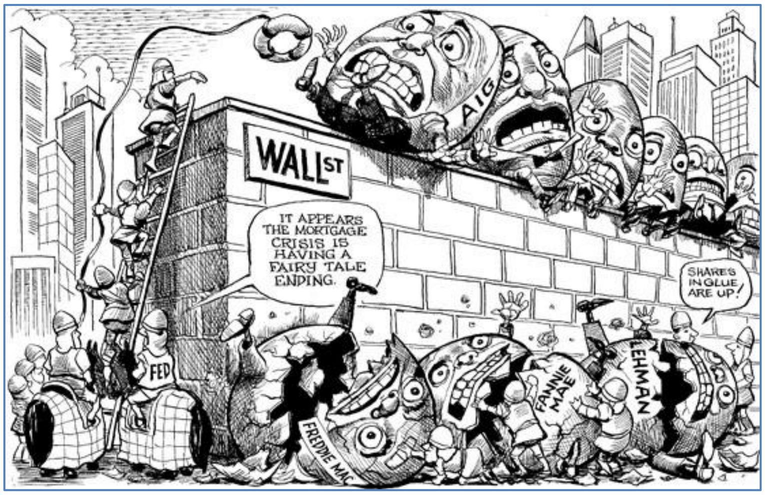
What’s left of the economy?

Frank Ackerman


WALL ST
IT APPEARS THE MORTGAGE CRISIS IS HAVING A FAIRY TALE ENDING.
SHARES IN GLUE ARE UP!
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The Economist

Like a well-known egg, the American economy had a great fall – and all the president’s men (and women) couldn’t put it back together again. But at least they’ve tried; the president’s loudest critics want to walk away and let the egg reassemble itself.

What would it take to put the economy back together? And what should it look like when it’s fixed? Most people would like to see a lot more jobs, a lot less deficit spending, and some kind of guarantee that the crash won’t happen again.

There is, unfortunately, no simple trick that could accomplish this without rethinking and reorganizing the economy. The timid half-measures offered by the Democratic leadership in Washington, let alone the not-so-benign neglect championed by Republicans, will not produce an economy that works for working Americans. We need to re-examine how the economy works, and what’s it’s supposed to do for us, in order to develop a strategy for reviving it.

There are two intersecting problems. One is the problem of individual incomes: the economy produces too little for many people, and too much for a few. The other is the problem of collective welfare: the economy produces the wrong things, violating basic rights and starving social needs. Any complete solution must address both problems, both providing fair and reliable incomes, and also protecting rights and satisfying social needs.

This account starts with a look at the inadequacy of the economic idea that is nearly a national religion: the virtues of free markets. It turns next to the problem of individual incomes, examining patterns of inequality and the need for short-term economic stimulus and long-term planning for the growth industries of the future. Discussion of the problem of collective welfare then leads to a complementary strategy of expanding the realm of rights and the provision of social goods outside the market.

Faint praise for free markets

There are important things that markets do well – but the praise for free markets should be much fainter than usual. There are equally important things that markets do badly, if at all.

The successes of markets all involve decentralization of decision-making. The number of different prices and transactions in a modern industrial economy is staggeringly large, and centralized planning or control of all such details is essentially impossible. In a market economy, only those who are buying or selling steel have to think about the price of steel. The same is true for the price of milk, haircuts, cell phones, and everything else. Producers can adjust what they sell and consumers can adjust what they buy, in response to changing prices, without any explicit coordination – because the market provides implicit coordination.

When small businesses sell their products to well-informed customers, decentralized market decision-making creates a quasi-democratic outcome: customers “vote” with their dollars for the products and services they want to buy. Lots of people like to cook, and plenty of them can raise the money needed to start a restaurant. The ones that offer food that their customers like will stay in business. Richer people eat out more often, and get more votes about restaurant survival – but restaurant spending is more equally distributed than income. (Someone with 100 times your income does not spend 100 times as much at restaurants as you do.)

Markets can also produce good outcomes via the stewardship of small-scale property ownership. Homeowners take better care of their houses than tenants or absentee landlords; landowners who live on and depend on their land are more likely to protest when the latest technology for gas drilling or coal mining threatens to destroy the local environment. If ownership of property were widely enough distributed – as in airbrushed pictures of small-town life or the American past – this, too, would be quasi-democratic.

