When the stock market dramatically and swiftly declined in September 2008, prompting Senator John McCain to suspend his presidential campaign and return to Washington, D.C., to discuss federal action to prevent a financial meltdown, it signaled that something was fundamentally wrong with the American economy. That jittery month did not just mark the twilight of the presidency of George W. Bush. The bear market signaled what no journalist or politician and few economists had predicted: that the Great Recession was here. The Federal Reserve's initial response actually worsened the situation. But the immediate crisis in the financial markets did pass and the stock market has rebounded. Yet unemployment has remained high, state governments are broke, and the federal government faces a fiscal crisis that is unprecedented in peacetime. To most Americans, the prospects for a brighter economic future still do not seem all that promising.

Republicans in general and conservatives in particular blame the crisis on an “out of control” public sector, especially the federal government that spends more than it takes in. Democrats in general and liberals in particular, on the other hand, blame the crisis on an “out of control” private sector that does not serve the common good. While there is an element of truth in each of these assessments, both parties have been
equally complicit in moving the country away from the enduring principles of economic policy that made the American economic story an exceptional one. Indeed, both Republicans and Democrats have pushed policies that have violated the principles that undergirded the successful policies of the past, principles which were outlined by James Madison and Alexander Hamilton in *The Federalist* papers and implemented by George Washington, Abraham Lincoln, Franklin D. Roosevelt, and Ronald Reagan as the country developed. More specifically, the principles in question are these:

1. Alexander Hamilton established the first principle of American economics by drawing on the bitter lessons learned under the feckless Continental Congress. Hamilton made it the Washington administration’s firm policy that Congress must finance the federal government by current taxation—not money creation—thus limiting peacetime borrowing to no more than that required for the purchase of federally owned durable assets like ships or buildings. Yet both parties today rely on deficit spending for all sorts of government activities financed by money creation not only through the Federal Reserve but also especially foreign official dollar reserves, causing chronic episodes of commodity-led inflation as well as federal budget and international-payments deficits.

2. Abraham Lincoln and a Republican Congress enacted the second principle during the Civil War, after several decades of Hamiltonian development had made it feasible: the most efficient and (least un-) popular way to pay for “public goods” like justice and national defense, which benefit all classes of citizens proportionately, is a broad based, low-rate income tax levied equally on labor and property income. Yet today, each party advocates a tax policy blatantly biased toward its own dominant faction and against the other party’s: Republicans seek to shift the burden of general government from taxes on all income to labor-income taxes alone, while Democrats seek to pile high marginal income-tax rates and extra layers of taxation on property income, in order to subsidize personal social benefits (e.g. Social Security, Medicare, and other social spending) with the income tax and/or taxes on property income.

3. FDR implemented the third principle of economically and politically successful American economic policy when he insisted that “quasi-public” goods, such as Social Security retirement pensions (or more recently, tax-favored savings accounts)—goods targeted to serve workers or property owners—be paid for by current taxes on labor or property income, respectively, not general revenues. Yet today, both parties have diverted payroll-tax surpluses from the benefits they are designed to finance to fund public goods instead of using income taxes levied both on labor and property income. Democrats have diverted the payroll-tax surpluses to increase other federal spending, while Republicans have diverted the payroll-tax surpluses to giving tax loopholes or credits for investing personal financial accounts in the stock and bond markets.

4. With limited success, Reagan attempted to establish the fourth principle, that Congress limit the methods and size of government—particularly social benefits—to avoid general unemployment or disinvestment in people or property. Yet today, both parties are complicit in permitting the levels of social benefits as well as income- and payroll-tax rates to mushroom—as they have in developed Europe and Asia—to levels that crowd out new investment in people and property.

Of course, the parties themselves are not entirely to blame. The modern discipline of economics, which both Democrats and Republicans follow religiously for ideas and policies that will deliver the goods (and keep them in power), is in as much disarray as is the country economically. Like the revered enchanters and astrologers that proved themselves useless in the kingdoms of antiquity, most mainstream economists were blind-sided by the current crisis. They have not only misled policymakers, officeholders, and administrations but also have proven themselves incapable of crafting meaningful solutions.

