

## PART I

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### GOVERNMENT AND CHANGE IN AMERICA

#### *The Danger of an Ideology*

IT IS CONVENTIONAL wisdom in America today that high levels of taxes and government spending diminish America's prosperity. The claim strikes a deep intuitive chord, not only among those on the Right, but also among many on today's Left. It has become so obvious to so many over the last thirty years, it hardly seems to require demonstration any longer. It is apparently so widely accepted by the public and rolls off the tongues of policymakers from both parties with such fluency that one would think the evidence needn't even be gathered. Republican followers of Ronald Reagan remain the most ardent supporters of the idea. "Closed case: tax cuts mean growth," wrote former Tennessee Republican Senator Fred Thompson, who can't seem to imagine there could be an alternative argument.<sup>1</sup> Dick Arme y, the former Texas congressman, has made almost a career of criticizing those who argue otherwise. Arme y, who holds a doctorate in economics, claims to provide academic proof for the case against taxes and government, and sarcastically accuses those who dare disagree of fearing "big thoughts."<sup>2</sup> The leading Republican lobbying groups—notably the Club of Growth, run by Stephen Moore who once worked for Arme y

in Congress, and Americans for Freedom, headed by the conservative firebrand Grover Norquist—make lower taxes their principal cause. Deregulation and minimal government oversight of markets go hand in hand with this argument, other cornerstones of the Reagan revolution kept alive in subsequent decades.

Many of today's Democrats only partially disagree. To the conventional Democrat today, tax increases and increased government spending are by and large to be minimized and at best avoided. This is partly simple electoral calculation; holding any other position is considered politically destructive because the public has been so well convinced of its merit. But it has also become a matter of belief, as Democrats revise their traditional views and make deficit reduction their primary government objective. In fact, many Democrats had a hand in persuading the public of the dangers of big government. President Clinton successfully raised taxes on better-off Americans in 1993, but with the express purpose of reducing the federal deficit, not developing new social programs. The triumph of Republicans in the 1994 congressional elections reinforced the perception that American public opinion had turned against government. Clinton, determined to win a second term, abided by the sentiment. He proudly announced the new position of the centrist Democrats: "The era of big government is over," he said with some fanfare in his State of the Union address of January, 1996, the year of his presidential re-election bid. For all the success of the Clinton tax increase, the Democratic Leadership Council (DLC), which Clinton helped found in the mid-1980s, continued to urge Democrats in later years to tread lightly regarding tax increases and the new social programs that require them. An "American Dream Initiative" in 2006, put forward by the DLC, recommended paying for modest new proposals only by closing tax loopholes, and de-

manded that no new programs should be enacted without a way of financing them. By then, Democrats generally favored more tax cuts for the middle class, and by 2008 the leading Democratic presidential candidates only agreed to raise taxes on high-income Americans. Without more tax money—PAYGO, as it was called—there could be few social initiatives. The Republicans had won strategically. Some Democrats also emphatically put the best face on the economic status of workers over these years, claiming a degree of success that was exaggerated, in an effort to make a case for minimizing new government social programs and to justify their political strategy.<sup>3</sup>

Federal deregulation also reflects such attitudes about government. The lax federal oversight under George W. Bush has taken an increasingly obvious toll, most notably in the credit crisis of 2008 with hundreds of billions of dollars of losses accrued at major financial institutions, but also in areas such as food and drug safety, airline traffic and safety, and most tragically with the aftermath of Hurricane Katrina. But few Democrats acknowledged how much they themselves contributed to a weakened regulatory attitude in the United States. Deregulation began to gain influence with the Nixon Administration in the early 1970s, but Jimmy Carter was a sincere believer and, aside from airline and trucking deregulation, which were arguably sensible, gave financial deregulation a decided push. Under Clinton, much of the New Deal regulatory apparatus designed to restrain financial market excesses was formally and proudly eliminated in 1999, though *de facto* erosions of the famed Glass-Steagall restriction were underway for a decade.

When Clinton had hundreds of billions of dollars of budget surpluses to bestow in the late 1990s, he left federal spending on transportation, education, and poverty programs below the spending levels reached as a proportion of national income (the Gross Domestic Product) under his Republican predeces-

or, George H. W. Bush, or under President Reagan. To meet his social goals, Clinton generally resorted to tax credits, despite the reduction in growth of military spending made possible by the end of the Cold War, to provide help for the working poor and the adoption of tax-advantaged programs to expand health insurance, retirement savings, and the affordability of college education.

Such an approach fit neatly into the new conventional wisdom that bigger government was a danger to prosperity. It also fit the ascending ideology of greater reliance on free markets. A tax break may encourage savings by exempting investment from income tax until retirement or raising incentives to work by creating a tax credit even as one's income rises. But the market does the rest of the work, not government. The same faith in markets of course motivated broad deregulation. "Market incentives" became the new buzz phrase among middle-of-the-road Democratic economists. Such an approach also had the great virtue of not requiring a tax increase to support a social program. But in fact it was costly to government; tax revenues were lost. Meanwhile, with Clinton's encouragement, Wall Street hadn't had such a friendly response from Democrats in anyone's memory.

Some reforming of social programs was certainly necessary. Using subsidies rather than outright handouts can often make sense. Markets do have efficient distributive capacities which should be utilized as often as is sensible. But the new focus did not represent the return of clear-eyed pragmatism that it promised. Quite the opposite, it was an ideological turning point that moved the nation to the adoption of an antigovernment faith. "We know government doesn't have all the answers," Clinton said in his 1996 State of the Union address. But, though some progressive programs had indeed been overly ambitious and failed, no one ever promised that government

did have all the answers. By citing this straw man, Clinton had joined those who painted the government with an ideological broad brush of disapproval, and he brought the Democratic Party with him.

Nobelist economist Milton Friedman, famed mentor and revered hero to Armev and others, was before his death in 2006 the leading and most articulate academic economist in favor of this antigovernment position. Friedman's influence over theorists and policymakers alike was serious, and his rise to prominence simply remarkable. In the 1950s and 1960s, he was widely considered an extremist, if a well-schooled, intelligent, and articulate one. The frigid reception to his classic free-market book of 1962, *Capitalism and Freedom*, reflected the progressive attitudes of the Kennedy-Johnson years. But he pulled the entire mainstream profession unexpectedly in his direction in later years. By the 1970s, the book had become a best-seller, and his apostasy had become gospel to many.

Looking back, Friedman wrote in the preface to a 2002 edition of *Capitalism and Freedom* that people's experience with government expansion since 1962 had convinced them his economic philosophy was right.<sup>4</sup> In fact, the conservative movement's great friend was not the book's insights, which were simplistic, but the damaging hyperinflation of the 1970s, which Friedman and others misleadingly attributed to government spending directly. By the late 1970s, most of America was convinced that government was the issue. It was effective simple politics and bad analysis. In Reagan's 1980 debate with Jimmy Carter before the November presidential election, he told Americans they had to live with inflation, not because they lived too well but because government did. The well-said message stuck in the mind of the public. After the debate, Reagan's approval ratings rose markedly in public opinion surveys, and he won easily a week later.<sup>5</sup>

Friedman offered much ideology but little evidence that big government was the root of the problem. The causes of inflation in the 1970s were far more complex than the growing money supply—the factor that Friedman emphasized and linked to growing federal spending.<sup>6</sup> Rising government budget deficits can contribute to inflation, but other equally or more prominent causes in this complex decade included the eightfold hike in oil prices by the cartel of exporting nations, remarkably bad crop supplies worldwide, a sudden downshift in productivity growth not anticipated by any economist, including Friedman, and the fall in the value of the dollar. As for the size of government, federal expenditures were only one percentage point higher in the first half of the 1970s as a proportion of GDP than they were in the first half of the 1960s, yet annual inflation started to rise rapidly in the early 1970s while annual consumer price inflation was only slightly more than 1 percent in the early 1960s. What of the budget deficits that horrified Americans in the 1970s? Even in the worst years of the 1970s, as a proportion of the economy budget deficits were not larger than they were during the worst years of George W. Bush’s administration in the early 2000s, when inflation was mild.

