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THE AUSTERITY TRAP AND THE GROWTH ALTERNATIVE

Jeff Faux

The next president of the United States will be under enormous pressure to solve the nation's long-festering economic problems. He will face a stubborn trade deficit, a spiraling international debt, and widespread anxiety about America's ability to compete in the world. He will be told—correctly—that he must act quickly and decisively to take advantage of the initial "honeymoon" period with Congress. He will also be told—incorrectly—that he should act according to the conventional wisdom of the media pundits, financiers, and economic advisers who determine the tone and content of respectable political opinion. If he takes their advice, his presidency—and the economy he presides over—could be doomed almost from the moment he assumes office.

According to conventional wisdom, the fundamental problem with the U.S. economy is that consumers have been spending too much and saving too little. Specifically, we are told, federal spending on entitlement programs—in particular, Social Security and Medicare for the elderly—has diverted resources that would otherwise have been available for productive investment. As a consequence of this unchecked extravagance, the argument goes, the U.S. government has had to borrow furiously from abroad, to the point where the United States is now the world's largest debtor. By this logic, the next president will thus have no choice but to drastically reduce the federal deficit by cutting domestic programs and taxing consumption, thereby increasing savings and freeing resources for more business investment. In short, the government must impose austerity, pain, and sacrifice on the average American family in order to pay for the excesses of the past.

This austerity trap will be difficult to avoid because of the conspiracy of silence that governs the present campaign. Both major candidates, their

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advisers, the media, and, to some degree, even the electorate itself seem to be in agreement that the American people cannot bear to hear of the economic pain that the financial establishment has decided will be necessary to administer after the election. The campaign is therefore not likely to be a forum for debating the merits of austerity or examining alternative strategies for coping with America's declining economy. Instead, the winning candidate will arrive in the Oval Office exhausted and largely unprepared for governing, and will be particularly vulnerable to the assertions of those who purport to speak for the nation's established institutions.

They will tell him that the world's financial markets are waiting to see whether he has the courage his predecessor lacked. They will demand that he slash the federal deficit drastically, even to the point of risking an unpopular but perhaps necessary contraction early in his term, in the hope that he can enjoy its fruits by the time he is up for reelection. The temptation will be particularly strong for a Democratic president. Not only will he want to reassure an anxious financial community, but the existence of the present deficit will seem to foreclose the new domestic initiatives demanded by the constituencies that elected him. By cutting back now, he will be told, he can at least promise more spending sometime in the future.

But austerity cannot be shut on and off like a faucet—especially given the conditions that Ronald Reagan has left us. Reagan was able to borrow his way out of the 1981–82 recession. The next president will not have that option. Given the overburden of corporate and consumer debt, the next downturn could quickly get out of control, plunging the United States and the rest of the world into an economic nightmare. Even if that nightmare can be avoided, austerity is more likely a formula for an endless fall in living standards than a prescription for American recovery. Reagan was fortunate in that he could mask the eroding living standards of the past several years with a flood of cheap imports. We are coming to the end of that charade. Yet if we attempt to correct our balance of trade by lowering wages and cutting consumption, as austerity advocates would have us do, rather than by increasing efficiency and expanding production, the result will be to permanently turn the United States into a low-wage producer.

On the surface, the austerity proposition is an intellectually seductive one. It has gained respectability among liberal Democrats outraged at the excessive materialism of the Reagan years as well as among conservative Republicans who want to return their party to the principles of fiscal sobriety. But underneath the austerity strategy is an extension of the economic assumptions and political goals that have governed U.S. policy since

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1978 and that are leading us rapidly into a global economic crisis. Ronald Reagan avoided the austerity trap implicit in his economic assumptions by writing IOUs on the U.S. Treasury. His successor will not have it so easy.

The "Root Malady"

The overconsumption thesis in various forms has gained widespread acceptance among politicians and economic advisers in both political parties. But perhaps the most elaborate and most widely quoted exposition of this thesis is that of Peter G. Peterson, Wall Street investment banker and former commerce secretary under President Richard Nixon. Peterson presented his views in a cover article in *The Atlantic Monthly* that appeared just before the October 1987 stock market crash.[1] He later publicized them in double full-page ads in the nation's major newspapers, which carried endorsements from 250 Republican and Democratic bankers, business people, and academics. Peterson's austerity ideas were at the heart of the consensus reached by 100 high-level political and business leaders brought together by former president Jimmy Carter in April 1988, and they appear to reflect the views of the majority of the bipartisan economic commission set up by Congress to advise the new president on economic strategy. Peterson's influential position, as well as his frank discussions of the implications of his proposals, thus makes him the most useful of the austerity advocates to study.

In Peterson's words, the central problem we face is our "national preference for consumption over production—the root malady." This malady infects society primarily through federal entitlements—largely Social Security, Medicare, and government retirement benefits, which in the 1970s, says Peterson, became "inflation-proof and untouchable." Growing entitlements have led to low savings and investment, which translates into slow productivity growth. Peterson is careful to note that these trends did not begin with Ronald Reagan (indeed, at times he seems to royally pardon all members of the political establishment), but Reagan, he points out, made them worse by his unwillingness to cut entitlements in order to pay for his military spending increases and tax reductions. Since Peterson has little basic quarrel with either Reagan's tax cuts or his military spending increases, he defines the fundamental problem as Reagan's adherence to the "Laffer Curve," which led him to believe, wrongly, that he could avoid cutting entitlements because increased economic growth, generated by tax cuts, would raise enough revenue to balance the budget. It didn't, of course, and the result has been the explosive federal budget deficit.

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The fiscal deficit grew to be so large, Peterson argues, that it could not be financed through domestic savings. Therefore, U.S. interest rates rose, attracting funds from countries running a surplus. As a result, demand for dollars to buy U.S. assets increased, driving the value of the dollar to unprecedented heights in the early 1980s. The high dollar made U.S. exports more expensive and foreign imports cheaper, and thus created the huge trade deficit. It also transformed the United States from the world's largest creditor to the world's largest debtor.

Peterson concludes that the federal budget should be balanced with drastic cutbacks in entitlements—particularly cost-of-living adjustments—as well as domestic spending cuts, "restraints" (not *cuts*) in military spending, and new taxes on consumption (for example, a gasoline tax). On the other hand, "investment-based" taxes should be reduced to stimulate investment and increase production for export. He proposes eliminating the corporate income tax and taxing interest, dividends, and capital gains at rates lower than those for ordinary income. Costs of health care should be cut by subjecting them to the "discipline of the market." Protectionism should be fought.

Peterson admits that, essentially, this is a plan for austerity. "Over the next five years," he writes, "we must be prepared for a perceptible fall in real after-tax employee compensation combined with a similar decline, or at best stagnation, in real government spending." The period of austerity will be a long one—some 20 years by Peterson's reckoning. After roughly 10 years, our high savings and investment, along with a further declining dollar and lower wages, will have begun to turn our current account deficit into a modest surplus. Any benefits, however, will have to be "focused on raising net exports," and it will not be until about 2007 that the period of austerity will end.

Some of the observations upon which Peterson builds his case are reasonable. His concern over the growing foreign debt is well founded; it will have profound consequences for America's freedom to maneuver in the world as well as to decide its own domestic economic fate. Peterson is also correct to rebut the administration's boast of having created 9 million jobs between 1981 and 1986; after all, many of those jobs have been part-time and low-wage, and, in any event, the total number of jobs created in the six preceding years (14 million) was much greater. Peterson's critique of the Laffer Curve and the supply-sider insistence that the trade imbalance was a symptom of health is also on target. Finally, Peterson is right to argue that we have to invest more and export more in order to work our way out of our debt dilemma.

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But despite his critique of part—only part—of supply-side practice, and despite his sensible conviction that we must invest and produce our way out of the mess left us by Ronald Reagan, Peterson's analysis and the austerity program that follows from it remain dangerously flawed. On closer inspection it is apparent that it shares most of the basic economic premises of the discredited Reaganomics that it purports to criticize and that it hopes to supplant.

Overconsumption or Underproduction?

There is some truth to the proposition that America has been consuming more than it has been producing. Trade deficits, by definition, reflect an excess of consumption over production. It does not follow, however, that "overconsumption"—with its implication of excessive hedonism—is the principal cause of our trade imbalance. Nor does it follow that reducing consumption is a sensible way to redress that imbalance. The evidence instead suggests that the "root malady" of the U.S. economy is not excessive consumption, but insufficient production.

It is true that as a proportion of total production, personal consumption expenditures—the category where the entitlements Peterson is concerned with show up in the Gross National Product (GNP)[2]—have risen in the 1980s. In 1980 personal consumption made up 62.8 percent of GNP (which represents total production of goods and services); in 1987 it made up 65.3 percent. This would seem to confirm Peterson's point. But these figures tell us nothing by themselves. For obviously the proportion of GNP represented by consumption is not only a function of the size of consumption but of the size of GNP as well. So if consumption continues to grow at its historic rate but production slows down, there will be an increase in consumption as a proportion of GNP.

This is precisely what has been happening in the U.S. economy. Thus far in the 1980s, consumption spending, adjusted for price changes, has grown at a slightly faster rate (3.2 percent annually) than it did in the 1970s (3 percent annually). This is considerably slower than the 4.3 percent annual growth rate of the 1960s and below the long-term trend of 3.4 percent per year dating from the end of the Korean War. Thus, there has been little significant change in consumer spending since the increase in entitlement programs in the early 1970s—the time at which, according to Peterson, our economic "malady" took root.

Where there has been a dramatic change is on the production side of the picture. Production of goods and services, as measured by GNP adjusted

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for price changes, has declined steadily from a 4.3 percent annual rate of growth in the 1960–69 period, to 3.1 percent from 1970 to 1979, to 2.6 percent from 1980 to 1987. During the 1980s the rate of growth has been substantially below the long-term trend. In fact, if production in the 1980s had grown at the 1960–69 rate, we would now be producing more than we are consuming, and we would be enjoying a trade surplus. Even if production simply matched its 1970s performance, we would be running close to a trade balance.[3]

Peterson's misstatement of the consumption-production relationship leads, in turn, to an oversimplified and exaggerated assertion about the direct connection between the fiscal deficit and the trade deficit. In this, Peterson takes his cues from the commonly held view that high interest rates—and the subsequent rise of the dollar—were triggered by the huge fiscal deficit, which soaked up available domestic savings. By this reasoning it follows that if we reduce the deficit, interest rates will drop, the dollar will fall further (although this last point is conveniently understated by Peterson), and the trade deficit will be eliminated. "Fiscal balance," writes Peterson, "is thus the cornerstone of any plan to cut our trade deficit."

There is little doubt that higher interest rates, and the resulting appreciation of the dollar, contributed to the rising trade deficit in the first half of the 1980s. What is not clear, however, is just how much responsibility the federal deficit bears for pushing up interest rates. After all, when the fiscal deficit was cut in 1979, interest rates rose; and when the deficit rose from 1982 to 1986, interest rates dropped. Indeed, empirical studies have generally failed to validate the tight theoretical connection between budget deficits and interest rates that is so appealing to Peterson and others. In its analysis of the evidence, for instance, the Congressional Budget Office, an advocate of lower deficits, concluded, "A variety of empirical studies have attempted to examine the effects of deficits on interest rates. . . . Few have uncovered a clear pattern of correlation, let alone a causal link."[4] And as New York financial adviser Peter Bernstein asks, if budget deficits lead to high interest rates, why has Germany, with much higher savings rates and lower budgets, had real interest rates above those of the United States for the past two years?[5]

The advent of the falling dollar in 1986 makes one all the more skeptical of the conventional wisdom, which, as Bernstein observes, belies a "sloppy" inconsistency in its interpretation of facts:

> We were told that the dollar rose because the budget deficit was so big. Now we are told that the dollar can go into free-fall because the budget deficit is so big.

