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# Out Of Recession And Into A Prosperous 21st Century:

## — What It Takes —

by John J. Waelti and James T. Peach

> American economic problems consist of both short-term, or cyclical problems and long-term, structural problems. The supply-side policies of the 1980s have exacerbated our structural problems and severely constrained opportunities to use fiscal policy to get out of recession. Both cyclical and structural problems need to be confronted. Priority should be given to a dramatic increase in federal spending on physical and social infrastructure, targeted in such a way that pressure on state and local government is relieved. Then, as the economy improves, federal taxes should be increased in order to reduce the structural federal budget deficit.

**T**he American economy is performing far below its capacity to generate employment, income, and the public and private goods and services necessary for a prosperous, civilized and just society. On this, all but the most pollyanish agree. However, between efforts to shift blame and the vested interests in various “solutions,” causes and remedies of this imbroglio are conflicting and confusing—unnecessarily so, in our opinion.

We assert that both cause and remedy are clear. Reluctance to define and follow the necessary strategy is the result of neither complexity nor incomprehensibility. Failure follows instead from the insistence on clinging to myths and shibboleths of the ideology which has shaped economic and political policy during the past decade—an ideology that is totally inappropriate for today’s vastly different world.

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### Differentiate The Problems

The confusion over our current economic problems is clarified by differentiating between the short-term or cyclical problem, and the set of long-term structural problems.

The short-term problem is the recession and while many economists are convinced that the recession is over, we are less certain. The policy goal is to get out of it—ordinarily a straightforward task. However, the task this time is complicated by our long-term, structural problems. It is for this reason that people are more worried and depressed than, as administration economists lament, “statistics would warrant.” People, once again ahead of politicians, realize that this recession is different—more ominous and foreboding than past recessions. Our economy was in trouble before the recession, and we will be in trouble when we get out of it—if we don’t deal with our long-term structural problems.

### Four Problems

These long-term, structural problems include at least the following:

- High levels of debt for individuals, business and government;

- Frail financial institutions, and loss of confidence in them;
- Large trade deficits, and;
- Structural unemployment and related social problems of drugs, crime, violence, and inadequate health care.

All of these structural problems are exacerbated by an increasingly skewed distribution of income.

A brief word on each is in order.

**High Levels of Debt.** Debt, *per se*, is neither evil nor unwise. Debt can be a tool for advancing the welfare of individuals, businesses and society. Too much debt, however, inhibits individuals from saving and investing, and it forces reduced consumption. Too much debt inhibits business from making productive investment. So too, with government. Too much debt inhibits government spending for investment in physical and human capital. And ominously, too much debt significantly hampers our capacity to stabilize the economy, as illustrated by our present inhibitions to use fiscal policy to get out of the recession.

**Frail Financial Institutions.** Frail financial institutions undermine confidence in the entire system, particularly when life savings and retirement funds are at stake. Frail financial institutions are also unable to supply necessary capital for investment. While much is made of the fact that no depositors of insured savings have lost a penny through failed banks and S&Ls, a prominent school of thought attributes deposit insurance to be the cause of the S&L problem, and advocates its repeal.

