August 10, 2012

"This is the great danger America faces. That we will cease to be one nation and become instead a collection of interest groups…each seeking to satisfy private wants."
-BARBARA JORDAN, CIVIL RIGHTS ACTIVIST AND CONGRESSWOMAN

A third way? Last week's EVA was the first installment in a two-part series on what I believe is one of the most important books in recent years: Woody Brock's American Gridlock: Why the Left and Right Are Both Wrong. Click the following link if you missed last week's issue and want to read it now: https://blog.evergreengavekal.com//client_data/files/2012/520_eva8.3.12.pdf

The reason I feel it is so vital is that it directly confronts our country's most pressing social and economic challenges. It also provides rational and non-partisan solutions to these vexing problems, which, if allowed to continue to fester, threaten our nation's existence as a free market democracy.

Two years ago, I wrote one of the most popular EVAs ever (perhaps that's not saying much) on how Canada extricated itself from its near bankruptcy in the mid-1990s. Then, last fall, we ran a three-part series, A *12 Step Program to Restore Fiscal Sobriety*, outlining ways in which I felt the US could effect a similar turnaround. Thus, these two current EVAs on *American Gridlock* are revisiting the theme of what can be done to halt our slide into national insolvency.

Woefully, in the last two years, almost nothing has been done by our elected leaders to avoid the impending disaster. The leadership vacuum in Washington, DC is utterly deplorable. Instead, a virulent "dialogue of the deaf," as Woody puts it in his book, continues to dominate our national political discourse (such as it is).

How we can break this gridlock we all constantly witness is, of course, the ultimate question. It's my contention that the way we're headed presently doesn't provide much hope. That's why I believe we need to adopt the kind of thoroughly logic-based problem analysis that Woody's book provides in abundance while abandoning our highly emotional and, usually, very biased prevailing mindsets.

It's my opinion that what I only somewhat jokingly refer to as Brockonomics offers a "third way" to solve our economic and social impasses. Given that its basis is rational and centered on universally accepted objectives and principles, it has the ability to transcend the present polarization between ultra-liberals and arch-conservatives.

Lord knows, what we've been doing for at least the last decade certainly hasn't been working. Perhaps it's time to consider a variety of remedial measures that have been proven by some of the most gifted minds the world has ever known. And, just maybe, that's a bit better than the ideas du jour that the mad chefs in DC keep cooking up…

It's the type of deficit, stupid. Last week's EVA noted the challenges that most of the rich world is having with this hard and fast formula: GDP equals consumer spending plus private investments plus government spending and net exports.

Because consumers have been paying down debt, and income growth has been non-existent for years, households are not a source of economic expansion. Similarly, businesses have been reluctant to make the kind of investments that drive GDP. And, with much of the rest of the world fighting against the same gale-force headwinds we've been coping with, exports are hard-pressed to pick up much slack. That leaves the government to do the heavy lifting (or spending).

As we are all too well aware, politicians seem to have no trouble whatsoever expending taxpayer wealth. But with trillion-dollar deficits having failed to catalyze even a normal recovery, the dilemma is becoming ever more daunting.

The ultimate goal for the increasingly sclerotic Western economies (plus Japan) is to boost growth and reduce unemployment without upsetting the bond market. This is clearly no six-inch putt but the US, at least, is in an enviable position to jam the ball in the hole.

Woody gives a simple outline of how this could work by using a tale of two countries, as illustrated by the table below:

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Ok, you might plausibly object that there is some fuzzy math going on with Country B. It "spends" $1 trillion more than it takes in, just like Country A, but it shows no deficit. The key word is "spends" because in the case of Country B it's deficit is directed toward high-return *investments*.

One of my long-standing gripes with US government accounting (one that Woody shares) is that it makes no distinction between a dollar spent on entitlements and one spent to build a bridge or fund a research grant. As Woody points out, entitlement spending is necessary (at least up to a point) but it is unproductive. By contrast, *well-directed* public investing has a "multiplier" of roughly 2.5 to 1.

