Slouching Towards Utopia?:
An Economic History of the Long Twentieth Century

XX. The Neoliberal Turn

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20.1: Failing to Surpass a Very High Bar

The Thirty Glorious Years that had followed World War II were so good for the global economy that they made it impossible for any reversion to anything more like normal post-1870 growth to seem satisfactory. With incomes relatively equally distributed (for white guys at least), doubling in a generation, and with economic uncertainty very low with respect to either employment or prices—except on the upside—the bar was very high. It mattered that the only ideas on the menu were from the right. Really-existing socialism had proven a bust. Thus there was nothing as far as economic policy was concerned on the left side of the menu.

Governments in the 1970s failed to surpass that high bar. And when they failed to meet that bar, calls for institutional reform of the social democracy that had guided the global north from 1945 became louder and louder. And the only ideas that were deemed practical for implementation came from the right.

20.1.1: Productivity Growth Slowdown

Since 1973 output-per-worker growth as measured by standard statistics in the global north has averaged not the 3% per year of 1938-1973 but rather 1.5% per year. In long-term historical perspective this is still great: it is equal to the growth rate over 1870-1913, that "economic El Dorado" that economists after 1918 desperately wished that they could get back to. But it came after expectations had been revolutionized in an upward direction by 1945-1973. Moreover, the wedge between average and typical was larger after 1973 than before 1914. Income distribution did widen in the first Gilded Age before 1914, yes, but it did not widen by that much: while mean income growth was 1.5% per year, median income growth was 1.0% per year, at least—plus there were the enormous income gains flowing to immigrants to rich countries, then a record share of the population. Pockets of rural discontent, yes. But an urban and urbanization boom the likes of which had never before been seen.

By contrast, after 1973 median income growth was, at best, 0.5% per year as conventionally measured. Income inequality started rising, and rising rapidly, just as productivity growth slowed.

It is still not clear why in the 1970s the growth rate of output per worker in the global north slowed so much and stayed so low relative to its 3% per year of 1938-1973. In Western Europe and in Japan the easy days of post-WWII "catchup", when simply applying to production technologies already deployed in the United States yielded enormous dividends, were over. In the United States and also in Western Europe the post-WWII baby boom generation entered the workforce, and making the members of this rat-in-the-snake of the age distribution fully productive was a difficult task, and the failure to fully accomplish it was one source of drag. All over the global north attention turned to pollution control, and so a great deal of investment and socio-economic progress took the form of the public good of a cleaner environment rather than higher private incomes—and that cleaner environment was often overlooked. Plus increasing uncertainty required increasing flexibility: businesses had to make investments to enable them to operate when oil prices were high and when oil prices were low, when the value of the domestic currency was high and when the value of the domestic currency was low. And money spent increasing flexibility is not spent increasing productivity.

And then there is the argument that true economic productivity growth did not slow down at all. The mass distribution of communications, computation, and video and audio entertainment technologies would have been worth a great deal to previous generations—yet they have now become simply part of our expected background. Perhaps our standard price and income measures confuse a rise in the price of and a decline in the ability to acquire traditional indicia of stable middle-class status for a stagnation in real standards of living.

Economists still do not, after 45 years, understand the post-1973 productivity slowdown at any useful level. Nor do they truly understand the mid-1990s speedup. Nor do they understand the late-2000s renewed slowdown. But these happened. And they had a powerful influence on political economy.

Starting in 1973 people in the global north could no longer expect 3% productivity and real income growth in an average year. It became more like 1.5% and 0.5%. And people got mad. Social democracy had failed.

20.1.2: Oil Price Shocks and Export Disorder

A second economic failure of social democracy was the derangement of the oil market when Arab-Israeli wars generated solidarity among Middle-Eastern oil producers and when their organization, OPEC, realized just how strong were the monopoly market muscles that it had to flex. World oil prices were tripled in the fall of 1973.

This sent the world economy into a major recession, accompanied by rapid inflation. This pushed the world economy toward a much more energy-conserving pattern of production. This meant that a lot of people lost real incomes and jobs in ways that would not come back after the recession was over: the market was seeing signals that energy-intensive high-productivity manufacturing needed to change in an energy-efficient labor-intensive direction. And this, too, became social democracy's fault.

It is possible that the tripling of world oil prices was an intended result not of U.S. foreign policy but of Richard Nixon and Henry Kissinger action as long geopolitical cowboys. Kissinger, especially, sought to strengthen the then-Shah of Iran as a counterweight to Soviet influence in the middle east. With the oil price tripled, the shah was indeed immensely strengthened—at the price of enormous economic damage to both the industrial and the developing world. The economic repercussions of the oil price rise did come as a surprise. It is most likely that the oil price rise struck the administration as not worth its concern, and certainly as not worth trying to roll back—it did, after all, strengthen the shah, few had any conception of the economic damage it might do, and those few were not listened to by the U.S. government.

