book club synopsis

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Balance: The Economics of Great Powers from Ancient Rome to Modern America

Glenn Hubbard & Tim Kane

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As the fate of business becomes even more intertwined with that of government, understanding how and why world powers ascend and decline is critical. In *Balance*, authors Glenn Hubbard and Tim Kane examine the rise and fall of Great Powers, evaluating the economic and political circumstances that contributed to each empire's decline. By looking carefully at the past, Hubbard and Kane offer insight into the future and what can be done to affect it.

About authors

Glenn Hubbard is the dean of Columbia University's Graduate School of Business and the former chairman of the President's Council of Economic Advisers. In addition, he served as deputy assistant secretary at the U.S. Department of Treasury from 1991 to 1993. Hubbard is a frequent contributor to BusinessWeek, The Wall Street Journal, and The New York Times, as well as PBS' The Nightly Business Report and American Public Media's Marketplace.

Tim Kane is the chief economist of the Hudson Institute. He has twice been a member of the Joint Economic Committee of the U.S. Congress and served as an intelligence officer in the U.S. Air Force from 1990 to 1995. Kane regularly writes for The Atlantic, The New York Times, The Los Angeles Times and USA TODAY.

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chapter one:

introduction:

Balance: The Economics of Great Powers from Ancient Rome to Modern America offers a sweeping analysis of why "Great Powers" have declined. Examining history through an economic lens, Glenn Hubbard, dean of Columbia University's Graduate School of Business and former chairman of President George W. Bush's Council of Economic Advisers, and Tim Kane, chief economist of the conservative Hudson Institute in Washington, D.C., write "not about empire, but about economic data and the hard facts of Great Powers in human history."

Paul Kennedy's *The Rise and Fall of the Great Power*s is the jumping off point for *Balance*. Kennedy's work introduced readers to the "insight that relative economic strength was the main foundation for military and diplomatic forces that dominate most traditional narratives." The explosion of unparalleled historical data in recent years gives Hubbard and Kane the means to re-examine Kennedy's work and its subjects, adding a new way to measure economic power. Rather than examine how vibrant societies grow, *Balance* focuses on how they become politically and economically stagnant.

Understanding Great Power imbalance and decline: In this chapter and subsequent ones, the authors state some key points that they will return to time and again.

- Military defeat is a capstone on the decline of Great Powers, but history errs in confusing symptom with cause.
- Economic imbalance within a country is critical to its unraveling.
- Imperial overstretch or external threats are not the problem.

- Overcentralization of political power is a common factor in imperial decline, usually a century or more after the centralization is enacted.
- Empires and nations often lose their balance without understanding the tectonic economic forces in motion.
- Political institutions are often too slow to adapt to changing economic reality.

How decline happens:

- In each case of Great Power decline, the rulers did what seemed to make sense in the short term but was often hostile to long-term growth.
- America could change the rules of the budgetary game through a fiscal amendment to the Constitution.
- The paradox of a great democracy in decline is that the voters want their benefits but do not want to pay higher taxes.
- There is overconfidence that modern Western democracies are different and thus immune to the fates of past empires.
- Great Power decline almost always follows a template: denial of the internal nature of stagnation, centralization of power, and shortchanging of the future to overspend in the present.

***Balance's* road map:** The opening chapters of the book describe the authors' theory of Great Power decline. The book then features eight case-study chapters.

Hubbard and Kane "hope to show that the economic crisis at the beginning of the 21st century is much more significant than most people realize. It is also slower moving, making it more dangerous. The whole world system is brittle, with demographics and debt compounding the risks. We should all recognize that when Great Powers declined, rarely were they replaced by challengers. Rome fell, and the world went dark for a thousand years. The big question facing America and the Great Powers of our generation is whether we can learn from a newer, richer, more economic history in time."

chapter two:

the economics of great power

How do you determine what is a Great Power and how do you measure its rise and fall? Hubbard and Kane question whether decline is inevitable, and if the notion of the so-called "barbarian at the gates" is helpful. They explore from a historical and contemporary perspective how wealth and growth are measured, focusing on the economic measures such as GDP, the Penn World Tables and historical accounting that can be used to examine societies. They then put forward an algorithm that computes economic power using hard data and offer their economic power worldview.

The authors note: "We do not believe that Great Power imbalance … is inevitable. Although the ominous pattern of Great Power imbalance follows from institutional decline, it must also be said that many, many times in history empires and nations did reform their institutions."

The influence of Paul Kennedy's *The Rise and Fall of the Great Powers* (1988): Declinism—the tendency of the public to see rivals abroad and failure within—has a long pedigree. It's taken many forms: the Cold War specter of the Soviet Union, Japanophobia in the 1980s and, most recently, China.

- Kennedy encouraged readers to think about history in economic terms, looking at the rise of the Western world, Ming China, the powerful Muslim world of the 1500s and then the roots of the Renaissance, Reformation and the Industrial Revolution.

- The book's greatest contribution may have been its emphasis on long-term, relative economic power. Kennedy observes that "the historical record suggests that there is a very clear connection in the long run between an individual Great Power's economic rise and fall and its growth and decline as an important military power (or world empire). This flows from two related facts: That economic resources are necessary to support a large-scale military establishment, and that both wealth and power are always relative and should be seen as such."
- Kennedy pushed readers to think about relative economic strength as a great power's foundation. The authors disagree, however, with many of Kennedy's conclusions as he failed to understand every dimension of economics; they question his prediction of a new balance of power among nations and his assertion that America's military expenditures have come at the expense of economic vitality.
- Kennedy maintains that imperial overstretch is a cause of decline as states face a trade-off between security expenditures and economic investment. Hubbard and Kane question this point throughout their case studies.
- Declinist narratives keep fear alive as they posit an antagonist or bogeyman that is in conflict with a particular country or economic model and predict a clash between the two. What they don't do is measure economic power correctly.
- Kennedy does not try to explain the rise and fall of Great Powers with a rigorous model that can interpret the clash of institutions, civilizations and cultures.

What is the wealth of a nation? A look at measurements

- Englishman William Petty's *Political Arithmetick* used "numbers, weights, and measure" to prove that England was not suffering economic decline in the late 1600s. He argued that the Netherlands, with a merchant fleet nine times greater than the French but a population one-tenth the size, was more powerful than France and superior in foreign trade, foreign assets, labor specialization and urbanization.

- Adam Smith's landmark *An Inquiry into the Nature and Causes of the Wealth of Nations* notes that wealth is really the stream of goods and services that it creates.
- The notion of GDP did not exist until well into the 20th century, with GNP following in the 1940s.

Microscopes and telescopes: "If we think of the idea of gross domestic product as an economic microscope—offering a profoundly detailed view of living, breathing economies—what then is the telescope that lets us look back in time?" ask Hubbard and Kane. The telescope they use is historical GDP data, which they use to calculate growth rates for countries, correcting for fluctuating prices or inflation. This provides a picture of real economic growth. Using this macro measurement we can see the world—past and present—with greater clarity. The authors rely on two data sources:

- Penn World Table (PWT): This is an enormous database of benchmark comparisons that compiles data on 189 countries and territories across six decades (to 2010). With the PWT the economist can examine comparative global development.
- Historical accounting: Economist Angus Maddison's *The World Economy* allows for the comparative technique back to A.D. 0 and has detailed accounts of population dynamics, trade and GDP per capita.

