.⁶ The Niskanen Center has been thinking creatively about these issues,⁷ along with Eric Liu and Nick Hanauer on the left and Oren Cass and Abby McCloskey on the right.⁸ My colleagues, Homi Karas, Geoff Gertz, and Kemal Dervis are rethinking the so-called Washington Consensus.⁹ The Economist magazine celebrated its 175th anniversary by reviewing the history of liberalism (in the classical British sense) and called for newer and much bolder thinking.¹⁰ Economists, as members of the discipline most associated with capitalism and market primacy, are branching out to form groups such as the Center for Equitable Growth, the Institute for New Economic Thinking, and Economics for Inclusive Prosperity. They are becoming more empirical, less wedded to abstract models with no institutional detail, and more willing to join with those from other disciplines to study economic and social behavior.

Political scientists have also tackled the issue. In their comprehensive and impassioned book, *American Amnesia*, Jacob Hacker and Paul Pierson tell the story of how a market-based ideology – what they call Randianism (after author, Ayn Rand) – led to the undermining of the earlier mixed economy model in the U.S.¹¹ The mixed economy had married the nimble fingers of the market with the powerful, but much clumsier thumb of

government to produce widespread prosperity from the early 1940s to the mid-1970s.¹² Capitalism played a major role but democratic government added the key ingredients that enabled its success.

Starting earlier in the twentieth century, we saw the creation of the Federal Reserve, the income tax, antitrust laws, the regulation of food and drugs, social insurance, collective bargaining rights, the GI bill, the interstate highway system, and the 1960s War on Poverty. All of these added the guiding hand of government to the dynamism of the market during this period. After about 1980, according to Hacker and Pierson, this “constructive balance shattered under the pressure of an increasingly conservative Republican party and an increasingly insular, parochial, and extreme business leadership,” – the latter exemplified by the Business Roundtable, the Chamber of Congress, and the Koch brothers.

By starving the public sector of the resources and support it needed to be effective, the market purists have created a self-fulfilling prophecy. Government has become less effective in meeting a variety of challenges, new and old, and this, in turn, has sowed public distrust and loss of confidence in public institutions, creating a vicious circle. Business leaders went from recognizing the need to partner with government and to take constructive positions on a broad array of policy concerns, as exemplified by the Committee for Economic Development during the 1950s and 1960s, to later opposing almost all government intervention and focusing only on their own narrow interests.

The shift wasn't all about partisanship either. After all, it was President Eisenhower who created the interstate highway system and President Nixon who called for a guaranteed income while President Clinton talked about “ending welfare as we know it” and went on to say, “the era of big government is over.” Government went from being seen as good to being seen as bad. Liberal became a pejorative word. At the same time, markets grew in esteem and began to be celebrated as having almost magical powers. In the words of Hacker and Pierson, “the siren song of ‘free markets’ is simple and catchy. The anthem of market failure is not so hummable, made up of a series of rich but complicated themes.”¹³ As I will argue below, the siren song was seductive, its intellectual pedigree strong, and its composers and populizers all too powerful. Or as Hacker and Pierson put it, “Ideas were crucial [and] they intersected with and guided powerful economic interests.”¹⁴ Warren Buffet put it even more succinctly: “There’s a class war and my class is winning.”

In the U.S. political context, we are hearing a lot of talk now about a revival of socialism. Some politicians, such as Bernie Sanders and Alexandria Ocasio Cortez, are self-described socialists, and President Trump and many Republicans are having a field day trashing ideas such as the Green New Deal, Medicare for All, or a national jobs guarantee program. Whatever one thinks of these ideas, they do not fit the usual definition of socialism, which entails government ownership of the means of production. Still, they have moved the discourse way to the left and are challenging the more moderate “mixed-economy” version of capitalism that calls for markets and governments to work together to achieve a variety of goals.

The good news is that this wide-ranging discussion about alternatives to capitalism has paved the way for new understandings and possibly new politics, making it a good time to

debate their intellectual foundations. Between market fundamentalism on one end of the spectrum to a Nordic-style welfare state on the other, there are many choices.

Challenges to the Market Paradigm

Old paradigms give way to new ones when some combination of actual events and new ways of understanding those events appear on the scene. Then the ice begins to crack. More and more people question the status quo and come to embrace new ways of thinking and new directions for policy. Right now, cracks in the ice are appearing for three reasons: 1) the disruptive effects of trade and technology on individual lives and communities, 2) virtually unprecedented levels of inequality and the possibility that ever-rising inequality is baked into a market economy, and 3) the failure of supply-side economics to deliver on its promises along with some deeper questioning of its goals.¹⁵

Effects of Trade and Technology

Free trade and technology are believed by many to have led to a loss of jobs and stagnant wages among less-skilled Americans. In the academic version of capitalism, the overall benefits of trade and technology far exceed the costs, but many people and places are hurt in the process. It is assumed that the winners can and will compensate the losers. It's assumed that those living in declining communities can and will move to areas that are thriving.¹⁶ But that's like assuming a can opener and it hasn't happened.

The winners are riding high and the losers have seen their jobs disappear, their communities decline, their neighbors die from opioids or suicide, and their trust in government and in elites plummet. They handed an electoral victory to President Trump in 2016 because he promised to fix both trade and immigration, not with the kind of adjustment assistance called for by most economists, but with tariffs and a wall. To be sure, there was a large element of cultural alienation or status anxiety mixed in with the economics. These grievances have produced a populist moment with all of its attendant effects on political norms, respect for the truth, and other democratic values. But in crisis lies opportunity. The reaction to Trumpism is now leading to a counter-reaction, most decidedly on the left but spreading to thoughtful people on the right as well.

