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# Public Policy Brief

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## WHAT IS THE AMERICAN MODEL REALLY ABOUT?

Soft Budgets and the  
Keynesian Devolution

JAMES K. GALBRAITH

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# Preface

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The “American model” serves as a point of reference in discussions of economic policy around the world. In countless op-ed pieces and sometimes even in front-page articles, the American case is portrayed as a paradigm of the free market in its purest form. Some say that U.S. performance relative to that of most countries in Western Europe during the 1990s demonstrates the efficiency and dynamism of this model. Others agree, but point to what they see as the unacceptable social costs of economic success: deprivation at the bottom of the economic ladder and deep economic insecurity on its middle rungs.

In this policy brief, James K. Galbraith offers a radically different perspective on the American success story of the 1990s. He argues that the real sources of American economic strength have been misunderstood by analysts across the full range of the ideological spectrum.

Far from embracing a textbook model of untrammelled free enterprise, the United States has relied heavily upon government intervention in health care, pensions, and education. For example, though the ranks of the uninsured grow every year, high-quality health care is available to most of the population. When all of the various health insurance tax breaks and programs for the poor, elderly, and disabled are accounted for, the government pays nearly 60 percent of all health care costs, or 5.8 percent of gross domestic product. Similarly, Social Security payments provide 60 percent of the elderly with their primary source of income. And the vast system of public universities picks up much of the slack in labor markets for the young.

Not only are these programs largely successful and popular with the American public, but they also provide a Keynesian stimulus to spending

that, along with abundant credit, helps account for the strength of the economy as a whole. Thus, the United States has succeeded in many respects not by adhering strictly to free-market precepts, but by defying them. European policymakers have learned the wrong lesson from the American experience and have been tightening budget constraints rather than loosening them.

Galbraith argues that while the American system has many problems of its own, the European Union would benefit from some selective imitation of the American style of big government. For example, a standardized pension program for the entire European Union, patterned after Social Security, would not only help alleviate the severe economic inequalities among regions, but would also provide an infusion to the Continent's anemic economy. Now that the United States finds itself in a weak, jobless recovery, the key to restoring growth here, too, may lie in the kinds of programs that Galbraith emphasizes, which could be shored up by, for example, taking steps to ease the financial straits of state and local governments.

I am sure that Galbraith's brief will provide fresh insights into the cliché-ridden and often sterile debate over Europe's economic problems. As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*  
June 2003

# What Is the American Model Really About?

The American model fascinates Europeans. To many on the right, and certainly to those in lofty perches in the official economic institutions (such as the Organization for Economic Cooperation and Development and the European Commission), the American version of the free market as they imagine it represents an ideal type. It is the highest form of capitalism. It is to be celebrated for its efficiency and technological dynamism, and even its capacity to deliver full employment—all free from the dead hand of governmental regulation and control.<sup>1</sup>

These charms are largely lost on the European public. Certainly they are lost on those who form the intellectual left. In their view, the American model is repellent. Indeed, many perceive a fundamental clash between modern Americanism and such “traditional European values” as fairness, solidarity, and tolerance. This view emphasizes the rapacity of the American multinational corporation, the absence of universal social services in the United States, and the poverty and inequality delivered by American labor markets. It is a position taken by many who seek to defend European social democracy from further degradation.

There is also an emerging group of European progressives who regard the arrival of the American way as a fact of nature, against which resistance is futile. They are therefore attracted to American solutions to the problems of the American model. In particular they emphasize the importance of investments in education, of job training, and of new institutions for “lifelong learning.” Such measures are particularly intended to help workers adjust to the inevitable disruptiveness of life under unfettered capitalism. Such was the theme, for instance, of the Portuguese presidency of the European Union a few years ago.

All three groups—the European right, the left-leaning public, and the “third way” liberals—are concerned mainly with the evolution of economic and social conditions in Europe. None of them are deeply involved in the study of the United States for its own sake. In this way the American model has become a stylized battleground for Europeans, a terrain for struggle between those who would destroy European social democracy, those who would defend it, and those who would adapt it as best they can.

What the three groups share is a stabilized understanding of what the American model is. This understanding is advanced by various forces emanating from within the United States and is characterized by the principal tenets of the “Washington consensus”—the development strategy for the whole world, as articulated by the World Bank and the International Monetary Fund. These principles include deregulation; privatization; and the free setting of prices and, especially, wages, in competitive markets, without interference from unions or concern for the shape of the resulting distribution. The principles favor free international trade. They favor reduction to the minimum of public subsidies, public transfer payments including pensions, and public enterprise. And they favor the application of “sound” fiscal and monetary policies, with the former dedicated to budget balance and the latter exclusively to price stability.