Thinking about growth: "Institutions are the foundation for growth," write Hubbard and Kane, "a claim that is … small in the sense that it isn't all that controversial. Everyone agrees that a society's economic institutions—property rights, work rules, market freedom—are one of the main factors that define relative prosperity and growth. Our claim is big, however, saying that it is 100% of the explanation." In Hubbard and Kane's model of growth there are three pillars:

- Commercial expansion, such as trade routes
- Investment, which diverts income away from consumption and toward durable equipment that enhances output
- Innovative growth, sometimes referred to as technology and at other times as "ideas"

Focusing on growth, however, can be misleading. Media coverage of China in recent years has focused on growth rates without enough attention being paid to the fact that China's GDP is one-fifth of the U.S. level. According to Hubbard and Kane: "Growth is the modern yardstick of international economics … but it needs to be combined with other metrics to have meaning. … Our public dialogue would be enhanced if the global economic conversation included GDP, productivity, and growth."

How to measure economic power: Hubbard and Kane have come up with their own formula: "The measure of one country's economic power at a moment in time should be a combination of its GDP, GDP growth, and GDP per capita (which reflect technological prowess)."

$$\text{Economic Power} = \text{GDP} \times \text{Productivity} \times \text{Growth}\sqrt{} 1/2$$

An economic power worldview: The authors assert that they are "applying the worldview to grand strategy—to show that the challenge of relative great power is not rising adversaries competing over scarce resources. Nor is the danger that the leading power overstretches itself, or misallocates its energies between military expenditure and economic investment." They reject those ideas, noting, "History shows instead that Great Powers lost their leadership role when they stop pushing at the technological frontier."

- A state's military power derives from its economic productivity.
- Economic power is important relative to contemporary nations.
- Great Power decline is fundamentally economic in nature.
- Economic decline is a consequence of stagnant institutions, primarily a political system biased toward status quo inaction.
- Imperial overstretch is not a cause of decline; economies become unbalanced in many ways. Excessive military expenditure is one, but there are many examples of thriving economies coincident with wars and large militaries.

chapter three:

economic behavior and institutions

As Hubbard and Kane scan world history through their economic lens, they also emphasize how behavior and attitudes have as much impact on the imbalance of nations as the hard accounting of economic power. Economists must think about the messy, emotional behaviors of human beings.

Game theory in microeconomics and expectations theory in macroeconomics have led to a fundamental shift in how economists think. An elegant theory with mathematical neatness can no longer stand on its own as a way to understand economics. "The behavior of the real world, measured using empirical data, is essential to any policy," observe the authors. "As any football or basketball coach can tell you, players learn more in five minutes of a real game than an hour of chalk talk."

This chapter introduces some behavioral economic terms and establishes a behavioral template of Great Power imbalance that the authors refer to in the case studies that follow.

How do people really behave? Some key ideas of behavioral economics:

- Humans will settle for what is good, not necessarily what is best.
- Bounded rationality influences individual actions: When making decisions, the rationality of individuals is limited by the information they have, the cognitive limitations of their minds and the time they have to make the decision.

- People make decisions that are satisfying. Individuals will make a choice that is good enough within the constraints of time and place, leaving most humans happy with the outcomes.
- Herding (the tendency of humans to follow the crowd when they do not have time to consider a decision thoughtfully) comes into play in actions and decision-making.
- The endowment effect influences behavior as individuals assign significant additional value to goods and ideas the moment they claim possession over them.
- Heuristics (logical, decision-making shortcuts) shape behavior. Hubbard and Kane observe that these "include looking to past experience, modeling the behaviors and decisions of our peers, and relying on gut reactions and emotion to inform our choices."
- Ignorance is the ultimate bind for people, leaders and empires: "The profound boundaries of economic rationality afflict every Great Power in the face of decline for the simple reason that they rarely know what ails their economy."

National vision and division:

- Global elites today recognize that no nation is guaranteed its relative status in the world—it cannot be assumed to be permanently backward or advanced. Every nation has to mind its institutions if it hopes to develop.
- Norms are important and powerful sources of motivation for the individual.
- Identity behavior is relevant to the rise and fall of great powers. Nationality is the broadest reaching social identity, but class, faction, religion and creed also affect identify. In democracies, identities can harden into rigid political identities. These in turn can stymie consensual progress so that institutional reform, short of revolution, is impossible.

Long-term or short-term: Nations that build strong economies orient themselves toward long-term payoffs, even if this process requires some short-term pain. Economies need inventors and entrepreneurs to fuel growth, and the unwillingness to take risks is not sound policy for an economy. There are often sociopolitical barriers to long-term prosperity forcing short-term instead of long-term actions.

- People have a tendency toward loss-aversion, overvaluing currently held assets, but also feel extraordinarily bad about losing an asset compared to the potential happiness of doubling its value.
- Loss aversion, however, is not the same as risk aversion. A person, or national political institution, may prefer a riskier gamble over a safer gamble yet prefer not gambling at all (loss-averse). "A collective sense of loss aversion makes countries hesitant to change their economies, even when they see trading partners and perceived competitor nations growing and changing," observe Hubbard and Kane.

Economic and political institutions:

- Institutions are constraints that structure economic behavior, including legal protection, markets, government regulation and structure, social norms and religious beliefs.
- Static economies are dominated by rent-seeking coalitions (a group of people who can make money by manipulating the rules of government to their advantage) that limit access both to political and economic institutions. Examples include monopolistic firms, guilds and labor unions.
- Institutional explanations of why nations prosper and grow or fail have centered on historical foundations such as the rule of law, the presence of an independent judiciary and the importance of property rights.
- An institutional explanation of why nations prosper and fail should also point out the factors that stimulate or check prosperity—inclusive economic and political institutions or extractive institutions that fail to protect property rights and reward incumbent firms and interest groups.
- Great Power decline reflects the inability of political institutions to adapt to changing economic realities.

Template for Great Power imbalance: "Every decade that a Great Power can maintain balance is a triumph because the pressures to fall are natural, powerful and constant," observe Hubbard and Kane. The key factors to watch for in the following case studies are:

- Bounded rationality: Rulers are limited in their ability to choose the ideal economic policies. Ignorance is the ultimate bind, especially for nations that struggled with economic crises before the discovery of the laws of economics. Furthermore, the public choice of leaders is bounded by available candidates, as well as by the veil of ignorance concerning their policies.
- National identity: This produces strong cultural, political and economic institutions, which are essential for growth and power, but that strength also implies a conservatism in the sense of resistance to structural change. Political identity is a key factor in polarization and growth.
- Loss aversion: Leaders rarely innovate when they are averse to losing their status as leaders. In a dynamic world, economic change is often happening faster than political change, but loss aversion makes leading economies reluctant to reform.
- Time preference: Even when officials are cognizant of the need for reform, they defer necessary changes for another day or year. Voters, too, habitually discount the future value of higher prosperity tomorrow and avoid making painful choices in the present.

chapter four:

the ruin of rome

The scale of the Roman Empire was the central feature of its rise to power, according to Hubbard and Kane, and perhaps also its fall from power. No other civilization has ruled the entire area surrounding the Mediterranean, and "no society approached Rome's degree of technological sophistication for nearly 2,000 years." Rome's population itself reached 1 million; it wasn't until 19th century London that the world would see another city of this size. To understand Rome's decline the authors look to the economic seeds planted long before the Empire's cultural and military weakness took hold. The rise and fall of the Roman Empire have the same roots; Rome didn't perish from overstretch but from fragile governing institutions.

SUMMARY OF DECLINE

Great Power: Imperial Rome

Turning point: A.D. 117-317

Economic imbalance: Fiscal, monetary and regulatory

Political roots: Growth of welfare state, centralized governance, military dictatorship

Behavioral dysfunction: Bounded rationality in the extreme about inflation and free labor markets; collective action problem with the Roman army

A sketch of the Roman economy: Imperial Rome has been divided into two eras: the Principate (27 B.C.-A.D. 235) and the Dominate (to A.D. 276). "The evidence suggests that the economic peak was not at the beginning of the Principate," write Hubbard and Kane, but its end.

