Book The Predator State

How Conservatives Abandoned the Free Market and Why Liberals Should Too

James Galbraith
Free Press, 2008

Recommendation

James K. Galbraith, son of noted economist John Kenneth Galbraith, wrote this book at his father's suggestion. Indeed, he spends a fair amount of ink defending his father's ideas and legacy, which were pushed aside by the Reagan Revolution and its aftermath. Now, in the wake of the administration of Republican President George W. Bush, who even admitted to abandoning free-market principles, the time is ripe to see what liberals really have to offer. Galbraith suggests: not much. Intimidated by the force of the conservative wave that swept them from power almost three decades ago, liberals have adopted conservative frameworks, says Galbraith. They genuflect to market supremacy, free trade, tax cuts and deregulation – ideas conservatives have dropped. *BooksInShort* finds that Galbraith provides a thought-provoking analysis of conservative rule. He offers plenty of polemics, Bush-bashing and rhetorical flourishes that will delight liberal readers. Conservatives, who perhaps feel that their exile actually began with Bush II, may find little to cheer but a good bit to agree with herein.

Take-Aways

- • Conservatives have abandoned their core economic ideas, yet liberals cling to those principles – or at least they pretend to.
- • The Reagan tax cuts, justified by so-called supply-side economics, did not work; savings and investment did not grow.
- Monetarism proved so costly that policy makers abandoned it within months. Since then, inflation has been held down by globalization and not by monetary policy.
- Reagan's trade and monetary policies made industrial unions lose power.
- David Ricardo's doctrine of "comparative advantage" has no application in the real world.
- Excessive inequality causes unemployment and inefficiency.
- Government directly or indirectly accounts for more than half of the U.S. economy.
- Republican-era reforms did not dismantle New Deal institutions, but they allowed predators to capture them and exploit them for private advantage.
- Liberals are so used to playing defense that they adopted the right's framework and terminology. Particularly in the present crisis, they need to think for themselves and develop a new approach.
- The liberal answer to America's economic and political decline should include a new emphasis on standards, and unembarrassed advocacy of planning, especially for the nation's energy future.

Summary

Conservative Intellectual Bankruptcy

The election of Ronald Reagan seemed to repudiate decades of liberal rule and ideology: out with planning, federal deficits, protectionism and regulation; in with monetarism, tax cuts, free trade, balanced budgets and market rule. Yet, the "Reagan Revolution" did not deliver the change it promised. Reagan failed to act like a free trader when he negotiated de facto import quotas ("voluntary restraints") with Japanese carmakers. Monetarism proved to be little more than a slogan, impossible to implement effectively in an era when the market produced many new forms of money.

> "The United States is not a 'free-market' economy with an underdeveloped or withered state sector."

Contrary to what many believe, the conservatives did not destroy the New Deal's institutions, nor did they ruin institutions established by Lyndon B. Johnson and Richard Nixon. They did, however, damage these institutions, particularly by allowing predators to capture and exploit them for private gain. During George W. Bush's presidency, lobbyists and private interest groups appropriated the state's regulatory machinery and used it to their advantage.

> "It is, rather, an advanced postindustrial developed country like any other, with a government sector responsible for well over half of economic activity."

The right has largely abandoned its untenable notions of supply-side economics, free trade, market discipline and the removal of government from the economy. The left, however, still seems compelled to speak in the right's dated language. Liberals pay undue homage to the ideas of market wisdom and the benefits of free trade; they shy away from discussing planning, still cowed by the connotations conservatives assigned to it: centralization and failed socialist states. Liberals need to get past these concepts and understand three economic principles:

- **Markets aren't magic** – They aren't well-prepared for the future and they do not allow future generations a voice in present decisions. The U.S. has to plan. Planning has faults, but it's better than not planning.
- **Standards are necessary** – Legislated standards should govern economic equality, wages, workplace safety and environmental protection, among other areas. Wage rates are particularly meaningful. Unequal pay causes inefficiency and unemployment because people compete for the few high-paying jobs instead of

occupying the many low-paying jobs. This leads to inefficiency, because time spent searching for work is time not spent working. Distribution of wealth is a social decision and U.S. society should treat it as such.
- **The U.S. has a privileged position in the world** – Unlike other countries, the U.S. does not have to produce exports to pay in full for its imports. Foreigners are more than willing to accept U.S. debt. Currently, the federal government has no alternative to international borrowing; however, that doesn't mean an alternative won't emerge. The United States needs to prepare accordingly.