But Friedman’s argument about the dangers of government was politically effective for a variety of reasons, including weariness over the Vietnam War, the Watergate scandal, the counterculture, and national desegregation policies. It also found reinforcing echoes in America’s nostalgia for an artificial *laissez-faire* past. Reagan was Friedman’s translator. And the mythology remains with the nation. In his early campaigning for the Republican presidential campaign in 2008, Mike Huckabee, governor of Arkansas, and admirer of Reagan, put the old American myth simply. “The greatness of this country has never been in its government,” he said in a speech before the

New Hampshire primary. “Any time the government gives something to us, they first have to take something from us.”<sup>7</sup>

This book is a refutation of such assertions. The popular economic case against big government, including the more moderate Democratic version, does not stand up to the evidence. Big-government and high-tax nations do not grow systematically more slowly than nations with lower government spending as a proportion of the economy and lower tax rates. More precisely, big-government and high-tax nations elsewhere simply do not in the real world automatically undermine the capacity to produce more for an extra hour of work—its productivity. Peter Lindert of the University of California at Davis spent years compiling data on the subject in a 2004 book. There is, he concludes, a dramatic “conflict between intuition and evidence. It is well-known that higher taxes and transfers reduce productivity. Well-known—but unsupported by statistics and history.”<sup>8</sup>

I am not arguing here that there is evidence that big government and high taxes are always and everywhere good. If government is managed poorly, it can have damaging effects. Can taxes be raised too high in the short run? Yes. High taxes can undermine motivation and incentives to work and invest, but economists who devotedly maintain that government undermines growth almost always seriously exaggerate these disincentives. Can social programs be poorly managed or counter productive? Yes.

What I am arguing is that judging by the careful assessment of economic achievements by nations with high taxes and large governments, and judging by American history itself, active and sizable government has been essential to growth and prosperity among the world’s rich nations, including America. Any impact on incentives and any displacement of private spending by higher taxes have been well more than compensated for,

history shows, by spending programs and regulatory functions that enhance growth. If tax revenues are used to invest productively in the nation's human capital, its infrastructure, its legal system, and the fair distribution of economic rewards, they have typically been essential to growth. These programs create the tools and assets that enable the private markets to function.

The book goes one step further. It argues that big or small government is not the critical criterion in economics. To the contrary, government's management of change is what is critical. And government is a key and arguably the main agent of change. Without an active government, a nation cannot respond adequately to its times. If it does not respond to new conditions, both economic growth and the ability to retain a nation's values will suffer. In the laboratory of the real world, the governments of rich nations have on balance been central to economic growth, and in the process have retained their citizens' faith in their nations' promise and social values. Does this mean government must be big? The lesson is that pragmatic government should prevail over any categorical or typically ideological dismissal of the uses of government, including Bill Clinton's. If what we think of as big government is necessary to manage change, and in a complex society it may well be, then we should pursue it actively and positively, and make it function well.

Today, an ideological antagonism toward government in the United States has deeply undermined the nation's capacity to deal with its rapidly changing times. These changes include rising competition around the globe, a marked worsening in wage growth and widening of income distribution since the 1970s, the rapidly rising costs of health care, an aging population, and the need for ever-more years of education. The two-worker family has become the nation's norm. The possibilities for advanced transportation and better energy use due to tech-

nological innovation have excitingly expanded, as transportation and other infrastructures, including public water systems, are allowed to decay. Change also includes constantly evolving ideas in America about who should participate in the full rights and opportunities of the nation, an evolution in American society that at first excluded and then progressively welcomed to the fold all manner of immigrants—from the early Germans and Swedes to the Irish, Italians, and Jews and ultimately Latinos. Over time, women, African Americans, Native Americans, and gays were also welcomed. Our knowledge about what is required to lead a full life changes as well. We now know, for example, how important early education is to human development. We are much more aware of the most subtle abuses of race and gender. And we believe that old age can be productive.

But today's conventional wisdom reflects a narrow view of government. Government, as Garry Wills notes, is thought to be a "necessary evil," a last resort.<sup>9</sup> In terms of the economy, the argument against government goes something like this. First, higher taxes will undermine the incentives of those who work and invest. Second, social programs are administered so poorly that they are a waste of resources, and moreover create dependencies among those who receive help. Finally, social spending crowds out the vibrant private sector, especially if it must be financed in the bond markets, and thereby undermines productivity. Regarding the nation's social and political values, the central complaint of advocates of less government—an age-old one among political conservatives—is that any intrusion of government reduces individual choice and freedom itself. Hence, for example, Friedman's book title, *Capitalism and Freedom*.

The empirical problem with the economic claims is that the economies of nations with high taxes and big governments

have grown rapidly, are highly productive, and provide their citizens with a standard of living every bit the equivalent of America's and some argue superior to it. The problem with the political claims is that so-called big government has enlarged freedom by protecting civil rights, minimizing discrimination, giving people decent health care and the educational and economic tools to fulfill their lives, which ultimately contribute to further prosperity, and have withstood the return of totalitarianism everywhere in the West.<sup>10</sup> Democracy has simply thrived in "the welfare states" of Europe.

In fact, there really is no example of small government among rich nations. The size of government grew across all the world's rich nations, particularly in the twentieth century, and the rate of economic growth only increased. While Milton Friedman complained about the growth of government in the 1950s and the 1960s, the American economy never grew faster in its history, and the incomes of all Americans, discounted for inflation, doubled over less than twenty-five years—that is, grew by 100 percent. After the Reagan revolution of reduced taxes and deregulation, rapid growth in the standard of living was never recaptured except for a few years in the late 1990s. Since the 1970s, the income of a typical male has actually fallen, discounted for inflation, and typical family income grew by only 25 percent over more than thirty-five years, largely because spouses went to work.<sup>11</sup> People met the rest of their needs by borrowing heavily.

It is simply not the size of government spending or the level of taxes, but the composition and quality of the spending that affects how fast economies grow and standards of living improve. We are not discussing short-term economic policies here, but rather the long-term support of growth. Cuts in taxes will often temporarily help stimulate growth, but the latter is largely a liberal argument, derived from the philosophy

first developed in the 1930s by the British economist John Maynard Keynes. The same (and even more potent) stimulatory effects can be temporarily attained by more government spending as well. The conservative argument for tax cuts is based on the dubious claim that such tax cuts result in more than merely modest incentives to work harder and invest more.

It is not that big government is to be encouraged in and of itself. What we know is that nations with bigger governments have not as a rule grown more slowly than those with relatively smaller governments; to the contrary, they have sometimes grown faster. That can only be the case because their spending programs on balance enhance rather than detract from growth, fill the many gaps that markets cannot, and that regulations on balance make markets work better and minimize abuse and corruption. This rather easily demonstrable fact is but a heresy in modern America.

But government must change with the times to fulfill its central functions. A critical purpose of government, as noted, is to respond to and facilitate changing conditions in society and the economy in order to retain a nation's prosperity and its values. When business operates well, it also must and does respond to changing needs and wants. For government, one of the crucial benefits of democracy itself is that it creates ways to communicate new needs and takes note of shifting opinion and evolving knowledge. Democracy is thus critical to adapting to change. Free speech and open public discourse are components of democracy and thus essential to change.<sup>12</sup>

Social and economic conditions have changed rapidly and continually since the colonial years, and change today is not more profound than it has been in the past. But it is profound, nevertheless. The problem for government, as for many other institutions, is to reorient itself from proven successes in the past. Few talk about government as an agent of change.

Much of this book will be about how government has adapted to change in the past, and about identifying the ideological restraints that have kept the nation from adapting in recent decades. The implementation of experimental, pragmatic, and courageous policies, based on new conditions and pressing contemporary problems, was more common in America's history than is widely realized. Many want to believe otherwise—that a certain set of duties and obligations is more or less written in a foundation of stone. In today's America, radically new economic and social conditions have been ignored and neglected because of the high level of antagonism toward government and the resulting tendency to resort to historical narratives, based more on ideology than facts, to limit further uses of government. America has often—but not always—adapted to its needs.

