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THE LONG, SLOW SLIDE INTO ECONOMIC MEDIOCRITY

by

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The recession of 1991 has not been the common garden variety of economic recessions experienced in the United States since the end of World War II. The dip was not sharp, and the recovery has been slow, if there has been any recovery. In our view, 1991 is simply one year in the long, slow slide into economic mediocrity.

The overall economy appeared to cruise along in the 1980s with the Gross National Product (GNP) measured in current dollars, more than doubling between 1978 and 1988. But when we take account of inflation and population growth during that period the picture changes dramatically. GNP measured in constant 1982 dollars and computed on a per capita basis increased slightly less than 17 percent between 1978 and 1988. Stated differently, the increase in real income per person over that period amounted to only about 1.7 percent per year. In terms of the output of goods and services available to each person in the United States between 1978 and 1988, the economy was growing very slowly.

The slow growth of the American economy in real terms over the even longer period, 1965-1989, becomes clear from the following comparison with our two most important foreign industrial competitors:¹

	Average Annual Growth Rate, Deflated GNP, per Capita (in percent)
United States	1.6
West Germany	2.4
Japan	4.3

In the 1980s this poor performance of the U.S. economy was eclipsed by a rapid growth of GNP measured in current dollars. Fueled by large federal budget deficits and a huge expansion in consumer debt, the GNP of the nation in current dollars grew rapidly, and the money take home pay of most Americans increased. Thus, for much of the 1980s prosperity reigned, employment was high (even though many of the employed were earning low hourly wages cooking hamburgers) and fortunes were made on Wall Street. The Reagan and Bush administrations talked supply-side economics and tilted the tax structure in favor of the rich but, in fact, practiced a form of Keynesian economics, albeit a rather peculiar one. Huge federal deficits maintained and expanded the aggregate demand for goods and services.

¹World Development Report, 1991, Published by the Oxford Press for the World Bank, Table 1, Basic Indicators, pages 204-5, May, 1991.

But beneath this dollar camouflage, all was not well. Increases in nonfarm worker productivity were small and erratic in this period ranging from -0.9 percent in 1982 to +2.9 percent in 1983.² Average hourly earnings of all nonfarm workers, adjusted for inflation, declined slowly but steadily through the 1980s.³ Real family incomes in all but the top two deciles declined between 1977 and 1988; stated differently, the real incomes of 80 percent of the population of the United States declined in this eleven-year period.⁴ Finally, the 1980s were years of hard-times for farmers as well, as the Federal Reserve tightened the money supply eventually leading to dramatically declining land values. For working men and women in most sectors of the economy the decade of the 1980s was not a happy time; it was a time of false hopes and poor economic performances.

How did the bottom 80 percent of the U.S. population try to cope with the economic condition in which their real family incomes were slipping downward while the affluent top 20 percent were enjoying increases in income and wealth? Families in the bottom income deciles employed two strategies. Increasingly they became two income earner families, and increasingly they went into debt. Moving to two income earner families helped, but it could not keep real family incomes from declining for 80 percent of the population in the 1980s. Those families then tried to maintain their real standard

²Economic Report of the President, Transmitted to the Congress, February 1991, Table 13-47, page 339.

³Statistical Abstract of the United States, 1990, U.S. Department of Commerce, Bureau of the Census, Table 666, page 407.

⁴Phillips, Kevin. The Politics of the Rich and Poor, Harper Perennial, 1991, New York, N.Y.

of living by increasing their debt load. For many this was up to the limit when they could no longer service their volume of debt without danger of defaulting.

The "recession" which began in the third quarter of 1990 with a decline in industrial production and nonresidential investment and a rise in unemployment, and which continues in the third and fourth quarters of 1991, is real in the sense that economic activity has declined. But we contend that it is not a slump from some "normal" high level, but rather a settling down to a level consistent with a low productivity economy, where it is not operating under the forced draft of expanding private and public debt. We contend that the economy's deterioration became conspicuous in 1990 when two important things happened: (1) the expansion in consumer credit came to an end and (2) the government budget compromise signalled the end of the expansion in the federal debt.⁵ Both of these developments had to occur because consumer debt had reached a point where it could no longer be serviced, and public debt had reached a point where it was feared that further expansion would lead to dire financial consequences. So planned debt expansion, private and public, come to an end in 1990, and with it the false prosperity of the 1980s. The national economy now unveils its true state: underway on the long, slow slide to economic mediocrity.

