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The Economics of Illusion and the Illusion of Economics

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Summary: The US economy faces an investment crisis which cannot be addressed by frugality of tax rises and budget cuts or by protectionist blaming of foreigners. Proposes to encourage personal savings at the expense of consumption, and collective investment in social infrastructure.

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Societies, like individuals, often want to avoid facing their most pressing problems. Recognizing reality can be painful; addressing it can be even more painful—requiring sacrifice and change. Thus societies, like individuals, often deny that their problems exist. Or they erect "straw men," which are not the real problems at all, and try to confront them instead. Or they deny responsibility for problems, blaming others. America has been using all these ploys to avoid coping with its economic mess.

Some still deny a problem exists. Those who call themselves "supply-siders" claim that, notwithstanding the nation's mounting indebtedness to the rest of the world (estimated at more than $350 billion by the close of 1987) and the sudden drop of over 508 points in the Dow Jones Industrial Average on October 19, the economy is still buoyant, and we have only to keep taxes down in order to reap the eventual rewards. Monetarists are somewhat less optimistic, but their solution is no less simple: the Federal Reserve Board must exercise a steadier hand in controlling the money supply. As reality has steadily intruded upon orthodoxy, however, these two schools of denial have claimed fewer and fewer adherents. Both supply-side economics and monetarism share a rare but unfortunate distinction among economic theories: they have been tried in practice, and they have failed.

The stock market crash of October 19 came as "reality therapy"; for the moment collective attention was genuinely engaged. But even among more conventional economic experts, denial has set in. The problem, say the pundits, is to avoid recession and regain the confidence of Wall Street by trimming the federal budget deficit—cutting public spending and, if necessary, raising taxes. But there is an awkwardness to this diagnosis. True, the budget deficit has grown. Yet for the five years before August 1987, the Dow Jones Average grew along with it. If the federal budget deficit is the core problem, when did it become so? And why did it so suddenly create havoc, in a year when the projected deficit was almost one-third below what it had been in 1986? More to the point, why is it so important to regain the confidence of Wall Street anyway? The Street's confidence over the last few years was so misplaced—buoyed by takeover threats and speculation—that we should feel relieved it has abandoned its delusions.

There is a problem with the conventional prescription as well. Frugality is a questionable cure for a pending recession. To raise taxes and cut public spending now would reduce overall demand for goods and services precisely at a time when demand is already poised to fall. The sudden disappearance from the stock market of half a trillion dollars is unlikely to induce consumers and corporations toward extravagance any time soon. The combined contraction, to the contrary, could convert a mild recession into a severe one.

We find ourselves inside an economic straitjacket, where all the traditional tools of macroeconomic policy are tightly constrained. To expand the money supply to offset the budget cut is to risk a further decline in the value of the dollar, along with inflation. This in turn might prompt foreign lenders (whose continuing fealty has allowed us to deny the seriousness of our economic problems in the first place) to demand higher interest rates in order to counteract the declining worth of our repayments to them. But higher interest rates could plunge us into a severe recession as well. There is little room to maneuver. The probability of a recession within a year to 18 months is relatively high.

The conventional view of the public objective (to restore Wall Street's confidence), of the problem (the budget deficit), and of the solution (to cut public spending), has distracted us from facing the reason it is so difficult to avoid a recession

this time around, and has thus prevented us from taking steps to assure greater maneuverability in the future.

II

If none of the other standard methods of denial work, there is always the possibility of blaming others for our economic problems—in this case, foreigners. In the year before a presidential election, foreigners are the perfect foil. Candidates can talk tough without committing public money; foreigners cannot vote.

The Reagan Administration has insisted that it wants to "coordinate" its economic policies with other advanced industrial nations, but says the others have been resisting. The Louvre accord of February 1987, in which the major trading nations agreed to stabilize currencies and simultaneously reduce America's budget deficit while expanding their own economies, seemed a step in the right direction. But in the late summer and early fall West Germany had the temerity to raise its interest rates—prompting Treasury Secretary James Baker to announce on October 18 (the day before Black Monday) that, in response to their uncooperativeness, the United States would allow the dollar to fall. In other words, the economic strain was their fault, and they were to be punished for it.

