The Agenda for Shared Prosperity

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Linda Lawson, American Public Human Services Association
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LAWRENCE MISHEL: Welcome to our forum of the Agenda for Shared Prosperity. Let me say a few words about this policy initiative and then I'll introduce our first speaker. EPI, as well as most of the country, has concluded that the economy isn't working for working people. But we also have concluded that it's not enough to be able to say that and argue with those who deny. We do that, we do it very well.

But we have to go beyond that. We have to be able to propose policy solutions that will resonate with people so that they understand that things can be different. One of the biggest barriers to addressing progressive policy change is that too many people think nothing can be done about the economic firestorm that they find themselves and their families and communities in, which is why we developed the Agenda for Shared Prosperity Initiative.

Its assumptions are that the economy is not working for working people and that this has a lot to do with policy. We've debated the tax cuts for a number of years. But too few people say that the tax cuts haven't worked. There are many people who will say, "Oh, it's traded big deficits or rang up the debt."

Many people will appropriately say that it's very unfair and inequitable because the tax cuts disproportionately go to those who have the most. But the name of the last tax bill was about employment and growth. That was what they sell it as.

You all should know that this recovery is inferior when it comes to GDP and employment growth. It certainly is dramatically inferior when it comes to income

growth for typical workers because we know that there's been 18% productivity growth over the last five years. But the wages of both the college-educated worker and a high school-educated worker have gone nowhere in that time period, which leads to what is now universally cited as a way to describe this period as one where there's a giant disconnect between pay and productivity.

So we have set out to bring forth policies that are going to reconnect pay and productivity. That's the litmus test that we think should be applied to every candidate or every organization that offers policies: What are you doing to reconnect pay and productivity?

We also acknowledge that there are some new assumptions we have to address. One is that the employment-based, employer-provided health and pension assistance are unraveling. We can no longer proceed as if we just have to supplement for low-income people what other people get from their employers.

Right now retiree health insurance is becoming a thing of the past. Employer-provided health coverage has been falling throughout this recovery. Pensions have weakened tremendously over the years as you had a loss of defined-benefit guarantee payment plans and the rise of 401(k) plans. But even in this last four or five years, there's even a decline of pension coverage even when you include 401(k)s.

So that is unraveling. The other thing I'd like to say is that an assumption of the Agenda for Shared Prosperity is that solutions have to be at the scale of the problem. There are many people who mistakenly think that you can just offer a few middle-class tax credits and you're going to do the job.

It won't do the job. Neither will conventional policies, which just say, "Let the economy rip. Let's have globalization accelerate on the terms that we now have it. Let's seek a balanced budget and give some insurance to those who lose their jobs and everything will be okay." That won't cut it either because that does nothing to reconnect pay and productivity. Today we examine this issue at the level of the aggregate economy, macroeconomics, and the importance of having full employment and how do you get there.

To kick us off on this we have a very special speaker, which I'm honored to introduce. Congressman Frank is a great guy to have on your side because he's clearly one of the smartest folks in Congress. He's got a searing wit, he's humorous, and he's very knowledgeable about the issues that we care about and he fights for them.

He's knowledgeable about the parliamentary procedure and everything else. So he's a real progressive juggernaut in my view, and it's really great he's now a chairman of a very important committee over economics. And so we welcome Congressman Barney Frank from Massachusetts.

BARNEY FRANK: Thank you. I was really delighted to come here and we have obviously benefited a great deal from the work that's done. Dave Smith, as many of you know, became the chief economist for the committee, and I think under my predecessors there was no economy. They just accepted and received wisdom.

Yes it is a nice thing to have gotten the chairmanship. And you have to point out that people who aren't as familiar with Washington sometimes introduce me and point to my having gotten the chairmanship as a mark of the respect my colleagues have for me. And as you know, you get the chairmanship from outlasting other people.

I'm reminded of a great quote from Lord Melbourne who was distressed by the increasing democratization in England in the 19th century, and he said at one point, "The thing that I most like about the Order of the Garter is that there is no damn nonsense about merit connected with its being given." That's the way it works with chairmanships. There's no damn nonsense about merit.

Things have been moving in good direction on this set of issues from the political standpoint, but we obviously have a long way to go. About a year ago and before we were debating whether or not there was a lag in real income gains for most workers, I had one very big debate during a Federal Reserve hearing with Spencer Bachus, not the senior Republican on the committee but a leading member. I had been arguing the facts of the decline in real income for workers and how real wages had been declining.

He came back at one hearing, very vigorously, with numbers given to him by the Treasury talking about how compensation was in fact increasing, and we quickly realized it was compensation versus wages. In fact, in the Fed report for that year, they pointed to a great increase in worker compensation in 2004, which consisted almost entirely of the Pension Guarantee Corporation ordering companies to put money into underfunded pensions.

By this calculation, that counted as an increase in compensation for the workers. But when you looked at it, all of the increase in compensation came from increased health care costs, meaning not a penny went into any kind of take-home pay for any worker. They've given that up now. They now acknowledge this.

For a while it seemed that there was a great identity between global warming and income inequality. My Republican friends had finally been forced to concede that it was happening, but they were arguing that it was a fact of nature neither caused by nor curable by human action. They are gradually giving way on both fronts. It really is a great intellectual parallel on these.

They do now almost all of them agree that there's been increase in inequality. Congressman Chris Shays asked Secretary of the Treasury Paulson at our hearing Tuesday or Wednesday why there was such angst in America about the economy given how great things are supposed to be going. In his answer, Paulson said part

of it is what the Chairman was talking about was my comments about the increased inequality.

So they do now acknowledge that. But then the question is what do we do about it? But it was important to have won that argument. I think we now need to get to, "OK, it's here and what do we do about it?" I want to talk specifically about what I think our agenda should be.

The first thing we have to do is still to play some defense, and that is to deal with Ben Bernanke's yearning to go to inflation targeting and to defacto amend Humphrey-Hawkins [Full Employment Act]. But he will be appearing before us again in July for the semi-annual Humphrey-Hawkins hearing about a month before Gus' 100th birthday. We're trying to get in touch with Gus to see how he's doing and sadly his wife just died. But we'd love to have Gus there on his 100th birthday – we're not sure it's gonna work out – to be introduced of course by his successor Maxine Waters.

But they still have this itch to do inflation targeting, and they've got an argument for it. Some of you have heard Michigan has been arguing that inflation targeting would actually be very good for reducing unemployment because they say inflation now is a matter of expectation.

The more business people expect inflation to be controlled, the less inflation we will have. Therefore if they get tough and tell people 2% is the number, we are

much less likely to get above inflation and therefore their need to clamp down on the economy to reduce inflation will be diminished and they will be less likely to cause unemployment. This is the anchoring of inflation expectation they have talked about.

We have been resisting that. It's a very jerry-rigged argument. Bernanke and Frederic Mishkin, Bernanke's close collaborator on this, are acknowledging that there's still a cost to getting rid of inflation. They talk about the sacrifice ratio in terms of reducing unemployment, and they now say averaging estimates obtained from a comprehensive battery of equations and specifications suggest that the sacrifice ratio may be 40% larger. That is, it may be 40% more costly to reduce inflation than it was two decades ago; i.e., it will take more unemployment initiatives – the most interesting aspect.

It may be 40% more costly to reduce inflation than it was two decades ago. Remember cost is entirely in unemployment. He talks about the sacrifice ratio. Of course one other way to look at the sacrifice ratio is that 100% of the sacrifice will come from people who work for wages and none from the profit sector of the economy. But again, it may be 40% more costly to reduce inflation than it was two decades ago. Is this really bad news, he says? I will return to this question later.

So we are determined. I do think we have had some success. I know the *Financial Times* did an editorial about the debate that we were having with

Bernanke, and it ruefully acknowledged, I think, that we have deterred him from going to inflation targeting. We will continue to press. But there is that ongoing fight.

One of the things someone should go back and see how Henry B. Gonzales went after the Fed on procedural grounds. Remember 20 years ago when I got to Congress, the Open Market Committee didn't announce for six weeks what its decision had been. They not only wouldn't publish the minutes, they also literally denied that they had any. Henry, through the force of his intellect and personality often underestimated at the time, forced them to do a much greater degree of openness, and it really would be interesting to go back.

We don't do enough of this. Expensing of stock options is another example. We don't do enough of going back and looking at the predictions of gloom and doom that people made and holding them to the absence of any such.

In fact I said yesterday to the Federal group – the securities industry people and board of directors – that the two phenomena that most resemble each other in my mind from that standpoint are the expensing of stock options and same-sex marriage in Massachusetts. In both cases, there were widespread predictions of chaos and disruption, and by now most people have forgotten that they happened unless they were sort of directly involved. But we will continue to press the Fed, and the inflation targeting to oppose it. There's still an effort to do it so.

It is striking to me even in the financial pages of the *New York Times*, you will get a typical story. Well, there's bad news and good news. The bad news is that wages are rising. The good news is that profits are rising. The *Times*—there was a quote. I'm gonna ask Bernanke about this, but a week ago in the *Times*, a story – not a direct quote – was saying that, "meanwhile the Federal Reserve is worried that wage increases will cause inflation."

This is the time when real wages have started to go down again and have never come close to getting level with productivity. Bernanke, to his credit, will say that. But another example was the first time Bernanke testified a year and a half ago, and we looked at the semiannual report.

There were 13 different chapters on various sectors of the economy. In every sector of the economy the numbers were real numbers corrected for inflation except wages, which were nominal. It was not that they consciously sat down and said, let's play with these numbers. It's even worse. That's the way they think.