The fact that the nation’s brightest economists and most gifted political leaders were caught off guard by the events of the last three years suggests that they need to relearn the fundamentals of economics in much the same way as the legendary Vince Lombardi, when he became coach in 1959 of the Green Bay Packers—which had lost ten straight seasons—had to reacquaint his players with the basics of football. Those fundamentals include not simply the four principles of all successful American economic policy, but also the general principles of economic thought
on which they are based, which date back to Aristotle, Augustine, and Aquinas—particularly their understanding of the role of the family and the social sector—all neglected by economic thinkers since Adam Smith. This essay will therefore begin by exploring that deeper understanding of economics. After laying this foundation, the essay will then build on it by proposing reforms that address the present crisis by updating the four policy principles noted above.

**Learning from Aristotle and Augustine**

Though many Americans regard Adam Smith as the founder of economics, the discipline dates back to a much earlier era. The four human activities that economics seeks to quantify were identified by Jesus, who once noted that since the days of Noah and Lot, people have been doing four kinds of things: “planting and building;” “buying and selling;” “marrying and being given in marriage;” and “eating and drinking” (Luke 18:27–28). In other words, men and women produce, exchange, give, and use (or consume) both human and nonhuman goods.

“Scholastic economics” began when Thomas Aquinas integrated these four elements around A.D. 1250 within scholastic natural law, drawing on Aristotle and Augustine to outline personal, domestic, and political economy. This “AAA” outline was taught for more than five centuries by Catholic and—after the Reformation—Protestant thinkers, notably Samuel Pufendorf, whose work was used by Adam Smith’s own teacher, Francis Hutcheson, and recommended by American Founders like Alexander Hamilton.²

“Classical economics” began when Smith oversimplified these four elements to two—production and exchange. In doing so, he dropped Augustine’s theory of utility, which explains consumption. He also replaced Augustine’s theory of personal gifts and Aristotle’s theory of distributive justice with his famous assumption that everyone is motivated by self-love. He also claimed that Aristotle’s theory of production, which included both people and property, could be pared to labor alone.

A century later, “neoclassical economics” was born when W. S. Jevons

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² For a recent outline of the history of economic thought, citing key sources, see part 1 of Mueller, *Redeeming Economics*, pp. 11–130.
in England, Carl Menger in Austria, and Leon Walras in Switzerland—scholars who were dissatisfied with flaws in Smith's revision—almost simultaneously but independently rediscovered Augustine's theory of utility, and began reintegrating it with production and exchange.

As this brief summary suggests, the insights of Aristotle and Augustine are absolutely necessary in helping the modern discipline restore the lost cornerstone of distribution. To be sure, Aristotle's definition of man as a "rational"³ and "political animal"⁴ is well known. Indeed, these insights remain central to social science twenty-three centuries later. Yet the rest of Aristotle's three-fold definition is curiously omitted: that man is also a "conjugal" or "matrimonial" animal. As Aristotle observed, "Man and wife . . . are [even] more inclined by nature to conjugal than political society."⁵ Aristotle also called the formula by which any human community distributes the use of its common (that is, jointly owned) resources "distributive justice." There are as many kinds of distributive justice as there are communities: a married couple, a family, a charitable foundation, a business firm, or a government.

Augustine's insights are no less important. "Human society is knit together by transactions of giving and receiving,"⁶ Augustine noted. But these outwardly similar transactions are of two essentially different kinds, he added: "sale or gift."⁷ The difference springs from his understanding of the Two Great Commandments. Augustine started from Aristotle's insight that "every agent acts for an end" and his definition of love—willing some good to some person. But Augustine drew an implication that Aristotle had not: every person always acts for the sake of some person(s). For example, when I say, "I love vanilla ice cream," I really mean that


I love *myself* and use (consume) vanilla ice cream to express that love (in preference, say, to strawberry ice cream or Brussels sprouts, which reflects my separate scale of utility).

In other words, Augustine’s insight is that human beings always act on two scales of preference—one for persons as ends and the other for other things as means: personal love and utility, respectively. This is why human beings express their preferences for persons with both kinds of external acts: gifts and exchanges. The social analog to personal gifts Aristotle called distributive justice, since it amounts to a collective gift: it’s the formula social communities like a family, or nation under a single government, use to distribute their common or jointly owned goods. Both a personal gift and distributive justice are a kind of “transfer payment”; both are determined by the geometric proportion that matches distributive shares with the relative significance of persons sharing in the distribution; and both are practically limited by the fact of scarcity.

Augustine also introduced the important distinction between “private” goods like bread, which inherently only one person at a time can consume, and “public” goods (like a theater performance, national defense, or enforcement of justice), which many people can simultaneously enjoy, because they are not “diminished by being shared.”