These principles suggest a relatively new image of the United States, an image based entirely on views propagated since the early 1980s by right-wing political spokesmen and certain academics. Such an image was forcefully, even eloquently, articulated by President Ronald Reagan and captured by his phrase “the magic of the marketplace.” It is a tribute to the enduring power of Reagan’s rhetoric that such an image of the United States continues to serve as a template for political and economic arguments in Europe 20 years later.

But it is also an image with little foundation in the American reality. It is useless as a guide to American economic performance. It is rooted in neither the historical nor the modern facts of American life. It is, in short, a fantasy.

It is a dangerous fantasy for European progressives. By accepting it they find themselves acknowledging the existence of an economy led to full

employment, at least for a time, through the application of free market principles, including radical deregulation and the destruction of unions. Progressives thus find themselves in the position of defending the dismal economic performance of modern Europe—specifically, its high rate of unemployment—on the ground that the alternative has unacceptable social costs. In this way acquiescence in mass unemployment becomes the price of defending civilization. The case for social democracy is fatally weakened by the concession that it requires 10 percent of the population to remain idle or to labor off the books in the gray economy.

Ordinary Europeans do not find this attractive. They prefer politicians who promise jobs. This is what made it possible last year, until the winds of war began to frighten people, for the conservative prime minister of Bavaria to run a close campaign against the socialist federal chancellor of Germany, based on a promise to reduce unemployment. The absurdity of this position is self-evident when one examines the actual policies—mainly anti-union measures dressed up as “labor market reform”—offered by the Christian Democratic Union. But the position appeared credible mainly because of its reference to the supposed facts of the American model and their application to the Bavarian case.

It is equally ineffective for the European left to defend Europe by decrying the social evils of the American model. The image routinely conjured for this purpose—of an economy of wage slaves and debt peons dominated by tycoons and maintained by racism, violence, and mass incarceration—is plainly false, as any ordinary traveler to the United States can see. This country has undoubted social problems, some of which are severe, but the conventional framework that roots these problems in poverty and oppression doesn't fit. Real wages in the United States are high. Some 70 percent of American households own their own homes. More than a quarter of the adult population has a college degree, and nearly half has had some college education. (No European country except the Netherlands approaches these levels of education.) Even health care, on which Europeans pride themselves, is abundantly available in the United States, where the urban landscape is everywhere flecked with hospitals and clinics. Poverty among the American elderly is low, and most seniors live independently, often in the benign climates of Florida, California, or southern Texas. In southern Europe, the elderly overwhelmingly live with their families, if they can.

Moreover, with unemployment low and jobs plentiful as recently as two years ago, American real wages were rising, crime had declined, and most working Americans were reasonably contented. This is a major part of the reason why, in spite of a widely criticized campaign, Vice President Al Gore was elected president of the United States in the year 2000, with a plurality of over half a million votes and a larger total vote than any president-elect in history except Ronald Reagan himself in the boom and landslide year of 1984. The fact that the election was later stolen from Gore by the Florida political establishment and the Supreme Court cannot gainsay this achievement.

By reacting to the United States through Reaganite perceptions, Europeans deny themselves a correct understanding of the keys to the American boom. This failure will prove an embarrassment to those on the right. They will be obliged to change their account now that it is apparent that the boom has ended. But the more serious problem is suffered by those European progressives who, because of their misunderstanding of the American model, cannot draw on the actual sources of recent American success. Progressives therefore find themselves caught up in the advocacy of “placebo” policies made popular in the United States itself, under the general rubric of the “third way.” This advocacy may lead (and indeed in recent years has led) to the election of center-left governments in Europe. But it cannot lead to their subsequent economic or political success, for the simple fact is that economic placebos, like medical ones, produce only psychotherapeutic benefits.

### **The Real American Model: Soft Budgets in the Social Sectors**

So what are the foundation stones of the “actually existing American model”?

It is useful to approach this question by applying a concept familiar to students of Central and Eastern Europe in the late years of communist rule—that of the “soft budget constraint,” widely attributed to the Hungarian economist Janos Kornai (1986). This concept described the condition of state-owned heavy industry under the communist regimes as unable to make a profit or compete in international markets, yet so

central to the social fabric of the system in which it was embedded, including the provision of social services, that it could not be allowed to fail. These industrial entities became widely deplored dependents of the state budget and state banks, and in many cases collapsed along with the regimes of which they were a part. In retrospect, they are quietly (in Russia, not so quietly) mourned by many. They provided millions with the rudiments of a comfortable and secure life, which have not been restored under the ensuing post-socialist orders.

