



HIGHLIGHTS

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THE RETURN OF BIG GOVERNMENT Policy Advice for President Obama

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Introduction

Perhaps the only silver lining in the current global crisis is that economists and policymakers have rediscovered the benefits of Big Government. We all became Keynesians again as we instinctively turned to Big Government for help. In truth—as Margaret Thatcher famously said in another context—there is no alternative. There is still, however, a great danger. Strong forces are aligning to steer policy down the wrong path. Some of those responsible are simply self-interested predators; others misunderstand the scope of the problem as well as the policy options at hand. Of equal importance, we need to formulate policy that not only resolves the current crisis but also puts in place a financial and economic structure that is conducive to what Hyman P. Minsky called tranquility. As Minsky always warned, stability is destabilizing, so if we manage to restore stability while retaining the current “money manager” regime, we only guarantee that another systemic crisis will rock our world in a few years.

Why Did We Have a Golden Age?

Paul Krugman (2008) has argued that four factors were largely responsible for the United States’ early postwar success: pent-up demand (rationing and patriotic saving during the war), the baby boom (generating spending on all the things young people need), moderate inflation (which, in contrast to orthodox thinking actually is good for business), and Big Government (“military

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Keynesianism” increased demand). To these, based on Minsky’s teachings, I would add (in no particular order):

High wage / high consumption bias. Strong unions pushed up wages, allowing growing domestic consumption based on income (not debt); this also promoted labor-saving innovation, technological advancement, and all of that good stuff.

High government debt ratios / low private debt. We emerged from World War II with private balance sheets stuffed full of very safe government debt; in Minsky’s terminology, we had a “robust” financial sector with highly liquid assets (this is also related to Krugman’s “pent-up demand” point).

External markets for U.S. output. The United States could sell abroad, thanks to the Marshall Plan, which provided the financial where-with-all to purchase U.S. exports (as well as some destruction of productive capacity in war-torn Europe and Japan).

Government spending “ratchet.” Government spending grew faster than GDP, supplementing private sector demand and thereby keeping labor, plants, and equipment operating close to full capacity.

In spite of the conventional wisdom, the early postwar “Keynesian golden era” of rapid government growth actually resulted in very small budget deficits, because robust economic growth generated rising tax revenues. Further, growth reduced government debt ratios—in effect, Treasury bonds were “leveraged” to generate the postwar boom. From 1960 onward, the baby boom drove rapid growth of state and local government spending, so that even though federal government spending remained relatively constant as a percent of GDP, total government spending grew rapidly until the 1970s. This pulled up aggregate demand and private sector incomes, and thus consumption. In the early ’70s, government spending began to grow more slowly than GDP; inflation-adjusted wages stagnated, poverty rates stopped falling, unemployment rates trended upward, and economic growth slowed. Intensified efforts to promote saving and investment only made matters worse: saving depressed demand, and investment produced fragility. Another major

transformation occurred in the 1990s, with innovations in the financial sector that increased access to credit, as well as changed attitudes toward prudent levels of debt. Now consumption led the way, but it was financed by debt rather than by growing income. Robust growth returned, but this time it was fueled by private sector deficit spending. The rest, as they say, is history: a series of booms and busts—in real estate construction, dot-com IPOs, and securitized subprime mortgages—culminating in debt deflation and a deepening recession.

Policies for the Short Run

We first must deal with the burgeoning crisis, which requires a big and immediate intervention. Here is a brief list of policies to deal with the crisis over the short term:

- (1) *Liquidity.* The Federal Reserve (Fed) finally figured out that it must lend without limit to any financial institution. Forget collateral—it doesn’t matter; forget the auctions—just lend at the discount window. Provide loans of different maturities to meet the needs of the borrowing institutions, and to manage interest rates so as to control the term structure. Raise the Federal Deposit Insurance Corporation’s (FDIC) limit to infinity. Continue to increase coverage to money market funds and other kinds of deposits. If the Fed had done this at the very beginning, the liquidity crisis would not have been nearly so bad.
- (2) *Paulson plans.* Bush Treasury Secretary Henry Paulson famously demanded \$700 billion from Congress with no strings attached, and insisted that the sky would fall the next day if he didn’t get the money. It didn’t. His “final” plan was to use the capital to promote banking consolidation, picking and choosing which favored institutions would get subsidies to take over other institutions (Papadimitriou and Wray 2008). Advice to President Obama: discard (and reverse where possible) all of Paulson’s actions.
- (3) *Insolvency of financial institutions.* Paulson’s premise was that insolvency is a matter that must be resolved immediately. But that is false. Financial institutions can stay in business for years with more liabilities than assets. If the economy recovers, many of those assets will rise in value; the insolvency problem can conceivably solve itself if we

