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Distribution and the Possibilities for Economic Change

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Chapter 1

An Economy That No Longer Performs

AFTER DECADES of believing in their economic invulnerability, Americans were jolted by the 1973–74 Arab oil embargo. The actions of a few desert sheiks could make *them* line up at the gas pump and substantially reduce *their* standard of living. Sudden economic vulnerability is disconcerting, just as that first small heart attack is disconcerting. It reminds us that our economy can be eclipsed.

When the shutdown of a major oil exporter for just a few months in 1979 once again resulted in the convulsions of gas lines, it was possible to ask whether that first mild heart attack was not the harbinger of something worse. Seemingly unsolvable problems were emerging everywhere–inflation, unemployment, slow growth, environmental decay, irreconcilable group demands, and complex, cumbersome regulations. Were the problems unsolvable or were our leaders incompetent? Had Americans lost the work ethic? Had we stopped inventing new processes and products? Should we invest more and consume less? Do we need to junk our social welfare, health, safety, and environmental protection systems in order to compete? Why were others doing better?

Where the U.S. economy had once generated the world's highest standard of living, it was now well down the list and slipping farther each year. Leaving the rich Middle East sheikdoms aside, we stood fifth among the nations of the world in per capita GNP in 1978, having been surpassed by Switzerland, Denmark, West Germany, and Sweden.[1] Switzerland, which stood first, actually had a per capita GNP 45 percent larger than ours. And on the outside, the world's fastest economic runner, Japan, was advancing rapidly with a per capita GNP only 7 percent below ours. In our entire history we have never grown even half as rapidly as the Japanese.

While the slippage in our economic position was first noticed in the 1970s, our economic status was actually surpassed (after just half a century of delivering the world's highest standard of living) by Kuwait in the early 1950s.[2] Kuwait was ignored, however, as a simple case of a country inheriting wealth (oil in the ground) rather than earning it. We failed to remember that our supremacy had also been based on a rich inheritance of vast mineral, energy, and climatic resources. No one inherited more wealth than we. We are not the little poor boy who worked his way to the top, but the little rich boy who inherited a vast fortune. Perhaps we had now squandered that inheritance. Perhaps we could not survive without it.

Of course, one can always argue that things are not really as bad as they seem. Since many goods are not traded in international markets and may be cheaper here than abroad, per capita GNP may paint too pessimistic a picture of our relative position. A group of American economists argued in 1975 that we still had the highest real standard of living among industrialized countries.[3] What we lost in per capita GNP to the two or three countries that were then ahead of us, we more than made up in terms of lower living costs.

Whether this is still true today depends upon changes in the *terms of trade*—the amount of exports that you have to give up to get a given amount of imports. In Switzerland, for example, oil cost less in 1978 than it did in 1975.[4] While the dollar price of oil is up, the value of the Swiss franc is up even more. Thus fewer domestic goods have to be given up to buy a given quantity of oil. The country's GNP simply buys more than it did. In countries like Switzerland, where imports are over one-third of the GNP, changes in the terms of trade can have a dramatic effect on the real standard of living.

While it is easy to calculate per capita GNPs, it is notoriously difficult to make precise standard-of-living comparisons among countries. In each country, individuals naturally shift their purchases toward those items that are relatively cheap in that country. Tastes, circumstances, traditions, and habits differ. Individuals do not buy the same basket of goods and services. What is a necessity in one country may be a luxury in another. Health care may be provided by government in one country and purchased privately in another. And how do you evaluate vast expenditures, such as those we make on health care, where we are spending more than the rest of the world but getting less if you look at life expectancy (U.S. males are now sixteenth in the world)?

But whatever our precise ranking at the moment, the rest of the world is catching up, and if they have not already surpassed us, they soon will. From many perspectives, this catching-up process is desirable. Most rich people find it more comfortable to live in a neighborhood with other rich people. The tensions are less and life is more enjoyable. What is not so comfortable is the prospect that our rich neighbors will continue to grow so rapidly that we slip into relative backwardness.

Up to now, we have comforted ourselves with the belief that the economic growth of others would slow down as soon as they had caught up with us. It was simply easier to adopt existing technologies than to develop new technologies—or so we told ourselves. But as other countries have approached our productivity levels, and as individual industries in these countries have begun to be more productive, the "catching-up" hypothesis becomes less and less persuasive.