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> We were told that the budget deficit made interest rates go up and therefore made the dollar go up. If we could cut the budget, interest rates would fall and the dollar would fall. Now we are told that the weaker dollar is making interest rates rise. In fact, we are told that we must raise interest rates in order to keep a weak dollar from raising interest rates.[6]

For that matter, one can make a plausible argument that the trade deficit has been the cause of our budget deficit, rather than the other way around. As Bernstein explains, the large trade deficit has served as a drag on economic growth, the consequence of which has been reduced government revenues. Because of our severe trade imbalance, then, the budget deficit failed to close as it normally would in a cyclical rebound.

These discrepancies in logic do not mean that the combination of low savings and high public deficits has no effect on the trade balance; it does. But such contradictions clearly indicate that the effect of low savings and high public deficits is neither as precise nor as automatic nor as symmetrical as the austerity advocates assume—*which it must be in order to justify their draconian policies*. If there are major factors at work in the fiscal deficit–trade deficit relationship other than the simple ones assumed by Peterson, events in the real world could overwhelm supply-side theories, and the sacrifice called for by austerity advocates would once again be in vain—just as the sacrifices imposed, in their different ways, by Federal Reserve Chairman Paul Volcker and President Reagan in the name of restoring competitiveness made us *less* competitive.

The attraction of Peterson's analysis—its simplicity—is also its fatal weakness. For it seems clear that at least part of our current trade deficit problem comes from factors quite independent of either Jimmy Carter's or Ronald Reagan's fiscal policies, such as the Federal Reserve Board's tight monetary policy. After all, the Fed's orchestrated rise in interest rates, which drove up the dollar, began in 1979, and had nothing to do with the need to finance the fiscal deficit, which had fallen steadily from $69.4 billion in 1975 to $16.1 billion in 1979. Rather, the policy reflected the Fed's brutal decision to use tight money to wring an oil- and food-price–driven inflation out of the system. The effect of the Fed's tight money policies was magnified by the concurrent deregulation of financial markets: among other things, deregulation led to a bidding up of rates by savings institutions, which had previously been limited in their ability to compete for deposits.[7] Thus, chronologically at least, money and banking policy provides a more compelling explanation of the origin of rising interest rates and the high dollar than does Peterson's emphasis on the fiscal deficit.

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However one views the relationship between fiscal policy and interest rates, it is much too simple to explain our trade problems solely in terms of macroeconomic policy. Because he fails to consider the production side of the problem, Peterson also overlooks the impact on the trade deficit of such factors as the relocation of U.S. production facilities overseas, the decline of American industrial productivity and innovation, and the global economic slowdown. Increased capital mobility has made it easier for U.S. corporations to relocate their facilities abroad. Spurred not only by a rising dollar but by the lower wages, cheaper components, and more relaxed regulatory climate of the Third World, as well as by the desire to avoid protectionism and be closer to overseas markets, many companies have opted to close shop in the United States and move abroad. Ironically, the trade surplus many countries enjoy with the United States is partly a result of this shift. The biggest exporters from Taiwan and Japan are General Electric and IBM respectively. Indeed, almost 20 percent of U.S. imports now come from American affiliates overseas.[8]

"Production flight" is part of the reason for America's declining industrial base. But just as important is the country's excessive military spending, which generates fewer and fewer commercial spin-offs; the lure of the casino economy, which diverts capital to nonproductive investment; and an ideological aversion to the kinds of industrial policies that have served our trading partners so well. (Peterson, to his credit, acknowledges the economic liabilities of our military spending, but he fails to apply this analytical insight to his policy prescriptions, thus sparing the Pentagon his scalpel.) The upshot of all this is that the U.S. share of world trade in manufactured goods, which had already dropped from 25 percent in 1953 to 15.6 percent in 1979, deteriorated further to 8 percent in the Reagan years.[9] With the U.S. industrial base hollowed out, U.S. demand can no longer be met by U.S. production.

The worldwide economic slowdown has also taken a toll on U.S. production. Annual rates of growth in real output among industrial, developing, and communist nations in the 1980s have been, in general, one-third to one-half of what they were in the 1960s, which has meant fewer buyers for U.S. goods abroad.[10] The efforts of Third World countries to export their way out of debt and underdevelopment have only compounded the problem. U.S. trade with Latin America, for instance, which was roughly balanced in 1980, registered an $18-billion deficit in 1985. "If Latin America's growth had not stopped in 1981," New York Governor Mario Cuomo's Commission on Trade and Competitiveness reports, "and if the

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U.S. maintained its market share of exports to those countries, our balance of trade would be $66 billion more favorable than it is."[11]

One result of the slowdown in growth and the relocation of industrial facilities in low-wage countries has been the expansion of excess industrial capacity throughout the globe, which has had the effect of intensifying competition to the detriment of U.S.-based producers. In 1987 world overcapacity was estimated to be 15 to 20 percent in automobile production, 20 percent in steel, 25 percent in semiconductors, and over 20 percent in petrochemicals. In the space of a few years Brazil has become a net exporter of automobiles and consumer aircraft. Mexico is now a major center for auto engine production. South Korea has become a world-class manufacturer of automobiles, personal computers, videocassette recorders, and refrigerators. Thailand, the Philippines, and other less developed countries are now beginning to be sources of low-wage manufacturing for Hong Kong and Korean firms selling to the United States.

The combination of insufficient global demand and excess capacity has disproportionately affected the United States because of its more open markets. Peterson correctly notes that the United States has become "everyone's buyer of last resort." But that is not because U.S. Social Security recipients suddenly started buying more goods and services, as Peterson suggests. It is because a disproportionate amount of the world's excess production is sold in the United States. Thus America, with a GNP only twice as large as Japan's, takes six times as many manufacturing imports from the Third World. With a GNP about the same size as Western Europe's, the United States takes in twice as many Third World manufactured goods.

On the basis of these fundamental trends, therefore, it does not appear that the trade deficit problem is a case of America overconsuming. Rather, it would seem that the world is underconsuming and that American industry is underproducing.

Entitlements Bashing

Given Peterson's concerns about overconsumption, one would expect him to call, at the very least, for curbs on some of the more obvious examples of excessive self-indulgence in our economy: luxury goods, merger mania, greenmail, and other nonproductive personal consumption and business investment. But Peterson ultimately seeks to spare from any greater hardship those, as he puts it, who contribute to rather than take from the pot:

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a sly code-phrase for upper-income people. His critique, consequently, is aimed at a narrower target and limited largely to federal spending.

Even within this more narrow purview, one would expect Peterson's scalpel to range more widely than it does. While he acknowledges that military spending constitutes one of the "big growth areas" of the past seven years, this problem, he seems to believe, is essentially under control. Military expenditures, he reports, have been "effectively frozen" for the past couple of years, though at a level, he neglects to add, that reflects eight years of steady increases—from 21.6 percent of federal outlays in 1980 to 27.1 percent in 1987. Peterson also excludes interest payments on the national debt from consideration—another big growth area that rose from 8.5 percent to 13.3 percent of federal outlays—because he considers them a symptom and not a source of the problem, despite the Fed's tight money policy, which at the very least has added to debt-servicing costs. He also grudgingly admits that cuts in domestic investments, such as education and physical infrastructure, have gone about as far as they can go.

This leaves only one major area: entitlement benefits. Peterson rails against the inexorable growth in entitlements over the past 21 years, which he claims has turned the federal government into "an ever larger and more efficient consumption machine." Civil service and military pensions, he maintains, are unjustifiably generous. Farm subsidy entitlements come under attack—with some justification in this case—because they tend to favor corporate farms over family farms. Health-care "hyperinflation" gets a particularly severe drubbing. Though not a federal entitlement program per se, health-care costs affect federal spending in such areas as veterans' benefits and Medicare.

It is the latter, along with Social Security, that Peterson is particularly eager to savage, not only because these programs represent the "lion's share" of non-means-tested benefits but also because of a professed concern that they benefit "those groups least likely to be poor." The image that seems to drive this argument for Peterson is that of an elderly population bloated with entitlements, consuming the seed corn of our economy. Yet the fact is that, as a share of total government outlays, entitlements actually dropped between 1980 and 1987 from 45.2 percent to 44.1 percent.

Peterson and his austerity allies make much of the fact that the poverty rate for people over 65 has decreased while the poverty rate for the population as a whole has risen. In 1979, seven years after what Peterson calls the "egregious" indexing of Social Security benefits, 15.2 percent of those 65 and over were still *below* the poverty threshold established for that age group (which is lower than the threshold for younger households),

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compared with 11.7 percent of the entire population. By 1986, the poverty rate for the elderly had dropped to 12.4 percent while that of the general population had risen to 13.6 percent. Therefore, goes the logic of austerity, the elderly as a group can "afford" to give up some income.

But Peterson does not appear to take seriously his own passing admission that Social Security enabled many of the elderly to escape poverty in the first place. If we look at the population that lives *just above* the poverty line, we find that 20.5 percent of the elderly receive incomes less than 25 percent above poverty, compared with 18.2 percent of all Americans. Almost 60 percent of all elderly people survive on less than $10,000 a year—an overwhelming portion of which comes from Social Security. As with his analysis of consumption patterns, Peterson here, too, ignores that there are two parts to a ratio. In other words, it isn't so much that the financial situation of the elderly has improved dramatically; it's more that the financial situation of those under 65 has deteriorated. Had the poverty rate of families under 65 not risen since 1978, it would still be below that of the elderly.

Peterson calls for cutting cost-of-living adjustments (COLAs) for non–means-tested programs, including Social Security, to 60 percent of the rise in the Consumer Price Index (which he cannot resist calling a "diet-COLA"). According to the Congressional Budget Office, this would reduce the deficit by about $75 billion over five years.[12] It would mean a cut in real income for the 18 million elderly Americans who make less than $10,000 per year (23 million more make under $15,000). Peterson also favors raising the retirement age, cutting benefits in excess of contribution (which would also hit the poor), and, of course, cutting back on unspecified civil service and retirement programs. Putting all of this together, however, would not raise nearly as much revenue as would increasing marginal income-tax rates slightly. An increase to 30 percent for individuals and 35 percent for corporations would generate $89.5 billion in additional revenue. But for a hint of the possibility of raising revenues from a higher income tax, one reads Peterson in vain.

Peterson of course promises to spare the poor by maintaining means-tested welfare benefits. This professed concern for the disadvantaged cannot help but remind us of Ronald Reagan's similar assurances that his cutbacks would not remove the safety net for the truly needy. That is, it is hard to see this concern as anything other than a smoke screen for Peterson's ultimate intention: to shift income from consumption to investment, which in his schema means from the poor and middle class to the wealthy. If, for example, he were simply concerned with rich people getting untaxed

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Social Security and federal retirement checks, he could easily argue in favor of taxing all retirement benefits above a certain income level. If he were truly exercised about excessive health care costs, he could at least have us consider the superior public-supported health care systems of other nations, which deliver better care to more people for less. (Instead Peterson tells us offhandedly that the solution lies in "the discipline of market forces.") And, of course, if he were truly concerned with the poor, Peterson would acknowledge the reality that his own numbers suggest: programs whose constituency is limited to the relatively powerless nonvoting low-income population—as means-tested programs are—will always be the hardest to maintain in periods of cutback.

Instead, Peterson reserves his outrage primarily for COLAs. And a look at the consequences of his proposals suggests why. Cutting COLAs for the elderly establishes a powerful precedent against other cost-of-living arrangements, such as collective bargaining contracts. Moreover, reducing Social Security checks is the best single way to undermine faith in the system. What better proof could the young have that they will not get their retirement benefits than to watch the Social Security checks of their elders fall behind the cost of living? But the most telling clue to Peterson's intentions with respect to Social Security is that nowhere does he mention the most significant fact of all—that the Social Security system is now beginning to build up enormous surpluses in anticipation of the retirement of the baby boomers, which will start in the second decade of the next century. Because of changes made in the Social Security law in 1977 and 1983, the system will be collecting much more than it is paying out until the year 2018 (seven years after the first of the boomers retire). These surpluses will be huge—$2.6 trillion (in 1988 dollars) by 2011. They represent new net savings to the U.S. economy through 2018.[13] After that, the system will be paying out more than it is bringing in, and by the year 2048 it will be back on a pay-as-you-go basis, as it was until recently.

