

THE ECONOMIC CONSEQUENCES OF MR. BUSH

The Bush Agenda

A Panel Discussion

Anwar Shaikh, Darrick Hamilton, and Jeff Madrick

Three analysts discuss the major economic issues the nation now faces, given George W. Bush's electoral victory last fall. The problems are many, but three stand out: debt, deficits, and the dollar.

Jeff Madrick: I came prepared today, just one day after the election, to discuss the economy under John Kerry. Of course, both Senator Kerry and President Bush would have faced the same problems—problems in large part created by George Bush. So, since it turned out Mr. Bush won, this is not that much of a setback, at least for my talk. In sum, I think that the next four years are going to be quite difficult economically, both in the short run and the long term, as certain problems start to manifest themselves in quite tangible ways. Good economic management argues that we should deal with the long-term issues sooner rather than later. I

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worry that, under George Bush, they will be dealt with in quite destructive ways or, worse, they might not be dealt with at all.

Let me begin by reminding you all that the George Bush stimulus policies were not designed to be a stimulus. The tax cuts were designed to give the money back to the people because they (this always strikes me as quite ironic) were paying too much for their government's services. Hence, we had a budget surplus. Now, following that logic, if we have a deficit, does it not follow logically that we should ask the people for money because they are getting more services for their money than they should? Of course, the Bush administration and its many advocates did not draw that logical conclusion. The policy all along was a smokescreen for a "starve-the-beast" philosophy, which argues, "Let's reduce taxes," a philosophy that goes back at least to Ronald Reagan and has been explicitly espoused by Milton Friedman. Let's reduce taxes, and, in that way, ultimately, we will reduce the size of government. So, in the meantime, don't worry about deficits, don't worry about cash flow, don't worry about social policies, and don't worry about public investment. The idea is to get the government out of the economy any way you can, even through irresponsible fiscal policies.

Well, guess what—that philosophy is not working. It did not even work under Ronald Reagan. The early 1980s was a very confusing period, and Reagan was forced by circumstances to reverse part of his big tax cut of 1981. And the economic history of the 1980s is quite a sorry one—slow growth on average, sagging wages, rising inequality, no secular increase in productivity growth, and gargantuan new federal budget deficits. So the first point to keep in mind is that the Bush tax cuts were not designed primarily to stimulate the economy. They were designed for the long run, to cut taxes in the long run and thereby force government to shrink. The scenario was repeated with another tax cut for similar reasons. For those of us who think that deficits can affect financial markets, what we had was not much bang for the buck at the front end from the Bush tax cuts, not much stimulus, and yet a worrisome problem for the long run in the financial markets.

I want to emphasize that the nature of the tax cut, which you heard a lot about, is that it went mostly to the wealthy. As a stimulus, it

could have been designed to get more bang for the buck by, say, expanding unemployment insurance more aggressively, and by giving money to the states, which badly needed it for social programs that they cut back on, even including education spending—even K-twelve spending, which very rarely gets cut, even in a recession. Higher-education spending invariably gets cut. Perhaps we could have given a temporary rebate to low-income Americans, who would have spent it right away. The rich just do not spend it right away. So here we have this vast set of stimuli, and we did not get much bang for the buck, partly because it was always designed for the long run anyway and did nothing to help the distribution of income. So, unsurprisingly, we got a modest recovery and an expansion, which has not been able to raise wages significantly.

Now, that's the set of circumstances we have. What is going to happen in January when George Bush begins his second term? We could be facing a very slow economic expansion at that time. Think of the problems that we face. Capital investment is up, but not at a stunning rate, especially when you consider that tax credits that will expire soon are motivating the current gain. Capital spending is still actually lower as a proportion of GDP than it was four years ago. So we have not recovered fully. We have run out of stimulus gas. Can we really cut taxes still more? Much of the near-term tax cut benefit is past us. We will not have extremely easy Federal Reserve policy because the Fed now is raising interest rates, not reducing them. Remember, they reduced them from something like 6 or 6½ percent to 1½ percent over the course of the Bush administration. Not a bad set of circumstances to help a president shine. We will not have that anymore. This expansion has been supported by consumption, by consumer spending. In the last quarter, the consumer savings rate fell to a negligible 0.4 percent. Wages after inflation are not rising by most measures. Median family income is looking pretty bad. Where is the consumer going to get any money to spend? Even businesspeople are aware that the economy is possibly going to slow to a crawl next year and maybe even threaten a recession. Of course, I have been around long enough to know not to predict the economy in the short

run. A burst in job growth and personal income is not impossible. But let us say it will at best be a modest improvement over current sluggish rates. We may have a problem.

What will be President Bush's first act? Maybe he will extend unemployment insurance and investment tax credits. But he definitely will try to make permanent his tax cuts, which are set to expire in a few years. People spend more of tax cuts when they are permanent, he will probably argue. By the time that readers see this, he may well have succeeded at that already. So we are going to be dealing with a serious increase in the long-term budget deficit. Will markets buy that? And remember, the current budget deficit projections are unquestionably understated. The Congressional Budget Office (CBO) estimate assumes that spending on domestic programs, to put it simply, will not rise faster than inflation or keep up with population growth, and it does not make any assumption for reducing the alternative minimum tax, which will hurt too many people as other tax rates are cut. A realistic projection of the deficit is dispiriting, to say the least [see Price and Sawicky, "The Budget Arithmetic Test," in this issue].