So we still have this defensive argument. That's why these two papers today are particularly important because the argument that shared prosperity is anti-growth has to be attacked and it is obviously done very well. What I then want to get on to is, "What's our affirmative agenda?" And I met with various business groups, and I've been somewhat disappointed.

I began my chairmanship by saying, let's make a deal. I want to see an immigration bill. I would like to see us be able to get to trade. There are poor people overseas who could benefit if we did the right thing although they didn't seem to see my conservative colleagues who have been all for trade and WTP, etc., continue to insist on agricultural policies that are the single greatest obstacle. I listen to my free market, anti-government, anti-subsidy colleagues talk and then I see how they vote on agricultural policy.

But there are three affirmative things I think we need to deal with. First, I think we've gotten more acceptance on health care. The business community has itself to blame because in 1993 when Bill Clinton was trying to do something about health care, it wasn't a plan that many of us thought was the best way but at least it was a recognition.

The big businesses sat on their hands. When General Motors and Ford and the others now complain about the oppressive cost of health care, it is legitimate for us to say, "Yeah, where were you in 1993 when we could maybe have done something about that at that moment?"

So this is a self-inflicted wound. It's still something that we should deal with but if I could just do one thing, it would be to establish a universal single-pay health care system both for equity and to get health care out of the employment system.

There's some recognition of that. There were two others where the business community has been more resistant. I met with them and they still don't get it. I think the problem frankly is they still think they run the country and they don't have to listen to our concerns.

You know I regret some of the difficulties in immigration, but at least out of this may come their recognition of what's going on. Paulson is at least starting to acknowledge it. Don Evans, the former Secretary of Commerce, a great personal friend of the president, has commissioned a study. They're beginning to understand the problem. Of course, I think as the two papers make clear, there's a good economic argument against this inequality.

There was a good argument that the inequality is retarding growth. I mean Henry Ford in 1925 had it figured out better than these guys when he said he had to pay the workers $5 a day because, if they didn't have any money, who was gonna buy the cars? Well, whatever they want to think about the economic issue, the political issue was very clear. There will be real gridlock on everything they want until we go forward. So there are two other things besides health care that I think we should be explicit about.

The first is unions, and I keep telling them to get over this dislike of unions and accept unions as a very important thing. I know when I went to college 50 years ago, I remember taking a course with John Dunlop and there was this big argument among economists: Do unions really affect wages?

Of course at the time they were talking about manufacturing unions by and large and international trends, etc. I guess I better say in perpetuity now whatever the argument was about whether unions raised wages in the 50s, it is clear that the absence of unions has helped lower wages today.

Particularly when we are talking about low-wage service employees, there is no competition here. We're talking about people in the service industries. So we have to make it clear to them and they obviously haven't gotten it at all. We need to have them deal with unions. On my approach to private equity, I very much agree with the notion that they should be paying their fair share of taxes, which they aren't close to doing now. And then the argument is if you tax us more, we'll stop doing this. Well, do they think this is a favor to me and who asked them to do it in the first place?

You know on the notion of real value added from a change in the form of ownership, I'm very skeptical. I'm not ready to stop them doing it, but I'm not ready to drive them to keep doing it either. But what we have said other than that, from my committee standpoint, is that private equity is the largest single owner of hotels in America today. They are increasingly very large owners of office buildings with the service employees and we should acknowledge better. One thing that came of 9/11 is a good unintended consequence – the best make-work program in the history of America, better than anything Harry Hopkins ever did.

There are very nice people who sit in the lobby of office buildings all over America and ask you to sign your name on the theory that that will keep you from blowing up the building. It has of course no safety impact whatsoever. But there are tens of thousands of people who are now employed doing that, and it's a good thing. The Service Employees [union] are trying to organize them and that would be a good thing. I think we have to be very clear. Unions are important and they are one of the prerequisites. The restoration of unions to a central place in the economy, particularly for these low-wage workers, is one of the things that has to be done to diminish inequality.

They have to understand that and it's therefore one of the things we insist on their doing. I was generally happy with Bill Clinton, given where we were. Different people have different things that they thought were a problem. To me, his biggest single sin was that comment that the era of great government is over.

The problem was it implied that we had big government. When was this era of big government? I think maybe it was from 1933 to 1936. I mean that's the only period in American history it seems to me that could be described as an era of big government. And this notion that we always cheer when government is shrunk. It is very clear any effort to diminish the growth and inequality in America that's caused by globalization, technological trades, and all these other factors will require a much more active government role, and I think we have got to insist on that.

So health care, the business community and the conservatives have to concede, needs to be fixed. The question is how to fix it. But we have to insist that unions and government have a role. I found the best way to argue it has to do with education.

While Greenspan and Bernanke concede that there's inequality, their answer is increased education. While increased education would be a good thing, they greatly exaggerated the extent to which it's going to diminish inequality. First of all, 40-year old factory workers were losing their jobs. And I don't know what they think they're going to educate them for, particularly when, as I recall, a lot of the jobs for which people were being educated 15 years ago have been outsourced.

Secondly, they just missed their own economics, it seems to me. What they're saying is you get a great wage premium for having a college education, and therefore, let's substantially increase the number of people who have a college education. Well, by their own rules, if you significantly increase the supply of something, you'll probably decrease its price. So that if everybody does have a college education – the education premium – I don't know what it's gonna be a premium over as you move it.

But here's one that I think we can get them on, really. Part of it is because elementary and secondary education is clearly a governmental function. So is

higher education – training people for jobs, etc. Greenspan already said the best program for that was community college.

The way in which we finance higher education in America today reinforces inequality and deepens it. It does not diminish it. That's in large part because of the assault on government. Every public university in America has lost money from its state government. It's the exception now for a state university to get as much as 50% of its revenue from the taxes.

Community colleges are overwhelming the public and they are hurting. The example I always give is Bristol Community College in my district in Fall River, Massachusetts. They've got a very good nursing program. The president said here's my problem. I've got 42 slots. Now we have a terrible nursing shortage in this country, so they're telling us we gotta import nurses. Massachusetts in particular has a lot of hospitals. We have a lot of people in the area and we've lost the traditional manufacturing base there.

It makes a great deal of sense to train a lot of people to be nurses. I think one other advantage is that we will be training people for jobs that are very unlikely to be outsourced. It is very hard to stick a needle in someone's ass from Bangalore. So we would be giving people jobs that would be sticking around. But because the state legislature has been told to cut taxes and that government is bad, etc., we've only got 42 places. They could use 200 places and health care would be better off and we would have nurses.

So it is very clear that this assault on government is the problem. I've had disagreements with some who've given Bush credit on doing better stuff in Africa. That's true, probably because the Republicans wouldn't allow Clinton to do it.

But when you cut taxes and of course run this disastrous war, which is prohibitively expensive along with its other problems, you then say OK. What they've done is set up a set of zero-sum situations. So that you can help people in Africa only if you cut health care, education, and the women's, infant's and children's program back home.

So we have got to go on the offensive about the importance of government. Now that should be self-evident. But one point that I want to make is to my friends on the left. If we, in general, tell the average citizen that government stinks and that the people who run it are entirely corrupt and don't care about them, don't be surprised when they then say, "Oh let's not give those people any more authority."

It doesn't mean we shouldn't be critical, but we need to be more specific and more refined. You tell people that the politicians don't care about how they vote and they only care about big money, etc. Why would you be surprised if they don't vote? But we have too much joined in the demonization of government as an entity. We have to start personalizing our criticism of government and stop dismantling respect for government in general.

I want to throw this open now, but those are the things I think we need to get very specific about. We've gotta take care of people by providing some alternative wage situation. It means health care. It means education at the elementary and secondary as well as higher education. I mean at every level.

Just to summarize, they now acknowledge that we have increased inequality. But the latest figures by the best measures show there is now greater income inequality than at any time since 1929. Think about what that means. It's now worse than it was in 1929. That means Hoover made it better than it is today. We're back now to the pre-Hoover era of inequality.

I think Bob Frank and others have done a very good job of making this clear. They've stopped arguing about not paying attention to inequality. It's just a matter of jealousy. That argument we've also won, when they acknowledge there is growing inequality, is there is a substantial disparity in that virtually all of the increased wealth is going to profit.

So they acknowledge that there is increased inequality. They acknowledge that it's a bad thing morally as well as something that causes political problems. Now we need to engage in what to do about it. As I said I think three things for sure are getting health care out of the employment system. I say the only way to do that is obviously have some government role and a broader government role in general, including the tax system and support of unions. The first thing to do is to get the Democrats in line on that.

I was at a Democratic leadership meeting a couple months ago, and some of my moderate colleagues say that we've gotta stick with PAYGO. We can't be for raising taxes. Then one of them said, "I need $20 billion more for agriculture." Another one needed $30 billion more for the military. Then another one wanted money for NASA. We're not gonna raise taxes and $70 billion dollars in increased spending was just asked for in a year.

What are we talking about? Well, the argument is PAYGO is our way of keeping them from doing more tax cuts. We have got to start making the case intellectually as was made in these papers. I think we've gotten as much political use as we're gonna get out of the deficit argument.

It's become an obstacle to our own ability to go forward. So we need to expand the role of government. There needs to be an institutional response to increased inequality caused by these factors in the economy, and that has to include both government and unions in an appropriate way. We have to begin arguing that within some of the Democratic ranks that the unions are okay and even government is okay, but don't get too wedded in deficit. Then go beyond that. I am encouraged because if I look back compared even to two years ago, we've won the argument that there is increasing inequality caused by factors in the economy that could be changed, and that it does have negative consequences.