As we have noted before, Richard Nixon was somewhat Trumpian, and gathered somewhat Trumpian figures around him. Nixon administration Treasury bureaucrat Paul Volcker spoke of his boss at the Treasury Department, Nixon protege John Connolly, as someone who always favored bold action with little concern for the direction in which the bold action was taken. One of the bold actions Nixon and Connolly took was to blow up the system of pegged-but-adjustable exchange rates that had helped fuel the post-World War II trade boom.

The idea behind these "Bretton Woods" arrangements had been to preserve almost all of the benefits of fixed exchange rates in terms of making international terms of trade stable and predictable while retaining flexibility to adjust the system in response to the emergency of a major economic shift—a flexibility-in-emergencies that the classical gold standard and the gold exchange standard had lacked. The International Monetary Fund was set up to be a referee: to decide when there was a "fundamental disequilibrium" that required adjustment of exchange rates, and when countries were simply misusing their levers of domestic monetary management and needed to be told to get back in line.

The United States under Nixon did not want to get back in line. The Bretton Woods system posed an obstacle to Nixon's and Treasury Secretary John Connolly's plans in advance of the 1972 election to use price controls to reduce inflation while at the same time using expansionary monetary policy to reduce unemployment. With low tariffs and at a fixed exchange rate, the resulting trade deficit would undermine that policy.

Nixon's appointee as Chair of the Federal Reserve, Arthur Burns,"feared... with a passion" the breakdown of Bretton Woods. Paul Volcker reports an "interesting discussion with Arthur Burns" over lunch at the American embassy in Paris, at which "the Chairman of the Federal Reserve Board made one last appeal" not to break the system. Volcker reports that:

> To me, it simply seemed too late, and with some exasperation I said to him "Arthur, if you want a par value system, you better go home right away and tighten money." With a great sigh, he replied, "I would even do that…"

But he did not. At some level he did not want to joggle the elbow of his long-term political patron, Richard Nixon. At some level, he did not believe Congress would tolerate a Federal Reserve that looked like it was trying to generate another recession so soon after the recession of 1970, and he believed that the Federal Reserve needed above all to preserve its independence. But is the independence of a central bank that will not dare to cross either the executive or the legislature worth anything?

U.S. Treasury Secretary John Connolly claimed, with respect to the dollar, that "it's our currency, but it's your problem." So the Bretton Woods fixed-parity system was abandoned, and the U.S. forced the move to the current system of largely-floating exchange rates. This meant that after 1973 every decision to engage in international trade by a business—and every decision by a worker to work in an export or an import-competing industry—became a speculation on the foreign exchanges. Some economists, most prominently Milton Friedman, did not fear this: rational markets would, after all, produce stability, and foreign exchange values would fluctuate slowly, gradually, and predictably in response only to the slow change of underlying fundamental comparative advantage. Milton Friedman, I think, understood neither finance nor foreign exchange markets. Foreign exchange markets capitalize all expected future interest rate differences between countries and load that capitalized value into the current value of the exchange rate. And financial markets regularly project large and persistent movements in interest rates, and then quickly and idiosyncratically revise their projections.

20.1.3: Inflation

And then there was the inflation of the 1970s, and its cure. The 1970s were the world's only peacetime outburst of inflation in this century. The 1970s was the only era in which business enterprise and financing transactions were also "speculation[s] on the future of monetary policy", and concern about inflation was an important factors in nearly all business decisions.

At a surface level, the United States had a burst of inflation in the 1970s because no one—until Paul Volcker took office as Chairman of the Federal Reserve—in a position to make anti-inflation policy placed a sufficiently high priority on stopping inflation. Other goals took precedence: people wanted to solve the energy crisis, or maintain a high-pressure economy, or make certain that the current recession did not get any worse. As a result, policy makers throughout the 1970s were willing to run some risk of non-declining or increasing inflation in order to achieve other goals. After the fact, most such policy makers believed that they had misjudged the risks: that they would have achieved more of their goals if they had spent more of their political capital and institutional capability trying to control inflation earlier.

At a somewhat deeper level, the United States had a burst of inflation in the 1970s because economic policy makers during the 1960s dealt their successors a very bad hand. Lyndon Johnson, Arthur Okun, and William McChesney Martin left Richard Nixon, Paul McCracken, and Arthur Burns nothing but painful dilemmas with no attractive choices. Bad luck coupled with bad cards coupled with a tendency to cut corners made the lack of success at inflation control in the 1970s worse than anyone had imagined ex ante that it could be.

And, in one sense, the truest cause of the 1970s inflation was the shadow of the Great Depression. The memory left by the Depression predisposed the left and center to think that any unemployment was too much, and eliminated any mandate the Federal Reserve might have had for controlling inflation by risking unemployment. Thus the memory of the Great Depression meant that the U.S. was highly likely to suffer an inflation like the 1970s in the post-World War II period—maybe not as long, and maybe not in that particular decade, but nevertheless an inflation of recognizably the same genus.

Sooner or later in post-World War II America random variation would have led the economy to fall off of the tightrope of full employment and low inflation on the over-expansionary side. Eventually some combination of shocks would produce a macroeconomy with strong excess demand. And once that happened—given the shadow cast by the Great Depression—there was no institution with enough authority, power, and will to quickly bring inflation back down again.