- Principate institutions and technologies fueled economic growth for some 200 years, which then tapered off at that higher level. A few key institutions were the army, labor specialization and urbanization.
- In the Principate, Roman roads, markets, laws, taxes and bureaucratic efficiency enhanced key institutions.
- By the third century the absence of new technologies or further institutional development suggests that population pressures were likely eroding average incomes.
- The economy was predominantly rural and agricultural, and land ownership was the dominant source of personal wealth.

Roman institutions and culture: "The interesting story of Roman civilization," write Hubbard and Kane, "is not the dramatic narrative of one dictator succeeding another and another, but the economic logic of geographic expansion, assimilation and growth." Rome's unique mix of institutions allowed it to dominate neighboring regions. Key factors included:

- The army as an institution that facilitated Rome's rapid expansion: Emperor Augustus instituted two important military reforms—15-year voluntary enlistment instead of conscription and a Praetorian unit in Rome that protected the city.
- The army's dominance provided an economic benefit: The legions were needed only at the frontier while the interior provinces in the West enjoyed peace, which enhanced the climate for trade and investment.
- Rome's cultural identity: This took the place of an ethnic identity.
- The practice of Romanization: Granting citizenship to non-Italians strengthened the society for centuries.
- Technological achievements: The invention of concrete enabled the extensive infrastructure achievements.
- Vibrant markets for urban trade: Despite the role markets played, the Romans never fully understood the power of free markets, and its elites scorned merchants.

- Dependence upon slave labor: One out of three people in Rome were slaves, which also resulted in the culture's scorning of manual labor.
- Roman attitudes toward different occupations: There was a rigid occupational hierarchy, a kind of caste system culturally and sometimes legally enforced, that was an unintentional but definitive barrier to progress.

Imperial imbalance: From Hubbard and Kane's vantage point "Roman economic imbalance was an ongoing inability to match its fiscal outlays with available revenue. Rome made fiscal commitments that it could not square with taxation, with monetary debasement, or with dictatorial central planning." Three key errors were:

- The building of Hadrian's wall, begun in A.D. 122, across Britain's midsection: The wall symbolized Rome's pulling back from the frontiers and orienting itself and its treasury inward—understretching the empire—and setting a negative precedent. Compounding this error, Hadrian sought to curry popular favor by cancelling debts and financing municipal burdens through the central treasury.
- The debasement of silver coinage by Emperor Septimus Severus at the turn of the second century: Thinning a hard currency can lead to galloping inflation despite shoring up short-term deficits. The Roman denarius was 93.5 percent pure during most of Trajan's reign; by A.D. 235 it was 40 percent, and by A.D. 284 the silver content was 2 percent.
- The effort by Emperor Diocletian at the turn of the third century to command and control the economy as a cure for weakness: Acting as a central planner Diocletian expanded the dole and the civil service, instituted price controls that drained goods from the markets and pushed more trade into barter, imposed greater tax burdens, nationalized trade guilds, banned the free movement of rural Romans and ordered all male citizens to maintain the profession of their father. The people-side of the economy lost its flexibility.

The collective action problem: Rome also had special interest groups that tried to protect their status at the expense of the greater good. The army's monopoly of power eroded the separation of civilian and military authority, such that the military was in complete control over imperial succession. The legions adopted rent-seeking tactics, maximizing their own pay and power at the expense of everything else, and the Praetorian Guard fought hard to preserve its advantage in the design of the state.

Conclude Hubbard and Kane: "The ignorance of inflation's cost, of scale economies, of the dangers of rent-seeking, and of nationalizing industries was tragic. Even when emperors tried to make this right, their ignorance of moral hazard often set bad precedent. Each new emperor tended to forgive all private debts of citizens that were due to the state. Aurelian went so far as to haul out the public records of all such debts and have them set afire. Think about the incentive effects. Lesson one: Rack up debt and never pay while the emperor lives. Lesson two: Kill the emperor."

chapter five:

treasure of china

During A.D. 1405-33 the great Ming Dynasty mariner Admiral Zheng He (aka Cheng Ho) led expeditionary voyages to Southeast Asia, South Asia, the Middle East and East Africa, and it is said that, like the European explorers of his age, Zheng had the potential on his voyages to make important discoveries. But after 1433 the voyages stopped: "'Despite all the opportunities which beckoned overseas, China had decided to turn its back on the world,'" writes Paul Kennedy. For Hubbard and Kane, Zheng's example symbolizes China's economic imbalance and its political stagnation all in one. For the Confucian system enshrined a static hierarchy where everyone knew his place. That worldview was the antithesis of the kinds of institutional experimentation, innovation, and evolution that a Great Power needs to maintain its balance and grow.

SUMMARY OF DECLINE:
Great Power: Imperial China
Turning point: 15th century
Economic imbalance: Severe contraction in foreign trade
Political roots: Centralized government, autocratic policymaking and factionalized bureaucracy
Behavioral dysfunction: Loss aversion by zero-sum-thinking bureaucrats; identity heuristics hostile to merchants, profit, and foreign ideas; ignorance about importance of trade

A lack of corporations: The institution of the corporation, which limited the liability of the individual and encouraged entrepreneurs to take risks and pool their capital, was a keystone of Western growth. China had no corporate bodies outside of the state, nor did it have independent cities. A corporation expands the scope of profit-sharing beyond the family; in China familial strength is valued. Moreover, the corporation enables innovation and competition and normalizes failure without personal bankruptcy, another key to entrepreneurship. Without these elements of commerce enshrined in law, note Hubbard and Kane, it is no surprise that China's great inventions were not capitalized privately.

Economic decline: Regardless of the military incursions that China experienced—the Manchu, the Ming, the Mongols—Hubbard and Kane believe that economics is the best explanation for China's imperial decline. "The Great Power of China—its culture and institutions—survived and even thrived despite the shifting identities of sovereign dynasties at the top … Indeed, this firmness of Chinese culture explains the perseverance of its great power despite different dynastic heads. The firmness also explains China's later inflexibility and slowness to innovate economically." Chinese dynasties fell as a result of self-inflicted economic woes most often due to the high costs of a centralized bureaucracy.

Innovation and growth: The Chinese had the potential to make the technological leap from an agrarian society to an industrial one. Examples of their technological prowess were the invention of paper, the wheelbarrow, woodblock printing and movable type, the development of a complex chemical industry, cast-iron production, and improvements in rice cultivation.

The rise and fall of trade: China was also developing its trade after Admiral Zheng's voyages cemented trade relations with western India, Japan and other places. While economists see trade as the handmaiden of growth, it is also expensive, and the gains often go more to the private sector than the public. Simultaneously with the outgrowth of trade, an internal power struggle developed in imperial politics. Exploration and trade fell away in an excessively centralized government.

Then, according to Hubbard and Kane "a near civil war between the eunuchs and the mandarins burned for decades. The tribute trade collapsed. The unrivaled Ming fleet rotted away in port. Meanwhile, people in coastal towns continued to profit from foreign trade for decades, but their prosperity was seen as offensive and threatening by the Ming court. The mandarins did what any myopic, economically ignorant bureaucracy would do: They undercut their potential rivals."

The great divergence: The mandarin order, with all of its well-defined interest groups, locked the Manchu institutions into inflexibility. Call it loss aversion on a national scale, say Hubbard and Kane, or a dynastic collective action problem, but it led to weakness and then exploitation at the hands of imperial Europeans who carved up the Middle Kingdom.