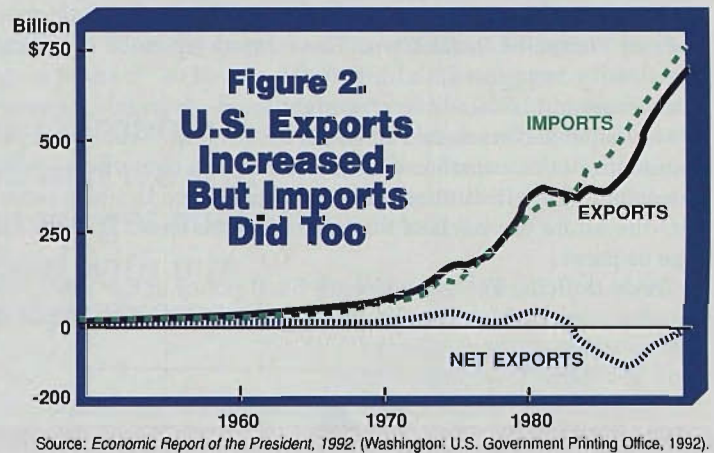
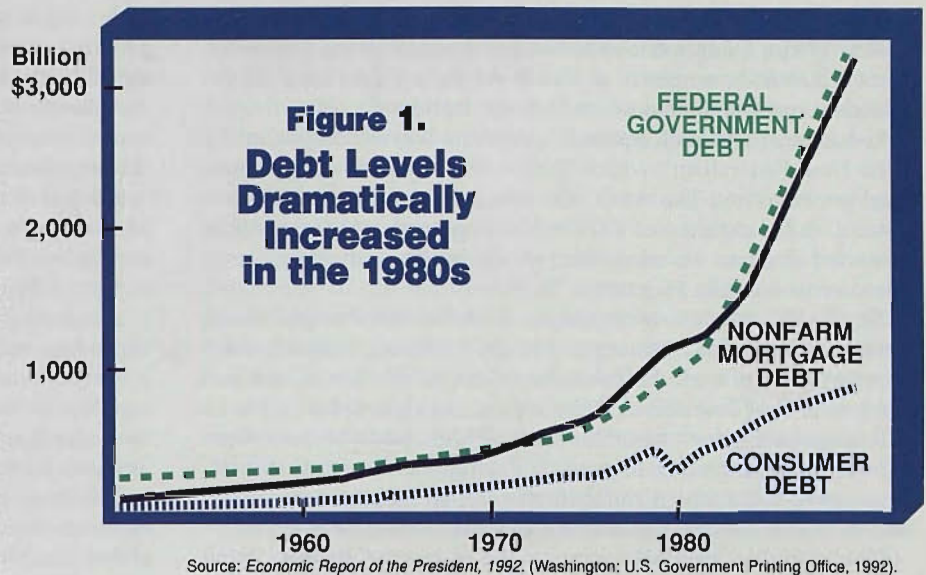
**Trade Deficits.** This is a widely misunderstood issue. U.S. trade deficits have been large in recent years but it is not true that we are exporting less or that American productivity has declined. U.S. merchandise exports increased from 4.1 percent of GNP in 1970 to 7.3 percent of GNP in 1990. Moreover, U.S. exports per capita (measured in constant dollars) increased substantially over the same time period. These are hardly the signs of declining competitiveness or productivity. Instead, our trade deficit results from the fact that U.S. imports (especially petroleum and automotive products) have increased more rapidly than our exports. This does not mean, however, that we can be complacent about insufficient investment in human and physical capital since such investment largely determines long run productivity and economic well-being.

**Structural Unemployment and Related Social Problems.** Drugs, crime, violence and inadequate health care impose obvious social and economic costs to our society. As important, however, is a siege mentality, a withdrawal of the underclass from the larger society, and a fracturing which costs the nation its sense of community. A nation which lacks a sense of community suffers a crippling paralysis. Only if the most wealthy and privileged of its citizens share in burden and sacrifice will the rest of the nation willingly put out the necessary effort to remedy our problems. A renewed national commitment to break this cycle of poverty and to address structural unemployment is essential.

## Misguided Directions

Let us briefly review the faulty assumptions and misguided policies of the 1980s and their relationships to these structural problems.

The nation began the 1980s with high inflation and a determination to bring it down. The objective was long-term economic growth through reduced taxes, increased savings, and increased investment. Related goals of those holding political power and



dominating economic thinking was to reduce the size and influence of government—particularly domestic programs of the federal government. Much rhetoric also was given to reducing the federal deficit—even while reducing taxes and increasing defense expenditures. This philosophy was called *supply-side economics*.

The flagship policy of supply-side economics was “the great tax cut of 1981.” Its appeal was irresistible: cut taxes, and increased savings, investment and output would follow, generating sufficient income that, even at lower tax rates, federal deficits would be reduced. The increased investment, assured by reduced taxes, and augmented by reduction of burdensome government regulations, would ensure continued economic growth. The rising tide of economic activity would lift not just large boats, but *all* boats.

This bears suspicious resemblance to advising the obese that the way to health and vigor is to lie under a shade tree and devour chocolate bon bons. But if the promise is delivered with sufficient vigor and persuasiveness, the tempting remedy must be tried.

Indeed, the 1981 tax cut was immediately effective in raising employment and income. However, this resulted not from increased savings and investment, but from the old-fashioned Keynesian fiscal pull of increased *disposable* income generated by the tax cut. The expansion was led by consumption.

Although the increased employment and income were welcome, several other effects of supply-side policies were not. These policies are largely responsible for our current structural problems.

**High Levels of Debt.** Although many federal domestic programs were reduced in real terms, spending for national defense increased. Tax revenues generated by the economic expansion were not only insufficient to reduce federal deficits, but incredi-

bly, deficits *increased* during the economic expansion of the 1980s. While Congress is blamed for appropriating too much money, it must be emphasized that never during the 1980s did the President present a balanced budget to Congress.