But by the late 1970s, the disorders inflation had caused and the disorders for which inflation had been blamed had created a mandate to fight inflation by inducing a significant recession that a Federal Reserve chair who wished could pick up and use. Fed Chair Arthur Burns did not want to use that mandate. Jimmy Carter replaced Arthur Burns by G. William Miller; G. William Miller did not want to use that mandate. Jimmy Carter was disappointed with his Treasury Secretary, Michael Blumenthal, and, in a fit of pique, fired him—and four other cabinet members. Carter's aides told him that he couldn't just fire the Treasury Secretary without naming a replacement—it would look like he was running a disorganized white house. Because Carter was running a disorganized white house, there was no obvious replacement to name. So Carter decided to move Miller over from the Fed. Carter's aides then told him that he couldn't just leave a vacancy as Fed Chair without naming a replacement—it would look like he was running a disorganized white house. Carter than grabbed the most senior career Treasury and Federal Reserve official—New York Federal Reserve Bank President Paul Volcker—and made him Federal Reserve Chair. As best as I can determine, there was no more than a cursory inquiry into what policies Volcker believed should be followed.

He used his mandate: raise interest rates high enough and keep them high long enough to convince the economy that things were different, and that in the future inflation would stay below 5% per year indefinitely. And, while doing so, claim that he was simply exercising monetary control, and that the high level of interest rates was neither his wish nor his responsibility but simply the market reaction to the economic situation. Unemployment rose above 10%. The U.S., and the world, for the first time since the Great Depression, experienced an economic downturn for which the word "recession" seems too mild a description.

Many observers would say that the costs of the Volcker disinflation of the early 1980s were certainly worth paying. They compare the U.S. economy after 1984, an economy with relatively stable prices and—up until 2009—relatively moderate unemployment, with what they estimate to have been the likely consequence of business as usual: inflation slowly creeping upward from near ten toward twenty percent per year over the 1980s, higher unemployment as well as inflation deranged the functioning of the price mechanism.

Federal Reserve staff, especially, have to believe that that was true. For 1979-1984 was absolutely brutal interims of its macroeconomic distress.

Nevertheless, other observers believe that their ought to have been a better way: Perhaps inflation could have been brought under control more cheaply by a successful incomes policy, made up of a government-business-labor compact to restrain nominal wage growth (which certainly would have been in the AFL-CIO's interest, as it is harder to think of anything worse for that organization's long-term strength than the 1980s as they actually happened)? Perhaps inflation could have been brought under control more cheaply by a Federal Reserve that did a better job of communicating its expectations and targets? Perhaps "gradualism" rather than "shock therapy"? 1979-1984 was what it was, and that macroeconomic disaster was also laid at the feet of social democracy.

20.2: The Right-Wing Critique

The right-wing critique of social democracy as it developed in the 1970s in the global north had several parts.

20.2.1: Treating Unequals Equally

First, social democracy was flawed because it treated unequals equally. This was the Polanyian backlash problem—the fact that social democracy appeared to be unfair and unjust because it treated those who ought to be kept unequal as if they were equals. Consider University of Chicago professor and future economics Nobel Prize winner George Stigler, writing in 1962—before the Civil Rights Act, before the Voting Rights Act, before affirmative action—about "The Problem of the Negro". What, for Stigler in 1962, was "the problem of the Negro"? It was:

> the stream of demonstrations, growing in size and in insolence" that was "approved or at least tolerated by the political, intellectual, and religious leaders of the nation…

Why was this a problem? Because it taught "a semi-literate Negro teenager in a slum… that evil prejudice of the white man was the fundamental cause of his low estate”. That, Stigler wrote, “must lead to hatred, and hatred to violence, and violence to the retardation of the mounting compassion and assistance of the white man”.

There is a story that the late Johnny Cash is supposed to have told, of him giving his concert at Folsom State Prison in California, notional site of his song “Folsom Prison Blues”. “Now Mr. Cash”, said the warden, “please don’t do anything to remind the convicts that they are in prison”. “You mean they’ve forgotten?” Generally, declarations that the oppressed should not be reminded of oppression are either (a) demands by oppressors not to have their bad consciences brought to the foreground, or (b) demonstrations by oppressors that they control not just what others do but what others can say—that telling the truth is itself too revolutionary an act to be tolerated.

Stigler went on: the American negro:

> lacks a desire to improve himself… lacks a willingness to discipline himself to this end. The task… [is] to make the Negro discontented with himself…. Love of knowledge and the willingness to work hard and achieve it are the product of cultural evolution. The Negro leaders should be helping the emergence of this cultural tradition, when instead they are diverting Negro energies to better school buildings…. The Negro boy… excluded from many occupations by… prejudice. … But he is excluded from more… by his own inferiority… lacking education, lacking a tenacity of purpose, lacking a willingness to work hard…. The Negro as a neighbor… is frequently repelled and avoided by the white man… because the Negro family is, on average, a loose, morally lax, group, and brings with its presence a rapid rise in crime and vandalism. No statutes, no sermons, no demonstrations, will obtain for the Negro the liking and respect that sober virtues commend…. It is not easy or popular to place the Negro's discontent upon himself…

Social democracy encouraged people to refers themselves as equals. And that, for many, was a very unfair thing for people to do.

