

The real American model

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The US economic model that commands around a third of the world's wealth fascinates and infuriates Europeans. But both reactions reveal ignorance of its most essential features. The keys to its success lie not in industry, but in those sectors providing social amenities to the middle class – health care, education, housing and pensions: systems of provision that have little to do with the free market.

The American Model fascinates Europeans in at least three ways. For many on the right, the free market – as they imagine that the United States practices it – represents an ideal type. It is the highest form of capitalism. It is to be celebrated for its efficiency, for its technological dynamism, and even for its capacity to deliver full employment – all free from the dead hand of governmental regulation and control.

These charms are largely lost on the left, among whom many perceive a fundamental clash between Americanism and such “traditional European values” as fairness, solidarity and tolerance. This view emphasises the rapacity of the American multinational corporation, the absence of universal social services, and the poverty and inequality delivered by American labour markets. It is a position taken by many who seek to defend European social democracy from further degradation.

And in the third place there is an emerging group who regard the arrival of the American Way as a fact of

nature, against which resistance is futile. They are therefore attracted to American-type solutions to the American Way's problems. In particular they emphasise the importance of investments in education, of job training, and of new institutions for “lifelong learning” – measures intended to help workers adjust to the disruptiveness of unfettered capitalism. Such was the theme, for instance, of the Portuguese presidency of the European Union a few years back.

These three groups share a common perception of what the American model is. This perception embodies such principles as deregulation, privatisation, and the free setting of prices and especially wages in competitive markets, without interference from unions or concern for the resulting inequality. It favours free international trade. It favours the reduction of public subsidies, public transfer payments including pensions, and public enterprise to the minimum. And it favours the application of “sound” fiscal and monetary policies, with the former dedicated to budget balance and the latter exclusively to price stability.

Jousting at illusions

This is a vision of America based entirely on the image propagated since the early 1980s by right-wing political spokesman and certain academics. Such was the image forcefully, even eloquently, articulated at the time by President Ronald Reagan, and captured by his phrase “the magic of the marketplace.” It is a tribute to the enduring power of Reagan’s rhetoric that such an image of the United States continues to serve as a template for political and economic arguments in Europe twenty years later on.

But it is also an image with little foundation in the American reality. It is useless as a guide to American economic performance. It is a vision rooted neither in the historical nor the modern facts of American life. And it is a dangerous fantasy for European progressives.

By accepting it, they 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. They therefore find themselves in the position of defending the dismal economic performance of modern Europe, and specifically high unemployment, on the ground that the alternative has unacceptable social costs.

In this way, acquiescence in mass unemployment becomes the price of defending civilisation. The case for social democracy is fatally weakened by the concession that it requires that 10% of population remain idle, or be forced to labour off the books in the grey economy. Ordinary Europeans do not find this attractive. They prefer politicians – even right-wing politicians – who promise jobs.

It is equally ineffective to defend Europe by decrying the social evils of the American Model. The image routinely conjured for this purpose – of an economy of wage slaves and debt peons dominated by tycoons and maintain by racism and violence and mass incarceration – is plainly false as any ordinary traveller to the United States can see.

Real wages in the United States are high. Some 70% of American households own their own homes. College degrees are held by over a quarter of the adult population; some college education has been

experienced by nearly half. (No European country save the Netherlands approaches these figures.)

Even health care is abundantly available in the United States, where the urban landscape is everywhere flecked with hospitals and clinics. Poverty among the elderly is low in America, and most seniors enjoy the independence of living on their own, often in the benign climates of Florida, California and Texas. This is not the case in much of Europe.

By regarding America through the lens of Reaganite propaganda, European progressives cut themselves off from a correct understanding of the keys to the recent American prosperity. They therefore often find themselves caught up in the advocacy of placebo policies made popular in the United States itself under the general rubric of the Third Way.

This may lead (and indeed in recent years has led) to the election of centre-left governments in Europe. But it cannot lead to their subsequent economic or political success, for the notoriously simple fact is that placebos do not have medical benefits other than psycho-therapeutic. The cure for unemployment, in particular, is made of sterner stuff than training programmes and “labour market

flexibility.”

