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THE RETURN OF BIG GOVERNMENT

Policy Advice for President Obama

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Preface

In the current global financial crisis, economists and policymakers have reembraced Big Government as a means of preventing the reoccurrence of a debt-deflation depression. According to Senior Scholar L. Randall Wray, the danger is that policy may not downsize finance and replace money manager capitalism. Moreover, we need a permanently larger fiscal presence, with more public services. His advice to President Obama is to discard all of former U.S. Treasury Secretary Henry M. Paulson's actions. Wray believes that we can afford any necessary spending and bailouts, and that these actions will not burden our grandchildren.

The interrelated factors largely responsible for America's "golden age" immediately following World War II include pent-up demand, the baby boom, moderate inflation, and Big Government. Based on the teachings of Hyman P. Minsky, Wray also includes factors such as a high wage / high consumption bias, a high government debt ratio and low private debt, external markets for U.S. output, and a government spending "ratchet" where spending grows faster than GDP. He notes that policy aimed to push private investment introduces inflationary pressures, promotes inequality, and creates excessive productive capacity. Ensuring a sustainable growth path will require job creation, income growth, debt relief, public infrastructure investment, more public services—and a greater role for government.

Wray proposes policies for both the near and far terms. Policies to deal with the immediate crisis include liquidity injection by the Federal Reserve, a "too big to save" doctrine (owners of troubled institutions either inject their own capital or face receivership and bankruptcy), tax relief that strengthens household balance sheets, fiscal stimulus, mortgage relief, and higher budgets for the pursuit of fraud. Policies to encourage sustainable economic growth in the medium to long term include green initiatives, combined with the stoppage of commodity markets speculation; payroll tax reform; the provision of federal funds to states that take actions to lift regressive taxes and reverse trends of rising inequality; health care reform; government control of social services such as education, health care, and military services; financial reform; and job creation.

Fear of large deficits relates to inflation, investment crowding-out, and insolvency. According to Wray, this fear is without merit. The key to mitigating inflation is to ensure that the correct nature and composition of government spending grows at a pace consistent with the level of fiscal stimulus. This is achieved with a federal jobs program. Obama was on the right track when he set a goal of creating millions of new jobs, says Wray, but he should provide jobs without limit to anyone willing and ready to work. This policy action is not inflationary if there is a fixed price, the quantity is floated, and the government offers a living wage, with benefits, that does not bid against the private sector. A government jobs program would operate like a buffer stock—expanding in a recession and shrinking in a boom.

The solution to resource crowding-out is not to hire away the resources needed by the private sector. In terms of financial crowding-out, says Wray, the theory that government deficits push up interest rates and replace private investment is wrong. Central bankers target the short-term interest rate, so higher rates in response to budget deficits are merely a policy decision. Moreover, Treasury debt is an inconsistent policy variable, because the market dictates the interest rate on each maturity. In terms of insolvency, a sovereign government that issues its own floating-rate currency can never become insolvent in its own currency. Therefore, analogies to household budgets are completely erroneous. In conclusion, says Wray, we must envision a new form of capitalism that is more economically, financially, socially, politically, and environmentally sustainable.

As always, I welcome your comments and suggestions.

Dimitri B. Papadimitriou, *President*
March 2009

The Return of Big Government

Introduction

Perhaps the only silver lining in the current global crisis is that economists and policymakers have rediscovered the benefits of Big Government. To be sure, the neocons, who have been running government even as they rail about its evil nature, never really intended to reduce its role. As I have argued, they simply changed its constituency: a government of the rich, for the rich, and by the rich (Wray 2005; see also, Galbraith 2008). Still, they proclaimed that Big Government is bad, then set out to govern in such a manner that everyone would agree with them. But, as common wisdom teaches, there are no atheists in foxholes. 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 (in James K. Galbraith's terminology); probably the best example is the continuation of former Treasury Secretary Henry Paulson's attempts to preserve the outsize role that Wall Street has played in recent years. As I will argue, public policy ought to be aimed in the opposite direction: to downsize finance. Others responsible for policy change simply misunderstand the scope of the problem as well as the policy options at hand. For example, even President Obama continually frets about the impacts that an appropriately sized fiscal stimulus might have on budget deficits and financial burdens of future generations. I will try to calm such fears. We can afford any necessary spending and bailouts, and these will not burden our grandchildren.

