It is now widely recognized that economists and policymakers alike had been living a 30-year fantasy. The best government is not that which governs least. The best economy is not that which is abandoned to the invisible fist of the unconstrained market. Our national and individual security is not best left to the fate of the private pursuit of maximum profit. The events of September 11 underscored what was already apparent: Big Government needs to play a bigger role in our economy. Our late Levy Institute colleague Hyman Minsky has been vindicated once more.

Three decades ago, President Nixon and Milton Friedman declared, "We're all Keynesians now." The announcement came at nearly the precise moment at which Keynesianism had lost currency among economists and policymakers alike. Since then, Keynesian economic policy has remained out of favor both in the ivory towers of academia and Washington, D.C. Arguments advocating fiscal responsibility, "small" government, and limited government "intervention" were propounded. While university classrooms reverberated with paeans to invisible hands and Walrasian auctioneers, the halls of Congress were filled with praise for the wonders of unbridled free markets.

Every U.S. president from Jimmy Carter forward reduced the presence of government in our society. President Reagan "got the government off the backs of the people," while President Clinton "ended welfare as we know it," withdrawing the safety net that protected needy Americans. Social spending was slashed, but federal income and corporate taxes were cut more, resulting in huge budget deficits throughout the Reagan, Bush, and early Clinton administrations. In the 1990s, President Clinton and Congress reined in spending, creating a "fiscally responsible" government whose budget would generate surpluses at just about any positive rate of economic growth.

Beginning in the early 1970s, not only were "welfare" programs cut, but the federal government took a series of steps that also reduced its support of state governments, slowed the growth in defense spending as the Cold War wound down, and increased payroll taxes, which together shrunk the role of government and tightened the fiscal stance. The government's role also changed in the international sphere, as trade barriers were relaxed and measures protecting American labor, consumers, and the environment were eliminated. Around the globe, the United States preached the gospel that unfettered markets, allowed to work properly, could deliver high growth and full employment.

And it all seemed to work—at least for the United States—as the approach generated a cornucopia of Goldilocks growth in the second half of the last decade of the old millennium. The economy boomed. Productivity doubled. Wall Street bubbled with "irrational exuberance." Unemployment disappeared, at least from sight. Welfare moms got jobs and gained self-respect. Crime fell. Free from intrusive government, technology innovated and created a New Economy. So long as government policy remained solely in the hands of the Board of Governors of the Federal Reserve, even inflation would remain at bay. Growth was pronounced to be structural, and recessions were banished to history; all this absent any Keynesian fine-tuning. The Goldilocks economy glittered.

To be sure, malcontents raised some complaints. In spite of the longest economic expansion in U.S. history, many millions were left behind. Evidence overwhelmingly showed a shift in wealth distribution to the wealthiest, stagnation in median household wealth and home ownership among those of average wealth, and an unprecedented burden of household debt. Two million people—mainly, undereducated men and men of color—were incarcerated, even as crime plummeted. Perhaps as many as 15 million people—again, most of them undereducated—might have worked but were not hired, even in tight labor markets. Income inequality, which had been rising for more than three decades, scarcely improved, even with the robust economy. Studies showed that many, perhaps most, of those leaving the welfare rolls were unable to obtain a permanent job. Indeed, after years of declining real wages at the bottom of the income scale, even if welfare leavers secured permanent employment, their earnings would not be enough to support a family, at least at a level approaching the average American standard of living. Throughout the country, permanent employees were replaced with low-paid contingent and part-time workers or, worse, with even cheaper foreign labor. U.S. manufacturing declined precipitously, as cheap imports created chronic and growing trade deficits. Decades of inadequate investment in public infrastructure resulted in deteriorating schools, bridges and roads, and public health facilities and services.

Meanwhile, since the Carter presidency, national and international financial crises have become depressingly routine. The list includes the LDC debt crisis of the early 1980s, the S&L debacle of the early-to-mid 1980s, the U.S. banking crisis of the early 1990s, Latin American crises too numerous to mention, crises involving transitional economies, the Asian Tiger crisis, the failure of LTCM and the near-collapse of a large segment of the U.S. financial system, and the phenomenal bursting of the NASDAQ bubble. By the end of the first half of 2001, the radiance of Goldilocks had begun to fade. On September 11, 2001, it vanished.

