

Cambridge University Press

978-1-107-00414-6 - Economic Politics in the United States: The Costs and Risks of Democracy:

Second Edition

William R. Keech

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ECONOMIC POLITICS IN THE UNITED STATES

Second Edition

This book uses macroeconomic performance to evaluate democratic institutions and processes in the United States. Originally published in 1995, this revised edition gives a more pessimistic assessment than the first did. Employing macroeconomic performance as a lens to evaluate democratic institutions, the author uses public choice and political economy models of political behavior that allow for opportunism on the part of public officials and shortsightedness on the part of voters to see if democratic institutions lead to inferior macroeconomic performance.

We have learned more about how and why democracy can work well or badly in the years since the first edition. It was not previously apparent how much the good economic performance of democracy in the United States was contingent on informal rules and institutions of restraint that are not part of the definition of democracy.

Since that first edition, the United States has experienced soaring government indebtedness, unintended adverse consequences of an effort to make housing more affordable, and massive problems in the financial system related to perverse incentives that were not restrained by public policies, informal institutions, or policy rules. Each of these was permitted or encouraged by the incentives of electoral politics and by limitations on government, the two essential features of democratic institutions.

William R. Keech is Research Professor of Political Economy in the Department of Political Science at Duke University. Keech is the author of numerous books, including the first edition of this book, *Economic Politics: The Costs of Democracy* (Cambridge University Press, 1995), and his articles have appeared in academic journals such as the *American Political Science Review*, *Public Choice*, and *American Economic Review*. Most of his academic career has been at the University of North Carolina at Chapel Hill and at Carnegie Mellon University. He has been president of the Southern Political Science Association and a member of the Council of the American Political Science Association. He received his PhD from the University of Wisconsin at Madison.

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Duke University



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Frontmatter

[More information](#)

To Cody, Tommy, and KC, our grandchildren

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Frontmatter

[More information](#)

Contents

<i>List of Figures and Tables</i>	<i>page</i> xii
<i>Preface to the Second Edition</i>	xiii
<i>Preface to the First Edition</i>	xvii

Note: Italicized sections are new to the second edition

PART ONE: INTRODUCTION	1
1. Macroeconomic Politics and the Costs and Risks of Democracy	3
The costs of democracy	4
Macroeconomic issues provide a lens	9
Some economic issues	10
Are there clear goals and optimal choices for policy?	11
Does the economy regulate itself, or does it need guidance?	11
Rules versus discretion	11
Structure, outcomes, and instruments	12
Some political issues	13
What motivates public officials?	13
The values and wisdom of voters	13
Accountability and independence	13
The meaning of politics and the political	14
Images of the democratic process	14
The democratic process as optimizing	15
The democratic process as pathological	15
The liberal interpretation of voting	16
<i>How and why the United States is a democracy</i>	17
The argument of this book	20

2. Macroeconomic Theories and Their Political Implications	25
Political economics and economic theory: three questions	26
Does the economy regulate itself?	26
What role does the theory imply for public officials?	27
What are the risks of mismanagement due to political incentives?	27
The classical system	28
Early Keynesianism	30
The theory of economic policy	36
Monetarism	36
New classical economics	39
Introducing the time-consistency problem	41
<i>Real business cycles and New Keynesian economics</i>	45
<i>Supply side economics</i>	47
<i>Animal spirits and behavioral economics</i>	48
<i>The state of macro</i>	51
The politics of macroeconomic theory	52
 PART TWO: MODELS OF MACROECONOMIC POLITICS	
IN A DEMOCRACY	55
3. Models of Accountability and Opportunism: The Electoral Cycle	57
Passive voters and casually opportunistic politicians	58
The strategy of modeling	60
Passive voters and maximizing opportunistic politicians	61
Sophisticated citizens as economic agents and as voters	65
Rational expectations models of political manipulation:	
Raising the question of competence	67
<i>The possibility that cycles might be induced by private behavior</i>	69
A brief look at some empirical evidence	70
In transition	72
4. Models of Choice: Partisanship	74
From electoral cycle to partisanship	75
Sources of partisan differences	76
A basic model: Party differences on a stable menu of choices	79
The issue of compatibility with economic theory	82
Normative issues	84
Strategic considerations and the need for a theory of change	85
Party differences in a world without a stable Phillips curve	89
The idea of a natural rate of unemployment	89
A welfare function for a natural rate world	91