We ought now to be able to make that argument about what to do about it and finally I would hope that people would be approaching all the presidential

candidates to get them to pick that argument. Now let me throw it open and I'll be glad to respond if there are any questions or comments.

Question and Answer, Part I

KEN YATES: I've spent 30 years in the Foreign Service, and I watched the budget for the Foreign Service go down consistently. I've watched our pay not go up consistently. We were the ones who were to make the sacrifice that was necessary. I come back and retire and try to live in this city. The taxes are outrageous in this town. Gasoline and real estate taxes are astronomical. They're unlivable. I don't know how anybody can afford to live in this city as a reasonable human being without making those extra profits.

Things are out of whack, I agree, but I'm not sure that it's government that's involved in it. Somewhere along the line we're going to have to put a limit, a ceiling, or controls on the spending that comes up that's not negotiable.

FRANK: Well, do you not see a contradiction between complaining about low wages in the Foreign Service and the shrinkage of the Foreign Service and that government is spending too much? I mean I think we can spend better.

When people ask where you get the money for some of the things you want to do, my answer is I'm not sure where to get the money. I know who to ask for the

money. I was in Congress on September 10th, 2001, and I know that there was not in the budget at that point any money for a war in Iraq. Since then we have found over $500 billion for that war. So I want to ask the person that found the $500 billion for the war in Iraq where she found that, and then maybe I can have some.

So the answer is I would disagree with you. Real estate taxes are too high. I think our tax structure is bad. I do not think gasoline taxes are too high. I think it would be a mistake to lower them and encourage even more gasoline use.

We do not appropriately provide at the federal level the funding for all the local programs, particularly for cities with a large number of low-income people. So they have to rely excessively on the property tax. But I don't think excessive spending by government is a problem. Incorrect spending in some areas, particularly in the national security area, is a problem. I would hope people, including some of my Democratic colleagues, give up this notion that we have to spend more and more and more on the military. We are still fighting the Cold War in our budget.

But I think that there are more unmet needs than not. And part of it is if we were to do more things in a sensible way in general, there wouldn't be as much of a squeeze on individuals, and that's particularly true in health care.

Yes, if we were to do universal single pay it would cost more money out of the public pot, but that would have a very substantial effect in freeing up individual income. I think people would be better off. Yes sir.

DAVE OXTER: I do public health advocacy. We did an analysis of appropriations over the last five years on public health programs, and we found there are about 100 programs that lost between five to 35 percent of their value. Is there anything on the agenda now that will address the public health issues, because these programs are spread across every department?

FRANK: There is a difference between the Democrats and Republicans. The appropriations for those programs will be higher under the Democrats than they would have been under the Republicans, and lower than they should be, including NIH [National Institute of Health]. Here's the deal. We are gonna be spending more on virtually every public health program in the federal budget than before, and George Bush is gonna veto it. So we are still in this struggle.

Here's the dilemma we're in now. The public generally supports us on increased programmatic spending. But the public on the whole supports the Republicans on lower spending overall. With regard to the public view of government, we have a hole that is smaller than the sum of the parts.

As you go to people, program by program, they are with us. But when you put it all together, they are not. One thing we need to do is connect the dots because as

long as there is a predisposition to cut government in general, the likelihood of being able to improve the spending in specific areas is very negligible.

Now if we end the war in Iraq, for which there are so many good reasons, we would obviously free up enormous amounts. There are other things we could do to cut excess. One victory I consider very important is that in the next spending for NASA, there will be no money for Mars.

We have managed to stop them from getting this kind of foothold for going to Mars, which would ultimately be a lot of money, not so much in the short term. But the answer is we are going to increase spending in various public health programs. But as long as you've got the current constraints of the war and the tax cuts, it won't be enough.

LINDA LAWSON: You mentioned community colleges, education, and the issue with nursing. This administration has put forward a number of different policies like the Wired Initiative and different things out of Department of Labor and Department of Education. Are we on the right track in terms of looking at the needs of business, including going towards this demand-driven system within Department of Labor and Department of Education, or what are we doing wrong and what do we need to do in order to change that?

FRANK: There are two things in this area. As doing what business wants, we overdo that. I think the notion that you have to drive people to do what is in their own interest

is essentially what we do. The big difference between Clinton and Bush was that under Clinton, we raised the top marginal tax rate to 39% and they [under Bush] brought it down to 35% and then said this is gonna be a major incentive.

Does anyone think there is anyone anywhere who decides to work harder because of a 4% cut in the marginal tax rate? It just doesn't make any sense. So I think business is getting more than it needs in general. I do think there are more specific things we could do particularly in regional areas to make sure that there are people who are better trained for those businesses.

In Massachusetts, if we were to get more money to the community colleges, I think we could do a better fit for some of the businesses we are trying to grow like biotechnology and clean energy. There's a technical aspect to this.

But fundamentally no, they're going in exactly the wrong direction. The situation we have is this: As you cut government, cut government, and cut government, what you then say is that people who have more money make even more money. You remove the government from the equation and you reinforce inequality. That's what's happening in higher education now.

Under the first President Bush, the Ivy League colleges and some others had an arrangement whereby they got together and agreed not to bid up scholarship offers to some highly desirable wealthy students. They literally said okay, we're

not gonna get into a bidding war for some of these students who are able to pay for it themselves so we can have more money for needy people.

That was the only anti-trust violation the first Bush administration ever found. They sued the colleges and made them stop doing this. It's a small piece, but it's a part of it. So what you now have is less money to go to needs-based scholarships, and that's just one example of how we reinforce inequality with this plan.

TOM POWELL: I'm recently here from Southern California and you don't have to sell me at all on the importance of demand side and the economy increasing consumer demand. But you know our last two recessions have been deflationary recessions. We're due for another recession in a couple years. We've had them every 10 years about where the new decade starts going back to 1918. So I think we're gonna have another one.

My question is very few financial instruments actually dictate the cost of capital. But yet we get beat up there. Have we examined possibly having deductions for certain businesses, while we increase taxes on other wealthy Americans that have it and on capital gains, given how low that tax is?

FRANK: Clearly the Democrats didn't put up as much of a fight as we should have in 2001. Too many caved in. Subsequently Democrats have gotten better. For example,

we've recovered from the scandal of so many Democrats supporting the abolishment of the estate tax.

I would say this. As you know, there is now the beginning of pushback there in two areas. Congressman Richard Neal of Massachusetts has got a very important program going on, namely to keep the alternative minimum tax from hitting more and more people who would be genuinely middle class.

By the way, some of the conservatives might be for alternative minimum tax hitting middle-class people because it particularly hits then in high tax states. The way the alternative minimum tax works, it's when you are paying a high state tax that you are more likely to get hit by it. What Neal is proposing is that we raise taxes on upper-income people who make more than $200,000 a year to reduce a tax burden on people significantly lower down on the chain, although obviously not the poor.

I think that is important both specifically and as a model of what we should be doing. Making the tax system less regressive is a good idea. You also have a hope they will go forward with it is the proposal now you're seeing from Baucus and Grassley and also from Charlie Rangel to increase the taxes on the private equity people. So we will be moving.

There's obvious debate about the extent to which capital gains and other incentivizing tax cuts promote growth. I think they greatly exaggerate that. But

the one deal I'm gonna make is if that's what you want to do, then make up for it in the distributional side by raising the top marginal rate.

I think we have the clearest argument there. We have almost a laboratory experiment: top marginal rate raised under Clinton, lowered under Bush, and the notion that this produced no economic gain as a result of it. In fact, one the things we ought to do is go back and look at all the Republican arguments in 1993 about the terrible economic impact the Clinton tax increases would have and document that, in fact, the opposite happened. We don't even have to prove that the Clinton tax increases caused this.

It is undeniable we raised taxes under Bill Clinton on wealthier people on the whole and subsequently we had one of the best economic performances in recent times. We don't have to prove that A caused B. All we have to do is acknowledge that A did not prevent B and that destroys their argument.

STEVE SHAFARMAN: I'd like to just ask your thoughts about going beyond the Earned Income Tax Credit to an even stronger way to promote demand. Last year Congressman Bob Filner introduced a Tax Cut for the Rest of Us Act, which would have adjusted the tax code to provide a very small guaranteed income to the very poor. It's updating ideas that were actually mainstreamed in the 60s and I'm sure you and many people in this room know about when even Richard Nixon and Daniel Patrick Moynihan supported a guaranteed income.

Congressman Filner has said that he would like to reintroduce this but can't because of PAYGO. Do you see any possibilities for something that would really provide expansion of the ITC and money to the very poor?

FRANK: I would hope so, but I think as a political matter I do have some sympathy with my colleagues who are using PAYGO and as long as George Bush is president, PAYGO has been a barrier against further tax cuts. The lure of tax cuts is obviously very powerful.

In fact, there two things I would advise people to be weary of. First is saying this senator is so brilliant that he can stop things from happening. A dead cat can stop things from happening. Like with Bill Thomas who's widely over-praised. Why? Because he was able to get tax cuts through the House of Representatives. Yes, and I'm able to get a hot knife through butter. Getting politicians to vote to cut taxes ain't hard. Reversing it is. When we had a Republican majority in Congress, Bill Clinton and Al Gore used the Social Security lockbox and it did hold off tax cuts. Then Bush came in and the dam broke and we're still paying the price in terms of a tax system which is inadequate to meet important public needs and unfair. PAYGO was a way to prevent that from getting worse.