### *The Evidence*

The fastest growth of social programs in history—the rise of the so-called welfare state—took place in the rich Western nations and Japan over the three decades after 1950.<sup>13</sup> Yet, over that same period, the incomes of a typical family—indeed, of most families—grew at unprecedentedly rapid rates in all these nations, a period which even included the sharp rise in oil prices in the 1970s. No government of a Western nation today spends less than 10 percent of Gross Domestic Product (GDP) on its poor, unhealthy, or aged, for example—what are usually called social transfers—yet all are immensely wealthy by historical standards.<sup>14</sup> In addition to social transfers, they all spend significantly on education and infrastructure, and they all remain vibrant democracies as well.

Nevertheless, the case that big government is damaging is presented as open and shut. If so, the evidence supporting it should be as close to unambiguous as such economic evidence can possibly be. Yet a reading of the literature shows that, for all its alleged obviousness, the advocates have not remotely proved the point. To the contrary, no case can be reasonably made that government has systematically impeded growth.

Martin Feldstein, Harvard economist, president of the National Bureau of Economic Research, and head of the Council of Economic Advisers under President Reagan, is one of the leading figures in the post-Friedman generation of economists who persistently cites the damage done by big government. Feldstein believes high taxes invariably suppress incentives to work and invest; social programs, if occasionally necessary, are too costly, inefficient, and usually undermine individual effort; and government spending displaces private enterprise, thereby reducing the economy's productivity. Feldstein often focuses on the issue of high taxes.

"Economists recognized," Feldstein wrote in 1994, referring to the 1980s, "that it was through improved incentives rather than through increased demand that a sustained increase in national income could be achieved. Research studies emphasized the adverse effects of high marginal tax rates and of the rules governing transfer programs like unemployment insurance and Social Security that penalized work and saving."<sup>15</sup>

This is a vast overgeneralization. By no means did all economists agree with this proposition, but it was a fairly conventional anti-Keynesian argument made by a growing school of conservative economists. They claimed that tax cuts do not stimulate the economy by increasing purchasing power, as Keynes argued but, as noted, by increasing incentives to work and invest. The latter means that permanently lower taxes

should produce a more vibrant economy. While respected studies were undertaken that supported Feldstein's claims, others completely refuted the assessment even in the 1980s.

Feldstein got a chance to put one of his sweeping claims to the test under Bill Clinton. He argued that the Clinton tax increase of three percentage points on high-income Americans, implemented in 1993, would clearly demonstrate the anti-growth impact of higher taxes. The reduced incentives to work due to the tax bite taken out of income would be seen in lower reported incomes by these individuals. Incomes were indeed lower in 1993, as Feldstein reported—and knew about at the time he finished the research, which gave him confidence to make the case.

The reason those incomes were lower, however, was well-documented later: wealthier individuals were able to move their income into 1992 tax returns, at the time the legislation was passed but before it went into effect. The lower incomes of 1993 were thus not related to reduced incentives to work and invest, but to clever strategies to report income in 1992 that would have normally been reported in 1993. In fact, in 1994, despite the higher tax rates, reported incomes for well-off individuals rose rapidly on average in 1994 and afterwards, the opposite of Feldstein's prediction. The high-income individuals kept working hard, taking more risk, and making a lot more money, even though the higher income tax rates remained. Moderately higher taxes simply did not undermine incentives to work, a serious failure of the Feldstein hypothesis.<sup>16</sup>

Another major claim of economists antagonistic to government programs is that social spending for programs like unemployment insurance, Social Security, and Medicare will as noted either undermine incentives to work and save or so displace private investment and business spending that they will reduce the efficiency and potential growth of the American

economy. In other words, social transfers—usually including tax financed spending for housing, unemployment, pensions, health care and welfare for the poor—will reduce the economy’s productivity or output per hour of work. People will work less hard, the taxes themselves distort markets and make the economy less efficient, and government spending is largely a waste that displaces more productive private spending. Harvard’s Robert Barro is among the leaders of this group, which typically tries to compare growth rates among different countries.<sup>17</sup>

Such studies must show a clear relationship between slower growth, lower GDP per capita, or reduced productivity to higher levels of government spending or higher taxes. But when studies done by Barro and others that purport to show government’s deleterious effect on growth or levels of income are probed by other experts, they do not hold up. Joel Slemrod, an economist at the University of Michigan, did a comprehensive and respected review of the studies in a classic paper, and says that the conclusion that big government undermines growth does not pass closer inspection. Economists Sergio Rebelo of Northwestern and William Easterly of New York University, neither of whom would describe himself as politically liberal, also conclude the statistical relationships found are “fragile.” In other words, slightly different assumptions or sets of data undermine the conclusions. Given how strenuously antigovernment researchers make their case, why is it impossible for them to prove it unambiguously?<sup>18</sup>

Peter Lindert, who is a mainstream economist, has done broad comparative analyses of experiences in Europe and North America and concludes unreservedly that “the net national costs of social transfers and of the taxes that finance them, are essentially zero. They do not bring the GDP the costs that much of the Anglo-American literature have imagined.” Lindert goes

on: “Whether one looks at the level or rates of change, one can find no clear negative relationship between social spending and GDP per capita. . . . Neither simple raw correlations nor the careful weighing of the apparent sources of growth shows any negative net effect of all that redistribution.”<sup>19</sup>

Who is the lay reader to believe? The case does not rest on simply choosing selectively the research studies that support the view. The ultimate point is that, if the case made that big government is detrimental to economic growth is as simple and unambiguous as some economists and political commentators claim it is, not to mention politicians, the statistical evidence should be easy to demonstrate and virtually impossible to refute. The opposite is true, as we’ve seen. The studies supporting the case generally fall apart on closer analysis.

What is going on? Some economists make truly simplistic analyses, ignoring such basic factors as the business cycle. For example, as Lindert notes, some will claim that that economies grow faster when social spending falls as a proportion of GDP. But the measured fall in social spending as a proportion of GDP is a function of the rising GDP during economic expansion, so it does not demonstrate any causal relationship.<sup>20</sup>

There are more subtle analyses and distorting assumptions, however. Lindert says that some of the most respected researchers often “torture” the data, redoing their computer programs with different data and assumptions until they find the conclusions they seek. Others do simulations of real-world conditions that are not “real world” at all. In demonstrating the antigovernment claims, some economists simply presume that all government spending basically goes down a black hole and has no economic value whatsoever. Others, somewhat more honest, will at least treat the tax revenues neutrally. But few deal with the facts as they really are, which shows that many of these spending programs have positive value.

As a result, the conclusions of many of these studies defy common sense. Many claim to demonstrate, for example, that a higher income tax so undermines the private economy that it necessarily results in a loss of GDP greater than the tax itself. Based on several of these studies done by reputable economists, for example, Sweden's GDP is now 10 to 50 percent lower than it otherwise would have been. Thus, if Sweden had only cut its taxes to the U.S. level and similarly limited its welfare state, it could be so much wealthier today that it would possibly be the richest nation in the world by far.<sup>21</sup> France's consumption would be 20 percent greater than it is today if it only adopted U.S. tax rates, according to one study.<sup>22</sup> What can they be waiting for, one wonders?

Because in fact these high-tax economies actually do well, it follows that what happens in the real world is that much of that tax money is spent constructively, on programs that inspire a sense of confidence, improve productivity, and promote good health and education. Even when there are moderate disincentives to invest and work, many of the programs are oriented to minimize these. For example, even high levels of unemployment insurance, a particular *bête noir* of conservatives, can remove less productive workers from the labor force and minimize any damaging consequences from shirking work. Regulations, in turn, enable markets to work better by making information more available and reducing abuse and corruption. Such regulation can save money, even if costly to comply with.