**Lifetime Income and Consumption**

Our matrimonial nature, Aristotle noted, explains why wealth takes two forms—people and property—an idea later expressed by University of Chicago economist Theodore W. Schultz when he called them “human and nonhuman capital.” Both forms are “reproducible”; both may be tangible or intangible (e.g. our bodies vs. our education, a machine vs. a patent); both require maintenance to remain productive; and both depreciate in use. Labor compensation is the return on previous investment in people, while property compensation is the return on previous investment in productive property.

Yet there is this important difference: the rate of return on property

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is the same for everyone in a competitive market. But the rate of return on investment in people varies inversely with the age of the person. For example, the stock market’s long-term average real rate of return is 6 to 7 percent, and is about the same whether I invest for my own retirement or on behalf of my children. But the real rate of return on college tuition at age 20 was estimated at about 16 percent in 2001 in the United States, far higher than the stock market’s long-term average. But after about age 40, the return on further education fell below the rate in the stock market, and after age 50 turned increasingly negative. This difference accounts for the pattern of lifetime earnings in the chart above.

Labor compensation starts at zero during childhood, while we spend time learning valuable skills; but it rises rapidly between childhood and the mid-30s as we enter and gain experience in the labor market; then rises more slowly to peak at around age 50; and finally drops to zero. Property

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income also starts near zero early in life (for those with little inherited property), but becomes increasingly significant as the expected rate of return on investment in human capital falls below that on investment in property. For those who acquire significant wealth from any source—whether inheritance, talent, luck, or hard work—the only practical way to save it is in the form of claims on property (stocks, bonds, etc.).

The large differences between total income and consumption in each phase of life reveal the other essential but neglected feature of family economics noted by Augustine: the central role of gifts. Family members acquire their incomes mostly by selling services or products to those outside the family. But within the family transactions are mostly gifts, not exchanges. We all need to be fed, clothed, sheltered, and transported, whether or not we earn income. Our income therefore typically exceeds consumption during active parenthood and the “empty nest” (after the children have left home), while consumption exceeds income during dependent childhood and old age. These differences reflect extensive gifts, not only from parents to dependent children, but also between husbands and wives, and later from adult children to aged parents.

Even with modern private-capital markets, an inherent “retirement gap” arises from the fact that for anyone to retire, labor compensation must fall to zero, yet consumption ordinarily remains higher than the property income earned from previously purchased stocks and bonds. The “retirement problem” is that of filling this gap without either forgoing retirement, suffering a sharp fall in consumption during retirement, or lowering one’s total lifetime earnings and consumption (which would result if one invested more—early in life—in lower-yielding productive property and less in higher-yielding human capital).

Without government social benefits, the retirement gap could be bridged only by a gift from someone (most often one’s adult children) whose own consumption is thereby reduced. Pay-as-you-go Social Security went a long way toward solving the retirement problem by providing an asset that private financial markets cannot. Starting a well-designed pay-as-you-go system therefore typically boosts the birthrate: the effects are evident in, for example, the American Baby Boom. However, once benefits have closed the retirement gap, any further expansion must come at the expense of smaller investment in people or productive property.
The Missing Element: The Family

Because “neoscholastic” economics recognizes gifts as well as exchanges, it offers a far more accurate paradigm than does neoclassical economics for evaluating (and guiding) modern economies like the United States. Its understanding of human capital naturally leads to an appreciation of birth-rates, or demography, as an economic indicator that helps to explain much, although not all, of the current fiscal crisis. It shows that people have children for two reasons: because they love the children for their own sakes, or because they love themselves and expect some benefit from the children. And these preferences are expressed in their behavior toward themselves or any children. Among the fifty countries for which sufficient data are available (comprising only about one-quarter of all countries, but two thirds of world population), just four factors explain most variation in birth rates.\(^{11}\) The birthrate is strongly and about equally inversely proportional to per-capita social benefits and per-capita national saving (both adjusted for differences in purchasing power), which represent provision by adults for their own well-being. When these factors are taken into account, a legacy of totalitarian government is also highly significant in reducing the birth-rate, by about 0.6 children per couple.

