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Capitalism: The Remix

By Sebastian Mallaby
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The nastier this recession gets, the more people will talk about the discrediting of markets and the failure of deregulation. So the next time the Dow dives off a cliff, splash your face with ice water and remember two things: This end-of-capitalism talk is bunk, and it distracts us from the debate we should be having. The real question is how to manage the necessary shift in the balance of our mixed economy. Outlandish though it may sound now, red-blooded capitalism must be part of the answer.

Even before the financial crisis, government was expanding. Public spending as a share of the economy jumped under President Bush, and regulation increased, too, notably in the form of the Sarbanes-Oxley law on corporate financial disclosure. Commentators trumpeting the abrupt death of free-market, small-government Republicanism appear to have slept through the Bush years.

Yes, the financial crisis has triggered an added surge in government. But this has happened in every recession since 1980 and does not represent an intellectual U-turn. Mainstream economists have always been pro-market, but they have also always recognized numerous qualifications and exceptions. The crisis has triggered two important ones.

The first is that, in an acute recession, government spending has to expand aggressively to make up for weak private spending. As a top adviser to Bill Clinton in the 1990s, Larry Summers supported reducing the deficit; as a top adviser to Barack Obama now, Summers supports massive deficit spending. This is not a flip-flop. Summers favors crisis spending now because we are in a crisis. In five years, he will again preach budget discipline. There is no paradox, no tarnished ideology.

The second economists' exception is that the financial sector is special. If a big financial institution goes bust, it threatens to sink others; if large parts of the financial sector get clogged, the entire economy goes down with them. Because financial-sector failures can hurt millions of ordinary people, banks will usually be rescued when they get into trouble; because the banks will be rescued, regulators should prevent them from taking excessive risks for which taxpayers end up paying. For decades we have had federal banking oversight, federal deposit insurance and federal bank rescues. No intellectual revolution is implied by the recent bailouts.

The point is that we have long been living in a mixed economy. Government is growing, but the shift is of degree, not kind. Moreover, there's no plausible escape from this trajectory. For now, government needs to stimulate the economy, but even after the recession ends, there will still be pressure for more government spending. People rightly want the things that government produces: security (from criminals and terrorists), clean air and water, food and medicine whose safety is guaranteed by regulators, public education, and so on. As society grows more prosperous, such public goods probably matter more than private ones such as DVDs or fancier vacations, so the share of government spending in the economy tends to rise.

Conservatives want to deal with this trend toward larger government by pretending we can reverse it, but that is unlikely to happen. Liberals want to celebrate the collapse of "free-market ideology," but free markets do a lot of jobs better than government. What we should do is embrace growing government but also be ruthless about making government and markets more efficient. If your private-sector engine is shrinking relative to your public-sector vehicle, you need to root out every design flaw that threatens to slow you down.

This points to a broad reform agenda. Government can be rendered more efficient by cutting out unneeded spending, as Obama suggested when he announced his choice for budget chief. It can also be improved via competitive procurement of government services, which argues for school vouchers and a cleanup of the defense-purchasing practices that allow lobbyists to skew outcomes. Social Security and Medicare must be revisited. A government that faces legitimate pressure to grow can't afford big retirement benefits for people who are too young or too wealthy to need them. Nor can it tolerate a situation in which, after adjusting for variations in demographics and labor costs, some states spend twice as much on health benefits per retiree as other states find adequate.

Market reengineering is also in order. The government should stop distorting markets by subsidizing housing finance through Fannie Mae and Freddie Mac, clinging to trade barriers, or offering tax deductions that encourage overspending on homes and health care. The tort system, an outrageously wasteful way to compensate victims and discipline firms, should be reformed. And, given the object lesson from the collapse of the Big Three carmakers, government should think carefully before empowering labor unions further.

The growth of U.S. government need not be an economic disaster. Sweden and Denmark combine large public sectors with fast growth in GDP per capita. But to get away with big government, you must have smart government. Once the financial crisis is behind us, this should be the guiding principle of the Obama years.

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