Ever-rising Inequality

Inequality has been increasing now for many decades. It partly reflects technological advances that have raised the wages of skilled workers, but that can't explain most of the trend, especially at the top. And even if it does reflect the fact that the demand for skills has outpaced the supply, it doesn't explain why the supply has not adjusted to meet that demand over many decades. In the neoclassical economic model, such adjustments are expected to happen more rapidly than that.

Even more troubling is the prospect of a *never-ending* trend of rising inequality. Inequality, unless counteracted by government policy or other extra-market forces, tends to feed on itself. The rich save more than the poor, causing an accumulation of capital at the top, and that accumulation automatically produces more inequality as the rich reap unearned gains from an ever-growing stock of financial assets.

That prospect was the essence of Thomas Piketty's book, *Capital*,¹⁷ as he argued when the rate of return to capital, r , is higher than the growth rate of the economy, g , asset holders will amass ever more income to add to their existing assets, and capital's share of national income will grow.¹ Since most of the people with significant amounts of capital are in the upper ranks, those ranks will grow as well.

Piketty explains that the period from about 1950 to 1980 when inequality declined in the U.S. was an anomaly caused by the destruction of capital, or lower rates of return on that capital, as the result of war and depression along with government policies that recognized the importance of unions, minimum wages, and social insurance. What we are seeing now, he argues, is a reassertion of the inherent contradiction in a capitalist society, which is its tendency to produce ever-rising inequality and to spawn political tensions and a threat to democracy in the process. Consistent with his thesis were declines in inequality in the early post World War II decades, followed by huge increases since then, especially at the very top of the distribution. That, in turn, has arguably led to the torquing of the rules of the game to favor capital – everything from less antitrust enforcement, financial deregulation, excessive patent protection, and other anticompetitive measures.

Piketty ends up calling for a very high tax on top incomes (80 percent) and a global tax on capital. Elizabeth Warren is calling for something similar, a 2 percent tax on wealth over \$50 million and 3 percent on wealth over \$1 billion. While the political feasibility of such proposals is slim, the fact that they are even being discussed makes the point that we may be near a tipping point in the battle between market capitalism as philosophy and its alternatives.

If one buys the Piketty story, there is no alternative to government intervention to ensure that incomes at the top don't get even more out of line. Distributional outcomes of the sort we have been experiencing in recent decades are not self-correcting, nor can they be addressed by modest tweaks in current policies as I document in my book, *The Forgotten Americans*.

The Failure of Supply-side Economics

Despite rising inequality, economic growth continues to motivate much policy making on both right and left. On the left, the agenda has included a call for more investment in education, research, and infrastructure. On the right it has included such supply-side policies as lower taxes, less regulation, and more fiscal responsibility (granted that adherence to the latter goal is now in tatters). While right and left may have disagreed about the means of achieving more growth and how it should be distributed, they have shared a belief in the ability of growth to improve people's lives.

Economic growth has many benefits. It makes it easier to tackle a host of social and environmental problems. If broadly distributed, it makes everyone better off and it has been the single most important reason for the reduction in global poverty and improvements in health and longevity.

But here again, the ice is cracking. And it is cracking for two reasons: first, because supply-side policies have mostly failed to deliver more growth; and second, because the objective itself is under greater scrutiny. Given a choice, for example, between more growth and a healthier environment, many people would choose the latter.

With the purported aim of raising the growth rate, supply-side policies were implemented under Reagan, under George W. Bush, and under Trump. There is little evidence that they have produced the promised increase in long-run growth. Tax cuts can lead to a sugar-high for the usual Keynesian reasons, but they have not necessarily put the economy on a higher long-term growth path. Indeed, because most of these tax cuts have been financed by adding to the national debt, many economists believe that in the long-run, growth may be impaired. Rising debt eventually leads to higher borrowing costs for both the public and the private sector and since much of the money is being borrowed from foreigners, any increase in U.S production and incomes will need to be earmarked in large part to repay foreign lenders with interest.¹⁸ While the new 2017 tax law could have a small effect, no serious economist predicts it will raise long-term growth rates by the one percentage point predicted by President Trump. Credible estimates from both liberal and conservative economists suggest an increase one-tenth as large at best.¹⁹ This underscores Charles Schultze's statement that there is nothing wrong with supply-side economics that dividing by ten doesn't solve.

But it is not just the failure of supply side economics that is causing increased doubts about economic growth. The objective itself is being questioned – and not just on the left.