The birthrate is also strongly and positively related to the rate of weekly worship or church attendance. This is because all gifts of scarce resources—whether rearing a child or devoting time to worship—require the same lowering of self and raising of others in our scale of preferences for persons. But regular worship is not only positively related to fertility in a roughly linear fashion. It is also inversely related to the incidence of abortion, which (like crime in general) rises exponentially as the rate of worship declines. As Augustine noted, a crime is the opposite of a gift: it is the taking from other persons their own goods.\(^{12}\) As with “legal” abortion, the objective facts remain the same whether or not the crime is recognized as such by human law.


In accounting for the “demographic winter” that has overtaken much of Western Europe, we may then identify four principal reasons, considering each in order of its importance: First, low rates of religious observance, which are associated with low birthrates and high incidence of abortion; second, social benefits so high as to displace gifts within the family, particularly the gift of life; third, legacies of totalitarianism; and finally, heavy reliance on the part of governments on so-called “consumption” taxes, which penalize investment in “human capital.”

So far, the United States has avoided demographic winter. One respected demographer, Nicholas Eberstadt, has argued that “U.S. demographic exceptionalism is not only here today; it will be here tomorrow, as well.”

The Social Security Trustees’ “Intermediate Assumptions,” which inform their annual report to Congress detailing the actuarial status of the system over the next seventy-five years, similarly assume “demographic exceptionalism” will continue. However, my own analysis contradicts this conclusion. First, as I showed in a paper published in 2000 and as Chart 2 reveals, projected Social Security imbalances are entirely due to the reduction in population resulting from legal abortion. Second, the Congressional Budget Office (CBO) now projects that the share of American national income absorbed by social benefits (mostly Social Security, Medicare, and Medicaid) will roughly double over the next seventy-five years. The CBO also estimates that the expansion of these programs will worsen the budget problem considerably.


The Choice America Faces

The United States therefore faces a clear choice. It can have legal abortion or a balanced Social Security system, but not both. By far the easiest way for the United States to avoid a declining population and an unbalanced Social Security system is to end legal abortion. In that case, the U.S. birth-rate would rise immediately to about 2.75 instead of falling below 1.7, and remain above the replacement rate through 2083, as Chart 3 indicates. This would match or exceed the Social Security Administration Trustees’ low-cost assumptions.

In this respect, America is not a demographic exception, either now or in the future. What may be true of the United States in the future is true already of the rest of the world. Weighting each country equally (e.g. Holland equals China), the most recent Total Fertility Rate, or the average number of births to a woman in her childbearing years, for all fifty countries is 1.83; without legal abortion it would be 2.29. Weighted by population, the TFR of all countries is now 2.15 (India is higher, China
lower); without abortion the world TFR would be about 2.70.\textsuperscript{18}

However, if the share of social benefits doubles as a share of national income while legal abortion continues, the empirical relationships strongly suggest that the U.S. birthrate will decline steadily from the current 2.1 replacement rate to less than 1.7. That would closely approximate the high-cost assumptions in the Social Security Trustees’ latest report.

Thus to avoid an American demographic winter, policymakers must not allow social benefits to double as a share of national income; indeed, they must not allow them to increase at all as a share of national income. This means that policymakers must realign economic policy to reflect the four principles of successful American economic policy. On the second, third, and fourth principles, at least, what is required is little more than to

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|}
\hline
 & Using CBO estimate that social benefits will double by 2083 & Using CBO estimate but assuming no legal abortion & Using Social Security Trustees intermediate-cost assumptions & Using Social Security Trustees low-cost assumptions & Using Social Security Trustees high-cost assumptions \\
\hline
2008 actual & 2.08 & 2.75 & 2.08 & 2.08 & 2.08 \\
\hline
2025 & 1.93 & 2.57 & 2.03 & 2.23 & 1.82 \\
\hline
2050 & 1.76 & 2.38 & 2.00 & 2.30 & 1.70 \\
\hline
2075 & 1.67 & 2.34 & 2.00 & 2.30 & 1.70 \\
\hline
2083 & 1.64 & 2.26 & 2.00 & 2.30 & 1.70 \\
\hline
\end{tabular}
\end{table}

Mueller, Dollars and Sense

update the principles of fiscal policy that were outlined by Jack Kemp and Ronald Reagan and successfully implemented during the 1980s. The first principle, however, was not implemented at that time. Let us therefore consider the latter three principles before returning to the first.

