

STRAW MAN CAPITALISM AND A NEW PATH TO PROSPERITY

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Soon after the \$700 billion Troubled Asset Relief Program (TARP) became law in October of 2008, the *Washington Post* ran a widely acclaimed article entitled “The End Of American Capitalism?”¹ The article called into question the supremacy of capitalism and the durability of free markets in the wake of the financial crisis. The same theme appeared in countless articles in the months that followed. By April 2009, a poll found that only fifty-three percent of American adults believed capitalism to be better than socialism.² This lack of confidence in capitalism provided the setting in which President Obama pledged “to act boldly, to turn adversity into opportunity, and use this crisis as a chance to transform our economy for the 21st century.”³ Public expenditures have gone toward bailouts of failing firms, economic stimulus plans, Cash for Clunkers, and other proactive government policies aimed at pulling the U.S. economy out of recession. President Obama’s pledged transformation has been a multi-trillion dollar failure and offers new evidence of the bankruptcy of countercyclical government interventionism as a means of economic recovery. If the short-term effects of these programs have been disappointing, the long-term effects of the nearly three trillion dollars in additional debt will be even more debilitating.

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1. Anthony Faiola, *The End Of American Capitalism?*, WASH. POST, Oct. 10, 2008, at A1.

2. *Just 53% Say Capitalism Better Than Socialism*, RASMUSSEN REP., Apr. 9, 2009, http://www.rasmussenreports.com/public_content/politics/general_politics/april_2009/just_53_say_capitalism_better_than_socialism.

3. Remarks at the Caterpillar Plant in East Peoria, Illinois, DAILY COMP. PRES. DOC. No. DCPD200900081 (Feb. 12, 2009).

I. THE TRANSLUCENT HAND

An elementary truth must be noted before any discussion of the financial crisis and its aftermath can take place: the economic system of the United States prior to the downturn did not represent free-market capitalism. This point is not novel. Economics textbooks, almost unanimously, describe the system as a “mixed economy” in which nearly every private sector is subjected to some degree of government regulation, and the 2008 *Federal Register* contains almost eighty-thousand pages.⁴ It is an error to consider “capitalism” and the American economic system to be roughly synonymous. This important distinction has been drowned out by the dissonant grumblings of unjustified acrimony towards markets. Free-market capitalism has become a straw man on which leftists blames every economic ill in an attempt to usher in policies that further increase the role of government in the marketplace.

Since the New Deal, fiscal conservatives have been on defense, not on offense. In 2009, there was no free market to defend. In the 1930s, government entities produced, on average, roughly fifteen percent of GDP.⁵ From 1970 through 2008, government on average accounted for about twenty-five percent of GDP (the effects of spending increases in 2009 will be considered subsequently).⁶ These figures do not even account for the unseen costs associated with the burden of government—the costs of complying with regulations—which were about another eight percent of GDP in 2008.⁷

The supply-side revolution associated with President Ronald Reagan—the most hopeful attempt at securing prosperity through limited government in twentieth-century American politics—was about tearing down big-government policies by, for example, lowering tax rates and lessening regulatory burdens. It was not a defense of a free-market status quo. Al-

4. Clyde Wayne Crews, Jr., *Ten Thousand Commandments: An Annual Snapshot of the Federal Regulatory State*, 2009 COMPETITIVE ENTER. INST. 2.

5. See BUREAU OF ECON. ANALYSIS, NAT'L INCOME PROD. ACCT. TABLES, TABLE 1.1.5 (2009), available at <http://www.bea.gov/National/nipaweb/SelectTable.asp?Selected=N>.

6. *Id.*

7. Crews, *supra* note 4, at 2.

though the revolution made some progress, it by no means created the Randian state assumed by its detractors.⁸

II. CRY ME A CRISIS

The contemporary leftists have taken to using the term “free-market fundamentalism” to pejoratively characterize the economic philosophy of President George W. Bush’s Administration and to blaming “deregulation” for the financial crisis.⁹ President Bush, however—even before the trillions of dollars in bailouts and guarantees during his last year in office—was far from a fiscal conservative. Veronique de Rugy, an expert on fiscal policy at George Mason University’s Mercatus Center, has done research that shows President Bush to have been the biggest regulator since Richard Nixon and that the Bush team “spent more taxpayer money on issuing and enforcing regulations than any previous administration in U.S. history.”¹⁰

President Obama seems to have overlooked this nontrivial fact. In a Democratic primary debate, Mr. Obama shared his thoughts on the government’s role in the financial crisis:

[T]he sub-prime lending mess, part of the reason it happened was because we had an administration that does not believe in any kind of oversight. . . . You’ve got to disclose if you’ve got a teaser rate and suddenly their mortgage payments are going to jack up and they can’t pay for them. And one of the things that I intend to do as president of the United States is restore a sense of accountability and regulatory oversight over the financial markets.¹¹

This reading of history is dead wrong. Worse yet, President Obama now works closely with many who were complicit in, or directly responsible for, the well-intentioned but pernicious policies that led to the subprime lending debacle that triggered the most severe recession in a generation.