The concept of the soft budget constraint is not normally applied to the United States. A brief examination of key American institutions will establish, however, that the concept goes far toward explaining the structure and conduct of our economy in the past 40 years, and particularly in the prosperous period of the late 1990s. But it is in the particular character of those institutions that the American economy can be distinguished from the failed economies of the former communist world.

Which institutions? The keys to the American model lie in those sectors providing social amenities to the middle class: health care, education, housing, and pensions.

In the United States, health care consumes some 14 percent of gross domestic product (GDP) (Levit et al. 2003).<sup>2</sup> A typical expenditure in Europe is 8 to 10 percent of GDP; in the U.K. the outlay is 7.3 percent (OECD 2003a). What few Europeans understand is that health expenditures within the direct U.S. government budget consume 5.8 percent of GDP (OECD 2003a). While in France, for example, this proportion of total output supplies medical services to the whole population, in the United States the direct public commitment is only to the elderly, the disabled, poor families, and veterans. For the rest of the covered population, medical care is paid out of private insurance, which offers tax advantages. Over all, the tax-financed share is just under 60 percent of total health expenditure, or nearly 8 percent of GDP (Woolhandler and Himmelstein 2002).

The scandals of American health care do not lie in its insufficiency (quite the reverse!), but rather in two notorious facts. The first is that some 41 million people lack either public or private insurance. These include many Latino immigrants, as well as younger working people. Hence, deficient pre- and perinatal care is an important problem. The second fact

relates to the rapacity of the private actors in the system—notably, drug producers, doctors, nursing home operators, and insurance companies. There is no doubt that some ideal system could provide a similar quantity of effective medical care for much less money. Nevertheless, it is precisely the presence of those actors and their political power that has made the American health care system into the economic powerhouse it is.

Higher education in the United States consumes about 2.25 percent of GDP. The figure for European countries is typically closer to 1 percent. Again, the United States spends more on public higher education as a share of GDP than do most European countries: 1.07 percent, compared with 0.97 percent in Germany and 1.01 percent in France. In addition there is the private share, another 1.22 percent of GDP, which involves institutions whose multibillion-dollar endowments are bolstered by the tax system (OECD 2003b). Fully public institutions, however, dominate the scene in most of the country. For instance, over 80 percent of university enrollments in my famously “free market” state of Texas are in state institutions financed by land grants that at one time proved, fortuitously, to be rich in oil (THECB 2003). Public and private institutions alike benefit from federal research grants, contracts, and student loans.

The economic and socializing role of the American university system receives too little attention among foreign observers, who tend to follow a narrow quantitative framework in assessing the contribution of extra years of schooling to the acquisition of “skills.” This is a nebulous construct at best, and is only very loosely related to what American universities actually do. The true role of this sector can be much better understood by examining its contribution to the demand side.

First, the U.S. population’s generally high level of education is reflected in the society’s competence and cohesion. As noted earlier, nearly 26 percent of the adult population has at least a four-year college degree, thanks in part to the postwar GI Bill and the late-1950s McGovern Act (NCES 2003). This population is, essentially, ipso facto qualified to participate in the economic life of an advanced credit economy. Having received education loans, the population is eligible for mortgages and access to the entire spectrum of private credit. It is presumed competent to navigate the tax and subsidy system in order to take advantage of credits, deductions, and guarantees. It is also presumed competent to consume advanced durable

goods, from private homes to automobiles to personal computers and telecommunications devices. And, of course, it does so.

Second, higher education has a direct effect on employment and labor force participation. It is not easy to obtain an accurate estimate of strictly public spending on universities in the United States, in part because such funding is a complex amalgam of federal, state, local, and private contributions and also because ostensibly private universities benefit substantially from public subsidies, from the huge incentive effect of the charitable deduction and the estate tax, and from publicly funded student loans. But the higher education sector in the United States is very large. It employs a great many people, including, of course, large numbers of the intelligentsia, who are thus kept contented and busy. Even more important, it provides activities and diversions for many who would spend their teenage years in the ranks of the jobless young if they were in Europe. The psychological benefits of legitimated idleness and of the rituals of accomplishment provided by colleges and universities at this stage of life should not be underestimated.