Since the Social Security system "saves" its money by buying U.S. Treasury bonds, it is now being used to finance the federal deficit. In effect, we are paying for federal spending with the regressive payroll taxes that support Social Security. This makes little sense; if payroll taxes for Social Security are rising, as they have been, the increases should go for financing workers' retirement, not the Pentagon's budget. What all of this means is that if the federal budget can be moderately restructured to prevent the need for dipping into the Social Security kitty, and if we can avoid a recession, the U.S. savings rate will in fact climb well into the 21st century without our doing anything else. As one expert witness said to Senator Daniel

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Patrick Moynihan, we could be "awash in capital" by the next decade.[14] As the savings rate climbs through the payroll taxes of low- and middle-income workers, it will have a drag effect on consumer spending. To mount an austerity strategy at this time could well be a formula for triggering a disastrous recession.

Peterson ignores the implications of these mounting future savings. But he does reluctantly admit the possibility that the federal deficit will not be eliminated by spending cuts alone. So as a last resort he proposes a number of near-term measures to increase federal revenue: a gasoline tax of 25 cents per gallon, a 5 percent value-added tax on all products, and additional tax breaks to encourage investment. These measures—all regressive in effect—have, according to Peterson, the virtue of raising revenue without unduly burdening those whom Peterson is counting on to invest in the country's future: the wealthy. If this has a ring of familiarity to it, it should.

Savings and Investment

Peterson's emphasis on cutting consumption and increasing savings is, of course, strikingly similar to the supply-side notion underlying Ronald Reagan's economic program. As the president's economic advisers announced in the 1982 *Economic Report of the President*: "The Administration seeks to increase capital formation by both raising the level of output and reducing the fraction of output consumed. . . . To achieve a higher national savings rate it is important to lower the household consumption rate."[15] Reagan's supply-side architects went on to argue in favor of lowering taxes for upper-income groups on the grounds that this would increase savings, and for corporations on the grounds that greater after-tax business returns would raise investment (capital formation).

With all this Peterson concurs. If Peterson has any real quarrel with Reaganomics, it is that it did not do enough to "alter the relative tax burden on savings versus consumption" or to cut federal spending, which is why Peterson argues for cutting entitlements and other non–means-tested programs and for "trading off increases in consumption-based taxes for reductions in investment-based taxes." What Peterson is proposing, in effect, is Reaganomics II—a tougher and more brutal version of the original. Peterson, the pin-striped Robespierre of the Reagan revolution, believes that still more blood must be spilled.

Here again, there is just enough truth in Peterson's analysis to make it appealing: both savings and investment hit postwar lows during the

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Reagan years, and increased investment is clearly needed to improve productivity and to expand production. But is a stronger dose of supply-side economics likely to bring about increased investment? Peterson says it will because he shares the Reaganite view that investment is a direct function of savings. Thus "the question," Peterson argues, "is not the easy and popular one of where to invest, but the brute one, ignored by both political parties, of where to find the resources." Leaving aside the self-righteous Nixonian refusal to take the "easy and popular" path, this is a revealing statement. It reflects a mechanistic view of the economic universe, assumes away unemployment and idle resources, and reduces the problem of investment to that of a perennial "capital shortage."

The notion that investment is stimulated by higher savings is an old "pre-Keynesian" idea, one that has repeatedly been disproven by real experience. One of the insights of John Maynard Keynes was to point out that investment is motivated primarily by expectations of increasing sales, not by an increase in the savings rate. Indeed, Keynes's point was that an increase in savings derives from an increase in income, which is primarily a function of consumer demand and investment. Savings is thus a "residual": it *results* from economic activity, but does not generate it.

Obviously, savings is an important factor in a nation's continuing prosperity. It represents the resources available for new investment and productivity growth (which are the real foundation of rising living standards). But that is not the same as being the *cause* of investment. As anyone who has ever been in business understands, the primary cause of investment is the prospect of sales. Without demand, there is little or no reason to invest.

Peterson stands Keynes on his head: he not only assumes that savings increases investment but that the savings rate can be improved significantly by increasing taxes on consumption. Yet there is much evidence that the propensity to save is very much a function of personal income and attitudes toward living standards and does not change in response to short-term shifts in taxes, interest rates, profits, or returns on capital. Despite many changes in the tax rate during the postwar period, the savings rate in the United States has been relatively stable, changing primarily, as Keynes would have predicted, as a result of cyclical changes in income.

It is true that the U.S. savings rate is lower than that of our commercial rivals, but this does not explain our lack of investment or our large trade deficit. After all, the savings gap has existed for several decades. And it has shrunk and expanded in ways that do not conform to the conventional supply-side assumptions about savings and trade deficits. For

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example, the ratio of gross savings to GNP in the U.S. economy compared to that of our trading partners was actually higher in 1985 (the last year for which data are available) than it was in 1970, when we were running a trade surplus.[16] And, despite the fiscal deficit, business savings in the United States since 1982, unlike personal savings, have actually been *above* the postwar average.

In any event, the Reagan years have clearly shown the futility of trying to increase the savings rate from the "supply side." The Reagan administration, of course, did succeed in dramatically shifting the tax burden from the "high-consuming" poor and middle classes to the "high-saving" upper classes and investing business. In 1986 corporations paid fewer taxes than they did in 1980. And as a share of total federal government revenues, receipts from the corporate income tax dropped from 13 percent to 8 percent. Payroll taxes, on the other hand, rose from 31 percent to 37 percent of total revenues, largely because of the increase in Social Security taxes. Despite the Tax Reform Act of 1986, which undid some of the earlier damage to the tax code by eliminating many of the loopholes for corporations and wealthy taxpayers, the rich will pay a lower share of their income in 1988 than they did a decade ago, while the poor will pay more.[17]

The change in federal tax policy and spending priorities over the past decade, then, has clearly favored upper-income people. Between 1977 and 1988, $129 billion in income will have been shifted from the lower 90 percent of the nation's income earners to the assumed big savers in the top 10 percent. Moreover, this shift reflects significant growth in income derived from property ownership, as opposed to that generated by labor—primarily wages and salaries. Between 1979 and 1986, income derived from owning assets (securities, real property, etc.) rose by 117 percent while income derived from labor increased just 67 percent.

Yet, despite this shift in income from "consumers" to "savers," the promised boom in savings and investment never materialized. In fact, the personal savings rate dropped from 7.8 percent of personal disposable income (on average) for the decade ending in 1981 to a post-Depression low of 2.8 percent in the third quarter of 1987. And it dropped despite high nominal and real interest rates, which should have provided an additional incentive to save. This experience thus once again proves Keynes's basic point: *savings is a function of income.* Because incomes for most Americans (the bottom 60 percent) have been stagnant or falling during this period, consumers have had less to save, and many have had to borrow just to maintain their current living standards. Since 1979, per capita consumer installment debt has almost doubled.

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This entirely understandable behavior of borrowing to maintain current livings standards (that is, by those who can still afford to borrow) suggests that insofar as personal savings is concerned, austerity may well have the opposite effect of that sought by Peterson. *As incomes decline, borrowing will rise and savings will drop further.* Under these circumstances, reducing the federal deficit—particularly in the way Peterson proposes, by cutting entitlements and taxing consumption—may have little or no effect on increasing savings available for investment, since it may be offset by consumer borrowing. In fact, this seems to be happening already. From 1985 to 1987, the federal deficit dropped from 4.9 to 3.4 percent of GNP. But during the same period, net private domestic savings, instead of rising in response to the shrinking federal deficit, actually declined by 1.4 percent of GNP as a result of falling incomes and increased borrowing. State and local surpluses also shrank, partly as a consequence of federal cutbacks. The overall result was that the net domestic savings available for investment actually declined![18]

Given this interactive process between personal income, net private savings, state and local surpluses, and the federal deficit, the supply-side program Peterson favors could have a further perverse effect on national savings as well as on income distribution in the future. As George Brockway notes, if middle-class consumers continue to borrow to offset falling living standards, "the money will have been lent them by the rich, where extra dollars will have been left untaxed to better enable them to make this 'investment.'"[19] As a result, the rich will be richer, the middle class will get poorer, and net national savings will decline. Presumably, at some point, the middle class will become so overextended with debt that it will not be able to borrow any more, but by that time much of the middle-class American dream will have dissolved, along with much of the economy.

On the investment side, Reagan's supply-side record is no better. Despite the fact that corporate coffers were swollen by increases in depreciation allowances and other tax benefits from the 1981 tax bill, real business fixed investment has risen a mere 2.4 percent annually during Ronald Reagan's tenure. That compares to 6.9 percent annually under the Carter administration. Economist Milton Lower has calculated that from 1981 to 1985 some $115 billion was added to the corporate cash flow each year, more than half of which was the result of the 1981 tax cuts and generous depreciation allowances. But during that same period, the increase in corporate investment in plant and equipment amounted to only $80 billion. Clearly, American corporations could not be said to have been suffering from a lack of investment capital, or from a lack of tax incentives.

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This experience has taught us a great deal—at great national cost—about the efficacy of supply-side tax incentives in raising the national level of capital investment. As tax analyst Robert McIntyre points out in a study of the Reagan years, "there was absolutely no correlation between tax incentives and improved capital spending or job creation." In fact, companies that received the largest tax benefits, his study shows, actually performed worse than companies that continued to pay at least a third of their domestic profits in federal income taxes.[20] Corporations, it seemed, were unwilling to sink the proceeds of their federal tax bonanza—let alone their own retained earnings—into a shaky economy battered by imports and slow growth. This experience would again tend to confirm Keynes's basic point: investment follows demand.

If much of the tax savings was not invested in the United States, then where did the money go? So far as we know, it went into investment overseas, into the mergers and acquisitions boom, and into financial speculation. It went, as well, into higher salaries and bonuses for executives, expense accounts, and the purchase of more high-priced consumer goods, including luxury and upscale imports, which of course only contributed to our trade deficit. What assurances are there that further tax reductions would not lead to the same results? On this question, Peterson is silent.

Yet, if the Reagan experience is any indication, the problem of investment in the first instance is not one of capital shortage, as Peterson would have us believe, but one of capital wastage. Over the past decade our capital markets have been turned into casinos, and paper entrepreneurship has become an obsession of American business, contributing to the extreme short-term horizon of American managers. The existence of large profits and fees in arbitrage and takeover plays has made any company that chooses to forgo short-term gains in the interest of long-term profitability and market share vulnerable to a takeover bid. Faced with increased international competition for a stagnating world market, many U.S. companies and investors have found it more profitable to engage in financial speculation than to innovate and undertake painful changes in management-labor practices. And with wages in developing countries as low as one-tenth of those in the United States, many companies have chosen to move production abroad rather than to invest in productivity-enhancing plants in this country.

Peterson does not address any of these problems that impede productive investment in the United States. Indeed, one of the more striking aspects of Peterson's analysis is that—with the exception of health care—he has virtually nothing to say about the structure and organization of

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the productive side of the American economy. He deals exclusively with aggregates, with the macroeconomic side. Increasing productive investment, especially in today's globalized economy with mobility of capital and technology, however, is a much more complex question than merely freeing up resources and increasing national savings. It is a question not just of "where to find the resources," to use Peterson's words, but of such issues as trade and industrial productivity, the structure of our capital markets, and the right mix of public and private investments.

If Peterson has no answer for how to increase productive private investment, except to shift the tax burden to the consuming poor and the middle class, he virtually ignores the question of how to increase public investment. Peterson agrees that *public* investment in human and physical capital supports economic growth, and he laments the decline in spending for bridges and roads, education and training, and remedial social services. Indeed, at one point he says "it is hard to imagine any long-term economic renaissance—especially one built on 'working smarter'—without a determined investment in the most precious of our assets: the skills, the intellect, work habits, health, and character of children." But in the face of his obsession with reducing the federal deficit, these quickly become empty words. For cutting the budget deficit precludes any increase in public investment to repair the damage wrought by neglect of the economy's physical infrastructure and human skills. Any serious program of public investment, Peterson says, must wait until we have turned a modest current account surplus—which he reckons will be some time in the late 1990s. Since public investment invariably takes time to translate into higher productivity and higher profits in the private sector, Peterson effectively blocks that avenue to higher growth for two or three decades!

