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James K. GALBRAITH
The University of Texas at Austin

What is the American model really about? Soft budgets and the Keynesian devolution

Abstract. Europeans tend to view the American success story of the 1990s through the prism of free-market public relations, as a triumph of falling wages, rising inequality, and increasing "flexibility" in labor markets. This is an illusion. If it were not, the United States would not now be in its present difficulties. The American return to full employment is better understood as the result of greatly expanded spending in the social sectors: health care, education, housing and pensions, notably, which in conjunction with the bubble in information technologies created the effective demand necessary to absorb the unemployed. Now that the bubble has collapsed the American model is in danger, as interlocking mechanisms of public and private finance all come under pressure. But the period of American success still holds lessons for Europeans considering how best to cope with their continuing scourge of mass unemployment.

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1. Introduction

The American Model fascinates Europeans. For many on the right and certainly for the propaganda branches of the official economic institutions (such as the OECD and the European Commission), the free market as they imagine that the United States practices it represents an ideal type. It is the highest form of capitalism. It is to be celebrated for its efficiency, for its technological dynamism, and even for its capacity to deliver full employment – all free from the dead hand of governmental regulation and control.

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 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.

And in the third place there is the position of an emerging group of European progressives. This group regards 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 Way. In particular they emphasize the importance of investments in education, of job training, and of new institutions for "lifelong learning." Such measures are intended, in particular, 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 back.

All three groups 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. And 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. It is an understanding advanced by many forces emanating within the United States, and characterized by the principal tenets of the "Washington Consensus" – that development strategy articulated by the World Bank and the IMF for the whole world. 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. They favor free international trade. They favor the reduction of public subsidies, public transfer payments including pensions, and public enterprise to the minimum. 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.

As inspection of this list makes apparent, such an image is comparatively recent. It is a vision of America based entirely on the image of America propagated since the early 1980s by right-wing political spokesman and certain academics. Such was the image forcefully, even eloquently, articulated at the time 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 twenty years later on.

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 a vision rooted neither in 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. They therefore find themselves in the position of defending the dismal economic performance of modern Europe, and specifically high 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 that ten percent of population remain idle, or be forced 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 on the ground of a promise to reduce unemployment. The absurdity of this position is self-evident when one examines the actual policies on offer by the CDU. But the claim appeared credible mainly because of its ability to make reference to the supposed facts of the "American Model" and their supposed 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 maintain by racism and violence and mass incarceration – is plainly false as any ordinary traveler to the United States can see. Real wages in the United States are high. Homes are comfortable – and some seventy percent of American households own their own. College degrees are held by over a quarter of the adult population; some college education has been experienced by nearly half. (No European country save the Netherlands approaches these figures.) 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 elderly is low in America, and most seniors enjoy the independence of living on their own, often in the benign climate of Florida, California and southern Texas. In Southern Europe, the elderly overwhelmingly live with their families – if they are lucky enough to have them.

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 for 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 America through Reaganite perceptions, Europeans cut themselves off from a correct understanding of the keys to the American boom. This will prove an embarrassment - to the extent that propagandists can be embarrassed - 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 the European progressives, who by virtue of their position prise 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 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 notoriously simple fact is that placebos do not have medical benefits other than psycho-therapeutic.

2. 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 an idea familiar to students of Central and Eastern Europe in the late years of communist rule. This is the concept of the "soft budget constraint," widely attributed to the Hungarian economist Janos Kornai. The notion of a soft budget constraint described the condition of state-owned heavy industry under the communist regimes: entities that could not make profits, could not compete on international markets, and yet were so central to the social fabric of the system in which they were embedded, including its provision of social services, that they could not be allowed to fail. These entities became widely-deplored dependencies of the state budget and the state banks, and of course in many cases they collapsed with the regimes of which they were part. In retrospect, they are quietly (and in Russia, not-so-quietly) mourned by many. To millions, they provided the rudiments of a comfortable and secure life, the threads of which have not been picked up in the post-socialist orders that since emerged.

The concept of the soft budget constraint is not normally applied to the United States. However, a brief examination of key American institutions will establish that the concept goes very far toward explaining the structure and conduct of our economy in the past twenty years, and particularly in the prosperous period of the late 1990s. It is however in the particular character of those institutions that America 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.

