



The progressive economic challenge

Progressive Governance Conference, 27th March 2009,
Chile

Pleenary session one – Progressive politics after the financial crisis

Speech by Robert B. Reich

I would like to offer a distinction that is very important both in economic and political terms. It is between a cyclical downturn of the business cycle, on the one hand, and mounting structural problems that underlie that downturn, on the other. Many people around the world witnessing what the global economy is going through assume this is a mainly a cyclical phenomenon - a deep and dangerous downturn, to be sure, but nonetheless primarily cyclical. It is assumed that a recovery will follow, and that the global economy will be restored to the growth path on which it was before the crisis began. Many anticipate that recovery to occur within the next year. According to this view, fiscal and monetary policies are necessary to stimulate the global economy in the interim. We may also need some temporary recapitalization of our credit markets and some modest regulatory changes with regard to our financial systems, which will get credit markets back in working order. Beyond these fixes, however, nothing else needs to change. The recovery will happen and the world economy will get back on track.

To me, this is a wrong-headed and dangerous view. We are witnessing is not just a cyclical downturn but the culmination of many structural problems. Unless addressed, these structural problems will generate deeper and deeper cyclical downturns over time, and more and more modest, if not anemic, recoveries. There is no getting "back on track" because the track we had been got us into this crisis in the first place. The track we were on was not sustainable.

Those who see the current crisis mainly a cyclical phenomenon would rather not address the underlying structural problems that have been growing for years in financial markets. They include increasing speculation, ever more myopic short-term

demands for financial returns, and, perhaps most basically, the ever-enlarging political and economic power of the financial sector relative to the real economy. Cyclists, if I may call them that, may be willing to temporarily recapitalize financial markets, root out some conflicts of interest, provide more disclosure, and require financial institutions to be better capitalized. Although all these steps may be necessary, they are hardly sufficient for avoiding next financial crisis.

The only way to do that is to take more fundamental steps. These would include changing compensation practices in financial markets, to better align them with long-term profitability rather than short term speculative bets. We should also change tax systems so that patient capital is better rewarded than short-term investments - reducing capital gains taxes on long-term holdings and increasing them on short-term holdings. And we should follow the suggestion Yale Professor James Tobin's made many years ago to impose a small transfer tax on all financial transactions, maybe one-tenth of 1 percent of their value, thereby throwing a little bit of sand into the wheels of finance and slowing financial markets lest they move toward excess.

Understanding this crisis in structural rather than cyclical terms would also force us to look at widening inequality and its pernicious effect on aggregate demand, both in the United States and around the world. We might then see that the solution is not merely stimulating the economy. A substantial Keynesian stimulus may be necessary but it will not be sufficient. We must also reverse the trend toward inequality. With so much concentration of wealth and income at the top, economies cannot summon adequate aggregate demand for all of the goods and services capable of being produced. The rich have a smaller marginal propensity to consume than does the middle class or the poor; that is, they do not spend nearly as much or as large a percentage of their income as everyone else. That's why they're rich. After all, the meaning of being "rich" is that you already have most of what you need.

In the United States, the growth of the median wage has slowed since the 1980s. During the last recovery, between 2001 and 2007, for the first time on record the median wage adjusted for inflation actually declined. Where did the money go? To the top. As late as 1980, the top 1 percent of income earners in the U.S. took home 9 percent of total national income. By 2007, after almost three decades of increasing economic concentration of earnings and of wealth, the top 1 percent took home 22 percent of national income.

I do not mean to suggest that we should blame rich. I am simply pointing out that this sort of dramatic inequality has a cumulative effect on aggregate demand. The only way the U.S. middle class was able to continue to spend was by going deeply into debt. But, as we all now know, that was not a sustainable strategy. The last time the United States experienced economic concentration on this scale was 1928, just before the Great Crash. In the 1920s, as in the late 1990s and early years of this century, the American middle class went deeply into debt, until the debt bubble burst. I am not

suggesting a necessary cause and effect -- the causes of the Great Crash of 1929 and the Great Downturn of 2008 were in many ways quite different --but merely pointing out that social equity and economic growth are not, as some have suggested, opposed. To the contrary, unless prosperity is widely shared, economic growth is impossible to sustain.

