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Stockman to America: Sinners, Repent!

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Can today's economic and political troubles be traced to Roosevelt's misinterpretation of John Maynard Keynes' prescriptions during the Depression? Or to Nixon's closing of the gold window in 1971, which put the United States on a fiat-money standard? Or to Reagan's inability to control the growth of government spending when he proposed, and Congress enacted, a massive income tax cut in 1981?

Or to the constitutional amendment allowing income taxes in 1913, along with the establishment in the same year of the Federal Reserve?

In a massive volume that melds economic history and social criticism, the former Reagan administration budget director David Stockman said yes to all of these. He found many more ways in which we went astray. Most notably, he decried the corruption of free-market capitalism by those seeking effortless profits at the public's expense. This is the source of the book's title, *The Great Deformation.*

But while Stockman put forth earnest effort recounting the history of monetary and fiscal folly in the United States, *The Great Deformation* is a very bad book. It is encumbered by florid prose, a tendency to rewrite history to favor Stockman's viewpoint and a hectoring tone. Less superficially, its real fault is that it condemns the United States today as a society gone profoundly wrong. I disagree: The U.S. today is one of the best societies human history has produced, though it is in need of a few significant changes.

Stockman's deep pessimism is not justified, and his policy recommendations are much too radical.

Stockman and Reagan

Stockman earned fame a couple of decades ago for serving in the Reagan administration, where he held the key position of budget director, and then for leaving it due to differences with the president over fiscal policy. Reagan was able to secure a major tax cut (the top income tax rate went from 70% to 28%) but not the corresponding spending cuts that he thought were needed. The result was a federal budget deficit that peaked at $221 billion, or 5% of GDP, in 1986. (For comparison, the 2009 budget deficit was 11.9% of GDP, and it did not sink below 10% of GDP until 2012.) Stockman wanted a balanced budget and resigned in protest. In his first, clumsily titled book *The Triumph of Politics* (1986), he forecast an economic catastrophe due to the Reagan deficits.

We know what happened next. During the long boom of 1982-2000, real value added per hour worked, the purest measure of economic performance, increased by a cumulative total of 31% — that is, 1.5% per year.[1] That's hardly a catastrophe, and the metric understates the amount of improvement that most people experienced. The startling increase in the standard of living between 1970 and the present — housing space per capita almost doubled, motor vehicle use almost tripled and all but the poorest households came to enjoy telephones, televisions and air conditioning — occurred mostly in this boom period.

Stockman's take on the long boom is that the observed growth in consumption was largely fueled by debt and thus unearned. But any unearned or debt-financed increases in consumption came on top of increases from the documented rate of real productivity growth. These latter increases were unquestionably earned.[2] And from the viewpoint of the government, the tax cuts paid off, with growth so robust that the federal budget was in surplus from 1998 to 2001 and pretty close to it in 2007, despite the vastly expanded reach of government programs.

But Stockman, defending his *Triumph of Politics* thesis, rewrote history so that the long boom in real economic performance didn't happen. It was, he says, just a boom in consumption, "a simulacrum of prosperity: a house of cards that would collapse with stunning speed and violence."

Perhaps Stockman forgot what economic life in the U.S. was like in 1981. It wasn't exactly a depression, but countless small businesses that had prospered for decades were driven into bankruptcy by interest rates often exceeding 20%. The Ibbotson index of the real (inflation-adjusted) total return on long-term Treasury bonds fell from a base of 100 in 1940 to 32.72 in September 1981, conveying the wealth destruction that had accrued to savers during the Great Inflation. The stock market was in shambles.

Looking beyond U.S. borders, incomes in India and China had barely budged since the Middle Ages. Now they are burgeoning. For the average person in the world, the decades since 1981 have been the most productive in history, even counting the recent recessionary years.[3] For a simulacrum of prosperity, it worked well.

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[1] Approximate (obtained by reading a graph). This productivity growth rate was less than the historical average but a big improvement from the period just prior, as growth rates began their long climb from the lows of the late 1970s to the boom rates of the late 1990s. The productivity growth rate has since fallen sharply in the Great Recession and its aftermath, but productivity is still growing, not shrinking.

[2] Stockman's concern about unearned consumption is also subject to a caveat. Our society increasingly rewards sophisticated knowledge acquired over time, rather than the sweat of one's brow. Households, especially young ones with children, are going to have to rely on debt more than they used to. Thus, as long as the borrower doesn't actually default, consumption financed by private debt is earned, just not earned in the past. That is what financial markets are for: to shift consumption across time periods.

