In Defense of Private Investment

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April 20, 2011
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In 1956, MIT Economist Robert Solow published a simple model that describes the basic mechanism driving economic growth: the accumulation of productive capital. By saving and investing a portion of income, society can accumulate additional capital, enabling society to produce more, save more and invest more – and of course consume more. For this re-enforcing process to work in the positive direction (growth), investment in new capital must exceed the consumption of existing capital. Furthermore, Professor Solow showed that the amount of investment needed to maintain living standards (real income per capita) was a function of the population growth rate. The faster the population grows, the larger the portion of income needed for investment to maintain a given standard of living. Finally, Professor Solow's work showed that to increase our standard of living each new generation of capital must be more productive than the last so that we can produce more with a given quantity of labor.

Professor Solow's growth model is critical to understanding the connection between private investment and the unemployment rate seen in the United States over the last four decades. The Solow model tells us that the speed with which an economy grows is largely controlled by the portion of society's income privately invested and the actual portion needed to maintain living standards is mostly determined by the pace of population growth. With regard to employment, the Solow model suggests that the share of income privately invested will drive the unemployment rate and be inversely correlated for a given labor force growth rate; this correlation will be stronger when the labor force growth rate is stable and real wages increase with worker productivity and weaker when otherwise. It is private investment that drives employment growth, and not government investment, because private capital drives the production process.

The high unemployment rates of the 1970s occurred at a time when the labor force was growing rapidly: baby boomers and women were entering the labor force. Employing, at the prevailing real wages, all the boomers and women entering the labor force required significant new capital: i.e., very high rates of private investment. Private investment did increase during the 1970s but not enough. A large and growing government was constraining how much income society could allocate toward private investment. As a result, the United States experienced growing unemployment rates. Even without a large and growing government, employing all of the boomers and women would have been challenging. But with growing government, it was impossible to increase private investment sufficiently to do so.

In 1981, President Reagan came into office, cut taxes and over time slowed the growth of government. Furthermore, the Federal Reserve chose to reduce the high inflation they had created in the 1970s. Also during this time, the growth rate of the working population slowed down. The very high unemployment seen in the early to mid-1980s was partly a continuation of the large numbers entering the workforce and partly the price of the 1970s and early 1980s inflation. Money inflation can promote employment by lowering the real value of wages; through this mechanism the inflation of the 1970s most likely increased employment above what it otherwise would have been. However, when inflation was slowed in the early to mid-1980s, real wages rose forcing unemployment higher than it likely would have been with the prevailing rate of private investment. As the 1980s progressed, the work force growth rate slowed, government spending as a share of income stabilized, and tax cuts motivated people to temporarily shift income from private consumption to private investment. As a result, private investment was able to gradually lower the unemployment rate.

By the 1990s, boomers and women were fully incorporated into the workforce and the growth of the working population had slowed significantly. This meant that less private investment (as a share of income) was necessary to drive employment growth. Under President Clinton, government spending declined as a share of income, enabling private investment to increase and drive growth in employment.

Toward the end of the century, government, being what it is, began to grow once again. This growth curtailed the amount of income society could privately invest and gradually slowed the pace of economic growth. With the "Great Recession of 2008", our policy makers have repeated many mistakes of the 1970s. Like then, our policy makers do not understand the forces driving the economy. Like then, the policies pursued have made things worse, not better.

The growth in government spending since 2007 has outpaced society's ability to sustain government while also achieving low unemployment rates and maintaining historical growth rates in living standards. If government spending as a share of income continues at current levels, living standards in the United States will stagnate, and perhaps fall. Unemployment will be high or low depending upon whether real wages rise or fall.

The only path forward to increase both employment and living standards is to increase the share of society's income privately invested. It will be difficult, if not impossible, to accomplish this without curtailing government. Unlike the 1980s, there will be no relief from a slower growing work force: the labor force is already growing at low rates and not likely to fall significantly. This time, we cannot simply slow the growth of government: we must actually cut government spending.

The greatest cost of the public debts that we are now accumulating is the private capital not being accumulated. That capital could have enabled our children to grow their living standards. Instead, we leave them with debts to repay and fewer means to repay them.