Left out of the Administration's calculation has been Japan's and West Germany's understandable skepticism that the United States will fulfill its side of the bargain. Not even the flurry of post-crash negotiations between the White House and Capitol Hill produced much more than the already-mandated Gramm-Rudman cuts. The Japanese worry about their own large budget deficit and about the future needs of their rapidly aging population; the West Germans are chronically afraid of inflation and are suspicious of Americans' spendthrift habits. From the viewpoint of these countries, the Reagan Administration has been unreasonable, even hypocritical, in blaming them for the deteriorating economic situation. It is as if the town drunk were criticizing everyone else for excessive sobriety.

By the start of 1988—as Japan, West Germany and other trading partners were reducing their interest rates moderately in response to their fears of a declining dollar—policymakers in Washington, Bonn and Tokyo were talking vaguely about stabilizing the dollar once again, but no one would say at what level or how. Some American officials were quietly predicting that the dollar would have to fall by another 20 percent or so to cure the U.S. trade imbalance. Yet a falling dollar would impose significant penalties upon the likes of Japan and West Germany, whose exports to the United States would become correspondingly more expensive and thus fewer. Germany is already experiencing high unemployment; a further decline in exports would push unemployment perilously higher. Were the United States to balance its trade account by importing less or exporting more, four million additional Americans would be put to work, but approximately the same number of foreigners would become jobless—two-thirds of them Japanese and Europeans. This is hardly a recipe for future coordination or cooperation.

A second means of blaming foreigners has fast become a campaign theme of both Republican and Democratic contenders: our mounting economic problems are attributable, at least in part, to our allies' insistence that we defend them from communists and terrorists, despite their unwillingness to pay a fair share of the cost of such defense. Were our trading partners to pay their due, our budget and trade deficits would shrink markedly, or so the argument goes.

It is true that the defense burden is unequally allocated. In 1983, for example, Americans produced a little over 40 percent of the combined gross national product of the United States, Japan, France, Great Britain and West Germany, yet provided almost 57 percent of the group's defense spending. By contrast, Japan's share of advanced-nation GNP was 14 percent but its defense share was only 3.3 percent. But here again, the blame is not without a touch of hypocrisy. Our trading partners have never insisted that we bear this disproportionate share. It is, rather, a price we have been willing—even eager—to pay, in order to contain what we have perceived to be the spread of world communism (a concern shared by our allies, but rarely to quite the same degree), and to ensure our continued leadership in the defense of the free world. The Reagan Administration showed little reluctance in raising American defense spending from its low of 4.6 percent of GNP in 1979, to almost 7 percent in the 1980s—an explosion that partly accounts for America's mounting indebtedness—while simultaneously reducing foreign aid and support for international institutions.

Of course, it may be necessary in future years for all allies and trading partners to foot a larger part of the combined cost of defending us all. But such a move would not be without political consequence: America would no longer be in the same position of leadership; our allies would be more independent of us, able and perhaps willing to seek different accommodations with the Soviets and other perceived threats. In addition, a militarized Japan and more militarized West Germany would represent a substantial change in how we and they, and others, understand their power in the world. Amid growing fears of American abandonment in the face of Soviet conventional forces, West European leaders are already talking of defense cooperation among themselves and of a greater European role in NATO decision-making. However the issue may be resolved, there is no basis at this juncture for arguing that our economic predicament is wholly or even mostly attributable to our allies' unwillingness to bear a fair burden of the common defense.

III

Congress, meanwhile, has been devising a third means of blaming foreigners for our economic problems, and of deflecting costs upon them. A mammoth new trade bill emerged from the House of Representatives during the year, designed, according to its progenitors, to ensure that American exporters competed on a "level playing field." Most of the bill's provisions would reduce presidential discretion over what to do about foreign nations found to have kept American goods out of their home markets, subsidized their exporters, or "dumped" their goods on American soil. Missouri Congressman Richard Gephardt, a Democratic presidential candidate, has championed a provision that would penalize imports from nations that maintained trade imbalances with the United States. He argues that his innovation is designed not to protect the American market but to open foreign markets; it would apply only to nations whose imbalances were large and maintained over several years; such nations would first be given an opportunity to negotiate; and penalties would be imposed gradually. Regardless of whether the overall bill—with or without the Gephardt Amendment—can fairly be described as "protectionist," its focus is indisputably on the transgressions of foreigners.