<i>Contents</i>	ix
Partisan differences in a natural rate world	92
Uncertainty and “characteristic mistakes”	93
The electoral cycle as an artifact of Republicans following Democratic “mistakes”	94
Studies of partisanship embedded in models of the economy	95
Conditional partisanship and secondary partisanship	98
Party differences as secondary consequences	99
Reversibility and limiting the choices of successors	100
Dimensions of choice in a world of asymmetric information	103
Costs of democracy in partisan models	103
Polarization	104
Dispersal of power	106
Congruence between partisan alternatives and economic institutions	106
5. <i>Unintended Consequences, Moral Hazard, and Time-Consistency</i>	108
<i>Democratic institutions and fiscal problems before the financial crisis</i>	110
<i>Electoral politics and deficit spending</i>	111
<i>Democratic institutions and processes and the emergence of the financial crisis</i>	112
<i>Democracy and financial crises in general</i>	112
<i>Moral hazard and democracy</i>	113
<i>Housing policy in the United States: Unintended consequences of good intentions</i>	114
<i>Links to democratic institutions</i>	117
<i>The failure to see danger signs is human nature</i>	118
<i>Democratic institutions and processes and the response to the financial crisis</i>	119
<i>The time-consistency problem</i>	119
<i>A “Greenspan Put”?</i>	121
<i>Reforms that would minimize vulnerability to comparable crises in the future</i>	122
<i>Conclusions</i>	124
 PART THREE: THE SOURCES AND AUTHORITY OF MACROECONOMIC GOALS	 127
6. The Authority of Macroeconomic Goals	129
Official definitions of national goals	130
Goals as understood in economic analysis: Outcomes	135
Income, Output, and Consumption Growth	135
Unemployment	137

Inflation and price stability	139
<i>High, very high, and hyperinflation</i>	141
Goals as understood in economic analysis: Intermediate targets	142
Rising debt to GDP ratio	151
The nature of goals in a system of democratic accountability	153
7. Voters, Elections, Accountability, and Choice	155
The heavy burden of the simple act of voting	156
Retrospective and prospective voting	158
Evidence of retrospective judgments	161
More refined inferences of voter preferences	163
Inferring incentives for manipulation by vote-motivated politicians	164
“Reagan proved that deficits don’t matter” (for elections)	167
Prospective voting	168
Party identity and policy voting	169
Retrospective voting and innovation in economic policy	170
Campaigns, incentives, and accountability	172
PART FOUR: INSTITUTIONS AND PROCESSES	177
8. Rules, Discretion, and Accountability in the Monetary Policy Process	179
<i>Rules, discretion, and stabilization policy</i>	180
Institutions and issues in monetary policy	181
The backing of the currency	181
The existence of central banks	182
<i>A lender of last resort function</i>	185
The independence and decision procedures of central banks	185
The motivations of monetary authorities	187
The targets of monetary policy	189
The Federal Reserve System	190
The founding of the Fed	190
Reforms of the 1930s	193
Reforms of the 1970s	194
Informal institutions: Patterns of discretionary monetary policy making	195
<i>The Accord</i>	196
<i>Volcker’s monetary targeting</i>	197

