WHY PROGRESSIVE INSTITUTIONS ARE UNSUSTAINABLE

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Classical Liberal vs. Modern Progressive

THE MODERN economic malaise in the United States is captured by two numbers. The first is the decline in average family income, which has slid for the past three years and now stands at the same level, adjusted for inflation, that it was in 1996. The second is the persistent level of unemployment at 9.1 percent, which excludes those who are underemployed or have in frustration given up the search for jobs. Everyone across the political spectrum deplores the result and wishes to reverse the trend. But this unanimity of ends gives way to a fierce difference of opinion on means. Just what should be done?

The deep polarization of views clusters on a broad range of macro- and microeconomic issues. The former covers taxation, deficits, public expenditures. The latter is focused single-mindedly on jobs. The intimate connection between these two is evident from the constant political refrain of whether the priority for government action should lie with the elimination of unemployment or with getting the government's fiscal house in order. This entire set of problems is complicated further by the precarious position of the real estate markets, as the major decline in real estate values has led to a torrent of underwater residences subject to foreclosures whose frequency increases with the decline in employment levels. The overall landscape is still more clouded because the budgetary position of many states is precarious, to say the least. What should be done about these pressing matters? In dealing with this question, it is hardly productive to revisit the political sniping that takes place on both sides of the aisle. It is far more important to ask about the fundamental differences in approach to ending the admitted stagnation in the economic sphere.

For simplicity, I shall ignore the important issues at the state level and concentrate on the nationwide problems with public finance, unemployment, and housing. It is somewhat hysterical to call the current malaise a depression. The overall levels of material wealth are far higher than they were in 1935, and the toxic brew of high tariffs, major deflation, high marginal tax rates, and incessant cartelization of labor and agricultural markets is less potent today than it was at the height of the New Deal. But to say that today's economic climate is better than it was at the depths of the depression is not a ringing endorsement of the status quo – nor does it explain what should be done. Matters do not become, nor do they remain, this grim simply by chance. Consistent bad results can only be explained by consistent bad policies and not by some mysterious run of bad luck. Bad policies in turn rest on an unsound worldview. So this nation has reached a crossroads in its choice of first principles. The nation must choose between the oft-rejected classical liberalism of its founding period and the modern progressive stance that served as the foundation of Franklin Delano Roosevelt's New Deal.

I strongly embrace the former first vision and roundly reject the latter. There is no middle ground on this topic. Nor is there any one way to explain why the progressive vision has led us so badly astray. But it is possible to see what went wrong by focusing on one part of the larger picture: namely, the relative durability of these alternative institutional arrangements. What is needed therefore is a rough measure of the useful half-life of social arrangements. Not even the most ideal set of institutions can just last forever. Every sound set of institutions must be defended, restored, and renewed to undo the damage that political factions of all ideological persuasions seek to turn social events and technological changes to partisan advantages. The problem of factions, both minority and majority, identified by James Madison in "Federalist No. 10," cannot be wished away by appeals to the virtues of deliberative democracy. What is needed is a choice of robust institutions that do not have to be re-engineered with each technological innovation or social change.

The terms *classical liberal* and *modern progressive* may seem quaint to some people, so let me explain why I use them. The former evokes references to 19th century theories of market liberalization, which were intended to reduce the dead hand of government over the operation of the economy. The second recalls the progressive movement of the first third of the 20th century, which championed the rise of the large administrative state to overcome the perceived weaknesses of the classical liberal synthesis. I use that term *progressive* here for two reasons. First, many Democrats and champions of large government use it as a form of self-identification. Second, their use

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of the term relocates the center of discussion away from such 1960s issues as criminal procedure, the death penalty, abortion, and affirmative action to the bread-and-butter economic issues dealing with the regulation of financial institutions, home mortgages, labor markets, and health care, all of which hearken back to the New Deal. In defending this modern roster of reforms, moreover, the modern progressives invoke a Keynesian renaissance that places discussions of stimulus packages, multiplier effects, and aggregate demand at the center of the discourse. The classical liberal has the opposite view. Governments are to supply public goods and maintain social stability, leaving innovation to the private sector.

The key components of the classical liberal theory are as follows. The first component is the call for limited government funded by tax revenues preferably generated under a flat tax (i.e., one that requires uniform rates for the taxable-income individuals, regardless of their aggregate income in any given tax period). In a sound system of public finance, the government's borrowing to meet the cost of capital improvements is acceptable, but borrowing to pay for short-term-consumption items is not.

It is, in other words, proper to use borrowed funds to create long-term capital improvements but not to fund short-term government activity, like the payment of salaries for public employees. Accordingly, the purpose of taxation is to fund the creation of (nonexcludable) public goods that could not be created or maintained without some system of coerced public support. Public finance, however, is not to operate a disguised system of wealth transfer for individuals, which, if anything, it discourages as a road map to reduce taxation to a rarified form of "theft."