Health care, in the United States, consumes some thirteen percent of GDP[1]. A typical figure in Europe is eight to ten percent; in the UK the number is 7.3 percent. What few Europeans understand is that health expenditures within the direct U.S. *government* budget consume 5.8 percent of GDP. But whereas in (say) France 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 and disabled, the poor, and to veterans. For the rest of the covered population, medical care is paid out of private insurance, which enjoys tax advantages. Overall, the tax-financed share is just under sixty percent of total health expenditure, or nearly eight percent of GDP (Woolhandler and Himmelstein, 2002).

The scandals of American health care do not lie in insufficiency of care (quite the reverse!), but rather in two notorious facts. The first is that some forty million persons lack either public or private insurance. This part includes many Latino immigrants, who tend to avoid contact with the welfare system, as well as younger working people. Hence, deficient pre- and perinatal care is an important problem. The second is the rapacity of the private actors in the system – drug producers, doctors, nursing home operators, and insurance companies notably. There is no doubt that a similar effective quantity of medical care could be provided for much less money, under some ideal system. 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 that it is.

Higher education in the United States consumes about two and a quarter percent of GDP. The figure for European countries is typically closer to one percent. Again the U.S. spends more on public *higher* education as a share of GDP than do most Europeans: 1.07 percent as compared to 0.97 percent in Germany or 1.01 percent in France. But then in addition there is the private share, another 1.22 percent of GDP, centered on institutions whose multi-billion dollar endowments are highly motivated by the tax system. Fully public institutions however dominate the scene in most of the country. For instance, over eighty percent of university enrollments in my famously "free market" state of Texas are in state institutions, financed by land grants that proved, fortuitously, to be rich in oil. Public and private institutions alike receive 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 production-function framework in assessing the contribution of extra years of schooling to the acquisition of "skills." This is a nebulous construct at best. And it is only very loosely related to what American universities actually do. The true role of this sector is much better understood by examining its contribution to the demand side.

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[1] And, as Paul A. Samuelson once remarked to me in private conversation, "it's the best thirteen percent of GDP."

First, there is the competence building and social cohesion entailed in the education level of the population as a whole. Just under twenty-six percent of the adult population of the U.S. has a four year university degree or better, a figure that owes its origins to the postwar GI Bill and to the late 1950s McGovern Act. This population is, essentially, *ipso facto* qualified to participate in the economic life of an advanced credit economy. Having had education loans, it is eligible for mortgages and for the entire spectrum of access to private credit. It is presumed competent to navigate the tax and subsidy system, to take advantage of credits, deductions and guarantees. It is also presumed competent to consume advanced durable consumers goods, from private homes to automobiles to personal computers and telecommunications devices. And, of course, it does so.

Second, there is the direct effect of higher education on employment and labor force participation. It is not easy to obtain full measures of strictly *public* spending on universities in the United States, in part because public university funding is a complex amalgam of federal, state, local and private flows, and partly because ostensibly private universities run substantially on public subsidies, on the huge incentive effect of the charitable deduction and the estate tax, and on publicly assisted 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 maintains a great many young people off the labor market, many of whom in Europe would spend their late teenage years in the ranks of the jobless young. 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 alternative public systems for keeping otherwise difficult-to-employ young people away from unemployment. These are the armed forces, with several million members, which consumes four percent of GDP and provides competent mechanical training to its members (including to virtually the whole of the population of commercial pilots, for example). And there is the prison system, whose much-expanded role in recent years is deplorable, but whose economic function is not altogether dissimilar in some respects. (Still, it is not the case, as some have alleged, that the prison population masked a huge problem of "hidden unemployment" in the United States in the late 1990s. There was a labor shortage at the time, and many of those in prison 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[2].

[2] The various public veterans programs and preferences can best be thought of as compensating military personnel for the disadvantages they would otherwise suffer relative to university graduates. No one, of course, thinks similar compensation warranted for ex-convicts.

Consumption of housing services accounts for about nine percent of US GDP, while residential construction accounts for another four percent. The housing sector exists on its present scale thanks to a vast network of supporting financial institutions, all subject to federal deposit insurance, and to the secondary mortgage markets provided by quasi-public corporations (Fannie Mae, Ginnie Mae, Freddie Mac). In recent years, such measures as the Community Reinvestment Act (which my home state former senator and fellow economics professor, Phil Gramm, has described as "worse than slavery") have tended to oblige private financial institutions to reduce the amount of redlining they would otherwise have engaged in with respect to ghetto neighborhoods, and so to extend credit to poorer communities where their historical presence had been largely predatory. As a result, interlocking patterns of economic development begin to occur, external diseconomies associated with urban poverty are reduced, and the prevalence of home ownership rises. This phenomenon has been called "the social construction of creditworthiness" by the economist Gary Dymski of the University of California at Riverside, a close student of credit flows in the economic kaleidoscope of greater Los Angeles.