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. In other words, we need to take this opportunity to replace money manager capitalism with another form that promotes economic, financial, and environmental sustainability. That is, I think, what President Obama means by "real change."

Minsky saw this crisis coming as early as the late 1950s. Some have called the current crisis the "Minsky moment," but actually it is more accurate to recognize this as the culmination of the "Minsky half century." What we need now is the "Big Government" Treasury to ramp up spending to prevent "It" (a debt deflation–led depression) from happening again. The federal budget deficit will grow toward a trillion dollars annually, allowing the private sector to strengthen its balance sheet by running budget surpluses. The (discretionary) fiscal stimulus package now appears to include almost $800 billion in new spending and/or tax cuts; the "automatic stabilizers" already in place will add to that. A trillion here, a trillion there, and we will be able to avoid another "great" depression.

But there is a real danger in the belief that all we need is a big but short-lived fiscal stimulus. As I will argue, what we really need is a "ratchet"—more government spending in the "depression" to provide needed effective demand, and then continued fiscal stimulus in the recovery to ensure that we can operate the new plant and equipment that will be put in place. Further, we need a permanently larger fiscal presence that will provide good jobs and better infrastructure, and needed public services. While we should applaud the Obama team's promise to spend more on infrastructure and "green" investments, critics are right that such policies will leave women as well as many people of color behind. But we also need more public services in the areas of health, education, child care, and elder care—areas that can potentially employ millions of women. The early postwar period is often called America's "golden age"—and it was for a lot of us, especially educated white males. America can do better than that. We will need millions of new, permanent jobs for those who are chronically left behind, even during rising tides.

Why Did We Have a Golden Age?

Paul Krugman (2008) has argued that four factors were largely responsible for the 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 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 wherewithal to purchase U.S. exports (also adding to demand for U.S. output was the destruction of productive capacity by war in 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.

No doubt there are other factors, but these lead to several relevant points. While much postwar "Keynesian" policy tried to push private investment (tax credits for saving and investing), some economists (Evsey Domar, Minsky, Harold Vatter and John Walker; see Wray 2008c) recognized that this is problematic, for several reasons that I can only briefly summarize here. First, it tends to introduce inflationary pressures, since, at the aggregate level, prices of consumer goods must be marked up above the wage bill required to produce those goods. This ensures that the workers who produced the goods cannot consume all of them, leaving consumption goods for workers (and others) in other sectors to consume (Minsky 2008b). Second, it tends to promote inequality, since wages and profits in the investment sector are higher due to greater economic power (of unions and firms). Third, it creates excessive productive capacity unless demand rises sufficiently (with capital-saving innovations, it is likely that the supply-side effects of investment outstrip the demand-side or multiplier effects, leaving capital idle and depressing demand). Finally, as emphasized by Minsky (2008a), modern investment goods are expensive and long-lived, requiring complex financial instruments and relations. This is related to the point I made above: investment-fueled economic growth will at the same time tend to produce growing private-debt ratios that increase financial fragility. For this reason, Minsky always argued that government-spending-led growth is more sustainable because it allows private sector spending to grow based on income rather than private debt.

We now see why the four factors I listed above are interrelated. As Krugman has argued, it was World War II and the subsequent cold war that ended the depression and set the stage for the "Golden Age." The government deficit reached 25 percent of GDP during the war, providing a massive amount of private sector saving in the form of safe financial assets that strengthened balance sheets. 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 (see Wray 2008c). This pulled up aggregate demand and private sector incomes, and thus consumption. Note that 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.

Economists have long recognized a macroeconomic turning point in the early 1970s. 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 (on the belief this would restore growth) 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 of firms and households about 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 thrift-financed real estate construction boom (and then collapse); a NASDAQ dot-com IPO boom (then bust); a securitized NINJA (no income, no job, no assets) subprime boom (and crisis); and pension fund–fueled index speculation in commodities futures (Wray 2008a, 2008b). With no more bubbles on the immediate horizon, we are left with debt deflation and deepening recession.

