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Beyond Rubinomics

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Every time I read about a solution to the economic crisis these days, I invariably find an underlying assumption that once we are past all this, America will be just fine again. If we get the banks spending, if we stop the mortgage defaults, if we stimulate enough and if we reregulate the errant, greedy financial community, prosperity is sure to follow.

The economic emergency, however, is not simply the consequence of mindless, ideological deregulation and investment bubbles gone bust. It is the result of a narrowly conceived economic model and the failure of Washington's social contract with America, whose weaknesses were essentially disguised by ever more debt. To save America, that social contract has to change, and the economic model on which it is based has to be modified.
In the 1980s the nation abandoned a working social contract with its citizens that promised, and even produced, a wondrous but often cruel free-market colossus that worked justly and prosperously for most. The abandonment of that social contract was hailed as the rebirth of individualism and America's gift to the world: limited government. But it caused rising inequality and the decline and stagnation of median wages over the course of a generation. It also led to the rampant neglect of public goods vital to the citizens' welfare and the prosperity of the economy. Meantime, the nation lived off and ran through the public investment it made from the 1930s to the 1970s with little protest from politicians or mainstream economists.

Where Democrats differed from Republicans was in believing that the nation actually had a working social contract with its citizens. Workers who lost jobs or took lower wages due to rapid globalization and technological change required an enhanced safety net--more generous unemployment insurance, job training and perhaps, in the minds of bolder social critics, guaranteed healthcare and pension benefits. Many Democrats came to believe it would be wrong to interfere with the labor or financial markets in any way that could damage the nation's productivity gains or rapid rates of economic growth. Expanding the social safety net became the order of the day.

The Democrats fostered what Barnard economist Marcellus Andrews calls a "debt-based social contract." There were many causes of the Clinton boom of the late 1990s, including the rapid fall in the cost of computer power leading to the Internet revolution. But more critical, it is clearer in retrospect, were cheap money, speculative stock and housing prices and a lot of borrowing. Debt covered up the failures of the social contract and the economic model. It did not succeed in protecting workers from rising debt payments, lost healthcare benefits, withering pensions or job turnover.

Borrowing--and hence the cover-up--was encouraged by a high dollar, the pride of Treasury Secretary Robert Rubin. The high dollar attracted foreign money to compensate for America's lack of savings; Americans were unable to save because they had to borrow just to keep up. It was also propped up by the deregulation of international capital flows, led by Rubin and his number-two man, eventually his successor, Lawrence Summers. The financial community then innovatively supplied the credit to the masses, partly by circumventing the banking regulations designed to restrain overlending, a constant and regular danger since the dawn of formal banking itself. Rubin, Summers and Alan Greenspan presided over this.

The Bush administration made conditions significantly worse. The economy was thriving, but hourly wages fell between 2002 and 2007 for the typical worker, even including fringe benefits, and for the first time since World War II, median family income did not rise as a result of economic recovery. Had a typical worker's earnings risen in the expansion at a normal rate, it would have meant another $2,500 to $3,000 in annual income by 2007, perhaps three or four months of mortgage payments. It is likely many would not have had to default.

The longer-term result was that except during the late 1990s, compensation to workers has stagnated or risen marginally since the 1970s. For many, it fell. Isabel Sawhill of the Brookings Institution and John Morton of the Pew Trust computed that a typical 30-year-old male in the middle of the pack now makes less than a typical male of the same age in the 1970s, discounted for inflation.

Access to borrowing was the salve that soothed the harsher reality of lower real wages. Now indebted Americans are paying a large price, losing homes and livelihoods. The debt has been the source of enormous wealth for a small privileged class located on Wall Street. Profits on Wall Street rose to 31 percent of all US profits.

Soaring oil prices in early 2008 forced America to face its lack of a serious national energy policy. Increasingly, prominent businessmen like Bernard Schwartz and Felix Rohatyn made the case for infrastructure investment, and the American Society of Civil Engineers awarded the nation's infrastructure a grade of D. Complaints about healthcare costs emanated from business, even as workers were saddled with a larger part of their annual health insurance bill.

The United States is no longer merely in crisis; it is in a state of emergency. The three phalanxes of attack are clear: provide the capital and asset support for the banks and shadow banks; stanch the mortgage defaults; stimulate the economy aggressively. That the Bush administration has been slow on the first, and as of December absent on the second and third, is a tribute to its laissez-faire Friedmanite ideology. The Democratic Congressional leadership now strongly argues for a large stimulus that includes serious public investment in infrastructure and energy alternatives. But it is by no means clear that the Obama administration, laden as it is with deficit hawks from the years of Rubinomics, will propose adequate plans to make the banks whole, stem the defaults--a very expensive proposition--reregulate finance, or even stimulate the economy.

But if Obama can get the economy back on four wheels again, then what?

The nation needs a new social contract that imaginatively deals with low wages and catches up with the tragic neglect of public assets over the past generation. This will involve institutional change, a meaningful shift in Federal Reserve objectives and frank and open Washington interference in the markets. It will require tolerance of government deficits but also eventual higher taxes. It need not undermine free trade, or even outsourcing, but it must begin to make developing countries respect their own workers and their own environments.

Most mainstream Democratic economists will have trouble accepting these statements of principle. If the economy does turn up in a year and a half or so, the good news for Democrats is that Obama, barring terrorist tragedies, is highly likely to win a second term. But fashioning the policies to re-establish a prosperous foundation for the nation will require a different way of thinking and a partial renunciation of the accepted economic model. Obama's appointments are--by historical standards, if not by current ones--center-right in a nation the election suggests wants to lean at least center left. Christina Romer, whose academic career is based on defending Friedmanite propositions, is to be head of the Council of Economic Advisors. The holdovers from Rubinomics are all deficit hawks: Summers and staffers from Rubin's Hamilton project at Brookings. Timothy Geithner is a Summers protégé. Summers and Rubin could not find money to invest in infrastructure in the flush 1990s, so obsessed were they with budget surpluses then.

