America's Dangerous Economic Mythologies

By Charles J. Zwick, Robert A. Levine and Peter A. Lewis

Notwithstanding the downturn in the economy (which preceded the events of Sept. 11), the United States remains in the midst of an unprecedented era of prosperity. Gross Domestic Product has nearly tripled in 30 years, life expectancy has increased by seven years and pretty much anyone so inclined can go to college.

Meanwhile, the development of our physical, social and security structures has lagged far behind. Roads, bridges, and water and sewer systems need hundreds of billions of dollars worth of repairs; the social safety nets are frayed; and the education program in public primary and secondary schools is inferior to that of other advanced nations. Moreover, the Sept. 11 tragedy and its aftermath have shown that both our national intelligence and our public health and security systems are inadequate.

Yet we somehow can't muster the resources to cope with these problems. Indeed, in recent years, even heretofore big-spending Democrats have contended that we cannot afford to do what is needed – that investing in the public sector would somehow set the economy back in the long run.

The attacks on New York and Washington quickly turned this consensus around by 180 degrees on the single issue of national-security spending. It is still unclear, though, whether this sort of political flexibility will be extended to other urgent national needs without some equivalent crisis.

The can't-afford-it conventional wisdom is based on myths that have replaced hard thinking about economic policy. Democratic and Republican politicians alike have used symbols to conceal hidden agendas, but in recent years the Republicans have been much better at the game. "Government should not" is traditional Republican ideology. But with help from Bill Clinton and the New Democrats, the Republicans have managed to morph "should not" into "cannot."

Before September, the political scene featured the ludicrous spectacle of Republicans espousing a twisted version of Keynesian economics (tax cuts stimulate the economy, spending increases do not) while Democrats retreated to the pre-Keynesian shibboleths of the 1920s (deficits are always bad). But the real Republican agenda, meekly accepted by official Democrats, was simply to deactivate large parts of the government.

Here, we deconstruct three economic mythologies – the burden of deficit spending and the national debt, the crisis of Social Security, and the inherent impotence of government as a problem-solver – that feed the view that, when it comes to government, less is always more. The inclination of politicians and their economic advisers to take this path of least resistance is leading America into an unstable and unbalanced future – one with a rich private sector and a threadbare public sector.

Myth 1: THE INHERENT VIRTUE OF A BALANCED BUDGET

The federal government, like a family, must balance its spending and its income. Budget deficits are imprudent liens on the future that impede economic growth by driving out private investment. Indeed, so long as there is a national debt, the budget should produce a surplus.

History shows that federal deficits are not a drag on the national economy – far from it. The United States economy has grown at a phenomenal pace over the last half-century, which witnessed deficits in 44 out of 50 years. Why, then, does the balanced-budget mythology remain so strong?

For starters, there is the intuitive power of the analogy to family finances. But the analogy is false, because the federal government, unlike a family (or a state government) can finance itself by printing money or by borrowing from the Federal Reserve – a reality that makes the federal purse into the appropriate balance wheel for the economy. For that matter, the family analogy doesn't even hold for families; there's nothing so terrible about going into debt if the money is spent on a productive asset like a house or a college education.

To perform its stabilizing role, the federal government must be able to run deficits when increased demand is needed to keep the economy from slipping into recession. By the same token, these fiscal requirements are reversed when the economy is fully employed: federal surpluses are appropriate in order to avoid the general inefficiency created by inflation and the specific inefficiency linked to crowding out private investment.

The technical rationale for the balanced budget is embedded in classical economics. With competitive markets and flexible prices, the argument goes, demand adjusts to productive capacity; labor and other resources could therefore not be involuntarily unemployed. But Keynes found two weak points in classical theory. First, it takes time for wages and prices to adjust – time in which resources certainly can be unemployed for many years, as they were during the Great Depression. Second, expectations of falling prices can create chronic macroeconomic disequilibria, a reality that Japan is rediscovering today.

In the United States, Keynesian theory was

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(somewhat inadvertently) put into practice with the arms buildup preceding World War II. The immense deficit spending necessitated by World War II ended the Depression. And Keynesian thinking remained the tacit basis for policy for decades; by the late 1960s, even President Nixon was explaining, "we are all Keynesians now."

But in much the same way as the Great Depression had proved the incomplete nature of classical theory, the oil-crisis-induced stagflation of the 1970s highlighted the shortcomings of Keynesian-style fiscal strategy. Keynesianism focused on adjusting the demand for goods and services. It offered no insight – or policy response – to supply shocks that affected relative prices and changed expectations of inflation.