How are we going to fight a recession? Well, I am a little mystified about that. As I mentioned, if Bush says we need more tax cuts, will there also be more government spending? There probably will be more government spending for defense and homeland security. That spending is already more than a hundred billion dollars a year over the level that it was when Bush took office. The cost of the war in Iraq is becoming quite significant now. This is one of the things that disturbs me most. The share of federal tax revenues as a proportion of gross domestic product (GDP) has fallen to about 16 percent, the lowest since the 1950s. The CBO estimate of security spending—that is, defense spending and homeland security spending, plus interest payments on the debt and entitlement spending—is 17.6 percent of GDP over the next ten years. We have a level of tax revenue that simply will not allow us to expand domestic spending and public investment the way that it must to put this economy on a more productive track. We are simply boxed in. We are especially boxed in if we have some fantasy about balancing the federal budget in ten years.

My view is that President Bush may take this deficit (here again, I might be naive) less seriously than John Kerry would have, but I am not so sure about that. Both of them claimed that they would cut the budget deficit in half in five years, which was the big step toward balancing the budget in ten years. If we try to balance the budget given these assumptions without a significant increase in the estimated rate of productivity growth, there will be absolutely no room to raise nonentitlement domestic expenditures, much less make needed public investment, which I think is so important.

So what issues do we face? First, the Milton Friedman/Reagan "starve-the-beast" philosophy has brought us to a point where we do not have money for public investment. Second, the second volley from the Bush cannon will be some form of privatization of social security. If he takes that idea even remotely seriously, that immediately adds a trillion or two trillion dollars to the deficit, depending on the nature of the plan. During two election campaigns, he has persistently avoided discussing transition costs, but that is a lot of money. You need to pay social security beneficiaries while you are redirecting some of the payroll taxes toward a private plan. The government would have to borrow money to pay for all this.

The more important issue, however, is the cost of health care. I think with John Kerry we would have been relatively unalarmist about social security. We can solve social security problems with modest reforms. That is not true of health care. The costs are seriously pressing, which means we will avoid discussing them until we near a crisis. Over the next four years, the possibility of crisis will increase—at least, the nation will become more aware of the possibility even if crisis does not arise. There is a strong chance that the pressure for change will not come from the Democrats, the public, or the Republicans. It will come from big business because it just cannot afford health-care benefits. And maybe that is our best opportunity: that big business finally decides we must make serious reforms in health care. I suspect that is what will happen down the road. My concern is Bush will wave casually at the issue, make some "owner society" claims about insurance savings accounts, and pacify the electorate, post-

poning the problem and thereby making it worse.

One of the other issues that we face is the trade deficit, which is not sustainable forever despite so many claims from our mainstream economists that it is. The argument is that we have a trade deficit not because we simply prefer so many cheap imported products but because foreign investors love to invest in America so much that they drive up the dollar to uncompetitive levels. This will not last forever. At some point, investors will lose confidence in the dollar. The day after Bush's election, the dollar fell on investor fear of uncontrolled budget deficits. I think this situation requires a serious policy. I would like to see the new administration pursue some kind of reduction in the value of the dollar in a cooperative way—serious discussions with the Asian economies, including China, about how to adjust these currencies. Under George Bush it is very unlikely that that will happen in a planned systematic and intelligent way. They will deal with this haphazardly, as they deal with almost everything, including the war in Iraq and now the shambles of peace in Iraq.

Finally, I want to say that globalization will put persistent pressure on wages in the United States, and there is little hope that the Bush administration will look at this problem in a serious way. There should be a call for new thinking about this kind of thing. It is nonsensical to ignore the fact that many American workers are hurt by globalized free trade. That does not make me a protectionist; in fact, I lean toward free trade with some limitations and restrictions. But it does make me believe that we need a serious economic and social policy to protect workers who are seriously hurt by this kind of thing—an attempt to equalize or at least reduce the lost wages and return them to the labor force in a productive way. We need a much better safety net.

Let me mention one last thing: international economic policy, in the sense that international development policy is a totally neglected issue. I would like to see one of these conferences that never seem to get anywhere to rethink the Washington consensus about international economy policy—which mostly emphasizes budget balance, free trade, and strong currencies—and the role of economic policy in foreign policy. The nonsense of Middle East policy for me is that

economics and development have so little part in any of it. It is very important to start to rethink that. Under George Bush's leadership, will that happen? I don't think so.

So let me summarize: Recession in which there will not be great tools to control it—or at least a slow economy in which the Bush administration will neither have nor implement tools to deal with it. It will immediately cut taxes again. There will be an attempt to privatize social security and set us off on a wrong and alarmist track on social security. There will be weak attempts at reforming health care that simply will not work. I hope that there will be business leadership on that, because it is getting to be a pressing problem. The trade deficit will be neglected, so people will fall back on the idea that it simply doesn't matter and merely reflects the desire of foreign investors to invest in the great U.S. economy. Thus, there will be few forward-looking policies and strategies to deal with globalization and free trade in a fair and constructive way. Finally, while I think that Bush will offer more foreign aid, it will not be coordinated, as I think is essential, with foreign policy and broader economic development ideas.

Anwar Shaikh: I should mention that my remarks draw on some of my work done at the New School Graduate School as well as that done jointly at the Levy Economics Institute of Bard College, with colleagues Dimitri Papadimitriou, Gennaro Zezza, and Claudio Dos Santos.

It seems to me there are several dimensions to the debate. The first issue facing us in this next period is the one that Jeff already outlined: large budget deficits and their impact on the economy. And this impact is twofold: it affects the rate of growth, as well as potential spending and tax packages that will have to be selected in the face of the problems arising from these deficits. The second issue is that interest rates are almost surely going to continue to rise, at perhaps a measured pace. But what will the impact be on the huge debt build-up in the private sector, particularly the household sector? Will it slow spending? Also, what will the impact be on business investment and on international capital flows? Low interest rates mean that the

international outflow of money is low, but now it will rise and make the balance of payments even worse. And a third issue is the prospect for growth and employment.