If there is a Democratic president and Democratic Congress in 2008, I think we should be ready to say we're gonna get beyond PAYGO. Although if you end the war in Iraq and you get the tax code a little fairer, you've got some revenue. You can even do some significant expansion of PAYGO.

But ultimately the goal should be to get beyond that. There's no question that it is a short-term defensive measure. You know it's OK to use these things as long as you don't fall in love with them. I think part of what we need to do is just tell them Democratic PAYGO is a short-term way to stave off further tax cuts. In this particular political climate, it makes sense.

But it's not such a great idea. I've been calling it the "PAYGO stick" because we're stuck with it. Yes, it is very helpful to make the case as the papers do to the Democrats that PAYGO was a short-term tactical move that made sense but not a long-term thing.

I'll make these the last point on the argument of, "Oh, it's not the government's money. It's the people's money." What I do find relevant is to say, "Of course it's the people's money." As people we have two sets of needs. We have needs that we can best deal with with money in our own pocket, and we have needs that can only be met if we pool our resources. That's what we call government. I think we have to continue to make that case for pooling our resources to do those things that are important to the quality of our lives, which can only be done if we do them together.

PART II

MARK LEVINSON: As Congressman Frank mentioned several times, we're releasing today two papers that are absolutely central to any progressive economic policy on growth

and full employment. Growth matters. Small differences in growth rates cumulate over time, and the impact on the economy is massive. Yearly differences in growth rates of less then 1% over a decade cumulate to mean up to several trillion dollars in output and several hundred billion dollars a year. Growth matters.

Whether this growth occurs or not, it does make possible many things: the rebuilding of cities, improving education, cleaning up the environment, creating decent employment, wages, and living standards. The question of course is what causes growth?

And I think I'm not revealing any secrets here when I say that the most influential policy voice in the Democratic Party today is Bob Rubin, from Goldman Sachs and Clinton's former Treasury Secretary. Bob Rubin has a theory of growth. In his memoirs of the Clinton administration, he put it very succinctly.

He said, I quote, "The threshold act that ushered in the sustained recovery of the 90s was deficit reduction." Now what's striking about this is that it is not a controversial or new theory. Republicans have believed it for decades, and the financial community has believed it for longer then that.

What's remarkable is that so many in the Democratic Party have bought into it hook, line, and sinker. The implications of this were, I think, most succinctly stated by Rubin's successor at the Treasury, Larry Summers, who has a way of saying things in a blunt manner.

Larry Summers said that financial markets don't just oil the wheels of economic growth, they are the wheels. So what is good for Wall Street, in this view, is good for America. Jeff Madrick today will offer a very different approach to growth. He will expand on remarks made from this stage several months ago by Joe Stiglitz, who argued that in the context of our current economy, growth and economic policy focused deficit reduction would be incredibly short-sighted and unnecessary.

One of the reasons we need growth is that it makes full employment possible, and full employment, we believe, is one of the keys to social justice in the United States today. When unemployment is high, everyone's wages are affected. The entire economy suffers in loss output and increased social spending.

Minorities are hit especially hard. When Martin Luther King gave his famous "I Have a Dream" speech at the March on Washington, that march was officially known as "The March on Washington for Jobs and Freedom." And one of the main demands of that march was a massive public works program to provide jobs for all of the unemployed.

Now, we're a long way from Martin Luther King and the March on Washington and not only is full employment rarely talked about today, the very concept has been dumbed down. So when many economists today talk about full employment, they based it on an idea called the natural rate of unemployment.

So full employment, rather than meaning a job for everyone willing and able to work, means – according to various economists – 5%, 6%, or even 7% unemployment. And in response to this idea, it was William Vickrey, the Nobel Prize-winning economist, who called the natural rate of unemployment "the most vicious euphemism ever coined."

Tom Palley's paper on full employment is a valuable analysis of what kind of policies in our globalized age are required to get to full employment, but to my mind it's a revival of the best traditions of American liberalism. Tom Palley will speak first on reviving full employment.

Tom runs the Economics for a Democratic and Open Society's project in Washington, D.C. He has worked as an economist at the AFL-CIO. He was the chief economist at the U.S.-China Economic and Security Review Commission. He's published extensively in academic and popular journals. He's the author of *Plenty of Nothing, the Downsizing of the American Dream and the Case for Structural Keynesianism*.

Following Tom, Jeff Madrick will speak on growth. Jeff Madrick is the editor of *Challenge* magazine, a visiting professor of humanities at the Cooper Union, and director of policy research at the Schwartz Center for Economic Policy Analysis at the New School in New York. He's a regular contributor on economic matters

to the *New York Review of Books* in the nation and other publications and he's the author of *Why Economies Grow*. But first Tom Palley.

THOMAS PALLEY: I'm very glad to be here this morning and thanks to EPI for hosting this event, which I think is really touching on so many important issues and so fits with the tenor of Barney Frank's comments about the need to connect specific policies to the big picture, which then becomes persuasive to people and helps them understand it.

It is my sense that when I think about policy, I think about what a good job progressives do on specific policy issues. We are winning the debate on specific issues like health care, maintaining a rock solid Social Security, and income transfer programs like the Earned Income Tax Credit.

Those are where we are setting the policy agenda and winning it. We could do better still on issues like globalization and trade. I think we are making progress on helping people think through those questions. But there's a very big gap in between globalization and specific policy programs, which is national macroeconomic policy.

And I think that that is an area of great weakness on our side and a sense where we've been out of the picture and I think talks by myself and Jeff Madrick try to fill in those issues and why they are so important. When we lose control of a national macroeconomic policy, we loose control of a lot of the political debate.

And that loss of control ends up having consequences for employment, wages, and social justice, and so I hope I can make some contributions in that direction.

OK, I want to start with a slide that I hope you've seen before and you'll see very often in the coming year leading up to this presidential debate. I think this is a critical slide that says everything and so much about the American economy. There are two lines to that chart. The upper line tracks productivity in the American economy beginning in 1959. The bottom line tracks real hourly compensation of production and non-supervisory works who are slightly over 80% of employment.

And from 1959 to the late 1970s, productivity and hourly compensation roughly tracked each other, which is what I think is the ultimate model that we need to restore in the American economy. That model has been broken, because after 1979 you will see that in the American economy, productivity continued to increase and the economy continued to grow, but hourly compensation essentially flat-lined. And that is the underlying problem. If we can fix that, we will remedy so much within the American economy.

Last year there was some increase in hourly compensation. Those year-to-year bumps tend to interrupt and distract us from seeing the big picture, which is this disconnect between the two that we need to restore. And what's interesting, of course, is that that productivity is going somewhere. We know it's not going to

ordinary workers, but it is going somewhere. And in fact what happens is it's going to the top part of the income distribution.

When wages flatlined, productivity ceased going in pay increases to working families, and started going in payments of higher wages, dividends, profits, interest, etc., to high-income families. And ergo, you had an expansion in income inequality. In other words, the rise of income inequality in this country is intimately connected to the disconnect between wages and productivity.

Why the change? Well of course it's not one factor at work, there are multiple factors at work. And part of the Agenda for Shared Prosperity is to try to identify those different pieces, connect them, and then lead to policies that can then remedy them. And, of course, there have been changes in labor markets.

Barney Frank talked about the decline of unions, the erosion of the minimum wage, and, in general, an erosion of bargaining power of working people in labor markets. We've had much discussion about globalization and obviously what contributes to that, like outsourcing, competition from low-wage workers offshore, and the ability of corporations to put workers in competition with each other across borders.

And Jeff Faux has written a paper for this project that outlines some of those issues. But what I want to say is very important and we have not been able to

direct enough attention there. This is where the Federal Reserve and Barney Frank's committee comes in so importantly: macroeconomic policy.

We've essentially had a retreat from full employment policy within this country, and today I want to describe that retreat and what's needed to reverse it. Again, let's go to the big picture. Those of you who are old enough to remember the business cycle pre-1970, were not so old to not be able to remember it.

You will see there's been a big change since 1979. Before 1979 the post-war business cycle from 1945 to the mid- to late 70s was essentially a domestic wage and investment driven cycle. That's what drove prosperity, when investment was up, the economy boomed, and wages moved with productivity that was in turn created by investment.

Post-1979 there's been a complete change in the business cycle. We now have a financially driven business cycle where we have increases in debt over the cycle, increases in asset prices, and asset price inflation that then drives the expansion. And in fact, the business cycles of Ronald Reagan, Bush I, Bill Clinton, and Bush II are all very similar in their characteristics.

And they clearly differ from the business cycle that existed before 1979. So we find that manufacturing employment, even though it rises in an upturn, no longer returns to the peaks that were the peak experience in the previous business cycle, and we're on a downward trend with regard to manufacturing employment.

We have rising trade deficits every business cycle, we have accelerated increase in household debt relative to GDP – and indeed debt in the economy relative to GDP – and we have equity price and home price booms as being sort of the engine of that expansion. That is the characteristic of today's business cycle and it's very different from the pre-1979 business cycle.

And macroeconomic policy fits in and has created that new business cycle. We've seen an elevation of concern with inflation and side-by-side with that, a disregard of full employment. We've seen a complete disregard of the trade deficit. If you went back to the 1970s and the 1960s, policy makers were always concerned with the trade deficit as a form of demand leakage that caused reduced amount in the economy and therefore brought the cycle to an end earlier.