[3] Stockman also faults Reagan's budget deficits for starting the U.S. on a path to an unsupportable debt level. In hindsight, there is something to this critique. Debt buildup beyond a supportable level could not have occurred if it had never been allowed to start. But we should remember that when increasing the amount of debt one owes, the starting point matters a great deal. The Reagan deficits took the federal debt load, expressed as a percentage of GDP, from 31% in 1981 to 51% in 1989. The trend is in the wrong direction, but both levels are supportable. Increases in debt are only a problem if the trend is continued indefinitely.

Easy Money and Moral Hazard

Stockman reserved his greatest disdain for Federal Reserve chairmen Alan Greenspan and Ben Bernanke, accusing them of easy-money policies designed to preserve the appearance of prosperity at all costs. Stockman focused on moral hazard, the encouragement of bad behavior by policies that remove or soften the consequences of such behavior. The bad behavior in this case is mostly financial speculation.

This critique is both familiar and correct. My 2009 article, "A Riskless Society is 'Unattainable and Infinitely Expensive'," expressed similar concerns. After each episode of private-sector financial folly, there is a bailout with public funds, contributing to the perception that there really is no risk in any activity. Private interests receive the benefits, the taxpayer pays the cost and the triggering event is larger each time.

Some observers date the beginning of the era of easy money and moral hazard to Greenspan's response to the 1987 stock market crash. Stockman correctly located it earlier, in the Johnson and Nixon administrations, when those two presidents bullied Fed chairmen William McChesney Martin and Arthur Burns into providing monetary ease for political reasons. (The Fed is supposed to be independent of political influence, and the generally well-regarded Martin is the source of the famous comment that the Fed's role is to "to take away the punch bowl just as the party gets going.") For Stockman, though, the origin of our present troubles preceded the easy money era. He blamed the 1913 founding of the Federal Reserve, which he said gave control over the money supply to a "politburo" instead of the impersonal discipline of a gold standard.

For Stockman as for many others, Greenspan's easy-money policies were a surprise, because the disciple of the conservative novelist Ayn Rand was seen as a hard-money man. As events unfolded during Greenspan's tenure, his repeated response — to flood the economy with central-bank credit whenever there was a downturn or threat of a crisis — confirmed that he was determined to create the monetary conditions needed for almost continuous economic growth, no matter what the undesirable side effects of such a policy might be.

I don't blame Greenspan. As the Nobel Prize-winning economist Robert Lucas has said, economic growth is so important that it's hard to think about anything else. It's what makes a child in Switzerland have a brighter future than a child in Bangladesh.

But the side effects of continual credit expansion are real, and they can be costly. The most serious side effect is moral hazard — the idea that all forms of financial risk-taking are acceptable because the Fed will bail out the losers. The savings and loan and emerging market debt crises of the 1980s, the Asian and Russian economic crises of the 1990s and the tech bubble and housing bubble of the 2000s can all be traced to the building of moral hazard. None of these events would have played out in such a costly manner if market participants lacked a backstop for their risk-taking.

Stockman regarded this habitual bubble-inflation as a form of crony capitalism and corruption. His view is cynical. He blamed evil intentions for what can be very easily explained by naïveté and good intentions. I don't think Alan Greenspan sought to enrich his "cronies," if he had any, by keeping interest rates low. More likely, he thought it was so important to keep the economy growing that some unintended benefits to banks and hedge funds could be tolerated and might even help his growth goals.

For Stockman, every issue is a moral one — a point of view that is not too surprising for a former divinity school student. When thinking about an issue, it can be constructive to ask whether there is a moral dimension to it. But the simplest explanation for a phenomenon is usually the best one. To understand today's never-ending fiscal crisis, the explanation I favor is not moral but behavioral. The tendency of voters to vote themselves benefits from the public treasury that they are not willing to pay for in taxes is a powerful force. It is not new, and it is not about to go away. The only defense against this tendency is a structurally limited government.

It's All Milton Friedman's Fault

One of Stockman's unlikely villains is a fellow conservative, the University of Chicago economist and Nobel Prize winner Milton Friedman. Stockman faulted Friedman for his advocacy of floating exchange rates, his desire to see the end of the gold standard and his overall approach, which Stockman characterizes as crypto-Keynesian.

> The nation's most famous modern conservative economist became the father of Big Government, chronic deficits, and national fiscal bankruptcy. … Friedman's monetarism thereby institutionalized a régime which allowed politicians to chronically spend without taxing. … Likewise, it was the free market professor of the Chicago school who also blessed the fundamental Keynesian proposition that Washington must continuously manage and stimulate the national economy.