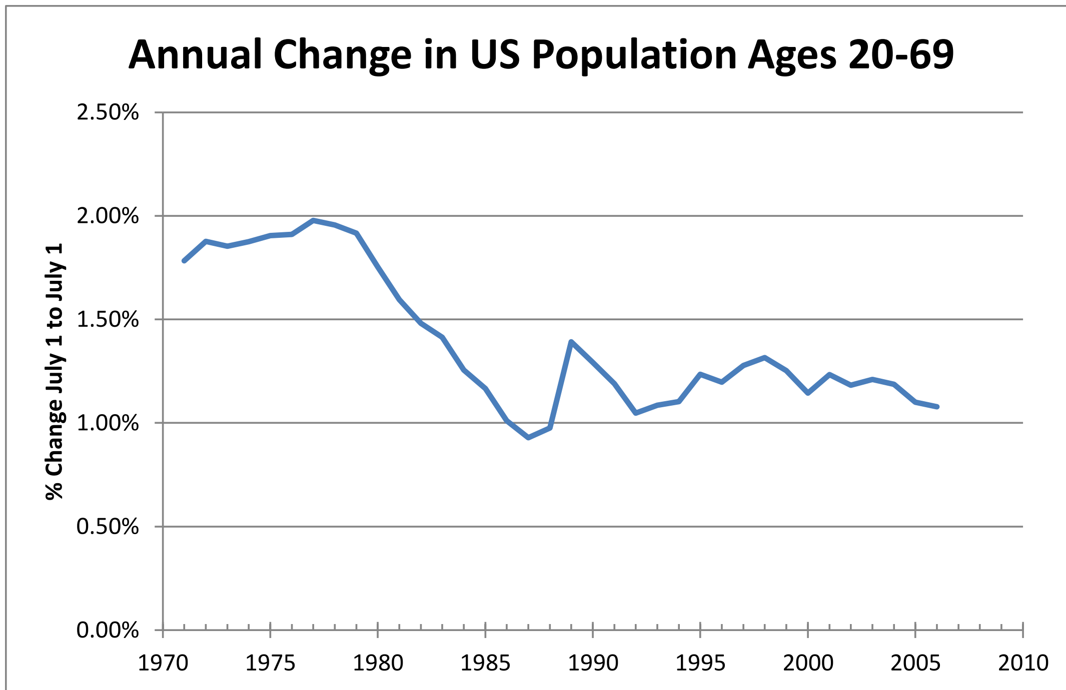

Chart 1: U.S. Census Bureau: Inter-censal Estimates of the United States Civilian Population by Age and Sex.

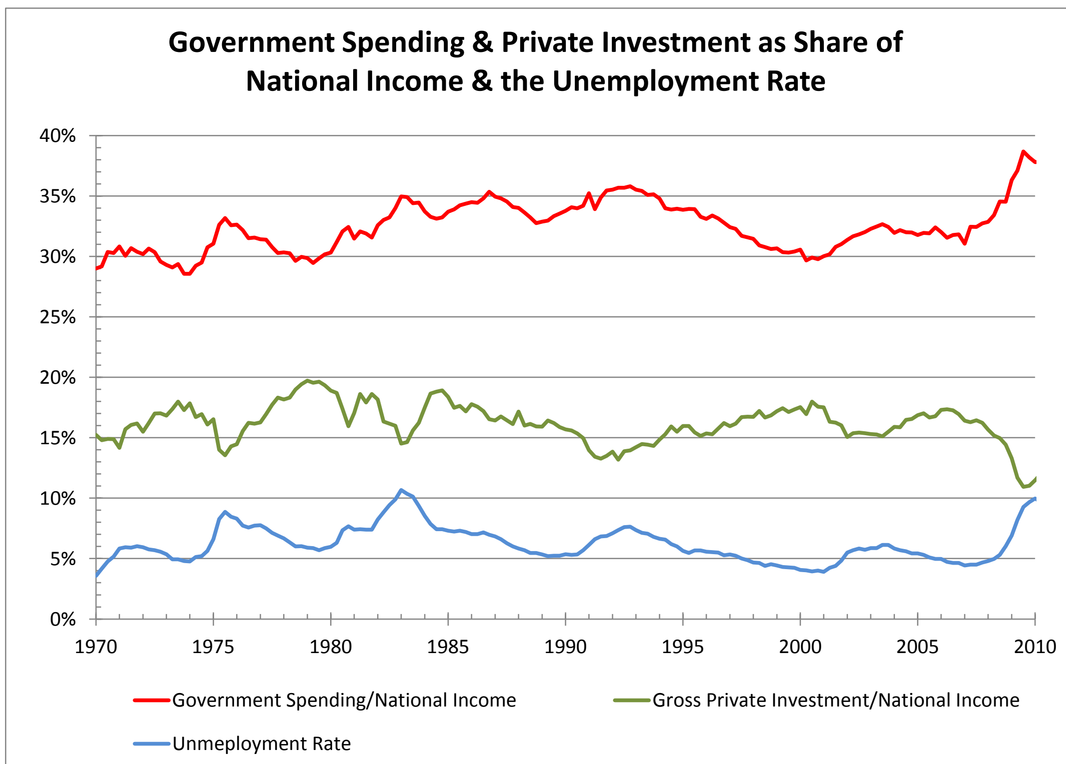

Chart 2: Government Spending, Private Investment and National Income Data from Bureau of Economic Analysis Tables 1.7.5, 3.1 and 5.1.