When it came to increasing home ownership, Congress abdicated its due diligence role in part because of the awesome lob-

8. DAVID STOCKMAN, *THE TRIUMPH OF POLITICS: WHY THE REAGAN REVOLUTION FAILED* (1986).

9. See Michael Hirsch, *Converting the Preachers*, *NEWSWEEK*, Oct. 27, 2009, <http://www.newsweek.com/id/219720>.

10. Veronique de Rugy, *Bush’s Regulatory Kiss-Off*, *REASON*, Jan. 2009, at 24–25.

11. Barack Obama, *Democratic Debate in Las Vegas*, *N.Y. TIMES*, Jan. 15, 2008.

bying power of the housing industry, which provided massive campaign contributions to members of Congress in both parties in return for ever-generous housing subsidies and a blind eye to the massive debt and risks of Fannie Mae and Freddie Mac. In a House Financial Services Committee hearing in 2003, Representative Barney Frank made a declaration indicative of Congress's attitude toward the Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac: "I do not want the same kind of focus on safety and soundness that we have in OCC [Office of the Comptroller of the Currency] and OTS [Office of Thrift Supervision]. I want to roll the dice a little bit more in this situation towards subsidized housing."¹² Such blatant carelessness cannot be forgiven.

Yet Representative Frank and the many other congressmen who are on the record making similar statements are politicians, not experts on risk-based capital standards. Where were the experts? In 2002, Peter Orszag (President Obama's current Director of the Office of Management and Budget) coauthored a paper with Nobel laureate Joseph Stiglitz (an Obama supporter and unyielding critic of free-market capitalism) that analyzed the state of the GSEs Fannie Mae and Freddie Mac:

The paper concludes that the probability of default by the GSEs is extremely small. Given this, the expected monetary costs of exposure to GSE insolvency are relatively small—even given very large levels of outstanding GSE debt and even assuming that the government would bear the cost of all GSE debt in the case of insolvency. For example, if the probability of the stress test conditions occurring is less than one in 500,000, and if the GSEs hold sufficient capital to withstand the stress test, the implication is that the expected cost to the government of providing an explicit government guarantee on \$1 trillion in GSE debt is less than \$2 million. To be sure, it is difficult to analyze extremely low-probability events, such as the one embodied in the stress test. Even if the analysis is off by an order of magnitude, however, the expected cost to the government is still very modest.¹³

12. *What They Said About Fan and Fred*, WALL ST. J., Oct. 2, 2008, at A19.

13. Joseph E. Stiglitz, Jonathan M. Orszag & Peter R. Orszag, *Implications of the New Fannie Mae and Freddie Mac Risk-based Capital Standard*, FANNIE MAE PAPERS, Mar. 2002, at 2.

In fact, the GSEs did not remain sound. Their failure put taxpayers on the line for \$1.45 billion in mortgage-backed security and debt purchases.¹⁴ This was only the tip of the iceberg. Eighteen months after a bailout frenzy that began with Bear Stearns in March 2008, the Federal Reserve, Treasury, and Federal Deposit Insurance Corporation had “committed” \$11 trillion, \$3 trillion of which had already been “invested.”¹⁵

III. NEW BOSS, SAME AS THE OLD BOSS

We will not dwell on the precise causes of the financial crisis, but we side with renowned Stanford economist John Taylor’s assertion that the failure is primarily due to government, not markets.¹⁶ To the extent there is a systemic culprit, it is not capitalism, but rather corporatism. Progressives wrongly conflate conservatives’ adoration of free enterprise with that of political profiteering and rent-seeking, whereby legislative loopholes and carve-outs are secured by lobbyists and politically favored special-interest groups. This process warps the playing field and creates perverse incentives. This point is one on which Michael Moore and Milton Friedman would agree.