In other words, each dollar invested in a high-return project produces $2.50 of economic activity (think of the cascade of hiring and spending that would occur should the government decide to build a network of natural gas filling stations along the interstate highway network). Woody's overarching point is that there are good deficits and bad deficits. Sorry, Dick Cheney, deficits, or at least their composition, do matter.

While this approach makes intuitive sense, there are two huge objections from skeptics. One is the Japanese experience over the last 20 years. The now infamous phrase "bridges to nowhere" originally referred to Japan's futile effort to revive its own post-bubble economy by erecting bridges where they weren't needed. The Land of the Rising Sun (and Deficits) even resorted to paving over riverbeds in a futile attempt to put the shock paddles to its once vibrant economy.

Yet, as Woody points out, there is a huge difference: Back in the 1990s, when Japan launched its "investment" spree, it already had a world-class infrastructure. America, however, has been under-investing in its physical asset base for at least 30 years. He notes that it's also a given that if *certifiably productive* infrastructure investing enhances an economy's growth, then under-investing is a drag on growth. Credible estimates are that the US needs to invest at least $1 trillion annually to rebuild its infrastructure network.

Additionally, I would point out, the US can presently borrow at next to nothing. Both Woody and I believe the bond market would actually welcome the Country B scenario versus the present situation of running $1 trillion deficits ad infinitum with almost nothing to show in return. This would allow us to fund our makeover at an almost outrageously low cost (but, hey, there should be a payback after all we've done for the world over the last 70 years!).

Of course, there is another more recent and proximate reason to question how effective this would be.

Time to Marshall our resources? The other big objection to a domestic Marshall Plan-type program is the inept execution of the 2009 stimulus spending package. Remember all the talk about shovel-ready projects? They turned out to be, for the most part, anything but—and the country has very little to show for what was nearly a $1 trillion outlay. Naturally, Woody has a series of logical suggestions on how to avoid a repeat of that sorry experience.

To depoliticize the process, he suggests that a national infrastructure bank be set up, controlled by a panel of very highly paid experts in the field. This is the acclaimed Singapore model that has worked so well at avoiding the corruption endemic with massive public spending projects in most of the rest of the world.

He further proposes structuring these as public/private endeavors, even bringing in foreign sovereign wealth funds to ensure that attractive rates of return are likely. Fortunately, thanks to the work of some of the scholars in Woody's pantheon of geniuses, there are now proven ways, using deductive logic and rigorous math, to accurately score infrastructure projects based on their overall return to society.

One other intriguing point Woody makes is that there are times when private investment returns are much higher than those available for public investing and vice versa. For example, in 1946 there was massive housing demand for discharged GIs and their families. Consequently, returns were quite attractive on homes; therefore, it made sense to build a lot of them. In contrast, 60 years later, in 2006, housing became grossly overbuilt, assuring that future returns would be very poor (little did we now how poor!).

As all investors painfully realize, private returns in almost all areas today are quite low (ironically, housing might be one of the few exceptions). Yet, presently, returns on certifiably productive public infrastructure investments are extremely robust (as a result of the aforementioned chronic underfunding). Or, said another way, the negative growth drags, or hidden costs, of letting our national capital stock continue to crumble are also very high. Avoiding a big negative is the same as incurring a major plus—unless double-entry accounting is somehow wrong after all these centuries of being proven right.

Despite the widespread cynicism toward big public spending projects, the fact of the matter is that the US formerly excelled in this regard. Not long ago, our national infrastructure was the envy of the world. The national interstate highway system, the internet, our energy grid, our water systems (including a vast network of hydroelectric dams), and countless medical breakthroughs were all heavily funded by public finance, with enormous social payback.

Is it really impossible for us to devise a process whereby we make the infrastructure investments we desperately need? Have we really fallen so far as a society that such a plan is not feasible? We better hope not because, frankly, I don't see any other way to resolve the conundrum of enhancing growth while placating the bond market.