It is now widely recognized that economists and policymakers alike had been living a 30-year fantasy. Our late Levy Institute colleague Hyman Minsky has been vindicated once more (Minsky 1986). The best government is not that which governs least. The best economy is not that which is abandoned to the invisible fist of the unconstrained market. Our national and individual security is not best left to the fate of the private pursuit of maximum profit. The events of September 11 underscored what was already apparent: Big Government needs to play a bigger role in our economy.

Views from outside the Beltway on the State of the Economy

There are those who believe that the U.S. recession will be mild and recovery will begin soon (Blinder 2001, Tyson 2001, Stevenson 2001), but one need only scan recent headlines (see box) to get some idea of the true state of the economy. In its November 26 announcement, the National Bureau of Economic Research proclaimed that the recession had begun last March. Also, according to revised estimates, third-quarter real GDP contracted significantly for the first time in a decade; the unemployment rate has spiked sharply, rising by a full one-and-a-half percentage points over the past year, to 5.4 percent and 7.7 million persons; total employment has plummeted by nearly 1.5 million since the beginning of the year, with the number of people forced to work part-time rising by over a million since August; consumer confidence has declined every month since July 2001; spending on durable goods has collapsed; and corporate profits have shown a huge drop. Preliminary reports on the "state of the States" indicate that 44 state governments face lower than expected revenues, 19 have budget overruns, 28 are considering budget cuts (with a total shortfall of $50 billion estimated for 2002), and 23 are anticipating budget problems ("Why States Will Be a Drag on Recovery," Business Week,
The Challenges Ahead, and Policy Responses

Although it is generally recognized that the good times are over, much uncertainty remains over the proper way to ramp up government involvement in the economy. Some advocate strong government involvement in homeland security and increased military capability (including Star Wars-like defense systems), while others call for significant spending on infrastructure (Rohatyn 2001). Almost everyone supports some version of tax relief.

Recent Headlines Marking the 2001 Economic Decline

As the Implosion Begins . . .? Levy Institute Strategic Analysis, July
"Will the Economy Ever Party Like It's 1999? Don't Count on It," New York Times, August 1
"Surplus + Slump = Stupidity," National Review, August 24
"The 'Non-recession' Has America in Denial," Newsweek, August 27
"Japanese Stocks Fall to a 17-Year Low on Profit Warnings," New York Times, September 4
"Fed Cuts Its Benchmark Rate to 2.5%, Hitting 39-Year Low," New York Times, October 3
"Cheap Credit, Except for Those Who Need It Most," New York Times, October 3
"Only Certainty to Economists Is Dire Outlook," New York Times, October 4
"Job Cuts Increased Even before Sept. 11," New York Times, October 6
"As Earnings Plunge, the Market's P/E Ratio Sets a Record," New York Times, October 12
"Retail Sales Decline 2.4%, Biggest Drop in a Decade," New York Times, October 13
"Out of Work, and Out of the Benefits Loop; Restrictions Will Keep Millions from Receiving Help," New York Times, October 17
"Locking up the Plastic; Many Americans Cut Back on High-Interest Debt," New York Times, October 18
"Less Information Technology Spending Seen," New York Times, October 29
"Recession, U.S.A.," Guardian, October 23
"Economic Expansion Ends; G.D.P. Falls by 0.4 Percent," New York Times, October 31
"Bush 'Deeply Concerned' about Possible Recession," Washington Post, November 1
"Argentina Beset by Deep Debt Crisis," New York Times, November 1
"The Federal Reserve's Tenth Interest-Rate Cut of the Year Will Not Stave off Recession," Economist, November 8
"Consumer Confidence Falls Again in November," New York Times, November 27

Although the proposed tax cuts would not increase the size of government, they would reverse budgetary agreements by increasing the size of deficits that were already inevitable in the face of the downturn, and thereby add net stimulus to the economy. Congress has already approved $55 billion in additional spending—$40 billion for the cleanup of New York and added national security, and $15 billion to help the ailing airlines, whose distress was worsened by the terrorist attacks—and there is great pressure to spread congressional largesse around to other firms whose financial problems were obvious and serious well before the attacks. In other words, corporate welfare programs have again become necessary, patriotic, and transparent—as they should be. Ironically, far less support exists for government programs targeted to the less fortunate who do not happen to own faltering businesses. Proposals to extend unemployment benefits for workers who have lost jobs as the economy slowed have not gone over quite so well within the beltway as corporate welfare.