Two professors of finance at the University of Chicago, Raghuram Rajan and Luigi Zingales, have written a book on this subject titled *Saving Capitalism from the Capitalists*.¹⁷ They argue that the dangerous combination of capitalism and politics poses a serious threat to economic growth and opportunity.¹⁸ Crony capitalism, or corporatism—whichever you prefer—has existed in Washington to some degree for as long as the federal government has been spending money. The current financial crisis was caused in significant part by a large amount of such interest-driven market manipulation. If you doubt the existence of such manipulation, take a look at the campaign contributions from

14. FED. RESERVE BANK OF ST. LOUIS, *THE FINANCIAL CRISIS: A TIMELINE OF EVENTS AND POLICY ACTIONS* (2009).

15. David Goldman, *CNNMoney.com’s Bailout Tracker*, CNNMONEY, <http://money.cnn.com/news/storysupplement/economy/bailouttracker/index.html> (last visited Feb. 19, 2010).

16. JOHN B. TAYLOR, *GETTING OFF TRACK*, at xi (2009).

17. RAGHURAM G. RAJAN & LUIGI ZINGALES, *SAVING CAPITALISM FROM THE CAPITALISTS* (2003).

18. *Id.* at 2.

Fannie Mae and Freddie Mac.¹⁹ This manipulation, and the problems associated with it, stem largely from the forced entanglement of business and politics. Remember, Fannie and Freddie are Government Sponsored Enterprises. Now, thanks to the bailouts, many more firms are inextricably linked to the federal government for the foreseeable future.

IV. EXIT, STAGE FAR LEFT

Bad monetary policy also played a pivotal role in the financial crisis. From late 2002 through 2004 the Federal Reserve Bank held interest rates on loans to banks at about one percent, which made the real federal funds rate negative.²⁰ Uncle Sam thus subsidized banks to make increasingly risky loans, and the result was the subprime mortgage madness that caused massive foreclosures. This was not a market dysfunction, but a government one, notwithstanding the blind euphoria of lenders and borrowers in the housing market that contributed to the multi-trillion dollar real estate bubble.

Loose fiscal policy accompanied loose monetary policy in the years running up to the financial crash in September 2008. As mentioned above, George W. Bush was not a small-government, free-market conservative—though he talked as if he were. President Bush presided over one of the most big-government administrations since Lyndon Johnson.

It is widely assumed that most of President Bush's spending and debt increases were a result of the defense and homeland security buildup after September 11, but those increases only accounted for about forty percent of all *new* spending. From 2001 to 2008, after adjusting for inflation, education spending was up fifty-eight percent, income-security programs up twenty-seven percent, Medicare up fifty-one percent, and community and regional development spending up ninety-four percent.²¹ It was in many of these areas that President Obama, then candidate, claimed we had an investment deficit. President Bush, hoping to keep his "ownership society" bona fides,

19. Posting of Lindsay Renick Mayer to Capital Eye Blog, <http://www.opensecrets.org/news/> (Sept. 11, 2008, 11:26 EDT).

20. FED. RES. BOARD, INTENDED FEDERAL FUNDS RATE, CHANGE AND LEVEL, 1990 TO PRESENT, <http://www.federalreserve.gov/fomc/fundsrate.htm>.

21. BRIAN RIEDL, HERITAGE FOUND., FEDERAL SPENDING BY THE NUMBERS 4 (2009).

never denied President Barack Obama's assertion that he had contributed to those investment deficits. President Obama has thus been able to continue arguing that government spending programs urgently need more funding.

Nevertheless, the traditional spending increases for which President Bush was responsible are distinct from the spending that occurred during the financial crisis. In December 2008, after the government responded to a year of market turmoil with massive bailout packages, President Bush explained his dogmatic drift by saying, "I've abandoned free-market principles to save the free-market system."²² Of course, lurching toward governmental solutions during times of crisis has been commonplace throughout American history, especially in the last century. But such solutions have seldom worked. Amity Shlaes points out in her book on the Great Depression, *The Forgotten Man*, that almost all of the New Deal programs failed to bring the economy anywhere near full employment and failed to drive the economy out of a decade-long depression.²³ Even by 1940, more than seven years after the New Deal was launched, the U.S. economy was still flat on its back.²⁴

V. ENTER LEVI A. THAN

President Obama ignored all of the historical evidence of the failure of Keynesian interventions, and he abandoned any suggestion that the free-market system could revive the economy. Instead he doubled down on the Bush Administration's government buildup. Data from the White House Office of Management and Budget show that between 2007 and 2010 the federal government's share of the economy is expected to have grown by thirty-one percent to the highest levels since World War II.²⁵ One reason the spending boom did not create an economic recovery or a return to hiring is that all of the new

22. *Bush says sacrificed free-market principles to save economy*, AGENCE FRANCE PRESS, Dec. 16, 2008, <http://www.google.com/hostednews/afp/article/ALeqM5jyyKrPjYt7VhpS8G8DrRkr18B0hA>.