It is true that the housing finance system is the source 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 in 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 pursued 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, and views the pattern of the savings and loan debacle as the model for such more recent disasters as Enron and WorldCom. Nevertheless, the fact remains that most Americans grow up in their own homes, and that for the present moment home equity remains the major collateral against which middle class Americans are able to borrow to support their consumption.

Finally, Social Security payments to the elderly and disabled together with public pensions account for eight percent of US GDP, on the reasonable assumption that these transfers are substantially spent rather than saved by their recipients. Some of this has been counted already in expenditures for health care and housing – but arguably not all that much. The American elderly 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 consumption.

To be precise, Social Security alone provides the major source of disposable income of sixty percent of American elderly; only the top forty percent of that population group has substantial other sources of income, public or private. The typical social security payment for an elderly couple in moderate health can approach twenty thousand dollars per year, which when combined with Medicare is adequate for modest comfort in most of the country[3]. Pockets of elderly poverty remain – single women with little work credit can be in trouble – but it is important to emphasize that these are pockets, not reservoirs, of poverty. All in all, poverty among the old in America has fallen dramatically since the early 1970s, and is now lower than among the general population. This is the accomplishment substantially of expanded social security pensions.

Social Security has been under attack in recent years, and especially so under the 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. Such accounts would create, overnight, millions of inexperienced and hapless investors, whose accounts could be manipulated and against whom fees could be charged essentially at will. 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 the social security payroll taxes. This argument has since lost weight, 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 campaign has since gone underground – the Republican Campaign Committee even purged the word "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 forty percent of total consumption of goods and services in the United States. Moreover we have not included the *direct* contribution of non-military public expenditure at the federal, state and local levels, which amounts to another fourteen percent of GDP. Of this, a bit more than two percent is activity directly undertaken by the Federal government; the rest is spent by state and local governments. And of that, a high fraction goes for public education. Over eighty-eight percent of American schoolchildren attend public schools, and that proportion has not fallen in recent years. Efforts to undermine public education in America, for instance by privatizing public school systems or providing vouchers to permit relocation of children away from weak schools, represent so far only a very tiny fraction of total public education expenditures. They receive a great deal of media attention because of the natural bias of a private media in favor of private initiatives, but they have never enjoyed widespread popular support – even in Texas.

[3] Not, of course, in New York City – but then, elderly New Yorkers go to Florida, which is not too bad.

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 to 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 transport, telecommunications and energy markets in recent years, reduction of public housing and welfare aimed at the poor, 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 expansion in the payment of disability benefits under Social Security in recent years represent movements in the other direction; and together they outweigh cutbacks in the traditional welfare program, Aid to Families with Dependent Children (now converted into a block grant to states called TANF – Temporary Assistance for Needy Families) – though obviously not always going to the same people.

In the 2000 election campaign, a key issue was the expansion of health care benefits to cover prescription drugs for the elderly – an increasingly important component of their health care costs. With the installation of George Bush, this issue faded. Following the 2002 election debacle for the Democrats, the White House has attempted to tie prescription drug coverage to a shift of elderly patients from the public program Medicare into private Health Maintenance Organizations (HMOs). Immediate and vociferous opposition was heard from *Republican* Senators and Congressmen, whose rural constituencies in many instances do not have any access to HMOs. For this reason, the rural Republicans – on many other matters the most robust individualists in Christendom – favor retaining socialized medicine for the old. Not all movements in American politics, even now, cut against the public sector.

The point to emphasize is not that the United States is full of hospitals, universities, housing and pensioners. So obviously is Europe. The point rather is 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, some are off-budget, some are "discretionary," some are "non-discretionary." But there exists a broad political constituency behind them, which givens them political staying power. And the control of the scale of these activities has slipped away from those who ostensibly control 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. And that is in providing 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 and higher education remain substantially public, and (outside the post-Thatcher UK) housing and pensions all remain substantially more public than 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 for public support as the private sector can do. And where the public sector is given a near-monopoly in the provision of a service (such as health care), then the private sector is forced to operate in other sectors – protected private retail shops and small farms, for instance – that may not enjoy comparable income elasticities of demand. The American system of dual systems 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, then expansion of human services becomes more difficult, rather than less so.