The real American model: ‘soft’ budgets in the social sectors

The “soft budget constraint” is an idea familiar to students of central and eastern Europe in the late years of communist rule. It described the condition of state-owned heavy industry under the communist regimes: entities that could not make profits, could not compete on international markets, and yet were so central to the social fabric of the system in which they were embedded, including its provision of social services, that they could not be allowed to fail. These entities became widely-deplored dependencies of the state budget and the state banks. Yet to millions, they provided the rudiments of a comfortable and secure life, the threads of which have not been picked up in the post-socialist orders that since emerged.

A brief examination of key American institutions shows that the concept goes very far toward explaining the structure and conduct of the US economy in the

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past twenty years, and particularly in the prosperous period of the late 1990s. But the institutions to which it is best applied in America are very different from those in eastern Europe. Indeed, the keys to the American model lie not in industry, but in those sectors providing social amenities to the middle class: health care, education, housing and pensions.

Health care, in the United States, consumes some 13% of GDP. A typical figure in Europe is 8-10%; in the UK the number is 7.3%. What few Europeans understand is that health expenditures within the direct US government budget consume 5.8% of GDP.

But whereas in (say) France a not-much-larger proportion of total output supplies medical services to the whole population, in the United States the direct public commitment is only to the elderly and disabled, the poor, and to veterans. For the rest of the covered population, medical care is paid out of private insurance, which enjoys tax advantages.

Overall, the tax-financed share is just under 60% of total health expenditure, or nearly 8% of GDP. The scandals of American health care do not lie in insufficiency of care (quite the reverse!), but rather in two notorious facts.

The first is that some 44 million persons lack either public or private insurance. This part includes many Latinos, who tend to avoid contact with the welfare system, as well as younger working people. Hence, deficient pre- and peri-natal care is an important problem.

The second is the rapacity of the private actors in the system – drug producers, doctors, nursing home operators, and insurance companies notably. Nevertheless, it is precisely the presence of those actors, and their political power, that has made the American health care system into the economic powerhouse that it is.

Higher education in the United States consumes about 2.25% of GDP. The figure for European countries is typically closer to 1%. Again the US spends more on public higher education as a share of GDP than do most Europeans: 1.07% as compared to 0.97% in Germany or 1.01% in France. But then in addition there is the private share, another 1.22% of GDP, centred on institutions whose multi-billion dollar endowments are highly motivated by the tax system. Many of these are to be found in the east, near traditional centres of capital wealth. Fully public institutions however dominate the scene in most of the country, including Texas and California.

The United States maintains two alternative public systems for keeping otherwise difficult-to-employ young people away from unemployment. These are the armed forces, with 1.4 million members, which consumes 4% of GDP and provides competent mechanical training to its members (including to virtually the whole of the population of commercial pilots, for example). And there is the prison system, whose much-expanded role in recent years is deplorable, but whose economic function also reduces unemployment. A major difference, of course, is that these three institutions provide very different levels of access to credit and other participatory mechanisms in later life.

Consumption of housing services accounts for about 9% of US GDP, while residential construction accounts for another 4%. The housing sector exists on its present scale thanks to a vast network of supporting financial institutions, subject to federal deposit insurance and to the secondary mortgage markets provided by quasi-public corporations (Fannie Mae, Ginnie Mae, Freddie Mac).

Despite continuing problems of discrimination against black neighbourhoods particularly, known as redlining, the fact remains that most Americans grow up in their own homes, and for the present moment home equity remains the major collateral against which middle class Americans are able to borrow to support their consumption.

Finally, social security payments to the elderly and disabled together with public pensions account for 8% of US GDP, on the reasonable assumption that these transfers are substantially spent rather than saved by their recipients. Some of this has been counted already in expenditures for health care and housing – but arguably not all that much. The American elderly live in paid-off homes and pay only a fraction of their medical (as distinct from pharmaceutical) expenses out of pocket. And social security funds a great deal of their ordinary consumption.