23. AMITY SHLAES, *THE FORGOTTEN MAN* (2007).

24. Shlaes notes that unemployment in 1940 was at 14.6 percent, and chronicles the popularity of Republican presidential candidate Wendell Wilkie, who ran in that year largely on opposition to New Deal policies. *Id.* at 366–83.

25. OFFICE OF MGMT. AND BUDGET, *MID-SESSION REVIEW: BUDGET OF THE U.S. GOVERNMENT 25* (2010); OFFICE OF MGMT. AND BUDGET, *HISTORICAL TABLES 25–26* (2005).

spending and debt translates into higher future tax increases, which stunt business expansion. A study in 2009 by the non-partisan Tax Foundation found that to return to a balanced budget with the new levels of debt under President Obama, tax rates would have to nearly triple.²⁶ According to the study, the highest tax rate would rise to more than ninety percent. Who wants to invest during that tax tsunami?

It is also a serious mistake to assume that government spending and debt will fade as the recession ends. Research from economic historian Robert Higgs shows that in times of economic crisis government grows and recedes, but it never shrinks back to its growth trajectory before the crisis.²⁷ In other words, crises that bring about large-scale market intervention result in a permanent increase in the size of government. We are in the midst of a cascade of market interventions.

The original purpose of TARP²⁸ was solely to buy up toxic assets.²⁹ However, TARP turned into a slush fund for the Treasury Department to assist auto companies, insurance companies, and the already-subsidized housing industry. The money, which some banks were forced to take, also came with strings attached: Firms were subject to (sometimes ad hoc) regulations including caps on executive pay compensation.³⁰ We also saw TARP money used for the preposterous Cash for Clunkers program, which merely paid Americans to take good cars off the road so that the government could demolish them. This program fell for the broken windows fallacy: You do not break windows so you can put people to work trying to fix them.

The growth of government certainly does not stop with banks and financial firms. President Obama says that the environment is also in crisis, and we must “act quickly and . . . act boldly to transform our entire economy—from our cars and

26. WILLIAM AHERN, TAX FOUND., CAN INCOME TAX HIKES CLOSE THE DEFICIT? 2 (2009).

27. ROBERT HIGGS, CRISIS AND LEVIATHAN: CRITICAL EPISODES IN THE GROWTH OF AMERICAN GOVERNMENT (1987).

28. Emergency Economic Stabilization Act of 2009, Pub. L. No. 110-343, 122 Stat. 3765.

29. Joe Nocera, Editorial, *First Bailout Formula Had It Right*, N.Y. TIMES, Jan. 24, 2009, at B1.

30. Editorial, *Rolling up the TARP*, WALL ST. J., Oct. 27, 2009, at A20.

our fuels to our factories and our buildings.”³¹ The Brookings Institute predicts the cap and trade component of such an endeavor alone to cause a loss in personal consumption of \$1 to \$2 trillion in present-value terms.³² Even if the prospects of climate change legislation now seem dim, the Administration is making threats that it will be able to accomplish the same goals through the Environmental Protection Agency. As Senators John Kerry and Lindsey Graham explain:

Failure to act comes with another cost. If Congress does not pass legislation dealing with climate change, the administration will use the Environmental Protection Agency to impose new regulations. Imposed regulations are likely to be tougher and they certainly will not include the job protections and investment incentives we are proposing.

The message to those who have stalled for years is clear: killing a Senate bill is not success; indeed, given the threat of agency regulation, those who have been content to make the legislative process grind to a halt would later come running to Congress in a panic to secure the kinds of incentives and investments we can pass today. Industry needs the certainty that comes with Congressional action.³³

In other words, businesses must pay protection money to the government through cap and trade or they will be hit upside the head with EPA rules that will be much more severe. This is what some might call extortion.

The disastrous \$787 billion American Recovery and Reinvestment Act of 2009³⁴ (the “stimulus”) was President Obama’s crowning achievement in his first year in office, but it failed to stimulate jobs or growth. In a report put out before the legislation was passed, Council of Economic Advisors Chairwoman Christina Romer and Vice President Joe Biden’s economic advisor Jared Bernstein argued that without the stimulus unemployment could approach nine percent by the end of the third

31. BarackObama.com, Barack Obama & Joe Biden, *New Energy for America*, http://www.barackobama.com/pdf/factsheet_energy_speech_080308.pdf (last visited Feb. 19, 2010).