Where do we go from here? Private sector–led expansions are (almost) inherently unsustainable because they generate growing debt burdens that eventually must be reversed. (I admit, however, that I continually underestimated the willingness of America's firms and households to accumulate debt—I started projecting this current crisis about 10 years too soon.) It is clear that what we need now is job creation, growth of income (especially wages), and debt relief, all of which will put household finances on better footing. We need public infrastructure investment—not private investment—as well as more (and better) public services. Virtually all economists now favor a bigger role for government; however, most see this as a temporary fix. What I am arguing is that we need a big and growing government—the ratchet—to generate a sustainable growth path.

We need a growing role for government. But will we be able to afford it? Will it cause inflation? Won't government spending crowd out private investment? What about government solvency? Isn't government subject to a budget constraint, just like households and firms? These are questions addressed in the final section.

Policies for the Short Run

We first must deal with the burgeoning crisis, which requires a big and immediate intervention. Here I will not delve deeply into the causes of the financial meltdown—interested readers are referred to my various Levy Policy Notes and Public Policy Briefs, which foresaw and then analyzed the processes that created a "perfect storm" (the title of a piece I wrote in

2003—perhaps a wee bit prematurely?). We must remember Minsky's admonition that "stability is destabilizing"—successful resolution of this crisis and restoration of a semblance of stability will encourage a return to risky practices. That is why we also need a package of policies for the medium- and longer-term. While we can never go back to the New Deal institutions and regulations, we can certainly learn from them. We had a long run of good times after World War II, and Roosevelt's New Deal had a lot to do with that. The unraveling of the social and economic fabric over time—partly in response to deregulation but mostly due to "natural" profit-seeking behavior of innovative firms—created conditions in which "It" became possible again. Hence, what we want to do is to promote institutions, regulations, and practices that can constrain modern capitalism's inherent thrust toward fragility.

Here is a brief list of policies to deal with the immediate crisis:

(1) *Liquidity.* While it took too long, the Federal Reserve (Fed) finally figured out that it must lend without limit to any financial institution. Forget collateral—it doesn't matter (we are on the hook, anyway, due to deposit insurance as well as the public interest in squelching a spreading meltdown). 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. Note that the Treasury's recently announced plan to issue bonds with a wider range of maturities does not help unless the Fed manages the interest rates on all the maturities. So, we need policy coordination. Raise the Federal Deposit Insurance Corporation's (FDIC) limit to infinity (we are going to bail out the depositors anyway). 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.* 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. Wrong. It didn't. He next tried to buy bad assets—but as we (now) know, bad assets on the books of

banks total $3 trillion to $5 trillion, so he would need much more than Congress had allocated. Then he proposed injecting capital into the banks. Ditto: too little, too late. So 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). Who needs socialism when Wall Street runs the Treasury? Advice to President Obama: discard (and reverse where possible) all of Paulson's actions. And, please, we do not need to create a "bad bank" in order to concentrate the toxic waste. We already have plenty of them: Goldman Sachs, Citibank, and Bank of America are our concentrators.

(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. Unfortunately, if you leave the crooks in charge of insolvent financial institutions, they like to "bet the bank"—to take huge risks, since they have nothing to lose. That is what happened to thrifts in the 1980s, and it appears to be happening right now. So 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. This could include hundreds of institutions. There will be collateral damage—for example, pension funds hold stocks in such institutions, so we will need to bail them out through the Pension Benefit Guarantee Corporation, which will itself go bankrupt so we will need to bail that out, too. The total cost may be in the trillions of dollars. Can we afford it? See

below. 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. Take-home pay would rise by an average of $77 per week, with an equivalent saving per worker for each employer. A worker who earned $40,000 annually would get a tax cut of $2,480 per year. Just as important, that worker's employer would also benefit from $2,480 in tax relief, which may help keep workers on the job. If desired, we can phase the tax back in when the stimulus is no longer needed (although payroll tax reform is included in my longer-run policy proposal).

(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. (Another silver lining: privatization of Social Security is, thankfully, a dead issue, as no one in his right mind would trust Wall Street with the third leg of his retirement stool.) 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. They need at least $400 billion in "block grants" (perhaps based on population) to be spread among them. Maybe some of the money would be targeted, to be spent on public infrastructure projects either already under way or on the shelf but ready to go; some would go to Medicaid; and some would come with no strings attached.