Let's return to the case of Sweden. Many critics argued that its welfare state had gone too far by the 1980s—taxes were too high, and wages too generous. Incomes compared to the rest of the wealthy countries were no longer near the top of the tables. Market-oriented adjustments were made in Sweden, including tax cuts, and conditions improved. But Sweden did

not cut taxes or social spending nearly to the U.S. levels, or even to Britain's. To the contrary, social transfers remained a very high proportion of national income, roughly 30 percent of GDP, not including education expenditures. The United States expends about 13 percent of GDP on such social transfers (Social Security, Medicare, unemployment insurance, housing, and poverty).

Yet, with such high levels of social transfers, the growth rate of GDP per person since the mid-1990s in Sweden was as high through the mid-2000s as the growth rate of the United States or almost any European nation—many of which equaled America's GDP growth rate per capita during this period (which included the Clinton boom years).<sup>23</sup> Sweden's average compensation per hour paid to its manufacturing workers is about equal to America's. (To make the wages comparable in this comparison, they are adjusted for what is called purchasing power parity—what goods and services the wage actually buys.) Sweden's productivity, which is according to many economists inevitably damaged by high levels of social transfers, has not fallen ignominiously. It is about 88 percent of America's level (see table 1).

The experience of other rich nations is even more telling. Let's keep in mind that Germany, France, and Italy spend almost as much on social transfers as does Sweden in terms of GDP, and the other Nordic nations spend roughly the same amount. This means that citizens enjoy free or very inexpensive, education, health care, and usually child care. The quality of health care and education through high school is very high. Time off for working mothers with children is shockingly generous from an American perspective. Thus, the typical citizen receives a great deal even before he or she earns a wage.

Yet, on top of that, and even despite such spending, German businesses pay its manufacturing workers 127 percent of

**TABLE 1**  
Comparing Productivity and Wages in Other Nations (2004 dollars)

<i>Country</i>	<i>Productivity</i>	<i>Manufacturing compensation (using purchasing power parity)</i>
USA	100	100
Sweden	88	98
Germany	92	127
France	107	91
Netherlands	100	101
Norway	125	110

Source: Mishel et al., *The State of Working America 2006/2007*, p. 329 and p. 342

American levels and Norway 110 percent. Despite the generous social programs, manufacturing workers in about half of the two dozen wealthiest nations earn as much as their counterparts in the United States. Productivity is higher in France, the Netherlands, and Norway than in the United States, and comparable in several other nations.

America's GDP per person is the highest in the world (with the special exception of Belgium). The main reason is that a very high proportion of both men and women work, and Americans on average work more hours than do their counterparts in other rich nations.<sup>24</sup> Thus, America does provide more jobs than most other nations. This is not a small achievement.<sup>25</sup> But it is probably largely because it pays lower wages, especially near the bottom of the spectrum. Jobs for those in the prime working ages in Europe are plentiful. About the same proportion of people between the ages of twenty-five and fifty-four work in Europe as in America. In Sweden, a higher proportion of women work than in the United States, partly because of family friendly laws for working mothers. Labor participation is especially high in the United States among young workers.<sup>26</sup>

In sum, America's productivity is 15 percent higher than the average of nations in the Organization for Economic and Co-operative Development (OECD), the two dozen or so richest nations in the world. But it is lower than a half dozen nations with much higher taxes and rates of social spending. And roughly half of the OECD countries pay higher or equal wages to workers in manufacturing, and almost all provide substantially more benefits than does the United States, including mostly free education and health care.<sup>27</sup>



Let us now look at how the changing size of American government may or may not have affected U.S. prosperity in recent years. Friedman's 2002 criticism of big government followed hard on the heels of the Clinton boom of the late 1990s, when the nation's productivity rose rapidly for the first time since the early 1970s. One would have thought, given Friedman's claims about the nation's disappointment with big government and his warnings about high taxes, that the proportion of national income collected as federal taxes fell sharply during the Clinton boom. In the years preceding the boom, however, tax receipts rose above their earlier levels and during the boom itself reached 20 percent of GDP, much higher than at any other time since the final years of World War II. Even federal spending—though it grew more slowly under Clinton, largely because of the peace dividend following the Cold War and less rapid increases in health care costs—had fallen as a proportion of income only to the levels of the early 1970s. At that level of spending in the 1970s, inflation was beginning to rise rapidly; not so, in the Clinton years. The causal relationship is far from simple. Indeed, there often is no relationship.

Some still argue that the 1981 income tax cuts under Reagan produced the Clinton boom. Given that they occurred fif-

teen years earlier, the claim is far-fetched on the face of it. Many also conveniently neglect the argument they would have made had there been a Democrat in office, which is that under Reagan federal spending increased rapidly. Military spending increased by roughly a full percentage point of GDP, Medicare spending rose rapidly, and interest on the soaring budget deficits rose by well more than one percentage point of GDP. If their contentions were consistent, growth would have been undermined by such spending. Price Fishback, a mainstream economist and historian, who is not left of center, writes: "In fact, Reagan and George H.W. Bush looked more like Keynesians than any of the peacetime presidents."<sup>28</sup>

Furthermore, Reagan did not reduce the nation's tax burden, he shifted it. While income tax rates were cut, payroll taxes to pay for Social Security and Medicare were markedly increased. Total taxes as a proportion of GDP were about the same in Reagan's last year in office as they were in three out of four of Jimmy Carter's years as president.<sup>29</sup>

Despite the lower income tax rates as well as reductions in regulations and lax implementation of those that remained on the books, productivity adjusted for the ups and downs of the business cycle did not improve under Reagan or his successor, George H.W. Bush. According to the ascending free-market ideology, these should have improved incentives. The productivity take-off began in 1996, not long after the Clinton income tax increase. Feldstein, Armey and others predicted that tax increase would have the opposite effect.



Friedman's ideal world, one deduces, was the economy he imagined reigned in the nineteenth century, when government spending and control over the economy was least, or so the advocates of this view claim. There may have been financial

panics, big busts, deep recessions, and corruption in the 1800s, but the nation, on balance, flourished, goes the argument. Workers may have been poor by modern standards, but average wages discounted for inflation rose inexorably if cyclically over time and poverty was reduced. Gross Domestic Product per capita—the nation’s income per man, woman, and child—rose severalfold discounted for inflation over the century, always making up for recessionary dips within a few years and then rising higher. By 1900, and probably earlier, America was the richest nation in the world, and also the most productive—generating more goods and services per hour of work than any other nation.<sup>30</sup>

In the twentieth century, there were complications, according to the argument. Government began to spend more as a proportion of GDP, a progressive income tax was introduced and made permanent, and a broad set of regulations was adopted, first at the turn of the century and then more vigorously with the New Deal of the 1930s, the Great Society of the 1960s, and the Nixon presidency of the early 1970s. The Progressives believed they were helping shield many from the harsh pains of volatile markets and the unfair balance of power in favor of business. But in making life more “fair,” they both undermined the economy and individual motivation, according to Friedman and like-minded thinkers who by and large minimized the personal pain suffered in the twentieth-century economy.

The key problem with the Friedman argument is that in the first three quarters of the century, despite higher taxes and the Great Depression of the 1930s, America prospered as never before, and Americans worked very hard as well despite growing social transfers. An agricultural economy in the early 1800s cannot fairly be compared to an industrial economy in the 1900s. But by the second half of the nineteenth century, America was fast becoming an industrial economy, based on

heavy industry. In this period, the great oil, steel, and aluminum companies were born; the railroads were built; mass-produced consumer products like cigarettes and breakfast cereals spread; and the national retail chains were established. The cities also began to grow. And the economy grew rapidly, while government revenues were around 6 or 7 percent of GDP.

But the economy on average grew no faster in those years—which saw deep recessions and countless strained and often ruined lives—than in the later years of the twentieth century, and in particular in the twenty-five years after World War II, when federal, state, and local government spending eventually reached roughly 30 percent of GDP and income levels in America became more equal.

U.S. history in the 1900s provides a working model for examining the potential deleterious effects of higher taxes in particular. Nancy L. Stokey, of the University of Chicago, and Sergio Rebelo of Northwestern, did a careful statistical analysis of the rate of growth over this period as American tax rates increased. The income tax was established in 1913, at which time taxes came to 2 percent of GDP in 1913. It rose to 15 percent in 1942. The economists adjusted for the business cycle, including the Great Depression. According to the conventional wisdom, there should be evidence of a reduced rate of economic growth on average as tax rates rose. But there is none. The authors conclude that, “this large rise in income tax rates produced no noticeable effect on the average growth rate of the economy.”