Few observers have recognized the nature of the challenges ahead. We identify three such challenges, only the first of which has significantly entered the public discussion. Most immediately, government must cushion the economic downturn. Nearly everyone acknowledges the need for
an economic stimulus, but as many of us have suggested for several months now, the chosen stimulus must be much larger than anything being currently argued in policy circles (Godley and Izurieta 2001a, b; Godley 2001; Papadimitriou and Wray 2001; Wray 2001, 2000). While Congress and the president consider a fiscal policy stimulus on the order of $100 billion to $150 billion annually, our Levy Institute colleagues Wynne Godley and Alex Izurieta (2001b) have estimated that even with a stimulus of $100 billion, the annual demand shortfall will rise to $600 billion within the next several years.

The second challenge, which is ignored in Washington and barely recognized elsewhere, concerns the pressing needs that have been neglected by the federal government since the Nixon era: investment in public infrastructure, public health services, precollegiate education, training and apprenticeship programs for people who will not attend college, job programs for people who cannot find work in the private sector, and fiscal relief for state and local governments. Current federal spending in all these areas is wholly inadequate if the nation is to compete in the global economy.

For three decades the neglect was systematic and intentional, based on the policy of devolution of responsibility to local government and private enterprise. Alas, 30 years of experience have discredited the promises of devolution. State and local governments have had to rely on increasingly regressive and business-depressing sales and property taxes or, when those failed, lotteries and tobacco settlements. At the same time, private enterprise has abandoned wide swaths of the country, relocating to the newest communities (with the newest infrastructure and fewest social needs) or abroad. The needs of the neglected physical infrastructure total almost $2 trillion, as emphasized in studies by the American Society of Civil Engineers and the Department of Education. Reports published in the aftermath of September 11 have detailed the nation's neglect of its public health services and its vulnerability to epidemics that were thought to affect only third world countries. The real threat lies not in anthrax-tainted mail, but in drug-resistant tuberculosis, pneumonia, and venereal diseases that have begun to spread outward from our inner cities; in unsafe bridges and dilapidated school buildings; in sewage treatment facilities that pollute our rivers; in arsenic-faced drinking water and lead-contaminated paint; and in Superfund sites that have never been superfunded.

The third challenge lies in the long-term prospects for renewing robust economic growth. Many policymakers are still predicting a speedy economic recovery and, perhaps, a restoration of New Economy-type growth. Such predictions are based on the belief that a continuation of the Fed's easy-money policy, together with the administration's proposed stimulus program, will restore private confidence and spending. As we and other Levy Institute colleagues have detailed elsewhere, the federal budget has become structurally unbalanced and will impede any resumption of economic growth.

Indeed, the budget surpluses of the past three years, which have resulted from the long-term structural imbalance, are largely responsible for this downturn. Until a fundamental restructuring of the federal budget stance occurs, recovery is highly unlikely. What is needed is not a short-term fiscal stimulus but a "permanent" relaxation of the fiscal strictures that is required should reach the level of roughly $600 billion per year within the next several years. Last year (before the recession officially began, although growth had begun to fall), federal spending amounted to just under 17 percent of GDP and federal tax revenues totaled just over 20 percent, leaving a budget surplus of about 2.7 percent of GDP. If we are correct, the series of "permanent" fiscal adjustments would then move the budget by 6 percent of GDP, to a sustained deficit of approximately 5 percent of GDP. An even larger deficit than this may be needed over the short run in order to stem the slide into recession. Even after this fiscal adjustment had taken place, the United States would still have the lowest debt-to-GDP ratio of any developed nation and the smallest government sector of any developed nation except Japan. A few nations have even smaller ratios and less government, but they are not countries that many Americans would wish to call home.