Let's take a magnifying lens to this startling comment. Friedman's basic prescription was for a central bank to increase the money supply by a fixed percentage every year. The central bank can only do that with a fiat money, which is created at the central bank's discretion. Under a gold standard, such a policy is impossible. Since Friedman blamed the Great Depression on an unduly restrictive monetary policy, it is natural that he wanted to break the link with gold.

Nixon, who was advised by Friedman among many other economists, eliminated the last remaining element of the gold standard in the U.S. when he ended the convertibility of dollars into gold on Aug. 15, 1971. As Friedman would have predicted, the end of the gold standard and the Fed's aggressive money creation led to runaway inflation. Fed chairman Arthur Burns, not Milton Friedman, bore responsibility for this legendary policy misadventure. In blaming hyperinflation — to say nothing of deficit spending and Keynesian economic fine-tuning — on Milton Friedman, Stockman distorted the historical record.

Yet Stockman had a point that it was risky to abandon the gold standard in favor of Friedman's rule-based monetary discipline, given that the Fed was composed of human beings who were subject to political pressure. The Great Inflation that ensued is testimony to this human weakness.

While Stockman had much more to say about Friedman, I will focus on Friedman's advocacy of floating exchange rates, a policy that was adopted and still prevails. About fixed and floating rates, Stockman said:

> Fixed exchange rates harmonized wages and prices among the major developed economies. … By contrast, floating currencies … led to government manipulation [of exchange rates], protectionism, economic inefficiency, and lower real incomes.

Real incomes have done just fine in the floating-rate period, especially in emerging markets, but that isn't the main point. The key issue is that there is no such thing as a truly fixed exchange rate. Even if two governments agree to keep the exchange rate between their currencies fixed at a rate that is initially fair, the rate will gradually become unfair as inflation progresses at different rates in the two countries. This situation will motivate speculators to buy the undervalued currency and sell the overvalued one with large amounts of borrowed funds, in the hope of making a killing when the inevitable revaluation takes place.

Stockman's concern that floating exchange rates provide a tempting venue for currency manipulators is thus misplaced. If floating exchange rates create the conditions for one set of manipulations and speculations, then fixed rates create conditions for another. Milton Friedman would say that the private speculators who thrive in a floating-rate world are contributing to socially valuable price discovery (the market's determination of what the fair price really is), rather than doing any harm.

As far as Friedman being a crypto-Keynesian, a clue is in the recent collection of Friedman writings, *The Indispensable Milton Friedman* (2012). Friedman admired Keynes' theory for its simplicity and elegance but said that it is unsupported by evidence. Friedman expressed the hope that if Keynes were alive today, he would be — owing to his intellectual honesty and technical competence — in the vanguard of the anti-Keynesian counter-revolution. Stockman, focusing not on Friedman's own words but on the policy actions of politicians claiming him as an influence, missed this point entirely.

The Death of Keynesianism

Stockman was at his best when he called into question the Keynesian assumptions that permeate policymakers' discussions and public understanding of the economy. It is hard to overstate the extent to which the following Keynesian views are simply assumed by most people to be correct:

- All other things being equal, government spending helps the economy.
- In a recession, government should increase spending to make up for the lack of demand from the private sector.
- There is a multiplier effect wherein a dollar of government spending is worth more to the economy than the dollar that is used to pay for the spending.

As Stockman noted, a person who questions these assumptions is often treated like a doctor who questions the usefulness of antibiotics. He or she is considered to be slow-witted, crazy or venal. Yet there is almost no evidence that any of these statements are true. In recent years, for example, stimulus on a scale vaster than anything Keynes imagined has not only failed to grow the economy, but has almost certainly retarded the recovery. This was due not only to the cost of the stimulus, but also to economic inefficiencies caused by the government spending itself.

The Keynesian assumptions stated above follow from the logic in Keynes' *General Theory of Employment, Interest, and Money* (1936). Keynes, who was primarily a scientist, not a polemicist, intended his theory to be tested by subsequent events. While many economists were satisfied that Keynes' propositions worked in practice, the agreement was far from universal. As briefly noted earlier, Milton Friedman dissented:

> I believe that Keynes's theory is the right kind of theory in its simplicity, its concentration on a few key magnitudes, its potential fruitfulness. I have been led to reject it, not on these grounds, but because I believe that it has been contradicted by evidence: its predictions have not been confirmed by experience.[4]

Keynesianism can be reduced (a little unfairly) to the idea that you can have something for nothing. You can't. If output is below potential and the government tries to increase demand by spending money on goods and services, one should ask, "Spending whose money?" The government doesn't have its own money. A government, like any other buyer, can only obtain goods and services by exchanging real economic resources that would otherwise be used for something else. This principle is called Ricardian equivalence, after the economist David Ricardo.[5]

If Ricardian equivalence applies exactly, the Keynesian multiplier is zero. That is, no wealth is created or destroyed by the government's taking money from Peter and giving it to Paul. The government can create value (a multiplier larger than zero) by moving resources from less efficient to more efficient uses. This can happen when a government is just starting out in providing necessary services. But today, the government has already grown large. The multiplier is more likely to be negative, because private parties spend each additional dollar more efficiently than the government does.