The Manhattan Institute's Oren Cass argues in his book, *The Once and Future Worker*, that the focus on economic growth has led us down the wrong path. He likens GDP to a pie and the ideology surrounding growth as "economic piety." That piety has not produced the kind of jobs and wages that support strong families and communities.²⁰

Another articulation of this theme from a center-right intellectual can be found in a National Affairs essay by Abby McCloskey entitled “Beyond Growth.” She argues that growth alone has left too many workers behind, frayed our social fabric, and caused people to lose a sense of purpose, dignity, and connection to one another. ²¹

Former Fed Chair Ben Bernanke has also chimed in. In a speech called “When Growth is Not Enough,” he notes that “the credibility of economists has been damaged by our insufficient attention, over the years, to the problems of economic adjustment and by our proclivity toward top-down, rather than bottom-up, policies.” Stagnant wages, declining mobility, social dysfunction, and political alienation have been the result.²²

In my own book, *The Forgotten Americans*, I make a similar argument. Everyone likes to promise more growth but actual understanding of what fuels the growth process is quite limited. My metaphor for growth is that it is like a car. Its engine – or what moves it forward – remains something of a mystery. Its speedometer (the GDP) is a flawed measure of welfare. Finally, and most importantly, even when we get to our destination, we may not be much happier. More material prosperity in an advanced country like the U.S. has not led to greater life satisfaction.²³ In fact, when it is accompanied by rising inequality, deteriorating communities, a lack of decent jobs, and environmental degradation, it may lead to dysfunction and even so-called “deaths of despair.” New efforts by the United Nations, the World Bank, and others to create broader measures of national welfare are showing little correlation between GDP and other metrics of well-being.

The problem with making economic growth a priority is that it makes it far harder to achieve other goals. For example, if one’s goal is to provide a safety net for the poor but that undermines their willingness to work and thus grow, we will end up being stingy. If we think raising the minimum wage reduces hiring of the most disadvantaged even though it makes the vast majority of workers better off, we may opt not to raise it. Too much contemporary debate is about the costs in lower efficiency or less growth caused by policies aimed at achieving other goals. *Of course, policies should be designed to mitigate such costs but not necessarily to avoid them entirely.* As the former French Prime Minister Lionel Jospin put it, [we can “say yes to a market economy but say no to a market society”](#).

Another way to think about economic growth is as a by-product of a healthy society, not the other way around. Political stability and responsiveness, a well-educated population, new scientific advances and access to knowledge, lack of corruption, and the rule of law establish a platform for growth which then happens spontaneously once the conditions are right. Bill Gates and Mark Zuckerberg weren’t thinking about marginal tax rates or regulatory barriers when they began activities that have transformed our society.

Declining marginal utility further reduces the value of growth. At an every-day level, we are all aware of the many things we buy that we don’t really need. Some of my favorite examples are an egg tray that syncs with your phone to alert you to buy more eggs, a snow sauna that creates artificial snow for those pining for a winter wonderland in Florida, pre-peeled bananas in plastic wrap, and neuticals (artificial testicles) for dogs whose owners are worried about their self-esteem (really! I didn’t make this up). ²⁴ Granted what seems like a luxury in one generation becomes a necessity in another but most people don’t miss what

they don't have, especially if they can't even imagine having it because it doesn't yet exist. I don't think the baby boom generation that grew up without cell phones felt deprived as a result.

In sum, these three developments – stagnant wages and employment for a large portion of the population, rising income inequality, and new skepticism about the overriding importance of economic growth – may finally be creating a counter-reaction to the market fundamentalism that has dominated policy making in recent decades.

At the same time, new ideas have been bubbling up from below – ideas that strike at the intellectual foundations of a pure market economy and further widen the cracks in the ice. I turn now to those ideas.

Intellectual Challenges to the Neoclassical Model

Economics students are taught that markets are, under certain assumptions, the most efficient way to allocate scarce resources. But the story is highly stylized and the assumptions too rarely hold. We must assume that there is perfect competition, that economies of scale are rare, that information is costless and equally available to all, that individuals are rational, far-seeing, and know how to maximize their own well-being, that one person's well-being doesn't depend on the well-being of others, that individual behavior doesn't impose costs or provide benefits to others (no "externalities"), that wages and prices are flexible – responding to any changes in demand or supply almost immediately, thereby assuring that markets clear and that full employment will be achieved.

There is nothing wrong with this stylized picture except that it doesn't exist in the real world. Its logic and its elegance, including its mathematical precision, are extraordinarily seductive. Despite its simplifying assumptions (or because of them), it has influenced countless generations of students, produced thousands of articles in peer-reviewed journals, and arguably had more influence on public policy than almost any other discipline. As Keynes famously wrote "Practical men who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back."²⁵

Professional economists are well aware of the shortcomings of the basic model. The problem is not so much with the "academic scribblers" as it is with the way the "Madmen in authority" have used these scribbles to create a market-based ethic that is not always consistent with human welfare. Here I briefly discuss three key weaknesses in the neoclassical paradigm: neglect of the business cycle, neglect of the institutional determinants of wages, and the challenge posed by behavioral economics.

The Business Cycle

Keynes himself challenged the neoliberal view that wages and prices adjust to inadequate demand. Many contemporary economists have not only accepted his view but are also careful to distinguish between an economy that grows because it is recovering from a downturn and still has excess capacity and high unemployment, and one that is growing because the labor force or worker productivity are increasing. Yet, many politicians, journalists, and ordinary citizens continue to conflate the two, failing to distinguish between policies affecting overall demand and those affecting supply.

The financial crisis of 2007 to 2008 and the long recession that followed were not predicted by economists and remain an embarrassment to this day. Even Alan Greenspan admitted after the fact that economists got this wrong. Leading observers of today's economy, such as Janet Yellen, are still worrying about the economy's financial stability and the potential for more crises. No one thinks the task of stabilizing the economy is easy or yet within our reach.

A related but more controversial view is that growth itself is no more than a series of short-runs in which keeping the economy on an even keel with all of its resources employed is the trick to insuring long-run growth. Economists like to distinguish between cycles and growth, between aggregate demand and aggregate supply, between actual and potential GDP. But, as Larry Summers and others have suggested, perhaps it's the case that demand creates its own supply. When businesses see their markets expanding, they make the investments and come up with the innovations critical to productivity growth. They entice sidelined workers back into the labor force and train them. If that's the case, it further undermines the priority attached to supply-side measures and suggests policy should focus on aggregate demand instead.