3. The unimportance of labor market adjustment

In all of this, then, in the great rise of America toward full employment and in 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. (See Galbraith 1998.) The U.S. did not approach full employment by increasing inequality: on the contrary, the relevant 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 which owed in part to changing family structures and in part to the boom in the stock market and capital gains income.

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, 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 the new jobs went to people who had never taken part in any training program.

Further, in earlier work I have argued that the much-repeated comparison of inegalitarian, full employment America with underemployed, egalitarian Europe was and is in part an optical illusion, based on a misperception of the appropriate boundaries. It is true that the United States is substantially more unequal than the countries of Northern Europe, and roughly as unequal, by most measures, as the countries of Southern Europe. But these pairwise comparisons ignore the component of inequality contributed by differences in average pay across European countries. These differences remain far more substantial than comparable differences across American states, which are, of course, already taken into account in measures of American inequality. (For this argument, see 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 an artifact not of inflexible labor markets in poor countries but rather of the simple fact that Europeans, when they are unemployed, prefer to be unemployed at home. This phenomenon can be remedied only by providing jobs. And that can be done *in situ* – clearly the better option – or else in richer countries toward which Europe's poor will eventually migrate if nothing is done for them where they live.

4. The myth and reality of the new economy

The rise to full employment in America 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 in high technology, also played its role, and it is worthwhile examining that phenomenon at this point.

What was the role of the Information Technology Boom that so filled the news emanating from America in the last years of the late millennium? The answer can be read from the national income and product accounts, which show that from 1997 to the peak in 2000, business nonresidential fixed investment rose by about $300 billion 1996 dollars, a gain of about two percent in relation to GDP, or from 12.3 to 14.4 percent. Most of the gain would have been technology investment. Since that time, the fall-off has been on the order of $150 billion, bringing business fixed investment as a whole back below the provision of health care in its relation to the scale of the United States economy. The entire fall-off in business investment to date may be replaced by the increase in the military budget already requested by the Bush administration.

In terms of employment, a U.S. Commerce Department study in 2000 estimated that eight percent of the American labor force worked in the "high technology" sectors. This estimate was almost surely greatly overstated, including for example the entire employment of the media and entertainment sectors in the total. Two to three percent of total employment might have be more realistic then, and perhaps half that would be a reasonable estimate for the situation 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 four 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 remarked in 2001, Cisco was never actually larger than France.) Complicit in all of that were the media, the stock analysts and the brokerage firms, and high government officials, notably President Clinton on one side (who courted high technology relentlessly for glamor and campaign funds) and Alan Greenspan on the other (who succumbed to the seduction of a "new paradigm" view, intended to excuse the Federal Reserve from blame for having tolerated high unemployment for decades beforehand). Greenspan knew there was a bubble, knew that he had the tools to control it, and failed to take the actions that prudence should have dictated.

5. The Keynesian devolution

But the bubble happened. And all together, these forces 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 U.S. which seems to have eluded European observers, was that while much of it was generated or encouraged by acts of public policy, most was not registered on the public balance sheet. Thus the U.S. 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 on behalf of businesses and households. These were the powerful new Keynesian mechanisms of the new economy in America, 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 fact that its implications for the balance sheets of the household sector cannot be sustained As Wynne Godley has emphasized in a series of papers, the American household sector has been spending ahead of its income relentlessly since 1997. Debt ratios to income have risen well above historic highs. The net negative acquisition of financial assets peaked at around three percent of GDP in 2001, and has since been falling sharply, a process known as reversion. For the moment, a continued willingness to borrow against the value of housing has held the American consumer up – and this is, of course, a very risky business for home-ownership in the long run. Once that ends, as households cut back on spending in order to bring their outlays in line with their (declining) incomes, a prolonged period of stagnation, if not recession, cannot be avoided. Unless, of course, the administration manages to embroil the country in a suitably expensive war.

A reversion toward historical norms in saving and spending behavior was already underway 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 to the economic statistics later demonstrated, the economy had already been in recession for three quarters. And in the aftermath of September 11 there came policy changes which produced a rapid return to economic growth by the end of the year. These included the tax cuts (already enacted but not yet in effect) which included a cash rebate to most taxpayers, spending increases for war and relief, rapid cuts in the interest rate, a reduction in world oil prices and a massive inventory liquidation by automobile manufacturers. These together help lift the economy in the fourth quarter of 2001 and the first few quarters of 2002, providing the professional chorus of optimists in the financial profession with their evidence that full employment prosperity would soon return.