20.2.2: Demanding Full Employment

Second, social democracy was flawed because it led people to expect that there would be full employment, and that they could easily get a job. That meant both that workers would be insufficiently differential—that social order would suffer—and that workers would be able to demand too-high wages. The government and Federal Reserve needed to focus on price stability, and then let the unemployment rate go wherever it needed to go. Government couldn't be a "nanny state" offering everybody a bottle when they cried. Monetary policy needed to be turned over to strongly anti-inflationary policymakers—as Jimmy Carter had already, wittingly or unwittingly, turned it over to Federal Reserve chairman Paul Volcker. Soon, the right wing believed, the fact that a strong Federal Reserve chairman had been given a blank check to stop inflation would lead people to expect that inflation would be stopped. And then inflation would stop. But, they argued, if the Fed was strong enough and disciplined enough, the shaping-up could be accomplished with only a small and temporary rise in unemployment.

so they would no longer be building inflation premia into their demands for wage raises or interest payments.

20.2.3: Too-Big Government Technocratically Unsuccessful

The third flaw was that government had gotten too big and tried to do too many things. Too much of what social democracy attempted was technocratically stupid, and unsuccessful. As Reagan's future chief economist Martin Feldstein put it:

> Expansionary policies… adopted in the hope of lowering… unemployment… [produced] inflation…. Retirement benefits were increased without considering the subsequent impact on investment and saving. Regulations were imposed to protect health and safety without evaluating the reduction in productivity…. Unemployment benefits would encourage layoffs…. Welfare programs to help [the] poor… weaken family structures...

The perception that there were substantial flaws in the fabric of the social insurance state as implemented—in really-existing social democracy—was not wrong. Why, in Britain, did social democratic education policy turn out to give children of doctors and lawyers the right to go to Oxford without paying for it? The system was flawed when social democratic industry policy used the nationalized "commanding heights" of the economy not to accelerate technological progress and keep employment high, but rather to retard the shift of labor out of "sunset" industries.

20.2.4: Electing Reagan and Thatcher

Perhaps social democracy might have muddled through. But union-side wage demands in Britain and strikes—especially public-sector strikes—pushed the center of the electorate toward thinking that union power needed to be curbed, and only the Conservatives could do so. The Volcker disinflation raised unemployment throughout the North Atlantic: social democracy could not even keep its own commitment to full employment. And then the Carter administration attempt to rescue American diplomatic hostages from Iran failed. And then the Argentine generals decided that they could win popularity by conquering the Falkland Islands from Britain, and Margaret Thatcher responded by winning a splendid little war. Reagan and Thatcher were in power for much of the 1980s

20.3: Hard Neoliberals in Power

20.4.1: Unsuccessful Domestic Policies of Right-Wing Governments in the 1980s

They sought to reduce the size of the government.

The chosen instrument to use to enforce a reduction in the size of the government was a tax cut. Tax cuts are always popular.

A new tax cut enacted by a new president would be very popular and, politicians and strategists calculated, would greatly weaken opposition to subsequent spending cuts: for the alternative proposed by those who wished to maintain spending would then necessarily include large budget deficits as a consequence.

Moreover the tax cut would have the added benefit of tilting the distribution of income in favor of the rich. Social democracy's problem was that it did not treat unequals sufficiently unequally. Industry should be rewarded, and sloth punished. The rich were industrious. Moreover, the rich saved and invested, thus enriching everyone in the future. The third principle, therefore, was to tilt the distribution of income in favor of the rich by cutting their taxes most.

Yet things did not work out well.

For one thing, in the short run of the early 1980's, the Reagan administration planned a massive buildup of the armed forces, and thus an expansion-not a contraction-of the size of the government. For another, there was a great unwillingness on the part of both Reagan and Thatcher to identify in advance which programs and subsidies would be cut in the shrinking of the government that the administration to be had planned. To reduce anxiety, politicians looked benignly on and encouraged the growth of the story that no spending cuts at all would be required: the tax cut alone and the lifting of the hand of regulation from the economy would create such a spur of economic growth that even domestic programs could be expanded, not contracted.

No one with a quantitative grasp of the government's budget and its pattern of change ever meant this story to be taken seriously. But administration makers welcomed its dissemination. Policy elites assured each other that their candidate would say a lot of silly things before the election, but that the candidate and his principal advisors understood the important issue. Tax cuts were to be followed by a ruthless attack against "weak claims" on the federal budget: programs like farm subsidies, subsidized student loans for the relatively rich, the exemption from taxation of social security income, the subsidization of the southwest's water projects, and so forth would themselves be slashed in order to balance the budget after the tax cut. "Weak claimants"-people for whom government subsidies and assistance truly served as a "safety net"-would be protected, while "weak claims" would be reduced.

