Growth STRATEGIES

Trend Analysis That Builds Business Decisions

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IN THIS ISSUE: STATE OF THE NATION

1 – SPINNING APART

America's largest economic problem is this: people can no longer depend on rising wages and salaries when the economy expands. So writes Jonathan Rauch on National Journal.

A number of policy responses are on the agenda already, such as creating jobs, helping more students finish college, and reducing wage-denuding health care inflation. Others, such as reforming the federal disability program, have yet to attract much notice. In truth, however, the extent of Washington's ability to repair the economy's gear-box is an open question, because the problem is complex. It implicates not just one slipped gear but many: disruptions in long-established connections between productivity and earnings, between labor and capital, between top earners and everyone else, between men and work, between men and marriage.

Slippage No. 1: Productivity is rising handsomely, but compensation of workers isn't keeping up.

Slippage No. 2: Productivity is rising, but it isn't being evenly allocated; the top is effectively disconnected from the rest of the spectrum.

Slippage No. 3: The decoupling of less-skilled men from jobs.

Slippage No. 4: Low-earning men are decreasingly able to form stable families.

Family structure, in short, has become both a leading cause and a primary casualty of an emerging class divide. At the top are families with two married earners, two college degrees, and kids who never question that their future includes a college degree and a good job; at the bottom, families with one (female) earner, no college, no marriage, and kids who grow up isolated from the world of work and higher education. And the two worlds are drifting apart.

WHAT WILL (OR WON'T) WORK

Liberals emphasize economic forces that are eroding less-skilled workers' ability to make a decent living; conservatives emphasize cultural changes and government programs that make it easier to get by without working. Both views, according to Rauch, are probably correct: Economic *and* cultural forces are at work – and remedies to both can and arguably should be tried. Among the sorts of measures that experts are discussing:

- Get more people, especially men, through high school and college.
- Expand federal support for job training and consolidate the tangle of programs.
- Expand and improve vocational education for those not suited to college.
- Change Social Security disability benefits so that the program helps people keep working (and helps employers accommodate disabilities) instead of encouraging them to leave the work-force, as it does now. An analogous overhaul of welfare in the 1990s was a notable success.
- Liberals talk about increasing wage subsidies for low-skill jobs, raising the minimum wage, or both. Although such measures can be

expensive, they may be worth it if they keep men working.

- Conservatives talk about nudging the culture back toward stigmatizing nonwork among men. Liberals may be squeamish about stigmatizing nonwork, but some men may need tough love.

And if nothing changes, what then? What will be the effect – on families, on kids, on neighborhoods, on politics and public spending – as millions of less-skilled Americans, and then entire neighborhoods and demographic groups, slip beyond the reach of economic growth? No one really knows, because the experiment hasn't been tried. Until now.

2 – THE LONG-TERM THREAT

The United States was built on the assumption that a rising tide lifts all ships. That has not been the case for the past generation, and there is no indication that this socio-economic reality will change any time soon. That means that a core assumption is at risk. The problem is that social stability has been built around this assumption – not on the assumption that everyone is owed a living, but the assumption that on the whole, all benefit from growing productivity and efficiency.

If we move to a system where half of the country is either stagnant or losing ground while the other half is surging, the social fabric of the United States is at risk, and with it the massive global power the United States has accumulated. Other superpowers such as Britain or Rome did not have the idea of a perpetually improving condition of the middle class as a core value. The United States does. If it loses that, it loses one of the pillars of its geopolitical power.

So writes George Friedman of Stratfor. He continues:

The left would argue that the solution is for laws to transfer wealth from the rich to the middle class. That would increase consumption but, depending on the scope, would threaten the amount of capital available to investment by the transfer itself and by eliminating incentives to invest. You can't invest what you don't have, and you won't accept the risk of investment if the payoff is transferred away from you.

The right will argue that allowing the free market to function will fix the problem. The free market doesn't guarantee social outcomes, merely economic ones. In other words, it may give more efficiency on the whole and grow the economy as a whole, but by itself it doesn't guarantee how wealth is distributed. The left cannot be indifferent to the historical consequences of extreme redistribution of wealth. The right cannot be indifferent to the political consequences of a middle-class life undermined, nor can it be indifferent to half the population's inability to buy the products and services that businesses sell.

The most significant actions made by governments tend to be unintentional, posits Friedman. The GI Bill was designed to limit unemployment among returning serviceman; it inadvertently created a professional class of college graduates. The VA loan was designed to stimulate the construction industry; it created the basis for suburban home ownership. The Interstate Highway System was meant to move troops rapidly in the event of war; it created a new pattern of land use that was suburbia.

It is unclear how the private sector can deal with the problem of pressure on the middle class. Government programs frequently fail to fulfill even minimal intentions while squandering scarce resources. The United States has been a fortunate country, with solutions frequently emerging in unexpected ways.

