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WHAT IS THE AMERICAN MODEL REALLY ABOUT?

Soft Budgets and the Keynesian Devolution

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The American model fascinates Europeans. To many on the right, 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.[1]

These charms are largely lost on the European public, especially the European left. Their 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.

An emerging group of European progressives is attracted to American solutions to the problems of the American model. 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.

For all three groups—the European right, the left-leaning public, and the Third Way liberals—the American model has become a stylized battleground, 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 principles of the

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American model are. These supposedly 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.

The image of the United States upon which these nostrums are based has 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.

By accepting the free market image, European progressives 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, high unemployment—on the ground that the alternative has unacceptable social costs. The case for social democracy is fatally weakened by the concession that it requires 10 percent of the population to remain idle, or to work off the books in the gray economy. Ordinary Europeans do not find this attractive.

It is equally ineffective for the European left to defend Europe by decrying the social evils of the American model. Real wages in the United States are high; some 70 percent of American households own their own home; and more than a quarter of the adult population has a college degree, with nearly half having some college education. Even health care, on which Europeans pride themselves, is abundantly available in the United States to those who are insured. Poverty among the elderly is low in America, and most seniors live independently.

By reacting to the United States through Reaganite perceptions, Europeans deny themselves a correct understanding of the keys to the American boom. Because of their misunderstanding, they cannot draw on the actual sources of recent American success.

The Real American Model: Soft Budgets in the Social Sectors

So what are the foundations of the actual American model?

It is useful to approach this question by applying the concept 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. Uncompetitive firms provided millions with the rudiments of a comfortable and secure life, which have not always been restored under the ensuing postsocialist orders.

A brief examination of some important American institutions will establish that the concept of the soft budget constraint goes very far toward explaining the structure and conduct of our economy in the past 40 years, particularly in the prosperous period of the late 1990s. 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).[2] A typical share in Europe is 8 to 10 percent of GDP; in the United Kingdom 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). This amount covers only 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).

Higher education in the United States consumes about 2.3 percent of GDP. That total is split nearly evenly between public spending and the private share, which involves institutions whose multibillion-dollar endowments are bolstered by the tax system. A more typical European figure would be the 1.4 percent of GDP spent on postsecondary education in Germany (OECD 2003b). Public and private institutions alike benefit from federal research grants, contracts, and student loans.

The economic and socializing role of the American university system, especially its effects on the demand side, receives too little attention among foreign observers. 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 qualified to participate in the economic life of an advanced credit economy. Having received education loans, the population is eligible for mortgages and the entire spectrum of access to private credit. It is presumed competent to navigate the tax and subsidy system in order to take advantage of credits, deductions, and guarantees.

Second, higher education has a direct effect on employment and labor force participation. 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 a place for many who would otherwise spend their young adulthood unemployed.

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 (BEA 2003). The second is the prison system, whose expansion in recent years is deplorable, but whose effect on the unemployment rate among young adults is similar to that of the military.

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 brought pressure on private financial institutions to reduce their practice of redlining and thus extend credit to poorer communities where their presence had previously been largely predatory.

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. Social Security is the major source of disposable income for 60 percent of the American elderly (SSA 2003). Poverty in this group has fallen dramatically since the early 1970s and is now lower than among the general population, largely as a result of expanded Social Security pensions.

The aforementioned elements together account for nearly 40 percent of the total consumption of goods and services in the United States. This does not include the direct contribution of nonmilitary public expenditures at the federal, state, and local levels, in such areas as primary and secondary education, transportation, and the administration of justice.

Thus, some of the most important sectors of the economy 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. A broad political constituency supports all of these government measures, affording them political staying power, while control over the scale of these activities has slipped away from those who ostensibly oversee the public budget. This is the genius, if one may call it that, of the American model.

The situation is different in Europe, where health care and higher education remain substantially public sector activities, as do housing and pensions (outside the post-Thatcher U.K.). This accounts 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 as effectively as the private sector for public support. And where the public sector has 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 Stability and Growth Pact, the expansion of human services becomes more difficult, rather than less so.

The Myth and the Reality of the New Economy

In the 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? 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 certainly did not become less flexible in the recent 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.[3]

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 a misperception of the appropriate boundaries. It is true that U.S. incomes are 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. (For this argument, see Galbraith, Conceicao, and Ferreira 1999.) Over all, unemployment and inequality are not substitutes, but complements, when measured at the appropriate level of geographic aggregation.

The rise to full employment in the United States in the late 1990s occurred, in part, because of a very steady expansion of the quasi-public sectors, while the federal government sector did not grow at all. State and local governments did expand as the boom gathered force; so did tax-subsidized expenditures on housing and health care. (To note this, of course, is not to minimize the contribution to private business investment of the technology sectors, abetted by private capital inflow from abroad.)

This trend spurred growth in the 1990s. It worked for the conventional Keynesian reason: a high level of effective demand. The peculiarity of effective demand in the United States during this period—a nuance that seems to have eluded European observers—was that much of it was generated or encouraged by acts of public policy, but most of it did not register on the public balance sheet. Thus the United States achieved full employment with record surpluses. One might call this the Keynesian Devolution.

A Crisis in the American Model?

The problem of the Keynesian Devolution lay not in its efficacy as a mechanism for growth and prosperity, but in its implications for the balance sheets of the household sector. As the Levy Institute has emphasized in a series of papers (Godley and Izurieta 2001a, 2001b, 2002; Papadimitriou et al. 2002), the American household sector's spending has exceeded its income since 1997. 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. When 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, is unavoidable.

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. 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, perhaps even a prolonged phase, of crisis. This crisis is mainly due to the behavior of sectors in which budget constraints continue to bite—or are starting to bite again after many years. To the extent that the state fiscal crisis affects education and health care and the household sector avoids new mortgage borrowing, soft budget constraints may give 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 through the absorption of 30 to 35 million people into gainful employment, particularly those in lower-income regions where unemployment and underemployment are pandemic.

How is this to be achieved? The objective of full employment must not be simply part of the European Charter, but a core objective of all policy-making institutions. 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, homebuyer subsidies, and secondary mortgage markets, can help distribute the burden of increasing effective demand over the private sector.

However, it is better to raise incomes than to underwrite a massive increase in debt. 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. The remedy is to move toward a Europeanized pension system that would pay all European elderly on the basis of continentwide average productivity. Similarly, Europe could 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.

In higher education, 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. New educational institutions should be funded not only through public grants, but also through private charitable donations that are strongly supported by the tax system.

Major improvements in European health facilities could also be funded by the European Union, 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. It needs softer budgets in strategic sectors in order to expand the mechanisms of the welfare state, which were introduced in the postwar period, from a national to a continental scale. A good place to start would be with the basics, such as a continental Social Security system, like that pioneered 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. 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.

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