Now we actually to some degree even celebrate the trade deficit, at least the Federal Reserve that views it as a form of inflation control that helps keep the lid on prices. We've had a complete disregard of exchange rates. Once upon a time the exchange rate was a central policy instrument and concern. Now we've turned it over to markets.

And of course what really has gone on when all of this gets summarized is a sense we've replaced a labor market floor with an asset price floor. So now policy-makers are no longer concerned about putting a floor in underneath labor markets. Instead they're concerned about an implosion of asset prices and they've put a floor under asset prices.

And in the business press this is talked about as how Greenspan or now Bernanke put it, which basically says that if the markets tumble, the Fed will intervene to maintain asset prices. So a complete rethinking, reframing of policy is needed. I want to emphasize how much ideas matter. I think that was very implicit in the tenor of Barney Frank's comments.

Ideas are the way in which people interrupt and understand the world. And no idea in economics has been more important then this idea of a natural rate of unemployment, sometimes called a Nehru. Let me just run through quickly how it explains one's thinking.

Once you buy into it, you can't get out of it and it frames your attitude towards policy. The first thing that the natural rate says is that the economy gravitates very quickly to full employment. Well if that's the case, there's no need for activist policy because the market will correct itself.

The second thing that the natural rate says is that there's no inflation versus unemployment trade-off. Policy cannot affect long run unemployment. Well if that's the case, employment policy is redundant. The third thing the natural rate says is that the only thing that policy can affect is inflation. Well, the policy implication of that is if all that you can affect is inflation, then aim for low inflation.

Number four, in the natural rate thinking, the Fed has no effect on income distribution, which is determined in labor markets by market processes. What follows from that is, the Fed is not to blame for labor markets.

And Benanke can wring his hands in sadness and sympathy at the increase in income inequality, but he can't do anything about it. He's protected from having any responsibility for this by this doctrine of the natural rate. And worse then that, the natural rate, when it's adopted by the Federal Reserve as its frame analysis, actually promotes a subtle form of wage suppression.

When wages lag, the Fed expresses sympathy for the failure of wages to rise. But once they start rising, then the Fed says there's an inflation danger and we have to step on the brake. So it really actually has sort of a trap for wages built into it.

And finally, and very importantly here, ultimately the natural rate theory explains unemployment in economy is due to labor market rigidities, things like the minimum wage, trade unions, that sort of thing. That's what economists call labor market rigidities. Well if labor market rigidities are the cause of employment, then policy should go about trying to flexiblize it. So you can see this labor market flexibility agenda as coming out of this big picture thinking about the causes of unemployment.

I want to say this is an idea that totally dominates the economics profession. Many of you have probably done economics classes, you've been exposed to this

way of thinking in your classrooms. You have the background and the intellect to see through that idea, but many people don't. They take it out with them into the world and then they start to interrupt and see the world in this way. Economic journalists start to write about the world in this way. Even policy makers on the Hill who work for the Democratic Party and have been to public policy and business schools and have taken economics classes, this is their way of thinking. And therefore they are sort of internally divided and where is that coming from?

So, what do we need? We need to create a new macro-policy regime. I believe all these different components that go together to promoting shared prosperity and macro-policy regime are the keys to this. So there are three pillars of the macro-policy regime: monetary policy, exchange rate policy and fiscal policy.

The first thing we want to do is to have policy makers at the Federal Reserve adopt what we would call a full employment interest rate policy. And of course you're going to talk about full employment and you have to know some sense of what it is. In a sense full employment is a little like pornography. Justice Potter Stewart, I think, who said about pornography, I don't know how to define it, but I recognize it when I see it. And in a sense, full employment is like that too. You know when it you see it.

Humphrey-Hawkins described it as 4% unemployment. Lord Beverage, the founder of the Beverage Curve in Great Britain in the 1940s, described it as a situation in which a number of vacancies equal to the number of unemployed, so

there was a job for every person. I like to think of full employment actually from a price side of things as when real wages are rising with productivity. That's the real measure of full employment. So put these pieces together and I think we can sort of talk about what a full employment regime looks like.

We have to say no to inflation targeting, which is really lurking in the wings and sort of part of the mainstream of ideas right now. There are two ways of objecting to it. One is sort of process objections and I think Alan Greenspan used to object along the lines that basically you were putting a millstone around the Fed's neck and taking away the freedom to act responsibility as outcomes happen.

And of course I also think of it as, if you put a fixed inflation out number and not just anchor expectations, it actually becomes an anvil on which financial markets can hammer policy makers. But for me the main objection against inflation targeting is that if you frame public policy in terms of one number, an inflation number, you will promote concerns with that one number over everything else.

That will become the focal point for policy discussions. And if it's an inflation number, then 2% is going to be 3%, even though 3% may be associated with much better unemployment outcomes, faster growth, and better wage outcomes. So from that point of view you want to keep all the things that policy is concerned about on the public policy table in the public policy discussion. And that's why you don't want to have inflation targeting and will automatically create bias to focus on inflation and neglect those other important pieces of policy.

We need to modernize financial regulation. There's been tremendous financial innovation over the last 20 years, but absolutely no parallel improvements in financial regulation. Today we have these problems of debt and asset price bubbles and yet we have only one instrument, the short-term interest rate, which the Fed thinks it can control in this $13 trillion economy. That's a ludicrous proposition.

If it uses the short-term interest rate to control financial markets, it has this sort of blunderbuss effect on the rest of the economy, the manufacturing sector, and the real economy. On the other hand if the interest rate is purely targeted on the real economy, it looses control over financial markets so you can have these asset price bubbles that when they implode, eventually have such bad negative effects.

And so what I've long argued for is not only just using existing instruments like margin controls and margin requirements with regard to the stock market, but also for changing regulatory framework for a framework with asset-based reserve climates where you basically extend the system the budget requirement to other asset classes. So if you're having a housing boom and you want to make mortgages more difficult, you just get mortgage lenders to hold the reserve requirement against all new mortgages that are issued. And right away you would raise the cost of mortgages if that was your problem.

The Fed also needs to use its bully pulpit. It's a very important influence on policy by its governance and research. In effect the Fed, with its 13 banks and huge research departments, is a major contributor to the formation of elite policy opinion. The Fed research needs to be less ideological and more open to different contributions. How to get the Fed to open up as an institution is a very difficult political task. And then I think there's some opportunity for institutional reform in the Fed. The last major Fed was established in 1913 and the last major reform was really about 1933, and there's been nothing major since.

We could use the upcoming centenary of the Fed in 2013 to rethink the Federal Reserve System a little bit and get to how to modernize the system and get it in track, so that it is no longer the 19th century economy of 1913. What does a Federal Reserve System of the 21st century look like? How do we get better representation in the banks themselves and at the board of governors too? And, of course, how do we open up the policy research and get new ideas in there? The second pillar of macro-policies is exchange rate policy.

We've given over management of the exchange rates to markets to with an absolute disastrous impact on the economy. It shows up through the overvalued dollar and the trade deficit. It has tremendously negative effect on manufacturing jobs, as EPI and Rob Scott have documented so well.

It has a tremendous negative effect on manufacturing investment and that's the great failure of the current business cycle and the failure of manufacturing

investment. Economist Robert Blecker at American University's written a fine paper documenting just how large that impact is. And the bottom line is exchange rates must be more important then ever in the era of the globalization with increased trade and ability of production. Yet we've actually backed away from paying attention to exchange rates. So we have two challenges.

The first is to get rid of some mistaken thinking about the trade deficit and then to get good policy in place. The trade deficit is not the result of the twin deficits and a shortage of saving in this country. By the way, the twin deficits are a ludicrous proposition. They're out there all the time. If you believe how ludicrous it is, think of the 1990s when we ran record trade surpluses and had a record trade deficit. If you want other evidence, think of Germany. Germany has consistently run huge trade surpluses with government deficits. Likewise, Japan runs huge trade surpluses with government deficit.

It's a ridiculous ideological proposition. The real cause of our trade deficit is that the composition of spending in this economy is wrong. We spend too much on imports and too little on domestically produced goods, and the reason for that composition being wrong is that prices are wrong. And the real cause of prices being wrong is the exchange rates.

So we need to get our exchange policy right. And I would add that into the bargain we have had bad trade arrangements that have created asymmetric openings between countries, particularly China.

So when it comes to exchange rate policy, what's needed? Well I think we've got a short-term agenda and a long-term agenda. In the short term we need another Plaza Accord realignment. The Plaza Accord realignment was created back in 1985 when the dollar was overvalued then and the G-7 countries got together to realign their currencies.

Well in today's era that can't work anymore. It can't just be the G-7 because it's a globalized economy. We need China and Japan to come to the table. They're key to this realignment because they each have large surpluses and indeed, they anchor the whole system of exchange rates throughout East Asia.

If we realign currencies, that will help readjust the trade deficit and bring jobs and investment back to the U.S. But what is very important here is that any accord and any adjustment must be 100% credible. Business people must believe it is going to hold because only if they believe it is going to hold, will they bring jobs and investment back to the U.S.
If they think there's going to be another reversal or another dollar appreciation a few years from now, then they won't go through that expense. Credibility is absolutely key. We have to avoid this cycle of ups and downs, with regard to the exchange rate, and that speaks to some system of managed exchange rates I'm talking about, based on target zones for the global economy.

And major players – the G-7, plus China and perhaps even Brazil and some of the other big economies – must come together to have a sensible system of exchange rates. Like I said, exchange rates are more important for every country now in the era of globalization.