Jared Bernstein notes that the economy's resources have been fully employed much less frequently over the last few decades than it was in the earlier postwar period. Perhaps that's why growth has been sluggish as well. This "demand-creates-its-own-supply" view of the world is at odds with neoclassical growth theory and with supply-side economics. That theory suggests that if labor, capital, and productivity are all growing, if output is expanding, it will create the income needed to fuel demand. In the contrarian demand-side view, if the 2017 tax cut does have a positive effect it will not be because it provided new tax incentives for investment, but because it revved up demand by expanding debt.

The Determinants of Wages

Although many economists would admit that neoclassical economics is hard to reconcile with major fluctuations in the economy, fewer quarrel with how it treats distribution. In theory, wages are set equal to an individual's productivity, which then determines what income that individual receives from the market. But to what extent does this assumption hold true in the real world?

No one would deny that there is, and should be, some relationship between productivity and market wages. However, producing goods and services is a team sport. Identifying the specific contribution of each member of the team is very difficult especially in a knowledge-

based and service-oriented, high tech economy. Workers often know more about their productivity than their managers. Human resource departments establish wage or salary scales based on very rough proxies for productivity such as education and years of experience, often constraining pay for some and overcompensating others. Unions can and have raised wages above productivity, helping workers share in revenues.²⁶ Earnings gaps by race or gender have been hard to explain away after adjusting for differences in productivity and audit studies have found clear and convincing evidence of discrimination by race and gender.²⁷ Monopolistic elements in both product and labor markets affect how much people are paid.²⁸ Workers in superstar firms earn big premiums relative to comparable workers in other firms.²⁹ Workers who suffer a negative shock to their wages rarely recover, suggesting that path-dependence is as important as one's human capital in determining income.³⁰ One lucky break may propel someone into a position from which they can't easily be dislodged and send misleading signals to future employers. In recent decades, compensation has not grown in parallel with productivity and labor's share of national income has fallen.³¹

Not only can there be many departures from the basic wages-equal-productivity theorem, but productivity may itself depend on wages. Good management, trust, and peer pressure may work better than economic incentives in facilitating effort and creativity in the work place. When Henry Ford doubled his wages, and simultaneously reduced hours of work, productivity in his plants rose about 30 percent. Fast food franchises that share profits with their workers actually earn higher profits than those that don't (this result is from a randomized trial).³² Higher minimum wages and better benefits, such as health care, child care, and paid leave can reduce turnover and absenteeism and pay for themselves by raising productivity and reducing hiring costs.³³ Of course, there are limits to adopting such measures and cases where over-regulation of labor markets and overly-generous benefits have gone too far. But, in general, the market paradigm has little or no room for the possibility that productivity is a function of wages paid as well as the other way around.

The problem is that once wage norms establish a certain standard of pay for a certain occupation or job, market forces may not correct it. Human resource departments and compensation committees establish benchmarks based on what other firms are doing. It becomes a circular process, not easily upset in the face of limited information, imperfect competition, and collective action problems. Take CEOs. Once very high compensation packages are established for whatever reason, no one firm can afford to ignore them for fear of losing their own top executive. Instead they are likely to engage in leap-frogging the competition for fear of sending a signal that their executive is (horror of horrors) "below average." One interesting provision in the 2017 tax bill is a prohibition on deducting CEO pay above \$1 million a year. Market-oriented conservatives will see this provision as inimical to efficiency. Progressives will see it as a bulwark against runaway rent-taking. My view is that it also deals with a collective action problem: no one firm can afford to pay less than the competition, even if doing so would have little or no effect on productivity and profits. Only an externally-set limit can achieve this goal.

At a still deeper level, productivity itself depends on circumstances over which most individuals have little control. We don't have the kind of equal opportunity enshrined in our founding documents. We don't get to pick our parents, our genetic endowments, our race or

gender, our neighborhoods, or our early schooling. That lack of choice provides an additional rationale for sharing income with those whose productivity is limited for one of these reasons.

Behavioral Economics

Behavioral economics has mounted a serious challenge to more orthodox thinking. Two of its practitioners, Daniel Kahnemann and Richard Thaler, have now been awarded Nobel prizes and with good reason. Thaler calls the people who populate neoclassical models “econs.” Econs are always rational, all-knowing, and far-sighted. They never lack will-power. They have stable and known preferences independent of the effects of advertising or other social influences. They always optimize and are never content with second choices. They are self-interested and don’t care about other people. The only problem is that Econs are not Humans.³⁴

Humans care about other people. Research suggests that an ethic of fairness is virtually innate. It may be the product of an evolutionary history in which cooperation with others was essential to survival. A common test of the proposition that people care about fairness as much as about self-interest is the so-called Ultimatum Game. In the game, a player is given a fixed amount of money and told they must offer some of it to a second player. If that second player accepts the offer, the first one can keep whatever is left. We would expect the first player to provide a small sum to the second player, both of whom would then be better off. But in multiple trials and versions of this basic game, pure self-interest rarely prevails. Most players offer either an equal amount of money, or a slightly-less-than-equal amount to the other player. In cases where the second player is offered a very low amount, they often refuse to take the money. They are indignant and feel disrespected. They have been treated unfairly. But far more common are cases where the first player understands this and behaves like a Human and not like an Econ.