32. WARWICK MCKIBBIN, PETE WILCOXEN & ADELE MORRIS, BROOKINGS INST., *CONSEQUENCES OF CAP AND TRADE* 31 (2009).

33. John Kerry & Lindsey Graham, *Yes We Can (Pass Climate Change Legislation)*, N.Y. TIMES, Oct. 11, 2009, at WK 11.

34. Pub. L. No. 111-5, 123 Stat. 115.

quarter of 2009, but that with the stimulus, it would stay below eight percent.³⁵ In the end of the third quarter of 2009, unemployment was at 9.8%.³⁶ The Vice President claimed that they had “misread the economy” and did not realize how bad the situation was. That, however, is the point.³⁷

Econometrically-modeled guesses about jobs that the stimulus could create (or “save”) are a microcosm of other attempts at planning. Failures in the marketplace are far more preferable to failures of government, as economist and Nobel laureate Milton Friedman explained:

I believe that what really distinguishes economists is not whether they recognize market failure, but how much importance they attach to government failure, especially when government seeks to remedy what are said to be market failures. That difference in turn is related to the time perspective that economists bring to various issues. Speaking for myself, I do not believe that I have more faith in the equilibrating tendencies of market forces than most Keynesians, but I have far less faith than most economists, whether Keynesians or monetarists, in the ability of government to offset market failure without making matters worse.³⁸

The self-correcting capacity of markets is infinitely dynamic, but only if protected from the facade of omniscience that government planners too often hope and pretend to possess.

VI. FACING A BOLD NEW ECONOMY

For decades, there will be squabbles among scholars about whether this recession was the “worst” downturn since the Great Depression. Not in dispute, though, is that its impact upon the conscience of the country is one of epic proportions. The eighteen months following the collapse and bailout of Bear Stearns in March of 2008 have, at least temporarily, fundamen-

35. CHRISTINA ROMER & JARED BERNSTEIN, THE JOB PLAN OF THE AMERICAN RECOVERY AND REINVESTMENT PLAN 4 fig.1 (2009).

36. News Release, Bureau of Labor Statistics, The Employment Situation—September 2009 (Oct. 2, 2009), available at http://www.bls.gov/schedule/archives/empsit_nr.htm#2009.

37. George’s Bottom Line, <http://blogs.abcnews.com/george> (July 5, 2009, 10:10 EDT).

38. BRIAN SNOWDON, HOWARD VANE & PETER WYNARCZYK, A MODERN GUIDE TO MACROECONOMICS: AN INTRODUCTION TO COMPETING SCHOOLS OF THOUGHT 174 (1994).

tally remade American capitalism. We have moved from a model of survival of the fittest in business to survival of the unfittest. The new dogma of “too big to fail” creates huge moral hazard problems as taxpayers underwrite bad business bets by banks and investment houses. In other words, the vast and sweeping government interventions that began in early 2008 did not save capitalism, as President Bush had hoped. Instead, they have given way to more political corporatism—or crony capitalism—where market decisions and capital allocation are increasingly steered by politicians in Washington, D.C. Wall Street is no longer the financial capital of the world—Capitol Hill is.

Each year, the Fraser Institute puts out a report showing the correlation between economic freedom and prosperity. The authors prefaced their assessment of “the impact of financial & economic crises on economic freedom” with some optimism this year, despite setbacks to market-oriented policies:

[T]hose who predict capitalism’s demise have to contend with one important historical fact: capitalism has an almost unlimited capacity to reinvent itself. It cannot be a mere coincidence that all prosperous countries are capitalistic in the sense that they are organized around private property and let markets play a major role in allocating resources.³⁹

Those who have lost faith in the merits of capitalism have done so on the basis of a false pretext. Though the outlook for the next few years seems bleak, free-market capitalism will find its way back to the hearts and minds of Americans.

Markets are the greatest engine of prosperity ever known. Harvard economist Andrei Shleifer recently published an article in the *Journal of Economic Literature* titled “The Age of Milton Friedman.” The article documents the progress of mankind over the quarter century from 1980 to 2005. “[A]s the world embraced free market policies, living standards rose sharply while life expectancy, educational attainment, and democracy improved and absolute poverty declined.”⁴⁰ Numerous other such accounts exist and support the notion that freedom and

39. 2009 FRASER INST. ANNUAL REPORT, ECONOMIC FREEDOM OF THE WORLD 25 (citation omitted).

40. Andrei Shleifer, *The Age of Milton Friedman*, 47 J. ECON. LITERATURE 123, 123 (2009).

capitalism have been the greatest anti-poverty program in the history of humankind.

If any good is to come out of the governmental expansions during the great financial crisis of 2008 and 2009, it will be the added evidence that government interference often makes crises in the financial markets worse. We will never know what might have happened had Washington stepped aside and let the strong survive and the weak perish, but our hunch is that unemployment would be much lower, the recession would have been much shorter, and the nation would be \$3 trillion less in debt.