

Woody Brock on Solving America's Fiscal Problems

By Robert Huebscher

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Brock on Twitter (@HWoodyBrock) and on Facebook (www.facebook.com/AmericanGridlock).

I spoke with Dr. Brock on February 14.

This is part one of the interview. Dr. Brock discusses trade relations with China and health care reform in part two, which will be published next week.

Your book contains a number of bold prescriptions for US policy makers, particularly with respect to fiscal policy. Before we talk about those, I would like to get a sense of how severe are the problems the US faces today. In your book you write this "time is different" with respect to the state of the economy and that the US faces the prospect of a lost decade. In what sense is this time different?

Let me be very precise, because this is a phrase that is easy to misuse. The first point is that at this stage of a recovery, our unemployment rate is far higher than ever before in history. Measured on the U-6 basis, it is 15.5%. The point is not simply that the recovery, in this sense, is a very bad one; it is that it is a slow recovery notwithstanding three years of 1% and lower interest rates and fiscal deficits double the level that could have caused most presidents to be impeached.

For these reasons, you could argue something is really wrong with macroeconomic policy. We are just not getting much bang for the buck.

Number two, a standard or Keynesian approach would say, "Well, let's just do more deficit spending." That approach could work if animal spirits remain dead in the private sector. In





that case, let's just have the government prime the pump even more, and to continue with 10% deficits. Why not 12%?

What's different this time is, for the first time in our history we have abused our welcome in the bond market. In Italy and elsewhere everyone said interest rates are fine at 3% and they won't go to 3.1%, they went to 7%. They may rise to 10%. They could go to 30%. If we go on borrowing and stimulating in a Keynesian manner, we will outstay our welcome in the bond market. That is why everybody is against deficits.

Finally, you have to look at the fact that it is different this time, because you and I and everyone else have been binge borrowing for 35 years. We have woken up and realized it is over. We must de-leverage. Likewise, during the Clinton 1995-2000 period, when the economy did extremely well, was that because of the Clinton tax policy? Not at all. What happened was an 8% of GDP increase in capital spending, which has only happened once before in the 20th century. That was the rewiring of America due to the telecommunications boom, and in particular Marc Andreessen's invention of the browser in November of 1994. That is a fact.

Unfortunately, you can't stimulate an economy like ours today by calling up to heaven and asking for another Industrial Revolution. They come at random, and they don't come very often. In those regards, the situation today is constrained and difficult.

How would the outcome be different if we pursue the smaller government fiscal policies that many are advocating, which some have called a “growth-through-austerity” approach?

The phrase growth-through-austerity is a contradiction in terms. Once again, if the private sector is stagnant or animal spirits are poor, as Keynes would put it, then if you have a contractionary fiscal policy of small measures, you are not going to drive the growth rate up nearly high enough.

There is something to understand in this. The average growth of the GDP in the 16 business cycles of the 20th century, for the first two and a half years of recovery was 6.4%, and before 1940 it was often much higher. In other words, you really rebounded. We need to grow at about 2.95% today just to hire the new kids coming out of school and to absorb new immigrants into the workforce, before we hire any of the millions who lost their jobs.

Our recovery has been at a 2% growth rate, when traditionally it would've been 6%. This is why small measures are going to have small results. It is just not enough.

In your book you call for a Marshall Plan of “good deficit” spending directed at infrastructure and other long-term needs. What do you see as the prime targets for that type of cost-effective investment?



This is a very, very important point as you know, and central to one of the chapters in [put in italics] *American Gridlock*. I see, first of all, the need for a true leader who mandates a Marshall Plan reflecting the fact that this huge country of ours has not put a new roof on its house in 50 years. That is not true of Japan or Switzerland, where the infrastructure is in very good condition. Both England and America have deferred their maintenance tremendously.

In particular, it's public sector investment maintenance, airline terminals, electric grids, and railroad tracks. In England, the leaves in the autumn stop the trains from moving. It is a real scandal, and everybody knows it. You read about it all the time. I am not talking just about railroads and potholes and bridges falling down, for which there a \$3-\$4 trillion need right now.