Keynesian economic assumptions have become deeply ingrained. They play into the natural human desire to get something for nothing and to find a secret formula that will make everybody better off. But there is no secret formula. Economic growth is the only thing that will make everybody better off, and it's hard work.

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[4] *The Indispensable Milton Friedman,* edited by Lanny Ebenstein, Regnery, Washington, DC, 2012, p. 198.

[5] In the interest of moving the argument along, I've oversimplified Ricardian equivalence somewhat.

Stockman's disdain for Keynesian orthodoxy, then, is well placed. My only quarrel is that he could have devoted more effort to debunking it. But if future historians note that today's troubles led to the death of Keynesianism, Stockman should receive some thanks for helping to discredit this misguided idea.

The Cure is Worse than the Disease

It would be nice if we could go back to a time of Stockman's imagining when businessmen were honest, voters weren't greedy and free-market capitalism meant that capitalists had no influence over the public purse and could fail if their business strategies were uncompetitive. That time didn't exist, as one can easily determine from a casual reading of 19^{th}- and early 20^{th}-century business history. Perhaps Stockman's background as a divinity student inspired him to call for the restoration of a golden age of goodness. He would not be the first preacher whose words recall the Biblical adage that "There were giants in the earth in those days."[6]

But there are no giants in the earth today, just ordinary people facing real problems and needing practical solutions. Stockman cheapened his critique of American society when he asserted that only a re-founding of the republic would be sufficient to solve our problems. His proposed set of remedies is the most startlingly conservative manifesto I can remember reading.

Most of the remedies are impractical or undesirable. Abolish social insurance? I've done too much work on retirement policy to think that a government guarantee of income in retirement can or should ever be completely removed. If saving for retirement is made completely private, those who do not save will have to be rescued by a new government program. Americans would not tolerate their fellows starving or freezing in the street.

Abolish deposit insurance? Its generosity should be reduced, but forcing ordinary bank depositors to become credit analysts — so they can decide which uninsured banks to patronize — is a bad idea.

Impose a 30% wealth tax to pay down the national debt? That's no way to reward thrift and productivity.

Some of Stockman's other proposals, however, are sensible: restoring Glass-Steagall and abandoning Keynesian micromanagement of the economy would be a good place to start. A fully private health-care system, with government subsidies for needy cases, is also appealing and, given recent legislation, is a missed opportunity.

As Stockman admitted, we are not likely to adopt any of these measures wholesale. What we are likely to do is muddle through. We will get some combination of higher taxes, higher inflation and lower government benefits, but no outright debt default and no depression. Stockman's forecast of a seemingly permanent fiscal crisis is about right for the years that it will take for the large baby-boom population to work its way through the Social Security and Medicare beneficiary pool. Then as the economist

[6] *King James Bible,* Genesis 6:4.

Tyler Cowen suggested in his fine book, *The Great Stagnation* (2011), America will begin to feel better. And, in the meantime, we should still be able to achieve pretty good rates of economic growth.

"Sundown in America," the title of one of the book's chapters and also the headline of Stockman's widely circulated op-ed in *The New York Times,* is a play on Ronald Reagan's phrase "morning in America." The title of Stockman's chapter implies a significant lowering of the long-term rate of economic growth. But the long-term average rate of real per capita productivity growth has been a remarkably constant 1.8% over periods of good and bad policy, high and low population growth, fast and slow innovation, easy and tight money and fixed and floating exchange rates. That does not mean it is impossible to ruin the good thing we've got going. But unless we really screw up a number of key growth drivers all at once, we can count on similar growth rates in the future.

Conclusion

Stockman is right in almost every detail but wrong in the large. He is right about the weaknesses of fiat money, the building of moral hazard, the corruption inherent in crony capitalism and the harm done by Keynesian policies.

But he is wrong about the future of America. We need to tilt our policies aggressively toward growth and place reasonable limits on entitlement spending, and that is about all. We do not need to dismantle the federal government, and we would need to reconstruct it if we did. In a free society, the needed productivity enhancement will come from the natural desire of human beings to provide more richly for themselves and their children.

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