<i>Contents</i>	xi
<i>The Great Moderation</i>	198
Independence and rules	201
<i>The Taylor Rule</i>	203
Accountability	204
9. Rules, Discretion, and Accountability in the Fiscal Policy Process	205
<i>The fiscal crisis</i>	207
Discretion, automatic policy, and rules in the policy process	208
Procedural “justice” and legitimation by process	210
Can the means justify the ends?	211
Constitutional institutions of fiscal policy	212
The separation of powers and countercyclical fiscal programs	212
Divided government and deficits	216
The constitutional status of the income tax	217
Discretion, rules, and accountability	217
<i>Constitutional budget rules</i>	218
Legislated institutions of fiscal policy	219
Institutions of centralization and coordination	220
Entitlements and indexation	223
Institutions of precommitment	225
Informal institutions: Patterns of discretionary fiscal policy making	228
Historically defined regimes	230
Characterizing fiscal policy since the New Deal	231
Econometric studies of budgeting regimes	232
Accountability, rules, discretion, and the political process	234
 PART FIVE: CONCLUSION	 237
10. The Costs and Risks of Democracy	239
Democratic politics and economic method	241
Costs, risks, and pathologies	243
Costs	243
Risks and pathologies	245
Institutional alternatives	246
Reflections	249
 <i>References</i>	 253
<i>Index</i>	275

Figures and Tables

FIGURES

2.1	Aggregate supply and demand in the classical system	<i>page</i> 29
2.2	Aggregate supply and demand in the Keynesian system	31
2.3	A simple Phillips curve	33
2.4	Long-run and short-run Phillips curves	38
4.1	Partisan differences on a simple Phillips curve	83
6.1	U.S. federal deficit as a percentage of GDP	147
6.2	U.S. federal debt as a percentage of GDP	147
7.1	Economic performance and vote for incumbent party's presidential candidate	162

TABLES

3.1	Illustrating the Nordhaus model	65
3.2	Average annual rates for unemployment, GDP growth, and inflation, by year of presidential term, 1949–2008	70
4.1	Recessions in the United States since World War II, by party of presidential administration	80
4.2	Some misery indices for the Reagan administration	92
4.3	Annual rates for unemployment, GDP growth	97
6.1	Gramm-Rudman-Hollings deficit targets and actual deficits	133
6.2	Selected data on U.S. federal deficit and debt	144
8.1	The Great Moderation	199

Cambridge University Press

978-1-107-00414-6 - Economic Politics in the United States: The Costs and Risks of Democracy:
Second Edition

William R. Keech

Frontmatter

[More information](#)

Preface to the Second Edition

This is a revised second edition of *Economic Politics: The Costs of Democracy* (Cambridge University Press, 1995). That book used macroeconomic performance since World War II in the United States to make general statements about democracy. The main conclusions were that democracy had basically benign influences on economic policy and performance. Political economy and public choice models of opportunistic behavior by politicians did not identify systematically inferior policy, as had been suggested or intimated by Nordhaus (1973), Tufte (1978), and others.

I am no longer so optimistic. In the intervening years, the United States has taken a wrong turn economically, and I believe that the wrong turn has much to do with the incentives of democratic politics. But these developments are not inevitable features of democracy. They are often avoided by other democratic nations and have been avoided in the past by the United States.

I have changed the title of the book to *Economic Politics in the United States: The Costs and Risks of Democracy*. Such a title might have been a more honest title of the original book, given its predominant focus on the United States, but the revised title highlights the fact that democratic politics have gone astray in that country. This book will consider democratic politics in the United States as just one example of how democracy can work constructively or otherwise in the context of economic policy making and performance.

Even if the consequences of democracy for economic performance had not changed in the years since 1995, some improvements are in order for the original book. Most obviously, the data in that book end in 1992 and need to be updated. I would also like to clarify the meaning of the title. Why and how is the United States a democracy? The original book begged the question of what makes the United States a democracy and implicitly used the United States as a representative and even a leading case of democracy. I have studied definitions and measures of democracy since then in the context of a project

Cambridge University Press

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Second Edition

William R. Keech

Frontmatter

[More information](#)

xiv

Preface to the Second Edition

that extends the questions to Latin America and will be much clearer on what makes the United States a democracy. I will distinguish two main features of democracy: elections and limitations on government.

This much might make a case for a revised edition of a book with the same basic message of benign consequences of democracy for economic performance. But new developments have made it clear to me that democratic institutions and practices in the United States have not recently been so healthy and benign. As practiced in the United States, democracy has recently had undesirable consequences for economic performance. Opportunistic responses to the incentives of democratic politics have made it likely that the American standard of living will not be maintained indefinitely into the future. These practices are not inherent in democracy, but they are at least in part related to democratic incentives.