The United States maintains two additional public systems that keep otherwise difficult-to-employ young people out of the ranks of the jobless. One is the armed forces, which consume 4 percent of GDP and provide competent mechanical training to their several million members, including virtually the entire population of future commercial pilots, for example (BEA 2003). The second is the prison system, whose much-expanded role in recent years is deplorable, but whose economic function is not altogether dissimilar in some respects to that of the military. (Still, it is not the case, as some have alleged, that the prison population masked a huge degree of “hidden unemployment” in the United States in the late 1990s. There was a labor shortage at the time, and many prisoners would not have been jobless had they been free.) A major difference, of course, is that these three institutions provide very different levels of access to credit and other participatory mechanisms in later life.<sup>3</sup>

Consumption of housing services accounts for about 9 percent of U.S. GDP, while residential construction accounts for another 4 percent (BEA 2003). The housing sector exists on its present scale thanks to a vast network of supporting financial institutions, all subject to federal deposit insurance, the secondary mortgage markets provided by quasi-public

corporations (Fannie Mae, Ginnie Mae, Freddie Mac), and the tax deductibility of mortgage interest. In recent years such measures as the Community Reinvestment Act have tended to oblige private financial institutions to reduce their practice of redlining and thus extend credit to poorer communities where their presence had previously been largely predatory. As a result, interlocking patterns of economic development have begun to occur, external diseconomies associated with urban poverty have been reduced, and the prevalence of home ownership has risen. This phenomenon has been called the “social construction of creditworthiness” by the economist Gary Dymksi of the University of California at Riverside, an expert on credit flows in the economic kaleidoscope of greater Los Angeles (Dymksi 1998).

It is true that the housing finance system is the cause of major problems. The crisis of the savings and loan institutions in the 1980s stemmed from two sources: the effect of high interest rates on a sector whose income was largely dependent on fixed-rate mortgages, and which therefore fell into insolvency by the late 1970s, and the emergence of a powerful, politically well-connected clique of criminals who championed and exploited deregulation in order to loot the corpses of these failing institutions. The lawyer-economist-criminologist Bill Black has coined the term “control fraud” to describe this pattern of behavior; he views the pattern of the savings and loan debacle as the model for more recent disasters, such as the collapse of Enron and WorldCom (Bernstein 2002). Nevertheless, most Americans grow up in their own homes, and at present, home equity remains the major collateral against which middle-class Americans can borrow to support their consumption.

Finally, Social Security payments to the elderly and other income-security programs finance about 8 percent of U.S. GDP, based on the reasonable assumption that these transfers are substantially spent rather than saved by their recipients. Some of these funds have already been counted as expenditures for health care and housing, but arguably not that much. The American elderly often live in paid-off homes and pay only a fraction of their medical (as distinct from pharmaceutical) expenses out of pocket. And Social Security funds a great deal of their ordinary daily consumption.

To be precise, Social Security alone is the major source of disposable income for 60 percent of the American elderly; only 40 percent of the

elderly have substantial other sources of income, public or private (SSA 2003). The typical Social Security payment to an elderly couple in moderate health approaches \$20,000 per year, which, when combined with Medicare, provides for a modest level of comfort in most of the country.<sup>4</sup> Pockets of poverty remain among the elderly—single women with little work credit can be in trouble—but it is important to emphasize that these are pockets, not reservoirs. All in all, poverty among the American elderly has fallen dramatically since the early 1970s and is now lower than among the general population. This accomplishment is substantially the result of expanded Social Security pensions.

Social Security has been under attack in recent years, and especially so under the current Bush administration, for a straightforward reason. Exactly as with the savings and loan debacle of the 1980s, sharp private financial operators have seen the opportunities inherent in diverting the cash flow of the public trust funds into private investment accounts. The availability of such accounts would create, overnight, millions of inexperienced investors who would be vulnerable to broker fraud and abuse. The campaign to privatize Social Security reached a high-water mark in the immediate wake of the stock market run-up of the late 1990s, when it was possible to argue that the future elderly were making a bad investment with Social Security payroll taxes. This argument has since lost its force, owing to the stock market collapse and the general disrepute into which brokers such as Merrill Lynch have rightly fallen. Mr. Bush's Social Security "Reform" Commission disappeared without a trace. The push for private investment accounts has since gone underground—the Republican campaign committee even purged "privatization" from the lexicon of its candidates in the 2002 election. It will resurface only if the fortunes of the Republican Party are revived by war and terrorism. Otherwise, Social Security will remain a public system in the United States.

Add these elements together (subtracting a bit for the double-counting mentioned earlier) and they account for nearly 40 percent of the total consumption of goods and services in the United States. Moreover, the direct contribution of nonmilitary public expenditure at the federal, state, and local levels, which amounts to another 14 percent of GDP (BEA 2003), has not been included. Of this, a bit more than 2 percent represents activity directly undertaken by the federal government; the rest is expenditures by state and local governments, of which a high percentage

goes for public education. More than 88 percent of American schoolchildren attend public schools, a proportion that has not fallen in recent years (NCES 2003). Efforts to undermine public education in the United States—for instance, by privatizing public school systems or providing vouchers to permit children attending weak schools to relocate—so far represent only a tiny fraction of total public education expenditures. They receive a great deal of media attention, but they have never enjoyed widespread popular support—even in Texas.