Overstretch or inwardness or …: "The thing that truly doomed Ming China was institutional fragility," say Hubbard and Kane. "China's history is marked by eras where the checks on imperial power were absent. The political institution of Chinese emperorship, designed to serve the greater good, morphed into a zero-sum struggle for influence among interest groups."

China had many of the institutions in place that are critical for modern economic development. Mandarin scholars during the Ming Dynasty, however, worked to turn the Ming emperors inward and won the short-term game. "What we see in hindsight is their cultish devotion to heuristics—farmers are noble; merchants are not. We also see that sea trade was creating prosperity for the people in 1436, but mandarins' benevolence was blind to commerce as a source of wealth."

The authors continue their assessment into the present-day: "The Chinese economy remains centrally organized rather than federally, a feature that makes institutional progress less likely. The nation is primed to grow further in the 21st century, but there are questions about how high that growth can go without a more open political system."

chapter six:

the sun fades on spain

The Spanish empire (1469-1898) became one of the worst failures in history as it fumbled its position of dominance. Never did a great power embody such potential to prosper or to lead the world. During Spain's golden era in the 16th century, Spain was called the "empire on which the sun never sets." Its sovereignty included the whole Iberian Peninsula; major parts of the Netherlands and Italy; Hungary; half of North and South America; the Philippines; and Portuguese trading ports along the coasts of West Africa, East Africa, and India; as well as Malacca and Macau.

SUMMARY OF DECLINE:
Great Power: Imperial Spain
Turning point: 1550
Economic imbalance: Fiscal deficit and state bankruptcy, wrong kind of property rights
Political roots: Centralized monarchy
Behavioral dysfunction: Locked in guild loss aversion; bounded rationality about the nature of productive opportunity

Spain achieved great power, but it never understood how to translate that power into productivity or prosperity. Mercantilism filled its treasury with a mountain of silver while leaving the productivity of its people—and long-term living standards—barren. There is widespread consensus on the facts of imperial Spain's rise and fall:

- Its rise to power was based on economics, primarily the discovery of New World riches. American silver funded its armies and navies in the 16th and 17th centuries.

- The country neglected capitalist development; it was hostile to many of its merchants and expelled thousands of Jewish citizens and non-Catholics.
- Fiscal imbalance led Spain to default on its debts more than once.
- Paul Kennedy claimed that a century and a half of war exposed Spanish weakness by the “spiraling costs of war.”

Why use Spain as a case study? Spain might appear to represent the strong counter to the authors’ theory of imbalance — the empire was constantly warring with other nations, had a history of religious intolerance in the Spanish Inquisition and had to deal with the many different Hapsburg lands under its domain. “Imperial Spain seems to be a perfect prototype of the war-loving and exploitative European empire,” observe Hubbard and Kane. “Wars were a leading cause, but pressure on the private economy and religious discrimination were also major factors. … We would submit that war was an ‘extension of politics by other means’… behind all that was an economic competition even more important to the final outcome.”

Almost a superpower: Why did Spain decline if it was more than a military overstretch issue? “Ignorance.” There was no body of economic theory in 1492 that Spain’s leaders could draw upon.

- Using Hubbard and Kane’s measure of economic power, Spain’s power declined after 1600, compared to a doubling of British power and nearly trebling of Dutch power.
- GDP stagnated between 1600 and 1700 in Spain and France in sharp contrast to Britain and the Netherlands.
- Spain’s emperors engaged in religious wars and saw armies, rather than commerce, as the measure of power.

Silver foundations: In 1492 Christopher Columbus came to the Americas; the Catholic armies of Grenada, after eight centuries of fighting, defeated the holdout emir of Grenada; and the Spanish crown expelled the Jews as an extension of the Inquisition. And explorers went in search of riches—one of which was silver.

- With the discovery by the Conquistadors of silver came the centralization of the silver “trade” with the crown reserving one-fifth of it.
- The empire prospered so long as the silver mines were productive.
- The glut of high-quality silver, however, resulted in the diminishment of the value of silver: “Charles V was ignorant of the inflationary effect that his silver would have on prices. The price of silver dropped while the prices of everything else rose.”
- Spain also went into debt (through loans from investors across Europe who were promised more silver) to pay for its military expansion.
- The result: Profits from American silver did not go into developing a financial sector but to the crown and into the military.

Property rights and wrongs: Conquest and control of sovereign land was seen by the Spaniards as a principal activity of the state. Requiring all trade with the Americas to dock only in the port of Seville, for example, established a new, rich guild that Charles V could tax and control, as well as a mechanism to exert control over his colonies.

- Various means of raising money were employed: Taxation, confiscation of land and treasure from the populace, granting of new monopoly guilds that restricted free commerce, the sale of noble titles that exempted them from future taxes. Observe the authors: “Spain enhanced property rights, but these property rights were anti-growth. They were licenses sold in exchange for fees—licenses as a way of doing business that acted as disincentives for innovation.”
- Another consequence: These types of economic incentives made unproductive careers—soldier, clergy, colonizer, guild member—more attractive than that of merchants and entrepreneurs.

Political crowding out: For economists, a large government risks distorting the broader economy in a handful of significant ways: Taxation by the state takes funds away from private citizens, which can result in lower consumption and less saving. If the state replaces the lost private activity, there is no net loss. But crowding out—the discouragement of private investment because of higher interest rates—is a secondary effect of expansive fiscal activity. "We can be sure that the banking sector in imperial Spain remained underdeveloped as a direct consequence of the crown's voracious appetite for debt," observe Hubbard and Kane.

- Spain also distorted the market for talent through the Inquisition, which drove innovators out of the Hapsburg lands to other friendlier countries.
- The labor market was driven away from entrepreneurship and toward military and government employment.
- Centralization of revenue collection during the first stage of growth was coupled with a loss of local autonomy: The powers of the bourgeoisie and the legislative Cortes were undercut and eventually the Catholic monarchs won the power of the purse.
- Hubbard and Kane's theory of Great Power imbalance holds that "political decay locks a society into a status quo economy, resistant to productive growth through disruptive new technologies."

chapter 7:

rule of slaves—the ottoman paradox

The Ottoman Empire was one of the longest-lasting empires in history, surviving for six centuries from 1299 until 1923. Why were Western European empires innovative during the years 1600-1800 while the Ottomans were not? By the time the Ottoman Empire ultimately collapsed, institutional stagnation had made it vulnerable as well as weak. Exposed to enemies on all sides, its inferior economy and military relative to the rising European powers made the dissolution of the empire all but inevitable.

> **SUMMARY OF DECLINE:**
> **Great Power:** Ottoman (Turkish) Empire
> **Turning point:** 1550-1600
> **Economic imbalance:** Fiscal, technological
> **Political roots:** Centralized governance, theocracy, rent-seeking bureaucratic class
> **Behavioral dysfunction:** Loss aversion by zero-sum bureaucrats; identity heuristics hostile to foreign ideas; bounded rationality about importance of technology for growth

Tolerance and diversity: The diversity of the early Ottoman Empire was its genius.

- The conquering Turks permitted foreign peoples to maintain their faiths and local traditions.
- Occupational guilds, a major force in the urban economy, were open to all religions.
- Non-Turks were active entrepreneurs involved in banking, shipbuilding, wool, tobacco production and luxury trades.

