

Government v market in America

The visible hand

May 28th 2009 | INDIANAPOLIS AND WASHINGTON, DC

From *The Economist* print edition

Americans have grown slightly more receptive to the idea of an activist government. Will they go along with Barack Obama's aspirations?

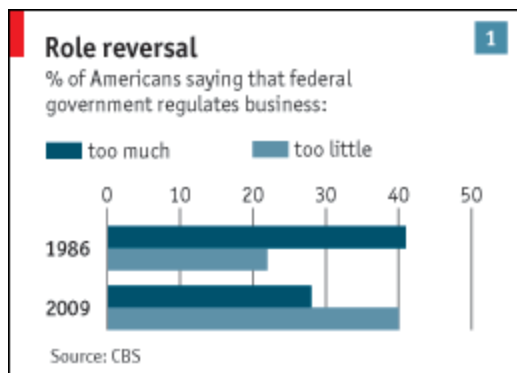
THE demonstrators thronging the steps of the war memorial in central Indianapolis are a small but spirited bunch. Steps away from the head office of one of the country's biggest health-insurance companies, they chant slogans calling for a single government-run health plan and wave signs with slogans like "One plan one nation" and "Patients not profits". One cheekily advises: "Accept personal responsibility. Do your own colonoscopy". After pursuing their cause for years, advocates of universal health care got a jolt of energy when Barack Obama took office. "Something happened in January that changed our cultural story for ever," a folk singer tells the crowd before launching into a song, "If not now, tell me when." Across the street, an argument breaks out. Dennis Majewski, a public-defence lawyer, agrees with the protesters. "We'll never rebound until we have national health-care insurance." But should the government look after "a known druggie whose drug habit gets him to the point he is seriously ill?" queries his cousin, Tom Majewski, a retired executive. Well, yes, says Dennis: "That person has a serious illness." Tom shoots back: "But it's a choice!"

The debate in Indianapolis is a microcosm of a broader re-examination by Americans of government's role in the economy. Private risk-taking run amok has plunged the country into its worst recession in decades. Partly in response, Mr Obama and Congress are exploring ambitious new ways to expand the government's responsibilities.

Mr Obama has been elusive on where he believes the boundary between government and the market should be. "The question we ask today is not whether our government is too big or too small, but whether it works," he said in his inaugural address. Yet his actions belie that agnosticism. Most of the big domestic initiatives taken since he became president involve expanded federal-government activity, either temporary or permanent. They include more oversight over the financial system and executive pay, extending health insurance to the 15% of Americans who lack it, shifting energy consumption from fossil to renewable fuels, and redistributing income from the wealthy to the middle-class. Congress is even more unabashedly activist. On May 22nd it passed by overwhelming majorities the most sweeping crackdown on the credit-card industry in decades. Even its name, the "Credit cardholders' bill of rights", suggests not just a set of rules but a treaty between business and the people. Now that credit cards are as vital to life as telephony or electricity, they will be regulated as such. But are Mr Obama and Congress in tune with America? Laissez-faire has clearly lost some lustre since Ronald Reagan was president. Yet a survey by the Pew Research Centre, released on May 21st, shows that Americans still like business. It found that 76% agree that the country's strength is "mostly based on the success of American business", and that 90% admire people who "get rich by working hard", proportions that have changed little in two decades. People are, however, jaded by business's excesses: just 37% of respondents believe that business strikes the right balance between profits and public interest, the lowest proportion since Pew began asking the question in 1987.

This undoubtedly helped fuel the country's shift to Democrats in the last two elections. Indiana, solidly Republican for years, has recently become a swing state. In 2006 its nine seats in Congress shifted from 7-2 in favour of Republicans to 5-4 in favour of Democrats. Mr Obama carried it in the 2008 presidential election, the first time a Democrat had done so since 1964.