In the end, then, Peterson has no credible plan for increasing productive investment or for improving American productivity. This, as we will see, has profound implications for the trade adjustment the United States must inevitably pursue in the coming years.

Trade Adjustment: Growth or Austerity?

Peterson is correct that the United States will have to make dramatic economic adjustments to bring its external account into line. In order to halt the accumulation of foreign debt and reduce its dependency on foreign capital, the United States must become a sizable net exporter of goods and services in the years ahead. At the end of 1987, U.S. foreign debt stood at roughly $424 billion. By the mid-1990s, assuming the most

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optimistic projections, this debt is expected to climb to well over $1 trillion. At that point, debt-servicing payments alone could reach close to $100 billion annually. Peterson claims that his adjustment scenario would reduce our current account to zero within the next decade. By his reckoning, this would require "a real improvement in U.S. net exports of more than $20 billion a year, each year, for the next ten years, or a total shift of $200 billion in our trade balance." And this is just to *stabilize* our foreign debt and cover debt-servicing costs. To actually *reduce* our foreign debt, even larger improvements in our trade balance would be required. To make matters worse, there are limits to how much we can improve our trade position in agriculture and services, as Peterson notes. Thus the burden for reversing our trade deficit falls largely on manufacturing, which was seriously weakened during the Reagan years.

Barring a major recession, there are essentially four ways for the United States to improve its trade balance. One is by increasing world demand so that other countries can consume more of our production, as well as their own. Second, we can improve productivity and expand U.S. capacity for producing high-quality and competitive products so that we can increase our share of the market at home and abroad. Third, we can lower the exchange value of the dollar to make our goods cheaper relative to those of our competitors. And, finally, we can lower wages, which would curb consumption and decrease production costs in the United States.

Given the magnitude of the U.S. trade deficit, some combination of these factors would be needed to meet Peterson's target. Certainly, the United States cannot hope to reduce its trade deficit without some revival of its traditional export markets in Latin America, or without West Germany and Japan expanding domestic demand and reducing their trade surpluses. And certainly the United States will be in no position to take advantage of expanded world demand without an improvement in the quality and competitiveness of the goods it produces. The relative weight given each of these factors will determine what consequences the adjustment process will have for the U.S. economy and our standard of living. To the extent that we can reverse our trade deficit by emphasizing the first two factors—increasing world demand and improving U.S. productivity growth—we can avoid the fall in living standards that would be involved in relying on a falling dollar and lower wages.

It is around this question of trade adjustment that the fuller implications of Peterson's austerity program become apparent. For in the end his trade adjustment program is little more than a prescription for a falling dollar and a falling standard of living for American workers. Since Peterson

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does not recognize world underconsumption as part of the U.S. trade and financial problem, it is not surprising that a call for increasing global demand does not figure in his prescription. In fact, he belittles the contribution that policies to spur faster growth in Japan, West Germany, and other countries could make to the U.S. trade balance, and ignores Third World debt relief and the salutary effect it could have on U.S. exports to Latin America. Implicitly, he seems to assume slow growth and a stagnant world market.

In the absence of expanding world markets, the enormous shift in the U.S. trade balance that Peterson envisions would require an extraordinary penetration of markets held by our trading partners. Leaving aside for now the question of whether such a shift can be accomplished without throwing the world economy into a recession, Peterson is extremely murky on how exactly we can wrestle market share from our competitors. He acknowledges that Europe and Japan will not voluntarily reduce their trade surpluses—much less run trade deficits—with us. Thus, we must somehow "dash their hopes" that they can keep our markets. "Confidence," says Peterson, "not fear is the best way to get foreigners to retool their export plants for their own domestic markets."

Confidence? In what? Presumably in America's determination not only to cut consumption but also to take back its markets, forcing competitors to rely more on producing for domestic consumption. But how is this to be achieved? Peterson is opposed to an activist trade policy that might aid U.S. firms to compete with foreign companies protected and subsidized by their governments. And he eschews industrial policy as a way of improving the productivity of U.S. industries and of encouraging companies to produce more in the United States and less abroad. Moreover, his reliance on failed supply-side policies, as discussed earlier, hardly augurs well for any increase in productive U.S. investment, and his postponement of any increase in public investment means that, among other things, we will be hampered by a less productive work force.

Thus, on the basis of Peterson's program, it is highly unlikely that we can improve productivity sufficiently to keep pace with our European and Japanese competitors or to offset the lower wages of newly industrializing countries. If the United States cannot win market share by improving the productivity of American factories and the quality of American products, that leaves it no choice but to reduce the relative price of U.S. products in the world's markets with more currency devaluation or by a further assault on U.S. wage levels. In the end, this seems to be the path Peterson envisions for us.

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Falling dollars. Peterson appears to have some sense of the limits and risks inherent in his lower-dollar strategy. He knows that his essentially laissez-faire program depends on further declines in the dollar's value. But, at the same time, as an international financier, he is concerned that the dollar could fall too far too fast and cause panic in international monetary markets. Accordingly, he favors a "modest" drop in the dollar's exchange rate. Such ambivalence is understandable. His plan for reducing the trade deficit and restoring balance to our external account cannot work without a falling dollar. Yet our experience to date offers little assurance that, if we follow Peterson's laissez-faire prescriptions, we will be able to keep the dollar's fall under control.

Currency devaluation, of course, has been the Reagan administration's principal answer to the complex problem of the U.S. trade deficit for the past three years. Behind this strategy lies the assumption that increases in the dollar's exchange rate after 1981 caused imports to rise and exports to drop. Therefore, it is argued, bringing the dollar back to pre-1981 levels will automatically restore our trade balance. Those who oppose more direct and assertive U.S. trade policies rely heavily on this theory.

Yet, as the dollar's value has dropped since 1985, there has been only a modest narrowing of the gap between our imports and exports. Indeed, 1987 as a whole posted a record U.S. trade deficit of $171.2 billion, up $15 billion from 1986. There has, of course, been some improvement in recent months, and we can expect some further improvement in the future. In terms of volume, the merchandise trade deficit seems to have peaked in the third quarter of 1986, and in dollar terms the deficits have declined since the record high of October 1987. The first quarter of 1988 saw a $36-billion deficit, which, if extrapolated, would suggest an annual deficit of some $144 billion—less than last year's but still considerable. Even if we make the optimistic assumption that this type of progress will continue, it will be years before the merchandise trade deficit disappears and even longer before we manage to reverse our rapid accumulation of international debt.

The trade deficit's relative insensitivity to the lower dollar suggests that most economists and policymakers have tended to underestimate the complexity of the international marketplace. To assume that the falling dollar would have the exact reverse effect of a rising one, bringing us safely back to equilibrium, was to misread the dynamic character of the new global economy and the many changes in worldwide industrial production that had affected our trade with other countries. Consider, for example, the vagaries of the U.S. trade deficit with Japan, which now represents 36 per-

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cent of the total U.S. trade imbalance. The dollar's appreciation against the yen reached its high point in 1982, which, even then, was only 10 percent above the 1980 level. The dollar-yen ratio began dropping in 1982, and by 1987 it had declined 42 percent. Yet over that same period, as the value of the dollar dropped, the U.S. trade deficit with Japan *rose*, from $17 billion to $58 billion. The difficulty was clearly not just the misalignment of the dollar's exchange rate.

For one thing, the high dollar of the early 1980s, coupled with the vastly increased mobility of capital and technology, created new and tougher competition for U.S. producers. These foreign competitors—often nurtured by the industrial policies of their home governments—have longer time horizons than the typical U.S. firm. Consequently, they have been willing to absorb the impact of the falling dollar by keeping their prices down, accepting lower profits in order to hang on to their share of the U.S. market. In contrast, some U.S. firms seem not to have reduced export prices as much as the dollar has fallen; instead, they have used the lower dollar as an opportunity to fatten their short-term earnings.[21] Moreover, because foreign producers can buy raw materials and other inputs in world markets with dollars, a falling dollar actually lowers some of their costs and thus partially offsets pressures to raise the dollar prices of their goods.

The falling dollar's impact on the U.S. trade balance has also been limited by foreign countries' protection of their home markets. Japanese multinationals, for example, have been able to offset lower profit margins in the United States with expanded domestic sales in Japan. At the same time, U.S. firms seeking to take advantage of the lower dollar by reentering export markets have once again come up against the formal and informal barriers erected by the Japanese to protect and develop homegrown industries.

Another complicating factor is that, although the dollar has fallen dramatically against the mark and the yen, it has not dropped very much vis-à-vis the currencies of the new competitor nations in Asia and Latin America. South Korea, Hong Kong, Singapore, Taiwan, Mexico, and Brazil have dramatically expanded their exports to the United States in the 1980s, in part because the value of the dollar rose some 30 percent between 1980 and 1985 against the currencies of these countries—and then *continued* to increase, by 6 percent, between the first quarter of 1985 and the fourth quarter of 1987. Though some Asian nations have finally begun to allow their "pegged" dollar exchange rates to fall, the dollar continues to rise sharply against the currencies of important Latin American countries, with predictable effects on our trade balance with them.[22]

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At the same time that the United States has faced tougher economic competition, its trade balance problem has been exacerbated by depressed domestic production and high U.S. interest rates, which have restrained private capital investment within the United States. Consequently, as noted earlier, we have lost some of our productive capacity, which makes it difficult for U.S. producers to expand now to take advantage of the lower dollar. In a number of product lines—consumer electronics, for instance—there are simply no longer any U.S. producers.

While this worsening of the trade balance in consumer goods had been under way for years—the 1980s may simply have accelerated what was a long-term process—the sector that had been the mainstay of U.S. trade throughout the postwar period—capital goods—is now also in decline. In 1981, the United States still had an export balance of $49.8 billion in the capital goods sector, but by 1986 real net exports of capital goods (excluding automobiles) had dropped to $0.9 billion, rising only to $2.3 billion in 1987, despite three years of a falling dollar. In fact, during this period, the entire increase in the nation's demand for capital goods was met by imports. Not only has this reversal eradicated this traditional bastion of export strength; it also means that, if we attempt to increase production in an effort to rebuild the U.S. economy, we will at first have to import much of the needed productive equipment, thus at least temporarily *worsening* the very trade balance we are attempting to correct.

These disturbing trends may grow worse for another reason: the lower dollar, it is now apparent, is not attracting American companies that have invested abroad back to the United States. Even the prospect of lower manufacturing costs does not seem able to reverse the flow of investment abroad generated by the many U.S. companies seeking to position themselves within foreign countries' trade barriers, to gain greater access to foreign technology, or to hedge against a possible future rise in the dollar's exchange value. Over the long run, this development will limit the growth of exports from the United States and make the trade deficit more difficult to eliminate. (Of course, U.S. companies' investment abroad is offset to some degree by the increased investment of foreigners—especially the Japanese and the British—in the United States, but reliance on the "kindness of strangers," whoever they are, hardly seems to be a sound basis for restoring economic health.)[23]

Thus any hopes Peterson may have that a further "modest" decline in the dollar will reverse the trade deficit are unrealistic. Theoretically, there is some exchange value of the dollar low enough to eliminate the trade deficit all by itself. At that level, U.S. exports would become *so* cheap and

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imports *so* expensive that we could hardly avoid selling more to the rest of the world than we buy from it. We don't know what that level is, but given the trade deficit's resistance so far to the effects of the lower dollar, we do know that in order to do the job entirely on its own, the dollar would have to fall much more than it has. The result would be a major decline in U.S. wages and incomes relative to those of our trading partners.