The market-based decentralization of information about prices occurs regardless of the size of the enterprises or the complexity of the goods they are trading. The quasi-democratic implications of markets, on the other hand, depend on the assumption that small businesses are producing well-understood products, and that ownership remains broadly distributed.

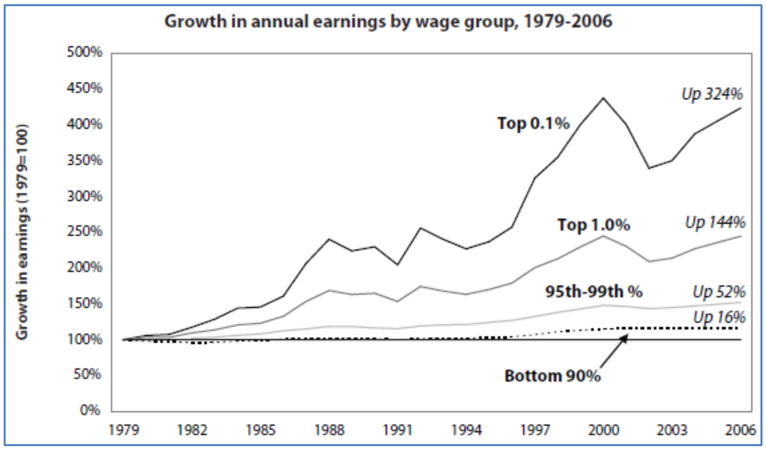
Yet small businesses that survive often become much bigger businesses. Economies of scale (reasons why it is cheaper to produce things in bulk) are pervasive, and enormous corporations are a fact of life. Even in the restaurant business, fast food chains have a substantial share of the market, although (unlike the situation in many industries) it remains relatively easy to start an independent restaurant. Long before businesses become “too big to fail,” they become too big to feel the quasi-democratic pressure of small shifts in consumer preferences.

When products are too complex for customers to understand – think of health insurance policies – then market choices may not reflect anyone’s informed preferences. If few enough people understand the market, and business-friendly regulators are willing to wink at transgressions, then the profit-maximizing strategy may be to cheat, as demonstrated by Enron, Bernie Madoff, the sellers of subprime-mortgage-backed securities, and so many others.

The failure of markets is even more complete when it comes to collective needs. The invisible hand is good at providing a balance between Chinese and Mexican restaurants in your neighborhood, but not at building the urban infrastructure (let alone social services and environmental protection) that restaurants and the rest of us depend on. Indeed, Adam Smith’s invisible hand metaphor implicitly assumed that the common good consisted of getting the right mix of village merchants’ services. This was probably not the whole story even in his day, in eighteenth-century Scotland – and it misses by a mile in twenty-first century America.

Stagnant incomes in a booming economy

It is no surprise that millions of people have seen their incomes fall in the Great Recession that began in 2008. More remarkable is the fact that average incomes were stalled for decades before that, even when the economy was growing. Productivity rose rapidly, but average incomes barely budged. As the Occupy Wall Street protesters accurately observed, the gains from economic growth were concentrated in the hands of the top 1%, leading to a rapid rise in income inequality.



Lawrence Mishel, EPI

This is not an eternal or unchangeable feature of economic life; in fact, it is a sharp departure from earlier years. From the 1950s through the 1970s, the distribution of income was little changed, actually growing slightly more equal during most of those years. Incomes rose in the top 1% at about the same rate as for everyone else. The average worker's earnings increased steadily, roughly in line with productivity, through the 1970s.

Since 1980, there has been a trend toward rapidly rising inequality, with little change in average real earnings, adjusted for inflation. Married couples (unlike one-adult households) continued to see rising *household* incomes, largely due to the ongoing increase in married women's hours of paid work. But there is a natural limit to such increases: by 2007, the average working-age married couple was doing more than 3,300 hours per year of paid work; in the top fifth of the income distribution, the average was more than 3,800 hours, roughly two full-time jobs.[1]

Another source of increasing consumption in the era of stagnant earnings was a rising tide of mortgages and home equity loans, allowing consumers to borrow against their principal assets, namely their homes. As long as the value of everyone's house keeps going up, what could possibly go wrong? This, too, reached a limit; the bubble had to burst sooner or later.

Many changes played a role in the economic lurch to the right in the 1980s. Major corporations saw their profits squeezed by the oil crises of the 1970s, by rising militancy and labor costs in the United States, and by renewed competition from Europe and Japan. As a result they took a more confrontational approach, demanding major concessions from workers who had won strong union contracts in earlier years. Manufacturing employment in the United States, a major source of middle-income jobs, reached an all-time peak of 21 million in 1979.[2] The Reagan administration attacked labor and social services, while cutting taxes for the rich, shifting the federal government toward policies that clearly favored inequality. These policies have never been reversed, and indeed are revered in much of American politics today.