All in all, the public sector underpins in one way or another activity in well over half of the American economy, and in so doing helps to sustain and stabilize the growth of the economy as a whole. The margins of American politics involve battles over the boundaries between public and private control. Deregulation of transportation, telecommunications, and energy markets in recent years, reduction in public housing and welfare, and the so-far unsuccessful assaults on public education and Social Security represent advances and victories for private interest. Expansion of the Earned Income Tax Credit after 1993 and a large increase in the number of Social Security disability recipients in recent years represent movements in the other direction; together, they outweigh cutbacks in the traditional welfare program, Aid to Families with Dependent Children (which has been converted into a block grant to states and is called Temporary Assistance for Needy Families), though their benefits do not invariably go to the same recipients.

The point to emphasize is not that the United States is full of hospitals, universities, housing, and pensioners. So, too, obviously, is Europe. It is rather that in the United States these sectors are funded by a bewildering variety of financial schemes involving public support in myriad direct and indirect ways, including direct appropriations, loans, guarantees, and tax favors. Some of these are on budget and some are off budget, some are discretionary and some are nondiscretionary, but there exists a broad political constituency behind all of them, which gives them political staying power. And control over the scale of these activities has slipped away from those who ostensibly oversee the public budget.

And this is the genius, if one may call it that, of the American model. The soft budget constraint (which as recently as the 1960s was entirely the province of the military) has come to apply precisely where it can do the

least harm, namely, in supplying income and employment in sectors that provide universally demanded human services to the population. In other words, powerful political constituencies exist to keep these sectors at the forefront of American life, and it is very likely that they will remain there.

One gets the impression that this is not the case in Europe, where health care and higher education remain substantially public sector activities, as do housing and pensions (outside the post-Thatcher U.K.), compared to those elements in the United States. This accounts, in part, for the higher share of European GDP measured as passing through the government sector. But it also helps to account for the difficulties Europe experiences in absorbing its employable population. Public sectors are subject to hard budget constraints, in part because the public sector cannot lobby nearly so effectively as the private sector for public support. And where the public sector is given a near monopoly in the provision of a service (such as health care), the private sector is forced to operate in other areas—protected private retail shops and small farms, for instance—that may not enjoy comparable rates of growth as incomes rise. The American system of dual mechanisms of finance is far less efficient, but it absorbs many more individuals into gainful employment. Moreover, as European national budgets come into conformity with criteria established by the European Union, expansion of human services becomes more difficult, rather than less so.

### **The Unimportance of Labor Market Adjustment**

In all of this, then—in the great rise of the United States toward full employment, followed by the subsidence of the past two years—what has been the role of the vaunted flexibility of American labor markets? Europeans are accustomed, of course, to being told that such flexibility was the essential ingredient in the rise of the New Economy in the United States, beginning with the brave new era of free markets under Reagan.

But in fact, increasing labor market flexibility is not the cause of falling American unemployment. When American labor markets became more unequal in the 1980s, unemployment was stubbornly high. American labor markets did not become more flexible as the economy approached full employment in the late 1990s. And they have certainly not become less flexible in the present recession.

Indeed, measurements of pay inequality in the United States show, unambiguously, that structures of pay became substantially more equal as the 1990s progressed and unemployment declined.<sup>5</sup> The United States did not approach full employment by increasing pay inequality; on the contrary, that form of inequality declined. This fact was deeply obscured in most people's perception by the rise in household income inequality—a very different matter, attributable in part to changing family structures and in part to the boom in the stock market and capital gains income. The American bubble concentrated wealth in the hands of a small number of technology tycoons, but the resulting boom in investment demand and employment actually reduced inequalities in pay and wages.

Moreover, the late 1990s also demonstrated the trivial role played in the employment picture by such measures as job retraining and lifelong education programs. Such policies had been in place since the early 1980s, when the Job Training Partnership Act supplanted public employment, but without noticeable effect (See Lafer 2002). It was only when labor demand rose to full-employment levels that unemployment disappeared. And then, of course, by far the largest fraction of new jobs went to people who had never taken part in any training program.

In earlier work I have argued that the much-repeated comparison of an inegalitarian, full-employment United States with an underemployed, egalitarian Europe was and is based, in part, on an optical illusion resulting from a misperception of the appropriate boundaries. It is true that U.S. society is substantially more unequal than the societies of northern European countries, and roughly as unequal, by most measures, as those of southern European countries. But these regional comparisons ignore the component of inequality contributed by differences in average pay among European countries. These differences remain far more substantial than comparable differences among American states, which are, of course, already taken into account in measures of American inequality (Galbraith, Conceicao, and Ferreira 1999).