Ok, let's take a deep breath and tackle the 80 trillion pound gorilla in the room (hey, even in dollars that's a lot of dough): healthcare and the bleak reality that it is bleeding red ink like Greece on any given day.

Code blue for healthcare. As highlighted in numerous past EVAs, the US spends more than 18% of GDP on healthcare. This is about 5% more than our closest peer country, a mind-blowing extra $800 billion annually. Yet, pathetically, we rank 50th in the world in terms of life expectancy! Talk about no bang for the buck—or $800 billion bucks!!

There are myriad causes of this but what's undeniably clear is that left on its present course the costs of providing medical care to our aging population will bankrupt America. Of course, we do have a shiny new Affordable Care Act (ACA) to save us from this totally predictable self-destruction, right?

Before I answer that, let me state that I'm not sure whether Woody is Republican or Democrat or an old-fashioned New England independent. I do know that the gushing reviews of his book appear to be bipartisan, with the strongest plugs from influential Democrats like Mort Zuckerman and Felix Rohatyn.

Moreover, Woody has come to believe—due to the exacting, logic-based work of those he respects—that easily accessible and affordable healthcare is in our country's best commercial interest. He cites the work of one of his icons, Kenneth Arrow, whose 1953 and 1963 essays conclusively proved that "the norm of economic efficiency *alone* implies the need for greater risk-sharing and for some version of universal coverage." Thus, even ignoring moral arguments, affordable and accessible healthcare makes good business sense.

However, despite its laudable goals, Woody believes—and convincingly asserts—that the Affordable Care Act will turn out to be immensely unaffordable. Why? Because of the most basic and immutable laws of supply and demand.

The ACA will by definition spike demand (or, more technically accurate, the demand curve) as tens of millions of new healthcare consumers enter the system. Therefore, supply must rise just as dramatically to avoid aggravating already appallingly high US medical outlays. The worst part is that embedded within ACA are numerous disincentives to supply, particularly those reducing physician compensation.

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Even though Woody labeled this chart worst case, he makes it clear that, given the law as it stands today, it is more likely to be the probable outcome. The pernicious impact on supply has already been emerging for years even prior to the proposed draconian physician compensation cutbacks.

There are 26% fewer general surgeons now than there were in 1981 despite a larger population. The number of college graduates intending to become GPs is down 27% in the last decade. The American Association of Medical Colleges estimates that we will face a deficit of between 124,000 and 159,000 doctors by 2025—and that's before the disincentives of the AHA are considered!

Some of you are no doubt saying "Duh!!" right about now. Yet this massive piece of legislation—one of the most important and sweeping in our nation's history—was drafted with no apparent regard for this disastrous combination of exploding demand and contracting supply. The only two possible results will be rationing or much higher prices—or both. (For the doubters among you, I refer you not only to his main text but to his appendix section on this, which includes six pages of mathematical proof—happy discrediting!). Even today, we are beginning to see this trend with the increasing number of physicians unwilling to take patients on Medicare.

The uplifting message, however, from *American Gridlock* is that we don't need to do a national version of Thelma and Louise by driving off of a very avoidable cliff. Woody proposes numerous rational solutions to both increase supply and subdue demand. These include de-catelizing medical study (i.e., making it much less exclusive while maintaining high standards), deregulating healthcare, automating its delivery (a trend that has momentum but is still in its infancy), allowing more immigrant physicians, tort reform, utilizing lower cost nurse practitioners, and relying on inexpensive in-pharmacy clinics for most procedures (which are typically routine). He believes there is no reason healthcare costs can't experience the kind of price decline seen with phone calls, TVs, and computers, et al.

Again, many of these trends toward healthcare cost rationalization are underway but they need to be accelerated with boosters rockets worthy of a space shuttle launch. Let's not kid ourselves—if we don't take radical reform measures such as these our country will be

DOA—DTUE (Dead on Arrival—Due To Unaffordable Entitlements).