**Income-Tax Reform**

First, the cost of current consumption of public goods like defense and justice, which benefit all classes of taxpayers about equally, should be balanced with an income tax levied equally on labor and property income at the lowest possible rate. The Fair and Simple Tax reform plan that my business partners and I proposed in 1995 replicates the economically and politically successful strategy of the Reagan years (the 1981 Kemp-Roth tax-rate cuts, the 1983 plan to balance Social Security, and the Tax Reform Act of 1986) by treating workers and investors evenhandedly and by combining reforms to the income and payroll taxes.\(^\text{19}\) The income tax would be reformed by imposing a single flat-tax rate on all labor and property income. All deductions, exemptions, and credits would be eliminated except a single credit, based solely on family size, equal to the income- and payroll-tax rates, up to an income exceeding the poverty level for a family of four. When paired with a Social Security payroll-tax cut of about 3 percentage points, the flat-tax rate would need to be set at an estimated 18 percent.

For administrative simplicity, the tax would be levied as part of the cost of goods and services purchased (including new investment property) rather than as a deduction from income paid to workers and owners of productive property. This means the income tax would be collected only from several million employers rather than more than 140 million households. The plan would also end the Alternative Minimum Tax and similar tax monstrosities. Estates would not be taxed separately as long as the flat-tax rate was applied to all realized capital gains (inflation adjusted at the taxpayer’s discretion). To be consistent and avoid multiple taxation

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of the same income, the tax would be levied on imports and rebated on exports—as is the practice with most of our trading partners.

Because the Fair and Simple Tax plan includes all property income (e.g., interest, dividends, and capital gains), whereas other forms of the flat tax exclude such property income while “expensing” investment in productive property, the Fair and Simple Tax plan has the broadest possible tax base, the lowest possible marginal income-tax rate, the fairest distribution of income taxes, and the greatest incentives for working, investing, and risk-taking.

Reform of Social Benefits

To implement the second principle essential to any strategy for avoiding an American demographic winter, policymakers must finance quasi-public goods benefiting workers or proprietors out of current taxes on labor or property income, respectively. This means each social-benefit program must be balanced with current payroll taxes at a level calibrated to prevent the birthrate from falling below the replacement rate. Since the United States is now at the replacement rate, this means that rather than doubling, U.S. social benefits must not be permitted to increase at all as a share of national income. (For many European countries, achieving the same result would require a decline in the share of national income devoted to social benefits.) The U.S. Social Security retirement system is easier to balance, because the program has an inherent link between benefits and prior contributions.\(^{20}\) Balancing the Medicare and Medicaid health-insurance programs is much harder, because unlike Social Security, the policymakers who designed these programs never created such an automatic link. Twenty-first century policymakers must now forge such a link.

As Ronald Reagan and Jack Kemp correctly saw, Social Security’s problems are not due to the program’s pay-as-you-go structure but rather the prospective size of promised benefits. The program’s main problems have always arisen from its not being kept on a pay-as-you-go basis. The dominant faction in each party seeks to “cure” this problem by actually

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increasing the current and prospective imbalances, though the measures they propose to effect their false cures are always politically unpopular as well as economically inefficient. Since about 1990 until last year, Social Security has been collecting about 25 per cent more from workers in payroll taxes than necessary to pay current retirement benefits. In other words, workers have been subsidizing from their labor income general government operations that ought to be paid for with an income tax on both labor and property income. But due to legal abortion, FICA taxes will not long exceed the needs of the Social Security system. Indeed, the needs of the system will soon exceed the FICA taxes that workers and employers jointly pay, as the declining ratio of workers to retirees throws the entire system seriously out of balance.

Democrats have proposed to “solve” this problem by raising income and estate taxes, thus forcing property owners to pay for worker’s benefits. This would necessarily raise the cost of hiring and the unemployment rate as similar policies have done in Europe. Meanwhile, Republicans want to divert the surplus payroll taxes from Social Security to subsidize property ownership through tax-advantaged financial accounts paid for with general revenues. By further reducing families’ after-tax labor income, this could only reduce the birthrate to European levels.

Since the birthrate is inversely proportional to the level of social benefits, policymakers can prevent American fertility from declining to European and Asian levels—assuming legal abortion continues—only by keeping total social benefits from increasing above 2001 levels. Each program must be balanced annually on a pay-as-you-go basis, thus eliminating both the current trust-fund surpluses and expected deficits.