have sufficient patience. That is how we managed the epidemic of bank insolvency in the early 1990s. Here is what we need to do: (a) insist that the owners of troubled institutions inject their own capital (to put some skin into the game); and (b) if they refuse to put in enough, the appropriate regulatory agency (the FDIC in most cases) moves in and places the institution in receivership. Management is replaced; the institution is closely supervised, with tight constraints on growth imposed; and then we hope for economic recovery. Hopeless institutions will have to be dealt with—but rather than adopting Paulson’s consolidation approach, we should close the institution, sell off the assets, and pay off the depositors. Finally, there has long been a doctrine of “too big to fail,” which counseled that we can let small banks fail but we must always bail out the big ones. This current crisis has revealed such policy to be nonsense. I advocate a “too big to save” doctrine. The big Wall Street banks serve almost no public purpose: let them fail. Save the small- and medium-size banks that actually know how to lend to firms and households.

- (4) *Immediate tax relief.* There is a growing consensus for an immediate payroll tax holiday: stop collecting the old age, survivors, and disability insurance (OASDI) portion of the payroll tax from employers and employees. Both the employer and the employee pay 6.2 percent (the self-employed pay 12.4 percent), up to a current maximum taxable base of \$102,000. Approximately 163 million people paid Social Security taxes on earnings in 2007. Total tax revenue raised was \$656 billion, which amounts to an average of \$4,025 per taxpayer. A tax holiday would provide immediate tax relief to workers and their employers, injecting \$12.62 billion into the economy each week.
- (5) *Fiscal stimulus.* Many argue that government spending is more stimulative than tax cuts, since part of the tax cut is saved. So what? Households have been spending more than their incomes for a dozen years, and the geniuses on Wall Street have wiped out nearly half of those households’ retirement savings. The answer is that we need both: a payroll tax holiday to strengthen household balance sheets, and more government spending to restore the economy. To do immediate good, we need spending that can get under way quickly. Increased unemployment compensation and

other forms of social spending are needed. It is also important to help state and local governments, which are reeling from the double whammy of higher expenses and plummeting tax revenues.

- (6) *Mortgage relief.* Millions of homeowners are underwater. Many mortgages need to be refinanced on more favorable terms; that includes lower, fixed mortgage rates as well as reduction of the principal to reflect current market value of the properties. Because most mortgages were sliced and diced to serve as collateral for underlying securities, it is very difficult to renegotiate terms. Congress wants to allow judges to change mortgage terms; perhaps there is a way to go further, and to force securities holders to accept losses. Failing that, existing mortgages can be paid off, with new mortgages issued. If securities holders cannot be forced to take losses, the Treasury will have to take them. “Socializing” losses in this manner is not normally a good thing, but these are not normal times. Let’s renationalize Fannie Mae and Freddie Mac and put them to work in the public interest. This time, they should be run by civil servants earning normal General Schedule salaries, they should hold the mortgages, and they must adopt reasonable underwriting criteria.
- (7) *Jail the crooks.* Vastly increase the budgets (and hire criminologists) for pursuit of fraud all the way up the real estate food chain: mortgage originators, property appraisers, risk-rating agencies, accountants, and—most importantly—the Wall Street money managers who created this mess.

Longer-Term Policy to Promote Growth and Stability

For the medium to longer term, we need to put into place policies that will encourage sustainable economic growth. Here I discuss eight important areas for reformulation of policy.

- (1) *Green policy.* Economic sustainability will require paying more attention to the environment. This is an area that Obama has already identified as important, and I have no special expertise here. I would simply caution that economic recovery could reverse the course of oil prices (likely back toward \$80 per barrel).