But too many of the Reagan administration's allies and supporters claimed, after the election, that they had taken this story seriously. They would not support spending cuts, for they were the "weak claimants" whose subsidies and programs were to be targeted for reduction. These two factors-the expansion of the military budget and the claim by key legislators and influence peddlers that the Republican trip they had purchased was not for a tax cut and spending cut, but just for a tax cut-left the United States with large and only gradually controlled budget deficits throughout the 1980's. Previous decades had seen one or perhaps two years of large budget deficits in recessions. Previously, large budget deficits had been seen only in years of deep recession. But the 1980's saw budget deficits, very large by the standards of the post-World War II era, persist throughout years of prosperity and low unemployment as well.

Large budget deficits threatened to become a drag on the American economy. Funds saved might not now be invested-they might be borrowed by the government and used for current spending. The large budget deficits of the 1980s reduced the rate at which the United States' capital stock grew. They reduced economic growth by half a percentage or so.

This was bitter for those who had worked very hard to elect a Republican administration because they thought that Democratic administrations were pursuing policies that reduced investment in and thus impoverished America's future because"the long-run benefits" of investment "apparently lie beyond the political horizon"-beyond, that is, the Democrats' political horizon. They had hoped to elect an administration committed to increasing savings and investment-to lowering taxes on those who did save and invest-in order to empower America's future. Yet the Reagan deficits threatened to be an order of magnitude more destructive of America's economic future than any of the inflationary, redistributive, or regulatory policies pushed by Democrats had been.

The deficits also did,substantial indirect harm: for more than half of the 1980's the U.S. dollar was substantially overvalued as the U.S. budget deficit sucked in capital from outside and raised the exchange rate. When a domestic industry's costs are greater than the prices at which foreign firms can sell, the market is sending the domestic industry a signal that it should shrink: foreigners are producing with more relative efficiently, and the resources used in the domestic industry should be transferred to some sector where domestic producers have more of a comparative advantage.

This was the signal that the market system sent to all U.S. manufacturing industries in the 1980's: that they should cut back on investment and shrink. In this case, it was a false signal, sent not by the market's interpretation of the logic of comparative advantage but by the extraordinary short-run demand of cash to borrow from the U.S. government. But firms responded to this signal even so. The U.S. sectors producing tradeable goods shrank. And some of the ground lost would never be recovered.

Ultimately, the Reagan tax cuts hammered manufacturing in the Midwest, creating what is now known as the “Rust Belt.” As it happened, this is precisely what my old teacher Martin Feldstein had warned about when he had argued against the deficits and for standby tax increases from his position inside the Reagan administration,. It made him very unpopular among a certain generation of Republican apparatchiks.

The productivity growth slowdown was not reversed during the 1980s. The size of the government relative to the economy was not improved. The technocratic quality of public regulation was not raised. The distribution of income was, however, set on a trend of sharply increasing inequality.

20.3.2: The Return of the Financial Crisis Business Cycle

And the business cycle returned.

As the 1980s turned into the 1990s, it became increasingly clear that serious dangers were produced by the freedom of international trade and international investment that had followed the collapse of Bretton Woods in the 1970s and the rollback of regulation in the 1980s. The 1980s saw one major international financial crisis: the third world debt crisis that followed 1982. The 1990s saw three major international financial crises happen one after the other, approximately 2.5 years apart: the collapse of the European Monetary System in 1992, the Mexican peso crisis of 1994-1995, the East Asian financial crisis of 1997-1998, and all that have followed since.

The reaction to the first such crisis—the debt crisis that followed 1982—was that it had been due to borrower fecklessness. Borrowers in the third world had willingly borrowed large sums at relatively low floating interest rates, thus taking on themselves and their countries the risk that monetary policy might tighten and the prices of their exports fall. The prices of their exports fell, and monetary policy worldwide was tightened as a result of Paul Volcker's decision to fight inflation first, a decision echoed by other industrial-core central banks. Much of the borrowed money turned out to have been used not for productive investment but to finance government deficits, or support elite consumption.

The second financial crisis, the collapse of the western European system of fixed exchange rates in 1992, also provoked few thoughts of systemic failure. The conservative government of Britain—and governments of other countries that had effectively pegged their currency to the deutschmark—had claimed that their commitment to their exchange rate peg was near-absolute: that they would accept a considerable domestic recession rather than abandon the peg.

When conflict between the German government and the Bundesbank over the financing of the absorption of East Germany into West Germany led to a substantial rise in interest rates, the governments of Italy, Britain, Sweden, and others were faced with the choice between severe domestic recession and abandoning their peg to the mark. Markets judged the commitment to the peg incredible and unbelievable, and placed heavy one-way bets on devaluation. And markets were right. And so the pattern was set

Yet, somehow, the belief that there needed to be institutional reforms to keep financial disorder from deranging the global economy did not gain purchase. And so pressures that would lead to the near-repeat of the Great Depression in 2008-2010 built.

20.3.3: False Idols

The root problem was that the world just did not seem to work as those advocating for the neoliberal term had confidently expected.

Back in 1979, a year before Reagan's eledtion, Milton and Rose Director Friedman's wrote their classic *Free to Choose: A Personal Statement* trying to set out and justify their brand of small-government libertarianism. In the book, they made three powerful factual claims—claims that seemed true or maybe true or at least arguably true at the time, but that now seem to be pretty clearly false. And their case for small-government libertarianism rested largely on those claims.