In any case, there may be limits to how far the dollar can fall; in the short term at least, our trading partners and creditors will resist any further substantial drop in the dollar's value, which they are likely to perceive as a threat to their trade surpluses. Currently, the dollar is being propped up and the deficit is being financed by the German and Japanese governments, which are eager to prevent an even lower dollar from undercutting their exports to the United States. (In 1987, the major industrial nations spent an estimated $130 billion on dollar assets to keep the dollar from dropping further.[24]) At some point, of course, foreign banks will be unwilling to absorb more dollar assets. For if the dollar falls further despite their efforts, they will suffer severe losses. At that point the problem becomes one of instability. The combination of foreign banks retreating from the dollar and a U.S. strategy to solve the trade deficit by driving down its currency could lead to a run on the dollar. The threat of foreign countries suddenly withdrawing their investments in the United States could force Washington to dramatically raise interest rates—just the opposite of what is needed to stimulate the Reagan-Peterson dream of a supply-side investment boom.

Moreover, although the lower dollar has a beneficial effect on the merchandise trade balance, it could have a long-term negative impact on the investment-income component of the overall current account. By making American assets cheap for foreigners and foreign assets expensive for Americans, a lower dollar could expand net foreign investment in the United States and, consequently, the stream of dividends and interest payments flowing abroad could widen. Evidence of this was seen in the first quarter of 1988; the trade deficit narrowed but was more than offset by a shift in net-investment income, which turned negative for the first time in 30 years.

Falling incomes. In the end, we must take Peterson at his word: when he uses the word austerity, he clearly means it. By his own calculations, consumption per worker in the United States will need to decline by $165 for each of the next 10 years. But even this calculation assumes an increase in net investment to its 1970s level and improvements in productivity, which, as we have seen, cannot be guaranteed. So consumption may have

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to fall much lower than Peterson states. His logic, in fact, suggests a need for *drastic* declines in wages and living standards so that U.S. goods can compete with goods made more cheaply in impoverished nations. Reading Peterson carefully, one understands that lower wages are not some unfortunate by-product of a prudent economic policy; they are the *purpose* of his policy.

Coming to grips with this reality is not pleasant. And understandably, Peterson, despite his relative frankness, does not fully reveal what awaits America along the path he recommends. But it seems that, in our new global economy, where capital can shift around the world in the blink of a microchip and where technology moves rapidly from high-wage countries to low-wage countries, Peterson intends that the United States will regain its trade balance by becoming a low-wage producer. This cannot be accomplished by just minor cuts in workers' take-home pay; in the low-wage countries of today's world, workers' earnings are one-fifth to one-fiftieth of those of their U.S. counterparts.

Liberal and conservative economists alike commonly dismiss these kinds of wage comparisons as irrelevant because, they argue, productivity in the United States is so much higher that it effectively counteracts the benefits producers might reap from low wages in other countries. But in the real world things do not work out so neatly. In the textile industries in Hong Kong and China, for example, hourly labor costs, including fringe benefits, are 21 percent and 2 percent, respectively, of U.S. textile industry labor costs; productivity is 50 percent (Hong Kong) and 10 to 15 percent (China) of U.S. productivity: this means that total labor cost per product is, in Hong Kong, roughly 40 percent of U.S. costs and, in China, less than 20 percent. To match these lower costs, even with America's higher productivity, U.S. textile industry wages would have to drop between 60 and 90 percent.

Of course, labor costs in a number of industrialized countries have risen even higher than U.S. costs, without impairing the health of the industries in these countries. For example, the hourly costs in Japan's and Italy's textile industries are 30 and 37 percent above those in the United States—and in both countries productivity is only 75 percent of U.S. productivity. But because both Italy and Japan control imports, these cost differentials do not spell disaster for their domestic industries. Textiles from Hong Kong and China do not flood Italy and Japan; instead, they are diverted into America.

One could argue that, over time, labor will become more expensive in the Third World countries competing with the United States and costs

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will even out. Thus there will be a limit to how far U.S. wages would have to fall. But the generally low wages paid throughout the Third World inhibit wage hikes in any export industry; already exporting countries such as South Korea and Taiwan are themselves under pressure from the newer, even lower-wage exporters—Malaysia and Thailand, for instance. The repressiveness of many Third World political systems makes a natural emergence of Western-style labor unions unlikely in the near future. Moreover, capital and technology have become so mobile that a significant rise in wage rates in one country would probably trigger the departure of production for another country.

The importance of lower U.S. wages in Peterson's strategy explains the otherwise out-of-place accolades Peterson gives the Reagan administration for breaking the air-traffic controllers union. He places it second only to high interest rates in the early 1980s ("the only Reagan, or Volcker-Reagan, measure that seriously tested our threshold of pain") in his list of Reagan's accomplishments. Peterson's low-wage program also clarifies his obsession with cutting cost-of-living adjustments (COLAs) in entitlements and pensions, for that would set a precedent for similar ceilings in wage negotiations. Eliminating COLAs in all forms of labor compensation is crucial to Peterson's program of reductions in real wages, as it is the only way to ensure that the price increases eventually caused by the falling dollar will translate into lower incomes, and thus, lower imports.

The imposition of these lower incomes would come at a time when a majority of the American people is already experiencing a decline in living standards. As we have seen, there has been a shift of income and wealth to the rich. But there has also been an absolute decline in wages. For three of the past four years, average hourly wages in America have risen less than consumer prices, and, in real terms, they are 3.5 percent below their level at the last cyclical peak in 1979. Family incomes for 60 percent of Americans have declined or stagnated over the past 10 years; this decline would have been greater had it not been for the fact that more people per family are working, and more are working at more than one job.

This decline in wages and living standards has been under way for several years. Until recently many analysts dismissed it as a temporary aberration—a function of the large baby-boom population swelling the labor supply. But the post–baby-boomers are now moving into the labor force, and their experience confirms the view that something more fundamental is going on.[25]

A Peterson austerity program will only intensify this trend. True, we can expect some recovery in the manufacturing sector. But if Peterson's

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strategy is to succeed, wages must remain depressed. For him, further decline in wages and living standards is the only way that the Reagan-era policies' consequences can be paid for. In other words, those who were shut out of the Reagan party in the first place will now be required to pick up the tab.

Peterson justifies the pain his strategy entails by saying that we have to make sacrifices today in order to avoid a further decline in our standards of living later. Yet, that is exactly what his low-dollar, low-wage strategy will produce, for it will undercut the one goal that all parties, regardless of their politics, agree is essential to increased U.S. growth—raising productivity. Without greater productivity, there will be no prosperity later. In a modern economy, low wages, by making labor cheap relative to capital, are a disincentive to capital investment. As Lester Thurow has pointed out, productivity has been much lower in U.S. service industries than in European services, principally because low wages here make it cheaper for employers to hire new workers than to invest in more efficient capital.[26] Moreover, whatever productive investment *is* made will be progressively less efficient because of a retarded rate of public investment in human capital and infrastructure during this prolonged period of stringent public budgets.

Finally, Peterson's strategy of lowering wages cannot help but intensify labor strife. His program encourages employers not only to cut wages but also to become more aggressive in breaking unions. This can hardly be conducive to establishing the new, more flexible production-labor arrangements that are required for a competitive modern economy.

Thus a low-wage austerity strategy, characterized by insufficient public investment in human capital and private investment hobbled by weak consumer demand, will ensure that U.S. incomes and living standards continue to decline. As a result, we will become an even poorer society. Basic necessities such as housing, medical care, and education will be even further out of reach for the average family. Peterson has it wrong. Austerity now will not lead to prosperity later. Austerity now will lead to austerity later as well.

The Dangers of Recession

If Peterson's austerity program promises us only more austerity and a poorer, more divided society over the long run, it poses an even greater danger in the short term: a deep recession that could bring down upon us the mountain of debt that has been building up over the years. If that were

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to occur, income levels and living standards in the United States would be set back by years. Peterson seems to be vaguely aware of the risk that, by withdrawing demand out of the U.S. economy, austerity could plunge us into a recession. "Correcting the current imbalance," Peterson notes at one point, "assumes that this shift [from consumption to savings] will not throw the world's economy into a tailspin, either by trade-led recessions in other countries or by a chain of debt defaults among the less-developed countries (against whom we will be competing for trade surpluses)."

Yet, in the end, Peterson seems amazingly unconcerned about this danger, and his strategy takes no precautions against it. It is hard to believe that this is entirely an oversight. Indeed, weathering a recession as a way to purge the system of excessive debt and to prevent the buildup of inflation is a time-honored proposition among financial leaders concerned with restoring the confidence of bondholders in the value of their holdings. As William Greider, author of *Secrets of the Temple*, the celebrated book on the workings of the Federal Reserve, observes, "To put things very crudely, the austerity crowd wants the real economy to take a bath. Further disinflation would restore financial market values and the wealth-holders' interest at the expense of everybody else."[27]

Whether or not austerity is a code word for recession, its advocates are flirting with disaster. The idea that one can manage a recession—use it to destroy excess debt and then restart the economy in an inflation-free environment—flies in the face of the economic reality that Ronald Reagan's deficit has created. In effect, by leaving his successor a fiscal deficit of more than $150 billion for 1989, Reagan has denied him the tool that his predecessors have used for the past 50 years to recover from a recession—namely, proactive deficit spending. The problem is as much political as it is real, but its effect is the same. With the next downturn, the deficit will inevitably increase as revenues from an already weakened tax system decline and the public costs of unemployment rise. And as projections for the deficit soar, no president—Gramm-Rudman or no Gramm-Rudman—will have the political courage to launch a countercyclical spending program, at least of the magnitude that may be required.

Without the tool of an expanding fiscal policy, the entire burden of preventing and getting out of a recession will fall on the shoulders of looser monetary policy. Yet, as we have already seen, pressures to stabilize the dollar and attract funds from overseas to finance our deficit will restrain the ability to lower interest rates. As Harvard economist Francis Bator has pointed out, shifting to tighter fiscal policy and looser monetary policy

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is difficult in the best of times: "Bringing about such a switch is a delicate task, best done gradually and when the economy is expanding rapidly. Fiscal compression works predictably and fast; monetary ease, acting in part through the exchange rate, works only slowly—the lags are variable and slow."

Peterson seems to hope that the rest of the world will help us out of this dilemma by taking up the slack (despite the fact that he envisions a wage-cutting trade war) and that any reduction in U.S. demand will be offset by a comparable increase in U.S. net exports. Yet this assumption is extremely problematic. For one thing, the task is sizable. Cutting consumption growth to one percent—roughly what would be needed to balance our international account by 1996—would require an increase of $25 billion in net exports per year; balancing it sooner, as Peterson would like, will make the task even harder. But where are the new export markets of this magnitude going to come from, given West Germany's and Japan's—not to mention Korea's and Taiwan's—propensity for running trade surpluses? Even if these countries were to retool to produce for their own markets, it would not necessarily mean an increase in imports of U.S. goods unless they also increased their growth dramatically. And what will happen to those debt-ridden Latin American countries that have become dependent on exports to the U.S. market to service their debt?

To assert that we can dramatically expand our export markets while those of our trading partners are, in effect, contracting and world demand is being reduced, requires an enormous faith in the willingness and ability of the world's markets to respond to America's desire to switch economic horses in the middle of a very fast-moving stream: other countries would need to increase their overall demand enough to accommodate not only their own excess production but ours as well. As James Tobin has observed: "A high investment economy is necessarily traveling to *terra incognita*. . . . When a consumer skips lunch today in order to save for future consumption, she gives no signal to prepare producers for her future consumption to make the necessary investments."[28] Thus, in the absence of well-coordinated planning of the kind Peterson opposes, it is unlikely that such a transition can be made safely. More likely than not, the result will be reduced investment and consumption all around and a deep and nasty recession.