(6) *Mortgage relief.* Millions of homeowners are underwater, with outstanding mortgages greater than home value, and it will get worse. Millions were duped into subprime loans at resetting rates they cannot afford. Millions more used homes as cash-out ATMs, have fallen behind in payments, and now face job loss or at least reduced hours and wages. Economic recovery, job creation, a payroll tax holiday, and rising wages will all provide relief because they will make it easier to service debt. But more direct measures will also be required. The FDIC was the only Bush Administration agency with any clue about what needs to be done to stop the death spiral. 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 (again, there will be collateral damage that will have to be resolved.) 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. A debt deflation is not the right time to worry about moral hazard. Who will issue the new mortgages? 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. Homeownership is not for everyone, and at least some owners will opt for economist Dean Baker's "rent to

own" plan. Give them back their down payments (plus fees paid to mortgage originator swindlers), let them stay in their homes paying fair market rents, and give them a couple of years to decide whether they really want to be homeowners. Finally, Congress is moving to give up to $15,000 in tax credits for the purchase of a home. Bad idea. This will encourage house flipping (you buy mine, I buy yours, nobody moves, and we reverse the deal later). It is far better to offer jobs and good mortgages to anyone who wants them.

(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). Some combination of pressure on our oil producing "friends," subsidies for alternative energy and conservation, and energy costs relief for low-income households will be needed. We will also have to stop the speculation in oil and other commodities, by closing loopholes in the futures markets and prohibiting pension funds from index speculation (Wray 2008b).

(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—and this might come as a shock to readers who have

bought into the claims made by intergenerational warriors financed by the Concorde Coalition—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 do it anyway, even when we are not on holiday). They can then credit the OASDI Trust Fund with the one-third-extra tax revenue that would have been received (once again, they do that anyway, since the Trust is just a Treasury promise to pay Social Security payments when they come due). 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. Let us accept the social commitment to ensure a decent retirement for all Americans (which will depend on our capacity to produce the real stuff retirees will want, plus our ability to import) and come up with a better way to redistribute resources from those of working age to those of retirement age. After all, that is really what payroll taxes are all about: taking income away from those accruing it to ensure they don't consume everything. It makes far more sense to tax all sources of income, in a progressive manner, in order to share the burden of taking care of a growing elderly population. Can we financially afford growing numbers of baby boomer retirees? Of course we can, as argued below. Can we ensure they get enough real resources to achieve the standard of living they expect at retirement? Probably, but that has nothing to do with affordability or payroll taxes. All it requires is that we (a) provide sufficiently large credits to their bank accounts, and (b) put at their command a sufficient quantity of real resources.

(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). I suggest we offer federal government funding to states that agree to eliminate regressive taxes (except for those imposed on "sin" goods such as alcohol and tobacco), on a dollar-for-dollar basis.

(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 (thanks largely to emulation of Hollywood and Wall Street) 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; I have already alluded to the reversal of the early postwar trend that saw poverty rates fall by half by the mid 1970s—and then virtually no further reduction since. I won't go into all of this in detail, 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 played an important role—a problem Obama has promised to address. What Jamie Galbraith has called the "predator state" has also played a major role, as Dick Cheney and his minions have richly rewarded their friends. So, we need to reverse those trends. Thankfully, Wall Street has already taken care of most of the excessively rich, downsizing their wealth and incomes to an extent not seen since 1929. Now we only need to drive a stake through the heart of finance to ensure it cannot recover. Next, we need to get incomes rising at the bottom—more on this below.

(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.* I have argued that 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. Our standards used to be higher. I can remember when all the kids expected levitating bullet trains coast to coast and perhaps even rocket ship transport to Martian sea vacations by the early 21st century. Here we are a half century later, stuck in traffic in gas-guzzling dinosaurs that aren't that far removed from the finned Buicks our grandparents drove. If anything, our relative dearth of public services is even worse than it was when John Kenneth Galbraith first brought it to our attention in the 1950s.[1] 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. Let the market mow lawns and determine toothpaste flavors; leave the important stuff—education, child and elder care, health care, military and security services, and other social services—to government.