[1] See the Economic Policy Institute website, http://stateofworkingamerica.org.

[2] Census Bureau, *Statistical Abstract of the United States*, Historical Tables. Although growing in absolute numbers before 1979, manufacturing employment was not keeping up with the expansion of the labor force, so that the percentage of workers in manufacturing had been declining since World War II.

In support of the attacks on equality after 1980, it has often been said that economic incentives are needed to promote investment in a market economy. This is true, and does imply, as an inevitable consequence, that a market economy requires some degree of inequality. If everyone was guaranteed an identical income and higher earnings were taxed at a 100% rate, investment would undoubtedly grind to a halt. Such abstract deduction about an implausible extreme, however, tells us almost nothing about real policy choices. How large do the incentives, and the resulting inequality, have to be in order to ensure a flow of investment? The answer suggested by history is: not very large at all.

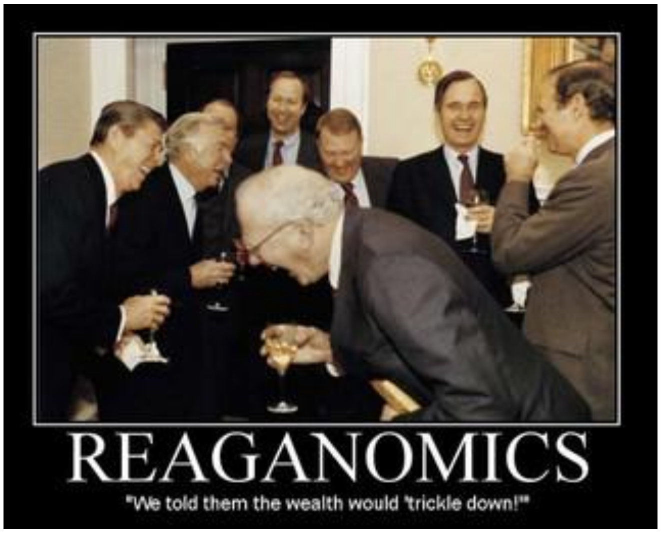
The U.S. economy grew more rapidly, on average, before 1980 than it has since then. Yet in the 1950s, the income tax rate on the highest income bracket was 90%. Throughout the 1960s and 1970s, it was 70%. These rates did not prevent investment and growth; indeed, they turned out to be compatible with growth at a faster pace than in recent years. Taking home “just” 30% of a multi-million-dollar income in the 1960s and 1970s, or even 10% in the 1950s, was enough to make it worth getting into the limousine and going to work on Wall Street or at corporate headquarters.

Since the Reagan tax cuts in the 1980s, the tax rate on top incomes has been below 40%. The supposed urgency of cutting it even lower, as the second Bush administration did, is not supported by even a shred of evidence. The economic argument for such low taxes on the rich is little more than greed gone wild. Drastic reductions in tax revenues have forced draconian cutbacks in all manner of government programs; for some tax-cutters, that was the goal all along. Restoring sensible taxes on the rich is the key to rebuilding the finances of public services.

Steering the market toward prosperity

Taxing the rich and undoing many budget cuts, while essential, is far from sufficient for economic recovery. To ensure that jobs and incomes are available for all, it will also be necessary to create an effective stimulus to end the economic slump in the short run, and to guide the development of new technologies and industries in the long run.

These objectives, calling for an active government role in steering the economy, clash with the free-market orthodoxy that is accepted so widely in current debate. That orthodoxy counsels a hands-off policy, in which the government just cuts spending in order to keep interest rates and inflation low enough to restore investors’ confidence, so that the private sector will lead the economic recovery. This amounts, as Paul Krugman has said in the *New York Times*, to waiting for the “confidence fairy” to wave a magic wand. More than three years into the Great Recession, spending has been slashed and interest rates and inflation are at historic lows, but the confidence fairy has not made an appearance.


REAGANOMICS
"We told them the wealth would 'trickle down!'"