One of the striking things about the Bush administration economic policy over the past four years is that it has been the huge budget deficits that have really saved the day, even though the official story is that it is tax cuts that have provided the stimulus. If you really want to offer only tax cuts, the procedure is very simple: you cut taxes and then government spending, so in the end the budget deficit is not at all changed. That way, you see if tax cuts alone stimulate growth. Of course, what actually happened is just the opposite. There were tax cuts, concentrated among the wealthy, but also a huge jump in government spending. So what you actually got was a massive budget deficit, not simply a tax cut. As it turns out, actual budget deficits have been following a path that my colleagues and I have been advocating over the past couple of years as a way to combat projected growth problems. We would, of course, have liked to see those budget deficits fueled by higher social expenditures, rather than military ones.

One of the things about the budget deficits is that they have been mirrored in recent times, once again, in foreign deficits. As a matter of accounting, the financial balance (receipts minus nonfinancial expenditures) of the private sector and the government sector must add up to the foreign (i.e., the current account) balance. But nowadays the private sector is close to balance because, while the household sector is a heavy borrower, the business sector has been running a financial surplus. So the sum of the household and business sectors has been approaching balance. The consequence, however, is that government deficits are then mirrored in trade deficits. In effect, foreign funds must be imported to finance the budget deficit. So one question arises: Can you solve the trade deficit through exchange rate movements—that is, by lowering the dollar? There have been rumblings in both conservative and liberal sectors that it is all Asia's fault. I do not think that this is correct. In my opinion, Asia is winning the trade wars not so much because of exchange rate interventions but largely because of its underlying competitiveness. And the answer to

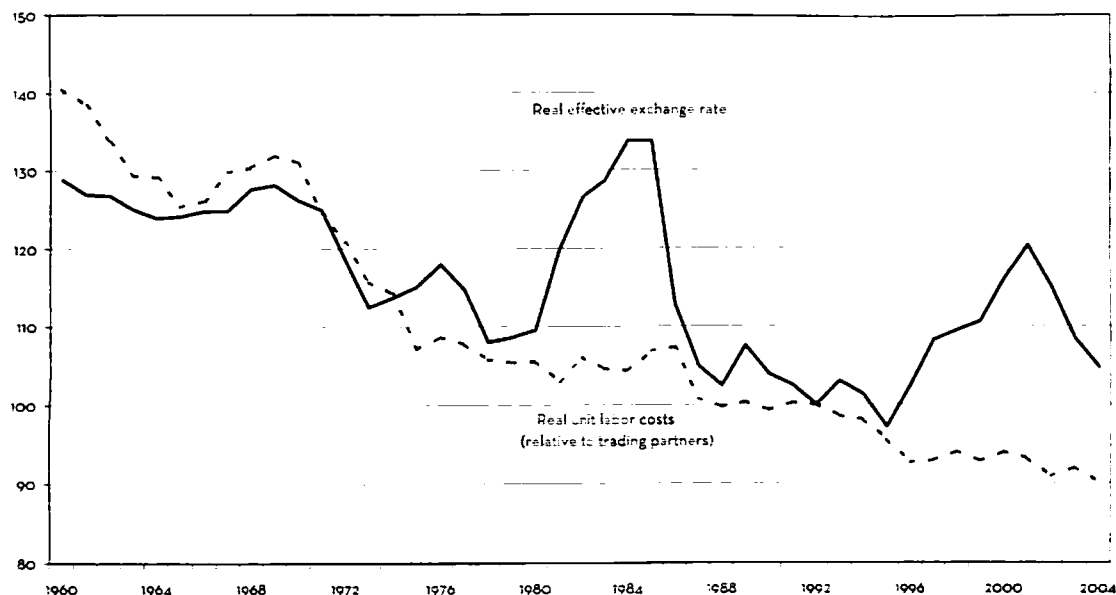


Figure 1. U.S. Real Effective Exchange Rate and Real Relative Unit Labor Costs (1992 = 100)

Source: A. Shaikh and R. Antonopoulos, "Explaining Long-Term Exchange Rate Behavior in the United States and Japan," Working Paper no. 250, Levy Economics Institute of Bard College, 1998, updated by Ascension Mejorado and the author.

the question as to whether the real exchange rate can solve our trade deficit depends on your theory of the real exchange rate. Conventional economic theory says that if the exchange rate is allowed to go free, it will float to the level that will make trade balance. The trouble is that this has never been true empirically. I have long argued that the problem lies with conventional theory itself because it misrepresents the operation of international competition. In my own theoretical and empirical work, I have tried to show that the real exchange rates, or more precisely the terms of trade, are governed in the same way as any other relative prices—by the underlying real costs.

Let me show you what I mean. Figure 1 compares the real exchange rate in the United States with the real unit labor costs of domestic goods versus foreign goods. What is very striking is the fact that these two follow each other closely except for a large rise in the real exchange rate that took place in the 1980s, when there was a massive capital inflow to the United States. Relatively low interest rates and capital flight from abroad—Latin America was in crisis and money

was flowing into the United States—caused this big deviation from the underlying center of gravity over the period from 1980 to 1985. But then, within just two years, the real exchange rate returned to its normal center of gravity. It continued more or less along the trend until the stock market boom, in the 1990s, which once again accelerated the capital inflows and once again pumped up the real exchange rate. With the collapse of the stock market boom, the real exchange rate is moving back down to the trend. It has fallen from its peak in 2002 by about 10 percent already. So just to get back to the underlying trend, we need another 20 percent fall in the real exchange rate; this is interesting because an overall 30 percent fall is something that people have been predicting on other grounds.