It follows that people may prefer to live in a society in which there are no beggars on the streets and limited wage premiums for those who happen to have been lucky enough to have been born with the talents of an opera star or a major league quarterback. They may want government to intervene to shore up incomes at the bottom and limit them at the top. They may support a higher minimum wage even if, in some cases, it causes employers to hire fewer low-skilled workers. Neoliberals focus on the inefficiencies of such policies and give short shrift to perceptions of fairness.³⁵ But trade-offs of this sort are ubiquitous. The purpose of a democracy is to find the right balance.

Put simply, markets are amoral. To be sure, they do a reasonable job of allocating resources, a far better job than any planned economy. But they can’t deal with the larger issue of what kind of society we want to live in. They cannot be left to decide what benefits should be provided to the least well-off, what kind of environment our children will inherit, and what kind of guard rails are needed to maintain competition and prevent unchecked economic power from influencing the political system.³⁶

In an earlier era, market failures were given more emphasis than now. Students were taught that, because of these flaws, a mixed economy would perform far better than one in

which markets dominated. Hacker and Pierson provide an account of how the intellectual terrain has shifted over time.³⁷ They compare the earliest version of Paul Samuelson’s widely-used textbook to later versions and show that the arguments for a mixed economy have waned. In his earliest version, Samuelson said “The private economy is not unlike a machine without an effective steering wheel or governor.” In later versions he retreated, dropping this sentence entirely, and his publisher promoted the revised text book as more market-oriented.³⁸ The lesson that markets don’t flourish unless government provides a variety of complementary inputs has been weakened, if not lost.

Political Failures

The argument that markets work best when complemented by government requires still another assumption – that government is capable of intervening in ways that are both smart and responsive to democratic values.

The current reality, however, is that government is not addressing such issues as growing inequality and climate change. We should be asking why.

In part, it’s because the market mindset and supply-side ideologies I’ve just described have blocked the way forward. It has now been almost 40 years since Ronald Reagan told us that government is the problem and not the solution. It has been almost as long since a “no new taxes” ideology has gripped the Republican party and cowed many Democrats into submission as well.

It’s also true that the American public is more conservative than the citizens of many other rich countries, and its politics more dominated by racial discord.³⁹ Add to that the fact that no one likes to pay the higher taxes that a more activist government requires.

While all these reasons for inaction can be invoked, polls also show that a majority of Americans over the past 25 years have wanted higher taxes on the rich and on corporations. The tax law of 2017 took the country in just the opposite direction. That law has been unpopular with the public – more evidence perhaps that the ice is cracking. But the fact that it has been so hard to raise taxes on the rich, despite consistent support for doing so, suggests that the problem might be less with the reigning economic paradigm or with a conservative-minded public and more with the difficulty our political system has in translating public preferences into legislative form.

Political theory has long contended that democracies are generally responsive to the will of the people. Empirical evidence supporting the theory is mixed.⁴⁰ The most recent research by Martin Gilens and Benjamin Page suggests that economic elites (at the 90th income percentile) and organized business interests have a large influence while the average citizen has virtually no impact. The so-called “median voter” celebrated in political theory – the swing voters that all politicians should, in theory, want to cultivate – may, in effect,

have very little say about what happens legislatively. In contrast, business interest groups have an outsized impact on policy. In the words of Gilens and Page, “In the United States, our findings indicate, the majority does *not* rule – at least not in the causal sense of actually determining policy outcomes. When a majority of citizens disagrees with economic elites or with organized interests, they generally lose. Moreover, because of status quo bias built into the U.S. political system, even when fairly large majorities of Americans favor policy change, they generally do not get it.”⁴¹

This is a devastating critique of democracy itself. It suggests that government has been captured by business interests and wealthy individuals. If we combine this conclusion with the earlier argument made by Thomas Piketty and others that capitalism leads to ever-greater inequality, then we are headed for ever-greater concentrations of income and wealth at the top. It’s not a pretty picture.

We may now have an economic system that is not self-correcting, but which has spawned a political system that is not self-correcting either. Supply-side economics has created supply-side politics – a political system dominated by those who supply the money.

The feedback loops between economic and political institutions makes the threat to democracy that much greater. More inequality leads to more capture and more capture leads to more inequality ad infinitum until a crisis of some sort ends the process. In the words of Bill Galston: “it is unarguable that beyond a certain point economic inequality is a threat to liberal democracy.”⁴²

It would help, of course, if we could restructure a variety of political institutions from an electoral college now biased toward smaller states, gerrymandered congressional districts, primaries dominated by activists who don’t represent the typical voter, and a finance system epitomized by Citizens United. But it’s hard to see how to do this as long as those who benefit from the status quo remain in charge while voters are poorly informed, disengaged, and vulnerable to populist appeals.

Strengthening political parties and substituting representative for popular democracy could help. As Jonathan Rauch argues, political parties need to exercise more influence on the choices provided to the voters. In a well-intentioned attempt to make the system more open and more democratic, parties have forfeited their ability to serve as restraining intermediaries and inadvertently created political chaos.⁴³ If the Republican party were institutionally stronger, it would have checked Trump long before now. Instead the party is now at a crossroads: it can cynically exploit the anxieties of its political base while continuing to serve the interests of its donor base, or it can rebuild a principled vision of society that deals with today’s economic and social divisions in a coherent fashion.