Friedman’s own claims in *Capitalism and Freedom* initially seemed odd because he made them against this background of a robust economy in the 1950s and 1960s, America’s “golden age” of growth. *Capitalism and Freedom* was a book of popular essays about the superiority of the free market, including the distribution of most social goods like pensions, education, and

health care, and the great dangers to prosperity of social spending. But it was based largely on speeches made in 1956, and much of his analysis and writing was presumably done earlier—perhaps too early to realize how well the economy was actually doing. At the point of his writing, a postwar recession in the late 1940s was still fresh in memory, and there was another recession in 1953 and 1954. Yet all along, even with the economic downturns, the economy was on balance growing rapidly over the 1950s and 1960s, as were worker incomes.

Friedman's central claim that growing government undermined personal political and civil freedom was not borne out. His later followers, like Dick Armey, always couch the argument for low taxes as a patriotic defense of individual freedom. The grassroots organization Armey formed and headed after leaving government is indeed called FreedomWorks, and has as its motto, "Lower Taxes, Less Government, More Freedom."

Yet all the welfare states that Friedman warned about remain sound, vibrant democracies, and some new ones were added to the list, such as Spain and Portugal. Spain spends 19 percent of GDP on welfare, including unemployment, health care, pensions, housing, and poverty, while Portugal spends more than 15 percent—all more than the United States spends at 13 percent of GDP.<sup>31</sup> The failure of Soviet central planning was helpful to Friedman's cause, but it did not serve as a useful example for the argument he was making. The Soviet Union started as a totalitarian state; it did not evolve into one because government began to intrude in free markets. More recently, the experiment with free markets in Russia did not prevent a return of authoritarianism.

And was freedom undermined in America during the period Friedman explores? Historical strides were made in civil rights and women's rights at this time; the elderly were raised out of poverty en masse. In the 1950s, nearly one in three over

sixty-five was poor; by the 1970s, only one in ten was poor. The poverty rate for all Americans was cut by at least ten percentage points from around 22 percent to 11 or 12 percent. Americans attended college in growing proportion. Nearly two thirds would own their own homes. All these added to freedom on balance, by all but the most narrow definition. Set-backs there were, and sacrifices as well. Busing to integrate schools affected working-class people more than others, to take a bitter example. But in spite of Friedman's dire warnings, large steps were taken to promote the equality the nation promised.

### *Looking-Back Narratives from the Right and Left*

The romantic view of the limited role of government in America's economic history in the 1800s is simply wrong. Despite a national distrust of central government, Washington exercised its power often and sometimes well. Laissez-faire—hands off, basically—remained the nation's sensibility, but the philosophy was violated in practice time and again. National government frequently had a strong and defining influence, even when its expenditures were a small share of total income. Government policies, when they were most effective, were experimental and often bold, changed pragmatically with the times, and were not beholden to an ideology even in the time of Adam Smith's great popularity under Jefferson.

In early America, the national government protected civil and property rights, set rules, did indeed have a tax policy of substantial tariffs, and had serious control over the nation's economy through its often radical land policies. Its courts established a competition policy. It invested in transportation, education, and health care. Such public investment was critical

to growth. Federal, state, and local governments often organized their social programs well, minimizing deleterious impacts on personal motivation and waste. And programs whose primary objectives are to make society more equitable and decent can foster growth by enhancing optimism, a sense of fairness, and reducing discrimination in markets, particularly for labor (which is always detrimental to growth). Such programs may help get the most out of human resources by assuring that for all that hard work, abiding by the law, and taking risk will be fairly and reasonably rewarded.

This is not to say that government always spent its money well or efficiently. There were errors and the dangers of bureaucratic inefficiency were sometimes evident. Commentators look back to find in the nation's history what they want to find. Dependence on such "looking-back narratives" typically reflects rising confusion and uncertainty. Commentators call upon history and the reputation of great men for authority. Some of America's early patriarchs were great men, but the phrase, "Founding Fathers," itself reflects a peculiar dependency on a special wisdom that simply defies human boundaries. It is reminiscent of the attachment the ancient Greeks had to their many gods, with the exception that unlike the well-known flaws of the Greek pantheon America does not easily accept the flaws of their early heroes. The Constitution was a brilliant result of the talents of the Founding Fathers and a document for a new age, but it was surely not "sacred," as Dick Armey likes to call it.<sup>32</sup> Books about the true brilliance of the Founding Fathers were especially popular amid the confusion and search for answers of the early 2000s, and a favorite pastime was to determine what the Founding Fathers truly thought and did in the early years of the nation—and what they would have thought and done today. One such book is

called *What Would the Founders Do? Our Questions, Their Answers*, written by an editor of *The National Review*.<sup>33</sup> These books, if well-intentioned and sometimes intelligent, were more a reflection of a nation looking to rid itself of confusion as painlessly as possible, and the books had a decidedly conservative cast, mostly restoring the federalists to a place equal to or superior to Jefferson's.

The U.S. Constitution, barely adopted at the Constitutional Convention in 1787, is similarly invoked often as inviolable authority. The faith placed in it also has a disturbing quality in a modern nation. The Right and in some measure the Left read an authority into the Constitution to support their present-day views that can't truly be warranted. Progressive taxes were never conceived of by the Founding Fathers or written into the Constitution, says one conservative activist, who has made a career of opposing income taxes.<sup>34</sup> Of course, the Sixteenth Amendment made such taxes constitutional, but this was allegedly a usurpation of an earlier and surer wisdom. If the Founding Fathers were against it, the argument of semi-divine faith goes, so should we be.

The Constitution and the Bill of Rights are cut many ways. They are called upon to support those favoring a right to choice for women and those unalterably opposed to it. The legality of gun control is to be determined by uncovering the Constitution's true meaning, again supplying arguments to both sides. The right, or not, to free speech similarly draws contrasting support from the Constitution—and on and on. The rise of “originalism” (as distinguished from “original intent”)—what the legislators really meant by the new laws when they were passed—is another “looking back” narrative. The argument is hardly unsophisticated, but there is no escaping its ideological uses. We must abide by this original two-hundred-

year-old context, states originalism, famously advocated by Supreme Court Judge Antonin Scalia, as if the Framers ever truly agreed on this themselves.<sup>35</sup>

There are a variety of scholarly arguments to refute this misleading claim, not least that the Framers themselves wanted the Constitution to be flexible and readily applied to new circumstances (as did legislators of the laws they made). Justice Stephen Breyer offers a penetrating counterargument about the Constitution's flexibility.<sup>36</sup> The establishment of a republic of checks and balances, The Bill of Rights, was a remarkable achievement. But the informal search for authority in the Constitution for so many contemporary issues is a sign of a nation astray and a nation afraid of the future.

What is the nation looking for in its past? In economics and social policy, the Right calls upon the alleged *laissez-faire* successes of the 1800s as a guide to the future. Personal freedom is central to their claims, and high taxes, social policies, and regulation are a threat to that freedom. Their view of personal freedom is a "negative" one, as the political philosopher Isaiah Berlin defined it. Government's intrusions on the individual's ability to, say, buy a house, choose a career, or save for retirement, in fact, should be limited.<sup>37</sup> In this view, Social Security is seen as an involuntary requirement to place one's retirement money aside—a violation of rights. Government health care deprives us of our choice of doctors and procedures. Freedom and individual responsibility require us to accept poverty as the plight of the untalented or lazy, rather than ameliorate it through government giveaways, which may require the poor to act in a certain way and deprive the better-off of choice by confiscating their income through taxes. The Right looks back to early America to justify this view.