- (2) *Payroll tax reform.* Payroll taxes are regressive, discourage work and employment, are inflationary because they add to labor costs, and reduce American competitiveness against all countries that do not tax wages. Further, the taxes are far too high, generating revenue that is about one third higher than what's needed to offset all OASDI (Social Security) spending. As part of my package of policies to deal with the current crisis, I recommended a payroll tax holiday. To placate those who fear the “unfunded entitlements” of baby boomer retirements, we can have the Treasury directly make all Social Security payments during the holiday. They can then credit the OASDI Trust Fund with the one-third-extra tax revenue that would have been received. Now, what should we do when the holiday comes to an end? I have the audacity of hope to believe that we can end the intergenerational fighting, that we will finally recognize that promised Social Security benefits can and will be paid as they come due, and that we can stop the nonsense about accumulating Trust funds (Treasury IOUs issued by the Treasury to itself) to take care of future retiring baby boomers (Papadimitriou and Wray 1999). Unless baby boomers can eat OASDI Trust Fund IOUs, they are no better off if the Trust is filled with quadrillions of Treasuries than they would be without a trust fund at all. So let us stop pretending, and recognize Social Security promises for what they are—that is, commitments by a sovereign government to credit bank accounts on schedule.
- (3) *State and local government revenue.* The “devolution” of the federal government that has taken place since the early 1970s puts more responsibility on state and local governments, but without the necessary funding; in response, they have increased (mostly) regressive taxes such as sales and excise taxes. These governments need immediate assistance, because tax revenues are plummeting. Once the crisis is past, we also need to encourage them to move away from regressive taxes (in the average state, poor people pay twice as much of their income in state and local taxes as do the rich).
- (4) *Inequality.* The rise in inequality is a major contributing factor to the run-up in household debt: stagnant real wages for most Americans in the face of rising expectations encouraged the debt binge. Hence the current financial crisis is indeed related to the rise in inequality—both because of stagnant incomes at the bottom and because of soaring incomes at the top. Many processes contributed to rising inequality, but the emphasis on stimulating private investment as well as the public subsidies for consolidation and the promotion of finance over industrial enterprise all encouraged rising inequality. The weakening of unions also played an important role—a problem Obama has promised to address. So, we need to reverse those trends.
- (5) *Health care.* While much is made of the “unfunded entitlements” of the public leg of the health care stool, the other two legs—the employer-funded leg and the patient-funded leg—are also broken and collapsing. In our “global economy,” one could not imagine a worse design for health care than the one that has evolved in the United States—highly inefficient and employment-killing, as it saddles employers with exorbitant costs. Sooner or later, it will be reformed. We might as well do it now: provide nationally funded and universal access to reasonable health care, with a much smaller privately funded system for nose jobs and other elective treatments. Note: nonprice rationing will be necessary. It makes no sense to devote most health care spending to the last dying gasps of life. Those unwilling to accept rationing of care can buy extra insurance and build up savings.
- (6) *Infrastructure and social spending.* Government spending needs to operate like a ratchet: it should increase in bad times to get us out of recessions, and increase in good times to generate demand for growth of capacity. What should we spend on? Infrastructure, social programs, and jobs. We've got a \$2 trillion public infrastructure deficit—and that's just to bring America up to the minimal standard expected by today's civil engineers. And our needs are much greater: wealthy (and aging) societies need services, many of which are best provided outside the private (profit-based) sector. The long-fashionable belief that the market knows best, that it is well suited to provide everything from elder care to health care to education, now seems crazily improbable. Heck, the market couldn't even do a relatively simple thing such as determine whether someone with no income, no job, and no assets ought to be buying a half-million-dollar McMansion with a loan-to-value ratio of 120 percent. Jimmy Stewart's heavily regulated

thrifts successfully financed more housing with virtually no defaults or insolvencies, and with none of the modern rocket-scientist models that generated the subprime fiasco.