- Muslim converts were considered as equal to born Muslims. After the rise of Shia Islam in 1566, orthodoxy and conservatism became more important, and the heuristic of cultural superiority became more important in the 17th century.
- The Ottoman governing hierarchy functioned as a federal dictatorship: The sultan was supreme, but there was a prefectural system with provincial governors rotating every three years.
- The timar system in newly conquered lands created a unique kind of military aristocracy as status and rights were not heritable. The timars were plots of land, not of fixed size, but of roughly equal value. The sultan gave to the people hereditary usufructuary rights to use the land of the timars and to keep its produce and administrative rights, including the right to collect tax revenues, to his cavalrymen, the sipahis, who lived among the locals with a small contingent of soldiers.
- The sipahi-timar structure was a constant incentive and reward for merit. It also led to a stable order that kept the concentration of power in Istanbul and other power centers.

The Janissaries: The Janissary Corps was a second political-military institution that counterbalanced the provincial influence on the throne. This elite personal guard was composed of Christian boys who became military slaves, forcibly converted to Islam, and had complete devotion to the sultan and their corps. But imbalances developed and the Janissaries were a symptom of a larger economic bias toward the status quo.

- Janissaries became rent-seekers over the centuries, becoming the defacto rulers and working hard to protect their privileges.
- The internal balance of power (Janissary/sipahi) served the sultan but a major weakness of Ottoman politics was the ambiguity of succession rules. The Janissaries became kingmakers, eventually staging palace coups, establishing puppet sultans and even ruling directly.

- By the 18th century there were more than 100,000 Janissaries; some had become merchants and tradesmen. The Janissaries were no longer warriors because of outmoded technology.
- The Janissaries crushed all efforts to reform their own military organization or the development of alternative military bodies.

"In retrospect," write Hubbard and Kane "the Janissary Corps is the institution most responsible for the political stagnation of Istanbul. Their conservatism held up all kinds of reforms that might have let the empire modernize, and not just in military reforms." Internal stability came at the price of economic dynamism. And the institution of military slavery is by nature not conducive to the development of capitalism and the rise of free markets. "This internal contradiction could not be resolved by the Ottomans, precisely because slaves managed the state."

Tax farming: Hubbard and Kane note that while they attribute the political stagnation to the bureaucracy, the economic imbalance and constant fiscal issues faced by the Ottoman empire were typical of decaying Great Powers. The empire also allowed itself to create national debts of a unique nature that it ultimately could not pay. As the cavalry became increasingly peripheral to warfare, the siphari-timar system was diminished and tax-farming in the 16th century was used to collect agricultural revenues.

- The sultanate sold rights to collect taxes in a region, usually to the top bidder for a year, but in the 17th century the Ottomans were selling contracts of five years and asking for a large portion of the contract to be paid up front. The tax farmers were free to keep excess revenues.
- In 1695 the sultan introduced a new institution called malikane, which was a lifetime contract for tax farming intended to raise significant funds for the sultan in the short term but also to incentivize the tax farmer toward the prosperity of the local people to foster long-term growth. It was also extended to other state-based revenues such as monopolies of trade and industry.

- Malikane crowded out private investment as money was more likely to be sunk into buying these financial products instead of going into industry or agricultural improvement.
- The role of peasants remained limited to their usufructuary rights, while the title-holder evolved from the sipahi to the tax farmer to the malikane owner.

chapter 8:

japanese opening

Japan's rise and fall can be separated into three parts. In Part One (1860-1905) the feudal society underwent rapid modernization, became the first non-European people to adopt liberal institutions, the first to war against a European power (Russia) and win, and saw a pattern of state-managed, export-driven capitalism that other Asian nations later copied with great success in the late 20th century. In Part Two (1900-1990), which includes the period of Japan's colonization of the Pacific region and World War II and its aftermath, Japan confirmed the successful institutions of state-managed capitalism. Part Three (post 1990), often referred to as the "Lost Decades," illustrates the limits of the Japanese economic supermodel and shows that the institutional model Japan pioneered has reached its limit. Hubbard and Kane believe that Japan's Asian model is fine for an economy aiming to catch up to the technological frontier but not much use in trying to surpass it.

> **SUMMARY OF DECLINE:**
> **Great Power:** Japan
> **Turning point:** 1994
> **Economic imbalance:** Fiscal, structural
> **Political roots:** Weak democracy relative to special interests and centralized bureaucracy
> **Behavioral dysfunction:** Heuristic of neo-mercantilism as growth; loss aversion by big banks and corporations

John Manjiro and the Meijin: During the Tokogawa shogunate, Japan had a unique sociopolitical form of feudalism. There was stability and peace among local warlords (daimyo) who were allowed autonomy, a competent central bureaucracy and agricultural reforms that enriched the people. Japan had free internal trade, resulting in a mixture of competition and cooperation.

By the 19th century Japan had urbanization, a surging population and high literacy rates. But outside pressure convinced many daimyo that Japan had to change or be conquered. When U.S. Commodore Perry arrived in 1853, John Manjiro, a Japanese fisherman who spoke English and had lived in the West, was able to explain to his countrymen the industrialization of the U.S. and its political culture in favorable terms. This led to progressive reforms instead of confrontation. In 1868, feudalism was abolished and the Meiji models of innovation came from the West. Among these were:

- The centralization of political power enforced with a prefectural system had created a constitutional monarchy with an elected parliament and an independent judiciary.
- Social classes were formally abolished, and occupational and migratory restrictions on individuals were lifted.
- The industrialization of the economy occurred.
- Military modernization occurred, modeled after the British navy and the German army.
- In economic terms three decades after the Meiji Restoration, Japanese GDP per capita had grown by 70 percent, by 1913 it had doubled, and by 1938 it had nearly doubled again.

Key features of the Asian miracle:

- Industrialization as the watchword of economic development
- Free markets emphasized for final goods that are supplied by government-guided private corporations
- An export-fueled economy
- Catching up to the West as a national mantra giving a missionary zeal to the economy
- Heavy interventionism: manipulating currency exchange rates to favor exports and subsidizing and directing production in certain sectors
- High personal savings rates and an educated workforce that valued hard work, late nights and few vacations
- Emphasis on agricultural reforms that liberate labor

Large industry firms: Efficiency in production of Japan's large industrial firms was a vital driver of its rapid convergence to American GDP per capita. Notable, however, is that firms were connected vertically and horizontally in the production chain. This bigness had its upside and downside:

- Upside: firms provided secure, stable meritocracies for workers
- Upside: safety net for elderly and less-productive workers
- Upside: guarantee of lifetime employment a cultural norm
- Downside: paucity of entrepreneurship
- Downside: high savings rates imply risk aversion that hinders entrepreneurship
- Downside: pioneering innovation found in America lacking in Japanese supermodel; large firms excelled in marginal innovation through R&D

Peaking productivity: Tokyo's export-fueled economy converged toward America until the early 1970s when the global recession caused it to shift into a lower gear. Japanese productivity hit its relative peak one year later and then the bubble burst.

A nationwide asset bubble—after real estate peaked in the 1980s, the Nikkei stock index crashed in late 1989—led to recession and what has been referred to as a "new normal." Overall growth rates fell behind the West, with a growth rate of 1 percent per year, and productivity no longer converging. Observe the authors: "The actual performance of Japanese GDP growth has been almost exactly in line with Western Europe, on average. What has been lost is not economic growth, but the extraordinary growth of a mythical supermodel that never existed."

Will Japan rise again? Japan's managed capitalism achieved rapid economic growth but hasn't allowed for understanding and distinguishing between catch-up capitalism and entrepreneurial capitalism. The catch-up model relies on coercive and centralized management of industry, export manipulation and heavy infrastructure investments. Each of these approaches stops being effective for an economy near the frontier. A frontier, i.e., entrepreneurial, economy needs decentralized competition in cutting-edge sectors, rather than centrally picked winners, a strong consumer culture and relatively lower government expenditures. Predict the authors: “The ceiling hit by Japan will soon be hit by Korea and will be hit by China in the next two decades.”