Friedman puts it this way in *Capitalism and Freedom*:

Political freedom means the absence of coercion of a man by his fellow men. The fundamental threat to freedom is power to coerce, be it in the hands of a monarch, a dictator, an oligarchy, or a momentary majority. The preservation of freedom requires the elimination of such concentration of power to the fullest possible extent and the dispersal and distribution of whatever power cannot be eliminated—a system of checks and balances. By removing the organization of economic activity from the control of political authority, the market eliminates this source of coercive power. It enables economic strength to be a check to political power rather than a reinforcement.<sup>38</sup>

The Left's view of freedom is traditionally close to Berlin's "positive" category. Not long after Friedman wrote the above, Lyndon Johnson put it this way in a 1968 speech: "The man who is hungry, who cannot find work or educate his children, who is bowed by want, that man is not fully free."<sup>39</sup> Roosevelt announced his own set of economic rights in his 1944 State of the Union address, but they went too far for the American public or Congress to accept. They included a right to a decent job, a good education, and adequate, modern health care.<sup>40</sup>

The protection of freedom has been a highly malleable concept in American history. All favor freedom, but its interpretation varies with the person and with the times. As the historian Eric Foner points out, the preservation of freedom was called upon to support slavery—the freedom to private property. It was also used to support abolitionism.<sup>41</sup>

In recent decades, however, some of the Left adopted a more "negative" view of freedom. A good example of the philosophical foundation of the moderate Left is the writing of Neil Gilbert, of the University of California at Berkeley, who dis-

cusses in several books how a new welfare state must reduce intrusion into American lives. The new American philosophy of government should enable people to do their own “rowing”; the welfare state of the 1960s simply went too far.<sup>42</sup> He calls for a renewed individualism in which Americans will reinvigorate their sense of personal responsibility.

Few will deny freedom a priority in American life. But it is so ambiguous and has been interpreted so broadly over the centuries that equality may well be more practicable, by which we may mean a level playing field, a more equal start. The challenges to maintaining the level playing field are always changing, as are the definitions of who—women, African Americans, Native Americans, gays—are even entitled to participate on an equal basis. Moreover, unfettered capitalism in the United States has been and can be abusive. We have too much history to think otherwise, from unconscionably low wages and egregious working conditions in the 1800s to stagnating wages since the 1970s for typical male workers to persistent gaps in wages between white males and black males or women.

Many on the Left believe these objectives can be met by preserving the spirit of the New Deal. Such efforts should include shoring up Social Security, expanding unemployment insurance, and preserving the Medicare program for the elderly passed under President Johnson in 1965. They also should include revitalizing some of the many financial regulations passed in the 1930s that have since been undone in part by the only Democratic presidents since Johnson, Jimmy Carter, and Bill Clinton. But invoking the specifics of the New Deal and the Great Society is inadequate in a changing time.

The New Deal failed to implement an efficient nationwide system of health care. But even beyond this gap, there have been many other changes in modern society since then that need addressing. Among the most important are the persistent

stagnation of wages for several decades, the rise of both the two-worker and single-parent families, and the financialization and indebtedness of the American economy. Talk of merely reinvigorating the New Deal is too restrictive a view of government's purpose. It suffers from the easy and unchallenging reliance on proven successes of the past, and does not adequately address the present or the future. It does not preserve "positive" freedom in a new era, as liberals have tried to do in the past.<sup>43</sup>

### *The Myth of Laissez-Faire*

What does our history truly teach us? It is not well-recognized, but America has had substantive social and economic policies in place since its earliest years.<sup>44</sup> One source of confusion is that contemporary economists, writing today in a time of substantial government spending, assume that a government's power is a function of how much it spends compared to the size of the economy. Tax revenues, largely from tariffs, excise taxes, and sales of government-owned land, were a small part of the economy in the late 1700s and early 1800s. Yet, clearly, under the first Federalists, presidents Washington and Adams, and even under the first Republican president, Jefferson, who was particularly skeptical of central government, the tools of government were wielded powerfully. These tools involved rules and regulations in land policies, trade, and internal commerce, as well as public investment in transportation and education. They included excise taxes and tariffs.

Much of the early Federalist history is well-known. Alexander Hamilton, Washington's treasury secretary, was determined to levy both excise taxes and tariffs on imports, invest in roads and other transportation infrastructure, establish a

central bank, field a militia, and assume the debts of the Continental Congress. This was “big government” by the standards of the day. More important even than tariffs to Hamilton were subsidies for incipient manufacturing industries, of which he was America’s arch-advocate. Aware of Adam Smith’s “invisible hand,” he undertook all these government interventions nevertheless—a set of measures, as one historian writes, “that Smith or any other protagonist of *laissez faire* would have found totally erroneous.” (In fact, less popularly recognized, Smith had justified substantial government intervention for education, defense, and other areas.) *Laissez-faire* was a pleasant abstraction to Hamilton, to be respected but to be violated when necessary. As he wrote, “This favorite dogma, when taken as a general rule, is true; but as an exclusive one, it is false, and leads to error in the administration of public affairs.”<sup>45</sup>

Many argue that the Constitution itself always allowed for federal government regulation and oversight in the famed commerce clause. We need not get into Constitutional controversies here.<sup>46</sup> What is clear is that America’s early economy was highly regulated. Product prices were dictated by local governments, for example, and the quality of products was also regulated. Sales of products were legally confined to certain places and hours. Labor markets were especially unfree. Most American immigrants at the time arrived as indentured servants, even at the time the Constitution was ratified. The law provided they would remain indentured for seven years, unless set free by their masters.<sup>47</sup>

The myth of *laissez faire*, in contemporary discussion, apparently begins with Jefferson’s victory for the presidency in 1800. Jefferson, a southerner and slaveholder, was after all in favor of nullification, the rights of states to override federal law. Jefferson was explicitly averse to expensive central government, federal indebtedness, and a central bank. He was an

admirer of Adam Smith's "invisible hand," and probably read *The Wealth of Nations* years after it was published in England in 1776, having been first published in America in 1789. In Jefferson's mind, as historian Joyce Appleby puts it, "The modern concept of self-interest gave to all men the capacity for rational decisions directed to personal ends."<sup>48</sup>

A good government, Jefferson summarized in a letter during Washington's term, must be "a wise and frugal government, which shall restrain men from injuring one another, which shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned."<sup>49</sup>

Thus, the philosophy was set in principle, but Jefferson violated it in practice. The pragmatic basis of American prosperity and freedom resided in one fact, about which Jefferson did not delude himself. Land was widely and inexpensively available. If you could own your own land, grow your own food, have a safe abode, you need not be beholden to any man or any ruler. Material self-sufficiency in an agricultural society of affordable land for the many was the source of freedom and "happiness."

But laissez faire economic policy would not make this possible. Jefferson bought the Louisiana territory from Napoleon for \$15 million, which he agreed to borrow. He willingly defied the Constitution's limits on his authority to do so without congressional approval. In most other matters, he rigidly abided by the Constitution. Given the importance of land to America's material, social, and political objectives, though, he did not stand on strict ideology.

But there was another critical choice Jefferson made. The broad distribution of land he thought ideal could be accomplished only through government control and regulation. The federal and state governments owned almost all the unclaimed

land at the start of the nation, and Jefferson was among the early political leaders who were determined to be sure the land was sold at affordable prices and was widely owned. To him, “the foundation of freedom in the United States rested on the abundance of its lands.”<sup>50</sup> In fact, early in his political career, he proposed that his home colony, Virginia, give fifty acres of land to every citizen. Virginia would not implement his lofty goals in the state constitutional convention, though Jefferson had successfully rid Virginia of some of the feudal trappings of the Old World, including entails and primogeniture.<sup>51</sup> Entails prohibited land to be divided and primogeniture required that all land be passed on to the eldest son. Thus, in England, huge private landholdings could be retained under legal protection from the Crown.