6. A crisis in the American model?

Unfortunately, these direct Keynesian measures were all temporary in effect. The tax rebates have been exhausted; the government's relief spending has been done. Interest rates have not been cut further – indeed there is not much left to cut. 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 of the Bush administration to a war footing – this time related to Iraq – has worked to inject a large additional element of 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. State and local spending grew rapidly in the good times of the late 1990s. And for the most part, states and localities were able to keep up activity 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 options realizations are in very bad shape at the moment. In particular, the state of California alone faces a budget gap most recently estimated at over thirty-four billion dollars, out of general revenue fund of eighty billion dollars last year. Overall estimates of the state budget gap comfortably exceed a hundred billion dollars, with untold additional billions needed at the local leve. If states and localities cannot avoid cutting their spending or raising taxes, they could deplete more than one 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 owing to the behavior of sectors where budget constraints continue to bite – or where they are starting to bite once again after many years. These include business investment, which is affected by the virtual disappearance of retained profits. Second, the state and local government sector, constitutionally constrained to balanced budgets, is entering a phase of deep fiscal crisis which could, potentially, gravely undermine the popular public programs that are presently administered at the state level. And third, looming over all, 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 to the extent that the household sector backs away from new mortgage borrowing, soft budget constraints may now be growing hard in the United States. Unless reversed, such a trend could spell tragedy for the continued success of the American Model.

7. 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, and particularly in the lower-income regions of Europe where unemployment and sub-employment 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 remain governed (nominally, at least) by the 1978 Full Employment Act, and the political economy of the U.S. 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 part not simply 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 reduction in unemployment in Spain following currency unification – from 20 to around 10 percent – owes to the reduction in credit risk associated with the transition from a devaluation-prone peseta to the euro, which reduced the bias toward tradeable goods in the composition of Spanish output, and facilitated the financing of enterprises in the services sector.

However, it should also be recognized that this aspect of the "American solution" – and particularly unsecured consumer credit – is unstable. Europeans would be unwise to encourage a build-up of private-sector debt on the American scale or excessive reliance on this one instrument.

It is better to raise incomes. Unlike the United States, Europe lacks retirement systems on the continental as opposed to the national scale, with consequent weak purchasing power of elderly and other economically secondary populations (including non-employed women) in the less wealthy countries. In particular the 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 continent-wide 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 right alongside that of a German or Dutch retiree whose payments, after a lifetime of equivalent or easier labor, amount to much more. The EU should begin the task of leveling up pensions. On similar ground it could also implement a system of topping up pay for the least-well paid members of the Euro work force, 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 transport, for instance, at least by U.S. standards. But an examination of European employment patterns compared to the U.S. reveals the key compositional or structural issue: an "across-the-board shortfall" in services employment in Europe. As European Commissioner Diamantopolou has correctly stated, this covers every area, from "business services to health and education."

In higher education, one step toward a solution seems clear to a trans-Atlantic 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 Eastern Germany, the Czech Republic, Hungary and Poland – could have significant effects on regional development patterns and also, ultimately, on continental integration. The competition from European institutions would force upgrading of existing national universities, all underfunded by American standards. Clearly, this (and not training programs) is the key to the knowledge base. And the key to a university system is money: not only through public grants but through private charitable donations, strongly incentivized 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.

In health care, Europeans have long had a superior mechanism for insuring *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 institutions or simply employing trained professionals to assume part of the burden of caring for them in their own homes.

In sum: Europe needs *public* investment, *private* credit, and direct transfers to lower income populations, both working and non-working. Europe needs, in short, softer budgets in strategic sectors, to redevelop the mechanisms of the welfare state, which were pioneered in the postwar period, from the national to the continental scale. This is the antithesis of the current conservative prescription. But the American experience stands as evidence that it is the 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 are not going to work. Meanwhile the American model *as it really exists* is also worth European investigation, notwithstanding its current troubles. 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, a revival of federal Revenue Sharing to support state and local spending, and an increase in the federal role in the support of the state-administered Medicaid program. This would constitute a further Keynesian Devolution; these and similar proposals will certainly form the core proposals of the American political opposition in the years immediately ahead.

It may well be that the path to European full employment also lies partly through such mechanisms. And 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.

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The author 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. I thank Travis Hale for checking facts. Date of present version: February 1, 2003.

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