- Japan needs much more internal competition. The root problem is that there are interest groups aligned against sectoral evolution of the economy.
- Japan is in the midst of a crisis that is turning the country into a negative role model—a debt bubble created by increasing expenditures, particularly on infrastructure, funded by selling debt.
- The working-age population peaked at 87 million in 1995.
- Japan is saddled with an aging population.

Conclude Hubbard and Kane: “Japan is cruising forward on a familiar road of Great Power decline because of unsustainable national debt. Stimulating the economy with fiscal deficits and currency manipulation would be somewhat understandable if the time it bought was used to engage in structural reform. But Japan’s supermodel institutions remain the same, as successive prime ministers have promised reform and then failed for one reason or another to follow through. … The Japanese dilemma confirms our thesis that economic imbalance is rooted in political stagnation. … Rent-seeking by a troika of big companies, big banks, and a big bureaucracy have hindered the political system from making structural reforms. The economy cannot reform until a crisis shakes up the existing political structure.”

chapter 9:

british decimation

No modern Great Power is more interesting (or controversial) than Great Britain itself, particularly its sudden relative decline: The world hegemon in 1880, Britain lost its colonial empire in the decades after World War II. Was the decline the result of World Wars I and II with their staggering cost? Was it because of overstretch in the 1880s and the inability to support its navy? Hubbard and Kane believe that the data on British GDP, productivity and growth rates make the narrative of the world wars as the reason for the decline less convincing.

> **SUMMARY OF DECLINE:**
> **Great Power:** United Kingdom
> **Turning point:** 1770-80
> **Economic imbalance:** Territorial
> **Political roots:** Loss aversion by class and geographic elites in England
> **Behavioral dysfunction:** British identity too narrow, distinguishing citizens from subjects

While the authors were tempted not to include the British Empire, they believe that it is impossible to discuss Great Power decline while ignoring the British Empire.

- The economic data available now show that the United Kingdom never really declined in absolute terms. Its “decline” was probably inevitable in a world where other countries have vastly larger populations and converge toward frontier technological levels.
- Britain experienced a self-inflicted economic and political imbalance with loss-averse interest groups and political stagnation.

- Britain declined because it understretched rather than overstretched: Had it been more expansively British, and less imperial, the British Empire could still be a superpower today.

The British Empire: In 1909 the British Empire was composed of one-fourth of the world's landmass and ruled one-fourth of the world's population. Based on GDP and growth rates, the United Kingdom had an economic power score three times higher than that of France and almost double that of Germany.

Growth continued between and after the World Wars. Observe Hubbard and Kane: "The body of Britain was not at all dead before or after the world wars. It just stopped being extraordinary."

Prophecy in vain: The British conceit of themselves as a free people was only partially true. While Britain was a pioneer in the development of self-government and the recognition of human rights, when it first developed the institutions of representative democracy the nation made an operational distinction between citizens who had the right to vote and the more numerous subjects who did not. That distinction continued into the 20th century.

Greater Britain redux: Even after losing the 13 colonies of the United States, England still had room to grow. The country's "territorial control reached its zenith in 1909," observe Hubbard and Kane. "Rather than consolidate its expansive lands in an integrated federation—granting citizenship to its colonial subjects in Australia, New Zealand, India, Africa, and Canada—it chose to maintain a more hegemonic relationship."

- The logical step of calling for deeper integration, beyond mere trade, was not taken.
- During the 19th century, the pattern of special interest rent-seeking also occurred.
- Britain has fallen into the technological wake of the U.S., has a much less entrepreneurial economy and its many strong institutions have led to sclerosis.

chapter 10:

europa

In their discussion of the euro currency crisis, Hubbard and Kane chart the healthy interest rate diversity that existed in the pre-euro era, the unhealthy illusion of equal risk that developed when the currencies converged and the return of rate diversity since 2008 and what that means for individual nations. The authors conclude that "Europe is in more danger of failing than America, but both should know better."

> **SUMMARY OF DECLINE**
> **Great Power:** European Union
> **Turning point:** 2010?
> **Economic imbalance:** Fiscal
> **Political roots:** Unconstrained budget deficits and easy debt; moral hazard by semi-sovereign states
> **Behavioral dysfunction:** Limited time horizons of elected officials; loss aversion; heuristic of cultural superiority

Theoretical models and European supermodels: Europe should not be seen as a single, homogeneous society even now with the creation of the European Union. Hubbard and Kane divide Europe into three economic supermodels:

- Core: The four largest economies include Germany, the United Kingdom, France and the Netherlands.
- Nordic: Although Sweden, Finland, Norway, Denmark and Iceland are ethnically and culturally distinct, their economic policies tend to be similar.
- Southern: Greece, Spain, Italy and Portugal are generally poorer than those in the north.

Hubbard and Kane's framework for interpreting growth, described as the "'barriers to riches" mind-set, assumes that all nations have the potential to be equal, but their failure to achieve equality traces to governments' establishing suboptimal policies that hinder private sector development.

Eurozone pros, cons and interest rates: Europeans have been pushing for greater unification and harmony rather than celebrating supermodel diversity and learning about the productivity frontier. The logic driving the economic integration of Europe was that less diversity would lead to a lasting pacification of the eternal war among its member states and that integration would lead to growth thanks to scale. There are problems, however, with a common European currency:

- When there are flexible exchange rates, rather than a fixed exchange rate as with the euro, there is the independence of monetary policy by each sovereign nation.
- The potential to manipulate one's currency makes it difficult for smaller countries to sell debt, which leads to higher interest rates for smaller economies, particularly when investors expect the rate of inflation will be higher there.
- The assumption of a common interest rate was a fundamental error. Low interest rates created a perverse incentive for member states to borrow excessively, especially when local inflation made real interest rates negative.
- Greater government indebtedness post 2008 has led to a renewed interest rate differential. National governments with perennial budget deficits are forced to roll over old debts with new bond issues leading to higher rates.

Is the eurozone crisis a euro crisis? The authors believe that the monetary policy of Europe is being wrongly blamed for the disastrous fiscal policies of some of its members. They see the collapse of an illusion—that there was a pan-European prosperity, as if European productivity levels were near or approaching the global frontier. Nearly all members of the European Union have used fiscal deficits to bridge that illusion with unaffordable transfers, pensions and public employment programs.

With regard to Germany: Above all other members of the European Union, Germany has upheld its obligations to restrain self-serving fiscal programs and should not be expected to pay for foreign pensions that are far more generous than its own people receive. The bailout solution—including the 2012 package—represents a second kind of systemic risk to the eurozone. Greece establishes a precedent, and that precedent will create a moral hazard.

Taking measure of institutions: The most contentious disagreement in the European Union is about the role of the Central Bank: Does it exist to be a lender to the banking system or to shore up governments? Contend Hubbard and Kane: "It is fair to say that the eurozone trade imbalances between the core and the periphery created an unsustainable dynamic, but we tend to think that fiscal union by itself may be too easy an answer."

In a federal organization, there are many ways to unify member states, which differs greatly between the United States and the eurozone. "The bank account of a citizen in Lansing, Michigan, is not threatened by confiscation by or default of the Michigan statehouse. The same security does not comfort the bank accounts of the people of Athens. … Member states there retain the power to confiscate their citizens' financial assets and potentially convert them to an independent currency overnight. We suspect the attraction of nationalizing private wealth to address fiscal imbalances is an important reason that leaving the euro is at all attractive to highly indebted eurozone members."