When between-country differences across Europe are taken into account for industrial pay, using the OECD's Structural Analysis data set, we find pay inequalities to be higher for Europe as a whole than for the United States. Thus we conclude that unemployment and inequality are not substitutes, but complements, when measured at the appropriate level of

geographic aggregation. And the distribution of unemployment across Europe—higher in the poorer and more unequal countries—emerges as simply a reflection, not of inflexible labor markets in poor countries, but rather of the fact that Europeans, when unemployed, prefer to be unemployed at home. This phenomenon can be remedied only by providing jobs. This can be done either in situ—clearly the better option—or in richer countries to which Europe's poor will eventually migrate if nothing is done for them where they live.

### **The Myth and the Reality of the New Economy**

The rise to full employment in the United States in the late 1990s occurred, in major part, because of a very steady expansion of the quasi-public sectors, in spite of the fact that the federal government sector did not grow at all. State and local governments did, in fact, expand rapidly as the boom gathered force. So did tax-subsidized expenditures on housing and health care. However, the more or less predominantly private sector—specifically, the high technology component—also played a role, which is worth examining at this point.

What was the role of the information technology boom that so filled the news emanating from the United States at the end of the last millennium? The answer can be gleaned from the national income and product accounts, which show that from 1997 to the peak in 2000, business non-residential fixed investment rose by about \$300 billion 1996 dollars, a gain of about 2 percent (from 12.3 to 14.4 percent) in relation to GDP. Most of the gain would have been in technology investment. A subsequent falloff, on the order of \$150 billion, has brought total business fixed investment to a level below that of health care expenditures. The entire falloff in business investment to date may be replaced by the increase in the military budget that has been requested by the Bush administration.

In terms of employment, generous estimates in 2000 held that 8 percent of the American labor force worked in the high-technology sector. This estimate (generated by the Clinton administration's Commerce Department)<sup>6</sup> was almost surely overstated, as it included, for example, total employment in the media and entertainment sectors. An estimate of 2 to 3

percent of total employment might have been more realistic then, and perhaps half that would be a reasonable estimate today.

It remains true, of course, that the bubble in the information sectors contributed the final ingredient to the concoction that produced the great American boom of the late 1990s, driving unemployment below 4 percent for a sustained and happy period, while numerous young and supposedly glamorous business figures grew extravagantly rich. But the overall role of this sector in that achievement has been as grotesquely overstated as were its stock valuations. (As the economist Robert Barbera [2001] remarked, Cisco was never actually larger than France.) Complicit in the exaggeration were the media, stock analysts, brokerage firms, and high government officials, notably President Clinton on one side (who courted high technology relentlessly for its glamour and campaign funds) and Alan Greenspan on the other (who succumbed to the seduction of a “new paradigm” view that would excuse the Federal Reserve for having tolerated high unemployment for decades beforehand). Greenspan knew that there was a bubble, knew that he had the tools to control it, and failed to take the actions that prudence dictated.

## **The Keynesian Devolution**

But the bubble happened, and all the forces mentioned above combined to generate full employment in the late 1990s for the conventional Keynesian reason: a high level of effective demand. The peculiarity of effective demand in the United States, which seems to have eluded European observers, was that although much of it was generated or encouraged by acts of public policy, most of it did not register on the public balance sheet. Thus the United States achieved full employment not only with formally balanced public budgets, but with recorded surpluses. One might call this the Keynesian Devolution. Left unstated are the implicit financial liabilities of the public sector with regard to businesses and households. These were the powerful new Keynesian mechanisms of the new economy in the United States, just as essential as recorded budget deficits were to Keynesian policy in the days before credit markets had reached their present scale.

The problem of the Keynesian Devolution lay not in its efficacy as a mechanism for growth and prosperity, but in the unsustainability of its

implications for the balance sheets of the household sector. As the Levy Institute has emphasized in a series of papers (Papadimitriou et al. 2002; Godley 2003), the American household sector's spending has relentlessly exceeded its income since 1997. Ratios of debt to income have risen well above historic highs. The net negative acquisition of financial assets peaked at around 3 percent of GDP in 2001 and has since been falling sharply, in a process known as reversion. For the moment, a continued willingness to borrow against the value of housing has propped up the American consumer—a very risky prospect for homeownership in the long run. When this borrowing ends, as households cut back on spending in order to bring their outlays into line with their (declining) incomes, a prolonged period of stagnation, if not recession, will be unavoidable.