In the period from 1972 to 1978, industrial productivity rose 1 percent per year in the United States, almost 4 percent in West Germany, and over 5 percent in Japan.[5] These countries were introducing new products and improving the process of making old products faster than we were. Major American firms were reduced to marketing new consumer goods such as video recorders, which were made exclusively by the Japanese. In many industries, such as steel, we are now the ones with the "easy" task of adopting the technologies developed by others. But we don't. Instead of junking our old, obsolete open-hearth furnaces and shifting to the large oxygen furnaces and continuous casting of the Japanese, we retreat into protection against the "unfair" competition of Japanese steel companies. The result is a reduction in real incomes as we all pay more for steel than we should. As a result, our economy ends up with a weak steel industry that cannot compete and has no incentive to compete, given its protection in the U.S. market.

This relative economic decline has both economic and political impacts. Economically, Americans face a relative decline in their standard of living. How will the average American react when it becomes obvious to the casual tourist (foreigners here, Americans there) that our economy is falling behind? Since we have never had that experience, no one knows; but if we are like human beings in the rest of the world, we won't like it. No one likes seeing others able to afford things that they cannot.

As gaps in living standards grow, so does dissatisfaction with the performance of government and economy. The larger the income gap, the more revolutionary the demands for change. Today's poor countries are in turmoil, but it should be remembered that these countries are not poor compared with the poor centuries ago. They are only poor relative to what has been achieved in today's rich countries. If we become relatively poor, we are apt to be just as unhappy.

Politically a declining economy means that we have to be willing to make greater sacrifices in our personal consumption to maintain any level of world influence. This can be done. The Russians have become our military and geopolitical equals despite a per capita GNP that is much lower than ours. They simply put a larger fraction of their GNP into defense. But the need to cut consumption creates strains in a democracy that do not exist in a dictatorship. Americans may gradually decide that they cannot afford to maintain a strategic military capability to defend countries that are richer than they are. They may decide that they cannot afford to lubricate peace settlements, such as that between Israel and Egypt, with large economic gifts. Some of the international economic burdens could be shifted to our wealthier allies, but this would inevitably mean letting them make more of the important, international decisions. In many circumstances (Israel vs. Egypt?)

the Germans and the Japanese may not make the same decisions that we would make.

The hard-core conservative solution is to "liberate free enterprise," reduce social expenditures, restructure taxes to encourage saving and investment (shift the tax burden from those who save, the rich, to those who consume, the poor), and eliminate government rules and regulations that do not help business. Specifically, the capital gains taxes that were reduced in 1978 should be reduced further; the "double" taxation of dividends should be ended; income transfer payments to the poor and the elderly should be frozen; environmentalism should be seen as an economic threat and rolled back. Laffer curves sprout like weeds to show that taxes should be cut to restore personal initiative. Only by returning to the virtues of hard work and free enterprise can the economy be saved.

In thinking about this solution, it is well to remember that none of our competitors became successful by following this route. Government absorbs slightly over 30 percent of the GNP in the United States, but over 50 percent of the GNP in West Germany. Fifteen other countries collect a larger fraction of their GNP in taxes.[6]

Other governments are not only larger; they are more pervasive. In West Germany, union leaders must by law sit on corporate boards. Sweden is famous for its comprehensive welfare state. Japan is marked by a degree of central investment planning and government control that would make any good capitalist cry. Other governments own or control major firms, such as Volkswagen or Renault. Ours is not the economy with the most rules and regulations; on the contrary, it is the one with the fewest rules and regulations. As many American firms have discovered to their horror, it simply isn't possible to fire workers abroad as it is here. It is a dubious achievement, but nowhere in the world is it easier to lay off workers.

Nor have our competitors unleashed work effort and savings by increasing income differentials. Indeed, they have done exactly the opposite. If you look at the earnings gap between the top and bottom 10 percent of the population, the West Germans work hard with 36 percent less inequality than we, and the Japanese work even harder with 50 percent less inequality.[7] If income differentials encourage individual initiative, we should be full of initiative, since among industrialized countries, only the French surpass us in terms of inequality.

Moreover, our own history shows that our economic performance since the New Deal and the onset of government "interference" has been better than it was prior to the New Deal. Our best economic decades were the 1940s (real per capita GNP grew 36 percent), when the economy was run as a command (socialist) wartime economy, and the 1960s (real per capita GNP grew 30 percent), when we had all that growth in social welfare programs.[8] Real per capita growth since the advent of government intervention has been more than twice as high as it was in the days when governments did not intervene or have social welfare programs.