Institutional diversity among member states may have fueled long-term growth in Europe since 1500. Maintaining that diversity in the European Union is the best way to generate the real growth its member states need to resolve their debts. The first step is to stanch the bleeding with real gradual austerity in public spending.

chapter 11:

california dreaming

For their final case study Hubbard and Kane turn their focus to an American state because they believe that this enables them to examine the larger theme of Balance. The American federalist structure in their view is an excellent institutional arrangement for economic growth because it allows for internal competition among the states as policymakers and permits citizens to migrate between states to find the best mix of low taxes and ample public goods.

> **SUMMARY OF DECLINE:**
> **Great Power:** California
> **Turning point:** 1992-present
> **Economic imbalance:** Fiscal
> **Political roots:** Partisan polarization from gerrymandering and term limits; extremely progressive tax rates and strong public-sector unions
> **Behavioral dysfunction:** Limited time horizons of elected officials; collective action problem of special interests

California's population, political power and ideological shift from conservative to liberal politics make it the best to analyze.

Hubbard and Kane consider California a Great Power because:

- If it were a country, California would rank in the top 10 in terms of raw GDP, has world-leading industries and military firepower.
- Its land area of 164,000 square miles is comparable to Japan's 145,000 and its population exceeds that of most of the United Nation's members.

- In terms of free trade, the other 49 states benefit more from their trade with California than with some of the nations that the U.S. has negotiated free trade agreements.
- In terms of economic power—the composite of GDP, productivity and growth—California ranks third behind the U.S. and China.
- Its concentration of innovation capacity in Silicon Valley is profound and unparalleled.
- What makes this interesting then is that while California may be the 10th-largest economy in the world, a few years ago it was the fifth.

Government bondage: With Orange County's bankruptcy in 1994, the first cracks became visible in California. Once the housing bubble popped, cities with weak fiscal balances sheets were exposed throughout the state and massive debt became common.

- Cities issue municipal bonds to fund expenditures.
- Labor is the biggest source of red ink and the biggest item within labor costs is pensions.
- Pensions are a budget problem, but changing them appears impossible. America's tax code lies at the root of the use of pensions for compensation as the IRS does not count benefits as taxable income. While private employers are regulated to prevent pension underfunding, governments are not.

Barriers to growth and governing: California has developed institutions that are barriers to growth. In a 2008 study of economic freedom, the state ranked 47th out of 50.

- The state income tax has a special tax bracket for millionaires (by income) who pay the top rate of 13.3 percent of their annual income to the state. While this may appear progressive, it creates a boom-and-bust cycle with state revenues robust when the economy is strong and severe drops when recession hits and incomes drop.

- Public workers have a strong grip on elected officials, allowing them to get the legislatures and city councils to establish generous work rules, revealing the political foundations of imbalance.
- The state continues to pursue fantastic and expensive projects, notably the high-speed rail line designed to connect the San Francisco Bay area and Los Angeles.
- The authors believe that California's public sector unions are barriers. The California State Teachers Association is the largest and most powerful and it uses its clout—and the dues it collects—to influence politicians.
- Term limits on California's assembly have restricted legislators' governing capability, as the term limits hampered their ability to master the ways of the capitol, build coalitions, propose legislation and try to get it passed. From Hubbard and Kane's point of view, term limits warp the behavior of the policymakers as they focus less on policy and more on the office or lobbying job they might get next.

Polarization by design: Because of its large and shifting demography, the state has been required to conduct a significant redistricting after every decennial census. This has led to extreme polarization.

Bankrupt incentives: Gerrymandered legislative districts locked polarized politics into place, and legislative term limits led to shortsighted time preferences—the legislators lacked the incentive to worry about or even consider long-term consequences. Budget deficits were cemented with votes on expenditures that had a lower threshold for passage than tax votes. All exerted their ill effects during the past decade.

Hubbard and Kane conclude that, "California shows how poorly structured political institutions can lead to a death spiral of economic mismanagement. The state has suffered political polarization just when it needed commonsense compromises. … These political institutions are poorly adapted to facing long-term budget challenges responsibly."

chapter 12:

united states beyond the consequence horizon

The authors believe that the challenges facing America originate from within. The most obvious sign is fiscal: the rising tide of budget deficits. Economically, the federal budget faces unfunded future entitlements that are unsustainable.

> **SUMMARY OF DECLINE**
> **Great Power:** America
> **Turning point:** 1975
> **Economic imbalance:** Fiscal
> **Political roots:** Partisan polarization
> **Behavioral dysfunction:** Loss aversion by political parties at the expense of entrepreneurial policymakers; collective action problem of special interests

Politically the polarization by both main parties has worsened in recent decades; however, the authors maintain, “The political stagnation is being turned around. There’s good reason to believe the United States will avoid the Great Power curse.”

Hubbard and Kane cite the 2010 Supreme Court decision of Citizens United v. Federal Election Commission as a critical turning point for the United States. “The history of the past four bitter decades of hyper partisanship has taught us that campaign finance reform failed to make politics less polarized. Instead it made it far worse. … We anticipate a third party that stands for something radical, like the abolitionists of the 1860s did … and most important of all, truly independent legislators.”

The center holds: The U.S. Constitution was designed to protect people from the encroachment of national power, yet during the past century the scope of the federal government has increased.

A first look at polarization: Polarization has gotten worse since the 1970s, and the center in American politics has melted away.

- Almost no member of Congress today holds the middle ground and moderation is no longer a political virtue.
- Yet a 2012 Pew Research Center study found that a growing number of Americans are nonpartisan, distrust centralized government and continue to support compromise.
- What seems to have gone wrong is a dilution of ideological principles with empty partisanship.
- The self-centered orientation of the modern political party creates a politics that avoids hard choices.

The history and future of debt: Over the centuries, every major debt spike (and its recovery) has been driven by war. Today's debt has been building for decades and cannot be pinned on a singular event, and certainly not to a war.

- Contemporary entitlements are five to 10 times larger than the costs of recent wars.
- Defense spending as a percentage of GDP has been cut in half since 1970.
- In the 1970s expenditures on Social Security, Medicare and Medicare were roughly equal to defense, but after the 1990s entitlement spending was larger by a 2:1 ratio.
- Relative to the size of the economy, defense spending has been whittled incessantly and those dollars shifted to mandatory social welfare programs.

"Entitlements" primer: The modest program that was enacted in 1935 to fight destitution among the elderly has evolved into a major retirement pension. Demographics are pushing the system toward bankruptcy, primarily because of the increase in life expectancy.

- Congress has not tried to save the balance of the "trust fund" but has been spending it.
- A reform to Social Security that might make sense is to equalize payments for all seniors, so that every elderly citizen receives the same amount each month.
- The longevity bubble—the fact that the entitlement promise expanded beyond its original obligation assumptions—must be addressed.
- The inflation index that has been adopted means that each new retiree cohort gets a better deal than the last.
- The health care entitlements have left tens of millions uninsured by distorting the idea of what health insurance is and how the American medical market operates.
- Medicare recipients can demand substantial medical care without having to pay much of the bill directly, leading to overconsumption as well as price inflation.
- Even if the economy grows at 2 percent to 3 percent annually, it will be outpaced by the automatic "cost of living" entitlement growth, a longer-living population with fewer children, rising health care costs and interest payments on the existing debt.

Breaking a political prisoners' dilemma: Modern deficits are unprecedented not just in scale but in nature. "Getting the federal budget 'under control' is impossible given the current rules of the political game," observe Hubbard and Kane. They use a lesson from game theory known as the prisoners' dilemma to illustrate their point. Two criminals can be motivated to confess when isolated from one another. The insight is that a stable equilibrium emerges that involves self-destructive behavior. Both prisoners will rationally confess and serve a three-month sentence.