Given the huge amount of debt hanging over the world's consumers, banks, businesses, and governments, even a shallow recession could quickly turn into a spiraling economic collapse. Compared to its state prior to the recession of 1981–82, the U.S. economy is extremely fragile. Debt of

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all kinds—corporate, consumer, and government—has increased. According to the General Accounting Office, 30 percent of all thrift institutions in America are insolvent or close to it.[29] And the federal savings and loan system is being kept alive with regulatory smoke and mirrors by a federal government that does not have the funds it needs to close down bleeding institutions and pay off insured depositors. Major banks still hold large sums of shaky Third World loans, and, as a result of leveraged buyouts, hostile mergers, and greenmail, many U.S. corporations are loaded with debt. Moreover, there is some question as to whether the federal government itself could handle the financial fallout of the next recession. A crisis in just one major bank, Continental Illinois, in a year of strong recovery, 1984, brought us to the brink of financial panic and forced the government to pump up the bank with $12.5 billion in new capital and loans.[30] If we barely coped then, one shudders to think what would happen today, given the weakened state of so many banks, if a recession were to hit. Clearly, there is a danger that the system would not hold.

Even if a major blowout can be avoided, it is hard to understand how a recession can be worth the risk. In the short run, a recession would only make the federal deficit worse. Moreover, depending on its intensity, it could set back investment and productivity growth—the very conditions we want to encourage—by years. Peterson's answer seems to be that we can't continue to go on as we are: at some point dollar-holders will "become aware that the situation is unsustainable" and lose confidence, creating a flight from the dollar. We would then have little choice but to raise interest rates to attract back dollar-holders, pushing us into a recession. Yet it is Peterson's low-dollar, low-wage program that is most likely to precipitate the very crash he is worried about. What better way for dollar-holders to lose confidence than by watching the spectacle of a falling dollar failing to clear the trade deficit? For that would only create expectations that the dollar must fall further and calculations on the part of dollar-holders that they had better get out now. Thus, Peterson's program runs the risk not just of an austerity-induced recession, but of a dollar-induced one as well.

Growth as a Cure for the "Root Malady"

The power of Peterson's austerity argument lies in its suggestion of inevitability. It's true, after all, that Reagan's debts must be serviced by increasing our exports relative to our imports—in other words, by transferring a larger share of the goods we produce to our creditors. It's also true that this will require a certain amount of economic pain, and that by not acting now

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we will create even more pain for ourselves later. But to acknowledge the hardships of adjustment is one thing; to conclude that austerity is our only alternative is quite another. The question is not simply one of pain, as Peterson would have us believe, but of what kind of pain and by whom it will be borne. And on this there is a clear choice: whether to accept the pain of a deep and permanent cut in our living standards or to accept the pain of changing our economic policies and institutions to better meet the new conditions of world competition and, thus, increase economic growth. In other words, we have a choice whether we work our way out of Reagan's debts by cutting consumption (austerity) or by increasing production (growth).

In the end, Peterson's program all but forecloses even the possibility of the latter option because it cannot answer the central questions we face about economic growth today: one, how do we induce productivity-enhancing investment in the United States, given today's fiercely competitive global economy and the mobility of capital and technology; and two, how do we maintain world economic expansion as we shift from being a massive net importer to being a net exporter without either a recession or an inflation explosion? The answer, which lies in the more reasoned and active use of government, is anathema to Peterson and many of the advocates of austerity. In short, austerity is an ideological choice, not an economic necessity.

Peterson sees America much as a short-sighted creditor sees a company on the verge of bankruptcy. He demands that the first, if not the only, priority of the new management be to squeeze as much revenue out of the firm as possible in order to pay its debts quickly. But financial health is not restored to the business firm simply by paying off its creditors; it comes from organizing the firm to produce more efficiently and market products more aggressively. So it is with America. We need a strategy that does more than pay off our creditors by shrinking our incomes and selling our assets. We need a strategy that will enable us to sell high-quality products to an expanding world economy at high enough prices so that we can pay wages that can sustain a rising living standard.

Managed growth is the alternative to austerity—the way we can work our way out of Reagan's debt and at the same time offer the promise of rising living standards to the bottom two-thirds of the nation whom Peterson's program would brutalize. It should be self-evident that the slow growth and austerity Peterson favors will only increase the burden of our past debt on our future income. By contrast, faster growth in production of goods and services will, by increasing income, make it easier to carry

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our debt load. This is perhaps best illustrated by the effects growth has on the federal budget deficit. For example, the baseline deficit projection of the Congressional Budget Office assumes a 2.6 percent growth rate for the next five years—what we managed on average in the period of 1980 to 1987—which would leave us a $134-billion deficit in 1993. If the annual growth rate were raised by just one percent—still well below the performance of the 1960s—we would eliminate the deficit by 1993.

There are other economic advantages to growth as well. Faster growth, by raising the prospects of higher profits, would make the United States a more attractive place to invest, and therefore make it easier to finance our trade and fiscal deficit during this adjustment period. By contrast, the prospect of slower growth and austerity would more than likely discourage the foreign investment that will be needed to help rebuild our productive capacity. Moreover, an economy running closer to full capacity at full employment would make the cost of adjustments in this new competitive era easier for labor, capital, and the government. Unemployment and earning losses are reduced when a laid-off worker can move quickly to a new job. Skills do not rust, discouragement and alienation from work do not set in, and the social and economic costs to the community and national public sector are vastly reduced. A high-growth environment provides incentives for recycling the plant and machinery of a firm or industry that is shrinking. It makes it possible for the entrepreneur to survive and learn from business failures. And it undergirds investment confidence in the future, encourages business to keep workers on the payroll when business slackens temporarily, and helps stretch management horizons.

Ronald Reagan, of course, also promised that economic growth would solve our problems. In the early 1980s, supply-siders were particularly fond of quoting John Kennedy to the effect that "a rising tide lifts all boats." Cutting the taxes of the wealthy, it was said, would spur investment and growth, which would close the budget deficit and spread the benefits to those who did not initially benefit from the tax cut. As we know, this did not happen. But the lesson of Reaganomics is not that growth cannot solve deficit problems. It is that the supply-side tax incentives upon which Reaganomics was based cannot produce the necessary growth. "Keynesianism in one country"—what in effect Reagan's supply-side budget deficits became—could work in the early 1960s because an increase in domestic consumption stopped at the water's edge. Had the United States dominated the world economy in 1981 the way it did in 1964—had there not been a relative decline in U.S. competitiveness and the great globalization of capital and technology in the intervening years—Reagan's Keynes-

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ianism might well have worked. But in the 1980s the structure of the national and international economies had substantially changed, and U.S. competitive dominance had eroded. As a result, deficit-fueled increases in demand did not lead to commensurate increases in production, but instead drew imports from countries with lower wages and national export strategies.

The lesson from this, however, is not to give up on growth and accept austerity, but to use the instruments of government to increase U.S. productivity and competitiveness and to begin to extend Keynesianism to the world economy as a whole. To work, then, a growth strategy must be concerned with two tasks. The first is to minimize the drop in living standards as much as possible by shifting the burden of regaining a trade balance away from dollar devaluation and wage cuts to increased exports through productivity and innovation. The second task is to expand world consumption to ensure that there are sufficient customers with income in their pockets to buy our goods as well as more of their own. To the extent that we can improve the efficiency with which we use our labor and capital, we lessen the need to brutalize our population with lower living standards in order to pay our foreign debt. And the more we can increase world demand, the less we will need to reduce consumption and run the risk of a worldwide recession.

A Public Sector–Led Investment Strategy. There is, of course, no simple formula for raising productivity growth—the ultimate basis for a rising standard of living—in a mature industrial nation like ours. But we do know from our own experience, as well as from that of other leading industrial countries, that it requires, at a minimum, adequate levels of both public and private investment. Indeed, maximizing productivity growth is in large part a matter of getting the right mix of public and private investment. Peterson would have us forgo public investment until we have balanced our current account. But the idea of cutting back on public investment in order to increase savings available for private investment is nonsensical in today's world. It's like a farmer selling his cows to buy a milking machine. As our history shows, public investment—education and training, roads, canals, airports, water systems, etc.—is not only closely associated with private investment, but often leads it. The Japanese, Germans, Swedes, and others can pursue high-wage, high-productivity strategies because the quality of their labor and public infrastructure makes their private investment more efficient. In an increasingly global and information-based economy, a high-quality labor force supported by efficient labor markets is critical for raising a nation's productivity.

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The overriding question, then, confronting a growth strategy is how to get an adequate level of both public and private investment, given the budget deficit on the one hand and the tendency for production flight on the other. The goal of increasing both public and private investment, austerity advocates might say, is all well and good, but how can it be done without cutting drastically the consumption of working Americans, given our current low savings rates? As we have seen, however, the problem is not so much one of capital shortage, but one of capital wastage and misplaced budgetary priorities. By eliminating capital wastage and rearranging our budget priorities, we can find the resources needed to fund public investment programs without crowding out productive private investment. In fact, with an adequate public investment program we can increase the efficiency of private investment.

A first order of business for a growth-oriented investment strategy must therefore be to address the extraordinary wastage of capital in our present society. Paper entrepreneurship has become a serious problem and is responsible in part for the enormous surge in corporate debt and for the extremely short-term time horizons of American managers. By taxing financial speculation and other forms of paper entrepreneurship, as well as lavish expense-account spending, we can both curb capital wastage and raise valuable government revenues for public investment. While raising or lowering tax rates has a limited impact on total investment, differential tax rates do affect the allocation of that capital. For example, taxes levied on the use of capital for buying and selling investments involving financial speculation and for short-term turnovers in general can reduce the after-tax profitability of these often wasteful transactions and encourage longer-term time horizons. As for the revenue that could be raised, a modest tax on the sale of securities, like that imposed by the Japanese, Germans, and British on their financial markets, could alone generate somewhere between $20 and $40 billion in funds. Unlike Peterson's supply-side approach, which declares all private investment equal (whether it's a stock market index future or a computerized lathe) and superior to public investment, a growth strategy would use tax policy to direct capital to productive investment.

As far as the federal budget deficit is concerned, if we concentrate on eliminating capital wastage and reordering our priorities the problem is not as hard to solve as Peterson suggests. It therefore need not stand in the way of a full public investment program that would increase the flow of income in the future. A sensible policy would shift budgetary priorities to those investments, such as education and public infrastructure, that

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can support long-term growth rates, while reducing the overall federal deficit through a mixture of tax revenues and cuts in unnecessary military expenditures. Even at present modest rates of growth, the deficit as a share of GNP has been declining since 1985 and will continue to decline somewhat over the next five years. On our present track, the deficit, it will be recalled, will decline to $134 billion, or 2.1 percent of GNP, by 1993. Getting it down to one percent involves trimming only $69 billion from that year's budget. If we act on the principle that the burden of paying for deficit reduction ought to be borne by those sectors of the economy that received the most benefit and bear greatest responsibility for today's capital wastage—primarily upper-income earners and the military sector—any one of a number of combinations of spending cuts and tax increases would do the job. For example, freezing defense spending for five years—a very reasonable proposition given the improvement in U.S.-Soviet relations—would net $50 billion. Creating a new 33 percent top income-tax bracket (to compensate for the quirk in the new tax law that actually reduces the tax rate for individuals making over $105,000) would generate an additional $8 billion. Raising the top marginal tax rate from 28 percent to 30 percent would yield $19 billion. Thus, barring a recession, a reasonably balanced combination of such modest initiatives plus the resultant reduction in interest service costs to the Treasury would reduce the deficit to one percent of GNP with little suffering.

Once the deficit is reduced to one percent, these tax revenues could then be used for an expanded public investment program. However, increased public investment need not—indeed should not—wait. New investment spending could be immediately financed on a pay-as-you-go basis. The tax on the sale of securities, which would generate $20 to $40 billion in funds, could be dedicated to education and training. An increase in the minimum corporate tax could finance a $5-billion investment in civilian research and development. A gasoline tax with a rebate for low-income consumers, which would encourage energy conservation, could be used to improve transportation infrastructure.

A highly productive, flexible labor force is the sine qua non for solving the demographic problem Peterson raises without drastic impoverishment of both today's and tomorrow's elderly population. Peterson is correct to point out that when the baby boomers begin to retire, their pensions will have to be supported by fewer workers. His answer, of course, is to cut today's pensions. But the financial future of those who retire in 2011 and beyond can only be as secure as the economy is. The way to ensure a comfortable retirement system is to invest today in a labor force that 23 years

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from now will be productive enough to support the retirement of the previous generation of workers. One out of four children is now born into poverty. The question of how generous the nation will be to the baby-boom retirees will be settled by what we do now for the children of the poor.

