THE NATION
How to Fix Our Broken Economy
by JEFF MADRICK

posted October 4, 2007 (October 22, 2007 issue)

The American economy is broken. And it's not likely that the Democrats, even if they do as well as expected in the 2008 elections are going to fix it. Of course, there's no chance that the Republicans will either, wedded as they are to endless tax cuts.

The experience of the past decade makes clear the need for a sharply new way of thinking about the economy. The subprime mortgage crisis, although dangerous, is not the issue. It's not even the rising prospect of recession and lost jobs. The real problem is that even when the financial times have seemed to be healthy, the economy was not. Since the 2001 recession gross domestic product is up, profits are at record levels and unemployment is low--but wages, capital investment and, now, productivity are weak. Without these, there is little on which to build an economic future.

Wages for the typical male are actually down since 2001. The fabulous accrual of private fortunes comes at a time when a typical household's income is lower than it was in 1999, despite the many working spouses. And while subdued wages have enabled companies to generate soaring profits, capital investment in equipment and computer software has in recent years been significantly lower as a proportion of GDP than it was in the late 1990s.

Productivity should be the biggest worry, but it gets the least attention. After growing robustly for a few years, productivity growth since 2003 is as low as it was before the Internet boom. Productivity, defined as the output the nation can produce per hour of work, is the nation's source of wealth. If it doesn't rise rapidly, there is no chance workers on average will see their standard of living rise.

Finally, the value of the dollar is significantly lower, and the trade deficit, though improving, will remain a problem. A lower dollar makes exports more competitive, but even with this dollar, rebalancing the economy will not be easy. After years of living with a high dollar, manufacturers don't have the capacity or trained workforce to make many of the products the rest of the world wants.

Tinkering with the safety net, placing a few restrictions in trade agreements or pressuring the Chinese to raise the value of their currency will not fix matters. What America needs is a set of policies that will make it a high-wage nation again, no longer dependent on ever increasing consumer debt and work hours to make ends meet. It must once again invest adequately in the public goods and services required to compete in the new century, including early education, transportation infrastructure, energy conservation and healthcare reform. The mainstream economic model on which most Democrats have relied since Bill Clinton's presidency will not deliver this. Here are a few of the key precepts of the outmoded mainstream model--hardly an agenda for our times.

Wage growth must be moderate. Every time wages have gone up more than moderately since the 1980s, Wall Street and Washington worry, and this has long included the Democrats. Fearing inflation, the Federal Reserve clamps down rapidly if wages begin to increase the way they once did--with overwhelming support from both parties. The one exception was the late 1990s, when the Fed allowed a wage rise in anticipation of rapidly rising productivity to offset it.

All this didn't start with the newest wave of job offshoring. As Isabel Sawhill of the Brookings Institution and John Morton of the Pew Charitable Trusts recently reported, a typical male in his 30s makes less today, after inflation, than his father did a generation ago. MIT economists Frank Levy and Peter Temin are the latest of many who have shown that even for men with college degrees, wages have not been keeping up with productivity since sometime in the 1970s.

Low taxes mean fast growth. "Case Closed: Tax cuts mean growth," wrote former Tennessee Senator and GOP presidential hopeful Fred Thompson in the Wall Street Journal in April. But most Democrats are hardly champions of tax increases either. Both parties emphasize that by minimizing government regulation and social spending, market incentives will stimulate productive investment. Moreover, they see low wages as a way to deal effectively with overseas competition. House Democrats, for example, are considering lowering corporate income taxes.

Balancing the budget increases savings. Mainstream Democrats and Republicans alike believe savings are the key to economic growth and that the most direct path to more savings is to reduce budget deficits. It's a page right out of pre-Depression economic theory. Since the early 1980s, when massive deficits became the norm, budget balancing has become a self-destructive rallying cry of the Democratic Party. By contrast, some Republicans, like Thompson, will give up savings for lower taxes and an ever lower ceiling on government spending, thereby "starving the beast." Surveys find that Americans who identify as Democrats are more concerned with the size of the federal deficits than are Republicans, a reversal from two decades ago. But the best way to raise savings is by growing incomes.

Public investment is not as important as a balanced budget. Republicans in general are distrustful of public investment. But when it comes to choosing between a budget deficit and investment in infrastructure, early education systems or basic research, most Democrats choose a balanced budget. This has left the nation bereft of the most critical foundation for the economic future.

Do Democrats really believe America can succeed in the coming century without high-quality, universal early education? Do they believe the nation will be satisfied with a rate of college attendance that is now exceeded in other rich nations? Do they believe we can get by with roads and bridges that professionals grade a C or D?

Some proponents of the savings model still believe the Clinton boom was proof that it worked. The tax hikes of 1993, they argue, cut deficits and increased savings. In fact, the Clinton boom was led by government stimulus of demand, a good old Keynesian tactic. Other factors, of course, also contributed, including the remarkable fall in computer-chip prices and the rise of a new crop of innovative mass-market corporate giants. But government stimulus was supplied by the Federal Reserve under Alan Greenspan, who kept interest rates low in the late 1990s, in part to calm the fragile financial markets during the international crises of 1997 and '98. In addition, consumers and businesses spent lavishly, supported by borrowing against the rising value of stocks and their homes.

This can't last. Building a nation on credit rather than higher wages has led to record levels of debt, compared with income; dependence on a high dollar to attract foreign capital (thereby undermining manufacturing at home); and the current subprime mortgage crisis. And families can't work many more hours than they do now.

Policy-makers need a better way to think about the economy, and there is one. It is a model grounded in history and based on what economists call demand-led growth theory. It partly harks back to John Maynard Keynes, who during the Great Depression argued that inadequate demand for goods and services is a primary cause of economic stagnation: When economies run at less than full employment of their capacities, it is because of a lack of buying power. Raising savings can, in fact, lead to stagnation because it reduces purchase of goods or services. Keynes argued that even if the government runs at a deficit, it is imperative to stimulate buying power.