The solution to a prolonged economic downturn was explained by John Maynard Keynes in the 1930s: an increase in government spending will put people back to work, generating additional jobs and incomes as they spend their new incomes. Deficit spending is almost inescapable in a recession, and will not impoverish future generations if the money is spent wisely to rebuild the economy. Balancing the budget when employment is relatively high, or over the course of a business cycle, is a sensible goal; balancing the budget during a downturn is not. The problem with the Obama stimulus package in 2009 was that it was too small, and too brief in duration, to solve the problem. It prevented a much worse decline, but would have had to be bigger and longer-lasting to bring about real recovery. With interest rates so low, what better time will there be for the government to borrow?

The government's role in guiding the economy will not end with the recession; there is an ongoing need for public involvement in managing the market. The economic crisis of recent years was caused in part by stagnation in middle-income jobs and by investment in financial speculation rather than useful production – which in turn resulted from the weakness of economic leadership after 1980.

Governments have always guided economic growth; the market does not pick new leading industries on its own. In the nineteenth century, massive federal land grants subsidized the railroads, and the settlement of Western states. Public investment in and regulation of irrigation turned the arid state of California into a center of agriculture. In the twentieth century, the interstate highway system and federal mortgage subsidies allowed automobiles and suburbs to flourish. Military spin-offs have created or reshaped civilian industries, from airplanes and airlines, to nuclear power plants, to computer chips and microprocessors. The Internet is an outgrowth of an early network that connected military researchers.

For the last thirty years, however, the federal government has largely abdicated this role, falling under the sway of free-market fundamentalism. Promotion of free trade and removal of barriers to competition were said to suffice, letting the market rather than the government pick the winners, and identify the new sources of growth in a complex global economy.

This theory has now been tested in practice: almost all of the barriers to trade that existed thirty years ago have been removed; any problems that could be solved that way have been solved by now. The results have been stagnant incomes, massive trade deficits, and the bleeding away of what remains of American manufacturing.

It can't be socialism, if it's in Texas

Other countries have not matched our foolishness in this regard. In Europe, in Japan, and in China, governments have promoted transformational new technologies such as high-speed rail and wind and solar power, making strategically chosen investments with long-term payoffs. If we want to be a producer, not just an importer, of the defining technologies of the 21st century, we need to do the same. China is not the only contemporary success story; a more instructive example is provided by Germany and other northern European countries. With average wages similar to U.S. levels, they have better and cheaper health care, longer vacations, higher taxes, stricter environmental protection – and they continue to produce and export manufactured goods.

The market will not create new growth sectors on its own; economic leadership is required to define what we want to produce and how we want to grow. Creation of new opportunities is also important as an alternative to things we want to discourage. Investment in speculation has proved difficult to eliminate; restriction of bad behavior by investors must be accompanied by creation of attractive opportunities to make money in socially useful pursuits. Similarly, the claim that higher wages will eliminate jobs, while routinely exaggerated, is worth considering – but if new industries are expanding, it may be desirable for higher wages to push labor and capital out of old, low-productivity industries into more promising areas for the future.

Beyond individual wealth

What many people need most is a higher income. The less you are earning right now, the more urgent it is to earn more. But no matter how low your income is, that's not all you need.

Human beings are social animals; we live with, interact with, and depend on others. We need to live in safe and comfortable communities, protected against violence and against environmental hazards. To live in any but the smallest communities, we need the shared infrastructure of transportation, communication, and urban settlement. We need to educate the young, ensure secure retirement for seniors, and provide health care for all. These and other intrinsically social services can only be provided efficiently through collective action; there are enormous economies of scale in the provision of infrastructure and social services.

In the absence of adequate public services, the market offers imperfect and expensive private substitutes: suburban sprawl and long commutes; gated communities and other exclusive neighborhoods where the house prices alone keep the riff-raff away; private schools at staggering prices; the world's most expensive (but far from best-performing) health care system; and good luck to you with saving for your retirement. The high cost of private replacements for public services keeps upper-middle-income households scrambling to earn more, well past the point of providing for their individual material needs.

Thus the second problem with the market economy – the failure to produce the things we need, the starvation of social needs – interacts with the first: impossibly high incomes, beyond the reach of almost everyone, seem to be required to buy sufficient private replacements for missing services. As successive waves of budget cuts make public services increasingly stingy and ill-provided, more and more people conclude that they will have to pay for the private versions on their own. This can lead to a further decline in support for the remnant public programs: why pay taxes to support a struggling state university, if you also have to pay tuition to send your children to better private colleges?