And above all, it again speaks to some of the comments that Barney Frank was making on ending this mentality of policy passivity. The current system of exchange rates is entirely sub-optimal and we need to fix that. If we don't, both in theory and in practice, then exchange rates depart from the fundamentals of economic theory that suggest where they should be.

We also know that China and the other East Asian countries are gaming the system. So the U.S. will have to, in this environment, abandon its anti-intervention policy mentality as the final pillar of macro-economic and fiscal policy. A whole debate about fiscal policy should be guided by sensible policy principles.

And this should be the way that we enter into a discussion about fiscal policy. First, spending that meets the needs of people and contributes to economic growth and that means as part of that, attending to public investment. I know that Jeff is going to be speaking about that. In that case we want to ensure that the funding for these important needs is adequate, it's raised in a progressive manner, and economically efficiently in the sense that it doesn't distort or reduce economic activity. Those are three sensible principles for funding.

And in addition to this, the system should embed automatic stabilizers that can help smooth the business cycle. Now when it comes to the Bush administration, we see a complete failure of fiscal policy on all of these accounts, as it has comprehensively failed to meet any of these principles.

The 2001 tax cuts exemplify this failure. They were regressive and benefited the wealthy. They did little for middle-income families. They generated low bang for the buck in terms of fighting the recession and they have remained in place long after the recession is over, therefore worsening the budget outlook.

We have consistently short-changed public investment during this period. We've also undermined our system of automatic stabilizers by weakening progressivity and undermined our automatic stabilizers. And we have failed to attend to the problems of unemployment insurance, which is one of the best policy automatic stabilizers there is.

Picking up on some comments by Barney Frank, Rubinomics is not the answer. Rubinomics worked brilliantly in the 1990s when we needed to stop Republicans from stripping government of revenue and cutting government. That's what the lockbox was about, that's what PAYGO was about, and that is, in fact, what Rubinomics is about. Rubinomics is stuck in the 1990s at a new political moment when there are real opportunities.

What's wrong with Rubinomics? It's based on the faulty economics crowding out, i.e., that government deficits and government spending crowd out private investment. And it's based on the faulty argument of the twin deficits that I've already discussed a little bit. There's no evidence for either proposition.

And the deficit focus that Rubinomics engenders, promises therefore to shortchange public investment and shortchange the spending on important needs. Parallel to that economic policy failure, it really embeds a very dangerous politics.

It makes government look like a problem. It emphasizes shortage of savings that promote regressive policy, tax cuts on capital income, and tax cuts for the rich. And it sets up a very dangerous flip-flop because deficits will be needed to fight the next recession. When that happens, if you've got Rubinomics, you're in a real dangerous position. You have to do an about-turn on policy.

And then I think in general, the politics of fiscal austerity have little appeal. So all around this is a bad political position to lock yourself into, and that just compounds the fact that it's bad economics as well. So we need a new fiscal policy conversation that escapes the focus on deficits and instead starts with what we need and want? After that, we ask how we ensure that we efficiently provide and adequately fund those things. Now that's not to say that deficits are never a problem. There's a big space between "deficits are everything" and "deficits are nothing."

Deficits can be a problem if they drive an unsustainable increase in the debt-to-GDP ratio, or if they end up displacing future needed spending. So yes, we have a concern, but it's a very background concern to the bigger conversation that begins with what we need and how we fund it in economically efficient and progressive ways.

So let me close with this last slide that I call the challenge macro-policy because it really is a difficult issue I've worked on a lot on how to get this issue into public debate and get people to understand. I believe macro-economic policy is a key part of restoring shared prosperity.

But it's really an issue that's quite difficult to get attention. First of all, you probably get from the flavor of my comments today that it is somewhat academic and this town has not really had much of a taste for academic stuff. It also doesn't involve legislation. You can't legislate the exchange rate or the interest rate.

And that again means it has less attraction up on the Hill because that focus there is so much on legislation. And indeed, many of the political groups around town like to go back to their constituencies and say, "Look, we've got this piece of legislation." You can't do this with macro-economic policy, and that means it gets less attention.

And then we've got this underlying problem that macro-economics is dominated by conservative thinking. Even those economists that we would go to

occasionally for public support are schooled and trained and have an underlying attachment to ideas coming out of the natural rate. And that really makes it hard to break through. We've got to sort of fight amongst ourselves in a way to sort our own set of ideas in our house to get policy right. Anyway, I hope that this talk and the policy brief that is being raised today have helped engage people's understanding. If you're in the media, I hope you'll be writing about it. If you're on the Hill, I hope you'll take back an importance for macro-economic policy even if it can't be legislated. Thanks very much.

JEFF MADRICK: I'm going to take a somewhat different tack. I'm going to talk a little bit about the theory behind why Rubinomics is wrong. What are they thinking about, and how can all those smart people at Harvard and MIT and Princeton, not to mention the University of Chicago, be off on this? What are they ignoring, is there an equally distinguished body of theory that can present another way of looking at the subject and how does it work? But before I begin that, I want to pick up a little bit from what Congressman Frank was talking about.

Even though I'm a New Yorker, I'm a little bit encouraged these days. It seems the avenues of truth have opened up now. The reason I'm saying that is suddenly we see a piece, from Frank Levy and Peter Temin and which Barney Frank referred to, from MIT, saying, "Oh my gosh, wages are bad."

In fact they don't rise with productivity. In fact maybe wages are not set in a free market the way we think they are, that's coming from MIT. They're saying there may be institutional problems, social norms. Probably Levy has trouble getting somebody to sit down with him in the MIT cafeteria, these days.

Peter Temin of course is a long distinguished economic historian. Kind of interesting that we get a piece from Isabelle Sawhill, a moderate Democrat, talking about wages being down and – oh my gosh – maybe even some hints of a class society, the lack of social mobility. I think one of the great myths about the American economy is the social mobility myth that we can rise from the bottom to the top.

But really happened was the median wage kept going up in America. So even if you didn't rise from the bottom to the top, and even if you more or less stayed in the same social environment in which you were born, your standard of living kept rising. It stopped happening specifically for males beginning in the 1970's and indeed in the late 1960's.

And some work we're doing at the New School shows that pretty clearly. Wages and salaries for all men are lower today, discounted for inflation, than they were in 1969. Kind of frightening, I think. But the truth is coming out, even in the *New York Times* and I used to write a column there.

The business section is always talking about – oh my gosh – wages are going up. What kind of nation talks about wages going up in fear? But we've been fearful of that for 30 years. And let's not dismiss this argument out of hand. We had problems in the 1970s. The issue is we've seriously overreacted to those problems.

There was a panic among policy makers in the 1970's and to some degree, I think, a panic or a giving in among economists. Now the truth is coming out. Why is the truth coming out? It has a little bit to do with the truth, but has more to do with what happened last November.

The Democrats won in Congress. Newspapers and the media put their finger to the wind and say – again I apologize for my New York cynicism, but I've been in the media a long time – that maybe our readers want to hear something a little different.

Let's start talking about some of these crazy things groups like EPI, or Tom Palley, or even occasionally myself, were talking about how wages haven't been doing so well because it seems like the public is interested in that again. That's one thing that's going on. It's a very encouraging thing.

I'm going make some policy recommendations here I guess. I'm going to talk about demand-led theory and why high wages and government stimulus cannot only, in the abstract sense, lead to more growth, but why it does. Because it can

actually increase productivity, the potential output per hour of growth, which is something that's left out basically of mainstream theory.

Mostly I'm going to talk a little bit more about public investment. That's our real deficit. And I think Bill Clinton mentioned once or twice early in his presidential term, that the real deficit was our lack of investment in social goods, in public goods, and the old Galbraith affluent society.

He forgot that pretty quickly under the influence of Bob Rubin. One of the things I'm going to suggest strongly is you all put pressure on the Congressional Budget Office (CBO) to start talking about the potential returns from public investment. Congress can do this, and it's ridiculous that they don't do it.

We began doing it with the Republicans because the Republicans demanded "dynamic" scoring. Because when you reduce taxes, they said, that will increase incentives and therefore you'll get more growth. So when you do your budget forecast CBO, take that into account.

Well let's start taking into account the returns from early education and transportation, and the budget returns and the tax revenue increases. And I'll come back to talk about that in a little bit. Clearly, there has to be a maintenance of demand through fiscal and monetary stimulus, the implication of demand-led theory.

High wages themselves are the source of justice in America. And as I suggested, maybe rising median wages may indeed be the source of the American dream, more so than social mobility and our old friend Horatio.

I'm going to argue in a second higher wages can make us grow faster and that's something we have to keep in mind deeply as it's something that's been lost. We shouldn't worry so much about stimulating inflation, as Tom discussed.

We can have these aggressive social policies as Tom discusses. And we can invest in public investment even if it means a growing budget deficit. So, what are we talking about? What is this thing called demand-led theory? Is it really academic poppycock? Is it the equivalent of the poppycock on the other side, which is typically called supply side?

So as not to be confused with the old Reagan economics, we should call it supply-oriented economic growth theory as that's the mainstream neoclassical theory. When I gave a talk in this not too long ago, I picked up a copy of Adam Smith's *The Wealth of Nations* and there was a mainstream economist talking along with him.

He said, "Why are you bringing Adam Smith to a demand led theory… discussion?" Adam Smith is about the invisible hand, getting government out of the way, letting markets work and he's about savings, and the importance of

savings. What does it have to do with this? Now probably this guy knew better and maybe you all know what I'm going to say.

