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## How We Got Into This Mess

**Trade, the war on unions, and underfunded schools all lowered wages. Cheap credit propped us up -- but now the debt is due. Herewith, a national economic strategy to turn America around.**

**DAMON SILVERS** | *April 21, 2008*

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We are living through a profound financial crisis. That crisis has many proximate causes in the governance and deregulation of Wall Street. But its real roots lie in the long-term weakening of the real American economy in an era of globalization -- in closed factories, outsourced high-tech jobs, low-wage jobs with no benefits, and in the unsustainable effort to maintain middle-class living standards through borrowing.

For 30 years, America's economic elites and their political allies have pursued policies designed to produce this low-wage economy. But at the same time, policy-makers of both parties have sought, with some success, to maintain high levels of consumer spending. The creation of this low-wage, high-spending economy has systematically destroyed the various ways we individually and collectively save and invest. Instead of an income-driven economy, we have become an economy driven by asset bubbles fueled by cheap debt. The ultimate unsustainability of this strategy has brought us to our current economic crisis.

The assault on good jobs has proceeded on two fronts. In the purely domestic realm, starting with the effective abolition of the right to form unions in the private sector, both the formal and informal structures that encouraged the growth of worker bargaining power have been dismantled. A genuinely progressive tax system contributed greatly both to America's ability to make major public investments and to our increased levels of income equality after World War II. Now we have a tax system that taxes upper middle-income workers and individuals with incomes measured in billions at the same marginal rate (unless those billions come from managing hedge funds and private equity, in which case the billionaire's marginal tax rate is actually lower than that of middle-income workers).

At the same time, U.S. public policy has promoted the emergence of a global market with no rules other than those designed to protect economic elites. Global corporations all have strategies for success in the global economy, but the United States has consciously refused to have a strategy for how to remain a middle-class society in a global economy.

Without rules for the globalized economy or a meaningful national strategy for preserving and increasing their incomes, America's workers were fully exposed to competition from low-wage economies. The resulting downward pressure on wages and the soaring trade deficit should have shrunk U.S. consumer spending. But debt-financed asset bubbles provided an illusory way for Americans, and America, to maintain their levels of consumption.

For a time, the trade deficit itself, combined with the strategic behavior of our trading partners, provided the financing for these asset bubbles and the high levels of consumer spending. The strategic behavior was the refusal by the Chinese and others to allow their currencies to appreciate, either by formally or informally pegging the value of their currency to the dollar. In this way our trading partners enabled us to keep purchasing from their factories, even as our real economic capacity was declining.

Neither individuals nor countries can borrow forever to fund current consumption, however -- and thus came the collapse of the housing bubble and with it, the global credit crisis. This is not an ordinary business-cycle downturn -- it is a crisis of a failed economic and social model.

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In the 1980s, the United States began to set the course that led to the present economic crisis. This was the period when both the Reagan administration and the business community began to seriously attack the institutions that drove the high-wage postwar economy. This was the period when the progressive income tax was substantially eliminated for high-income Americans and when the federal government ceased in a meaningful way to protect workers' right to organize and collectively bargain, fueling a dramatic decline in union strength.

In the 1990s, these trends were accelerated by a series of trade agreements and technological developments that fully exposed the U.S. economy to goods and services produced by low-wage labor around the world. Prior to 1989, both China and India, the world's two most populous countries, were pursuing economic policies of internally driven development and were not participants in larger global markets as exporters. Mexico, our closest low-wage neighbor, was not economically integrated into the United States. American business historically had been supportive of high-trade barriers, fearing competition from foreign manufacturers.

All this changed as these countries and others deliberately began to transform themselves into export platforms integrated into the global economy, and more important, as U.S.-based global corporations began to see their non-U.S. operations not just as sources of raw materials but as cheap production sites. NAFTA was the first legal embodiment of these changes, and it was followed by the development of the World Trade Organization in the later 1990s, and then, and ultimately most consequentially, by the granting of most favored nation status to China in 1998.

The resulting downward pressure on wages meant that although the productivity of U.S. workers improved dramatically since 1980, their real wages remained flat, with the exception of a brief period in the late 1990s, at the height of the tech and telecom asset bubbles and before China really became a force in U.S. markets.

But the story of the decoupling of wages and productivity doesn't do justice to the full destructiveness of our low-wage strategy, since it also destroyed our savings and our ability to invest. Employers not only reduced wages but dismantled our pension system.

In 1980, roughly half of the nation's private-sector workers were covered by a defined benefit pension plan, with typical employer contributions of around 8 percent of payroll. Today, less than 20 percent of the private-sector workforce has such a plan. The other 30 percent has a 401(k) or other savings account, with employer contributions averaging less than 3 percent. Hidden in this change is a 5 percent real pay cut, but one with no impact on current consumption. The corporate retreat from employer-provided health care, particularly retiree health care, is a similar story.

In the public sector, starting in the 1980s, tax cuts that overwhelmingly benefited the rich robbed government of revenues necessary to fund public investment, both at the state and federal level. The nation is now left with schools that do less and less just when we need them to do more and more, with no money for infrastructure just when the roads and bridges we built during the great postwar infrastructure boom are wearing out, and, perhaps worst, no public resources to take on the great challenge of global warming and sustainable energy.

Ultimately, even the retreat from public and private savings was not enough to maintain a healthy consumer-driven economy in an environment of falling wages. So as a nation we went from eating our own seed corn to borrowing money in order to buy more seed corn to eat. Ironically, the very conditions that were driving down wages created a ready and willing source of a temporary rescue in the form of cheap debt. As our trade deficit skyrocketed, our trading partners in Asia accumulated trillions of dollars. China, Japan, and, more recently, the oil-producing countries lent their dollars back to us.