Shifting the Paradigm

Although political reform is badly needed, so is a shift in the market mindset. My critique of market fundamentalism is not a narrative about evil people or simple greed. It's a story about the alleged miracle of markets turned into an ideology that has permeated policy making for almost half a century. Business leaders, as well as the ordinary citizens who might have otherwise put up greater resistance, have been socialized to think of markets as basically good and government as basically bad. Markets, they are told, grow the pie and eventually everyone will get a piece of it.

This view has now entered the country's DNA. To be sure, progressives have derisively labelled it "trickle down," but progressives have no grand theory to explain the world that can begin to compete with the neoliberal paradigm. Instead they sound like special pleaders or bleeding hearts, socialists or communists in the making.

Most people have simply bought into the idea that income is based on effort and talent, that wages do mirror individual productivity, and that those at the top are superstars and thus deserving of their riches. Those in the top ranks are able to justify their good fortune via a similar logic: they earned it. Companies create jobs. They are the wealth creators and as such need to be freed from taxes and regulations. This world view has animated a starve the beast agenda and deprived government of the resources it needs to work effectively, insuring further public disappointment and distrust of the one sector that has the power to turn the tide.

My point here is that the market narrative is so pervasive that we don't even know when we are dancing to its tune. It has affected the entire zeitgeist and provided a powerful rationale for the rich and powerful to justify their good fortune. The successful tell themselves they achieved their wealth because of their extraordinary accomplishments, not because of luck or having been born in privileged circumstances. The unsuccessful blame themselves rather than their bad luck or modest beginnings for not having won the brass ring. They have been left in the lurch and turn to social assistance with regret, if not outright shame.

What's the Alternative?

Although the ice may be cracking with the weaknesses in a pure market economy becoming more apparent, an alternative narrative that is widely accepted still eludes us.

I see three possible directions for our politics. *All of them reject the primacy of markets.*

The first is what I will call Social Democracy (or Democratic Socialism). It is an ambitious agenda of government intervention in the economy epitomized by The Green New Deal,

Medicare for All, a guaranteed jobs program, an extension of social insurance to include such things as paid leave and lifelong learning, higher benefits for the less advantaged, a universal basic income, and the like. It is expensive, requires big tax increases, and a major disruption of existing institutions, including the labor market and the health care system. It places faith in the ability of government to not be “all thumbs.” It is mainly favored by those on the political left. It promises bold, not incremental change. Whether it can be adopted or sustained in a country whose citizens are more moderate than their elected officials remains to be seen. But it represents a revolt against the status quo and is further evidence that the ice is cracking.

The second approach I will call democratic liberalism. It would embrace an updated version of the mixed economy of the earlier postwar period. It would restrain the worst aspects of capitalism without going as far as the Social Democratic model. It would emphasize opportunity and pre-distribution over large transfers of income after the fact because of the kind of public conservatism and hostility to taxes and transfers noted above. It would rebuild confidence in government by making the existing tax system much simpler and public spending more transparent, perhaps by substituting a VAT for most income taxes and earmarking these or other revenues for specific purposes so that the public could see where their money was going. It would rely on public-private partnerships to rebuild infrastructure, train workers, and create a more efficient health care system. It would recognize climate change as a national emergency but address it via a tax on carbon or other market mechanisms. It would, in short, *redirect rather than supplant the market*. It would reject the idea that markets perform miracles but also the idea that government can always provide the solution. Government can be clumsy, inflexible, and too easily captured by narrow interests for whom the benefits of particular policies loom large.

The third is what I will call Social Capitalism. This social-capital approach is favored mainly by those on the political right including such public intellectuals as David Brooks, Yuval Levin, and Ben Sasse. It’s not clear what kind of government they envisage, only that – like their more progressive counterparts – they see markets as flawed and inadequate. They emphasize the need for a renewal of social capital and trust. A thriving middle class is not just people with a certain level of income. It’s people with other resources, including the kind of social and human capital that make them self-sufficient, self-respecting, and part of a community. Social capitalism substitutes for markets; not big government but rather such intermediaries as families, churches, nonprofits, grassroot organizations, and local communities. By relying more on civic virtue and nongovernmental institutions, government policies are less necessary. Its advocates typically support national service, new incentives for charitable giving, and more devolution of authority to the local level as well as strengthening “the little platoons” of a robust civic and faith-based society. Families are foundational and traditional marriage celebrated. Government can support or nudge the civic virtues in light touch ways. For example, low rates of saving for retirement can be countered by automatic enrollment in a retirement plan with an opt-out provision to retain some freedom of choice. Teenage pregnancy has fallen in response to a television program depicting the difficulties of becoming a young single parent. Many other examples could be cited.⁴⁴ These approaches owe much to the insights being provided by behavioral economics

and their success often flies in the face of the assumptions embedded in the neoclassical paradigm.

Of course, there are overlaps between these models and still other models now hard to imagine. My point is not to argue for a particular model (although I tilt toward the second with increasing sympathy for the third) but for the need to have a more robust debate about the alternatives to market fundamentalism.

All three of the above models would lean against the current paradigm with its emphasis on markets and economic growth. They all recognize that more material goods in an already affluent society, if badly distributed, make people less happy, not more.⁴⁵ Those at the bottom suffer a loss of relative status even if their incomes are still growing. They are more aware of what they *can't* buy than what they can. They may have a cell phone and a microwave but not a Porsche, a Rolex, or a house in the Hamptons. Behavioral economists call this “loss aversion” and understand that it is about relative and not absolute status in one’s own society. Having citizens who feel fairly treated, respected, and engaged in productive activity is the primary goal of a liberal democracy and cannot be left to accidents of the market.