- (7) *Financial reform.* The market has decisively spoken: It is not capable of self-regulation. It cannot tell who is credit-worthy. It cannot be trusted to innovate new financial products. It cannot be relied upon to determine compensation schemes. It makes terrible credit allocation decisions. It cries out for downsizing and heavy-handed reregulation. Obama needs to listen.
- (8) *Jobs.* I've saved the most controversial proposal for last. I believe that anyone who is willing and ready to work should be able to work. Here are the problems: first, capitalism has no internal processes to ensure full employment of labor resources; and second, policy always intervenes to ensure that full employment will not be reached, on the belief that it would generate inflation. John Maynard Keynes (1964) explained the first point: firms hire the amount of labor they need to produce the amount of output they expect to sell. The existence of unemployed labor will not induce employers to hire more, even at lower wages, for the simple reason that additional production is not warranted by expected sales. Regarding the second point, transcripts from Federal Open Market Committee meetings conclusively demonstrate that the Fed fights against falling unemployment by raising its target interest rate in an attempt to slow economic growth. Whether these policy actions have the desired effect is beside the point. What is clear is that policymakers oppose providing sufficient jobs to satisfy demand, on the belief that if everyone is working, inflation will result. Obama is on the right track when he sets a goal of creating millions of new jobs. He can and should go much farther; there is no reason to constrain the supply of jobs. Provide them, without limit, to anyone willing and ready to work. Give people useful things to do (see above for ideas). And here is the most important thing to do to ensure this will not be inflationary: Set a fixed price (nominal wage) and float the quantity (hire those that show up to work). Offer a living wage and a package of benefits but do not bid against the private sector if it is willing to pay more. In this way, the government's jobs

program will operate like a buffer stock, expanding in a recession, when private jobs are scarce and private sector wages are falling; and shrinking in a boom, when the private sector bids workers away. This also makes the government's budget move countercyclically: more spending in a recession, less in an expansion.

But Can We Afford Big Government?

Many on the Obama team still worry about the long-term impacts of current budget deficits, and are afraid of the deficit growing too big for three reasons: inflation, investment crowding-out, and insolvency. I will try to calm those fears.

First, inflation: most fear that too much government spending will drive demand beyond full capacity, generating wage and price pressures. However, in the current circumstances, that is highly unlikely, with global demand plummeting, unemployment rising, and commodity prices busting. Still, I have called for faster growth of government even after this crisis passes. So the key is to ensure that government spending grows at a pace just consistent with the required level of fiscal stimulus.

Further, it does make a difference where government demand is directed. Right now, it probably doesn't matter too much what the government spends on, but for the longer run, the composition and nature of government spending is critical. Government has to avoid spending that leads to accelerated inflation. To be sure, moderate and stable inflation is not a bad thing, but rising inflation is not acceptable. As discussed above, a comprehensive jobs program that fixes the wage but hires all who want to work generates exactly the right amount of non-inflationary spending.

Economists worry about financial crowding-out, which can occur even with unemployed resources. There are different versions, but the most important ones boil down to the argument that government deficits push up interest rates as government borrowing competes with private borrowing. By contrast, the types of private spending that are sensitive (supposedly, investment and real estate spending) will be reduced. For a long time, economists of the Big Government persuasion argued that empirical results are mixed—we find many cases of rising budget deficits and falling interest rates, and falling budget deficits and rising interest rates—so even if the theory is correct, the real-world results don't necessarily comply. But it is simpler than that: the theory is just plain wrong. The Fed

determines the short-term interest rate. Period. Yes, it might raise the rate in response to budget deficits, but that is a policy decision. If Congress doesn't like that, it should change the instructions it provides to the Fed.

For those who are still skeptical, let me move on to a further important point. Government spends by crediting bank accounts (bank deposits go up, and bank reserves are credited by the Fed). All else being equal, this generates excess reserves that are offered in the overnight interbank lending market (the "fed funds market" in the United States), putting downward pressure on overnight rates. Let me repeat that: *government spending pushes interest rates down*. When they fall below the target, the Fed sells bonds as a higher-interest-rate-earning alternative to excess reserves—thus pushing the overnight rate back to the target. We conclude: government deficits do not exert upward pressure on interest rates—quite the contrary; they put downward pressure that is relieved through bond sales.

Finally, insolvency. Let me state the conclusion first: a sovereign government that issues its own floating rate currency can never become insolvent in its own currency. The U.S. Treasury can always make all payments as they come due, whether it is for spending on goods and services, for social spending, to hire workers, or to meet interest payments on its debt. While analogies to household budgets are often made, these are completely erroneous. I do not know any households that can issue Treasury coins or Federal Reserve notes, though some try occasionally (counterfeiting, but that is risky business). To be sure, government does not really spend by direct issues of coined nickels. Rather, it spends by crediting bank accounts. It taxes by debiting them. When its credits to bank accounts exceed its debits to them, we call the difference a budget deficit. Government spending can be too big (beyond full employment), it can misdirect resources, and it can be wasteful or undesirable—but it cannot lead to insolvency.

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