The first claim was that macroeconomic distress is caused by the government, not by the unstable private market. The form of macroeconomic regulation required to produce economic stability is straightforward and easily achieved, and it is only because the government tries to do too much that we have large business cycles. The second claim was that externalities were relatively small, or at least that they were better dealt with via contract and tort law than through government regulation. The third, and most important, claim was that, in the absence of government-mandated discrimination, the market economy would produce a sufficiently egalitarian distribution of income. The Friedmans argued that a minimal safety net for those whom bad luck or a lack of prudence had rendered destitute, and elimination of all legal barriers to equality of opportunity, would lead to a more equitable outcome than would social-democratic monkeying with taxes and subsidies, because those would fall prey to rent-seekers with power and wealth.

Alas, it turned out to be wrong. Ben Bernanke during the Great Recession followed the Friedmans' playback for how a government should manage the business cycle to the letter, and the Great Recession still came. Whatever you think of the role of externalities in the economy of the 1970s, in the high-tech information-age write-once run-everywhere economy of the 1990s, externalities are omnipresent. And the

Second Gilded Age demonstrates that slimming government and regulation can produce an astonishingly unequal distribution of income and wealth.

20.3.4: Neoliberalism in the Global Periphery

One big benefit of the neoliberal turn for the world's poor economies was that slimming-down the state and opening up the world economy to finance was supposed to make it easier for poor economies to rais the capital needed to relax binding growth constraints. That, indeed, was a reason why so many of those working in economic development were willing in the 1990s to make the neoliberal bet: international capital mobility would come to the rescue by relaxing capital constraints where they were binding, and by reducing the scope for corruption and rent-seeking, which was often a more significant binding growth constraint. The hope was that, like the pre-1913 era of British overseas investment, which financed a huge amount of industrialization in the resource-rich, temperate periphery of the world economy, net capital outflows from the industrial core would finance much late twentieth and twenty-first century industrialization.

But that was not the outcome: while international capital flows soared after 1980, the large net flow of capital from rich to poor countries simply never materialized. In fact, the principal outcome was an enormous flow of capital from the periphery to the rich core. For most of the past generation, and looking into the future, the message of the market is that the benefits of international capital mobility do not include a relaxation of the capital constraint, and thus an acceleration of growth in the global periphery.

The reason is that investments in the global north economic core—especially the United States —offer a form of protection for capital against unanticipated political disturbances.

20.4: The Neoliberal Turn

20.4.1: The Persistence of Neoliberalism

The story as I have told it is of a social-democratic system of governance that ran into bad luck in the 1970s, as its flaws and chance led it to lose support, in part because of a very high bar. The right-wingers then got their chance. But their policies were no more successful—save in reducing inflation. Rapid growth did not resume. Indeed, median incomes performed significantly worse under Reagan and Thatcher, as what productivity growth there was was funneled into the pockets of the rich, and a Second Gilded Age drew near.

Yet even though the policies of rolling back social democracy had not surpassed the high bar—or even a low bar—the neoliberal turn became accepted, conventional wisdom. It was not that policies became "neoliberal" everywhere. But that was where the energy was. Social democracy was under pressure. Market was preferred to government. Hard incentives were preferred to more lavish benefits. The need for fiscal balance always required spending austerity (but rarely required higher taxes). It was not Ronald Reagan but Bill Clinton who announced, in one of his state of the union speeches, that "the era of big government is over". It was not Margaret Thatcher but Barack Obama who called for austerity when the unemployment rate was above 9%: "Families across the country are tightening their belts and making tough decisions. The federal government should do the same".

What gives?

After World War II, there had been high and largely justified hopes for social democracy both in the global north and the global south. Strong redistributive social insurance states would severely reduce the income and wealth inequalities that had been characteristic of Bismarckian Germany or the Gilded Age United States. Public investment would build physical infrastructure, spend money like water on education, and use Keynesian policies to make sure that growth was free of the recessions and depressions that had characterized the 1800s and the first half of the 1900s.

But everything had not gone according to plan. Nationalization of the monopolistic commanding heights of the economy did not go well. Nationalize of more went badly. The nationalized commanding heights of the economy turned out more often than not to become employment bureaus for the politically well-connected: under Juan Peron in Argentina the number of employees of the (newly nationalized) Argentinian railroad system close to tripled, while the number of trains and the volume of goods carried fell. The state was simply not very good as a bank, or as a stock exchange, or as a nursery for inefficient enterprises.

Milton Friedman-style neoliberals had tried to draw a line. They argued that you needed government, but not all that much government. The government needed to guarantee full employment (and low inflation) via activist monetary policy. But, they go on, attempts by the government to do more than simply maintain full employment and price stability would inevitably come to grief. Government policies would be turned to enrich the politically powerful rather than to enhance social welfare, and so almost always do more harm than good. (Why he thought that activist monetary policy was different—-why Milton Friedman believed government could be successful there while it could not be successful anywhere else—-was never something that he could explain very well.)