The newly revealed gaps in Keynesianism emboldened some opportunistic conservatives to reconstruct a fiscal policy around a crude version of classical theory. Supply-siders asserted that the incentive effects of deep cuts in tax rates would increase the supply of both labor and capital by so much that total tax revenues would actually increase. The Laffer Curve did not work as advertised (though it did fulfill the hidden agenda of redistributing a lot of income to those supplying a lot of capital and skilled labor). Instead, it led to budget deficits in the 1980s so immense that the Federal Reserve was forced to offset the fiscal stimulus with high interest rates.

When Democratic political leaders attacked the Reagan deficits, they were supported by mainstream Democratic economists who were worried about negative effects on private investment and price stability. That view outlived the immediate fiscal crisis, leading to an about-face in the 1990s in which Democrats led the fight for balanced budgets. It formed the ideological basis for the New Democrats and for President Clinton's expediency in discarding 60 years of Democratic ideals and half of his own election platform in order to co-opt the political middle.

Clinton's good fortune in presiding over a long economic expansion and a stock market boom that multiplied tax revenues in the 1990s beyond anyone's dreams seemed to ratify the shift. The Democrats became the party of the balanced budget and debt reduction. That led to Al Gore's absurd promise to balance the budget annually, forever and ever. And now both parties, and all right-thinking Americans, have been baptized into the mythology of the balanced budget.

The problematic fallout is twofold. First it has led to the perverse timing of running deficits when surpluses are needed, and vice versa. That became clear in the summer of 2001, even before the terrorist attacks, as President George W. Bush had thc bad luck to be in the White House when the 1990s boom finally ended. Now, it should force us to relearn the lesson that government tax and spending policy should be countercyclical, becoming more expansionary in recessions in order to offset falling private demand.

Second, since the core rationale for government spending is to cover needs that private markets do not, we should not let the fear of deficits cloud our long-term strategies. Some public goals, like some family and business ones, are worth borrowing to finance.

Indeed, though it may be surprising to those who grew up in an era of righteous opposition to deficits, the historical evidence does not show that the burden of the national debt slows down the economy. If anything, the reverse is true. Except for a drop from 1985 to 1989, productivity increased fastest when the debt grew. In any case, although the data are too sparse to prove that increased debt increases productivity, they offer good reason to be skeptical of the converse.

The federal government should move fiscal policy back into the role of active contributor to economic balance, as it was from the 1940s through the 1970s. Washington should also be prepared to support public investments that increase the nation's growth potential.

Myth 2: SOCIAL SECURITY IS IN CRISIS

The Social Security system is going bankrupt! Unless major changes are made, individuals now covered by Social Security will either not receive what they were promised, or payroll taxes will rocket out of control. We must act now or the problem will only get worse, and we will end up mortgaging our children's future.

None of this is true. To understand why, the issue must be deconstructed. Start with the practical matter of whether the Social Security system is going bankrupt. The 2001 annual report of the Social Security Trustees makes three projections based on demography and economic growth. One concludes that the Social Security trust fund will be fully funded for another 75 years. The more pessimistic second and third projections give it 35 and 25 years, the latter of which has been defined as imminent bankruptcy.

Yet the pessimistic projections are not based on recent productivity and GDP growth. Given appropriate fiscal and monetary policies, we see no reason to assume that the future can't be at least as good as the past. The real issue, then, is how to deal with uncertainty and risk. And the answer is surely not to throw up our hands and assume the worst. Rather, to be safe, we should continue an adaptive-management approach suggested by the trustees – a policy that assumes "periodic change in these programs will continue to be necessary, as it has been since they were enacted."

Unfortunately, Democrats and Republicans alike accept the myth of imminent bankruptcy. Each party has a different agenda – for the Republicans, to shrink government, for the Democrats, to scare aging voters otherwise inclined to identify with conservatives. One peculiarly Republican addendum, however, is that Social Security can be saved by partial conversion to a system of personal private investment. That is inherently contradictory: the slow-growth economic premises leading to the crisis forecast would make private investment the riskiest possible option, and would make it far more difficult to fund the transition.

Note, in any case, that the trust fund isn't now and never has been the public equivalent of an actuarially sound private pension fund with contractually fixed liabilities. Rather, it is a politically defined social support system that backs its extraordinary promises to bear the economic risks of retirees through its ability to tax. Social Security has also always carried a nonactuarial element of redistribution – a basic minimum retirement income for all retirees no matter how small their contributions, as well as protection for widows, children and the disabled.

The trust fund was created as an accounting device, for two related reasons. First, it emphasized that the pensions were a guarantee – in modern budget jargon, an entitlement – not subject to the annual appropriation process. Second, it symbolized the nature of that guarantee by connecting the payroll to the pension benefits. This second point has been stressed by many Social Security advocates as legitimizing the system, as compared to a means-based welfare system. As valid as these political devices were (and are), they clearly confuse the debate over reform.