I want energy grids. I want airports. I want schools. I want automated systems for medical services to be stimulated using the private sector. But government has to basically address the areas where the need is greatest. How do you measure the need for a new "McMansion" for you and your wife, or for some new public investment? That is what the great 1970 book *Public Investment, The Rate of Return, and Optimal Fiscal Policy* by Kenneth J. Arrow and Mordecai Kurz, was all about. They showed how you can properly measure a return for different kinds of projects. In particular, if you haven't put a new roof on your house as a nation, the return is much higher than if you had.

In their book, they make the point Keynes never made, which is that there is a different kind of cycle involving fiscal policy. It is the cycle of differing rates of return between the private and public sector investment opportunities. If everyone's coming home from war and you have baby boomers needing houses, the private sector borrows and builds Levittowns, as in the 1950s.

When I went to Japan in 1968 as a student, no one had houses, but they had great bullet trains. Where do you think the return on capital was higher, more bullet trains, or houses for people who didn't have any houses? The high return came from building the houses for the people who lived near the bullet train. Conversely, in the US today, we will *not* have a high rate of return on building another two million McMansions.

We need public investment, but it should be directed to projects that can be managed by the private sector. The problem, as Arrow and Kurz described, is how to make sure you build the subset of bullet trains that have high return-on-capital. The interstate highway system by today's analysis would have been a terrible mistake: opponents would claim it increased the deficit. But when it was originally built, it was a good deficit because it had a 13% rate of return-on-capital. The Louisiana Purchase had a huge rate of return on capital.

My proposal is we need to borrow and spend and invest in high job-multiplier projects that the bond market welcomes, because it knows the debt from building these things won't be on the shoulders of our grandchildren who could one day say, "Hell no, we won't pay."



Rather, these investments should pay for themselves. This is the basic crux of what I am getting at. We don't need Mc Mansions. We need infrastructure.

As John Kenneth Galbraith brilliantly put it years ago, we have ended up in a world of private splendor and public squalor.

One criticism that has been raised with respect to the approach that you advocate is that the so-called multiplier on government spending has been negative or at best zero. In other words, econometric studies by researchers such as Robert Barro at Harvard have shown that, historically, the economy has not benefited from fiscal expansion. Is this an example of the inductive reasoning that you criticized in your book?

I have nothing against inductive reasoning, that is to say, the use of data for statistical hypothesis testing. That is fine if it is done right.

But Robert Barro is biased. Granted, he is a brilliant guy. But he is conservative. He does not believe in Keynesian policy. He originally relied on rational expectations, which is now a completely failed theory, to support many of his earlier papers.

Lacy Hunt has made this observation of multipliers – you could call it zero or one depending on how you define it. It is a much-abused term. This is correct, if you do basic econometrics. If the government borrows to make transfer payments keeping public workers on their jobs in Oakland, California, which gives Nancy Pelosi votes, does that create jobs or just keep people in the workplace?

It keeps people in the workplace.

Exactly. Of course, there is no multiplier. That has all been transfer spending. Instead you could take the money and you build a Grand Coulee Dam, or you are doing what we are doing right now in Aiken, South Carolina, where they are undertaking government-financed work that is productive. Do you know that in Aiken the unemployment rate fell 25%? Because the money in such cases is spent in the following manner – and this must be understood.

Suppose \$1 trillion is borrowed and given to you, the project manager of Infrastructure Inc. You will keep \$50-\$100 billion of that and you will go hire 14 subcontractors. They will keep some of their money and they will hire sub-subcontractors to do the project and you have a multiplier going on that is four-to-one. Nobody can deny the distinction between that approach versus just keep people in their jobs in Oakland, California.

The problem with induction is that Barro and people who measure this are looking at a *sample of data when there was no public investment*. Obviously, if the data sample is a period of nothing but transfer payment spending, and that is where the borrowed money



now goes – let's be polite and call it income maintenance – well, obviously the jobs multiplier isn't going to show up. I am proposing that we hugely substitute productive investment spending for transfer payments, where you get a whole bunch of good things, including this employment multiplier effect – which nobody argues against.