At the Levy Institute, we looked at the consequences of a further 20 percent fall in the exchange rate over the space of a few years. The answer is that it would improve the foreign trade balance, but not in a big way. It would reduce it from where it is now, on the order of 5½ percent, to about 4½ percent. But it may also hurt growth in a round-about way, because a reduction of the trade imbalance would also mean a relatively smaller stimulus for foreign countries. They, of course, are getting the benefit of our importing more than we are exporting, so their effective demand growth would be reduced in this process. That feedback effect will have some negative impact for us.

From my point of view, the emphasis on China's undervalued currency is a misplacement of the problem. The imbalance in U.S. trade is almost identical to the imbalance in manufacturing goods alone. The loss of U.S. manufacturing competitiveness overall is much more important than the specific imbalances with China or Asia. It is really the same pattern that every internationally competitive country has experienced as new countries come in with lower wages and modern technology and begin to undercut the dominant countries in the world market. And that means we really have to be talking about competition policy, that is, reducing unit labor costs, particularly in manufacturing.

The second set of effects arises from the interest rate. We know that interest rates are going to rise. One of the projects we undertook at the

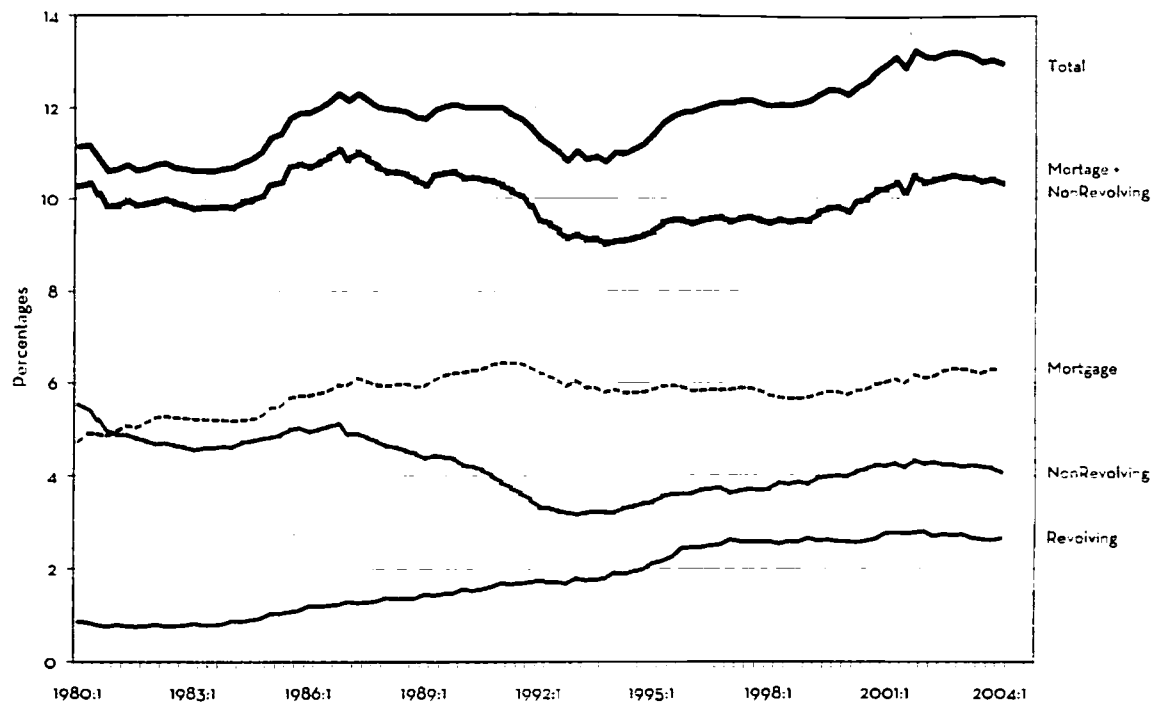


Figure 2. Debt Service Components Relative to Disposable Income (Percentages)

Source: Levy Economics Institute of Bard College, forthcoming working paper.

Levy Institute was to break down the components of the debt service (interest and principal payment) of the household sector relative to personal disposable income. Those data are published for the aggregate, but it turns out that the data for the components are not made available. So we reproduced the actual Federal Reserve Board data in order to identify the components and to see what would happen if interest rates changed. If you look at the sum of mortgage and nonrevolving debt service (nonrevolving debt is cars, personal loans, and home equity finance), we find that this sum has been fairly stable for a long time. In effect, people had been switching away from high-cost debt in the form of car finance and home equity toward mortgage debt, because mortgage debt is over a longer term and its amortization cost is much lower even if the interest rate is the same. So this sum is quite stable. On the other hand, though the scale in Figure 2 tends to mask it, credit card debt has expanded quite sharply. More important, the detailed breakdown at the bottom of the figure shows that all three types of debt service ratios have saturated at historically high levels. This suggests that higher inter-

est rates will lead to lower debt levels as people seek to prevent debt service ratios from rising even further. That is, the rise in interest rates is likely to have a one-to-one impact on the amount of debt per unit of disposable income, the debt-to-income ratio. This would inevitably slow consumer spending and reduce the rate of economic growth.