Economic Freedom

Economic freedom does not require political participation, as do freedom of speech and similar constitutional liberties. It is the freedom to buy, the "freedom to shop," which has ascended to the status of a political freedom. Money is a great leveler. Anyone can become rich and exercise this liberty.

> "Plainly the public no longer believes what conservative leaders say about free markets."

The market is a venue where money talks. Somehow, according to those who believe in market wisdom, the market arranges the optimal definition of values and the best allocation of scarce resources. The market, in their eyes, is free and, therefore, good. Thus, if government policies impede the functioning of the market, government is bad. Every American politician must pay lip service, at least, to the primacy of the market, much as apparatchiks in the former U.S.S.R. had to appear to exalt Karl Marx. However, behavioral economics teaches that the rational market is a fantasy, because human beings do not make decisions the way the market model suggests. People make decisions with social considerations, such as fairness, in mind. Moreover, corporations do their best to destroy, distort and regulate markets to their own advantage. Why, then, should liberals treat the market as sacrosanct?

Who Do Tax Cuts Cut?

Supply-side economists argued that people would save more money if the government taxed them for not saving. But neither theoretical justifications nor evidence suggest that people make the trade-off between consumption and savings in the way supply-side economists described. These economists advocated tax cuts for the rich, presuming that the rich would save and that their doing so would have great social benefits. In fact, the wealthy can dispose of their income in many ways, for instance, by buying real estate or fine art. Cutting their taxes does not automatically channel their savings into financial investments that benefit the broader economy. More tellingly, with the exception that saving is a public good, the private market has no incentive to do it.

> "Simply put, the conservative faith in tax cuts is based on a mirage."

The government must address the gap between real private saving and the socially optimal saving level. Yet, previous policies enacted to encourage private saving have had no demonstrable impact; the level of private saving in the U.S. has not increased since the late '70s. Tax cuts did little more than channel greater income to the rich at the expense of the broader society.

Monetarism

In 1979, the Federal Reserve adopted Milton Friedman's monetarism doctrine that "Inflation is always and everywhere a monetary phenomenon." To suppress inflation, the Fed chairman at the time, Paul Volcker, strangled the money supply. Interest rates – hitherto the Fed's policy target – soared. Inflation fell, but Volcker's monetarism caused shuttered factories and high unemployment.

> "The policy sequence of cutting budget deficits in order to reassure credit markets and lower long-term interest rates was tried. It did not work."

Monetarism does not deserve credit for beating inflation, which was caused by the collapse of the exchange rate regime established in Bretton Woods, New Hampshire, and by subsequent increases in prices of oil and other commodities. Union agreements provided cost-of-living allowances that raised wages and, in turn, prices. Inflation was not, in other words, a monetary phenomenon. The collapse of labor union power and the influx of low-priced foreign commodities and manufactured goods brought inflation down. In fact, the Federal Reserve could not control the money supply. It could not even clearly define what the money supply was. Former Fed Chair Alan Greenspan concedes in his memoirs that he did not deserve credit for controlling inflation. He said that the absence of unions and even the availability of inexpensive bikes from China were more responsible for low inflation than Fed action. During Greenspan's tenure, the fact that high employment does not contribute to inflation also became clear.

Balanced Budgets Take a Hit

Conservative advocacy of balanced budgets did not survive the first Reagan administration. In fact, Reagan governed like the Keynesian Nixon claimed to be. His tax cuts and deficits spurred an economic boom that brought him re-election in 1984. Volcker's high interest rates strengthened the dollar and restored its position as the world's reserve currency.

> "Given three countries and three commodities, it is not obvious that each country will always be the relatively most efficient producer of exactly one good."

In 1990, President George H.W. Bush signed an accord with congressional Democrats aimed at reducing the deficit. His concessions on taxes probably cost him re-election. The accord reflected bad politics and bad economics, because the economy actually needed a bigger deficit. The economic boom during Bill Clinton's presidency did not result from deficit reduction. It happened, in large part, because Greenspan raised short-term interest rates, and prevented banks from pocketing profits on the difference between low short-term rates and higher long-term rates. Though the federal deficit fell during the Clinton administration, private borrowers took over the deficit, borrowing heavily on credit cards and mortgages. His successor, George W. Bush, proved indifferent to deficits. With this history, declaring fealty to low deficits or balanced budgets makes little sense for the Democrats.