Two new, unfavorable basic manifestations of economic problems have arisen in the United States that are related to the incentives of democratic politics. The first is fiscal policy and the emergence of large annual federal deficits and increasing national debt. The second is the financial crisis of 2007–9 and its aftermath. The themes of contemporary U.S. fiscal policy have been to cut taxes or avoid raising them, to spend as needed or desired, and to postpone painful choices. Few politicians have cultivated a democratic constituency for fiscal responsibility. In several ways, both the onset and the aftermath of the financial crisis are related to the incentives of democratic politics. And, of course, the deep recession that resulted has made the fiscal situation even more dire than it would have been without the financial crisis. Both the fiscal and the financial crises will be linked to excessive present orientation in American politics.

THE FISCAL CRISIS

In the political climate of the past few decades, cutting taxes has been the favored solution to many economic problems. A rationale for this has been to encourage economic growth. There is something to this rationale, but a low tax burden is only one cause of growth. For example, an educated and healthy workforce provides human capital for growth, but education takes government revenues and, therefore, is not favored. Tax minimizing is sometimes at odds with growth maximizing, and the United States has chosen the former.

Each year the United States has postponed dealing with the rising costs of entitlement programs (in particular, Social Security, Medicare, and Medicaid), and it has gotten more difficult to do so. The war in Iraq added enormously to the fiscal pressures on the United States, as elaborated in Stiglitz and Bilmes (2008). This is the only time in American history when a war was associated with reductions in taxes.

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Second Edition

William R. Keech

Frontmatter

[More information](#)*Preface to the Second Edition*

xv

THE FINANCIAL CRISIS OF 2007–9, AND THE ENSUING
RECESSION

A case will be made that the crash was due at least in part to the incentives of democratic politics. Easy credit and the encouragement of home ownership were ways to please voters without direct, foreseen, or immediate budgetary consequences. The failures of regulation can be connected to incentives of democratic politics by way of the limitations on government feature of democracy. Lobbying Congress and administrative agencies is an important First Amendment right “to petition the Government for a redress of grievances,” but it has been used to excess. A deep recession in a country that lacks fiscal discipline and is already deeply in debt is especially threatening to future prosperity.

Even though recent experience in the United States illustrates some dangers of democracy, a longer view of U.S. history shows that the dangers are not inherent in that form of government. What have been lost are informal institutions of prudence and restraint. These new themes are expressed in a new Chapter 5 on Unintended Consequences, Moral Hazard, and Time-Consistency, and at various places in the other chapters.

For their careful reading of the entire revised edition, I would like to thank Henry Chappell and Jim Granato. For readings of particular chapters, I would like to thank James Campbell, Neil deMarchi, Luis Dopico, Richard Froyen, Michael Munger, and John Seater. Douglas Hibbs deserves special thanks. I am also grateful to audiences in the History of Political Economy Seminar and the Triangle Dynamic Macro Seminar at Duke University, and the Political Economy Colloquium at the University of Wisconsin–Madison. Needless to say, I bear full responsibility for the final version. Rebecca Hatch and Tusi Undes Wen have been very effective and cooperative research assistants. Duke University has a remarkable group of people in its political science and economics departments who are interested in political economy, which makes it an exciting place for me to be. I gratefully acknowledge the help and support of the staff of the Duke Department of Political Science, especially Doric C. Cross, and of the Duke University Libraries, especially Maurice Parker.

Scott Parris has been an extremely patient and supportive editor through both editions of this book, and a few false starts on other projects. I am very lucky to have had the opportunity to work with him. My wife, Sharon, has been a patient and supportive partner, who has shared both editions of this project.

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Frontmatter

[More information](#)

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William R. Keech

Frontmatter

[More information](#)

Preface to the First Edition

This book uses macroeconomic issues to address questions about how democracy works. It continues the kind of investigation I pursued in my first book, *The Impact of Negro Voting: The Role of the Vote in the Quest for Equality* (1968, 1981), which used racial issues to study the consequences of extending the franchise. It is a statement of applied democratic theory that uses economic issues to bring into focus questions about democratic institutions and practices. It brings together a body of research that has been written largely in the past fifteen years on the political dimensions of macroeconomic policy and performance. The book draws on work done by economists and by political scientists in roughly equal measure, and it is designed to present a variety of arguments fairly and neutrally.