The second question is, what about investment? Consumption spending is going to be negatively affected by the interest rates for the reasons I outlined, though some part of that will be offset by higher incomes for retired people from higher interest payments. But many economists have found that there's very little impact on investment due to interest rate changes, provided the underlying profitability of business is healthy. So the question is: what determines investment spending, and what does that imply for the impact of interest rates on investment spending? Part of my research has shown that investment spending is very strongly determined by profitability. You can show that the growth of investment is extremely closely related to the incremental rate of profit in the corporate sector. Every economic theory says that investment is determined by its profitability. Keynes called this profitability the marginal efficiency of investment. It is very volatile, and it transmits this volatility to investment and hence, to a lesser extent, to GDP. One of the striking things is that the incremental profit rate leads the GDP growth rate because it leads the investment growth rate. That means that we have some sense of the potential prospects. Figure 3 shows that the profit rate has peaked and started to decline. The growth rate more or less follows the profit rate, which suggests a scenario very similar to the one projected by Jeff and many others: that we are going to experience a reduction in the growth rate. Not a collapse, but a reduction.

So where could we go from here? There are two paths, historically. The path that Bush might take is the path that Reagan took, which is to insist that we cut the budget deficits by cutting government spending. Since we cannot do it in Iraq, we have to do it somewhere else. The real purpose of that, in my opinion, is to undermine labor and reduce the growth of wages relative to productivity, to bring down unit labor costs and restore profitability. This is what happened un-

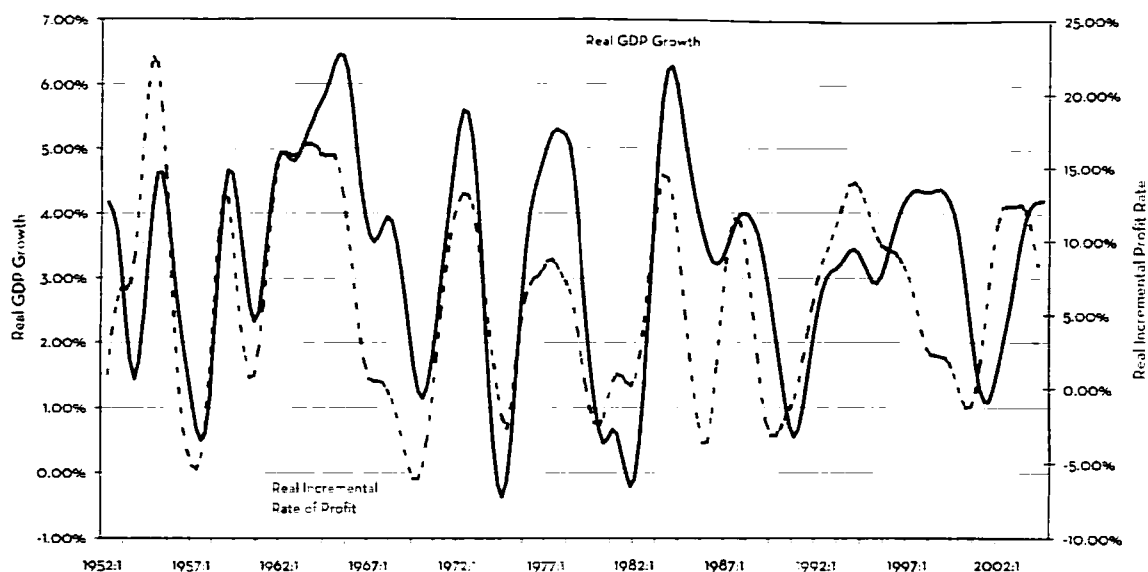


Figure 3. Real GDP Growth and the Real Incremental Rate of Profit

Source: Author's calculations. Real GDP and price deflators from Bureau of Economic Advisers; incremental profit rate calculated for nonfarm nonfinancial corporations from the flow of funds table F102, measured as the change in real profits over lagged real investment. Both series smoothed via the Hodrick-Prescott Filter and multiplied by 4 to get annual rates from the quarterly data.

der Reagan: a policy that would raise unemployment in order to raise profitability, and therefore raise growth in the future. The other possible path is to raise profitability by raising productivity and lowering business costs, particularly health-care costs. The U.S. health-care system is rather backward compared to that of most advanced countries because its costs are borne largely by individuals and businesses. Many companies are beginning to realize that a general health-care system would actually be cheaper and, in fact, may lower business costs—costs that have a direct impact on profitability.

Darrick Hamilton: My research interests in general are around issues of ethnic and racial inequality, so today I'm going to examine five broad domestic issues under Bush in the context of ethnic and racial inequality.

The first major domestic issue is budget deficits. Just to give you some background, we've seen record budget deficits. We've gone from record surpluses to record deficits; however, that is little bit misleading because we probably should look at deficits as a percentage of

GDP rather than just looking at the raw number. Nonetheless, we went from an annual \$236 billion surplus to an annual \$413 billion deficit. The Bush plan to address this problem is to stimulate the economy from tax cuts—basically, the tax cuts that he's already passed. Furthermore, he plans to make the tax cuts permanent. In addition, he wants to limit discretionary spending on government programs except for homeland security and defense, which has been discussed already. This is the policy of "starving the beast." This is basically a market solution whereby the tax code is used as a stimulus by putting funds in the hand of consumers in order to spur market transactions. Realistically, given the current tax code and government spending, as well as the international conflict that we're engaged in, it's not likely that this will result in a reduced deficit. We know that the deficit will pass on to our children, and at some point the nation is going to have to pay for deficit spending. Some people might argue that one of the reasons we had growth under Clinton was the result of a low deficit. It's a little bit anti-Keynesian, but the idea is that lower deficits might contribute to lower interest rates, or some people might argue that paying back the debt also provided financing that led to expansion and growth.