(7) *Financial reform.* The market has decisively spoken: It is not capable of self-regulation. It cannot tell who is creditworthy. 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. In short, it is telling us that government of Goldman Sachs, by Goldman Sachs, and for Goldman Sachs is no way to run a country or an economy. President 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. I even believe that able adults *ought* to work, rather than relying on handouts. Further, I think these principles are consistent with capitalism and with the United Nations' Universal Declaration of Human Rights, which includes the right to a job. 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. The second point was developed as Karl Marx's "reserve army of the unemployed" argument, updated as a Phillips Curve trade-off, transformed as Milton Friedman's natural rate hypothesis, later bastardized as the Lucas "surprise" hypothesis, then rejected by real-business-cycle claims, and finally revived as the New Monetary Consensus Taylor rule. 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. Let that sink in for a moment: if everyone is gainfully employed producing the stuff we Americans want to consume, that will be more inflationary than an economy in which we maintain, say, 10 percent of the employable population in enforced idleness, subsisting on handouts and producing nothing of use. Only an economist could love such an outrageous proposition. It sounds silly because it is. (The British economist Joan Robinson used to argue that one should study economics in order to identify the lies economists tell.) I do not have the space here to explain what is wrong with the conventional views or to detail an alternative. Let me just say that Obama is on the right track when he sets a goal of creating millions of new jobs, many of which will be created through programs modeled on the New Deal. He can and should go much further; 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. One key to ensuring that government spending is not inflationary is to make sure it does not increase demand beyond full employment. The jobs program I am describing here is an automatic stabilizer: spending increases up to the point of full employment, and then no farther. It provides full employment without generating inflationary pressures. (But can we afford it? You betcha. See below.)

This package of policies will help to restore sustainable economic growth, putting America on a new path to an even better Golden Age. It will reduce inequality, shift the emphasis away from private investment and toward consumption (out of earned income, not debt or welfare) and public spending, reduce the role of high finance, and provide better services and more secure retirements for our aging baby boomers. Still, as Minsky argued, we have to be diligent, because the stability created by these policies will encourage experimentation by profit seekers to push risky practices. This means that the policymaker's work is never done. New challenges will arise—but that is no reason to forego Golden Ages.

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. I suspect that a large part of the reason can be attributed to Rubinitis (better known as deficit-phobia). Why, in the face of the biggest economic catastrophe this nation has faced since the 1930s, would Obama lose his courage? The three "ayes" have it: inflation, investment crowding-out, and insolvency. I will try to calm those fears.

First, inflation: price pressures can arise from many sources—excess demand, commodity price hikes, bottlenecks, wage or profit pressures, composition of demand (trade surpluses and private investment tend to be inflationary for reasons mentioned above), and so on. 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—to avoid bottlenecks, to add to productive capacity, toward underutilized resources, and toward resources whose prices are rising at less than the average rate of price increase. Right now, it probably doesn't matter too much what the government spends on (the often quoted Keynes statement about digging holes comes to mind), but for the longer run, the composition and nature of government spending is critical. This is for two reasons. First, to maintain public support for its policies, Big Government has got to spend in a way that has obvious benefits for Americans. Second, government has to avoid spending that leads to accelerated inflation. To be sure, moderate and stable inflation is not a bad thing—the no-longer-fashionable New Monetary Consensus wrongly interpreted both theory and evidence to support the erroneous argument that moderate inflation hurts growth—but rising inflation is not acceptable. Can we have the audacity of hope to believe that government can formulate a policy that ensures just the right amount of noninflationary spending? Yes, we can. As discussed above, a comprehensive jobs program that fixes the wage but hires all who want to work does exactly that. Note that the program, by definition, only spends on underutilized resources (those who are unemployed), adds to productive capacity (workers do useful things), and targets a resource whose price increase is below average (the wage is fixed, with only occasional adjustments—much as the minimum wage is now periodically adjusted upward).

The second reason is investment crowding-out. There are two main kinds of crowding-out: resource and financial. If the government were to hire away all of the competent engineers, investment projects that required engineers could get crowded out for the simple reason that the government has an unlimited checking account and can always win any bidding war. At full employment (as in World War II), additional government hiring crowds out private hiring. The solution to resource crowding-out is pretty simple: to avoid it, don't hire away the resources the private sector needs. When the economy is well below full employment, this is easy enough; when it is close to full employment, care is required.

