Intelligent Design for the American Economy

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Over the past thirty years or so, the United States re-designed its economy. We did it the way America and other countries too have often done: Deliberately and intelligently – to the extent intelligence is a necessary attribute of deliberate. It does not necessarily mean smart. This time it was not at all smart.

Intelligent Design means, simply, that economic re-design does not happen all by itself. Redesign was not the emergent outcome of numberless individual behaviors aimed at other goals. It was not the unguided result of purposeless evolution. New direction was repeatedly the result of decisions taken by powerful individuals backed by broad political forces and guided by their vision of how the economy ought to change.

Yes, there was an Invisible Hand.

But the Invisible Hand was repeatedly lifted at the elbow by the Government, which then rearranged things and replaced the Hand in a new position--from which it could go on to perform its magic. Government provides or arranges. In response, some sectors grow--sometimes quickly--and in growing pull other new activities into existence around them. After some years, and some iterations, the effect is to re-direct and re-shape the economy. This is how things have been since long before the National Economic Council staff of Croesus King of Lydia came up with the game-changing idea of " coinage." What governments have done and failed to do to structure, nudge, and put their thumbs on the scales has been of decisive importance for economic development. Do not believe me? Look around you. See the hundred-fold divergence across political jurisdictions in relative levels of economic productivity and prosperity.

The Founding Fathers were keen on re-designing the agrarian economy. Led by Hamilton's ideas on the primacy of commerce, banking, and industry--including the necessity of protecting infant industries--the Federalists set out to nurture and support America's infant industrial sector. When Hamilton's and Adams's Federalists were replaced by Jefferson's and Madison's small-government Democratic-Republicans, they quickly decided that their small-government principles had been an out-of-power luxury. Wars of conquest, territorial acquisition, continental surveying, canal and then railroad subsidies were good for voters, good for immigrants, good for pretty much everyone except the outnumbered and outgunned Amerindians in the way. The Federalists and their successors also steered money into infrastructure--at the time it was canals. And as the key policy instrument for developing an industrial sector, pre-Civil War America channeled Department of War money to fund experiments in high-tech industry at the Springfield Arsenal, and built steep tariffs walls against imported manufactured goods.

Again and again America renewed this high-tariff industrialization policy--rammed through over the angry protests of its farmers and the Southern Planters. America kept high tariffs to protect its infant industries right up through the end of the 19th century, when those infants had grown to be the largest firms in the world. It worked very well for America as an industrializing producer if not for Americans as consumers of cheap British-made manufactures. We industrialized at what was for the nineteenth century a very rapid pace to overtake free-trade Britain as an industrial power.

The nineteenth-century government took the lead in creating the transcontinental railroads. Railroad expansion re-shaped the economy by opening vast regions to profitable farming and settlement but also accelerating the development of feeder industries as steel. The government did not tax and spend. Instead, the government gave railway companies huge valuable checkerboards of land. Government spending as calculated by national income accountants was a small share of GDP in the nineteenth century. But any government that builds infrastructure and allocates land title on the scale of the nineteenth-century U.S. government is Big Government incarnate indeed. These were the policies that Intelligently Designed nineteenth and early twentieth century America.

After World War II it was again government that led the reshaping of the US economy: First, by the housing and highway programs that enabled the huge and rapid suburbanization that drove the economy and reconfigured the landscape. Second it financed the large scale development of world leading research universities, and sent millions of young Americans to them, and these Universities have been major contributors to the best American economic performance ever since. And third, it directly supported, mostly though the defense budget, the development of American industrial dominance in the critical new technology industries of the time, commercial jet aviation and computing – extending back into semiconductors forward into software and applications up through what became the Internet. This was a big time exercise in direction, hands-on, winner picking, and it was a very big winner for the US.

And when push came to economic shove, America's government even deliberately devalued the dollar in the interest of national economic prosperity. It did so more than once, each party taking a crack: under Franklin Delano Roosevelt, under Nixon, and under Reagan. We used all the tools: infrastructure development, tariff protection, direct picking and promoting of winners, exchange rate devaluation, and in the first Reagan administration bare naked import quotas in the form of "voluntary" export restraints.

This history is elementary. This history is nevertheless worth reviewing. Why? Because America at least is about to have another debate over whether its economy evolves or is designed--with the political opponents of President Barack Obama claiming as strongly as they can that what is good in America's economy has always just evolved with no guidance, and only what is bad has been designed by the government.

We are going to have another debate because over the past thirty years, but especially over the past decade, policy once again redesigned the American economy. But this time it was different. One set of policies – originating in Washington, paved the way for the economy to move into expanding areas of activity. And another set of targeted policies, originating in East Asian governments, first Japan and more recently China, took up the slack and filled in the gaps left as government provided incentives for the US economy to migrate out of large familiar sectors.