But Adam Smith, in chapter three of his famous book, talked about the division of labor and the famous pen factory. If you divide the 19 tasks in making a pen, except one, you can increase the productivity of that factory, not by five times, not by 10 times, but by thousands of times. Now Smith didn't conjure this up academically. In fact, one of the great myths about economists is that they sit around and think of these theories in their room and then go out and apply them.

Actually economists are observers and Smith observed there was a lot of wealth in the economy in Scotland. And he observed that these factories were doing great by dividing labor and he made a principle out of it, not that he wasn't brilliant, but that's what he discovered.

But he also wrote in chapter three was that productivity is limited by the extent of the market. He said you need a big market to sell all those pens. And then later in the book he talked much more casually, but interestingly as always – he was a truly brilliant writer – about economic growth since the Middle Ages.

And what did he talk about? Did he talk about savings? He talked about Mediterranean trade. He talked about the development of the towns and the cities how that met with the growth of markets, and you could begin to think about scales of production and about productivity. And you couldn't think about it

without that. Now has anybody had a serious diagram of what leads to what? That's the difficult part. In fact, in the book I wrote, *Why Economies Grow*, I argue that these things feed into each other.

It's very hard to find a starting place for growth, but it's very dangerous to eliminate some of the major links. To me, markets and demand are the major links in the growth chain. So how does this theory work and what's going on today? Neoclassical economics, which dominates Rubinomics and Larry Summer's thinking, dominates what is considered among both the left and the right wing as the economic mainstream and academic thinking.

Let's say, MIT, Princeton, and Berkeley on the "left" and Chicago on the "right" are dominated by this theory, and it was a very innovative theory back in 1957, mostly attributed to Robert Solo, although others were working on it. The upshot of it was basically, that economies only grow through invention.
Some economists still say precisely that. Now that notion was amended over time. What's interesting and radical about the Solo notion was, before that, people thought savings were the road to growth. Solo said that has a limit and you can only save so much because returns on those savings go down overtime. You need new technology, you need new ideas.

He was sort of undermining the status quo. People came along and said it can't only be technology, so it must have something to do with education or maybe

transportation. And then some more people came along later on and said, you know what, I think it really does have something to do with savings too.

We've got something called indigenous growth models, which were suggested. Solo made too strong a point. He said there were diminishing returns on savings and investment. Some of these economists from the mainstream – neoclassical economists, many of them we would consider right wing – start saying if you invest in R&D, you'll get even bigger returns because ideas will generate ideas.

So something called indigenous growth theory came along. So where do we stand with the Solo model? Let me take just one step back because people often forget this about the Solo model. The Solo model was all about the invisible hand. It was about by and large keeping government out.

Now Solo made compromises. He thought government could be useful, but only in the short-term. By and large, he said keep government out and the invisible hand of Adam Smith will work. And in the Solo model, if you save it will be invested. You build, and there will be a market for it. The opposite ironically of what John Maynard Keynes said, which was we saved but it wasn't invested and we built but there was no demand. So the heart then of the neoclassical model was the Solo model amended.

I'm being a little flip, but by and large, mainstream economists have long said save more, R&D, education, transportation, and you're going to grow. Who

could disagree with it? I don't even disagree with it except that it's not the complete story. It's an over-abstracted story.

It has elements of truth and we shouldn't disregard it. It says nothing about the Adam Smith warning that all of this doesn't matter if you don't have markets, and how do you have markets unless you have some demand stimulus and some wage growth?

There are two strands of demand by growth theory and this is not new. This goes back essentially to the successes to Adam Smith and most of it was done in England. But there are plenty of people here who talk about demand growth theory – Tom Palley is one of them in fact – and they do very good work.

There are two strands. One is that there are frequently times in the American economy when we don't fully utilize resources and we have to keep stimulating the economy. The MIT school and the new Keynes school argued that you only have to stimulate the economy in the short-term and then neoclassical principles will take over and you'll grow fast, and the economy will adjust.

That's one argument for constant need for demand and higher wages to create demand. The other is the demand itself: higher wages can create growing productivity. Higher output and higher wages can contribute to growing productivity through greater economies of scale. We find that leads to more investment.

More investment leads to more ideas. We learn by doing, an idea that actually came right out of mainstream economists and is one of the best ideas. So the more we do and the more we learn about producing, not only manufacturing but services, the more that enhances productivity growth.

When we neglect demand, when we don't grow as fast as we should, and when we don't have as much output in the economy, we tend to reduce the potential economic growth of the country and neglect productivity. What does history tell us about who is right and who is wrong?

If we follow the neoclassical view, history should tell us that technology's all that mattered. But in truth, and I know this may run counter to a lot of conventional wisdom, all major originations in the 1800s had access by and large to the same technology. The U.S. didn't invent the steam engine, but we exploited it. England didn't invent the windmills – and the Industrial Revolution started there – but they exploited it.

Technologies were by and large borrowed and then redeveloped and enlarged to fit the nation. What we did was exploit technology, but it would be very hard to argue we were the great inventors in technology. In fact, the great French economist Fernand Braudell – looking at capitalist development ages – said, "There is no such thing as technology in itself."

In other words it doesn't stand alone. It has to be part of the system. And Schumpeter himself said writers about economics exaggerate the role of invention. He of course exaggerated the role of entrepreneurship, but it still had a role and of course so does invention.

In my own view, the main advantage of the American economy was the size of its domestic market, which has some relevance now. In other words, we had a huge market – continent-wide, one language, no tariffs, one currency usually, one language, and a remarkable advantage. We had huge natural resources and so forth. That to me was the main advantage Americans had. Indeed, it even had the development of the Internet in the late 1990s. In fact, I think the new economy of the late 1990s was indeed a resurgence of mass markets and mass production. The companies, like Intel and Microsoft and Wal-Mart and even Fidelity Management, were a resurgence of mass production and mass distribution economies after taking a whack for awhile based on the market.

Do high wages hurt growth? I want to end with that because there's plenty in paper you can read. America paid the highest wages in the world since the colonial years according to the best economic history we can come up with.

We always paid the highest wages available in the world, first in agriculture, then in construction and manufacturing, even though we didn't pay enough often, especially in manufacturing. We had the highest wages in the world and what did

we do? We grew like crazy. When did we stop paying the highest wages in the world? In the early or mid-70s, the trend started downward.

How did it happen? It happened partly because business had to invest in productivity equipment because we paid the highest pages in the world. But surely, partly, it was because there was great demand and they invested because of these surging markets. Just one example from history: James Duke, the father of the cigarette and, sadly, of lung cancer.

An invention in England could make about 1000 times as many cigarettes a day as were being made in traditional ways in America. He saw it in England, and he had a little money. He brought the machine back and said to himself, "Who's going to buy all these cigarettes that I can make?" Just like the guy who owned the pen factory must have said the same thing.

So he started marketing like crazy and by and large he invented the idea of smoking cigarettes rather than chewing tobacco. And he was one of the first great marketers in America. And what do we do best in America? We market. That's, in many ways, our great managerial talent.

Whether we want it or not, we market. We create huge markets and huge demand and that in turn creates more productivity, and it was a major source of our economic growth. High wages rose rapidly in the late 1990s, and wages rose rapidly in the Golden Age of the 1950s and 60s.

Wages are not rising rapidly in Europe, but when Europe grew rapidly, wages rose. Wages and rapid growth go together. I should say one quick word about taxes because it keeps coming up. I read in Fred Thompson's piece that low taxes mean high growth. The fact of the matter is, taxes rose in America throughout the 20th century on average as a percentage of GDP and we became the greatest, most powerful and productive economy in the world. When serious people – and these are not especially progressive economists – do international studies of whether high taxes suppress growth in other advanced countries, they find no relationship.

They find no relationship between the size of government and the rapidity of growth. Does that mean 100% government is fine? No. Does that mean 100% tax rates are fine? No. Does that mean savings never matter? No. But we've got to start acknowledging there's a big missing side to the way we think about growth.

And the policy implications are clear. Higher wages are not only fair, but they are also good for growth over time, within reason. There are times when we can't push wages too high or we push them too fast. We're a long way from that particular moment.

Stimulus and tolerance of higher inflation rates will promote growth and will grow faster over time. And we'll probably lower the unemployment rates, raise employment, and increase bargaining power of workers that, too, will raise

wages, which will in turn feed the market, the capital investment process and on and on.

That's how to grow in America. We can't eliminate that side of the equation any longer. There is a long distinguished school of thought and good empirical evidence that this approach is right. It doesn't mean everything about the neoclassical approach is wrong, but it means we need a seriously balanced approach to the way we look at problems in this nation.

There is a stranglehold on theory for a bunch of complex, and I think not very attractive, reasons on the part of mainstream economists and, needless to say, on the part of people on Wall Street whose power grows by the day as we see in the over-subscription of Blackstone yesterday.

Think about it. There are strong arguments to support what Tom is talking about and what I'm talking about and what Congressman Frank is talking about. Nobody should be cowed by Ivy League departments that have taken the wrong turn.

Question and Answer, Part II

QUESTION: Maybe we ought to be paying some attention to stopping the conflation of growth and prosperity and try to think of ways to have full employment and prosperity without growth, if that's possible. It's a difficult problem obviously.

The second big element, and here I'm addressing Mr. Palley, is immigration. One of the reasons wages are stagnant is that we have a huge amount of low-wage labor being added to the labor market every year. And people on the left have responded to that by saying, "Oh well, these are people who need help and so on." Part of the wage problem is the immigration problem.