To be precise, social security alone provides the major source of disposable income of 60% of American elderly; only the top 40% of that population group has substantial other sources of income, public or private. The typical social security payment for an elderly couple in moderate health can reach \$18,000 per year, which when combined with Medicare is adequate for modest comfort in most of the country. Pockets of elderly poverty remain, but overall, poverty among the old in America has fallen dramatically since the early 1970s, and is now lower than among the general

population. This is the accomplishment substantially of expanded public pensions.

The point to emphasise is not merely that the United States is full of hospitals, universities, housing and pensioners, but that in the US these sectors 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 favours. Some of these are on budget, some are off-budget, some are “discretionary”, some are “non-discretionary”. But there exists a broad political constituency behind them, which gives them political staying power – despite continuing assaults on them and some erosion under a right-wing congress, president and court system. The control of the scale of these activities has, to some extent, slipped away from those who ostensibly control the public budget.

And this is the genius, if one may call it that, of the American Model. The soft budget constraint (which as recently as the 1960s was entirely the province of the military) has come to apply precisely where it can do the least harm. And that is in providing income and employment in sectors that provide universally demanded human services to the population. In other words, powerful political constituencies exist to keep these sectors at the forefront of American life, and it is very likely that they will remain there.

The unimportance of labour market flexibility

The supposed flexibility of American labour markets has been much cited as an explanation of in the great rise of America toward full employment in the late 1990s – though this talk is heard less now that unemployment is back above 6%. Still, Europeans are accustomed to being told that such flexibility was the essential ingredient in the rise of the New Economy in the US, beginning with the new era of free markets under Reagan.

But the truth is that increasing labour market flexibility was not the cause of falling American unemployment in the 1990s. When American labour markets became more unequal in the 1980s, unemployment was stubbornly high. American labour markets did not become more flexible as full employment approached in the late 1990s. They did not become less flexible in the present recession.

The US did not approach full employment by increasing inequality: on the contrary, the relevant form of inequality declined.

Logically, increased labour market flexibility should mean increased inequalities of pay: with technological changes favouring the better-educated and more-skilled, the weekly earnings at the top of the distribution should have risen and those at the bottom should have fallen in the boom. But the reality was quite the reverse. Measurements of pay inequality in the United States show, unambiguously, that structures of pay became substantially more equal as the 1990s progressed. The US did not approach full employment by increasing inequality: on the contrary, the relevant form of inequality declined.

This fact was obscured in most people’s perception by the rise in household income inequality – a very different matter which owed in part to changing family structures and in part to the boom in the stock market and capital gains income. Pay however, became more equal from 1994 until nearly the end of the decade.

The late 1990s also demonstrated the trivial role played in the employment picture by such measures as job retraining and lifelong education programmes.

Such policies had been in place since the early 1980s, without noticeable effect. It was only when labour demand rose to full employment levels that unemployment disappeared. And then, by far the largest fraction of the new jobs went to people who had never taken part in any training programme.

The myth and reality of the new economy

The rise to full employment in America in the late 1990s occurred in major part because of a very steady expansion of the quasi-public sectors discussed above. And it happened in spite of the fact that the federal government sector did not grow at all. State and local governments did, in fact, expand – though not all that much – as the boom gathered force. So did tax-subsidised expenditures on housing and health care. However, the more or less predominantly private sector, specifically in high technology, also played an important role, and it is worthwhile examining that phenomenon at this point.

What was the role of the information technology boom that so filled the news emanating from America in the last years of the late millennium? The national income and product accounts show that from 1997 to the peak in 2000, business non-residential fixed investment

rose by about \$300 billion 1996 dollars, a gain of about 2% in relation to GDP, or from 12.3-14.4%. Most of the gain would have been technology investment.

Since that time, the fall-off has been on the order of \$150 billion, bringing business fixed investment as a whole back below the provision of health care in its relation to the scale of the United States economy. The entire fall-off in business investment to date may be offset by the increase in the military budget already requested by the Bush administration – replacing a private-sector boom under the Democrats with a public-sector initiative under the Republicans.