The British are often held up as a horrible example of what will happen to us if we do not mend our ways and reverse the trend toward big government. But whatever is wrong with the British economy, it has little to do with the size of government. British growth fell behind that of the leading industrial countries in the nineteenth century and has remained behind ever since. Slow growth did not arrive with the Labour government in 1945. On the contrary, British growth since 1945 has actually been better than before. There is no doubt that the British economy is in sad shape, but as the West Germanys of the world demonstrate, its problems are not a simple function of government size.

As both our experience and foreign experience demonstrate, there is no conflict between social expenditures or government intervention and economic success. Indeed, the lack of investment planning, worker participation, and social spending may be a cause of our poor performance. As we, and others, have shown, social reforms can be productive, as well as just, if done in the right way. If done in the wrong way, they can, of course, be both disastrous and unjust. There may also be some merit in "liberating free enterprise" if it is done in the right way. There are certainly unnecessary rules and regulations that are now strangling our economy. The trick is not rules versus no rules, but finding the right rules.

The American problem is not returning to some golden age of economic growth (there was no such golden age) but in recognizing that we have an economic structure that has never in its entire history performed as well as Japan and West Germany have performed since World War II. We are now the ones who must copy and adapt the policies and innovations that have been successful elsewhere. To retreat into our mythical past is to guarantee that our days of economic glory are over.

Unsolvable Problems

But our problems are not limited to slow growth. Throughout our society there are painful, persistent problems that are not being solved by our system of political economy. Energy, inflation, unemployment, environmental decay, ever-spreading waves of regulations, sharp income gaps between minorities and majorities—the list is almost endless. Because of our inability to solve these problems, the lament is often heard that the U.S. economy and political system have lost their ability to get things done. Meaningful compromises cannot be made, and the politics of confrontation are upon us like the plague. Programs that would improve the general welfare cannot be started because strong minorities veto them. No one has the ability to impose solutions, and no solutions command universal assent.

The problem is real, but it has not been properly diagnosed. One cannot lose an ability that one never had. What is perceived as a lost ability to act is in fact (1) a shift from international cold war problems to domestic problems, and (2) an inability to impose large economic losses explicitly.

As domestic problems rise in importance relative to international problems, action becomes increasingly difficult. International confrontations can be, and to some extent are, portrayed as situations where everyone is fairly sharing sacrifices to hold the foreign enemy in check. Since every member of society is facing a common threat, an overwhelming consensus and bipartisan approach can be achieved.

Domestic problems are much more contentious in the sense that when policies are adopted to solve domestic problems, there are *American* winners and *American* losers. Some incomes go up as a result of the solution; but others go down. Individuals do not sacrifice equally. Some gain; some lose. A program to raise the occupational position of women and minorities automatically lowers the occupational position of white men. Every black or female appointed to President Carter's cabinet is one less white male who can be appointed.

People often ask why President Kennedy was so easily able to get the Man on the Moon project underway, while both Presidents Nixon and Ford found it impossible to get their Project Independence underway. There is a very simple answer. Metaphorically, some American has to have his or her house torn down to achieve energy independence, but no American lives between the earth and the moon. Everyone is in favor of energy independence in general, but there are vigorous objectors to every particular path to energy independence. In contrast, once a consensus had been reached on going to the moon, the particular path could be left to the technicians. In domestic problems, the means are usually as contentious as the ends themselves.

As we shall see in later chapters, there *are* solutions for each of our problem areas. We do not face a world of unsolvable problems. But while there are solutions in each case, these solutions have a common characteristic. Each requires that some large group —sometimes a minority and sometimes the majority—be willing to tolerate a large reduction in their real standard of living. When the economic pluses and minuses are added up, the pluses usually exceed the minuses, but there are large economic losses. These have to be allocated to someone, and no group wants to be the group that must suffer economic losses for the general good.

Recently I was asked to address a Harvard alumni reunion on the problem of accelerating economic growth. I suggested that we were all in favor of more investment, but that the heart of the problem was deciding whose income should fall to make room for more investment. Who would they take income away from if they were given the task of raising our investment in plant and equipment from 10 to 15 percent of the GNP? One hand was quickly raised, and the suggestion was made to eliminate welfare payments. Not surprisingly, the person was suggesting that someone else's income be lowered, but I pointed out that welfare constitutes only 1.2 percent of the GNP.[9] Where were they going to get the remaining funds—3.8 percent of GNP? Whose income were they willing to cut after they had eliminated government programs for the poor? Not a hand went up.