Why is the American economy involved in such a long, slow decline? There are probably many reasons; we offer two that we feel are central. First, the treasure house of natural resources that Americans lucked into are either used up, or have become

⁵It is true the federal budget deficit increased in 1991, but that occurred from a decline in tax revenues in the "recession," not from a planned expanded deficit.

increasingly costly to acquire. Our best agricultural lands are in production; our wonderful white pine and hardwood forests are gone -- used up; the easy petroleum deposits have been exploited; supplies of clean, unpolluted water are becoming exceedingly scarce; and important minerals like iron ore and gold must be extracted through costly (and often environmentally damaging) processes.

Second, if the United States was to remain productive and rich, and avoid long-term economic decline, in the face of its limited or declining natural resources, it had to make significant investments in those areas which would increase the productivity of its work force. Besides a functioning market economic system, maintaining and increasing the "Wealth of Nations" in the face of increasingly scarce natural resources requires an increase in the productivity of the work force. And this could be achieved only through heavy investments in four areas:

1. plant and equipment;
2. research, both basic and applied;
3. public goods (e.g., infrastructure);
4. human capital for all members of society.

It is our thesis that, since the end of World War II, investment in the first two areas, if not generous, has been minimally adequate. But investment in the last two areas has been a disaster.

We have built the plants and done the research to enable us to produce some marvelously sophisticated and productive farm equipment, some even more marvelously sophisticated and productive communications and computational equipment, and to

produce some devastating weapons of war. In certain sectors of our economy technological developments have surpassed our wildest dreams. Still, over the long period, 1965-89, real per capita GNP grew at only 1.6 percent per year. After allowances are made for capital consumption and obsolescence, the allocation of goods and services to nonconsumption uses of the military, and the increased flow of income to the top 20 percent of the population, it is probably the case that the real standard of living of 80 percent of the American population did not increase much, perhaps even declined, over the period 1965-89. Certainly the quality of life in the big cities declined over this period with increased traffic congestion, air and water pollution, crime and homicide rates and the incidence of homelessness and poverty. In rural areas poverty may be less visible, but it is just as widespread as in the big cities. Integral sectors of the economy and whole segments of the population have experienced a deterioration in the quality of life as well as reduced standards of living over the past 20 years. This long, slow slide into economic second-rateness will be reversed, we believe, only if our investment policies in the four areas noted above are changed dramatically.

We believe that private firms will make the investments in plant and equipment necessary for sustainable growth only if first the federal government will assure the private sector that it will pursue sane fiscal, monetary and other economic policies in the future, thus assuring the long term economic sustainability of investments (i.e., the opposite of policies pursued in the 1980s); and second the federal government establishes an intelligent capital gains policy which encourages business investments but does not lead to windfall gains for the very rich.

With some prodding of the federal and state governments by the scientific and business communities we believe those governments will respond with the needed investments in research. Americans have traditionally placed a high priority on research, hence our governments have done a reasonably good job in funding research. They just require a little more prodding at the right times (such as now).

A huge gap exists between investment needs and political reality with respect to the third and fourth investment areas. A revolution will have to occur in the thinking of the American electorate and its political leaders, if the investment needs of the third and fourth areas are to be realized.

In the public goods investment area, outside the military, recent administrations pursued a niggardly policy. Even for such conventional public goods as roads and highways, airport facilities and prisons it was stingy in the extreme. But when we came to those public goods essential to the welfare of society and the effective operation of the economy in a modern, high-tech context, the recent administrations have drawn a complete blank. The federal government as well as many state and local governments have failed to take the lead in the development of rapid transit and other public transportation systems to reduce traffic congestion. They have failed to take the lead in protecting the environment by aggressively dealing with pollution problems, and they have failed to take the lead in developing a public health system to provide health coverage for everyone. These and other public goods must be provided by government, most likely the federal government, if Americans are to lead productive lives. Worker productivity is not going to be high and on the increase where the individuals involved

are in poor health and are working in polluted, congested conditions. This is a set of facts that Americans must confront and deal with if they want to avoid economic mediocrity, if not ruin.