The Reagan Administration, not to be outdone, and perhaps to forestall even more extreme measures by Congress, has vowed to "get tough on unfair foreign trade." The past year has marked a sharp turn toward toughness. First came a stiff duty on Canadian softwood shakes and shingles in response to alleged unfair subsidies, followed by 100-percent tariffs on $300-million worth of Japanese electronics products in retaliation for Japan's apparent dumping of semiconductors in third markets, a brief war with the European Economic Community over citrus and pasta, threatened tariffs on $100-million worth of Brazilian imports in response to Brazilian curbs on American computers and software products, talk of additional tariffs on $100-million worth of food imports from Europe in retaliation for bans on meat from animals treated with growth hormones, and a movement to withdraw special duty-free preferences for products from developing nations that have maintained substantial trade imbalances with the United States. C. William Verity, the newly appointed secretary of commerce, has warned the Japanese of reprisals unless American corporations are allowed to bid on contracts to build the planned Kansai International Airport.

Summarizing these and related developments, Special U.S. Trade Representative Clayton Yeutter recently touted what he terms the Administration's "extremely aggressive" approach to foreign trade. "Some of our trading partners have complained loudly about what they see as high-handed American practices," he said. "But that won't dissuade us from protecting our interests."

Here again, the responsibility for America's economic problems has been safely externalized. It is true, of course, that some nations subsidize their exports to us and hobble our exports to them. But absent international agreement on what sorts of subsidies and non-tariff protections are unfair, America's responses merely reflect what the United States unilaterally deems to be unfair. The dominant metaphors create the impression of unsportsmanlike, if not indecent, behavior—"tilting the playing field," "dumping"—when in reality the playing field has always been as hilly as the Ozarks, and dumped goods are often known to American consumers by the less pejorative term "bargains."

Our trading partners may sense hypocrisy here as well. All told, by the end of 1987, fully 35 percent (by value) of the goods produced in the United States were protected by some form of nontariff barrier—including countervailing duties, anti-dumping levies and so-called voluntary restraint agreements ("voluntary" only to the extent that our trading partner willingly accepted American demands to hold back exports under threat of more severe quotas should no agreement be reached). The comparable figure in 1980 had been 20 percent. Moreover, the U.S. government continues to subsidize American industry to a degree that makes most other nations seem like laissez-faire purists by comparison. Federally subsidized loans and loan guarantees, state and local tax abatements, and generous grants of "eminent domain" authority are routinely available to American businesses. Over one-third of all the research and development costs of American corporations are now funded by the federal government.

The Defense Department and its sister agencies—the Department of Energy and the National Security Agency—have emerged as the most magnanimous and determined developers of American technology. The past year has marked something of a record. In January the Administration formally approved a $4.4-billion plan for building a "superconducting supercollider," a 52-mile underground racetrack for subatomic particles deemed by the Energy Department to be "critical" for America's international competitiveness in related technologies. Then in July the president announced that the Pentagon would lead a $150-million effort aimed at developing practical applications for "superconducting" materials—special alloys that, when cooled, lose all resistance to the flow of electric current. The National Security Agency, meanwhile, has been pouring $20 million a year into its Supercomputer Research Center, which is seeking to build the world's fastest computers. In October the Pentagon agreed to fund Sematech, a research joint venture comprising America's leading semiconductor manufacturers, designed to improve their manufacturing competitiveness. And at the end of the year the National Aeronautics and Space Administration, whose mission has drifted steadily toward Defense Department needs, awarded $5 billion in contracts to design and build components for a space station—a project justified by NASA as having "potentially vital consequences for the nation's defense and its competitiveness."

Other Pentagon "competitiveness" projects include the funding of computer-integrated manufacturing facilities, computer-aided design technologies, robots, very large-scale integrated circuits, complex software, new materials technologies, and a wide range of other gadgets applicable to the nation's commercial competitiveness. The Administration has even sought to justify "Star Wars" in part by reference to all the fancy new technologies it presumably will spawn; the director of the project recently claimed that it would "so stimulate the national economy that it will pay for itself" through commercial spin-offs. And, for an ever-growing list of complex gadgets, the Pentagon has decided to "buy American"—limiting its purchases to American corporations. Indeed, at the very time the United States was excoriating Japan for barring American contractors from bidding on its new airport and for discouraging purchases of American-made supercomputers, the Pentagon was deterring the Massachusetts Institute of Technology from buying a Japanese supercomputer, and Congress was instructing the Defense Department to buy all its large computers from American companies.

In short, the Pentagon and its sister agencies have become the source of America's high-technology industrial policy—a policy that is more costly, complex and intrusive upon the private sector than any ever imagined by our trading partners. The problem is not that they do it and we don't. The real problem for us is that we do it under the aegis of national defense—which is an exceedingly awkward and inefficient way to promote high technology—while they do it more openly and directly.