Another argument for maintaining buying power is that increases in demand do not merely help to fully use otherwise underused resources; they can also increase an economy's productivity in just the way Adam Smith suggested. High demand enhances productivity by making it possible to exploit economies of scale. The division of labor can result in lower costs by producing more volume, but this is only worthwhile if you can sell many more products.

Contemporary demand-theory economists in Europe, Britain and the United States have added new wrinkles: growing output stimulates more investment, and more investment creates new ideas and other spillover consequences that can induce still greater investment. The increased production and investment also results in "learning by doing," another important source of increased productivity: you learn more about how to produce efficiently, in other words, as you do more producing.

This way of thinking about economic policy has broad consequences. It means higher wages are not just a cost of business; they are exactly what Henry Ford talked about when he justified paying workers up to $5 a day, well more than the going rate. He had to be sure someone could buy his cars. Demand-led theory points out that if wages rise, they can stimulate productivity, reducing pressure on business to raise prices. Given this dynamic, Federal Reserve policy can take greater risks of higher short-term inflation. Today's seemingly low unemployment rate, as unlikely as it may appear, can be pushed still lower.

Such a theory means that federal policies to promote higher wages have an additional justification: economic growth. Higher minimum wages, support of living wages and laws more favorable to unionized labor may actually improve productivity and benefit us all rather than being a cost to society.

When one also considers the potential social and fiscal returns from public investment, the Democratic determination to balance the budget makes no sense. There is overwhelming evidence that the benefits of public investment in some cases generate enough additional income and cost savings that the resulting revenues cover most of, or even more than, the initial cost. The most promising are studies of early education programs that have made their participants better workers, better citizens and probably more fulfilled people. An important new model developed by William Dickens and Charles Baschnagel at the Brookings Institution assesses the fiscal returns that will be produced by a high-quality universal early education program. Over time, the cautious researchers find, the returns in higher government taxes and reduced welfare expenditures will more than pay for the programs.

The Congressional Budget Office should similarly score the potential returns of public investment in transportation, energy conservation and research projects. It typically regards such outlays as costs with no future tax benefits. Thus, a $100 billion expenditure may in fact be only $50 billion over time, as tax returns rise because of an improved economy. In some cases, that $100 billion outlay may be wiped away entirely.

Healthcare reform fits into this category. A new, efficient healthcare system, many claim, will pay for itself over time through reduced administrative expense and healthier people who require less expensive care. Still, even in the best of circumstances, there will be substantial initial outlays. With the support of demand-led theory, Democrats can tolerate such deficits in the short run. Without it, serious healthcare reform, despite the encouraging proposals of some Democratic presidential candidates, will remain a pipe dream.

There are two final components of this approach to economic policy. The first has to do with globalization. The objective of trade pacts should not be to protect American workers per se but to bring to the rest of the world the progressive revolution in living standards that US factory workers started to enjoy a century ago. Higher minimum wages, protection against labor abuses, adequate healthcare and a decent environment will help develop domestic markets in these nations, which will in turn stimulate their productivity growth and make them less dependent on exporting to the United States. Meanwhile, Americans will compete on a more level playing field and find export markets for their goods.

The other final component is the re-regulation of finance. Our financial system now operates under a set of domestic incentives that strongly favor short-term profits, from which CEOs personally benefit. Some in Congress, notably Representative Barney Frank, are taking up this cause. Addressing these issues should be an integral part of a new

economic model, including requirements for more transparent reporting (including on hedge funds and other private investment vehicles), greater shareholder power and more restrictions on how executives are compensated. The system also favors debt. Closer oversight of credit standards is required.

Similarly, the international flow of hot capital has upended theory about the system of floating exchange rates. The fact that America's dollar stays high despite a huge trade deficit is not self- correcting. As Robert Wade of the London School of Economics argues, some intelligent combination of semi-pegged currencies and capital-flow restraint would go miles toward rebalancing the international economy.

The mainstream Democratic model is at best outdated; at worst, it never worked. Wages can surely rise too rapidly and contribute to destabilizing inflation, as occurred in the 1970s. Inflation can be embedded in the expectations of labor and consumers, making it intractable. Very high inflation will distort the economy. Budget deficits can be too high. But we are a long way from such an economy. Policy-makers are fighting the last war. The wage share of the nation's income has fallen sharply since rising in the late '90s. Inflation is at rock bottom and inflationary expectations are weak. Labor unions, which in the '70s helped push wages high, are now too weak to bargain for a fair share. The budget deficit is low.

And so are taxes, for that matter. No economist has ever made a defensible case that high taxes impede economic growth in the long run. Joel Slemrod of the University of Michigan methodically analyzed studies on high-tax and low-tax countries and found that tax rates did not affect growth. Nancy Stokey of the University of Chicago and Sergio Rebelo of Northwestern University note that the long rise in the income tax since 1913 has "produced no noticeable effect on the average growth rate of the economy."

Let's also keep in mind that until twenty-five years ago America generally paid the highest wages in the world. Government was often an equal if sometimes too reluctant partner in the economy. In a time of wide-eyed confidence in the power of private enterprise, whose dynamic energies are vital and will remain remarkable, Americans should remember that government guaranteed access to land in early America, built canals, established free primary schools and later high schools, started agricultural universities, subsidized railroads, sanitized cities, protected workers, established a central bank, built highways and generously helped the elderly.

When America has been at its best, it has been willing to experiment rather than retreat. Current mainstream thinking has ushered in a self-defeating age of limits. It will take both government and business to break the yoke that unnecessarily burdens us.