On the other hand Mitch Daniels, Indiana's Republican governor, was re-elected by a wide margin. Mr Daniels suggests it is too soon to say that Americans want bigger government. Indiana voted for Mr



Obama because it wanted change. “He got a significant crossover vote in the Republican suburbs,” admits Mr Daniels. But he goes on to say: “Those people did not become French in the last five months.” He argues that Mr Obama will lose the state in 2012 if he pursues what the governor derisively calls “shock and awe statism”, such as the caps on carbon emissions that are so unpopular in coal-reliant Indiana.

Polls back him up: Pew finds that Americans still think the federal government controls too much of their lives.

Andrew Kohut, president of the Pew Research Centre, sees a parallel with 1981, when polls showed high approval for Reagan coupled with anxiety about his policies, such as cuts to Social Security (government-funded pensions) and welfare. Reagan may have wanted to push the country further right than it wanted to go. In 1982, with the economy deep in recession, voters punished the Republicans in the elections. Polls show that the increased trust in government is almost entirely limited to Democrats. Republicans are more distrustful, and the views of independents have not changed much. This seems to suggest that what looks like increased faith in government is actually faith in Mr Obama. Yet history suggests that many of Mr Obama’s expected moves towards big government, however controversial they may be, will in the end turn out to be permanent.

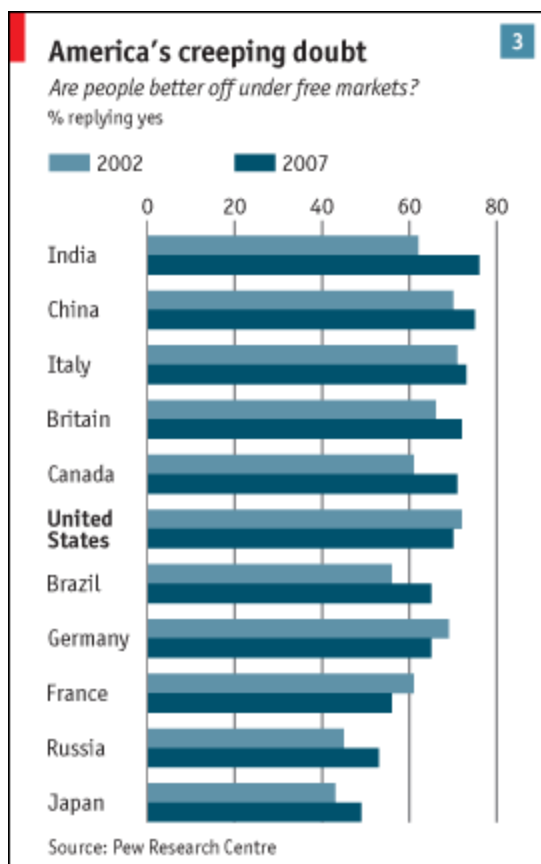
A history lesson

Americans trace their mistrust of government to their roots. The country was founded by refugees from state-sanctioned religious persecution who later revolted against English-imposed taxes. “The natural progress of things is for liberty to yield and for government to gain ground,” said Thomas Jefferson. Henry David Thoreau, writing some years later, mused: “I heartily accept the motto, ‘That government is best which governs least’ ... It finally amounts to this, which also I believe, that government is best which governs not at all.”

This self-portrait, however, has always been as much mythology as fact. The constitution, often portrayed as designed to shackle government, actually imposed a structure that the earlier Articles of Confederation lacked, notes Garry Wills, a historian. “We are pious toward our history in order to be cynical toward our government,” he wrote in “A Necessary Evil”. Thoreau’s anti-government, anti-tax crusades captured American sentiment, but he never had much of a following.

The federal government was tiny for much of the first century of the country’s existence, then expanded steadily. Industrialisation and unionisation led to an era between the 1890s and early 1920s that brought antitrust laws, regulation of interstate commerce, income tax and the regulation of food and drug quality. Price Fishback, an economist at the University of Arizona, writes that the ideological bias against government began seriously to retreat in the face of the Depression and the two world wars, so that “by 1950 the majority of elites and the general public easily turned to government when they saw a problem they thought should be solved.”