Returning to Woody's dominant message, we need to change the way we think. As a society, we must become more logical and less emotional, and in turn alter the way we communicate with each other, particularly our political "adversaries." We need to go back in time a few decades to where societally beneficial goals were agreed upon (such as that "all men are created equal" or, today, "all citizens have the right to affordable healthcare"). Then rational processes can be designed to provide these (as opposed to an attitude of: "we'll pass the bill and then tell you what's inside").

Undeniably, our society is facing an almost overwhelming number of threats to our future prosperity. Woody certainly doesn't have all the answers. However, as he makes clear, many of the brilliant individuals he's studied, and studied under, have shown us long ago the way out of the jungle in which we are now entangled. If only we would read their maps…

Time for real capitalism—before it's too late. One of the main epiphanies for me in reading Woody's book was how many solutions to our most nettlesome problems have already been created—and validated—through proof-positive means. We simply need to rediscover them and relinquish our current "dialogue of the deaf," where neither side can hear any sound waves emanating from the other camp. If not, we will continue to be caught, as Woody writes, "in the crossfire between Fox and MSNBC. The result is that we are all losers."

As he also points out, the problem with the favorite sport of our elected officials—can kicking—is that the cost of remedial action is skyrocketing. Once again, the unfolding collapse of the European economic model, and its welfare superstructure, should make that inarguably clear.

The rhetoric from the left that all will be ok if we just raise taxes on the "rich" is simply absurd. Entitlement growth, barring sweeping reforms, will totally overwhelm any revenue gains from higher marginal tax rates even ignoring the fact that they generally produce lower collections.

(Bill Clinton showed you can raise rates a little without hurting the economy but he also instituted a number of pro-growth policies. France is going to prove one more time that you can't tax your way to solvency, at least with an already punitive redistribution system. The French are going to make a bad situation much, much worse, in my view.)

The result is that we are witnessing the disintegration of the modern welfare state as we know it, with Europe leading the charge toward the abyss. Conservatives shouldn't rejoice in this as the implications for social upheaval unlike any we've seen, at least since the 1930s, are profound.

In fact, capitalism itself is being questioned as it hasn't been in many decades, perhaps since the Great Depression. Yet, as Woody points out, it isn't true capitalism that should be under the microscope and analyzed to discover its flawed DNA but rather the "bastardized" version. In this perverted iteration, special interest groups have been allowed to distort the efficient functioning of the marketplace. Paraphrasing Adam Smith, the famed 18th century framer of free market principles, Woody writes "true economic efficiency requires perfect competition, that is, a competitive structure free of cartels, oligopolies, (and) monopolies."

Yet, our policymakers have allowed privileged entities to avoid the discipline of a freely functioning market. Another outstanding book I've read recently, *The Rational Optimist*, makes the same point. As its author, Matt Ridley, observes, about the only two areas where costs have risen over the last 60 years, in terms of the number of labor hours to pay for a unit of goods or service, are healthcare and education.

These are both sectors where the US government has been hugely involved in terms of subsidies and where it has permitted de facto cartels. Basically, the relentless competition and innovation that has characterized most aspects of our economy have been largely prevented from impacting healthcare and education. The negative effects of this are immense and continuing to escalate.

Among the many great thinkers highlighted in *American Gridlock*, is Mancur Olson, author of *Rise and Decline of Nations*. Woody summarizes one of his key points with this powerful sentence: "As empires get rich, special interest groups become so entrenched that there is no one left representing the collective interest of the people." Does that strike as much of a chord with you as it does with me?

The younger you are, the more this should resonate. As Woody makes high-definition clear, it's the youth who are being totally disadvantaged (to put it politely) by our current policies. Consequently, it's my suggestion that you buy your son or daughter or young friend a copy of *American Gridlock*. Maybe their generation can do a better job of stewardship with our country's almost limitless resources—human and natural--than mine has done.

IMPORTANT DISCLOSURES