Hence the first meaning of neoliberalism: at the margin, get the state's nose out of the economy as much as possible. When the state is neither an instrument of positive redistribution nor an instrument of growth-boosting investment, its interventions in the economy are likely to go awry. Reducing such—substituting market means for public means to attain social-democratic ends where market means would be effective—seems and seemed worth trying.

And there was supposed to be a second meaning of neoliberalism: use the government where the government works: North America, northern Europe, southern Europe, and East Asia provide powerful examples of government interventions and policies that appear to be powerful boosters of growth: the centrality of education (especially female secondary education) in accelerating the demographic transition, the importance of making it easy for domestic producers to acquire industrial core technology (embodied in capital goods or not), administrative simplicity and transparency, transportation and communications infrastructure that only the government can provide.

Public investment plus market support were supposed to attract a broad center to a durable governing coalition. Call that "left-neoliberalism".

But there was also a third meaning: "right-neoliberalism", preached by the revived and restored classical liberals, via the Mont Pelerin society and a plutocrat-funded network of astroturf interest groups and think tanks. The claim that social democracy was one huge mistake–that it created a North Atlantic of takers who mooched off the makers. It held that if we got rid of social democracy, we would have a utopia because the makers wouldn't have to carry the takers on their backs and the takers would shape up–or if the takers did not shape up, serve them right! The moochers would then wallow in their much deserved squalor and misery. And the makers would not have to, as they do now, suffer the pain of watching the moochers live tolerable lives.

Within the neoliberal community, the argument for the left- rather than the right0=-wing version was that neoliberalism needed to support rather than replace social democracy, because social democracy was the only political system that could in the long run stably underpin a market economy that preserves a space for private property and private enterprise. Therefore the right had better shut up and try to make social democracy work, or else. But what if the right were to go into dismantle-social-democracy mode. And once the right was committed to dismantling social democracy, the ability to construct and maintain the proper regulations needed to make market mechanisms tools to achieve social democratic ends fell apart as well.

20.4.2: A Second Gilded Age

Inside the economies and polities of the global north, the neoliberal turn had one major effect: it brought on a Second Gilded Age.

It did also shift the balance of biases in the government. Perhaps under social democracy before 1980 there had been a bias toward extending the government when equities were balanced, and a bias toward command-and-control mechanisms. Certainly after 1980 there was a balance toward tax cuts—and hence toward expanded government deficits and reduced investment in the future—a bias toward market mechanisms, and a bias toward allowing monopoly to grow and entrench itself. Whether this was a net plus or minus is hard to say with any confidence out of any source other than one's prior political beliefs. Certainly it meant that government had fewer resources when challenges did arise, and that mobilizing government to cope with new problems was next to impossible. Would a Second Marshall Plan have been a good thing to launch in 1990 in the aftermath of the collapse or really-existing socialism? Probably. But the neoliberal air made it impossible to contemplate. Should government have taken on a powerful role in prepping to fight global warming starting in 1990? Yes—but it never happened, for Reagan had declared that "the government was the problem".

The rise in inequality, however, was powerful and long-lasting.

French economist Thomas Piketty popularized the striking differences between how the economy in the global north had functioned in the Gilded Age that preceded World War I, and how it had functioned the decades following World War II. In the First Gilded Age, wealth was predominantly inherited, the rich dominated politics, and economic (as well as race and gender) inequality was extreme. After the upheaval of WWII, everything had changed. Income growth accelerated, wealth was predominantly earned (justly or unjustly), politics became dominated by the middle class, and economic inequality was modest (even if race and gender equality remained a long way off). The West seemed to have entered a new era. And then things shifted back.

Piketty's central point was that we shouldn't have been surprised by this. In a capitalist economy it is normal for a large proportion of the wealth to be inherited. It is normal for its distribution to be highly unequal. It is normal for a plutocratic elite, once it has formed, to use its political power to shape the economy in a way that enables its members to capture a large chunk of a society's income. And it is normal for this to put a drag on economic growth. Rapid growth like 1945-1973, after all, requires creative destruction; and, because what would be destroyed would be the plutocrats' wealth, they are unlikely to encourage it.

And as inequality grew, the American economy became financialized. The post-WWII social-democratic age had seen finance consume about 3% of America's national income in order to carry out its intermediary role. But today, at the height of the Second Gilded Age, that percentage is more like 8%. Is the U.S. getting good value from the extra 5% of national income now going into the pockets of financiers? It seems unlikely. At a typical 5% annual real interest rate for risky cash flows, diverting that large a share of resources away from goods and services directly useful this year is a good bargain only if it boosts overall annual economic growth by 0.3%—or 6% per 25-year generation. But there are no signs that the US economy today would be 6% less productive if it had had the finance-insurance system of 1950. A well-functioning financial system provides insurance by diversifying and thus dissipating some risks, and otherwises matching those who fear risk with those who can comfortably bear it; matches large, illiquid investment projects with the relatively small pools of money contributed by individual savers; improves opportunities to borrow and lend to allow one to spend more when one is poor and save more when one is rich; improves the ease of transactions; and improves corporate governance. The ease of transactions is greatly improved in ou current financial system relative to the past. But the rest?