In putting these elements together, the theory departs in a conscious way from narrower forms of libertarian thought that see the sole proper use of government power to be the control of force and fraud. The hardline libertarian thus has no reason to develop any theory of taxation or eminent domain in the first place, let alone a theory of optimal taxation on the one hand, or sound public improvements on the other. I reject this extreme version of libertarianism not because it resonates at most only with a tiny minority of the population. I reject it for the best of theoretical reasons. Taxation and eminent domain are both needed to solve a wide range of collective-action problems, whereby high transaction barriers prevent people from getting together voluntarily to work on projects that work to their joint advantage. Coercion is not the only threat to social order. Holdout problems by private individuals, each of whom wants a disproportionate share of social gain, must also be candidly addressed. The real question is how to shape their use so that they perform their assigned functions well. It is not to deprive any government of the tools that it needs to perform its essential functions to maintain and preserve public order.

The second component of the classical liberal system draws on traditional libertarian theory insofar as it relies on a system of strong property rights that allow individuals choice on how to use and dispose of their property so long as they do not encroach on the land of their neighbors or create nuisances – smells, filth, and waste – to their neighbors. But the opposite of the coin is every bit as important. Ordinary forms of economic competition may displace established businesses and thus be a source of private grievances. But the disappointed business should never be heard to say that ruinous competition should be treated as though it were a nuisance when its social consequences cut in the opposite direction. Nuisances shrink the overall size of the social pie that economic nuisance expands. Classical liberalism steers between the risks of anarchy and authoritarianism. Put simply, the theory is never that any individual can do what he will with what he owns. The theory is that the rules that preserve the like liberties of property owners should maximize their joint welfare by imposing parallel limitations against disrupting the quiet enjoyment that neighbors have of their own property.

The third component of the overall system requires a strong commitment to the principle of freedom of contract. Quite simply, the terms and conditions of individual employment contracts should be decided by employers and employees operating within the general confines of a competitive market. Such contracts should be left untouched by minimum-wage and antidiscrimination laws on the one hand and maintain a distinctive, privileged role for labor unions on the other. Unions are monopoly institutions whose combined activities are wholly exempt from the antitrust laws and who receive explicit backing from the government that strengthens their bargaining position against the government. That effort to undermine competitive markets is no better in the market for labor than it is for goods and services. During the heyday of classical liberalism, labor unions were in fact subject to the watchful eyes of an antitrust law and were afforded no special privileges of collective bargaining. Those principles of freedom of contract extended also to the operation of real estate markets and supported, among other things, the ability of a mortgage lender to quickly repossess property from debtors in the event of default, both to

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encourage lending in the first instance and to preserve the physical condition, and thus the value of property, after default took place.

In sum, the pillars of classical liberalism call for flat taxes, with revenues put to limited uses; strong property rights; and free markets. Each of these premises is systematically rejected in the progressive agenda as it evolved during the first third of the 20th century, culminating in Roosevelt's New Deal. For these modern progressives, any notion of limited government at either the federal or state level is regarded as a misguided holdover from the simpler economic era that had long vanished from view with the industrialization of the post-Civil War period. At the public level, the progressives did not, of course, repudiate the use of taxation to fund the creation of public goods, which is so key to the classical liberal agenda. But they took strong exception to the classical liberal view that this objective, closely watched, marked the outer limits for the exertion of government power. In their view, the second permissible function of taxation was to take advantage of the pronounced, diminishing marginal utility of wealth and to arrange for a set of wealth transfers of indeterminate amounts from the rich to the poor through a wide variety of programs.

The theory behind this transfer program rests on the true but incomplete insight that the same dollar is worth more to a poor person than to a rich one. Using this theory, the government could improve welfare by social transfers, even if at the margin they might do some – progressives always thought small – damage to overall wealth creation. Of these, perhaps the most notable methods are as follows. The first is progressive taxation, in which the rate of taxation increases with income. The rate of progressivity could be modest, if the lowest rate is, say, 10 percent and the highest is 20 percent. Or it could be far steeper, with a differential from, say, 0 percent to 75 percent. One weakness of the theory is that it does not indicate *which* progressive rate structure is desired but only claims that *some* such rate structure is required. The second is the imposition of a progressive estate and gift tax system, which is intended to equalize wealth within society by preventing the passing of large accumulations of wealth between generations, free of taxation. Side by side with the progressive tax are the many transfer programs that also had their legislative origins in the 1930s. These include unemployment benefits, Social Security, disability payments, family leave, and much more, all of which started small, received emphatic judicial benediction when challenged constitutionally, and grew steadily and inexorably larger thereafter.

In its most explicit form, this redistributive rationale for taxation assumes such paramount importance under the progressive mindset that taxation necessarily has a key role to play in the operation of the economy even if the government by some miracle no longer had to play any role in the creation of public goods. Securing, not prohibiting, the orderly transfer of wealth from A to B, based on wealth differentials, is the raison d'être of the program. The contrast between the modern progressive and classical liberal agendas could not be more explicit.

On the second point, government interference in private business relationships is, according to the progressive mindset, regarded as an essential government function in order to overcome perceived differentials in economic power. The first of these differences involves employers and employees. The second is between banks and their borrowers. The older notions of free and voluntary exchange that captivated Adam Smith may have applied to a nation of small shopkeepers and manufacturers but were assumed to have no relevance to the complex and divisive process of