Crises usually bring about clamour for more government. It sometimes shrinks afterwards, but never back to its original size. The federal government first issued a national currency to finance the civil war. Financial panic in 1907 led to the creation of the Federal Reserve in 1913. The Depression led to the creation of the Securities and Exchange Commission and the Federal Deposit Insurance Corporation to safeguard the financial system, and the Federal National Mortgage Association (Fannie Mae) to develop a national mortgage market. The federal safety-net came into existence with Social Security and unemployment insurance. The second world war cemented the conviction that an active government was needed to preserve full employment, a belief that was codified in the 1946 Employment Act.



The first concerted effort to roll back some of this power began under Jimmy Carter with the deregulation of airlines, transport and banking. Reagan turned the trend into a governing philosophy, declaring on becoming president in 1981 that: "Government is not the solution to our problem; government is the problem." In 1986 a CBS News poll found 41% of respondents thought the government regulated business too much and 22% thought it regulated it too little (a view that has now been reversed; see chart 1). Reagan's enduring legacy was to entrench lower taxes as part of small-government philosophy. Lower taxes seized the public's imagination in a way that deregulation never has. Even so, the government did not actually shrink under Reagan; it merely stopped growing. Federal spending, excluding defence, grew from less than 5% of GDP at the outset of the Depression to around 16% in the late 1970s, and has remained there until now (see chart 2).

For the next two decades, small government remained the stated preference of presidents, including Bill Clinton, who in 1996 declared that "the era of big government is over." Though there was only a little true deregulation in this period, financial innovation grew most where regulation was lightest. The fastest-growing derivatives, for example, were not covered by commodity-futures

laws, and the fastest-growing subprime lenders were not banks and thus not federally regulated.

The swing back towards more activist government began under George Bush, partly in response to new crises. The terrorist attacks in 2001 led to the creation of the Department of Homeland Security, the Patriot Act, the federalisation of airport security, an expansion of money-laundering rules and federally subsidised terrorism insurance. The stockmarket collapse led to the Sarbanes-Oxley act overseeing corporate governance and accounting standards. Mr Bush was happy to expand government in order to maintain Republican hegemony so long as he could also cut taxes; that this meant a larger budget deficit was not a priority for him. He thus introduced a costly drug benefit for the elderly.

Household income stagnated as energy and health-care costs rose and more of the gains in income went to the wealthy. One result was that Americans, traditionally fonder of the free market than the rest of the world, became less so. In 2007 an international survey by Pew found that American support for free markets had edged down from five years earlier. Yet in most countries it rose, especially in the developing world (see chart 3). The globalisation that had benefited them so much had unsettled Americans, many of whom blamed stagnant wages on competition from poorer countries.

Thus the arrival of the financial crisis found Americans already souring on unconstrained capitalism. Luke Kenley, an influential state senator from Indiana, sees a philosophical divide along generational lines. People over 50, such as himself, "have a great comfort level with the American free-enterprise system", and recognise the current turmoil as the marketplace correcting its own previous excesses. But his own grown-up children do not share that faith. His son John, a lawyer aged 38, suggests that "Reagan had a time and a place, but those messages don't resonate." The disaster in the housing and mortgage markets shows that free markets don't always get incentives right or generate the information people need to make wise decisions. There may be times, he adds, when government is better suited to giving people the information they need.



The financial crisis propelled Mr Obama into the White House and he has aggressively exploited the opportunity. Some of the ways are obvious: he is using the government's ownership stakes in banks to change how they pay their executives, and its control of General Motors and Chrysler to boost their production of cars that use alternative fuels.

Mr Obama explained his thinking on May 22nd on C-Span: "We want to get out of the business of helping auto companies as quickly as we can... In the same way I want to get out of the business of helping banks. But we have to make some strategic decisions about strategic industries."

Other approaches are a bit more subtle. Much of the \$787 billion federal stimulus package passed in February goes to the states, but only if they comply with federal guidelines on how to spend the money. For instance, to obtain additional federal assistance for

unemployment insurance, states must make more workers eligible for benefits, in particular part-time workers.