A reversion toward historical norms in saving and spending behavior was already under way in the United States before the traumatic events of September 11, 2001. At the moment that crisis hit, an almost universal view held that it would drive the economy into recession. In fact, as revisions of the economic statistics later demonstrated, the economy had already been in recession for three quarters, and in the aftermath of September 11 came policy changes that produced a rapid return to economic growth by the end of the year. These included tax cuts (already enacted but not yet in effect) that provided a cash rebate to most taxpayers, spending increases for war and relief for victims of the attacks, rapid cuts in the interest rate, a reduction in world oil prices, and a massive inventory liquidation by automobile manufacturers. Together, these helped lift the economy in the fourth quarter of 2001 and in 2002, providing the professional chorus of optimists in the financial profession with evidence that full-employment prosperity would soon return.

### **A Crisis in the American Model?**

Unfortunately, all these direct Keynesian measures were temporary. The tax rebates have been exhausted; the government's relief spending is finished. Interest rates are already close to zero, leaving little room for further cuts. Oil prices have returned to pre-September 11 levels. The automobile companies continued to provide bargains to consumers through the end of 2002 while maintaining output and employment, but they appear now

to be cutting their losses. Meanwhile, the return to war—this time against Iraq—injected additional uncertainty into the business climate.

Furthermore, the new fiscal era dawned badly for the state and local government sector, which continues to operate under quasi-hard budget constraints imposed by constitutional balanced-budget requirements (Lav and Johnson 2002). State and local spending grew rapidly in the good times of the late 1990s, and states and localities generally maintained their spending levels in the first two years of the new millennium, through the depletion of financial reserves. But that moment is largely past. States that relied heavily on capital gains taxes and income taxes on stock option realizations are in very bad shape at the moment. For fiscal year 2004, California faces a budget gap of \$18 billion to \$26 billion, while the combined budget shortfall for all states is in the range of \$70 billion to \$85 billion. Local governments confront similar crises (Lav and Johnson 2002). If states and localities cannot avoid cutting their spending or raising taxes, they could deplete as much as 1 percent from the overall spending stream in the year ahead.

Thus the American Model is entering a moment, even a prolonged phase, of crisis. This crisis is mainly due to the behavior of sectors where budget constraints continue to bite—or where they are starting to bite again after many years. These include business investment, which is affected by the virtual disappearance of retained profits. The state and local government sector, constitutionally required to balance its budgets, is entering a phase of deep fiscal crisis that could gravely undermine the popular public programs that are currently administered at the state level. Looming over all of this is the household sector, which may fall victim to a combination of its own financial prudence and the closing of lending windows. To the extent that the state fiscal crisis affects education and health care and the household sector backs away from new mortgage borrowing, soft budget constraints may be giving way to hard constraints. Unless reversed, such a trend could derail the continued success of the American Model.

### **What, Then, for Europe?**

A comprehensive approach to European unemployment must produce a consistently higher rate of economic growth, aimed at absorbing 30 to 35

million Europeans into gainful employment, particularly in lower-income regions where unemployment and underemployment are pandemic.

How is this to be achieved? Part of the answer must lie in the orientation of macroeconomic policy. American monetary and fiscal policy remains governed (nominally, at least) by the 1978 Full Employment Act, and the political economy of the United States does not tolerate the sole focus on inflation that is the obsession and constitutional mandate of the European Central Bank. To achieve higher economic growth, the objective of full employment must be not simply part of the European Charter, but a core objective of all policymaking institutions. This includes the fiscal authorities and the central bank. It must be more important in practice than either price stability or fiscal balance, and the authorities must recognize that fiscal balance is a consequence, not a cause, of full employment.

Expanded credit access, through loan guarantees, home-buyer subsidies, and secondary mortgage markets, can help distribute the burden of increasing effective demand over the private sector. It seems likely that some part of the sharp drop in unemployment in Spain following currency unification—from 20 percent to around 10 percent—has resulted from the reduction in credit risk associated with the transition from a devaluation-prone peseta to the euro. This step alleviated the bias favoring tradeable goods in the composition of Spanish output and facilitated the financing of enterprises in the services sector.

It should also be recognized, however, that this aspect of the “American solution”—particularly unsecured consumer credit—is unstable. Europeans would be unwise to encourage a buildup of private-sector debt on the American scale or excessive reliance on this single instrument.

It is better to raise incomes. Unlike the United States, Europe lacks retirement systems on the continental as opposed to the national scale; consequently, the purchasing power of the elderly and other economically secondary populations (including nonemployed women) in the less wealthy countries is weak. In particular, elderly residents of poorer European countries remain poor by European standards. This is manifestly unjust, and it is also uneconomic. The remedy is to move toward a Europeanized pension system that would pay all European elderly on the basis of continentwide average productivity. Why, in an integrated

continental economy, should a Portuguese worker be obliged to retire on a pension set by past average productivity in Portugal alone? His or her home might be next to that of a German or Dutch retiree whose pension payments, after a lifetime of equivalent or easier labor, amount to much more. The EU should begin the task of leveling pensions. Similarly, it could also implement a system to increase the income of the lowest-paid members of the European Union workforce, analogous to the U.S. Earned Income Tax Credit.