The two teams performed a kind of cosmetic surgery on the US economy, a body sculpting. You can track the chest and bicep measurements via Table B-18 of the Economic Report of the President. Global policymakers performed what was sold as a liposuction, though it turned out to be muscle removal, and reduced the weight of manufacturing in the economy by 9% of GDP from 21.2% of GDP in 1979 to 12.0% of GDP at the peak of the last business cycle. That is a big number--about two full Pentagons: call it a Decagon. As some pieces of the body shrank, others were bulked up. FIRE alone took up half the slack: finance, insurance, real estate, rental, and leasing rose by 5% of GDP: from 15.2% of GDP to 20.4%: this is most of the paper-shuffling part of the economy. Professional and business services--much of it, too, paper shuffling--came second. And the third great paper-shuffling industry of health care administration filled out the rest.

Note that although what manufactured goods we made became a much smaller share of GDP, that decline vastly outstrips the decline in manufacturing in what we buy. Our current immense trade deficit of 5% of GDP is virtually all manufacturing. Yes, you can argue that a post-industrial society will have manufacturing play a smaller role--but the decline should not be this great and should not come this fast. To finance the purchase of all the manufactured goods we were not making we accumulated debt--great and growing mountains of it--to pay for those excess imports. And the rapidly-growing industrializing economies of the world and predominantly Asia were eager to build up the manufacturing capacity that our redesign of the American economy told them that we did not want.

This body sculpting of America was supposed to move us into the industries of the future. Other, poorer people elsewhere were supposed to pour the plastic into molds and snap the pieces together, while we concentrated on the high-value activities. But when an investment bank collects healthy fees for convincing its clients that they really want to invest in derivative securities built on top of subprime mortgages, is the value added really value added? When a consulting firm collects healthy fees for convincing its clients that they want to shed high-cost labor in America at the price of losing the human capital to make the next generation of production improvements, are its profits--healthy as they may be in the national income accounts--really an addition to national wealth?

The increase of the role of finance in America's GDP came about not so much by increasing the numbers of those employed in the sector but by raising the pay and profits of those in finance. However, pay did not soar for the legions of bank clerks and back office workers. They remained modestly paid. It all went to the top. And finance went to the top of all industries. By 2005, at the peak, over 40% of corporate profits were "earned" by financial corporations. And some of the most lucrative parts of finance were not structured as corporations. Their take came on top of that.

When you think of it, for finance to capture over 40% of corporate profits is terrifying. Finance collects savings from households and lends to younger Americans so that they can buy their houses. But mortgage finance is supposed to be a low-margin low-risk business with the government providing a backstop, and the interest payments on mortgages are supposed to flow through with very small subtractions to the interest earned on the savings accounts of other American households. Finance also collects savings from all over the world –including some of that colossal American debt held by foreigners, though it is mostly kept in US government bonds – and underwrites and makes liquid the securities that form their capital base. But it is the operating companies that produce value and make the profits. Finance simply aggregates and slices the profits in various ways. It is supposed to take a small commission as it serves as an intermediary between the companies that make the money and the households that saved the capital, by packaging the money flows to households in safe, convenient and liquid forms. But how did this provision of safely, convenience and liquidity—which in the fall of 2008 turned out, of course, to be none of the three –ever come to be priced at 40% of the total?

Now government did not force the U.S. economy into this new manufacturing, engineering, and exports-light and this finance-, real estate transactions, and imports-heavy configuration. Rather it enabled and supported the shift, in ways similar to how it enabled and supported the earlier waves of post-WWII suburbanization through innovative financing programs to make single family home ownership (though not apartment rentals or ownership) available to average Americans. In this case deregulation was the instrument of choice. This enabled and supported the movement of the economy in the direction to which policy was opening the gates and out of the areas Asian government policy was so successfully targeting.

And it is not all finance. Our newly redrawn contour map of the US economy shows a comparable bulge in health care administration. The administration of our ill-designed health care system now costs us about 4% of GDP over and above the costs of health care administration in other comparable countries. This does not count the actual treatment--not even unnecessary and inappropriate treatment. The US spends over 17% of GDP on health care treatment and administration, well over half again as much as a proportion of GDP as other rich, advanced nations such as Germany, Switzerland, France and Denmark. And we have health outcomes worse than theirs--even if we say that "we" includes only white Americans.

That the Intelligent Re-Design of the US economy effected over the past 30 years has proved to be not at all smart was not because government always gets it wrong. Earlier re-designs of the US economy were engineered by government action with specific, concrete intent. Most were broadly successful.