The second major issue is education. Bush succeeded in passing the domestic centerpiece of his first term, which was the "no child left behind" legislation. That increased oversight of students, teachers, and school performance. There were more requirements for tests, and funding was attached to the performance of students. So if the students of schools underperformed or a subgroup within the school underperformed, financial penalties were attached to the school. Critics argue that we increased the requirements on schools but did not fund it properly. The government issued all these requirements but then did not provide proper funding. The ongoing Bush plan for education is, again, to require additional testing but expand it to the eleventh grade and one other grade. He also wants to create a \$500 million fund toward paying the school districts for effective teachers. If teachers are performing well in a school district or a state, then they get a bloc grant that can go toward encouraging them, so the plan provides a financial

incentive for productivity among teachers. They also want to experiment with private school vouchers. I am all for providing market incentives for schools or teachers that perform well. And I particularly like the idea of requiring schools to report statistics on certain groups within the schools so that we do not have schools with overall growth in terms of test scores, but with subgroups not benefiting from the growth. I think those are all noble policies, but with the voucher program, some groups will be treated unequally unless we attach to the voucher program some sort of needs criteria. One thousand dollars for a middle-income person is different than \$1,000 for a poor person. But, again, Bush's solution is a market-oriented one, and in this case, it will be via sanctions against poor performance, and subsidies and vouchers for schools that perform well.

The next social issue is jobs. His proposal to increase jobs is, again, a stimulus from the tax cut. He also wants to protect businesses from frivolous lawsuits and government regulations. For workers who are unemployed, he proposes a \$3,000 re-employment account that aids them in their search for jobs by paying for things like child care or other job-search related expenses. But, again, we see a common theme—Bush sees a problem, and his solution is a market-based one through the tax code.

Then we have health care. We have increasing health-care costs; we have 45 million people uninsured (which is an increase from the 40 million that we had uninsured in 2000). Bush's solution is a health savings account and tax credits. The health savings account is like a pension plan, a 401(k) plan for workers to take money from their payroll checks to put into a savings account for medical expenses provided that they purchase a high-deductible, low-premium health insurance plan. What effect might this have on the health-care system? Young workers will likely be attracted to this type of program and opt for this system rather than employer-sponsored health insurance coverage. But what will be left is older, sicker workers stuck with employer-based insurance, and further that employer-based insurance will not benefit from the reduced costs associated with risk pooling when they had the younger workers, who were healthier.

We also might have the incentive for employers to opt out of employer-provided insurance. They might provide incentive to their workers to not insure through the employer-sponsored insurance, so ultimately it will lead to a more market-type solution for health insurance, where you have individual workers going out to purchase their own health insurance.

In contrast, Bush also has an associated health plan proposal that will allow small businesses to come together in pools to purchase insurance so that they can pool risks and reduce their premium and costs, which is somewhat in opposition to the first proposal. Provided that it is not feasible to radically change the health finance system, it is not such a bad proposal. A problem is that it will be regulated by the federal government, so if firms opt into the program, they may be exempt from some of the state regulations that already exist. That could lead to reduced quality of care for workers, because they will not be covered by some of the state regulations.

Finally, Bush proposes medical liability caps. The idea behind the medical liability caps is that premiums will be reduced due to cost savings associated with fewer lawsuits. But if we look at some states that do have medical liability caps, it doesn't do much to reduce health-care costs. I have not seen evidence that it reduces health-care costs beyond 5 percent, and that is a generous assessment—it is more on the order of 1 to 2 percent. Once again, Bush has a market-oriented solution to a social problem, and it will move the nation toward an individual-based health insurance program.

The final big issue is social security. They're concerned about the solvency of the social security system. The Bush plan, similar to the health-care plan, is for a personal savings account, so it allows workers to take their payroll taxes and put them into a personal savings account where their money can grow until retirement age, when they can take their money out. One problem with that is it doesn't seem feasible, given the current fiscal crisis that we have with deficits. Another issue is that it ignores why we started social security in the first place. Social security began as a social insurance program because we, as a society, did not like to see our elderly poor and sick in the

streets. So it's income redistributive to begin with. We might have a change where some workers do well and some don't do well. Are you going to tell the workers who don't do well, "Tough luck"? I think that goes against the original motivation behind the social security program. It would lose some of its redistributive nature.

I'm an economist, and you might be surprised that I am critical of some of these market-based solutions to some social problems. Well, the problem with these market-based solutions is that the very problems we are trying to solve are caused by market failures. So the market-based solutions might not be the way to solve problems of a program that began as a result of market failure. Putting all this in the context of inequality, I'll go through these very briefly. In education we know there are large disparities between blacks, whites, and Hispanics, both in quantity of education and the quality of education. We can see that exhibited by performance on scholastic exams. Blacks and Hispanics have 20 percent less earnings than whites. In terms of health, blacks and Hispanics are underinsured compared to whites, and we also see that blacks have higher infant mortality rates than whites, as well as lower life expectancies. So we have large disparities. Probably the biggest disparity is in the form of wealth, and that's probably the most important indicator of social well-being. The Pew Hispanic Center recently released a report that showed that in 2002 the median household wealth for whites was about \$88,000, but only \$7,000 for Hispanics, and \$5,000 for blacks—respectively, 9 percent and 7 percent of that for whites. So we have gaping disparities of wealth, which is a key determinant of social well-being. If we look at the recession, it caused wealth reductions for blacks and Hispanics and not for whites. We had a 27 percent reduction for blacks and Hispanics; in contrast, there was a slight growth for whites of 2 percent.