Such public investments are not only important in and of themselves, but they also make private capital investment more efficient. As David Alan Aschauer, an economist with the Federal Reserve Bank of Chicago, has shown, the failure to make public investments in physical infrastructure depresses productivity and ultimately private investment as well. This is illustrated by the fact that public investment, as a share of the economy, dropped sharply from 2.3 percent in the late 1960s to only 0.4 percent in the early 1980s, a period when both productivity growth and private investment also slowed. By contrast, in the period from 1953 to 1971—a period when we were enjoying both high productivity growth and a high rate of personal consumption—both net public and private investment per worker were rising. Since 1971 public investment has dropped substantially, and although private investment per worker has continued to increase, it has done so at a slower rate, in part because public investment has lagged. Today, concludes Aschauer, "the marginal productivity of public capital may very well exceed that of private capital in private technologies."[31]

A public investment program can help sustain private investment in other ways if it is organized, not only as traditional public works, but as part of a larger industrial sectoral strategy involving the full use of government instruments, such as trade relief and investment subsidies, to support new public-private partnerships for regaining America's competitive position. Japan and other leading industrial societies have used such strategies successfully over the past two decades to increase their share of our markets to the detriment of our own industries, whose decline is reflected in America's current trade balance problems. We need to design an American version of this technological and strategic planning to ensure an increase in domestic production based on higher wages and higher productivity in the future. If we fail to move in this direction, we will be left with little choice but to dramatically lower wages or to lose more and more production.

Such a public-private sectoral strategy could help increase U.S. productive investment in two ways. First, it can provide timely assistance in the form of trade relief and investment credits to industries that are threatened by foreign competition, enabling them to survive by adjusting and modernizing. Second, it can help new industries to emerge and gain competitive advantages in the world marketplace. It can do so, for example,

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by creating government-supported research consortiums and by developing large-scale public modernization projects designed to create an internal market (or to create a demand-side pull) for new technologies. The public-private development of new technologies will in the future become increasingly important to a nation's competitive position and thus its standard of living. Whichever country makes its technology the world standard will have enormous advantages in capturing the economic rents that come from such new technologies. Thus, to cite a small example, Japanese firms that control the market for videotape recorders regularly change technical protocols to prevent U.S. manufacturers from producing peripheral equipment for that market. On a larger scale, today, as a matter of public policy, the Japanese and Europeans have begun to wire all their households in order to achieve a base of sufficient scale to create telecommunications standards of the future. By contrast, the U.S. industry is becoming fractionated, uncoordinated, and largely ignored by the government as well as subject to increasing foreign competition. Although deregulation may have spurred innovation among individual firms, the absence of a national strategy is gradually denying U.S. industry the domestic base it will need to compete with the growing business-government complexes of Europe and Japan.

An effective strategy will require us to rethink policy in three areas. First, we need to establish a more active government role in setting strategic goals and in building business-government-labor cooperation in pursuit of those goals. That means not only setting up permanent tripartite institutions for strategic planning and industrial revitalization, but also providing the government with a full range of the tools it needs—from tax penalties on capital wastage to investment subsidies to trade protection relief—in order to leverage private investment and encourage higher productivity and better economic performance. To take advantage of such government benefits, industries would be required to make reciprocal commitments on investment, modernization, and labor practices, designed to increase the competitiveness of U.S.-based production. In this way, the government can help threatened industries survive and can give companies an alternative to moving production abroad. It can also help pool research and development efforts as well as help provide public markets for emerging industries.

Second, America's trade policies must be brought in line with international reality. An almost blind allegiance to the principle of free trade—although by no means perfectly practiced—has denied the United States the minimum policy tools it needs to protect itself from the targeted trade

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practices of other nations. After years of frustrating negotiation it should be clear by now that import restrictions are a fundamental part of the Japanese model and, to a lesser extent, European models as well. They are therefore not likely to be readily given up. Indeed, the Japanese model is being reproduced by many of the newly industrializing nations of Asia and Latin America. And the next stages in the creation of a truly common West European market may further increase barriers to outside producers. All this argues for a more managed trade policy that would be an integral part of U.S. strategic industrial policy. At a minimum, the U.S. government needs the authority to provide temporary relief to industries under attack and to be able to nurture emerging industries with a temporarily protected domestic market in return for long-term investment commitments.

It also needs the authority to penalize countries that deny us access to their markets and to negotiate bilateral arrangements to achieve true reciprocity—whether in the direction of more open markets or mutually beneficial trade restraints. Without such authority and the willingness to use it, other nations will have little incentive to reduce their large trade surpluses, and unless surplus countries begin to adjust as well, there is little hope that we can reduce our trade deficit sufficiently. The experience of recent years suggests, however vaguely, the utility of this approach: the mere threat of tougher trade legislation has helped encourage many countries to begin to move production facilities to the United States to avoid the possibility of being shut out of the U.S. market sometime in the future, just as American companies have increased investment in Europe and Japan to avoid trade restraints there. Thus, a commonsense trade policy can be a powerful tool in helping reestablish the connection between production and access to our markets.

Finally, we need a new social contract between labor and management. Implicit in Peterson's austerity program is an assumption that productivity is maximized by making workers as insecure and frightened as possible. This contradicts everything that we have learned over the past two decades about the contribution employee involvement in shop-floor production decisions can make to productivity and innovation. Indeed, job security and a sharing of the benefits of productivity are essential to a modern enterprise's long-run success. No rational worker will cooperate with company efforts to increase productivity if the result is to be unemployment or lower pay. While this insight is gradually seeping into the consciousness of American business and labor, an effective participatory system is not possible as long as lowering wages and breaking unions are major tools

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of management and the objective, whether implicit or explicit, of government policy.

A new social contract requires a revision of the legal framework of collective bargaining, which was established in the 1930s when labor and management were assumed to be implacable and permanent adversaries. Today, given the corporate conglomerate structure of American business, the interests of workers and local managers, in fact, are often allied with each other against the interests of an absentee multinational corporation that is indifferent to the long-term investment needs of the branch plant. In a new collective bargaining system, the long-range investment plans of a company, as well as the quality of the product manufactured, ought to be legitimate subjects for negotiations, as should be new forms of worker participation and ownership. A new social contract requires a strengthening of the right of labor unions to organize workers and an end to the increasingly common destructive anti-labor practices that have expanded in recent years. It is no accident that labor unions are more prominent in the economies of our major commercial rivals: in the long run they provide an essential stability and organized structure for the development of labor-management cooperation. As Lester Thurow has observed, "If labor unions were to disappear, we would have to invent them all over again."

All these measures—the taxation of capital wastage, an adequate public investment program, a system of strategic planning, a more active trade policy, and a new social contract—involve the reasoned use of government. Such measures are central to the economic strategies of our major economic competitors. And they will be increasingly critical to our ability to improve productivity and increase productive investment in today's more competitive and dynamic world economy. While the full benefits of such a strategy will not be felt for years to come, since improvement of productivity is, by its nature, a long-term task, a public sector–led investment strategy will nonetheless have some immediate benefits for both the trade deficit and domestic growth. It will ensure that the money diverted from capital waste to public investment is spent directly in the United States. In turn, this will help reduce the leakage out of the economy in the form of imports, thus improving our trade deficit and reducing the drag on domestic growth. Moreover, by the use of selective trade restraints and sectoral strategies, it will reduce import penetration and increase production in the United States. This, too, will have a beneficial effect on our trade deficit and domestic growth. Finally, because a portion of the public investment will be targeted to areas of high unemployment and idle

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resources, it will increase growth with less inflation than would comparable private investment.

Global Keynesianism. Even with these benefits, a growth strategy cannot fully work without an increase in world demand. To reduce our trade deficit, especially in the short run, we need not only to reduce the import propensity of the American economy, but also to expand the demand for our exports. And to do so without provoking a trade-led recession in other countries, we need to expand world demand enough so as to accommodate both our increased exports and the production of other countries that will have been displaced from the U.S. market. This necessarily involves two tasks: one, getting nations that run persistent trade surpluses—Japan, West Germany, South Korea, Taiwan—to reduce those surpluses by increasing consumption (internal demand); and second, stimulating faster and more balanced growth in debt-burdened Third World countries, which have been forced to expand exports and cut imports dramatically to service their debts. Here again, these tasks will entail a more active use of government—in this case more active international diplomacy—than Peterson or the other austerity advocates are willing to consider.

Peterson does not concern himself much with how to get nations that run a persistent trade surplus to adjust. At most, he would simply "dash hopes"—ours as well as theirs—by lowering U.S. wages. Peterson is correct that Japan and West Germany, the two largest surplus nations, will not "voluntarily" change their economic policies to permit us to export more. After all, they have done quite well by letting the United States serve as the principal market for the world's exports. Why should they change their policies voluntarily?

This, of course, is a political as much as it is an economic problem—for all concerned. Japanese and German leaders face complex domestic political pressures (for instance, German fears of inflation) that must at least be recognized in an effort to reach a mutually satisfactory deal. But the prevailing attitude of austerity advocates in this country poses perhaps an even more serious political problem. Peterson, given his interest in lowering wages, is not even interested in cutting a deal. Neither, from the evidence, is the Reagan administration. To be sure, the Japanese have, at our urging, increased domestic demand somewhat and have expanded their aid to developing countries, but they are still running an annual trade surplus of close to $100 billion. This cannot continue if the world economy is to avoid a recession. As Keynes argued in his proposals for the International Monetary Fund, the burden of adjustment must be equally shared by deficit and surplus countries.

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In order to reach an agreement on mutual adjustment with trade surplus countries, U.S. political leaders must accept that we will have to make serious commitments to deficit reduction and greater power sharing. They must also take advantage of the bargaining chips we have at our disposal (for example, access to the U.S. market and U.S. military "protection"). The Reagan administration has been unwilling to do either.

To some degree, the budget deficit question is as symbolic as it is substantive. The formal position of our trading partners is that the United States must cut its deficit in order to relieve pressure on world interest rates. That is, they do not want to cut their own rates and initiate growth until we have cut our deficit, for otherwise the U.S. deficit will attract the capital they will need to expand capacity. At the same time, it is not necessarily to their advantage to have U.S. interest rates fall, for the dollar will drop even further and undercut their export markets. Given this ambivalence, reducing the deficit to one percent of GNP, as mentioned earlier, should be enough to satisfy our trading partners. While some foreign central bankers may not be completely happy with this goal, they will probably be willing to live with it since this will relieve some of the current pressure for them to intervene in the foreign exchange market.

If they balk, the United States has some strong cards it can play in negotiating with them. The most important card is continued access to our market—still the largest in the world and especially important to the Japanese. We must let them know that we are willing to ration their access to our market if they are not willing to come to a reasonable agreement to coordinate economic policies for world reflation. Second, we need to put these countries on notice that we are no longer willing to bear a disproportionate share of the alliance defense burden, and that we are willing to reduce our military commitment to them unless they cooperate with us more fully on trade adjustment now and on reducing that burden in the future. It is the height of folly for the United States to go further into debt to defend wealthier nations who use our open market to dispose of their surplus production and who, it might be added, have expanding political and economic relations with the very nation, the Soviet Union, we are supposedly defending them against.

At the same time, in order to help avoid the impression of American arrogance, we need to acknowledge that the days of U.S. economic hegemony are over. We are still patronizing nations that have become economic powers in their own right and therefore deserve to be treated more like equal partners in the running of the world economy—that is, as long as they are also willing to accept the responsibilities. The discussion in

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the United States has been about "burden sharing"; it also needs to be about "power sharing." Acceding to Japan's and West Germany's demands for more say in the International Monetary Fund and the World Bank would be a first step in this direction; another would be working together with them to bring about a new global financial system in which the yen and the mark would be part of a block of reserve currencies with the dollar.