I don't disagree with Barro. He is just taking a sample that has nothing to do with my argument. I want good spending so that the deficit we incur is a good deficit, meaning it won't indebt our grandchildren. But we have been doing nothing but the wrong kind of borrowing for income maintenance, which as you say has no job multiplier or anything, and the kids inherit the debt.

Another criticism is that the portion of the federal budget allocated to discretionary spending has decreased and will continue to do so as the need to fund entitlement programs will grow. Does that mean that your Marshall Plan will be funded through additional borrowing? And if so, what are the implications?

We are now at a stage where consumption spending is 71% of US GDP, but it should drop back to a more normal 62% or 63%. You want to increase the share of GDP that goes to investment spending. You want to increase the domestic savings rate, which has gone to 6% from 1%. You need a lot of rebalancing. Everyone agrees.

But if what you are saying is that, out of the regular tax income that comes in as revenue to the government, a larger and larger proportion is going to social spending, then indeed, less of the cash flow is available annually to be spent on infrastructure. The mistake in that analysis, which sounds very persuasive – and any CEO would know this – is to confuse how you spend your income with the question of what you invest in for a positive return. They have nothing to do with each other.

When you say it would have to come out of the deficit, my answer is fine, let there be a new deficit. Let's call it a capital account and change the balance sheets to be like that of a corporation, in which case the cash flow and the income have absolutely nothing to do with investment decisions. I don't see a conflict there.

If you made me philosopher King, I would want to make sure that all nonproductive investment – “roads to nowhere” in my world – become roads to somewhere. I would make sure that the total expenditures, *excluding* profitable investments, would equal the tax revenue. If you did that, you wouldn't be putting any more bad debt on the shoulders of our children.

Financing is never a problem if you are investing in something that makes a return.

We should stop using the word deficit cavalierly the way we do, as no company ever would, and we have to start thinking in terms of profitable government investment rather than wasteful government spending. You and I know that that's not what the debate



around the world is about. Everywhere there is deficit-phobia. Deficits must be bad. This is ridiculous.

I would like to come back to a point you made earlier, which is that Industrial Revolutions occur at random, and they are essentially unpredictable and you cannot create them. You also said that the US benefited from a private capital expenditure boom at the time of the dot-com era. But could the government create a public sector boom in the energy sector, where we clearly have long-term needs, but where there is really no incentive now to invest outside of fossil fuels?

It is a tricky question, because the energy sector is not a private sector, strictly speaking. With environmentalism the way it is, it has become a kind of public-private sector. Government is not particularly good at proclaiming to the private sector, "Now is thy time to go build the big pipeline." The market will do that on its own when it is ready.

In that sense, I don't believe in government telling the private sector what to do, because it really is only going to do it when it makes sense. What government could do is remove all those roadblocks and obstacles – which, incidentally, would have prevented the interstate highway system from ever being built – by giving special powers, executive orders, supreme court decisions, all kinds of things that I discussed in *American Gridlock* about how to get rid of NIMBYism – "not in my backyard." This has paralyzed us.

In doing that and removing obstacles, the private sector on its own would indeed be doing what it was trying to do with the new pipeline that Obama just canceled. So the message right now from government is, no matter what you and the private sector think you need or want to do, we are going to screw things up and make it difficult for you, and lower the return of investment for doing it.

It's not so much we need government to say energy is the area that matters. We are going to stimulate energy. It is just get out of the way and let it happen.

That is very different from the Marshall Plan idea I have, where public investment by definition benefits the public good. The market is never going to do it on its own. Government mandated the ARPANET, now known as the Internet, which it owns. Government mandated that the Hoover Dam be built. Government mandated the interstate highway system. They were all built by private contractors, but because they are public goods, government has to be involved in the correct way. That is why it is difficult in the private sector to say, "Let there be a Netscape revolution." Government's best approach to that problem is to stay out of the way and encourage entrepreneurialism and not put roadblocks up, the way they have with energy.

You call upon members of the media to perform logic audits of policy makers as a way to silence what you call the "dialogue of the deaf." Can you expand on what



you'd like to see from the media? I know you hold Martin Wolf in high regard. Who else do you look to in the media for insightful analysis?