Reduction in federal domestic programs was accompanied by "The New Federalism" which shifted responsibility to state and local governments. The result was rising state and local taxes and a strain on the capacity of state and local governments to meet the increased demand for education, public health and safety, transportation and public assistance.

The lax attitude toward regulation contributed to the junk bond frenzy and what has been euphemistically termed "restructuring" of American industry. Faithful, long-time employees of old line companies find themselves without jobs, health benefits and even anticipated retirement benefits. The high debt loads of these firms inhibit their capacity to invest. Perhaps more importantly, employees lost faith in their employers. A shaken and disillusioned workforce may haunt this nation for some time to come.

Finally, individuals were encouraged to borrow on their home equity in the 1980s. Soft real estate prices have left many people with a reduced net worth and a legacy of burdensome debt.

**Frail Financial Institutions.** The relaxed vigilance of federal regulatory agencies, along with unwise management decisions—and in some cases, outright fraud—is largely responsible for failed and weakened financial institutions. Even insurance companies, once considered invulnerable, are now viewed with suspicion. These institutions manage pension funds which represent the future for much of this nation's work force. This should give us pause.

**Trade Deficits.** The expansionary fiscal policy of the 1980s was accompanied by high interest rates. Among the consequences of

high interest rates were a highly valued dollar and relatively inexpensive imports for U.S. consumers. These factors, combined with significantly increased disposable incomes for the wealthy, and the absence of a national energy policy, contributed to an unprecedented increase in imports. Thus, despite impressive increases in U.S. exports, the trade imbalance worsened during the 1980s.

**Related Economic and Social Consequences.** The number of billionaires and centi-millionaires increased at an astonishing rate during the 1980s. So too, have the number of homeless people, hungry children, school drop-outs, and drug addicts. This is hardly a formula for upward mobility, a broad middle class, and a stable society working toward common goals of civility and justice.

While these larger social problems are not purely the result of supply-side economics, the increasingly skewed income distribution resulting from those macroeconomic policies have further weakened a deteriorating social fabric, and have contributed significantly to the sense of despair and disillusionment of a large segment of our society. The drug problem is but one manifestation of this disillusionment and despair.

## A Digression on the Peace Dividend

The watershed event of this generation is the decline and fall of the Soviet Union, and with it, the end of the overriding fear of the "Great International Communist Conspiracy." While there are widespread economic consequences of the changed international power structure, the immediate macroeconomic consequences of cutting the defense budget are especially important to this discussion.

Many people had hoped for a "peace dividend"—the shift of a significant portion of defense expenditures to a combination of reduced taxes and more expenditures on domestic problems. This notion is challenged on two counts. First, some caution. We are concerned that "the world is still a dangerous place," and therefore we need to avoid reducing defense expenditures too much.

Second, the more serious challenge is the macroeconomic argument—we need to avoid deep and fast cuts in military expenditures because our economy can't shift workers fast enough from military to domestic needs without severe dislocations and local economic hardships. We are thus in the Galbraithian world in which we need production not for its product, but for the employment and income it generates.

Thus, the conversion of military expenditures to civilian employment, though urgently needed, must be done gradually. With this background, let us proceed to examine the solution.

## What Must be Done

The immediate goal is to get out of recession, but it must be done in such a way that our long-term problems are addressed at the same time. This requires a direct, long-term commitment from the federal government, initially for increased expenditures, and inevitably for increased federal taxes with which to pay for these outlays.

The standard procedure for combating economic recession is some combination of expansionary monetary and fiscal policies. An expansionary monetary policy in a stagnant economy is, by itself, relatively ineffective. Although expanded reserves can be made available to the commercial banking system, the government can neither force skittish bankers to lend, nor debt-ridden businesses and consumers to borrow—especially after the heyday binge of the 1980s and the inevitable reaction to it. Banks have been chastised for being "fast and loose." Now, acting more cautiously, they complain about a lack of "qualified borrowers." Moreover, potential borrowers are unable, or see no reason, to borrow in a depressed economy. It should not surprise us that the recent easy monetary policy has not resulted in a strong economic recovery.

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We are thus left with an expansionary fiscal policy as the surest way to get out of recession. But herein lies the dilemma. To expand government expenditures, or cut federal taxes, will surely increase our annual deficits which most believe are already too high. This illustrates the fundamental, egregious error of not having reduced federal deficits during the economic expansion of the 1980s. We have foolishly and myopically stripped ourselves of our most effective means of fighting recession. Not to embark on an expansionary fiscal policy, however, means that the economy will languish in recession, or experience anemic, sluggish growth, at best.