This time, however, policy makers--and the vast frog bog of policy advisors, commentators, opinion leaders, and private sector power wielders--had a blinding vision. The government initiatives that led to the

New Look US economy at the outset of the 21st Century responded to a vision of how the deregulated global market economy should work. This vision was more than merely ideological; it was positively religious. This was the enabling pull, side: dismantling the barriers, the rules and regulations enabled the metastasizing growth of finance; checking the move toward universal health coverage enabled the growth of negative-sum health care administration. On the push side there have been Asian governments eager to sell us whatever we want to buy and desperate to promote economic development to raise their billions out of dire poverty as fast as possible--governments that have painfully learned that they cannot afford the ideological indulgence of taking their eye off the ball that is the real economy, and cannot afford to choose a cat because it is red (or white) and not because it catches the mice.

So what now?

A simple reflation of our flattened economy, pumping it back up to its state and configuration of 2007 – what we are now trying, not all that successfully, to achieve--will not do.

A simple return to the industrial structure of a generation ago also will not do. Time and other countries have moved on. The place at the table the U.S. occupied in the post-WWII international division of labor is no longer open. And, indeed, the table has shifted. A 1980s General Motors could not compete in the world auto industry if we had one--indeed, it could barely compete then, and only when aided by a Reagan administration that persuaded Toyota and Honda to "voluntarily" sell fewer cars than they could have.

We need another re-design. And this time we need a smart and not just an intelligent design. And that means that Government, once again, will have to lead. Indeed government--somewhere--will lead in any case: the Invisible Hand simply never works without a government elbow.

It might be best for us, and perhaps even for the world, if the government that led were the American government.

Who is going to draw the new design--even select the new design principles? A few self-styled smart guys, like us? A blue-ribbon commission? Of course not. In the past that was not how it was done. And it won't be done that way in the future, at least we hope in won't. An effort at redesign is never the result of a single bright idea, with a present, quantitative plan. No one can ever know the complex configuration that an effort at redesign will eventually yield, let alone its extent.

But everyone knows the initial direction:

* American manufacturing growing to replace imports from Britain
* Full-bore westward expansion on the railroad
* A Cold War buildup of permanent military capacity
* Suburban houses and roads and cars, oil and appliances
* Jet planes and something having to do with computing and science.

The direction always seemed obvious. It was. Most Americans, not just a few, supported the shifts in the past. They seemed right and appropriate to them.

Even the last round--the massive shift out of manufacturing and into finance and health care administration--seemed the wave of the future when viewed, as it was from a particular perspective.

Part of the policy shift that enabled the economic shift was, admittedly, sneaky: small, incremental changes in the arcane rules of financial regulations. But the big shift was obvious and generally understood: part and parcel of a move to unfetter the market and fetter the government by taking three steps to the right and dismantle pieces of the post-World War

II mixed economy. It was a response to a question: what by the logics of dominant American economic theory and a long history of populist political rhetoric makes an economy innovative, flexible and prosperous? The answer chosen was to remove the need--as well as the temptation--for government meddling.

This round, once again, everyone knows the initial direction:

* Infrastructure repair and upgrading
* Alternative energy and energy-production technologies
* Reduced dependence on oil supplies from troubled regions of the globe
* Reduced accumulation of debt to foreigners
* Health care system rationalization to bring service up to levels of other rich nations and costs down to something closer to reasonable reality
* Research and innovation--bio-tech, nano-tech, and info-tech and exploitation of the advances and products that eventually flow from inventions and innovations in these areas.

It's a start and a direction. Compare it to the alternatives:

* A further increase in the role of finance in the economy
* Ever-larger employment of clerical workers in doctors' offices trying to get insurers to pay and insurance offices trying to disallow claims
* A permanently lower level of economic activity.

This seems like an obvious and broadly acceptable set of starting directions.

More and better ones will surely be added. For there will come a long and broad refocusing of policy debate on what to do about the economy, and away from its past preoccupation with the realization of abstract economic principles.

The art of politics is to move the political possible to overlap the economically sensible. An intelligent redesign of the US economy is the policy task – and the task for economists. The policy debate then becomes a debate about policy instruments –none of them perfect, none non-controversial – to achieve this.

The book by chapters:

1. Introduction
2. Past Redesigns: from Hamilton to Tariffs to Erie Canal up through FDR and Ike.
3. Targeting Industries: Asian Industrial Policy: How it works; what it did. US responses.
4. The most recent US redesign. The Policy framework; the consequences.
5. Directions for a New Redesign
6. Rethinking economic policies in this new light: Taxation; regulation; spending; etc. This is a long chapter (or chapters: close to half of the book). Core notion is to promote "competitiveness" as, for taxation, shifting taxation off payroll and companies and onto consumption side. Exchange rates. We will consider a broad range from taxes through trade policy, through R&D, health care, defense, education, immigration. Point is not to lay out the right answer but to recast discussion in terms of Reshaping Economy. There will be a piece on why Innovation (all by itself) will not do it and some other one off solutions.
7. The United States 20 Years Out if We Don't.

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