The purpose of my book, *American Gridlock* is to encourage the use of higher orders of logic – new ways of thinking, to put it in slang terms, or new modalities of deductive logic, to put it academic terms. By using new disciplines, such as general equilibrium theory, game theory, Nash's theory of bargaining and politics, the theory of endogenous risk from Stanford about what really caused markets to have a perfect storm in 2008 and 2009. By using new ways of thinking, my book attempts to show that there are answers to our policy problems – solutions to Medicare and Medicaid, solutions to the lost decade –that you derive from principles that almost aren't debatable.

If this is true, then you don't need the stale rhetoric of the right versus the left, MSNBC versus Fox, *The New York Times* versus *The Wall Street Journal*. It is a stale dialogue. People are sick and tired of gridlock. The Pew Foundation surveys this in its poll results. We are fed up with the Washington where nothing works, where there are no win-win solutions. But in the book I show there *are* win-win policies, and you can thus transcend that dialogue.

Now, when I travel the world and see people of importance, the *Financial Times* is always on their desk, but 25 years ago it wasn't. It was the *International Herald Tribune*, which is now the *International New York Times*.

When it was the *Herald Tribune*, like the *Financial Times* today, it was bipartisan, and you didn't feel you were reading something left-wing. Now that *The New York Times* bought out the *Herald Tribune* and it is now the *International New York Times* that you are buying, it is predictably left-wing, as it is in America.

Martin Wolf, Gideon Rachman, Philip Stevens and the editorial writers of the *Financial Times* can't be labeled as left-wing or right-wing. With Martin Wolf, who is particularly good on global financial stuff – he's not the only good one, but he's just very good on central banking and issues like that – he is not telling you, the way that Paul Krugman does in *The New York Times*, that because you are a Republican you are heartless and hopeless.

With Martin Wolf you feel you are on a search for truth. He is trying to figure out the euro mess. That's what a great journalist does. They lead you in the mode of Plato, from the flickering shadows of the interior cave of ignorance to the sunshine of truth coming outside. We should expect this type of thinking, free of prejudice, from our commentators.

I go much further than that in my book. I believe it is such a crisis today that I am about to give a lecture to prepare some students at MIT for a new national game of "Gotcha." Gotcha is the game whereby the press can't wait to find out what some senator did wrong, with whom he was sleeping, his sexual peccadilloes, or his financial transgressions. We are obsessed with these.



Well, I want a new game of Gotcha. I want to “out” politicians and policymakers and people like Greenspan who really screwed up, and I want it circulated worldwide on the Internet. I want a scoring system showing the Idiocy Quotient of these people.

Let me repeat – the idiocy quotient.

I want, for every such person, an objective policy analyst at the Kennedy School or wherever to rank you in terms of how many hundreds of thousands of jobs your great grandchildren won't have and how much debt you are adding to their future life. I want you branded by how bad you are to your grandchildren. That is much more important than what you did in bed with somebody. So I want a much higher level of logic auditing.

But the cynical response is, “Oh, nothing can happen.” But read Felix Rohatyn’s book on infrastructure investment; everything can happen. The invention of double-entry bookkeeping in Genoa – in the middle of the 15th century – made more people honest than anything in the history of the world. For the first time you could invest and know where your money was going.

The cost-benefit analysis that began in the Kennedy era in the water resources area, which did tremendous amounts of good, can be matched, and we can hold officials more and more accountable for these things. The media must focus on serious things and do it with a sense of humor. I want these people outed like the Amish do; I want them exposed. The American people who want to throw the rascals out would be sympathetic. But you must make it fun, you make it funny.

If you do this, then the Congressmen running for reelection will have to think twice about taking orders from donors and lobbyists on K St. I want to focus on those who take orders from K St., and publicly humiliate and brand them as someone who has just caused 400,000 more grandchildren to lose their jobs.

You elevate the level of debate by creating policy analysts who are not prejudiced, and analysts who ask much deeper questions about the damage these people are doing by forever kicking the can down the alley, to use their own admitted term.

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