Free Trade and Comparative Advantage

Contrary to popular belief, Adam Smith was not an unqualified free trader. While he favored free trade within the British Empire, he was more cautious about trading with its enemies, such as France. He recognized that national wealth was crucial to national power. David Ricardo developed the idea of comparative advantage, especially the notion that if countries specialized in producing the goods to which they are best suited and traded them freely, everyone would benefit. This doctrine, however, is impracticable and untrue, either because determining which countries are best advantaged for any particular kind of production is functionally impossible or because not every country is going to be best at something. Moreover, expanding production is quite difficult for some countries. For instance, the World Bank thought Mongolia had a comparative advantage in animal husbandry, but expansion of its herds led to overgrazing, desertification and economic disaster.

> "The deepest issue raised by the inequality of economic incomes is...as ever, the distribution of political power."

The Bretton Woods system controlled financial speculation to facilitate trade. After it collapsed, no regulatory regime remained to control financial speculation. In many countries, free-trade ideology led to disastrous bank loans and harmful public policies. In the U.S., the "Reagan Revolution," as it turned out, was not a revolution in favor of free trade. Reagan negotiated "voluntary export restraints" with the Japanese, allowing Japan to make higher margins on its production and giving it incentives to open plants in the U.S. with low regulatory requirements for American content. Reagan was a protectionist, but his form of protection did not help the U.S. He effectively turned America's manufacturing sector over to Japan. And, despite the claims of supply-side economists, Reagan's tax cuts did not lead to increased revenue or balanced budgets.

> "As liberals emerge from a protective crouch that has lasted three decades, the inadequacy of their policy vision must be faced."

The markets bear much of the responsibility for the decline of American industry. The markets demanded that U.S. companies pay more attention to short-term returns than long-term stability. By contrast, manufacturing thrives in China, with its underdeveloped financial markets. Domestic prices for goods are low, and companies operate as long-term, growing enterprises while they improve product quality to qualify for export markets.

> "A program of planning and of standards, particularly if it is aimed at providing a new generation of investment goods to the world and especially if that generation of goods is itself directed at meeting the challenge of climate change, could in fact move the world back toward a dollar-centric system."

Because insurance companies greatly benefit from America's inefficient healthcare system, they have blocked efforts to introduce a more economical public insurance model. Moving guaranteed student loans from the government's purview to private lenders allowed corporations to profit on the students' interest payments, with no contribution to public welfare. Privatizing Social Security would have similarly negative consequences for the elderly, while further enriching Wall Street. Subprime mortgages gave bankers a way to exploit the ignorance of the poor by selling them mortgage loans at unfixed, unsustainably low rates. These bankers knew, or should have known, that rates would rise to unaffordable levels, leaving the poor on the hook.

What Liberals Should Do

During George W. Bush's presidency, lobbyists and industry representatives took over the apparatus of the state. They had no dedication to, or sense of, public service and public purpose. They made the state serve their private interests, wielding both regulation and deregulation. To counteract this, liberals need to acknowledge reality, recognize that standards and planning are good and necessary, and advocate for them unabashedly. Although the markets have an important role, the U.S. has a public-sector economy. To serve it, liberals need to advocate standards that will govern wage rates, environmental protection and trade.

> "[This system would preserve] the leadership position of the United States and thus the country's capacity to lead effectively."

In terms of commerce, America's trade deficit is a consequence of the Bretton Woods system. Reagan inadvertently re-established the dollar's primacy in the world economy. However, its pivotal role in global finance is again questionable and, possibly, risky. The U.S. needs to give the world a reason – perhaps with the right plans and standards – to invest in it. The U.S. can again anchor the global financial system, and lead the world in innovation and economic development. What's more, there may be no alternative.

About the Author

Economist **James K. Galbraith** holds the Lloyd M. Bentsen, Jr., chair of government/business relations at the LBJ School of Public Affairs. A Levy Economics Institute senior scholar and chair of the board of Economists for Peace and Security, he is a former executive director of the U.S. Congress Joint Economic Committee.