There are also large areas of public or quasi-public social commitment in the United States that are comparatively underfunded in Europe. Europe funds certain sectors very well—public transportation, for instance—at least by U.S. standards. But an examination of European employment patterns compared with those in the United States reveals the key compositional or structural issue: a deep deficiency of services employment in Europe, evident in nearly every major sector. Europe does not lack competitive factory jobs so much as it lacks the effective means to employ people in mundane services activities in the nontraded goods sectors.

In higher education, one step toward a solution seems clear to a transatlantic observer. Why can't Europe begin to emulate the American university system? There are virtually no pan-European universities; the creation of even a handful of major EU-funded institutions, strategically located in Greece, Portugal, southern Italy, and Spain—as well as in the former East Germany, the Czech Republic, Hungary, and Poland—could have significant effects on regional development patterns and, ultimately, on continental integration. The competition from these pan-European institutions would force an upgrading of existing national universities, which are underfunded by American standards. Clearly, this measure (not training programs) is the key to what Europeans like to call the “knowledge base.” The key to a successful university system is money—obtained not only through public grants, but through private charitable donations that are strongly supported by the tax system. A European wealth tax with targeted charitable deduction provisions for universities—perhaps favoring transnational institutions—might do wonders for higher education in Europe.

Europeans have long had a superior mechanism for ensuring access to health care, and perhaps also for managing the delivery of services. But, as

noted above, they do not provide care itself on the American scale. Major improvements in European health facilities could be funded by the EU, with special emphasis on lower-income regions. Perhaps equally important would be an expansion in facilities for the care of the infirm elderly, whether in the form of institutions or by simply employing trained professionals to assume part of the burden of caring for the elderly in their own homes.

In sum, Europe needs public investment, private credit, and direct transfers to lower-income populations, both working and nonworking. Europe needs, in short, softer budgets in strategic sectors in order to transform the mechanisms of the welfare state, which were pioneered in the postwar period, from a national to a continental scale. This is the antithesis of the current conservative prescription. But the American experience stands as evidence that it is a prescription that works. As we have learned, these measures are not, in the economic sense, transfers from the rich to the poor. They are, rather, the use of appropriate means to mobilize otherwise unemployed resources in poor and otherwise fiscally incapable regions.

It would be nice to imagine that Europe might move smoothly back to full employment under the influence of purely European models. But so long as European policymakers remain fixated on labor markets and sound finance, these models will not work. Meanwhile, the American model as it really exists, notwithstanding its current troubles, is also worth European investigation. It is clear enough to most Americans that the only way out of our current troubles is through expansion of the public and quasi-public instrumentalities we already have—for instance, through a revival of federal revenue sharing to support state and local spending and an increase in the federal role in support of the state-administered Medicaid program. This would constitute a further Keynesian Devolution; these and similar proposals will certainly form the core agenda of the American political opposition in the years immediately ahead.

The path to European full employment also may lie partly through such mechanisms. A good place to start might well be with the basics, such as a continental Social Security system, pioneered as it was in the American New Deal.

## **Notes**

1. The author thanks Travis Hale for checking facts.
2. When the figure was only 13 percent, Paul A. Samuelson remarked to me in private conversation, “It’s the best 13 percent of GDP.”
3. The various public veterans programs and preferences can best be thought of as a means of compensating military personnel for the disadvantages they would otherwise suffer relative to university graduates. No one, of course, thinks similar compensation is warranted for ex-convicts.
4. Not, of course, in New York City—but then, many elderly New Yorkers go to Florida, which is not too bad.
5. For details on this issue, see Galbraith (1998) or, for updated measures, refer to the University of Texas Inequality Project website at <http://utip.gov.utexas.edu>.
6. The actual study of this topic has proved ephemeral, probably for good reason.

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## About the Author

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James K. Galbraith is Lloyd M. Bentsen Jr. Professor of Government/Business Relations at the Lyndon B. Johnson School of Public Affairs, the University of Texas at Austin, and a Senior Scholar of The Levy Economics Institute. He directs the University of Texas Inequality Project. He is the author of numerous scholarly and popular works. Cambridge University Press recently published *Inequality and Industrial Change: A Global View*, a book that Galbraith co-edited with Maureen Berner. Galbraith is the author of *Created Unequal: The Crisis in American Pay*, a Twentieth Century Fund study published in 1998. He writes a column on economic and political issues for the *Texas Observer*. He received a B.A. from Harvard University and a Ph.D. from Yale University and studied economics as a Marshall Scholar at King's College, Cambridge University.

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