

WHY AMERICA MUST REVIVE ITS MIDDLE CLASS

BY JEFFREY D. SACHS

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AMERICA WAS ONCE THE GREAT MIDDLE-CLASS SOCIETY. NOW WE ARE divided between rich and poor, with the greatest degree of inequality among high-income democracies. The top 1% of households take almost a quarter of all household income—a share not seen since 1929. An economy this lopsided cannot prosper. The poor and working classes are squeezed. The rich are increasingly absenting themselves from the country's troubles. Their businesses sell goods and outsource jobs to China; their homes are behind gated walls; much of their corporate income is in offshore tax havens.

It should be no surprise that our politics are foul as a result of it all. The rich finance candidates while the poor cannot. Political scientists have shown that members of Congress—many of whom are wealthy themselves—devote their legislative votes to the wishes of their well-to-do constituents. President Obama has dined regularly with the lords of finance; meanwhile, billionaire oil magnates fund the tax-cutting frenzy of the Tea Party.

America has been here once before. In the first three decades of the 20th century, new fortunes in industry pushed up incomes and wealth at the top while mass immigration set a low floor. The Republicans won the White House throughout the 1920s—Harding, Coolidge and Hoover—and the Supreme Court weighed in for the big corporations, striking down labor standards, minimum wages and other social protections.

Then came the Great Depression in 1929 and Franklin D. Roosevelt's New Deal four years later. FDR railed against "a small group [who] had concentrated into their own hands an almost complete control over other people's property, other people's money, other people's labor—other people's lives."

Today the economic and political forces are different, but the need for a new course is the same. On the economic front, the rise of China and globalization are the critical new variables. Great profits are being earned, and kept, abroad. At home, workers with lower skills and education are being squeezed by competition from overseas. Manufacturing has shrunk.

How did we get here? Certainly prosperity hasn't always come at the price of large-scale inequality; quite the contrary. The 1950s and '60s marked an era of rapid economic growth and narrow differences in income. This was partly the result of a more robust social safety net. The New Deal, World War II and the vigorous postwar recovery had reversed the outlandish inequalities of the 1920s. Top tax rates were 70% or higher till the Reagan years, and the economy grew robustly nonetheless. Social Security, the GI Bill, interstate-highway construction and many other programs ensured that the elderly were protected, higher education was increasingly within reach of all, and the business sector had the modern infrastructure needed to prosper. In this highly effective "mixed economy," one bolstered both by business and by activist government, the gap between rich and poor narrowed substantially.

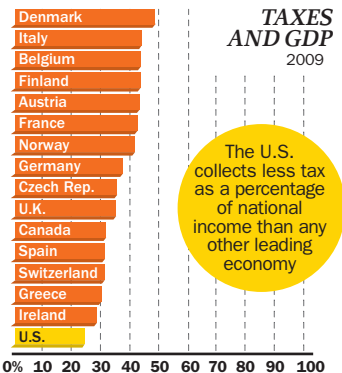
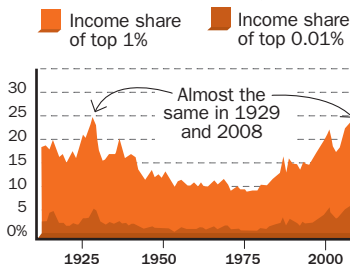
Things began to fray, and fray badly, in the 1970s. The U.S. dollar was toppled from its unique perch; oil and food prices spiked; Japanese automobile imports began to challenge the Big Three automakers; and inflation soared. America was experiencing its first taste of the new globalized competition.

Yet America misdiagnosed the problems. Rather than focus on the overseas challenge to U.S. competitiveness, Ronald Reagan declared in 1980 that government was not the solution to our problems—it was the problem. The key to re-establishing a sound economy, he claimed, was to slash taxes, reduce government programs like energy research and social insurance and generally adhere to a free-market course.

The Reagan diagnosis neglected the fact that the federal government had been a handmaiden of the country's inclusive growth of the 1950s and '60s. Worse, the Reagan Revolution failed to grapple with the even bigger upheaval of globalization.

It's hard to overstate the long-term consequences of these global changes and our failure to adjust to them. The new globalization has accelerated the hollowing out of U.S. industries such as apparel, autos and textiles and in the process devastated the middle class employed in manufacturing, except in the highest-skill areas. Although American consumers have been the beneficiaries of a flood of low-cost and