The entitlement-reform component of the Fair and Simple Tax plan adapts former chief Republican Social Security actuary Robert Myers’ suggestion by cutting the OASDI payroll-tax rates immediately by 25 percent (about 3 percentage points), thus returning the current trust-fund surplus to American working families, to invest without restriction in raising and educating their children or in corporate stocks and bonds, depending on their family situation. Prospective deficits would be removed at the same time by phasing in a reduction of equal proportion in promised benefits, prorated for the number of years the workers received the payroll-tax cuts. (Increasing the retirement age would
have a similar effect on the budget but would disproportionately penalize workers with lower incomes, workers who—after all—typically live short lives than workers with higher incomes.) New imbalances would then be prevented by automatically adjusting workers’ benefits in inverse proportion to their number of children and average life expectancy. Benefits would not be means-tested, however, as this would “welfarize” the Social Security system.

At the same time, Medicare and Medicaid would be reformed by linking each program’s benefits to prior payroll contributions and by maintaining overall annual balance in the same way as for Social Security. Rather than allowing current per-recipient spending to drive the programs’ shares of national income, the calculation must be reversed, by starting with the current total shares of social benefits in national income and dividing by the number of eligible beneficiaries.

**Monetary Reform**

Even apart from the demographic challenge that faces the United States, the American family budget has been squeezed by three factors that are the direct result of a faulty monetary policy: instability, insecurity, and declining take-home pay. American and world history show that only monetary reform—specifically, restoring the international gold standard without official-reserve currencies—will end their root causes: chronic episodes of inflation (or deflation), declining U.S. international competitiveness, and endless federal deficit spending. To put these problems in perspective, the stability of the U.S. dollar has varied widely in history. This variation is explained by two factors: how policymakers in this country set the monetary standard for the dollar and whether policymakers in other countries used securities payable in dollars as their own monetary standard.

The United States has alternated between two kinds of standard money: inconvertible paper money, on the one hand, or a fixed weight of some precious metal (first silver, then gold), on the other. The dollar was an inconvertible paper money during and after the Revolutionary War (1776–92), the War of 1812 (1812–17), the Civil War (1862–79), and again from 1971 to the present. The dollar was effectively defined as a weight of silver in 1792–1812 and 1817–34, and as a weight of gold in
1834–61 and 1879–1971. The dollar was not used by foreign monetary authorities as a monetary-reserve asset before 1913, but has been an official “reserve currency” for many since 1913, and for most since 1944.

Applying these two criteria divides the monetary history of the United States into distinct phases. We can compare the stability of monetary regimes by examining the variation in the Consumer Price Index (as reconstructed back to 1800) by two measures: long-term CPI stability (measured by the annual average change from beginning to end of each monetary standard) and short-term CPI volatility (measured by the standard deviation of annual CPI changes during the period). Weighting

<table>
<thead>
<tr>
<th>Time period and monetary system</th>
<th>Long-run stability (average annual change)</th>
<th>Short-run volatility (standard-deviation annual change)</th>
<th>Maximum price change (high vs. low)</th>
<th>Stability rank (weighing both criteria equally)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1800–34: Domestic silver standard (interrupted by domestic paper standard, 1812–17)</td>
<td>-1.5%</td>
<td>5.2%</td>
<td>76%</td>
<td>4</td>
</tr>
<tr>
<td>1834–61: Domestic gold standard</td>
<td>-0.4%</td>
<td>3.5%</td>
<td>36%</td>
<td>2</td>
</tr>
<tr>
<td>1862–79: Domestic paper standard</td>
<td>0.1%</td>
<td>8.8%</td>
<td>74%</td>
<td>3</td>
</tr>
<tr>
<td>1879–1914: International gold standard</td>
<td>0.2%</td>
<td>2.2%</td>
<td>20%</td>
<td>1</td>
</tr>
<tr>
<td>1914–44: Interwar international gold-dollar-sterling standard</td>
<td>1.9%</td>
<td>7.2%</td>
<td>99%</td>
<td>5</td>
</tr>
<tr>
<td>1944–71: Bretton Woods international gold-dollar standard</td>
<td>3.1%</td>
<td>3.1%</td>
<td>130%</td>
<td>4</td>
</tr>
<tr>
<td>1971–2010: International paper-dollar standard</td>
<td>4.3%</td>
<td>2.8%</td>
<td>438%</td>
<td>4</td>
</tr>
<tr>
<td>1971–1981</td>
<td>8.4%</td>
<td>2.7%</td>
<td>125%</td>
<td></td>
</tr>
<tr>
<td>1981–2010</td>
<td>3.1%</td>
<td>1.2%</td>
<td>140%</td>
<td></td>
</tr>
</tbody>
</table>

these criteria equally, we see that the regime defined by the classical gold standard from 1879–1914 was the most stable of all.