We acknowledge Godley's analysis in pointing out the rationale for a bias toward running budget deficits: the high probability that the United States will continue to run significant trade deficits into the foreseeable future. To the extent that the trade deficit declines, the necessary fiscal adjustment is reduced commensurately. The federal government can run a sustained balanced budget only if our trade deficit is eliminated, because the sum of the federal budget balance plus the trade balance must equal the private sector's balance (comprising households and firms). The "normal" case for the United States is a small private sector surplus (meaning that, collectively, households and firms spend less than their incomes); this can be achieved only if the budget deficit exceeds the trade deficit. As the world economy slows ("The World's Economies Slide Together into Recession," New York Times, November 25, 2001, A6), it is unlikely that the U.S. trade deficit will improve, although the fate of our trade balance is ultimately unpredictable. Should the deficit miraculously disappear, the long-term fiscal stance can be tightened accordingly, while still permitting the normal private sector surplus to be sustained. Any long-term strategy that relies on a sustained Goldilocks private sector deficit and a sustained public sector surplus is doomed to fail because the structurally tight government budget will result in a recession and a cyclical budget deficit—precisely what is currently taking place.

A Policy Proposal for Sustainable Growth

As we have argued above and elsewhere, a combination of tax cuts and spending increases totaling at least $600 billion will be needed to achieve the required long-term fiscal adjustment. President Bush's original tax cuts amounted to an average fiscal adjustment of about $100 billion annually, although the original phase-in would have "back-loaded" much of the fiscal relaxation. Since Congress and the president will likely agree to accelerate these tax breaks, let us assume that personal income tax relief, as well as proposed business tax cuts, will amount to $100 billion annually by next year. In addition, $55 billion has been approved for emergency spending as a result of the September 11 tragedy. Together, these measures amount to a fiscal adjustment of about 1.5 percent of GDP. Hence, we must identify an additional adjustment that is equal to 4.5 percent of GDP, or $450 billion annually.

Another Levy Institute colleague, James K. Galbraith (2001), has suggested federal government revenue sharing as a way to relieve state and local government budgets. He proposed that the federal government provide as much as $300 billion this year and gradually less in subsequent years. Given the long-term federal budget imbalance, however, we instead suggest the implementation of a "permanent" and significant revenue sharing agreement. Further, given the nation's deficient infrastructure, it makes sense to increase the federal government's share of funding of projects to rehabilitate it. Thus we propose an annual $150 billion infrastructure investment program, in the form of federal funding of state and local projects. House Resolution 1452, introduced in Congress in 1999, provided for federal loans to state and local governments, school districts, and Indian reservations, based on a formula that allocated the loans according to population. We recommend the use of a similar formula, but one that would replace loans with revenue sharing. This difference ensures that local priorities are taken into account, while federal funding relieves state and local governments and thus reduces the incentive to use regressive taxes and lotteries to meet critical needs.

An additional $300 billion of fiscal relaxation will still be needed. Half of this could take the form of payroll tax relief. It is not the most of the benefits of the president's tax relief plan went to top income earners. Since three-fourths of Americans pay more in payroll taxes than in income taxes, real tax relief for most Americans can come only through payroll tax cuts. Because payroll taxes also increase the costs of employing labor, we recommend that a $150 billion annual tax credit against payroll taxes be shared equally by employers and employees. This would ease the burden of payroll taxes by one-third, providing real tax relief to workers and their employers. It would also make American labor more competitive by reducing employer costs, and would diminish the incentive of layoffs during the current downturn than capital gains tax cuts (Carpenter 2001), which by encouraging equity sales could prompt a dramatic drop in the stock market, or corporate income tax relief, which offers little benefit to corporations without earnings.
Another $150 billion of fiscal adjustment could be achieved through a combination of expansion (by at least $30 billion) of the Earned Income Tax Credit, expansion of medical insurance to the currently uninsured, a substantial increase in federal spending on unemployment compensation (which would extend the duration of benefit payments and also provide benefits to the more than 60 percent of the jobless who currently receive none), and significant improvements in public health services. Finally, a comprehensive, federally funded job training and job creation program, as outlined below, could eliminate both structural and cyclical unemployment and all the obstacles that prevent people from working.