But the biggest and most difficult investment problem confronting Americans is that concerned with human capital, or the insufficient investment in human capital. How are Americans to go about enhancing the quality and capacity of the work force from top to bottom? Solving this investment problem involves more than providing the needed funds; it also involves figuring out how to build human capital in all the children and young people of America. We present a policy scenario for building human capital which contains some strong policy medicine. Certainly there are other policy approaches, some of which might be superior to ours.

The obvious place to begin is to provide all pre-adults with an excellent education. But that is easier said than done. We also begin with a public school system in place that ranges from very good to very bad, with the bad schools typically located in areas with a low tax base. It is reported that a third of all American children now live in poverty and that percentage is growing. The family unit is breaking down with a high proportion of children living with a single parent, often a working mother, where parental guidance is weak to nonexistent, with the result that children spend endless hours watching violence or fantasies on T.V., or loitering on the street.

How then are these children, all of them, to receive a good education? Obviously they must be the beneficiaries of good pedagogical practices and methods, but we must leave recommendations in this area to others, since we have no expertise in this

direction. But we do have some common sense suggestions and some that are based on economic theory which can improve the public educational system.

First, the school year should be lengthened exposing students to more class days. The three-month summer vacation is an education anachronism.

Second, the quality of education in a particular school district should not be linked to its tax base. If state governments will not correct this policy failure, the federal government must.

Third, teachers in high schools need to be able to focus on teaching and learning. Other developed countries have managed to maintain curricula and a general atmosphere in high schools that foster learning and reward students academic accomplishments. The United States' public school system should be capable to do the same. One way to ensure this is to require all students graduating from high school to take and pass a nationally devised and administered examination.

Fourth, salaries of teachers in public schools must be competitive with other professions. This means salaries must be increased substantially and they should reward excellence in teaching.

Fifth, there should be no disincentives for parents to invest in the human capital of their children. It is an illusion that we can undo the changes in family and household structure that modern societies go through. But we can create incentives for each and every parent, including single parents, to invest in their childrens' human capital. An example for such an incentive would be social welfare payments that are a function of student attendance, efforts and performance in school.

Sixth, for those students whose domestic family environment does not foster learning, there must be in place a system that allows them to graduate from high school away from that environment. There now are several successful models to accomplish this (e.g., Minnesota's Humphrey Job Corps Center). There must be more of this, with strong support from the federal government. In fact the federal government should initiate a National Youth Training Program to (1) assist young people complete high school, and (2) continue on in some kind of job training.

But building human capital in children and young people requires more than conventional schooling at this stage of cultural and economic development in America. It requires that each and every child be raised and nurtured in a healthy, productive environment. To achieve this objective the federal government must develop within the Social Security System a child protection and development policy and set of programs comparable to the old age and retirement benefits policy and set of programs. Each pregnant mother, infant, child and teen-ager must be guaranteed adequate health care, a proper diet, and decent place to live and a high quality education through high school. Under this policy high school drop-out or loitering in street gangs would be uncommon. If a student drops out of the public school system he, or she, would be picked up under the National Youth Training Program discussed above.

After graduation from high school each girl and each boy should receive at least two more years of training. It is now generally agreed upon among economists that private markets for human capital investments have a tendency to fail. Thus, in the

absence of appropriate government programs there is a tendency for underinvestment in human capital.

In college education this market failure has long been recognized and many programs have been put in place that provide financial support to students based on economic needs and/or individual talent. However, college education has become more and more expensive. Hence, existing programs provide less support than in the past which, of course, works against the need to increase investments in human capital of the U.S. population. This is aggravated by the fact that federal, state and local governments all too often find it more attractive to reduce the deficits of public budgets by cutting investment expenditures in college and university training and research rather than public consumption.

