

DAY OF RECKONING

The Consequences of
American Economic Policy

"Every citizen ought to read it."

—Christopher Lehmann-Haupt, The New York Times

BENJAMIN M. FRIEDMAN

WITH A NEW INTRODUCTION BY THE AUTHOR

DAY
OF
RECKONING

The Consequences of
American Economic Policy

Benjamin Friedman



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Day of Reckoning

IN MEMORY OF MY FATHER
AND WITH LOVE FOR MY SONS

Acknowledgments



This book is about debt: debt and the material and moral impoverishment that inevitably follow, no less for a nation than for an individual or a family, from continually borrowing for no purpose other than to live beyond one's means.

There is also another kind of debt. Debts of personal gratitude are often enriching, not impoverishing, and it is my good fortune to have accumulated many of these in the course of writing this book. I want here to acknowledge the most important among them.

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None of these institutions, however, nor any other organization with which I am associated, nor any of the many individuals from whose help I have benefited bears any responsibility for the contents of this book. The opinions and interpretations I have expressed here are mine, and so too is the responsibility for any errors they may contain or any controversies to which they may give rise.

And finally, for the support that has mattered the most in

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Benjamin M. Friedman

Cambridge, Massachusetts

June 1988

Introduction to the Vintage Edition



Ronald Reagan left behind a serious economic problem, one that George Bush, in the first portion of his term, has done nothing to solve and has barely even acknowledged. The chronic federal deficit is sapping our productivity at home and our ability to compete abroad. As a result, our standard of living has already begun to grow more slowly, and America's influence in world affairs has suffered. If we do nothing to correct the problem, both our standard of living and our global power will continue to weaken. Ultimately, the resulting decay will threaten our society's most fundamental values.

On average during the 1980s, the government's borrowing to cover its budget deficit absorbed three fourths of the net saving of all American families and all American businesses combined. Under our current policies, it will continue to do so. Meanwhile, we are devoting barely two cents out of every dollar of our national income to net investment in business plant and machinery—considerably less than in the 1950s or the 1960s or even the 1970s—so that gains in productivity have continued to be disappointing. Business therefore cannot pay

higher real wages. The economic expansion that began in 1983 may be the longest on record, but it is also the first in fifty years in which the average working American's wage has declined compared to inflation.

Our problem is both more complex and more threatening because so much of what we have borrowed has come from abroad. When Ronald Reagan became President, America was the world's leading lending nation. By the time George Bush assumed office, America was the world's largest debtor, increasingly beholden to the foreigners who buy our Treasury securities and, when private investors draw back, support the dollar. Our international indebtedness continues to accelerate, even as foreign lenders increasingly cash in their dollar IOUs for direct ownership of our businesses and our real estate.

One reason that the transition from Reagan to Bush has not solved these problems, nor even given any clear sense of how to attack them, is that neither candidate in the campaign to succeed President Reagan was willing to address the issue seriously. Pretending that there is no problem—or, if there is one, that it can be solved without sacrifices like spending cuts or higher taxes—no doubt was politically safer than addressing the hard choices America now faces. Similarly, Bush's presidency began much like Reagan's in this regard, by sweeping the problem under a rug woven of unrealistically optimistic economic assumptions and even more than the usual amount of duplicitous bookkeeping (of which the most astonishing example was the scheme that kept the \$100 billion savings and loan bailout "off budget" and even made the deficit in the program's first few years look *smaller* the more the bailout cost).

A further difficulty is that various confusions, some simple and others more subtle, have clouded what little genuine discussion our fiscal problem has received. For example, some

defenders of today's large deficit—in reality, there are no defenders of the deficit, only opponents of measures that would reduce it—argue that deficits simply do not matter. A common way to make this argument is to point to Japan, where the government's deficit (as a share of national income) is even larger than ours, yet investment has proceeded at a good pace, productivity and living standards have grown rapidly, and manufacturers are obviously competitive in world markets.

What this familiar argument ignores, of course, is that the Japanese also *save* far more of their incomes than we do—between two and three times as much, depending on conventions of measurement. If we saved the way the Japanese do, we too could run a deficit like theirs and still have plenty of saving left to support investment both at home and abroad. But the United States has always been a low-saving country by international standards, and a powerful lesson of the 1980s is that we do not know how to use government policy to increase our private saving. Despite higher market rates of return compared to inflation, lower tax rates, and (for a while) targeted saving incentives like expanded access to individual retirement accounts—all measures that advocates had confidently predicted would boost Americans' saving—our private saving rate has fallen to record lows in recent years. For America, therefore, cutting the deficit is essential to achieving capital formation, productivity growth, and all that follows.