A new political arrangement with surplus industrial countries, however, will not by itself generate sufficient demand for U.S. goods to reverse our trade balance problems; there is obviously a limit to how much of the U.S. trade deficit surplus nations like Japan and West Germany can reasonably absorb. For this reason, economic expansion in the Third World is critical to the success of any growth strategy. This is especially true of Latin America, one of the largest export markets, where imports have fallen 33 percent during the 1980s because of slow growth and debt-related austerity measures. A good part of that decline in imports represents forgone purchases of U.S. goods, which is why a recent report by the Joint Economic Committee concluded that "the potential contribution of Latin American markets to reviving U.S. exports appears to be twice as great as that of Germany and Japan."[32] The contribution that the Third World as a whole could make to reviving U.S. exports, of course, is greater still.

To succeed, any strategy to promote Third World growth must focus on three major objectives. First, the massive debt held by these countries needs to be radically restructured rather than just papered over, as is the current practice. National income currently used to service these debts represents unrealized demand for U.S. goods; restraints on the purchase of imports insisted upon by multilateral lending agencies further inhibits demand. Second, the emphasis on export-led development needs to be replaced with strategies to develop internal markets, in the interest of both reducing global excess capacity and satisfying basic needs. But this will obviously require that wages and living standards in these countries be raised to match productivity—the third major element in a Third World growth strategy. Unless we begin to take measures now, through our trade and lending practices, to encourage development models aimed at raising living standards and minimum labor and environmental standards, the world economy could be burdened with chronic overcapacity as well as excessive human exploitation. Again, the flip side of overproduction is insufficient demand. As Henry Ford figured out in the early 20th century, unless workers can afford to buy the goods that industry produces, industry cannot afford to produce them.

Together, increased world and domestic demand for U.S. production

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should raise the U.S. growth rate and, along with it, increase incomes, savings, and investment, providing the base for further productivity and more efficient growth in the future. This growth process, if it can be sustained, will allow us gradually to grow out of our current debt problem with increased living standards.

But as growth increases, so does the threat of inflation, which could bring the whole process to a screeching halt. This threat is the Achilles' heel of a growth approach. The final element in a global expansion policy, therefore, must be a strategy for dealing with inflation in the United States.

The experience of the late 1970s, with its 12 percent inflation rate and 18 percent interest rates, is still recent enough in our collective memory to give the austerity crowd a powerful reason to oppose faster growth. The financial markets, dominated by creditors, tend to resist faster growth, fearful that it will trigger inflation and run up interest rates. But economic policy should not be driven by hyperventilation on Wall Street. Indeed, the relative indifference with which the American people shrugged off the stock market crash of October 1987 suggests that, while markets may panic easily, this panic does not spread easily to the public at large. Nor should we be overly concerned about a modest rise in the price index. Something around 5 to 6 percent per year does not put the economy in jeopardy if real growth is rising at say, 3.5 percent and capacity is expanding. Beyond that, however, the markets are likely to get too nervous, interest rates will start to rise and management and labor will become more determined to raise prices and wages.

But here again, there are reasonable policies that can prevent a return to the Carter inflation years. These include standby authority to impose a surtax on withheld incomes at a specified rise in the inflation rate and an agreement with the chairman of the Federal Reserve that when the inflation rate reaches a certain point, gradual credit restrictions can be imposed on selective economic sectors.

In the long run, a growth economy will also need some form of incomes policy that constrains both labor and property income according to productivity growth. Tax-based policies that penalize excessive incomes might be part of such a strategy. But, because of the danger that incomes policies can permanently lock in the income distribution that exists at the time of enactment, part of any national dialogue on this question must address the issue of what kind of income distribution is appropriate for a high-growth economy. Many, of course, would argue that this is not the proper role for government. But in a modern economy much of the distri-

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bution of income and wealth is a function of government policies ostensibly put forward in the national interest but that are actually motivated by distributional goals—witness the austerity proposals of Peter Peterson.

Thus, there is another path, reasonable and better suited to the American tradition of growth and opportunity than Peterson's grim vision in which all but a few boats sink in an ebbing economic tide. Of course, even a growth alternative will not be without pain; the mistakes of the past will have to be paid for and, for better or worse, we are in a new competitive era in which America's postwar advantages are no longer sufficient for the economic challenges it now faces. But the pain of a growth strategy is much less likely to fall on ordinary Americans who have already sacrificed real wages and incomes on the altar of conservative redistributionist policies.

In the end, the point of economic policy for Peterson is income distribution. Those who garnered the benefits of the Reagan years are once again sheltered because of their presumed importance to the investment process. No calls for sacrifice are directed at the very symbols of Reaganite high living—the Wall Street speculators, the tax-financed real estate developers, the military contractors, the corporate executives indulging their lavish expense-account tastes. It is the auto worker averaging $14.43 per hour who must pay the Reagan bill while Lee Iacocca earns $17.9 million in a year when Chrysler's market share dropped 11 percent and profits fell 7 percent.[33]

The claims that austerity will be evenhanded are absurd. The *Wall Street Journal* reported that while signers of the Peterson ad were calling for sacrifices to balance the budget, a number of them were actively lobbying Congress for more tax breaks. When the *Journal* pressed him about this contradiction, Peterson provided some further insights into his sense of fairness by pointing out that the ad called for cutting the Social Security benefits of the wealthy, and that nearly all the signers are personally well off.

The human results of austerity are predictable. Young families not fortunate enough to have wealthy parents will miss out on the American dream of owning a home. The pressure of low wages and the need for multiple earners will erode family life. Poverty and near poverty will spread, as will ignorance. Agonizing decisions over whether to educate the children or provide a nursing home for the grandparents will be forced on

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families with hardly the means to do either. Public services will continue to deteriorate, parks and museums will close, and protection of the environment will be a luxury that the country can't afford. (A trip to the Third World should dispel the notion that slow growth will protect the environment.) It is not too hard to predict that in the event of a prolonged recession—and under the austerity scenario any recession would be prolonged—a severe shredding of the fabric of American social and political life will occur.

"We must accept the punishment we are inheriting from the ill-fated gamble of Reaganomics," says Peterson. And the punishment is conveniently targeted at the ordinary working American, whose real income and opportunity must be further eroded so as not to disturb the ideological comfort of the conventional wisdom. Indeed, the major discomfort associated with a growth strategy may be ideological. A competent growth strategy requires a more explicit and permanent role for government as manager and investor. When America dominated the global economy in the decades after World War II, we indulged our belief in an invisible hand of the market as the measure of all economic policy. Since the Depression taught us the folly of assuming that we could literally leave economics to the market, the guardians of America's conventional wisdom gradually accepted the notion that government could set the macroeconomic environment. But they still resist serious consideration of a public role in fostering the most efficient uses of our human and natural resources. One suspects that it is the prospect of a more activist government that Peterson and his austerity allies fear most. In order to avoid it, they are more than willing to sacrifice the living standards of the rest of us.

Notes

[1] Peter G. Peterson, "The Morning After," *The Atlantic Monthly*, October 1987, pp. 43–69.
[2] Personal consumption expenditure is the best measure of Peterson's overconsumption thesis. It is important to remember that Peterson's concern with government spending is centered on "entitlements"—transfer payments that in the national income accounts show up as consumer spending by the recipients of the entitlements, not as government spending for goods and services. Peterson is not particularly critical of the latter. He supports Reagan's defense buildup and even laments, in the abstract at least, the decline of investment in human capital and physical infrastructure.
[3] The calculations do not change significantly if one compares consumption and growth from peak to peak of the business cycle rather than by decades.

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[4] Congressional Budget Office, *The Economic Budget Outlook: Fiscal Years 1986-90*, February 1985, p. 83.
[5] Peter L. Bernstein Inc. Newsletter, *Low Savings Rates: The Argument Continued*, March 1, 1988.
[6] Peter L. Bernstein, "A Case of Mistaken Identity," *Wall Street Journal*, April 17, 1987, p. 14.
[7] Richard Medley, *High Interest Rates: It's Not Just the Deficit*, Briefing Paper (Washington, D.C.: Economic Policy Institute, June 1985).
[8] Kenichi Ohmae, "No Manufacturing Exodus, No Great Comeback," *Wall Street Journal*, April 25, 1988, p. A3.
[9] Center for Popular Economics, *Economic Report of the People* (Boston: South End Press, 1986), p. 33; and Kenichi Ohmae, "Don't Blame It on Tokyo," *New Perspectives Quarterly*, Fall 1987, p. 36.
[10] *Economic Report of the President 1988* (Washington, D.C.: U.S. Government Printing Office, 1988), Table B-11.
[11] The Cuomo Commission on Trade and Competitiveness, *The Cuomo Commission Report* (New York: Simon and Schuster, 1988), p. 54.
[12] This estimate is based on the figures presented in *Reducing the Deficits: Spending and Revenue Options* (Washington, D.C.: Congressional Budget Office, March 1988), p. 145. The estimate assumes savings and offsets increased proportionately.
[13] For a brief and lucid explanation of the economics of the Social Security trust fund over the next 60 years, see "Social Security Surpluses," the statement of Alicia H. Munnell, vice president and director of research, Federal Reserve Bank of Boston, before the Subcommittee on Social Security of the Committee on Ways and Means, U.S. House of Representatives, May 10, 1988.
[14] Daniel Patrick Moynihan, "Conspirators, Trillions, Limos in the Night," *New York Times*, May 23, 1988, p. A19.
[15] *Economic Report of the President 1982* (Washington, D.C.: U.S. Government Printing Office, 1982), pp. 116–117.
[16] *Japan Economic Institute Report*, May 2, 1988.
[17] For 1980 and 1986 data, see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1988-1992*, January 1987, Table F-3, p. 157. For 1987 data, see Department of the Treasury, *Final Monthly Treasury Statement of Receipts and Outlays of the United States Government*, Table 9, p. 20. For 1988 estimates, see Office of Management and Budget, *Mid-session Review of the 1988 Budget*, August 17, 1987, Table 11, p. 29.
[18] Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1989-1993*, February 1988.
[19] George P. Brockway, "On the Matter of Consumption," *The New Leader*, April 4, 1988.
[20] Robert S. McIntyre and David Wilhelm, *Money for Nothing* (Washington, D.C.: Citizens for Tax Justice, February 1988).
[21] Susan Chira, "Weaker Dollar Fails to Bring a Jump in U.S. Sales in Japan," *New York Times*, March 3, 1988.
[22] Jeff Faux, *Getting Rid of the Trade Deficit: A Cheaper Dollar is Not Enough*, Briefing Paper (Washington, D.C.: Economic Policy Institute, March 1988).
[23] Louis Uchitelle, "Overseas Spending by U.S. Companies Sets Record Pace," *New York Times*, May 20, 1988, pp. A1, D3.
[24] "How Long Can the Dollar Hold Its Own?" *Business Week*, May 23, 1987, p. 27.
[25] Lawrence Mishel, "The Quality of Jobs: Another View," *Monthly Labor Review* (forthcoming).

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[26] Lester Thurow, *Services in the American Economy* (Washington, D.C.: Economic Policy Institute, forthcoming).
[27] Interview in *New Perspectives Quarterly*, Spring 1988, p. 4.
[28] James Tobin, "The Future of Keynesian Economics," *Eastern Economic Journal*, October-December 1986, pp. 347–354.
[29] General Accounting Office, *Thrift Industry: Trends in Thrift Industrial Performance: December, 1977 through June, 1987* (Washington, D.C.: U.S. Government Printing Office, May, 1988).
[30] William Greider, *Secrets of the Temple* (New York: Simon and Schuster, 1988), p. 628.
[31] David Alan Aschauer, *Is the Public Capital Stock Too Low?* Chicago Fed Letter (Chicago: The Federal Reserve Bank of Chicago, October 1987).
[32] The Democratic Staff of the Joint Economic Committee, *Trade Deficits, Foreign Debts and Sagging Growth: An Analysis of the Cause and Effects of America's Trade Problem*, September 1986, p. 35.
[33] "Executive Pay: Who made the most and are they worth it?" *Business Week*, May 2, 1988, p. 54.

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