Fueled by cheap debt and inflated assets, the last five years have seen historically unprecedented investment returns in residential real estate, leveraged buyout funds (now called private equity), and hedge funds. These returns encouraged the belief that it was not necessary to fund retirement, because real estate appreciation made pensions unnecessary, or because hedge-fund and private-equity returns could make up in investment returns what pensions were lacking in direct contributions from employers.

So consumption rose as income and savings declined. In the early 1980s, consumer spending came to just over 60 percent of the U.S. gross domestic product. Today, it is over 70 percent. The increase is a measure of the extent to which we have maintained consumer spending by not investing in our future as a nation or our futures as individuals, and ultimately it is a measure of the unsustainability of our current economic policies.

The precise relative importance of manufacturing trade deficits, energy-related trade deficits, and the generating of credit capacity through pure financial engineering in creating the disastrously low-cost of risky debt in the last few years is unclear. But so long as cheap credit flowed from our trading partners, energy suppliers, and financial engineers, our economy looked much healthier than it really was. The vast amounts of economic activity in housing construction; in the transportation, marketing, and sale of consumer goods; and in government-related spending (not least, in Iraq) were artifacts of our ability to borrow, not measures of our overall productiveness.

The consequences of these policies are very clear. We have just gone through the first postwar economic expansion in which real wages did not rise. Pension and health-care coverage for Americans has shrunk dramatically. Poverty rates have been rising since 1999 and are now again above where they stood in 1973. Our negative balance of payments keeps growing, and the dollar keeps falling against the euro. We are losing the very high-tech jobs that we were supposed to keep in an era of globalization -- jobs in aerospace and information technology. The price of oil is over \$100 a barrel, and oil production on a daily basis is not increasing, while demand from other countries is growing apace. And hanging over our future is the threat of a radically destabilized climate because of our refusal to address the damage done by our carbon emissions.

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Our nation now faces a choice between continuing our low-wage, high-consumption economy until we truly bankrupt ourselves, or becoming a high-wage economy again, driven by investment in our human capital, in our physical capital, and most of all, investment in the technologies the world desperately needs -- the energy technologies of the 21st century.

We need a national economic strategy for a globalized world. Part of our strategy has to be to work together with the other major economic actors in the world to see that this new globalized economic order has rules -- rules on labor and environmental issues, rules for the enormous flows of capital across borders. Labor-market rules have to begin with the meaningful, enforceable recognition of the right of workers to organize, starting in the United States. Environmental rules have to begin with global rules governing carbon emissions, as the Bali talks on global warming recognized late last year. The regulations of capital flows have to be comprehensive and global, based on principles of transparency for pools of capital such as hedge funds and sovereign wealth funds, and the regulatory oversight of conflicts of interest and moral hazard in major financial intermediaries.

But even with rules, the United States also needs a strategy -- an idea about what our role will be in the global economy. We need to shed the delusion that we are so big and important in the global economy that we do not need a strategy, that the global economy will inherently work to benefit us.

The first place we need to start is public investment, which has historically meant infrastructure. Now it needs to mean the integration of infrastructure with energy technology -- energy-production technology like improved solar and wind generators but also energy-distribution technologies like those that drive digital electrical grids, and energy-conservation technologies, like advanced building materials.

Climate scientists tell us that time is running out -- that we need to change the way we fuel the global economy very quickly. For the United States, time is running out in a different sense. We have a window now in which we can act. We are still wealthy enough as a nation to have the resources to devote to this strategic shift, more resources than key competitors in the global economy. We have the resources to be the first mover and to reap first-mover advantages, to develop a critical industry we can market to the world. But this state of affairs is deteriorating -- so we need to act quickly.

To do so, we need a wartime sense of urgency -- both in developing and deploying new energy technology. We need to think about redesigning our electrical grid, renovating our entire building landscape to be energy efficient, deploying wind and solar power at scale, and radically accelerating the timetable for development of critical new technologies. To do these things fast will require tens of billions of dollars just at the development stage, but we as a nation are at our best in taking on these kinds of challenges.

The second big step is to change our labor-market policies to encourage a high-wage economy. That means national health care and a national pension policy to restore adequate retirement savings. It means rebuilding the connection between productivity and wages, making workers' right to organize and bargain real again, by passing the Employee Free Choice Act. And it means an end to a caste system in our labor markets, where currently we hire undocumented workers and then deny them all rights in the workplace. These measures have to be paired with improvements to our public schools at every level, so that worker productivity continues to increase. These policies should reinvigorate the middle class in the United States, a middle class based in part on the United States' role as the provider of the technologies at the heart of a global revolution in how we use energy, in part on the vast work that must be done to retool our own infrastructure, and in part on policies designed to make sure that ours is a society of rough economic equality. This new direction would make us a nation of savers, not of borrowers, a nation whose economy is no longer founded on borrowing but on providing the most sophisticated technologies to the rest of the world.

Steered by its economic elites, the United States has made choices for a generation about how to approach globalization under the influence of a fundamentally false ideology. This ideology says that rules to protect the public interest have no place in a global economy. It says that while strategy is good for businesses and good for wars, it has no place in U.S. economic thinking or policy-making. The choices this ideology has fostered have eroded the American middle class, damaged our national competitiveness, and helped expose the entire world to catastrophic environmental risk. Debt has been used to hide these consequences, but now that debt has come due.

So the next president will come into office facing a multitude of challenges -- a housing- and credit-market driven recession, rising energy prices, global warming, a current account deficit that is spiraling out of control, the war in Iraq, a collapsing dollar, a rising China and India, long-term crises in health care and retirement provision. Treating each of these crises individually while continuing our low-wage, high-debt economic strategy will certainly result in failure. The challenge is to understand that there is a choice, a different direction we can and must go in. And then, to go there.



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