The only rational approach is to address our cyclical and structural problems at the same time. This means an expansionary fiscal policy consisting of increased federal expenditures—*not tax cuts*—aimed at those items which will increase the productive capacity of our economy and promote rural and urban development. This includes spending for physical infrastructure, education, child development, health care, drug treatment, environmental improvement, and research and development. These outlays should be targeted in ways that take fiscal pressures off state and local government, thereby augmenting the expansionary effect of this strategy. For example, this is an opportunity to refurbish our land grant and other public universities. Roads, bridges, water and sewer systems in cities and small towns need upgrading; as do schools parks, law enforcement agencies and corrections facilities. Drug addicts require treatment programs and pre-school children need health, nutrition and educational programs.

These expenditures would provide an immediate and direct effect on employment throughout the nation, while alleviating pressure on state and local budgets. As people are put to work and new jobs are created, confidence would gradually be restored and private investment would be encouraged—not through tax gimmicks, but through the expectation of profits. Most importantly, this strategy addresses long-term goals of increasing productivity.

With these expenditures, federal deficits would increase in the short-term. This is so because higher federal taxes for these programs during recession would be too restrictive, and a rapid shift of expenditures from military to civilian needs would cause intolerable unemployment in the defense sector.

As the economy moves toward full employment, however, we will need to tighten our fiscal policy and reduce our *structural* deficit. The general goal should be to move *toward* a structurally balanced budget. This should be achieved not through reduced expenditure, but through increased federal taxes for the middle and upper classes. Here is where gradually redirected money from the cold war military budget could help us with the transition. State and local tax relief, allowed by the expenditures described above, could provide some offset to higher federal taxes.

We emphasize, however, that higher federal taxes in the future is the price that must be paid for the profligacy of the 1980s to relieve the burden on state and local governments, and to achieve the stable, just and prosperous society we all wish for.

## Complementary Tools

Several other tasks need to be undertaken. First, our financial institutions need to be closely monitored and regulated. While this is viewed in some quarters as burdensome and onerous, it is a necessary function of government to ensure that our citizenry have

absolute confidence in the security of savings and pension funds.

Second, deposit insurance should be maintained for those who request it. If banks wish to offer high interest rates for uninsured deposits, that should be possible so long as depositors are fully informed, and have the option of insured deposits, presumably at lower interest rates.

Third, we must totally re-examine federal policy on mergers and acquisitions. Economists, since the time of Adam Smith, have condemned monopoly and monopoly power as inefficient and dangerous to the well-being of society. In general, monopoly power means lower levels of output at higher prices. Yet, there are other dangers as well. Consider, for example, the banking system. Having the world's largest banks should not be a matter of national pride. Many large banks can serve as efficiently as a very few superbanks. Moreover, the failure of superbanks endangers the stability of the financial system more than the failure of smaller banks. Finally, the nation can ill-afford the disillusionment of employees whose careers are prematurely ended as a result of "restructuring."

Fourth, the drug problem deserves special mention. Drug treatment should be made available to anyone and everyone who request it. The reduced productivity and drug-induced crime are a drag on national productivity and quality of life. The only viable solution for drugs and related crime is to reduce demand. Interdiction of supply has been, and will continue to be, a total failure.

## In Perspective

The policies we recommend represent a significant departure from the ideology of the recent past. In particular, we reaffirm the responsibility of the public, working collectively through government, to achieve community goals. We assert that these recommendations are neither radical, nor complicated. The federal government has both the ability and the responsibility to stabilize the economy. It also has the responsibility for long-term public investments that affect long-term productivity and to work toward the achievement of a civilized and just society.

Our recommendation to work toward a structurally balanced budget gradually, and with determination, should offend no one. But the fact that we need higher federal taxes *will* offend some people. However, to insist that our economic affairs can be put in order without raising taxes smacks of hubris.

Under our program, the federal government would have a greater role in domestic affairs. However, ultimately, federal expenditures would not be much greater than during the 1980s as resources would gradually be shifted from the military to the civilian sector. The expenditures outlined here are necessary, not only as important public sector investments, but to achieve and maintain full employment.

Neither investment tax credits, nor capital gains tax reductions are needed. However, to the extent that people either believe such incentives are needed, or simply exercise the political muscle to obtain them, such gifts may be part of a political compromise that incorporates the steps we emphasize. We leave the compromising to the politicians, however. In any case, if the measures we recommend are put into place, private investment will naturally follow, with or without popular tax incentives.

Our intent is to recommend the basic policy measures necessary to begin a prosperous 21st century. They are neither radical nor complex. Perhaps it is their fundamental and direct simplicity that makes them difficult to implement. **C**