PALLEY: At the beginning of the talk I did try to outline just that it was just one slice of the problem. And that again is one of the great difficulties in policy. People like to have a silver bullet, something that sort of solves everything and sort of to connect the dots. The environmental constraint is very, very real, but I think the growth is still a part of the story. I think people like to talk about green growth and that we will change in the coming century from the things that we do, the things that we consume, and the way that we live. And then we can continue to have prosperity within an environmentally sustainable framework.

These are all things that evolve and change in accordance with that environmental constraint. And China is a very real concern in this. The Chinese people legitimately, and people everywhere legitimately, want a higher standard of living. That is a challenge for us: how to accommodate that growth globally within the constraints of the environment and in terms of the impact it has on us.

And that's where things are wrong today. Not only is their growth and their environment very degrading, but also the way that their growth is organized comes at the cost of prosperity for many families in America. That's something

that we can fix. I think that's where there's an exchange rate and trade piece comes in. How our corporations behave and go about doing business globally comes into it. I'm also of the opinion that immigration has had adverse affects on wages, particularly at the bottom of the income distribution.

And then there are ripple effects through it. I do believe that it's not possible to have a traditional 12 million workers geographically concentrated and very sectorally concentrated without having those sort of wage impacts. So we do need to attend to it and again this is not a forum on immigration, but clearly there's a pull and a push at work.

And the push out comes from a failure of development in particularly the Mexican economy. Our policies have contributed to it. We have a responsibility for that. When you allow Iowa corn grown on that 12-foot deep, black, rich soil to compete with corn grown on the sort of the steep, rocky hills of Mexico, you're going to drive people off the land and they can't live. They're going to look to come north to find jobs. And we have a responsibility for that. And at the same time, just as we push people and have the failure of Mexican policy, we've also pulled people. We have not gone about disincentivizing immigration in the sense of going after employers.

We've sort of turned a blind eye to it. The employer community, the chamber of commerce community as it were, has been a big part of this story. They've always wanted to have access to cheap labor and to undercut American workers

and you see that of course in the insistence on guest worker programs, which are really just a sort of an attempt to smuggle in those continuing strands.

But let's not lose sight of how important what we're talking about today is, because what we're talking about today are very big, important dots that should be connected with other important dots.

MADRICK: I don't know if we've reached the age of limits. I do worry about it, but I don't think this nation politically can deal with zero growth. I think that would be the bigger tragedy, so I'd rather take our chances of being able to technologically deal with global warming and change the way we live.

Note: At this point, three questions followed that were inaudible due to a sound malfunction. The responses are below, continuing with Madrick.

On the PAYGO issue, one of the underlying assumptions on this Federal Reserve policy is that the nation's productivity or its rate of growth is by and large fixed. It's a pot you can't make any bigger and therefore if you have deficits, you'll just run into financial problems. And especially, if there's a crisis and we already have all that debt out there, we'll have a problem.

Inflation will occur if wages go up because the pot is only so big and therefore you'll increase prices. I think there's a flaw in the argument. I think sustained

economic growth and higher wages, in many circumstances, can make the pot bigger and the current economic theory does not acknowledge that.

And there's a fairly simple reason. During the crises of the 1970s, it became clear that it was difficult in those periods to raise wages too rapidly for a variety of real reasons. There were some constraints maybe in the inflation and inflationary expectations and so forth. That policy is carried on far too long, and it's thought to be universal when really, it was probably a set of unusual circumstances in the 1970's that led to stagflation.

So my argument is you can make the pot grow faster. Deficits, especially if spent on public investment, can make the pot grow faster and we shouldn't worry about them so much. Is that universally and always the case? No. Robert Lynch did a book on returns on early education, for example, some of which we summarize in this paper.

The potential returns on early education are enormous and Bill Dickens and his co-author, at Brookings Institution, are going to issue a paper that is like this dynamic scoring I think the Congressional Budget Office should do on early education. They say that federal tax revenues spent on a good universal early education program will be almost entirely paid back or even more then paid back over time, discounting for the time and value of money as well.

There are enormous opportunities out there. So I think that should be the priority. We shouldn't ignore that problem, but that should be the priority. I'll leave the inflationary rates in the South to Tom because he's going to Argentina. And on the issue of wages, I do think running the economy hotter is probably the best thing we could do for wages. But there are a lot of institutional issues out there, like minimum wage, living wage, and so forth.

PALLEY: You started your comment talking about the 1970s and the breakdown, but I want to emphasize how important that is. In the 1970s, there was a major dislocation to the economy caused by the series of OPEC oil shocks.

And I think there was some sort of social tension in all the Western economies, with the Vietnam War, social change and so on. With these dislocations, the conservatives had on hand a set of theories developed in the 1960's – Nat Phelps, Milton Freedman and Free to Choose and all of that.

When the dislocation took place, they had the thinking that they'd invested in and fought through places like the American Enterprise Institute. They brought it to Washington through the Chamber of Commerce and so on. And that's very important that we need the ideas ready to go when the moment opens.

And I believe actually we're living in such a moment. I think there's a real hunger for new thinking being expressed by people, not so much by politicians. I think

that the war in Iraq has really opened people's eyes. I think the complete dismal experience of this is an unsatisfactory business expansion.

People are looking for new ideas. If we have ideas in leadership, we can really begin to change things and I think that's what this shared prosperity agenda is about. So I think I want to highlight the importance of the activities going on here and how they fit in, in a very pragmatic real sense.

With regard to work, I agree completely with you. My book, *Plenty of Nothing: The Downsizing of the American Dream and the Case for Structural Keynesianism* – I wish I'd called it *Institutional Keynesianism* – is all about that.

Going back to Adam Smith and the point that Jeff has been making, demand and the size of the market matter. He talked about it in a static sense and the level of demand, demand at a moment in time. But in a dynamic sense, it becomes the size of the market and the growing market.

Keynes didn't get the importance of institutions. The great American institutionalists – Leslie Cox, Leslie Mitchell, John Kenneth Galbraith – talked about the role of institutions as establishing patterns of income distribution, patterns of behavior, and consumption patterns. Put the two together, you have micro-economics, an institutionalism and a macro-economics of Keynes', and you have a very cogent way to explain what goes on economically.

Obviously labor market institutions, regulation in labor market and employment relations behavior, and standards all matter. It's a very, very important piece of it. Today we're only talking about the demand side of things, or the policy management piece of it. I do recommend a paper written by Tom Kochan and Beth Shulman, which addresses just the sort of issues that you're raising.

So I think there's a great coherence between the things that you are talking about and the things that we're talking about from the podium today. With regard to inflation targeting, I think you're really starting big and we'll drill down into some of the details for developing countries.

It is important to realize there is this monopoly of ideas and the Treasury is very much built into it and the conservative economic ideas we push through the IMF. By the way in some sense I think more progress has been made in undermining that. So we do see the Washington consensus, which was the expression of those ideas very much in disarray. And now this is an opportunity to begin and get things right here. We will export those ideas for better thinking and share those ideas with developing countries and improve policy outcomes there.

And just as inflation targeting is not a good idea here, I don't think specific inflation targeting is the right idea for developing countries. But on the other hand, I want to avoid this problem of saying that everything the other side says is bad. My point is, it's incomplete or it's put together in wrong ways and pieces of it are wrong. That's all I'll say.

So I do have concerns with inflation. Inflation is very regressive for poor people. They don't have access to sort of the type of protections that we as middle-class people might have to ownership of real assets like homes, mutual funds, and so on.

So there is a concern that we can have too much inflation and there has been a history of too much inflation in developing countries. But that's a long thing from saying that they should be running at 2% inflation. For their economies, you could easily see 4%, 5% inflation might be better in terms of employment. It would depend on the policy makers being able to control and run a good policy process in the country. So let's not throw the baby out with the bathwater when we come to discussions of inflation targeting in developing countries.

I think there's a chance for really changing the tenor and understanding of the whole government debate that's not just deficits and fiscal policy, but indeed, the role of government in our economy. I see PAYGO, the lockbox, and Rubinomics as being a leftover from the 1990s. If you don't think we can win that debate, then we should stick with it and that's the strategic decision that people need to think through now.

If you don't think you can win this debate politically and the other side is going to trump you with an appeal for tax cuts and the rhetoric of attacking government, then that's the best that we can do. But I think we can win it now, I think that

Barney Frank really made a very important point about how when we call it government, they don't like it. That's the sewing together of dots we need to do.

Once the big-picture thinking that I think is shared, then all the constraints or the attacks of the other side go away and you'll begin to get the support for those programs. You'll begin to be able to fund them adequately, progressively, and efficiently and that sort of says, I'm with you on the economics. There's got to be a place for deficits. There's got to be a place for deficits from a point of view of kind of a cyclical policy for fighting recessions.

And in a growing economy there's a place for deficits because just as you grow your business, a business finances new investment by borrowing. And so you will see the balance sheet of businesses, as the assets grow and the debt grows. The debt on a balance sheet grows by having a deficit, or borrowing.

We, too, in the United States of America, Inc. can have ongoing deficits financing the growth of the economy. But that again doesn't mean any amount of deficit is okay. It's finding that middle ground. I think we're ready to do that. People are ready with the right leadership, with the right rhetoric, equip them with the right ideas, Mark, and I think we can do it.

LEVINSON: On that note I'd like to end this session and thank our speakers for very useful and provocative papers. Shared Prosperity has a Web site where the work is posted, so I urge you to go there and see everything. Thank you. ***[END OF TRANSCRIPT]***