The Keynesian devolution

But the bubble happened. And all together, these forces combined to generate full employment in the late 1990s for the conventional Keynesian reason: a high level of effective demand, or total spending. The peculiarity of effective demand in the US which has eluded many European observers, was that while much of it was generated or encouraged by acts of public policy, most was not registered on the public balance sheet, but rather appeared as spending and as borrowing by the private sector.

Thus the US achieved full employment not only with formally balanced public budgets, but with recorded surpluses. One might call this the Keynesian Devolution. These were the powerful new Keynesian mechanisms of the new economy in America, just as essential as recorded budget deficits were to Keynesian policy in the days before credit markets had reached their present scale.

The problem of the Keynesian Devolution lay not in its efficacy as a mechanism for growth and prosperity, but in the fact that the rise in household debt burdens can not be sustained.

A reversion toward historical norms in saving and spending behaviour was already underway in the United States before the traumatic events of 11 September 2001. At the moment that crisis hit, an almost universal view held that it would drive the economy into recession. In fact, as revisions to the economic statistics later demonstrated, the economy had already been in recession for three quarters.

And in the aftermath of 11 September there came policy changes which produced a return to economic growth by the end of the year. These included the tax cuts (already enacted but not yet in effect) which included a cash rebate to most taxpayers, spending

increases for war and relief, rapid cuts in the interest rate, a reduction in world oil prices and a massive inventory liquidation by automobile manufacturers. These together helped lift the economy in the fourth quarter of 2001 and through most of 2002, providing the professional chorus of optimists in the financial profession with their evidence that full employment prosperity would soon return.

A crisis in the American model?

But unfortunately, these direct Keynesian measures were all temporary in effect. The tax rebates have been exhausted; the government's relief spending has been done. Interest rates have not been cut further – indeed there is not much left to cut. Oil prices returned to pre-11 September levels. The automobile companies continued to provide bargains to consumers through the end of 2002, but then started cutting their losses.

Meanwhile the return of George W. Bush to a war footing – this time related to Iraq – worked to inject a large additional element of uncertainty into the business climate; in the war's increasingly problematic aftermath this has been only slightly dispelled.

Worse, the new fiscal era dawned badly for the state and local government sector. For the most part, states and localities were able to keep up activity levels in the first two years of the new millennium through the depletion of financial reserves. But that moment is largely past. States that relied heavily on capital gains taxes and income taxes on stock options realisations are in very bad shape at the moment.

The state of California alone faces a budget gap recently estimated at over \$34 billion, out of general revenue fund of \$80 billion last year. Overall estimates of the state and local budget gap comfortably exceed \$80 billion. Cuts in these budgets could deplete close to 1% from the overall spending stream in the year ahead. Meanwhile, the Bush administration continues to insist on tax cuts structured to have very little effect on spending, especially in the short run.

Thus the American Model is entering a moment, even a prolonged phase, of crisis. There are three reasons for this. The first is the behaviour of sectors where budget constraints continue to bite – or where they are starting to bite once again after many years. These include business investment, which is affected by the virtual disappearance of retained profits.

Second, the state and local government sector is entering a phase of deep fiscal crisis which could,

potentially, gravely undermine the popular public programmes that are presently administered at the state level.

Third, and looming over all, is the household sector, which may fall victim to a combination of its own financial prudence and the closing of lending windows. To the extent that the state fiscal crisis affects education and health care, and to the extent that the household sector backs away from new mortgage borrowing, soft budget constraints may now be growing hard in the United States. Unless reversed, such a trend could spell tragedy for the continued success of the real American Model.

Nevertheless, Europeans should not be deluded. America's recent successes are not those of the free

market, deregulation, privatisation and the rest. They are certainly not successes of vast inequalities, low wages and labour training programmes. They are rather the successes of an unbridled, expansive, optimistic and government-supported credit market that has permitted, in the recent past, borrowing and spending on a heroic scale.

And if the American model is now in trouble, it will be mainly because the private sector reached the limits of its willingness to continue to borrow and spend, while the public sector may be unwilling – or unable – to take up the slack.

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