The government failure in supporting human capital investments is even more pronounced in the vocational and technical fields relative to many of our competitors in Europe and Asia. The private sector does not provide sufficient training in vocational skills either because it is caught in a "prisoners' dilemma." Obviously, training by a private firm results in costs and a firm needs to recover the costs of investing in the human capital of its employees. After an employee has participated in a training activity his/her value marginal product increases. Hence, any firm that did not provide the training activities can now pay more and hire the employee away from the firm that provided the training and which needs to recover the costs of that training. Consequently, insufficient job training is provided by private sector firms although each firm would be more profitable with better-trained employees. The United States needs

to get out of this vicious circle of underinvestment in human capital in the area of vocational and technical skills. Many of our competitors have found solutions to this problem that could guide our efforts. This usually includes a continuation of training in public trade schools and in private sector firms. Another reason for a National Youth Training Program.

Our approach would create incentives for each and every young person fresh out of high school to invest in his or her human capital. It would introduce educational activities as attractive alternatives to taking low-paying, low-productivity jobs right out of high school, to loitering, or to spending time in street gang activities. And it would increase the economic welfare of all Americans by raising the productivity of our work force and making America internationally competitive once again.

Is the total package of investment policies and programs outlined above likely to be adopted? Probably not. For many people much of the policy medicine carries too stiff a price. Giving up present consumption for investment and thus future consumption has not been a politically attractive alternative in the 1980s. Hence, it is likely that things must get much worse before our political leadership reacts and begins to take actions that would slow the economic decline and eventually reverse it.

But assume a miracle and something approaching our proposed investment package is adopted, what then should we expect? It should produce a labor force from bottom to top that is highly productive. It should produce entrepreneurs with the vision to create desirable new products and more efficient ways to produce old products, engineers with the skills to design and build the plant and equipment to produce those

new products or new ways to produce old ones, managers with the capacity to put together the diverse parts of the production and marketing processes to create viable business operations, and workers with the training and the skills to operate the high-tech production and marketing processes in a highly efficient manner. Such a labor force should be able to raise the rate of growth of the American economy, measured in terms of real, per capita GNP, from the skimpy 1.6 percent per year of the past 25 years to 3, 4 or 5 percent per year.

Investments in public goods, including public infrastructure and a healthy environment, would have high social rates of return. Investments in human capital would have even higher rates of return under the adverse economic conditions of the 1990s. Investments in human capital, including health, also represent the most efficient and the most cost effective way to reduce the evergrowing (and for public budgets increasingly burdensome) expenditures for welfare and social security programs.

Growing investment in human capital of all members of society create attractive opportunities for everyone including all those whose only feasible option is to be dependent on welfare programs for the long haul, and those who presently find it attractive to engage in criminal or other unproductive activities.

But whether we choose a set of sane tax, investment and other economic policies, or stick with those that have produced the long slow, slide into economic second-rateness, the 1990s are likely to be difficult years. The adoption of the investment policies outlined above may require some increased tax revenues and, in the short-run before an increased production and income payoff, per capita real incomes are likely to

be reduced further. On the other hand, if we stick with the policies that brought us to the "recession" of 1991, real per capita incomes will decline even more and, we must expect to continue the long downward slide toward economic ruin. Thus, we must expect difficult times ahead in the 1990s in which individuals, firms, industries and economic sectors struggle in every way they know how to maintain their income positions. This means we will see more, rather than less, of individuals and groups petitioning the federal government for income help and protection. The jockeying for income assistance and protection by and with the help of government in a largely negative-sum game will be intense in the 1990s. If we could find a politically feasible way to reduce the influence of special interest groups that would help us deal with reversing the long, slow slide into economic mediocrity. But that too may be easier said than done.

In sum, the problem for American society in 1991 is to recognize that they are not in some little economic downturn with recovery just around the corner. We are in just another year of a long-run trend of a slow growing economy which could in 1991 have reached a point of negative growth. And there is only one way to turn this trend around -- it is by becoming productive once again. And we will become productive once again only by investing in those things which have the capacity to make us productive once again.

Americans must decide. But before they can make a rational decision they must recognize the economic fix that we are in.