Jefferson wanted to regulate the distribution of this new land. After the Revolution, the states confiscated the holdings of the Loyalists. Jefferson’s state, Virginia, claimed the most land. When Virginia willingly ceded its land to the new Continental Congress, however, Jefferson demanded that it be done only if the land was sold according to the practices and principles he with others had conceived. His Virginia homesteading plan, which served as a guideline for the later federal territorial ordinances of the 1780s, required formal surveys and the division of land into sellable units of a limited size and at a fixed price. Thus, the influence of speculators, though hardly eliminated, was significantly reduced, and the ownership of land and its division into small plots was achieved.<sup>52</sup>

One historian computes that “about two thirds of white household heads owned land in places as different as Pennsylvania and Virginia. Such high levels of landownership persisted: about half the adults over twenty-one held land in 1798, and similar proportion owned land in early nineteenth century Tennessee and Ohio.” There were still enormous land

baronetcies—to which the great mansions on the upper Hudson River attest to this day—but three to four out of five workers who worked the farms in America owned them.<sup>53</sup>

This was a powerful use of government, even if land availability compared to the size of the population made low prices easier to implement. Federal laws controlled the sale of government land well into the twentieth century. Squatters were guaranteed low prices to acquire their land in the 1830s. The Homestead Act of 1862 controlled the sale of federal land for decades afterwards.<sup>54</sup> As the historian Frank Bourgin points out, the federal government was by far the largest owner of land in the nation, holding some 1.6 million acres at one point. It could have been a significant source of federal revenues.

Jefferson's famed advocacy of free trade and low tariffs was also grounded in practical needs, not ideological ones. Maintaining open markets and minimal tariffs would guarantee export markets for the sale of farmers' produce. It would keep the farmer strong and independent.

Jefferson's fear of big financial speculators was similar to his distrust of free-market speculation. To him, Hamilton's first Bank of the United States was a dangerous extension of the power of Eastern elites, and ultimately threatening to small farm owners. As for the new manufacturing industries, these too would eventually be controlled by elite interests, he believed. On this important point, Jefferson departed from Adam Smith's principal argument. For Smith, the source of wealth was the division of labor, which enabled farmers or manufacturers to increase output per hour of work and hire many laborers; it was the source of productivity growth.

But Jefferson could not ignore the rapid changes in the economy at the turn of the century. On balance, America prospered. "Never before," wrote Henry Adams in 1879 in his *Life of Albert Gallatin* (Jefferson's Treasury Secretary), "had the

country enjoyed so much peace, contentment, and prosperity.”<sup>55</sup> Markets for produce were growing and transportation was ever more available along the coast and into the interior. As the nation’s income grew, farming was less a means of self-sufficient production and more part and parcel of a burgeoning commercial market. Farmers increasingly bought land on credit and had to cultivate and sell their crops regularly in geographically widening markets to meet their debt service. There was a clamorous demand not merely for free trade with Britain and Europe but also better roads and new canals in emulation of the great domestic transportation systems of Britain, France, and the Netherlands.

For all his disdain for government, Jefferson always sought to set aside federal land for schools. He was initially ideologically hesitant to use federal moneys for new roads, but by his second term he had changed his mind regarding the federal financing of roads. He even began to concede the inevitability of manufacturing.

If his view of the purposes of government could be summarized at all, it was best captured by a British writer, Thomas Cooper, in his book, *Political Arithmetic*: “Prohibit nothing but protect no speculation, at an expense beyond its national value. . . . Cut the cost of government, eliminate direct taxes and spend customs revenue on domestic investment . . . improve your roads, clear your rivers, cut your canals, erect your bridges, facilitate intercourse, establish schools and colleges, diffuse knowledge of all kinds . . .”<sup>56</sup>

Jefferson had already approved the building of the Cumberland Road to connect the Potomac and the Ohio Rivers in 1806, which would become the largest public works project undertaken until the Erie Canal. He asked Albert Gallatin to prepare a comprehensive program of roads and canals to be implemented once the national debt was nearly paid off. Gal-

Jefferson drew up an ambitious ten-year plan for the development of transportation that would cost a stunning \$20 million, to be financed with bonds and paid off over time through tariffs and land sales. Jefferson believed a constitutional amendment was needed to authorize the spending. Perhaps he would have gotten it, but the embargo he imposed in 1808 on trade with Britain ended all such ambitious plans. "The planning that took place in Jefferson's second term of office remains to this day so little known," writes Frank Bourgin, "that the student of American history must marvel at this fact."<sup>57</sup> Bourgin focuses on the essential characteristic of American policy when it succeeded, which was when it responded to change willingly and constructively.

### *The Many Uses of Government in the 1800s*

As Garry Wills writes about the early American historian Henry Adams, he "believes that the Republicans transcended both parties and party ideology itself, to become that most American of things—pragmatic. . . . Adams is right to say that Jefferson represents the best of the American people, since they are a pragmatic people."<sup>58</sup>

Madison, Jefferson's successor, recognized full well that soon enough land ownership in America would not serve the political and democratizing function it once did. Eventually, there simply would not be enough land and there would be no recourse but to encourage manufacturing. But could wage labor replace the farm as a source of personal freedom? Madison had his doubts. He worried America would one day be as populous as Europe.

After the War of 1812, Madison pragmatically signed into law a new tariff to protect domestic manufacturing, which in

general Jefferson had opposed. He supported the renewal of a charter for a second national bank, again anathema to Jefferson. He would not fully support federal financing of internal improvements, however; like Jefferson, he argued a constitutional amendment was necessary.

It was admittedly difficult to imagine American going fully down the road of Europe, toward manufactures and vast new transportation systems. Adam Smith was taken only for what was useful to his various American readers. America had a touch of utopia to it. Even a Federalist like Noah Webster remained skeptical of the promise of a wage society. He captured the romance of America:

A man who makes heads of pins or springs of watches, spends his days in that manufacture and never looks beyond it. This manner of fabricating things for the use and convenience of life is the means of perfecting arts: but it cramps the human mind, by confining all its faculties to a point. In countries thinly inhabited, or where people live principally by agriculture, as in America, every man is in some measure an artist—he makes a variety of utensils, rough indeed, but such as will answer his purpose—he is husbandmen in summer and mechanic in winter—he travels about the country—he converses with a variety of professions—he reads public papers—he has access to parish library and thus becomes acquainted with history and politics, and every man in New England is a theologian. This will always be the case in America, so long as there is a vast tract of fertile land to be cultivated, which will occasion emigrations from the states already settled. Knowledge is diffused and genius aroused by the very situation of America.<sup>59</sup>

Maintaining this condition was not the long-term path to a productive economy, however; it was unlikely it could be sus-

tained. (Smith also was concerned about how wage labor would affect the population.) The clamor for new roads and canals grew louder. Farmers needed markets, workers needed jobs. Webster's romance did not apply to everybody. Gallatin's original 1807 plan attracted support after the Treaty of Ghent, which ended the War of 1812. John Calhoun, the powerful and persuasive congressman from South Carolina, was, along with House Speaker Henry Clay, the serious proponent of a new broad plan for internal improvements, which became familiar as "the American system." It was much along Gallatin's original lines.<sup>60</sup> But Madison could not get past his constitutional concerns and vetoed Calhoun's bill. Monroe was also sympathetic to federal development of roads and canals but he too hesitated, and made only modest headway on internal improvements.

In 1824, the Federalist John Quincy Adams, John Adams's son, was elected president, and was determined to expand the roads and canals. Bourgin calculates that under his administration the federal government spent more than in all previous administrations on roads and canals. But Adams never had broad political support for his programs and Andrew Jackson, who almost won the presidency in 1824 and was opposed to all such federal investment, was more than just nipping at his heels. With the rise of a new vitalizing democracy, and as more white males won suffrage and exercised their power in local and national elections, fear of central government rose. Jackson won the presidency in 1828, and stuck devotedly to his conviction that internal improvements were the province of state governments, not the federal government. The rhetoric of *laissez faire* was re-ignited under Jackson.

State and local governments started compensating for the lack of efforts by the central government. Frustrated by the Republican leadership in Washington since Jefferson's presi-

dency, many Republican followers of Jefferson and Madison returned to their home states to implement new policies there in response to growing opportunities and rapid commercial expansion. Commercial pressure for new transportation systems was intense. Private investment could not support the needs, largely because private investors did not have adequate funds nor would any single one or even a consortium of them reap all the gains. Turnpike companies went bankrupt right and left, for example, but the roads provided benefits that went far beyond the traveler.<sup>61</sup> They, like all transportation venues, carried customers and workers, goods and services, news and fashion, information and technology—all of which expanded markets and helped business.