What are the implications of the Bush plan for ethnic and racial disparity? As I mentioned, using market-based solutions does not seem appropriate when the problems that began might have stemmed from market failures. There are two things: one is that if we use a market-based solution, blacks, Hispanics, and poor whites might not be in the socioeconomic positions that benefit from market-based

solutions. They might not be in a position to even benefit from a tax-based solution—a credit, for example—toward some of their problems because they don't make enough money. Second, even for the middle class of these ethnic and racial groups, we can see that they have burdens on them that aren't considered in these market-based solutions. For example, Hispanic households remit a large sum of their earnings (about \$2,500) to their home country, so they have roots in networks of social and economic poverty even if they're middle class. Furthermore, from the research that I've done, with Ngina Chiteji we see that poverty in the extended family—having a parent or sibling in poverty—accounts for 10 percent of the black-white wealth gap.

The last point is that family network explains nearly as much of the wealth gap as demographic factors and socioeconomic factors combined. By family network factors, I mean the net transfer between households and their extended families. So, in sum, I'll reiterate my points: the market-based solutions will not solve the problems that might have stemmed from market failures, and it will especially not be a solution for ethnic and racial minorities (blacks and Hispanics) because of their socioeconomic positioning, as well as their links to relatives and friends that are in subpar socioeconomic positions.

Moderator: Let's open it up to questions, suggestions, and comments. The floor is open.

Q: Am I right in thinking that there is increasing talk of introducing a consumption tax on the part of the Bush administration? One's initial reaction is to say this is a wild scheme, and it's been much criticized, and how can they possibly do it? On the other hand, experience shows that they go ahead and do exactly what they say they're going to do, no matter what.

J.M.: I think there's a good chance he's going to try to generate interest in a sales tax or some form of consumption tax. There is some support in Congress. There's a good chance he'll have fifty-five senators and a serious majority in the House. Nevertheless, I doubt it's going to happen. It is naturally regressive—takes the same proportion out of lower-

income as upper-income people. To keep it revenue-neutral, as Bush would like to do, would require eliminating some deductions that people like. It is a tough sell, and the danger is that someday it will catch on and be adopted without correcting the regressive aspect of it.

D.H.: It definitely seems as if this administration has a strategy to be vague at first, especially when they talk about things like "We will simplify the tax code." So simplifying the tax code and being vague about it does leave them the opportunity to do things that ideologically are what they want to do.

Q: Nobody mentioned oil.

A.S.: I personally do not think that oil is a major economic factor in current growth dynamics. But it is clearly a major political factor in current U.S. policy. It is very hard to project oil prices without having some sense of how OPEC is going to react. Some of these fluctuations in profitability may be related to all of that, but one thing that you see is that profits are largely up, not down, in this period of rising oil prices. And so, unless there's a catastrophic change, which is always possible, I do not think that the main player in growth dynamics will be oil. Oil prices in real terms, by the way, have fallen for a long time. They are up now, but in real terms they've fallen for a long, long period. A few years ago, they were the lowest they had been in real terms in a century. I think we tend to forget that.

J.M.: Still, it is a change, and the upward change is clearly having a short-term impact on the economy.

Q: What about the economic and political benefits of a massive program, kind of like the railroads or something, to get us away from an oil economy? And then we could sell all that technology to China, and it would put us back in the game. We need a boost to our economy, and what if we made a concerted effort to design a non-oil technology—hybrid cars, solar, etc.—and become the world's leading expert and exporter of this technology? That could be a huge boon to our economy. If anybody can do it, we should be able to do it.

D.H.: I guess the issue is with politics. One of the things that Bush

said he would do is offer tax incentives to individuals if they purchased hybrid cars, but realistically, will he do it?

Q: My hope would be to get us out of the Middle East completely.

D.H.: His solution is more drilling in the Arctic, so it does not seem as if they want to go that route. I disagree with you. His solution to the oil crisis and energy crisis is to increase domestic production.

J.M.: There has been a long-time debate over this kind of industrial policy—how do you pick the right technologies, how do you pick the right industries—and for the most part, interest in that kind of large-scale industrial policy has withered. While I am a big believer in public investment, it is pretty hard to pick the technology that's going to be the winner. I think there are probably other ways to do that, like big taxes on gasoline.

Q: I would like to ask Anwar if he could give us a little bit of an overview of how the world economy could help to sort out some of the problems the United States faces.

A.S.: I am not sure I would argue that the world economy can help us sort out our problems in the immediate sense. But in the longer term the world is an exceedingly unstable and dangerous and miserable place. One could argue that the developed world has to stop thinking about it in terms of its immediate self-interest, and to start thinking about it in a global sense, even if it's only for security. Coming from a UN perspective, there is a huge amount of money that needs to be spent, that should be spent on combatting massive and intractable world poverty. It will not be done by private investment, because most of that investment is very capital-intensive and is actually displacing people. In many parts of the world, there is no prospect that most of the poor will ever find employment. So addressing this problem from the U.S. side would mean someone other than Bush at the helm. That is one of the many sad things about these next four years. Japan and Europe cannot join with the United States because the United States is aiming in a different direction, and the United Nations is caught in between. So I am afraid that things are going to get worse. And there

are many hot spots like Pakistan that are so unstable that we cannot even say what's going to happen next.

Q: Has the war been good or bad for the economy?

J.M.: It's risen rapidly, if you include homeland security. In fact, when everybody was saying that September 11 was a cause of the recession, my reaction was very much the opposite. It led to so much rapid defense spending and homeland security spending that it had helped create a deficit to keep the recession from getting too bad. We haven't had much of a solid expansion because, in my view, the nature of the deficit we've had is quite an inefficient way to stimulate an economy. Defense spending does create unproductive goods. If you spend some money on education, you might be developing a productive worker, not to mention improving the welfare of that young person.