I have taken aim at several audiences. First, the book is written to be accessible to a nontechnical audience of advanced undergraduates and thoughtful nonacademic citizens who might be interested in the relationship between politics and the macroeconomy, and in its implications for democratic theory. No special training in economics or political science is presumed. Although the book is meant to be readable by the nontechnical general public, it draws heavily on technical academic literature. As such, it makes the case that this literature is relevant to issues of broad public concern. Another audience is graduate students and faculty in political science and economics. For them, the book covers territory in the other discipline that may not be familiar, but more than this, it is an argument and an interpretation of known political and economic facts and ideas. In this way, it is also designed for the colleagues who have created the literature on which I draw.

The book was drafted with the support of the University of North Carolina at Chapel Hill, which provided a research leave for the fall of 1992, and the support of Harvard University and the Massachusetts

Cambridge University Press

978-1-107-00414-6 - Economic Politics in the United States: The Costs and Risks of Democracy:
Second Edition

William R. Keech

Frontmatter

[More information](#)

xviii

Preface to the First Edition

Institute of Technology, each of which provided me office space and an opportunity to extend my research leave to a full academic year by teaching a course on the topic of the book (to undergraduates at Harvard and to graduate students at MIT). An early draft was presented in May 1993 in a three-day “minicourse” sponsored by the Harvard Program in Political Economy, directed by James Alt and Kenneth Shepsle.

Of course, the gestation period is much longer than this. My interest in economics goes back to my employment by the Brookings Institution in the early 1970s, where I learned that economists have many interesting and important ideas and theories about politics that were not part of my political science graduate training in the early sixties. My understanding of economics owes much to a Professional Development Grant from the National Science Foundation (1977–8). I am grateful to the late Jack Walker for persuading me that the University of Michigan and its Institute for Public Policy Studies was the best place to use this grant. Many people there were important to my postdoctoral education, but Paul Courant and Edward Gramlich deserve special thanks for tutoring me in economics. I have also learned a lot from the excellent macroeconomics group at UNC Chapel Hill, among whom Richard Froyen deserves special thanks.

My understanding of the topic has profited enormously from what I learned from collaboration in research projects with Henry Chappell, an economist, and Carl Simon, a mathematician and economist. I thank the National Science Foundation Division of Social, Behavioral, and Economics Research for grants through the political science and the economics programs that supported my work with Chappell and with Simon. Parts of Chapters 2, 3, 4, 6, and 8 have been worked out in papers and articles co-written with Henry Chappell, Dean Lacy, Patrick Lynch, Irwin Morris, Kyoungsan Pak, Carl Simon, and Carol Swain. Several figures were adapted from those in Richard Froyen, *Macroeconomics: Theories and Policies*, 4th ed. (Macmillan, 1993). Hyeon-Woo Lee provided invaluable research assistance. Scott Parris has continued to make me glad to be working with Cambridge University Press.

An extraordinary number of colleagues have been willing to read and evaluate the entire manuscript, providing many penetrating observations. I have responded to their suggestions as well as I could, but many of their comments made it clear how far I am from saying final words on the subject. Several others helped in many different ways. I especially thank Alberto Alesina, James Alt, Robert Bates, Nathaniel Beck, Hakan Berument, Richard Broholm, Lawrence Broz, Henry Chappell, Robert Erikson, Ita Falk, Eduardo Feldman, Bruno Frey, Richard Froyen, James Granato, Thomas

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William R. Keech

Frontmatter

[More information](#)

Preface to the First Edition

xix

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Finally, the University of North Carolina at Chapel Hill and its Political Science Department have supported my work and intellectual growth in countless ways in the thirty years since I was first hired. Sharon Keech has done so as well. She has given this manuscript a penetrating nonacademic citizen's critique, and in many ways she has made it possible. The dedication is to our son and daughter.