Blaming others for our economic problems may be reassuring, but has two unfortunate consequences. It makes others angry and resentful, and thus less inclined to cooperate over the longer term. And it makes us less inclined to take responsibility for what needs to be remedied in ourselves—the issue to which I now turn.

IV

Our nation's growing economic problem, of which Wall Street has finally become aware, is due neither to the federal budget deficit per se, nor to foreigners' unwillingness to treat us fairly. It is due to our overwhelming failure to invest in our collective productivity, and the consequent decline in our capacity to add value to the world economy.

Indebtedness would be no cause for great alarm if the proceeds were invested in our future productivity. America's foreign debt is still small relative to its gross national product; Mexico has borrowed twice the amount as a proportion of its GNP. In the nineteenth century we borrowed far more, relatively speaking. But a century ago the loans were invested in factories, railroads, oil wells, inventions and an array of other assets that produced future wealth. Not this time around. We are consuming our way into economic oblivion. In 1986, for example, the nation generated some $800 billion more in goods and services than it had in the recession year of 1982, but we spent $900 billion more—Mr. Macawber's recipe for eventual misery. Even Wall Street's reverie before Black Monday was based not on productivity gains but on threats of takeovers, which prompted corporations to do whatever was necessary to raise their share prices in the short term—often cutting back on long-term investment while purchasing their own shares and going deeply into debt. The balloon had to burst eventually, and it did.

Without a surge in productivity, the present debt cannot be repaid unless we drastically reduce our standard of living. Our predicament is analogous to that of any person living beyond his means, who must grow poorer unless he generates more wealth. The plot is familiar: as creditors realize that he is unlikely to be able to repay, his IOUs begin to decline in value, and new loans—if available at all—come only at exorbitant rates. To maintain present consumption he begins selling off the contents of his house, including family heirlooms, and finally the house itself—which he thereupon rents from the new owners until he has no money left with which to pay the rent. So too with America; our failure to invest in future productivity is now reflected in a declining dollar, rising interest rates and the steady sale to foreigners of shares in our companies and of our prime real estate (47 percent of the commercial property in downtown Los Angeles is now in foreign hands, for example). Trying to offset our trade imbalance by selling off our assets makes as much sense as selling the house to help pay future rent.

Most of the panaceas now being offered by politicians and economists provide alternative means of growing poorer—by, for example, allowing the dollar to continue to fall, cutting wages, reducing environmental and safety regulations, slashing public spending, even engineering a recession. While these strategies impose the burden of becoming poorer on different groups of citizens over slightly different periods of time, their overall effects are much the same. There is no secret to becoming poorer. Even if we did nothing, the becoming-poorer strategy would occur automatically as the dollar continued to slide. To repeat: the only becoming-richer strategy is to invest in our future productivity.

The current obsession with the federal budget deficit obscures an important point about the nature and purpose of productive investments. Popular wisdom holds that government expenditure "crowds out" private investment. But the reverse may now be closer to the truth. A significant portion of the investments undertaken by American corporations in recent years has been unrelated to the task of improving American competitiveness, while many of the most important

types of productive investment can be undertaken only by the public sector.

Even as America's trade deficit has widened, American-owned corporations have continued to maintain their competitiveness by going overseas. Recent studies reveal that, while the percentage of world markets held by American corporations exporting from the United States has steadily declined during the last quarter-century, such declines have been offset by the gains of American corporations exporting from other nations. Economists Robert E. Lipsey and Irving B. Kravis have calculated that American multinational corporations accounted for over 17 percent of world exports in 1966, and their share has remained about the same since then. By the 1980s, almost half of the total exports of American multinational corporations came from their production facilities outside the United States, up from one-third or so 25 years earlier.

The trend is not limited to giant multinationals. According to one recent study by McKinsey & Company, America's most profitable mid-sized companies expanded their overseas production at an annual rate of 20 percent between 1981 and 1986—significantly faster than less profitable companies of similar size.

Thus in 1985 (the most recent year for which such data are available), American-owned corporations sold the Japanese almost $54-billion worth of products they had made in Japan—a sum greater than the American trade deficit with Japan that year. Japanese companies, meanwhile, sold us only $15 billion worth of goods that they made in the United States. IBM, for one, has 18,000 employees in Japan, producing all sorts of complex products whose sales, including exports from Japan, total about $6 billion a year. More than a third of Taiwan's notorious trade surplus with the United States is due to American corporations making things or buying things there, and selling them back in the United States. So too with Singapore, South Korea and Mexico. (Thus another reason why America's righteous indignation over these nations' trade imbalances is so misplaced.)