The End of Laissez-Faire. (Revisited?)
In 1926, John Maynard Keynes wrote

Let us clear from the ground the metaphysical or general principles upon which, from time to time, laissez-faire has been founded. . . . The world is not so governed from above that private and social interest always coincide. It is not so managed here below that in practice they coincide. It is not a correct deduction from the Principles of Economics that enlightened self-interest always operates in the public interest. Nor is it true that self-interest generally is enlightened: more often individuals acting separately to promote their own ends are too ignorant or too weak to attain even these. Experience does not show that individuals, when they make up a social unit, are always less clear-sighted than when they act separately. (The End of Laissez-Faire, 39-40)

He went on to argue that because the belief that unfettered markets can do everything was unjustified, it was necessary to decide what should be "Agenda" and what should be "Non-Agenda" for government policy. Ten years later, in the depths of the Great Depression, Keynes published his General Theory. In that seminal work, he maintained that there was no reason to believe either that private enterprise should be favored over government policy in any particular sphere or that the sum of the activities of private business would generate sufficient economic activity to fully employ the workforce. While some interpreted this as a call for government attempts at short-run "fine-tuning," Keynes's real point was that private domestic spending--especially private investment spending--would tend to fluctuate between boom and bust, but at an average level that was insufficient to fully utilize a nation's labor and capital resources. Minsky (1986) adapted Keynes's analysis when he argued that modern economies need the stabilizing influences of Big Government. Neither Keynes nor Minsky wanted the government involved in every aspect of economic life (both emphasized that there are many areas in which markets work just fine--areas that should be Non-Agenda), nor did either support the notion that through fine-tuning, policymakers could eliminate the business cycle. Rather, they both looked to government to devise an appropriate long-term budget stance based on long-term private sector spending propensities. As we have argued above, nations that tend to run trade deficits will need a more stimulative fiscal stance, while trade-surplus nations can operate with a more restrictive fiscal policy. Nations with thrifty consumers (for example, Japan) will need more fiscal stimulus than those with profligate consumers (the United States). Both Keynes and Minsky recognized that it would be desirable to build into the fiscal stance some mild automatic stabilizers, so that budget deficits would rise in slumps and fall in booms. This pattern can be achieved through a progressive tax system (with tax revenues rising with economic growth and falling in recession) and the provision of an adequate safety net (spending on which moves countercyclically). Both Keynes and Minsky also supported the creation of government jobs programs when required; indeed, Minsky advocated a permanent "employer of last resort" program, modeled on the New Deal's Works Progress Administration program. He argued that only government can provide a "perfectly elastic" demand for labor, standing by to offer a job at a basic wage to anyone ready, willing, and able to work but unable (for whatever reason) to secure private sector employment. Obviously, employment in such a program would fluctuate countercyclically, adding another automatic stabilizer to the system. Importantly, Minsky recognized that such a program would also help to stabilize wages and prices, reducing inflationary pressures in a boom and deflationary pressures in a bust.

Over the years, Keynes's ideas became conflated with justifications for the micromanagement of business decisions and the macromanagement of fine-tuning. Keynesian policy was cast aside in the stagflation period of the 1970s. It was ironic when a Republican president announced "We're all Keynesians now" on the eve of Keynes's banishment from Washington policymaking, and it is ironic now, when another Republican president instinctively returns to Keynesian demand stimulus as the economy turns down more quickly than it has since the Great Depression. It is both unfortunate and "non-Keynesian" that the proposed demand stimulus package is envisioned as temporary, while supply-side policies (trickle-down tax cuts for the wealthy) are proposed for long-term growth. If "Keynesian" policies are to be successful, it must be recognized that the real problem is a structurally unbalanced budget that will kill recovery by generating surpluses at a low growth rate. Hence, the discussion in the policymaking arena should turn to permanent adjustments to the budget that will eliminate structural budget surpluses.

References