Another source of confusion is the argument that the deficit is actually benign because it finances investment in physical infrastructure like roads, bridges, port facilities, and research stations. The government, in other words, is like any soundly run business, relying on debt to finance projects that will be productive over a long time. Indeed, some forms of public investment may enhance productivity just as much as, and perhaps even more than, private investment in new plants and

machines. If so, there is nothing wrong with using scarce private saving in this way. The same argument applies to investment in "human capital" through education and worker training.

These ideas are sound in principle, but this kind of investment activity does not account for today's swollen deficit. The increasingly familiar list of all the fixed assets the U.S. government owns, ranging from military installations to office buildings to national parks to undeveloped public lands, says absolutely nothing about why the government is now absorbing so much of the nation's private saving—large tax reductions together with continued spending, primarily for entitlement programs and the military. In fact, just as the federal deficit grew to record size in the 1980s, the share of federal spending devoted to potentially productivity-enhancing investment dwindled to an all-time low. On average during the decade, investment in civilian infrastructure accounted for just 1.2 percent of federal outlays. Federal, state and local spending on education has been either stagnant or declining.

A third familiar argument against taking the deficit seriously is that the problem is already disappearing by itself. In the 1988 campaign, George Bush repeatedly pointed to the decline in the deficit from \$221 billion in the government's 1985 fiscal year to \$155 billion in fiscal 1988. But that overall deficit for 1988 reflected the combination of a \$41 billion surplus in the Social Security account and a deficit in the general account of \$196 billion—much closer to the record \$221 billion of three years earlier, and closer still after allowing for the completion of the recovery to full employment. Similarly, most of the discussion early in the Bush administration about whether the deficit for fiscal 1990 would fall within the \$100 billion Gramm-Rudman-Hollings ceiling for that year ignored the fact that even if it did, that would still represent a \$68 billion Social

Security surplus together with a \$168 billion general account deficit. Corresponding comparisons showing marked “improvement” in the deficit from the early Reagan years—measured as a share of national income, the deficit peaked in 1983—not only neglect the growing Social Security surplus but also fail to take account of the important differences, for revenues and spending, between an economy with nearly 10 percent of its labor force idled, as was the case in 1983, and an economy operating at or near full employment.

Such comparisons are useless as guides to future action, both because the recovery to full employment was largely complete by the late 1980s and because drawing on the Social Security surplus merely shifts the problem without solving it. The Social Security surplus results from sharply increased payroll taxes intended to finance the retirement of the baby boom generation, beginning early in the next century, when the number of retirees will rise rapidly compared to the number of workers then making contributions. The purpose of these higher payroll taxes is to raise our national saving rate between now and then. If we dissipate the resulting Social Security surplus to help offset even larger current deficits along the way, our national saving will not rise, and either workers in the future will have to pay intolerably high payroll taxes or today’s workers, who are already paying so much, will have to accept severely shrunken benefits when they retire.

Because America’s fiscal problem is not going away on its own, the need for serious action—not pretenses based on Polyantha economic assumptions and ingenious budget accounting, but real action to restrain spending or raise revenues, or both—is as great as ever. In fact, as the cumulative effect of our inadequate investment and excessive foreign borrowing grows, the need is all the greater. But the American political system responds primarily to acute crises that arrest the pub-

lic's consciousness. Our fiscal problem, however, works in slow and subtle ways, even as it undermines our most cherished values. Along with our politicians' natural fear of confronting the need to reduce spending and raise taxes, this intangible quality of the damage that the deficit does is the chief impediment to achieving a political consensus on how to correct it. As a result, there is a vacuum at what should be the core of America's economic policy agenda.

But the moral imperative demanding that we solve the problem is no less for the gradualness of the harm that it causes. Although political discussion sometimes associates the argument that the deficit is too large, and should be reduced, with the claim that America is locked on a path to inevitable decline in the tide of world history, this supposed connection is exactly backward. Righting our fiscal imbalance is so important precisely because the slow but steady damage it is inflicting on American society and on America's place in the world is *not* inevitable. There is a difference between being overwhelmed by a larger force bearing superior arms and defeating oneself through inattention or recklessness. We can change course, and begin to reverse the erosion of our economy at home and our position abroad, but only if we choose a fiscal policy sharply different from what we have had in the 1980s.

Cambridge, Massachusetts
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