As the dollar declines, some American corporations are coming back to America, and some foreign-owned corporations are joining them. Toshiba soon will be exporting to Japan microwave ovens and television sets made in its Tennessee plant, for example. But to the extent such corporations are being drawn to the United States by the relatively low costs of production here associated with a low dollar, their new investments in America are unlikely to be of a sort that will greatly enhance the value of what Americans contribute to the world economy. They are more likely to be in plant and equipment tailored to relatively low-skilled labor. Should the dollar hit sufficiently low depths, America may eventually become an attractive place to make things now produced in Southeast Asia and Latin America. But under these circumstances the real incomes of Americans—adding no more value to globally available plant and equipment than is added by any other low-skilled workers around the globe—would be very low indeed.

Indeed the only factors of production that are relatively immobile internationally, and thus upon which depends uniquely the value that the nation adds to world commerce, are the skills of our citizens and their capacities to work together. To a significant extent, such assets represent returns on public investments—in education, training and retraining, research and development, and in all the systems for transporting our citizens and communicating among them—which comprise the nation's infrastructure. We do not commonly think of these sorts of expenditures as investments—the federal budget fails to distinguish capital expenditures, and the national income accounts treat all government expenditures as consumption—but they dramatically affect our future capacity to produce.

These public investments have either declined during the 1980s or, at best, remained at about the same level. Government spending on commercial research and development has declined 95 percent from its level two decades ago. (Even when added to private-sector research and development, the total is still less than two percent of GNP, lower than comparable research and development expenditures in any other advanced industrial nation.) Government spending to upgrade and expand the nation's infrastructure dropped from 2.3 percent of GNP two decades ago to 0.4 percent in the 1980s. Per pupil expenditures on public elementary and secondary education have shown no gain in real terms; as a percent of GNP they have declined—and this during an era in which demands on public education have significantly increased, due to the growing phenomena of broken homes, unwed mothers and a rising population of poor. The federal government has retreated from the field of public education, leaving states and localities—many of them severely handicapped by low tax bases—with almost the entire job. Not surprisingly, an estimated 20 percent of American 18-year-olds are now functionally illiterate; one-quarter of today's high school students drop out before graduation. This is not the sort of population likely to generate high productivity in future years.

We must do several things to reverse the trend. First, we must gradually scale back aggregate consumption by, for example, spurring the growth of personal savings through expanded Individual Retirement Accounts and Keogh plans, hobbling hostile takeovers and leveraged buyouts, and taxing more of Social Security benefits. Consumption might also be limited by reducing farm supports, jettisoning weapons projects that are of low priority or fail to perform as planned, and taxing consumption directly—through, for example, a progressive tax on a family's net spending.

But this is only half the agenda. We should simultaneously attend to the investment side of the ledger by, for example, inducing more private-sector spending on plant and equipment in America (restoring the investment tax credit and accelerating depreciation on investments made in the United States), and increasing government spending for education, retraining, child nutrition, research and development, and infrastructure. These investment strategies may make it more difficult to reduce the federal budget deficit in the short term, but they are more important to our long-term economic health than any immediate fix. To focus singularly on reducing the federal budget deficit distracts us from this more fundamental agenda, which long predates Black Monday.

An additional aspect of our investment strategy should be to take the nation's research and development efforts out from under the Pentagon and its sister agencies, and turn them over to civilian agencies whose explicit goal is to spur the nation's commercial competitiveness. As has been noted, we already have a bold industrial policy for high technology, but it is run out of the Defense Department. There are commercial spin-offs of course, but because the Pentagon's needs are quite different from what consumers need at a price they are willing to pay, the spin-offs are relatively few and far between. And defense projects are so enshrouded in secrecy that commercial entrepreneurs often cannot take advantage of the discoveries even if they want to. It is time we acknowledged our high-technology industrial policy—and, by implication, the legitimacy of other nations' similar programs—but undertook ours in a far more efficient and direct manner.

Reality can be painful. Denial, escapism and self-righteous indignation toward others are common defenses against such pain, no less for a nation than an individual. But reality can become progressively more painful the longer it is avoided. Our immediate responsibilities in the coming year are to accept the truth about ourselves—that we are falling behind in our collective capacities to add value to the world economy, and that we must invest in one another to regain our stride—and to elect a president capable of helping us address the truth.

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