An affluent society can and should make different choices than a poor one. As a society becomes wealthier, the pursuit of growth – a little more GDP but at the expense of less equity or a degrading environment – begins to pale in comparison to the benefits of living in a society that prioritizes other goals. More growth for growth’s sake has diminishing returns. French GDP per capita is about two-thirds that of the U.S. But once one adjusts for differences in leisure time, in life expectancy, and in inequality and translates them into what a reasonable model suggests would produce equivalent satisfactions, then the typical French citizen is 92 percent as well off as the typical American citizen.⁴¹ In terms of such values as equity, good health, good food, good wine, more leisure, longer lives, and happy farmers, the French have chosen a different, and arguably superior, path.

What is fair or equitable or contributes to “the good life” will be debated by philosophers and contested in the political arena. That’s as it should be. If economics is mostly about production, politics is mostly about distribution. Some, following John Rawls, will define the ideal distribution as one about which most people would feel comfortable even if they didn’t know in advance their own place in that distribution. They may favor the Social Democratic approach including a universal basic income as a way to achieve a Rawlsian world. Others will simply conclude that whatever the current amount of inequality, it is too great. They may simply prefer less inequality than we now have. We don’t need to agree on the exact endpoint to know the direction in which to move. Many people’s preferences will be based not just on how the current distribution affects them but how it affects others. Unlike Thaler’s self-interested Econs, they are Humans; they care about the kind of society in which they live.

Herbert Stein, a much-respected conservative economist, once said that the problem with inequality is that “it is unlovely.” So are climate change, crumbling roads, workers who have not seen a boost in real wages for decades, dilapidated buildings and ruined lives in small-towns, and many other aspects of American life. The fact is that *we know more about how to repurpose growth than we know about how to speed it up.*⁴⁶

Some might object that growth, even in a rich country, enables that country to help the global poor or to compete more effectively with rising hegemony, such as China. But altruism is bounded by ties of family, community, and nation, and a better way to deal with global inequalities is to be open to trade and immigration. As for preventing the rise of a new hegemon, that may depend more on modelling democratic values and maintaining strong alliances than on faster economic growth.

If one agrees with my assessment about the dangers of market fundamentalism and the need to reprioritize fairness and human flourishing, what exactly should be done? A good first step would be to enact legislation calling for more explicit attention to this goal. There should be a Council of Social Advisers in the White House that would report every year on the well-being of American families, on the overall distribution of income and other valued goods such as health and education, and on the health of civic society and confidence in democratic institutions. The report would produce credible metrics against which to measure progress, lay out the Administration's goals, and what it was doing or proposing as a way to achieve those goals. There would be hearings on the report and a more robust discussion about how to achieve greater fairness, a stronger middle class, and a healthier society.

In the end, of course, the solutions will have to come from the political system and the serious engagement of the public in the electoral process along with political reforms that more effectively translate their preferences into constructive action. If we want a weaver's society, one in which markets and government work together, we will need to do better.

Conclusions

Supply-side economics has spawned supply-side politics – the capture of politics by those who benefit from the status quo. The ability of our existing political institutions to respond to ever-rising inequality and the threat it poses to democracy is by no means assured.

In this context, it is encouraging that a market-based ideology appears to be on the wane. It is being challenged both by events and by new intellectual stirrings on the right and the left. What will replace it is unclear. But the cracking of the ice is a good sign.

In the meantime, the state of the nation is not good. Market fundamentalism is only one of the reasons, but it has shaped minds and hearts in ways that have made it difficult to move forward. The ice may be cracking, but we have a long way to go before spring.

Notes

¹ For more details on these failings and their political consequences, see Sawhill, Isabel. *The Forgotten Americans: An Economic Agenda for a Divided Nation*. New Haven, CT: Yale University Press, 2018 and Sawhill, Isabel. “What the Forgotten Americans Really Want and How to Give it To Them,” Brookings Institution, October 2018. <https://www.brookings.edu/longform/what-the-forgotten-americans-really-want-and-how-to-give-it-to-them/>.

² See Friedman, Milton. *Capitalism and Freedom*. Chicago, IL: University of Chicago Press, 1962. Friedman argues that economic freedom is a “necessary condition for political freedom,” p. 4.

³ In an earlier version of this essay, I used the term “neoliberalism” as a synonym for market fundamentalism. But the term is used to mean different things to different people, so I abandoned it.

⁴ Collier, Paul. *The Future of Capitalism: Facing the New Anxieties*. New York, NY: HarperCollins, 2019.

⁵ Rodrick, Dani. “Rescuing Economics from Neoliberalism,” *Boston Review*, November 6, 2017. As Rodrik says (p. 4), “A proper understanding of the economics that lies behind neoliberalism would allow us to identify – and to reject – ideology when it masquerades as economic science.” <http://bostonreview.net/class-inequality/dani-rodrik-rescuing-economics-neoliberalism>.

⁶ Kramer, Larry. “Beyond Neoliberalism: Rethinking Political Economy,” *William and Flora Hewlett Foundation*, April 26, 2018. <https://hewlett.org/library/beyond-neoliberalism-rethinking-political-economy/>.

⁷ Lindsay, Brink et al. “The Center Can Hold: Public Policy for an Age of Extremes,” *Niskanen Center*, December 2018.