A Zero-Sum Game

This is the heart of our fundamental problem. Our economic problems are solvable. For most of our problems there are several solutions. But all these solutions have the characteristic that someone must suffer large economic losses. No one wants to volunteer for this role, and we have a political process that is incapable of forcing anyone to shoulder this burden. Everyone wants someone else to suffer the necessary economic losses, and as a consequence none of the possible solutions can be adopted.

Basically we have created the world described in Robert Ardrey's *The Territorial Imperative*. To beat an animal of the same species on his home turf, the invader must be twice as strong as the defender. But no majority is twice as strong as the minority opposing it. Therefore we each veto the other's initiatives, but none of us has the ability to create successful initiatives ourselves.

Our political and economic structure simply isn't able to cope with an economy that has a substantial zero-sum element. A zero-sum game is any game where the losses exactly equal the winnings. All sporting events are zero-sum games. For every winner there is a loser, and winners can only exist if losers exist. What the winning gambler wins, the losing gambler must lose.

When there are large losses to be allocated, any economic decision has a large zero-sum element. The economic gains may exceed the economic losses, but the losses are so large as to negate a very substantial fraction of the gains. What is more important, the gains and losses are not allocated to the same individuals or groups. On average, society may be better off, but this average hides a large number of people who are much better off and large numbers of people who are much worse off. If you are among those who are worse off, the fact that someone else's income has risen by more than your income has fallen is of little comfort.

To protect our own income, we will fight to stop economic change from occurring or fight to prevent society from imposing the public policies that hurt us. From our perspective they are not good public policies even if they do result in a larger GNP. We want a solution to the problem, say the problem of energy, that does not reduce our income, but all solutions reduce someone's income. If the government chooses some policy option that does not lower our income, it will have made a supporter out of us, but it will have made an opponent out of someone else, since someone else will now have to shoulder the burden of large income reductions.

The problem with zero-sum games is that the essence of problem solving is loss allocation. But this is precisely what our political process is least capable of doing. When there are economic gains to be allocated, our political process can allocate them. When there are large economic losses to be allocated, our political process is paralyzed. And with political paralysis comes economic paralysis.

The importance of economic losers has also been magnified by a change in the political structure. In the past, political and economic power was distributed in such a way that substantial economic losses could be imposed on parts of the population if the establishment decided that it was in the general interest. Economic losses were allocated to particular powerless groups rather than spread across the population. These groups are no longer willing to accept losses and are able to raise substantially the costs for those who wish to impose losses upon them.

There are a number of reasons for this change. Vietnam and the subsequent political scandals clearly lessened the population's willingness to accept their nominal leader's judgments that some project was in their general interest. With the civil rights, poverty, black power, and women's liberation movements, many of the groups that have in the past absorbed economic losses have become militant. They are no longer willing to accept losses without a political fight. The success of their militancy and civil disobedience sets an example that spreads to other groups representing the environment, neighborhoods, and regions.

All minority groups have gone through a learning process. They have discovered that it is relatively easy with our legal system and a little militancy to delay anything for a very long period of time. To be able to delay a program is often to be able to kill it. Legal and administrative costs rise, but the delays and uncertainties are even more important. When the costs of delays and uncertainties are added into their calculations, both government and private industry often find that it pays to cancel projects that would otherwise be profitable. Costs are simply higher than benefits.

In one major environmental group, delays are such a major part of their strategy that they have a name for it—analysis paralysis. Laws are to be passed so that every project must meet a host of complicated time-consuming requirements. The idea is not to learn more about the costs and benefits of projects, but to kill them. If such requirements were to be useful in deciding whether a project should be undertaken, environmental-impact statements, for example, would have to be inexpensive, simple, and quick to complete. Then a firm might undertake the studies to help determine whether they should or should not start a project.

Instead, the studies are to be expensive and complex to serve as a financial deterrent to undertaking any project, to substantially lengthen the time necessary to complete any project, and to ensure that they can be challenged in court (another lengthy process). As a consequence, the developer will start the process only if he has already decided on other grounds to go ahead with the project. The result is an adversary situation where the developer cannot get his project underway—and where the environmentalists also cannot get existing plants (such as Reserve Mining) to clean up their current pollution. Where it helps them, both sides have learned the fine art of delay.

Consider the interstate highway system. Whatever one believes about the merits of completing the remaining intracity portion of the system, it is clear that it gives the country an intercity transportation network that would be sorely missed had it not been built. Even those who argue against it do so on the grounds that if it