Using this game theory shows that it is politically rational for the Republicans to maintain higher spending, regardless of the fiscal behavior of Democrats. "If the Republicans legislate spending cuts, their opponents attack them and they tend to lose seats. … Likewise, whether Republicans cut or maintain spending, Democrats are better off politically to maintain low taxes."

“Fiscal imbalance is an institutional failure,” emphasize Hubbard and Kane. “For most of the nation’s history, the rules of the budget game worked, but they no longer do. America is becoming imbalanced in a way that echoes the rent-seeking of the Roman and Ottoman empires. Fortunately, the nation has time to focus on the problem and institute new rules to regain our balance.”

A second look at polarization: In 1974, changes in the federal election law placed severe new limits on campaign finances by limiting the speech of individuals and groups. These changes also limited indirect speech by establishing dollar limits on the contributions an individual can make to a political campaign. While the law was repeatedly modified, each new iteration led to more party control over the flow of electioneering funds.

- Polarization got worse as a result of campaign finance reform in the 1970s. The parties became more ideologically rigid and the public saw more gridlock.
- The revised McCain-Feingold Act of 2002 instructed the Federal Election Commission to penalize corporations and unions that participated in campaigns in unapproved way. This limited most nonprofits (e.g., the NRA, the ACLU, the Sierra Club, universities, the NAACP) but not the Democratic and Republican Parties.
- In the 2010 Supreme Court case Citizens United v. Federal Election Commission the Court struck down restrictions on all independent expenditures for political speech. Individuals were allowed once again to create coordinating organizations for political activity, known as the freedom of assembly.
- Kane and Hubbard believe that Citizens United ends the repression of independent political voices for the first time in four decades and is likely to lead to free elections and new political coalitions.

chapter 13:

amending america

To avoid the Great Power curse, the common sense of the American people is right on target: The explosion of national debt is destroying the country's future. Hubbard and Kane identify seven major lessons of Great Power history that should guide the United States as it tries to regain its balance in the coming years. They consider some of the economic reforms that they believe will get America back on a path of economic growth and shared prosperity. Finally, Hubbard and Kane offer an economic defense of democracy and recommend several institutional reforms for American politics.

The seven lessons of Great Power history to draw upon:

- **Nothing is inevitable:** No great power is destined to succeed or fail. Great Powers have long cycles of prosperity and decline, with hundreds of decisive points.
- **Institutions matter:** Growth will accelerate in any country that establishes superior institutions with incentives for commerce, entrepreneurship and technological change.
- **The existential threat is internal not external:** In every case study Great Powers declined internally centuries before external threats toppled them. Fiscal imbalance is key.
- **Ignorance is the ultimate bind:** The Great Power rulers each missed something essential about their economy. The modern world's understanding of economics is far greater: "We submit that the real lesson from thinking about bounded rationality is to accept one's limits with humility and to stay alert."

- **Governments are the most dangerous "faction":** When the people who control the levers of government are able to enrich themselves at taxpayer expense, and when such centralized rent-seeking is unchecked, the situation can deteriorate toward fiscal ruin.
- **Loss aversion threatens innovation:** In most cases of imperial decline, there was a faction that controlled the government and insisted on the status quo. Because innovation threatens traditional production methods (and profits), resistance to economic innovation is common among all growing economies.
- **Understretch is a greater threat than overstretch:** The data collected since the publication of Paul Kennedy's *The Rise and Fall of the Great Powers* makes clear that imperial decline was not a result of "imperial overstretch."

Balance of economics: The military theory of the balance of power masks a more influential balance of economics between the leading states of the world at any given time. Relative economic power is shifting: away from countries like Japan to emerging markets such as India and China. These emerging markets, plus Europe and the United States, represent four clusters of economic power. If the U.S. can increase its productivity growth rate, it will accrue much more economic power.

The optimal economic future: The United States' fiscal balance must prioritize outcomes—more jobs, faster growth, less poverty—not inputs to optimize long-term prosperity. Excessive spending coupled with excessive government debt is dangerous. There are numerous approaches to balancing a budget. Three important strategies are:

- Reforming the tax code to encourage investment-driven growth and innovation
- Expanding the scale of its economy by lowering barriers to trade and the flow of ideas among states and across borders
- Focusing on arresting a decline in entrepreneurial business formation and job creation

Defending democracy: From the authors' point of view the failure of American democracy is behavioral: "The debt mess is a reflection of … perverse incentives of politicians to pursue re-election and the bounded rationality of voters who are not required to consider long-term fiscal constraints."

The authors conclude: "The weakness of democracy is not voter irrationality, then, but incumbent rationality. Without hard budget constraints, politicians have no incentive to limit deficits. … We are witnessing political paralysis in the face of excessive state expenditure, and the current budget rules are designed to generate exactly this result."

The reform odyssey: Wouldn't it be nice if Congress had a budget constraint that was as powerful as that which constrains most households? Some suggestions for fiscal constraints are:

- Congress should consider the dynamic effects—not the static scoring—of policy and budget changes.
- The federal government should use accrual accounting, which counts up the costs of new long-term obligations in the year the obligation is made, rather than cost accounting.
- Non-ideological fiscal rules are crucial as ideological rules tend to lack public support and be voted down.
- The best variable to constrain is expenditures, rather than debt, deficits, or revenue.
- Establishing a "glide path" toward balance, which might be as long as 10 years on more, is a necessary cushion against shocking the macro economy.

The 28th Amendment? The most promising fiscal rules for the United States may be one or more amendments to the Constitution. Congress, or the next constitutional convention, should reconsider a nonpartisan budget amendment. Key features would be:

- The annual constraint on expenditure should be defined by the medial federal inflation-adjusted revenues of the previous seven years, not the current year.

- Any amendment should be simple, focused only on fiscal balance. That balance should count accrued liabilities in entitlement programs, not just outlays. And the process should be neutral, not ideological.
- Any new rule or balanced budget should use escalating supermajorities for exemptions that are universal.
- The balanced budget act should provide a glide path to a lower debt-to-GDP ratio.

American rebirth: "This book has surveyed dangers of decline," write Hubband and Kane, "yet neither of us believe the United States is a nation in decline." The authors contend that declinism smacks of inevitability and failure, while the United States "has remained amazingly productive while innovating at the edge of potential economic growth."

Hubbard and Kane conclude that: "The United States will be well poised for a rebirth of the kind of growth that propelled it to an unrivaled economic power with global engagement, pioneering innovation, and ample jobs. History says that nothing lasts forever, but our own history says that American democracy has proven itself more powerful than all of the skeptics' and cynics' concern."

Summary by Lois Gilman

Lois Gilman has written for a variety of magazines, including Corporate Board Member, Money and TIME. She has worked on the program development of numerous business conferences, including the Fortune Global Forum and the Wall Street Journal CEO Council. Gilman was a head researcher at Time Life Books; a senior reporter at TIME Magazine; a program research manager at Fortune conferences; and the Web files editor of Business 2.0 magazine. She is also the author of *The Adoption Resource Book and The New York Parents' Book.*

about world 50

World 50 is the premier resource for senior executives from globally respected organizations to privately and candidly share ideas, solutions and collaborative discovery.

The World 50 community represents nearly 600 senior executives from 400 Global 1000 companies across six continents. Membership provides unparalleled access to world-class gatherings as well as year-round peer-to-peer and team-to-team collaboration, delivering insights found nowhere else. Intimate participation with remarkable practitioners and expert thinkers creates a candid dialogue on leading and growing significant enterprises in a global economy