⁸ Liu, Eric and Nick Nanauer. *The Gardens of Democracy: A New American Story of Citizenship, the Economy, and the Role of Government*. New York, NY: Penguin Random House, 2011; Cass, Oren. *The Once and Future Worker*. New York, NY: Encounter Books, 2018; McCloskey, Abby M. “Beyond Growth,” *National Affairs*, No. 39, Spring 2019.

⁹ Gertz, Geoffrey and Homi Kharas, “Introduction: Beyond neoliberalism in emerging markets,” Brookings Institution, May 1, 2019. <https://www.brookings.edu/research/introduction-beyond-neoliberalism-in-emerging-markets/>.

¹⁰ “Reinventing Liberalism for the 21st Century,” *The Economist*, September 13, 2018. <https://www.economist.com/essay/2018/09/13/the-economist-at-175>.

¹¹ Hacker, Jacob S. and Paul Pierson. *American Amnesia*. New York, NY: Simon & Schuster, 2016.

¹² This metaphor is originally credited to Charles Lindblom but is used extensively in Hacker, Jacob S. and Paul Pierson (2016).

¹³ Hacker and Pierson (2016) p. 71.

¹⁴ Hacker and Pierson (2016) p. 171.

¹⁵ For a more detailed accounting of these trends, see Sawhill (2018) ch. 3.

¹⁶ See Shambaugh, Jay and Ryan Nunn. *Place-based Policies for Shared Economic Growth*. Washington, DC: Brookings Institution, 2018; Austin, Benjamin, Edward Glaeser, and Lawrence Summers. "Saving the Heartland," *Brookings Papers on Economic Activity*, March 8, 2018; and Hendrickson, Clara, Mark Muro, and William Galston. "Strategies for Left-Behind Places," *Brookings Institution*, November 2018.

¹⁷ Piketty, Thomas. *Capital in the Twenty-first Century*. Cambridge, MA: Harvard University Press, 2014.

¹⁸ Page, Benjamin and William Gale. "CBO Estimates imply that TCJA will boost incomes for Foreign Investors but not for Americans," *Brookings Institution*, May 10, 2018. <https://www.brookings.edu/blog/up-front/2018/05/10/cbo-estimates-imply-that-tcja-will-boost-incomes-for-foreign-investors-but-not-for-americans/>.

¹⁹ Barro, Robert and Jason Furman. "Macroeconomic effects of the 2017 tax reform," *Brookings Papers on Economic Activity*, March 8, 2018

²⁰ Cass, Oren (2018).

²¹ McCloskey, Abby M. (2019).

²² Bernanke, Ben S. "When Growth is Not Enough," presented at the European Central Bank Forum on Central Banking, <https://www.brookings.edu/blog/ben-bernanke/2017/06/26/when-growth-is-not-enough/>

²³ Graham, Carol. *Happiness for All?* Princeton, NJ: Princeton University Press, 2017; Sawhill (2018) ch. 4.

²⁴ Monbiot, George. *Out of the Wreckage: A New Politics for an Age of Crisis*. New York, NY: Verso, 2017, p. 119. Also see <https://www.neuticles.com/>.

²⁵ Maynard Keynes, John. *The General Theory of Employment, Interest, and Money*. Basingstoke, UK: Palgrave Macmillan, 1936, ch. 24, p. 383.

²⁶ Van Heuvelen, Tom. "Moral Economies or Hidden Talents? A Longitudinal Analysis of Union Decline and Wage Inequality, 1973-2015." *Social Forces* 97, no. 2 (December 2018): 495-530.

²⁷ Francine Blau and Lawrence Kahn The Gender Wage Gap: Extent, Trends, and Explanation, *Journal of Economic Literature*, 2017 vol 55(3), pp 789-865. and Bertrand and Mullainathan, *American Economic Review*, 2004.

²⁸ Benmelech, Efraim, Nittai Bergman, and Hyunseob Kim. “Strong Employers and Weak Employees: How Does employer Concentration Affect Wages?” Working Paper. *National Bureau of Economic Research*, May 2018. <https://www.nber.org/digest/may18/w24307.shtml>; Furman, Jason and Peter Orszag. “Slower Productivity and Higher Inequality: Are they Related?” Working Paper. *Peterson Institute for International Economics*, June 2018. <https://piie.com/system/files/documents/wp18-4.pdf>

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³¹ Economic Policy Institute. “The Productivity-Pay Gap,” August 2018, <https://www.epi.org/productivity-pay-gap/>

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³³ AEI-Brookings Working Group on Paid Family Leave. “Paid Family and Medical Leave,” September 2019, <http://www.aei.org/wp-content/uploads/2018/09/The-AEI-Brookings-Working-Group-Report-on-Paid-Family-and-Medical-Leave.pdf>.

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³⁷ Hacker and Pierson (2016) p. 167-168.

³⁸ Hacker and Pierson (2016) p. 168.

³⁹ Alesina, Alberto, Edward Glaeser, and Bruce Sacerdote. "Why Doesn't the United States Have a European-Style Welfare State?" *Brookings Papers on Economic Activity* 2 (2001): 187-278.

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⁴⁴ Thaler, Richard and Cass Sunstein. *Nudge*. New York, NY: Penguin Random House, 2009.

⁴⁵ This same point as been made by Cornell professor, Robert Frank and a number of others.

⁴⁶ Sawhill (2018) p. 81-82.