As Chart 5 shows, the commodity-led inflations that triggered the respective recessions of 1974–75, 1979–80, 1990–91, and 2007–09 were preceded by commensurately massive monetization of U.S. public debt through the monetary system. The chart compares the annual rate of inflation of CPI nondurable goods—mostly food and energy prices—with a ratio of the main factors affecting demand for them: the lagged “World Dollar Base,” or total supply of “high-powered” dollars, divided by a proxy for the current demand for high-powered dollars (U.S. currency and commercial-bank reserves times current world oil production). In each case, voters blamed the president: Richard Nixon, Gerald Ford, Jimmy Carter, George H. W. Bush, George W. Bush, or Barack Obama.

Chart 6 (on page 40) shows why the dollar’s official-reserve currency role has eroded U.S. international competitiveness and why ending that role is necessary to end chronic U.S. payments deficits and restore U.S. international competitiveness. In 1980, U.S. residents owned net investments in the rest of the world equal to well more than 10 percent, but by 2009 had become net debtors equal to about 20 per cent, of U.S. GDP. Meanwhile U.S. net official monetary assets—official monetary assets minus foreign liabilities—declined by almost exactly the same amount, while the books of the rest of American residents remained in balance or showed a slight surplus. This comparison proves that the entire decline in the U.S. net investment position has been due to federal borrowing from foreign monetary authorities.

**Loss of Federal Budget Discipline**

Finally, the current monetary system is the main cause of the loss of federal budget discipline. “When a conservative says it is bad for the government to spend more than it takes in, he is simply showing the same common sense that tells him to come in out if the rain,” Ronald Reagan had remarked in a February 1977 address.²¹ He was restating in common language the

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Chart 5: World Dollar Base vs. Annual Rate of Commodity Inflation

The world dollar base is lagged 30 months and divided by the U.S. monetary base times world crude-oil production. Annual rate of commodity inflation is of CPI nondurables, mostly food and energy prices.

Source: Mueller, Redeeming Economics, Figure 16–9. Data source: Bureau of Labor Statistics. Calculated by LMBC.
first principle of successful economic policy that went back to Washington and Hamilton. Yet after leaving office, Reagan assessed the result this way: “With the tax cuts of 1981 and Tax Reform Act of 1986, I’d accomplished a lot of what I’d come to Washington to do. But on the other side of the ledger, cutting Federal spending and balancing the budget, I was less successful than I wanted to be. This was one of my biggest disappointments as president. I just didn’t deliver as much to the people as I’d promised.”

President Reagan’s disappointment can be traced to the unintended consequences of Milton Friedman’s “allowance theory” of federal budgeting. “I have long favored cutting taxes at any time, in any manner, by as much as possible as the only way of bringing effective pressure on Congress to cut spending,” Friedman explained. “Like every teenager, Congress will spend

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whatever revenue it receives plus as much more as it collectively believes it can get away with. Reducing spending requires cutting its allowance.\textsuperscript{23} President Reagan had borrowed Friedman’s reasoning in a 1980 presidential campaign debate\textsuperscript{24} and a 1982 budget speech, claiming that “increasing taxes only encourages government to continue its irresponsible spending habits. We can lecture it about extravagance till we’re blue in the face, or we can discipline it by cutting its allowance.”\textsuperscript{25}

C. Northcote Parkinson famously theorized that “work expands so as to fill the time available for its completion.” Though often misinterpreted as advice on time management, Parkinson’s Law was the history professor’s attempt to explain the inexorable growth of bureaucracy along the lines of the neoclassical libertarian theory of public choice.\textsuperscript{26} Friedman’s allowance analogy amounts to Parkinson’s fiscal corollary: public spending expands to absorb all available tax revenues. But the strategy failed in practice by overlooking Parkinson’s debt corollary: public borrowing expands to absorb all available means of finance. If tax revenues are Congress’ “allowance,” then purchases of Treasury securities by government trust funds and the banking system are its “credit cards.” The congressional teenager’s spending won’t be fazed by a cut in allowance, unless the indulgent parents also cut up the credit cards. Those “credit cards” consist, first, of the government trust funds accumulated ostensibly as “reserves” for Social Security and other supposedly self-financing programs, and second, purchases of U.S. public debt by the banking system, especially central banks that use such debt as official monetary “reserves.” Thus, while U.S. public debt jumped by more than 20 percentage points of GDP between 2007 and 2009, debt to the non-bank public debt stayed below 19 percent—because most of the increased debt was financed by central banks and trust funds.\textsuperscript{27}