The real question here is not whether the trust fund accumulates enough paper to write big pension checks, but whether the economy will generate sufficient wealth to make good on Congress's future promises without undue strain on active workers. We are told that the country cannot afford current Social Security benefits in the future because there will soon be too many retirees per worker to support. For example, the trustees' point out that in 40 years there will be only 2.1 workers for each retiree, as compared to 3.3 workers today.

What they do not explain is that this represents an increase in liabilities per worker of only 1.15 percent a year – far less than historical annual increases in labor productivity. Even worse, when the actuaries project productivity, they estimate the rate of growth at only 1.5 percent a year, significantly less than the average of 1.8 percent achieved over the past 40 years. Indeed, the 1.8 percent rate is arguably pessimistic; from 1995 to 2000, productivity grew by an annual average of 2.2 percent. If faster growth rates had been projected, the Social Security crisis would have been reduced to minor proportions – or eliminated entirely.

Myth 3:
WASHINGTON IS THE PROBLEM

Big government does more harm than good, undermining the efficiency of markets and denying the successful their just deserts.

The appropriate role of the federal government has been a central issue of political economy in the United States since the days of Jefferson and Hamilton. Where people stand on this matter depends largely on the fundamental values and beliefs they were taught.

From the New Deal at least though Lyndon Johnson's Great Society, Democrats were inclined to favor a larger role, Republicans a smaller one. In recent years, however, many Democrats have retreated from a defense of activist government, not so much because of a change in values as for political expediency.

Almost all Western economists agree that decentralized free markets generally allocate productive resources among competing private needs more efficiently than does any central mechanism. Indeed, markets are generally more efficient than the bureaucratic alternatives, even when they are not so free. But not all markets work very well. And intervention need not be as meddlesome as, say, that of the Soviet Ministry of Perfume and Paper Clips.

One has only to look at the enormous contribution the Federal Deposit Insurance Corporation has made to the banking system; the groundbreaking innovation of the Federal Housing Administration and the Federal National Mortgage Association, which created the largest homeowner class in the world; the impact of the Tennessee Valley Authority on rural America; the benefit of the Interstate System of highways; the importance of the National Institutes of Health, to name only a few. These institutions filled needs where markets didn't. Now we have new needs calling for new public innovations, institutions and investments.

By the same token, there is no reason to believe that the distribution of rewards produced by a totally free market is more equitable than distribution moderated by democratic processes. Since Adam Smith, most economists have agreed that markets distribute the rewards for production in accord with contributions to that production. Not Smith himself, but some of his successors unto the current day, conflated this result with equity. But economics offers no rationale for such a judgment.

A particular twist on this conflation of "free" with "fair" – one heard frequently from President George W. Bush as well as other Republican politicians – is "You earned it. What right do they have to take it away?"

The catch, of course, is "they" are us. "They" is the government we've elected to do things that we cannot do ourselves – things that have increased the ability of the skilled or powerful to earn all that money. "They" includes the armed forces and the police officers and firefighters who defend us. "They" build the roads and other infrastructure; "they" educate our children and keep the air and water clean.

"They" also provide the safety net that some conservatives say we should do without. But, for better or worse, this most controversial role of government looms much larger in political controversy than it does in fiscal fact. Right now, just 14 percent of the federal budget (about 2.5 percent of GDP) goes to subsidies for the poor, including Medicaid. The proper role of government in these tasks is a matter of judgment. But the debate should be based on facts, not myths – and certainly not the myth that we can't afford it.

BOOK EXCERPT

The Mystery of Capital

BY HERNANDO DE SOTO

Hernando de Soto is, in the view of many, the most influential development economist alive today – and, in my view, deservedly so. De Soto, the Peruvian economist who heads the Institute for Liberty and Democracy in Lima, has long been a darling of the libertarian right for his deeply skeptical view of the role of government, not to mention the Great Satan to the Maoist Shining Path guerillas, who bombed his institute at the height of their efforts to turn Peru into a Socialist paradise. ¶ But since the fall of the Soviet Union, de Soto's argument that legal institutions that ensure property rights and free markets hold the key to economic growth in poor countries has been embraced by the mainstream. Top-down development planning is dead, thanks in no small part to de Soto. ¶ *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else** is one of those "eureka" books – a work whose central thesis seems obvious when you read it, yet is both original and powerful. If you've never been exposed to de Soto's worldview, you're in for an eye-opener. Indeed, his capsule history of the evolution of capitalism in Europe alone is worth the price of admission.

DAVID H. WELLS/TIMEPIX

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