Many states have revolted against such conditions, arguing that they will saddle states and employers with added costs long after the stimulus money has run out. Republican governors in South Carolina, Alaska, Louisiana, Mississippi and Texas have made a show of refusing some of the stimulus money. Indiana has so far turned down the unemployment-insurance money but took most of the rest, although not enthusiastically. Mr Kenley flips through a thick wad of paper on his desk. It contains the federal guidelines a state must follow to get education-stimulus money, such as ensuring that poor and minority children are not taught disproportionately by unqualified teachers. Federal money to weatherproof poor families' homes must be channelled primarily through non-profit groups. It is the micromanagement that Mr Kenley objects to, not the goals: "They're going to control your behaviour with specifications and regulations. It's a tough pill to swallow, but we have to take the money and do the best we can."

Reuters **The angry ones**

Governor Daniels, who was a budget director under Mr Bush and has impeccable conservative credentials, has a more nuanced view. "People in a time of difficulty and apprehension are looking for energy, for active government, but that doesn't necessarily mean statist government. People... are still suspicious, though maybe a little less so, of government."

Accordingly, in 2007 Mr Daniels raised cigarette taxes to pay for health insurance for poor families who could not afford to have it. Mr Kenley opposed him, arguing that it would be more appropriate to encourage people, through the tax system, to provide for their own care. Mr Daniels's response was: "You need to do this or you'll end up with single payer [the single scheme that the protesters in Indianapolis were calling for]." He argues that reducing the number of uninsured by discouraging smoking does not conflict with Republican principles: "If it's not conservative enough for some, that's one of my rare heresies."

Robert Stone, an affable, bearded emergency-room doctor who organised last week's demonstration in Indianapolis, says it is encouraging that a conservative governor like Mr Daniels is willing to raise taxes to pay for expanded health care. But not, he goes on to say, if this is just a substitute for universal access. Mr Stone has run up small victories in the past year. In January the city council of New Albany, in the conservative southern part of the state, passed a resolution supporting a single-payer health plan. But Mr Stone has been unable to persuade many of the state's senior Democratic politicians to endorse the idea. Baron Hill, a Democratic congressman who represents the southern part of the state, has sounded sympathetic, and has even invited Mr Stone to address the Blue Dogs caucus of fiscally conservative

Democratic congressmen. But, to Mr Stone's frustration, he has yet to set a date. Government-run health care is still anathema to many Americans. Mr Stone received a reminder of that the day before the rally; a vitriolic letter decrying "so many socialist if not communist [sic] working against the best social economic and progressive system in the world, capitalism."

Can he get away with it?

Mr Obama, too, is aware of the emotional opposition that government ownership can elicit. He once advocated a single-payer system, but has since said that would make sense only if starting from scratch; now, he vows to work within the current system of employer-based health care. He has advocated a public plan similar to the federally funded Medicare plan (which is only for retirees) to compete with private plans, but even that is open to negotiation.

That scaled back goal, like many of Mr Obama's ambitions, faces a daunting obstacle: money. The economy has turned out weaker than the president expected, depriving him of hoped-for tax revenue. Congress is inclined to give away rather than sell permits to emit carbon dioxide in its cap-and-trade programme. Meanwhile, polls show high anxiety among voters about record deficits and rising debt. Such fiscal constraints, however, do not apply to new regulations. The costs will be difficult to identify, notes Robert Litan, a scholar at the Kauffman Foundation, a think-tank. Mr Obama, for example, has said his administration will be less inclined than its predecessor to invoke federal rules to shield companies from state consumer-protection laws. That means companies face a higher risk of product-liability suits, which could discourage innovation and restrain growth.

The public, however, will not see those costs, and thus probably will not care. "The public is not in a discriminating mood when it comes to regulation," says Mr Litan. "If it addresses something they're angry about, like executive compensation, fine. As for everything else, the public wants more certainty and less anxiety in their lives." In a few years, the question will be: "Did Obama move us out of the cellar? If the answer is yes, they won't care about the details.