According to their economic model, budget deficits reduce the nation's savings, push up interest rates and undermine long-term growth. Deficits must therefore be restrained. Meantime, the high dollar fortunately attracts foreign funds to compensate for the minimal savings, making borrowing at low rates still possible. A second component of this model is that rising wages are a cost that weakens profits and encourages businesses to raise prices. Resulting high inflation induces the Federal Reserve to step on the brakes. Modest, even tepid, wage gains, even when less than gains in productivity, are thus interpreted as healthy; they are less inflationary and the Fed then has the leeway to lower interest rates still more.

But there is another model. It suggests that deficits are often necessary to stimulate and maintain high rates of growth, and the higher wages that result in turn create the savings required for investment. Raising savings rates in the short run, on the other hand, often does just the opposite of what is intended. By reducing demand, it ultimately leads to slow growth, smaller incomes and less savings. Keynesian demand stimulus in an underperforming economy will not crowd out private investment due to federal borrowing but rather crowd it in by creating business opportunities due to more sales and prospective buying power. Strong sales are what generate capital investment.

If the stimulus is spent on domestic investment in infrastructure, energy alternatives and green investment, especially after so many years of decay and neglect, it will also create domestic jobs, often good ones, all the while improving the nation's productivity.

As for the question of tolerating higher wages that may bring about a return of inflation, the higher wages themselves may stimulate growth by encouraging demand without, it is important to emphasize, pressuring financial markets with ever higher levels of debt. The demand in turn stimulates capital investment--the source of productivity growth--and may generate greater economies of scale. It is Henry Ford paying his workers up to $5 a day to make sure they could afford his cars.

The latter was always the American way. It is conclusively true, notes Peter Lindert, economist at the University of California, Davis, in a working paper for the centrist National Bureau of Economic Research, that America paid the highest wages in the world from 1800 to the 1980s. How did we grow so rapidly then?

If and when the ship is righted, including intelligent re-regulation of finance, the nation must again develop imaginative and aggressive policies to raise wages. How? Through institutional effort and a recognition that labor markets are hardly perfect. As economic historian Peter Temin and economist Frank Levy, both of MIT, argued in a recent paper, it is increasingly obvious that institutional protections for workers matter, and indeed worked in the 1950s and '60s to raise the standard of living for workers at all income levels.

Briefly, then, America must:

§ Raise the minimum wage still higher and on a regular basis. It has fallen far behind increases in inflation since the 1970s, and that affects higher level wages as well.

§ Encourage living-wage programs by local governments. Governments can demand that their contractors and suppliers pay well above the minimum wage. There is substantial evidence that this does not result in an undue loss of jobs.

§ Enforce the labor laws vigilantly. Minimum-wage and maximum-hour laws are violated to a stunning degree. American workers shouldn't be forced by their employers to understate the number of hours worked or be locked in the warehouse so they can't leave on time. Workers often make only $2 and $3 an hour.

§ Unions are not seeking a free pass to organize secretly when they advocate for open check-offs on cards to approve of a union vote. They are seeking to organize without persistent and often illegal management interference. Penalties for illegally deterring such organizing are so light, it makes little sense for management not to pursue strategies to stop organizing even at the cost of prosecution.

§ Request that trading partners develop serious environmental standards and worker-protection laws. This is good for them, bringing a progressive revolution and a robust domestic market to their countries. It is good for America, which will be able to compete on a more level playing field.

§ Demand that the president, governors and mayors speak up about unconscionable executive salaries and low wages. The influence from the top cannot be underestimated. A president who looks the other way sends a strong signal to business. A president who demands responsible treatment of workers will get a response. Business does not like such attention.

§ These measures should be accompanied by serious investment in modernized infrastructure and energy alternatives, which can create millions of domestic jobs that pay good salaries. It should also be accompanied by a policy that supports a lower dollar--contrary to Rubinomics--in order to stimulate manufacturing exports again. Accomplishing this may require a new system of semi-fixed currencies across the globe. The unabashed high-dollar policy of the past twenty years has led to imbalances around the world that have contributed fundamentally to US overindebtedness.

§ And finally, the nation needs more balance on the part of the Federal Reserve between subduing inflation and creating jobs. Americans can live with inflation above 2 percent a year. There is no academic evidence to support a 2 percent annual target, although the Fed has made this its informal target.

These are the components of a restored social contract that's suitable to America's aspirations and values and that promotes prosperity.

In addition, it can enable America to redress the gross neglect of its public assets. High on the list, alongside infrastructure and energy, should be universal pre-K schooling, more subsidies for college and the rethinking of the healthcare system. Investment here can also create jobs traditionally held by women, who are neglected by policy initiatives. Health will rapidly become the largest budget issue of the nation in coming years unless it is addressed. I favor "Medicare for all," the highly efficient and well-liked insurance program for the nation's elderly. It can be implemented in a practical amount of time, it can be integrated with the private healthcare system and it enables government to negotiate fees and drug costs if it so chooses.

Higher budget deficits can be tolerated if the money is used for such public investment. But in Obama's third year, it may be time to raise taxes on all but poorer workers to pay for the half-trillion dollars or more of social spending we badly need. By then, the hope, by no means a fantasy, is that Obama may have proven to Americans that government can work. That, of course, is the key to success. To do so, however, will require shedding some of the ideological baggage of the Rubinomics holdovers he has advising him.

About Jeff Madrick

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