\textsuperscript{27}. See Mueller, \textit{Redeeming Economics}, pp. 343–44 and Figure 16–7.
Reagan’s Unfinished Monetary Reform

In 1980, Ronald Reagan’s advisers agreed that it was necessary to limit the power of the Federal Reserve governors who make monetary policy. But nothing was done because they disagreed about the policy rule. “Domestic monetarists,” following Milton Friedman, proposed that the Federal Reserve regulate the quantity of bank reserves and the money stock. Many “supply-siders” advising Jack Kemp proposed to make the value of a paper dollar equal by law and convertible into a weight of gold, as it was for most of the two-hundred-plus years of U.S. history. But “global monetarists,” following Robert Mundell, advocated at least a temporary return to the 1944 Bretton Woods gold-exchange system, while others heeded Jacques Rueff’s warning that only restoring a multilateral gold standard without foreign-exchange reserves would be effective. On June 29, 1984, Congressman Jack Kemp introduced the Gold Standard Act of 1984, which would have defined the dollar as a fixed weight of gold, restored gold convertibility of Federal Reserve notes and deposits, and provided for gold coinage. Kemp’s explanatory statement and Lewis E. Lehrman’s op-ed of that day, which Kemp inserted into the Congressional Record, remain valid.

Though they often disagreed, Friedman and Mundell exhibited colossal integrity in acknowledging that changing circumstances had made their earlier proposals infeasible. As Friedman summarized in a Financial Times interview, “The use of quantity of money as a target has not been a success. I’m not sure that I would as of today push it as hard as I once did.”28 According to a recent Wall Street Journal interview with Judy Shelton, Mundell believes that “it would not be possible today to forge a monetary system with the dollar as the key reserve currency, as President Franklin Roosevelt and Treasury Secretary Henry Morgenthau did in the 1940s. ‘To be fair, America’s position is not nearly as strong now,’ he concedes.”29

Thus, any presidential candidate who does not wish to become a by-word like Presidents Hoover or Carter must restore the first principle of

successful presidential economic policy, by defining the dollar again as a weight of gold and ending by treaty the dollar's role as the chief official-reserve currency. The essential requirement for restoring a stable international monetary system is that the major countries agree to replace all official foreign-exchange reserves with an independent monetary asset that is not ultimately some particular nation's liability. Many standards are possible in theory, but as monetary authorities still hold nearly 900 million ounces of gold, the simplest, most effective, and most tested solution is a modernized international gold standard without foreign-exchange reserves. This would require changes in U.S. law and an international monetary agreement.

There are two conditions for the success of such a reform. First, the gold values of all national currencies must be properly chosen to preclude the deflation of wages and prices that occurred in the 1920s and 1930s in those countries (notably Britain and the United States) which chose parities that did not allow for past wage and price inflation or massive sales of foreign exchange. Other countries, notably France in 1926 and 1959, restored gold convertibility successfully with strong economic growth but without inflation, deflation, or unemployment.

Second, existing official foreign exchange reserves must be removed from the balance sheets of monetary authorities by consolidating them into long-term government-to-government debts that would be repaid over several decades—much as the Washington-Hamilton administration funded the domestic and foreign Revolutionary War debt.

A sober overall assessment thus allows us to see that both demographic winter as well as chronic financial and budgetary crises result from poor policy choices, ignoring the basic principles of economically and politically successful U.S. economic policy. Moreover, the current administration and Congress so far appear intent on continuing the deadly mix of legal abortion and high social benefits that was the recipe for demographic winter in developed Europe and Asia, as well as the economic policies that have weakened the U.S. economy. The good news is that, precisely because it is a choice, there is nothing inevitable about the outcome. Unfortunately, it is quite possible that the United States, having avoided demographic winter so far, will choose it now along with steady economic decline. But it is also possible for both the United States and
most other nations now suffering demographic winter to choose a new springtime for both the American family and economy.

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