Why has the devotion of a great deal of skill and enterprise to finance and insurance sector not paid obvious economic dividends? There are two sustainable ways to make money in finance: find people with risks that need to be carried and match them with people with unused risk-bearing capacity, or find people with such risks and match them with people who are clueless but who have money. It seems likely that most of the growth in finance stems from a rising share of financial professionals who undertake the latter

One consequence in America of the coming of the Second Gilded Age was that, when the Great Recession came along, and when recovery from the Great Recession was delayed and hesitant, the government and the political system barely seemed to care. A good part of the reason was that the rich dominated public discourse to an extent that they had not in previous decades. And, with the growing inequality of the Second Gilded Age, for the rich there was no crisis. Those who fell into the top strata regarded themselves as doing well in the US economy of the early 2010s. And indeed they were.

But, for everyone else—roughly 90% of the US population—there has been no jump in income share relative to ten or 20 years ago to offset what now looks to be a permanent lost decade. On the contrary, the bottom 90% has continued to lose ground.

With the increased turn in America toward animosity on the political right toward people who are not white or whose grandparents were not born in the United States, it is conventional in many circles to make fun of those who blame the Tea Party of the early 2010s and the current state of American conservatism on "economic anxiety". This is, I think, short-sighted. For many people the economy since 2007 has proved gravely disappointing. And they seek an explanation, and something to change. That they lack onto weaknesses in their own upbringing and irrationality in their thinking does not mean that they have not been disturbed by something very real.

20.4.3: Stalling Growth in the World Economy's Periphery

Consider the North American Free Trade Agreement (NAFTA).. The key argument in favor of NAFTA had been that it was the most promising road the United States could take to raise the chances for Mexico to become democratic and prosperous, and that the US had both a strong selfish interest and a strong neighborly duty to try to help Mexico develop. Since NAFTA, Mexican real GDP has grown at 3.6% per year, and exports have boomed, going from a tenth of GDP in 1990 and a sixth of GDP in 1999 to a third of GDP today.

It is here—in the rapid development of export industries and the dramatic rise in export volumes—that NAFTA made the difference. NAFTA guarantees Mexican producers tariff and quota-free access to the US market, the largest consumer market in the world. Without this guarantee, fewer would have invested in the capacity to satisfy the US market. Increasing trade between the US and Mexico moves both countries toward a greater degree of specialization and a finer division of labor in important industries like autos, where labor-intensive portions are increasingly accomplished in Mexico, and textiles, where high-tech spinning and weaving is increasingly done in the US, while Mexico carries out lower-tech cutting and sewing.

Such efficiency gains from increasing the extent of the market and promoting specialization should have produced rapid growth in Mexican productivity. The key word here is “should.” Today’s 100 million Mexicans have real incomes of roughly $10,000 per year. The 3.6% rate of growth of GDP, coupled with a 2.5% per year rate of population and increase, means that Mexicans’ mean income is barely 15% above that of the pre-NAFTA days. Even successful neo-liberal policies have not delivered the rapid increases in productivity and working-class wages that neo-liberals like me would have confidently predicted had we been told back in 1995 that Mexican exports would multiply five-fold in the next twelve years.

We neoliberals point out that NAFTA did not cause poor infrastructure, high crime, and official corruption. We thus implicitly suggest that Mexicans would be far wose off today without NAFTA and its effects weighing in on the positive side of the scale. Having witnessed Mexico’s slow growth over the past 25 years, we can no longer repeat the old mantra that the neoliberal road of NAFTA and associated reforms is clearly and obviously the right one.

Mexico is not alone here: In the 1990s Argentina implemented perhaps 80% of the neoliberal economic policy agenda. It opened up its economy to world trade and international capital; it sought to guarantee low inflation and sound money. It strove to improve its legal system so that decisions would accord with general rules and foster confidence that contracts would be enforced--whether or not a bribe had been paid.

It failed. It continues to fail today.

The neoliberal establishment view was, and in some quarters remains, that neoliberalism did not fail but was failed: that Argentina's recurrent collapses are the fault of its politicians. I half-agree with this view. Argentine leaders have been repeatedly warned of the dangers of foreign borrowing, especially in dollars. But the problem is that world financial markets—structured and regulated in a highly neoliberal way—keep offering Argentinian governments ample credits at what appear at the time very favorable terms.

Argentina’s tragedy is that the country's political system has long performed in a predictable way, consistently producing governments that promise more than they can deliver. They promise rich oligarchs that they will not collect much in taxes. They promise workers and consumers generous social insurance. They promise rapid economic development, generous infrastructure spending, cushy low-work jobs for the politically connected, and so forth. Taken together, these promises mean that claims on national product always exceed 100% of the total. The basic political fight about how wealth should be distributed in Argentina remains unresolved.

Thus neoliberalism is not helping. Yes, Argentina's governments repeatedly make huge mistakes; its politicians sin against the gods of monetary economics. But did why does punishment need to be so swift and so severe?