Usually, however, economists worry more 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. Government will win the competition because its borrowing and spending are not interest-sensitive. 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. All central bankers everywhere now admit that they target the short-term interest rate; and they hit their targets within a self-determined margin of error. It makes no difference whether the budget deficit reaches a Japan-like 10 percent of GDP (with zero interest rates), or a United States–like 25 percent of GDP (during World War II, with interest rates at 3/8ths of 1 percent), or a United States–like budget *surplus* of 2 percent of GDP (under President Clinton—accompanied by rising rates!). 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.

There are two further, somewhat more technical, points to be made. The first is that the central bank operates with an overnight rate target, but it can choose the maturity it likes; indeed, Chairman Ben Bernanke's Fed experiments with longer maturity targets, a policy labeled "quantitative easing." This seems important because one objection is that the Treasury issues longer-term debt, and while it is true that the central bank sets overnight rates, longer rates are "market determined" and crowding-out in the longer maturity markets is still possible. However, the maturity of Treasury debt is a policy variable—and there is no reason in principle why the Treasury could not operate only at the short end (even overnight debt!) to avoid crowding-out. Unfortunately, as mentioned above, the Treasury is now planning to issue an even wider range of maturities. This does have the advantage of giving the market a safe asset with the desired maturity. However, the Treasury's plans include letting the market dictate the interest rate on each maturity. In present circumstances, when the Fed is trying to bring down longer rates, the Treasury's approach is inconsistent. It makes much more sense for the Fed to manage the term structure of interest rates by providing loans of reserves at a variety of maturities, and offering interest rates on deposits of reserves at different maturities. The Treasury could then stick to the short end of the market, where the Fed sets the overnight rate—ending any confusion over the links between deficits and interest rates.

For those who are still skeptical, let me move on to the second, more 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. Continuous budget deficits lead to continuous open market sales, causing the New York Fed to call on the Treasury to soak up reserves through new issues of bonds. The purpose of bond sales by the Fed or the Treasury is to substitute interest-earning bonds for undesired reserves—to allow the Fed to hit its interest rate target.[2] 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.

On to the final phobia: 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.[3] 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. The accounting and operating procedures adopted by the Treasury, the Fed, special deposit banks, and regular banks are complex, but they do not change the principle: government spending is accomplished by crediting bank accounts. 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.

Constraining government spending by imposing budgets is certainly desirable. We want to know in advance what the government is planning to do, and we want to hold it accountable; a budget is one lever of control. At this point, it is impossible to know how much additional government spending will be required to get us out of this deep recession. Whether the Obama team finally pushes through Congress $850 billion worth of useful projects, or $1.5 trillion, voters have the right to expect that the spending is well planned and that the projects are well executed. But the budgets for these projects ought to be set with regard to desired results and project competencies—the ability to successfully execute the plans—not out of some preconceived notion of what is "affordable." Our federal government can afford anything that is for sale in terms of its own currency. The trick is to ensure that it spends enough to produce sustainable growth and other desired outcomes while at the same time ensuring that its spending does not have undesirable outcomes such as fueling inflation or taking away resources that could be put to better use by the private sector.

In conclusion, we face huge, but not impossible, challenges. We need to resolve the current crisis, which has many facets: a financial crisis, a homeownership crisis, a jobs crisis, a retail sales crisis, and so on. We also need to deal with longer-term problems: inequality, environmental challenges including global warming, an aging society, and restoration of rising living standards for most Americans (note that this requires a change in our style of life or it will dangerously conflict with environmental sustainability). At the same time, we also have to dispel a large number of bogeymen: debt burdens, crowding-out, the inflation-unemployment trade-off, and federal government insolvency. Finally, we have to try to formulate policy solutions that do not simply set us up for another crisis. This requires not only that we understand the processes that brought us to the precipice but also that we envision a new form of capitalism that is more economically, financially, socially, politically, and environmentally sustainable. That is change we can believe in.

Notes

1. The view that America had an abundance of private goods and services but was seriously deficient in its supply of public infrastructure and services was put forward in John Kenneth Galbraith's *The Affluent Society*, published in 1958.
2. In the old days, these reserves earned no interest. Bernanke changed that, effectively eliminating the difference between very short-term Treasuries and bank reserves. This move also entirely eliminated the need to issue Treasuries—but that is a topic for another day.
3. While such a currency is often called "fiat" (which is somewhat misleading for reasons I won't discuss here), I prefer "sovereign currency."

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