RISING INCOME INEQUALITY



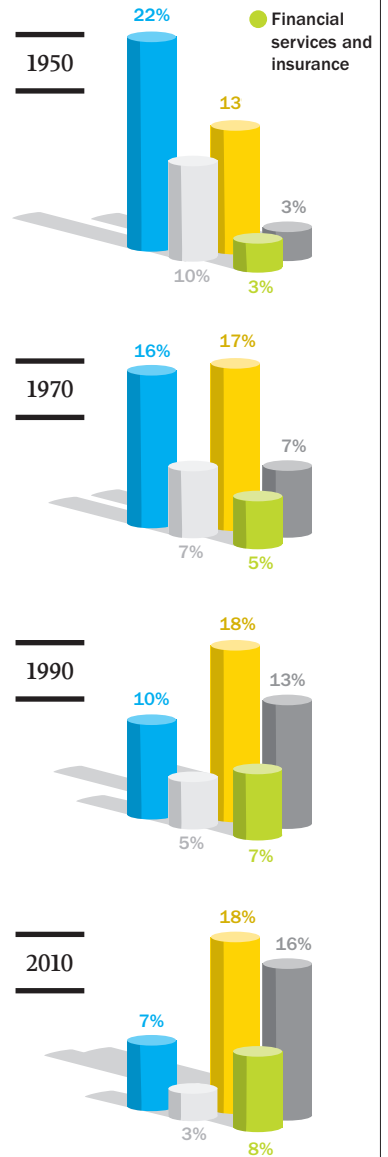
The U.S. collects less tax as a percentage of national income than any other leading economy

HOW WE SPENT...

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AS COSTS CHANGED OVER THE decades, we began devoting less of our budget to groceries and clothing and more to health care.

PERCENTAGE OF TOTAL PERSONAL CONSUMPTION SPENDING



high-quality Chinese products, America's industrial workers have paid for it in wage cuts and higher unemployment. The median earnings of full-time male workers reached their peak way back in 1973. Female workers have fared somewhat better, in part because they are disproportionately in areas like health care and education, which are more sheltered from global competition. The earnings of the CEOs who oversaw this loss of competitiveness, of course, soared spectacularly, especially as they grabbed stock options designed for their benefit.

This deterioration in Main Street earning prospects was covered up for more than 20 years by debt. First, there was mortgage debt. Washington encouraged housing construction at every turn through Fannie Mae and Freddie Mac, Wall Street deregulation and the Fed's low-interest-rate policies. The housing sector seemed like an employment winner, creating construction jobs that at least partly offset the lost manufacturing jobs. A winner, that is, until the bubble collapsed in 2007.

Eager to keep voters feeling prosperous, Washington also fed the fever of consumer credit. If people could no longer earn their way to affluence, they could

try to borrow their way instead. Only in 2008 did households come to understand the precariousness of their balance sheets.

The surge of financial inequality and recklessness has been a bipartisan affair, aided and abetted by every administration and Congress since 1981. And leaders from both parties have yet to accept the magnitude of the shifts in the world economy and the scope of the solutions needed. When Obama took office in 2009, he treated the financial crisis as a major but temporary shock. Obama called for a two-year jolt to spending. The famous stimulus legislation was a haphazard mix of tax cuts and spending increases, with no real attention to the long term. The idea was to build a bridge over the downturn and hope that the economy would bounce back to life by 2010.

We know the story since then. There has been no bounce back. Each year, as temporary stimulus measures have worn off, Obama has called for another sharp, short push. This was the message at the end of 2010 when the White House and Congress agreed to extend the George W. Bush-era tax cuts to 2012 and when the

White House received a temporary cut in payroll taxes. This is the message again today. The new American Jobs Act calls for more tax cuts and temporary outlays. But there are few takers for "just one more year" of stimulus when the results of the first three years have been so poor.

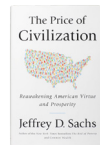
The Republican approach has boiled down to one idea: cut taxes permanently to revive the economy, and slash government spending to end the need for taxation. It's an argument that they've peddled, and largely implemented, for 30 years, with poor and worsening results. They claim, without evidence, that taxes and regulations are killing job creation, though many countries with much higher taxes and much stiffer corporate regulations have much higher employment rates than the U.S. The Republicans fail to understand that businesses are investing abroad not because of taxes but because higher wages in the U.S. are not sufficiently matched by higher skills, as they are in, say, Germany or Sweden. We are, to put it bluntly, simply uncompetitive in many industrial sectors.

The truth is that it will take more spending—not in the form of haphazard stimulus but in smart long-term public investments in education, infrastruc-

ture and human capital—to get us out of our present mess. We will keep our high living standards only if we embrace and manage the complexities of a technologically advanced and globalized economy.

It's time to stop arguing about spending cuts for everyone and tax cuts for the rich. Instead, Congress should be having a serious discussion about how we're going to fund our future competitiveness. In this way, we can build the skills and productivity in our society to compete effectively in the 21st century. If we do what needs to be done, we will look back at the decades from the 1980s till now as merely a detour from reform, a period when America lost track of the realities of a fast-changing world economy and our need to change with it. It's heartening to know that the young in America remain optimistic about the potential of government to solve problems. They are energized for a fresh start. ■

1973
THE YEAR FULL-TIME INFLATION-ADJUSTED MEDIAN EARNINGS FOR MEN PEAKED



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