States had been supporting modest transportation projects for a couple of decades. Frustrated by inactivity in Washington, the Republican senator from New York, DeWitt Clinton, returned to his home from Washington in 1803 to become mayor of New York City and later governor of the state, where he was eventually responsible for initiating work on the Erie Canal. The canal was easily the major public works project of the age and was financed largely with state-sponsored bonds.<sup>62</sup> It took many years to get the project started, in part because of the war with Britain. New York State had in fact been building roads for some time before it finally started the Erie Canal in 1817; it was completed eight years later. In addition, in this period, New York's legislature made some twenty-eight major loans to manufacturers, claiming "the establishment of useful manufactures is clearly connected with the public weal."<sup>63</sup>

In general, the states borrowed far more than the federal government until the Civil War, and invested several times as much in transportation. Pennsylvania, Maryland, and Massachusetts, among others, made significant investments in canals and other public works. On balance, state government

supplied more than two thirds of the money for the emerging nation's new canals.<sup>64</sup> They had invested substantially in other business, including local banks. And they were already supporting the railroads through land grants and with other financial subsidies. A Pennsylvania legislative document stated point blank that, "works of public importance deserve public encouragement."<sup>65</sup>

Local governments also issued hundreds of charters for corporations to do business. By contrast, such charters were more difficult to win in England, enabling government to restrain competition.<sup>66</sup> Similarly, the courts made major decisions promoting freer and more open competition among businesses, notably with the Charles River Bridge decision by the Supreme Court in 1837. The decision granted the right of another company to build a competitive bridge across the Charles. The courts overrode powerful and entrenched Harvard. This was in keeping with the Jacksonian anti-elitist spirit, which was more favorable to business competition than is realized.<sup>67</sup>

But the rise of laissez-faire attitudes under Jackson contributed significantly to America's philosophical skepticism of government and a diminished role for federal government until the Civil War. Jackson undid the Second Bank of the United States, distributing federal deposits to his beloved local banks throughout the states, and winning still more popularity with his growing constituency. Yet he defended tariffs to protect local industry and refused to side with southern planters in their attempts to "nullify" federal law. He sent federal troops to South Carolina to assert federal authority.

Jacksonian history is too complex to encapsulate here. Elite control of banking, for example, which he deplored, was not ideal by any modern standard. And even he could be a pragmatist at times. Still, it is hard to ignore the losses that could have been avoided in developing national infrastructure brought

about by his vetoes of such legislation, and the loss of financial stability brought about by the demise of the bank. Some middle ground would have been valuable.

Support of primary education infused by the democratic spirit mixed with public investment successfully in these years. The Founding Fathers were generally committed to providing education for the people; Jefferson was one of the early leaders. But it was local government, particularly in New England, which encouraged and directed serious investment in primary schools through local taxation, mostly of property, beginning in the early 1800s. The public school system before the Civil War was the first major example of an income redistribution policy in America, because all property owners paid taxes and provided free education even for the poor. Originally, in fact, families were required to pay tuition for their children to cover part of the costs, but these charges were eventually eliminated. In 1827, for example, Massachusetts early on made it mandatory for towns with fifty or more families to provide free schooling, and other states followed the precedent.

By international standards, schooling in America was a remarkable success. More than half of the school age population was enrolled in primary school by 1850.<sup>68</sup> More specifically, 681 of 1,000 aged five to fourteen were enrolled in school; in Prussia, renowned for its education, the ratio was 732 per 1,000, only slightly higher; in England, the ratio was only 498 per 1,000 and in France only 515. France spent a larger proportion of its national income on education, but the United States spent as much per child. England was far behind in spending. The resulting literacy and rudimentary math skills contributed significantly to economic growth.<sup>69</sup>



After the Civil War, the nation entered a new age of rapidly advancing industrialization and large mass production and distribution industries. Big business was on the rise in America and became indomitable. Coal, steel, and machinery grew into enormous industries. Sewing machines, wooden wagons, cigarettes, breakfast cereals, chewing gum, frozen meats, processed sugar and flour, and store-bought clothing and linens were the great new consumer products. Large retail chains like the Atlantic and Pacific Tea Company flourished, along with department stores. Oil and gas were being used to light homes and cities. The steamship dominated the waterways and ever faster and more powerful trains and railroads that they ran on spread like spider's webs across the continent. Workers were drawn to the factories and mines, as were millions of new immigrants. The mills in Lowell once hired as many as three hundred workers, and were thought miracles of organization. In a generation, factories had thousands of workers. "Increasingly, wage labor, rather than ownership of productive property, became the economic basis of family survival," writes Eric Foner.<sup>70</sup> The profile of the nation became more urban, and the frontier literally and figuratively receded. Wage labor replaced farm labor in America.

Even as business grew at unprecedented rates—and the power of big business was never greater due to its size and financial wherewithal—the federal government had a critical part in the nation's economy. It was still the nation's greatest landlord. Through donations of land, partly under the influence of the rich financiers, of course, the federal government aggressively subsidized the development of the railroads; a reasonable figure is that it provided approximately half the financing for the revolutionary and highly productive national transportation system. This constituted a use of government where a subsidy was provided, just like a tax exemption or tax

credit today. The government lost potential revenues by giving the land away rather than selling it.<sup>71</sup>

It is not clear that the private development of the railroads—grounded in intense speculation and resulting in frequent bankruptcy, and supported by government subsidy and plenty of pork barrel legislation—was ideal. It was a highly uncoordinated system, and to this day the national rail system is hardly a model of design. Germany managed its railroad development efficiently. But in the United States, government’s participation in growth of the railroads was essential as a provider of capital.

Similarly, government used land to finance the first state colleges. These were started under the Morrill Act, passed in 1857, and extended in 1862. Lincoln was an advocate of the legislation. Federal land was granted to each of these educational institutions to finance themselves. If there wasn’t enough federal land in a state, the university was granted title to land in another state, and the proceeds from the sale were to be used to sustain the college. The colleges were dedicated to the study of agriculture and the “mechanical arts,” and the foundation was laid for one of America’s exemplary achievements—the state university system. Cornell University in New York, the University of California at Berkeley, Ohio State, Pennsylvania State, Rutgers in New Jersey, Texas A&M, and the Massachusetts Institute of Technology, among many others, were started under this program.

The United States also expanded its postal system throughout the century. Mail was delivered routinely from city to city by pony express, the waterways, and eventually the rails. By the 1860s, major cities had post boxes on street corners; before that, people had to take their letters to the post office. The federal postal system in turn provided a steady demand for

new transportation venues—roads, waterways, and the railroads—thus aiding in the development.

The nation's defense requirements created demand for new firearms, which made possible critical mass production innovations that America pioneered. With a guaranteed contract, the Springfield Armory created a system of interchangeable parts before the Civil War that enabled the company to divide the functions of making a single rifle among many workers, much as Adam Smith noted a pin could be divided into eighteen separate manufacturing tasks. British firearms were still hand-crafted laboriously and beautifully; American firearms were made rapidly, practically, functionally, and at much lower cost. This system became the forerunner of a mass production revolution in the United States, culminating in the thousands of interchangeable parts needed to put together one of Ford's Model Ts. It began with government contracts.

The donations of federal lands for the development of the railroads and the land grant colleges—direct investments in American productivity—are not recorded as government expenditures though, and thus escape attention as a government outlay, but the potential revenue from land sales that was foregone was enormous.

Politically, the great achievement of the Civil War, aside from ending slavery, was the establishment of an uncontested national government. Jefferson and Madison had favored a dominant role for states, whose governments were by their nature closer to the people. Though loyal to the principle of small government, however, Jackson as noted successfully opposed nullification.<sup>72</sup> For Jackson, points out the historian Thomas Bender, the Union and the states became concurrent powers. For Lincoln, however, the Union superseded the states.<sup>73</sup>

(continued)