Unless the United States gets lucky again, its global dominance is in jeopardy. Considering its history, the United States can expect to get lucky again, but it usually gets lucky when it is frightened. And at this point it isn't frightened but angry. The conventional solutions offered by all sides do not yet grasp the magnitude of the problem, concludes Friedman: the foundation of American society is at risk.

3 – WHEN GOOD INTENTIONS GO AWRY

There's a natural human impulse to help people who need a hand. In the political world, that often translates to an impulse to have government help people who need a hand. But experience tells us that government programs sometimes produce unintended consequences that make things worse for the intended beneficiaries. So writes Michael Barone in The Washington Examiner.

Consider what could be called the three Hs: health care, housing and higher education. Over the last generation and more, government has stepped in to help ordinary individuals and those with special problems on all three issues. The results have not been as good as intended.

Take health care. During World War II, the government made the cost of health insurance policies deductible for employers and not taxable to employees.

Seven decades later, that's still the law. People whose employers provide health insurance effectively pay less for it than people whose employers don't. And those with employer-provided health insurance tend to be insulated from knowledge of the costs of treatment. That's one of the things pushing health care costs up more rapidly than inflation.

Government's efforts to help people – military contractors and their employees – created a mess.

Then there's housing. For more than two decades, government policies have tried to make it easier for modest-income people, especially racial minorities, to get mortgages to buy houses. Both the Clinton and Bush administrations pushed this hard.

They were aided and abetted by the government-sponsored entities Fannie Mae and Freddie Mac, whose willingness to buy such mortgages and sell them to investors pushed literally trillions of dollars into the housing market.

But this housing bubble burst when prices unexpectedly dropped and Fannie's and Freddie's mortgage-backed securities suddenly became unsalable. This was the proximate cause of the financial crisis of 2008 that sent the economy into recession and created the new normal of slow growth.

Meanwhile, thousands of new homeowners, a large proportion of them Hispanic and black, faced foreclosure and eviction. Government's efforts to help people – especially minorities with subpar credit – created a mess.

Finally, the third H, higher education. Going back three decades, government has subsidized college loans in a way that has pumped money into the nation's colleges and universities. The argument was that college degrees enabled people to make better livings and that government should help everyone who wanted one.

But as government has pumped more and more money in, institutions have been raising tuitions and fees faster than inflation for three decades. That leaves college unaffordable for almost every family without government-encouraged loans.

The result has been administrative bloat – colleges and universities have had more administrators than teachers since 2005 – and students with college loan debt that can't be discharged in bankruptcy.

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Many students leave school without degrees but with plenty of debt. Many who do earn degrees do so in subjects that don't lead to jobs after graduation.

But the debts remain and can build up for a lifetime. Government's efforts to help people – young people seeking a college education – created a mess.

Not all policies attempting to help people produce such results. The GI Bill of Rights providing higher-education benefits and housing loans after World War II worked because it rewarded not only past service but also strenuous effort.

The original Federal Housing Administration home mortgage program worked well because it limited loans to those with good credit ratings.

But policies trying to extend the benefits of health insurance, housing and higher education that tended to sever the connection between effort and reward have backfired and hurt many of the intended beneficiaries.

The impulse to help those in need is one of mankind's better traits. But the impulse to have government help them is often self-defeating.

4 – THE GLIDE PATH OPTION

All is not lost, writes John Maudlin on Front Line Thoughts:

The US still has the chance to pursue what I call the "glide path" option. We can reduce the deficit slowly, by say 1% a year, while aggressively pursuing organic growth policies such as unleashing the energy and biotechnology sectors, providing certainty to small businesses about government healthcare policies, reducing the regulatory burden on small businesses and encouraging new business startups, creating a competitive corporate tax environment (a much lower corporate tax with no deductions for anything, including oil-depletion allowances), implementing a pro-growth tax policy, etc.

We can balance the budget within five years. If the bond market perceived that the US was clearly committed to a balanced budget, rates would remain low, the dollar would be stronger, and we would steam away from the black hole. I would like to see something like Simpson-Bowles, with an even more radically restructured tax policy. Healthcare is clearly the challenge, but a compromise can be crafted, as has been demonstrated by the several bipartisan proposals that have been sponsored by conservative Republicans and liberal Democrats. The key word is *compromise*.

The crucial question is whether we can achieve the compromise that will be needed to get us on a glide path to a balanced budget.

If a compromise is not crafted in 2013, how will one be crafted in 2014, which is an election year? 2015 may be too late, as the bond market will watch Europe and Japan implode and wonder why the US is any different. Remember, the event horizon is determined by the confidence of the bond market in the willingness and ability of a country to pay its debts with a currency that has a value that can be maintained. Trillion-dollar deficits for the next three years will call into question the value of the dollar. That will mean higher interest rates, which will mean a much bigger, more deadly black hole.

I should note that something similar to the glide path was tried during the Clinton administration. Spending growth was controlled, and the economy was allowed to grow its way out of debt. While the US economy is fundamentally weaker today than it was then, it should be possible for the US free-market economy to once again become an engine of growth.