A.S.: A colleague here at the New School named David Gold actually works on this. I remember his showing a graph in which country GDP growth rates were plotted against country defense expenditures. The two moved in opposite directions. The second thing is that expanded defense spending is a hard path to retract from. I have this fantasy that Bush is going to announce in two months that Afghanistan has had elections, Iraq has had elections, and both countries have "free people" now, so our troops are coming home. It would be another sort of disaster if that happened, but it would reduce domestic defense expenditures. But I think that the main purpose of that expenditure will be to provide a rationale for further cutbacks in other social expenditures. And that ties in to the fact that the deficit is not really a risk for future generations; it is a risk for the very next generation because of social security cutbacks, health-care cutbacks, and so on. Darrick mentioned that a lot of the proposals about health care seem to center on plans that do not really help people. But you have to keep in mind that Bush, in my view at least, is not really trying to help people; he is trying to help a core set of businesses with which he is allied and that are crucial to his interests. So what looks like a bad health-care plan or social security plan for us might look very good for his constituency. I think that is the problem that we face.

D.H.: I agree with Anwar. You're going to have winners and losers. I think it's by design that he's definitely creating an environment that suits his constituents, which is high-powered business and the wealthy. So groups like that, racial minorities in particular, will suffer as they did in the Reagan years.

J.M.: We are going to have to face some serious long-term problems like social security and health-care costs under this fellow's watch. And the solutions he's going to propose and the track he's going to get us off on will be not merely an error, but could be a disaster. The idea of privatization of social security is simply going to lead in twenty years to high levels of elderly poverty. There are few things I will say with certainty, but that, I'm quite certain about. People will invest badly, they won't invest at all, and government will have to solve the mess. These sorts of hybrid attempts to make a market of the health care will also lead to disaster. At best, we will delay really solving the problem. For thirty years now, America has not reacted to serious changes in its economic circumstances—a secular period of slow growth, stagnant wages, and rising inequality amid soaring health-care costs and an aging population. We've really reacted badly to all of these things. We're facing serious long-term issues, and we're going to do it again under Bush. To me, these are bleak prospects.

Q: Is there an elephant in the room that is being ignored? I wanted to make a quick point if I may. It seems many Americans voted against their economic interest in favor of what is now called moral values. These issues now kind of leave the economic issues behind, and all of us well-educated economic determinists who sit up here are really left to the side of the whole discussion of the political future of the country. I leave it as a question.

J.M.: May I comment on that? While I think that it is true that cultural issues and moral values have moved to center stage, I remain an economic determinist in the sense that these issues were used as a scapegoat and took on a life of their own because of the stagnation and decline in wages, especially for white males in the 1970s and

1980s and because of the inflation, which—because of a failure on the part of mainstream economics and Democratic as well as Republican politicians, especially in the 1970s—the public blamed almost entirely on government spending. This sort of huge widespread religious revival, which often had the smiting of evil as its main purpose, has existed in American life almost since the beginning, certainly since the second great awakening in the early 1800s. This is not a case against religion, which I deeply respect, but it was a certain form of extreme evangelism that dominated large parts of American culture and kept resurfacing. It was part of the anticommunism of the 1950s. There were red scares even in the 1800s that were related to a kind of religious-right thinking that said, “There is an evil out there, and we’re going to stop it.” So I think there’s a combination of economic determinism and the continual resurgence of this American evangelism that keeps looking for something evil to smite, and you feel good because you’re smiting it.

D.H.: I don’t know the history as well, but in my lifetime, one of the things the Republican Party is so successful at is convincing voters, especially voters in the South and rural white males, that economically it doesn’t make that much of a difference whether a Democrat or a Republican is in office. Where it does make a difference is on those wedge issues—gays, blacks, AIDS. I think that is the brilliance of the Republican Party, to just take economic issues out of the landscape.

Q: What is the basis for all the support of free trade by economists?

A.S.: One of the premises shared by most economists (not at this table, but 99 percent of them) is the idea that free trade is optimal for providing benefits for all and also for spurring growth. But then the problem becomes, how do you explain the discrepancies between the processes you observe and these idealized predictions? One answer is that the actual processes are not sufficiently competitive, not as competitive as economists would like. The other answer is, the idealized model does not show how markets work or how competition really works. Current globalization policies of the World Bank, the Interna-

tional Monetary Fund, and the World Trade Organization are based on the notion that much of what went wrong in the 1980s was the result of insufficient application of market principles. Privatization policies are based on that. If it is true, then the suffering that people experience, that other people experience (and shock therapy, like that imposed in Russia, is always imposed on other people), would somehow benefit them in the long run. I do not think it is true because I believe international trade operates in the same way that competition does within the nation: it damages those who are less competitive. That means that if you open up international competition without adequate preparation, then there will be greater unevenness than before. The situation will actually be exacerbated.

We in the department had a conference on globalization devoted to this theme. Professor Ha-Joon Chang of Cambridge University, whose book called *Kicking Away the Ladder* traces the history of the developed world, shows that not a single rich country developed through free trade. On the contrary, from England onward, every development process involved state intervention, state protection, attempts to keep the others down and raise themselves up, until the countries in question got to the point where they were dominant; only then did they switch to the ideology of free trade. This includes Britain and the United States, of course. From that point of view, free trade, NAFTA, and other similar policies are the attempts of the developed part of the world to take advantage of the resources, labor, and markets of the developing world. The only hope, in my opinion, is the growing backlash taking place against globalization, which is coming from the streets and slowly filtering into academia and upward. But unfortunately, it is not yet influential at the top in policy circles.

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