During much of the last three decades, policymakers in the United States have been mesmerized by a philosophy that can best be characterized as "trickle-down economics," or, to use its more formal title, "supply-side economics." It has stood for the notion that tax reductions on the income and wealth of the richest members of society will benefit everyone else because the rich will thereby be inspired to work harder and invest more. Rarely has an economic theory been tried in practice and obviously failed. President Bush cut taxes on America's wealthy in 2001 -- income taxes, capital gains taxes, and inheritance taxes -- and nothing trickled down.

Progressives, by contrast, should be calling for "trickle up" economics. Such an approach would be based upon public investments in the health and education of all our people, and in the infrastructure linking them up with one another. Such investments add to the productivity of ordinary people, thereby making them more economically valuable. This added value enables them to command higher wages. And with higher wages, they can afford to purchase more goods and services. Aggregate demand can be sustained because more people have greater capacity to buy. Higher productivity enables the entire economy to grow more quickly. Even the wealthy prosper to a greater extent than otherwise. In this way, the benefits "trickle up."

Appropriately, the revenues necessary to make these investments would be derived from a more progressive tax system in which the very wealthy contributed a larger share.

This is neither the time nor place to address the large structural imbalances between countries running large trade surpluses, such as China and Japan, and those running large trade deficits, such as the United States. But there is no question that these imbalances, too, are unsustainable. When the dollar begins to drop, as it will when the global economy begins to recover, the great American middle class will discover that it is even poorer, because everything it purchases from abroad will cost that much more. This makes my argument for public investment even stronger.

The third domain of structural reform -- after finance, inequality and public investment, is the environment. Many cyclists understand the imminent danger of climate change but think it an issue to be addressed when and to the extent the global economy can afford to do so -- once the current deep recession is over. Structuralists, on the other hand, know that the current economic crisis is particularly deep and long-lasting at least in part because of the cumulative costs of climate change. Those costs

are sometimes difficult to measure or see as a whole. They come as droughts, floods, hurricanes, and rising sea levels. They show up as shortages of arable land and of water. They express themselves as increased costs of insurance. And, of course, increased costs of carbon-based fuels.

Uncertainty itself is an economic cost, and the uncertainties surrounding increasingly unpredictable weather patterns and commodities are taking a large toll. They are a drag on economic growth. If one takes a structural rather than cyclical view of the current global downturn, it makes no sense to wait until a supposed "recovery" to get to work on slowing the process of climate change. Major nations should impose a tax on carbon-based fuels, or an effective "cap and trade" system, immediately, and should invest significant sums in alternatives to carbon-based sources of energy.

We are in a progressive moment. In the United States, we have a young and dynamic new president who seeks to achieve many of the structural reforms I have outlined. The global economic crisis has, moreover, precipitated a reexamination of the roles of governments and markets. It has cast doubt on the so-called "Washington consensus" of the 1990s, which assumed that markets always know best. The question, however, is what happens when the immediate crisis is over, when the global economy looks as if it is beginning to turn the corner. Even if the recovery is weak, as I predict it will be, its mere fact may be enough to take attention away from structural reform. It may convince policy makers as well as the broad public that the cyclists were correct all along -- that although it was severe, the global crisis was not unlike other recessions.

And therefore we need not do anything dramatic or fundamental about our financial institutions, or our public investments, widening inequality, or climate change.

On the other hand, if the current crisis does have a silver lining, it would be a resurgence of progressive thought and action sufficiently strong to carry forward the necessary structural reforms right through the next upturn in the business cycle. Policy leaders and the broad public would understand that even when the global economy is in a cyclical recovery, the real challenge continues.

Robert B. Reich is professor of public policy at the Goldman School of Public Policy at the University of California, Berkeley.