Any progressive strategy for reshaping the economy must address the current failure to provide for social needs. This cannot be simply a matter of undoing budget cuts and restoring past benefits; it is essential to challenge the misguided notion that social services and government programs are “pork,” illegitimate concessions to special interests, or waste that should be eliminated in the name of efficiency. It is much easier to win support for universal, rather than means-tested services, as shown by the enduring popularity of Social Security and Medicare; some of the noisiest Tea Party enthusiasts famously called for keeping “the government’s hands off my Medicare.” (Change “the government” to “the one percent,” and “my” to “our,” and such slogans would have an appeal far beyond the paranoid precincts where they originated.)

The argument for social programs and protective regulations does not rely on cost-benefit analysis; once cost-benefit ground rules are accepted, the game is normally lost. It is often a matter of rights, defining the allowable scope of market activity and the limits of property versus human rights. Expanded social provision is a route to equality, removing more of life from the realm of commodities and rights, and entitling all to a shared standard of well-being.

Leveling the playing field up, not down

Markets can operate under many different ground rules; choices about what is and is not allowed in commerce are political and moral decisions, not economic calculations. In Russia in the 1990s, following the abrupt introduction of private enterprise, some bankers hired gangsters to kill other bankers. If successful, this is a perfectly logical way to increase market share; depending on what the gangsters charge, it may be a very efficient, cost-effective investment. There is of course a widely shared certainty that killing your business rivals is unacceptable, but this is a moral value, external to the market, that determines the allowable sphere of competition.

MORE BANK.
MORE FOR YOU.
MORE CONVENIENCE.
MORE LOCATIONS.
MORE HOURS.
TD
TD

Or, why not shoot the other bankers?

In the United States, human beings could be bought and sold before 1865; employers could hire children in many states before 1938. The country had a market economy both before and after these dates, first with and then without slavery and child labor. The bans on slavery and child labor establish basic human rights, and define the allowable limits within which market competition can occur.

Many regulations are best understood in similar terms, as political and moral agreements about the limits within which we expect markets to work. Are there minimum wages and maximum hours for employment? Are there limits to the pollution that can be released into our common air and water? “The market” doesn’t care: it is equally possible to have a market economy with a minimum wage of $5 or $10, with dirty air or clean. The question is, which do we want?

Moral commitments are often thought of as an individual matter, but in a competitive market it is important to express them in binding rules, applicable to all. This is particularly important for well-meaning businesses that want to do the right thing for labor and the environment. Any business is of course free to raise its workers’ pay, and to reduce its pollution, on its own – but it would risk being undersold by competitors who pay less and pollute more. Regulations can level the playing field upward, ensuring that competitors have to meet the same high standards; they prevent a race to the bottom, and let the businesses that have the best intentions operate without fear of unscrupulous competitors.

The expansion of human rights, defining the limits of the marketplace, can also be seen as a redefinition of property rights. Ownership of a bank does not include the right to kill rival bankers; ownership of a cotton plantation does not include the right to own farm workers. While these examples may seem forced, a similar logic is often raised in connection with environmental policy. Does ownership of a power plant include the right to emit air pollution, or does the public "own" the rights to clean air? Again, a market economy is equally possible with either answer; the market as a system does not prefer one or the other (although coal plant owners generally prefer one, and neighboring communities generally prefer the other). Cost-benefit analysis cannot provide an unbiased answer to the question, because strong, arbitrary assumptions about pollution rights and many other issues are buried deep in the technicalities of the analysis.

As environmental debates demonstrate, property rights are not an all-or-nothing proposition. Does the polluter have to pay for infringing on the public right to a clean environment, or do we have to pay the polluter for infringing on the right to pollute? The answer need not be the same for every pollutant, and it is certainly not constant over time. A famous analysis in environmental economics demonstrates that under ideal conditions, both answers are equally efficient and either approach will reach the same level of pollution control. The two approaches differ, of course, in the distribution of rights and the resulting distribution of resources.

The pursuit of collective welfare through the expansion of human rights and social programs leads to a more equitable society, complementing the crucial efforts to promote equality in private incomes through taxes on the rich and wage hikes for the poor. As more and more rights and services are provided to all, the sphere of social consumption expands relative to the private sphere; services provided to all are no longer commodities that individuals have to buy. Although inequality in individual incomes and private consumption can never be entirely eliminated in a market economy, more and more of human needs can be met outside the market. While the market remains essential as a vast, amoral calculating engine, we can make use of its calculations to invest in our common future, beyond the realm of commodities and inequality.