

A Darker Future For Us

It's not just the financial crisis: higher taxes, energy costs and health spending also threaten growth.

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We Americans are progress junkies. We think that today should be better than yesterday and that tomorrow should be better than today. Compared with most other peoples, we place more faith in "opportunity" and "getting ahead." We may now be on the cusp of a new era that frustrates these widespread expectations. It is not just the present financial crisis and its astonishing side effects, from bank rescues to frenzied stock-market swings. The crisis coincides with a series of other challenges—an aging society, runaway health spending, global warming—that imperil economic growth. America's next president takes office facing the most daunting economic conditions in decades: certainly since Ronald Reagan and double-digit inflation, and perhaps since Franklin Roosevelt and 25 percent unemployment.

It's fair to note that the U.S. economy has a long record of defying pessimistic predictions. Our national culture, with its pervasive ambition and its proven capacity for innovation, favors expansion. These are powerful forces. But it's equally true that economic progress has periodically stalled. The Great Depression lasted a decade; unemployment in the 1930s averaged 18 percent. The insistent inflation of the 1970s arrested living standards and the stock market (it was no higher in 1982 than in 1965). By 1979, inflation hit 13 percent, and "no other issue could rival [it] as a pressure on the American mind," as the political writer Theodore H. White later noted. Americans do not have a divine right to rapid economic growth.

Could the economy now be at one of these historic inflection points, when its past behavior is no longer a reliable guide to its future? That is the central question confronting the next president. Only the most hardened among us cannot have been rattled by recent events that were scarcely conceivable two years ago. Government has taken over mortgage giants Fannie Mae and Freddie Mac. The Treasury has made investments in many of the nation's major banks. The Federal Reserve is pumping out \$1 trillion to stabilize credit markets. U.S. unemployment is at 6.1 percent, up from a recent low of 4.4 percent, and headed toward 8 percent, by some estimates.

The great project of the next president is to improve the economy's stability without subverting its vitality. The good news is that even if the present slump deepens (an 8 percent peak jobless rate would make it the third-worst recession since World War II), the odds are that it won't approach the Great Depression in severity or suffering. Too much attention is being paid: the Fed and the Treasury have frantically supported the financial system—exactly the opposite of what happened in the 1930s when two fifths of the nation's banks were allowed to fail. And Congress is already contemplating a second "stimulus" package up to \$300 billion or perhaps more; some private economists want \$500 billion.

The bad news is that recovery, though boosting employment, may prove unsatisfying. Our new economic era may lapse into a state of "affluent deprivation." That's an unfamiliar term. It doesn't mean poverty. The United States will remain a wealthy society. Rather, "affluent deprivation" signifies a state of mind. People feel poorer, because their sluggish income gains get siphoned off into higher taxes, energy costs and health spending. Though these all involve benefits, they don't pay everyday bills or cover people's routine pleasures. There's an approaching collision between private and public wants—government spending for everything from retirement benefits to defense to the repair of roads and bridges.

To some observers, we are so materialistic that we can easily make sacrifices. Do we really need

fancier grills or more flat-screen TVs? Of course, there's waste and personal extravagance. But what this argument ignores is psychology. "Luxuries" quickly become "necessities"—cell phones being a recent example. "Getting ahead" feeds people's optimism, and an upbeat society shows more "tolerance of diversity, social mobility [and a greater] commitment to fairness," as Harvard economist Benjamin Friedman argued in a recent book. Economic growth has anchored our national self-esteem; slower growth suggests a grumpier and more contentious America.

Unfortunately, slower growth seems probable. What the new president, and everyone else, needs to understand is that the present crisis marks the end of an economic era. For roughly a quarter century, the U.S. economy benefited from the expansionary side effects of falling inflation—lower interest rates, greater debt, higher personal wealth—to the point now that we have now overdosed on its pleasures and are suffering the hangover. In our zeal to identify the villains of the present economic debacle, we ought to recognize that the larger causes lie in this prolonged prosperity and the permissive attitudes and practices it inspired.

Largely unrecognized, the dominant economic event of the past half century was the rise and fall of double-digit inflation. On the way up, starting at about 1 percent in 1960, inflation destabilized the economy. There were four recessions between 1969 and 1981. Unemployment peaked at 10.8 percent in late 1982. That last devastating recession, imposed by the then Fed chairman Paul Volcker with Reagan's backing, purged the worst inflationary psychology. By 1984, inflation had dropped from double digits to less than 4 percent; by 2001, it was 1 percent. This declining inflation—disinflation—bolstered the economy

Consider what happened. The stock market recovered spectacularly: lower inflation led to lower interest rates, which caused investors to switch from bonds to stocks. The Dow Jones industrial average, which traded under 1,000 for much of 1982, averaged about 2,500 in 1989 and almost 10,500 in 1999. There was a consumption boom. Feeling wealthier, Americans borrowed and spent. The personal savings rate dropped from 11 percent in 1982 to almost zero by 2005. There were only two mild recessions (1990–91 and 2001). But what's clear now is that this prosperity bred bad habits. The present crisis, though usually attributed to dubious "subprime" mortgages, really traces its origins in the widespread optimism unleashed by disinflation.

By now, the perverse consequences are clear. As stocks and real estate rose sharply in value, many Americans became convinced that prices could only go up. Once that mind-set took hold, lax investment standards (in the case of high-tech companies) and lending practices (in the case of homes) mushroomed. "Bubbles" followed. People overinvested in tech stocks and overborrowed to buy homes at inflated prices or to raise cash from bloated real-estate values. But the borrowing surge could not last indefinitely, because debts increasingly outpaced the rise of incomes. By 2006, household debt was 134 percent of personal income. Sooner or later, consumers had to retrench. They are now; car sales and retail spending are down.

The recession will end, but recovery won't ensure a return to previous rates of economic growth. Just beyond the horizon looms a larger threat: an aging society.

Arithmetically, economic growth reflects the increases in workers' hours and their productivity—a.k.a. efficiency. From 1960 to 2005, annual U.S. economic growth averaged 3.4 percent, split almost evenly between labor-force growth (1.5 percent) and productivity gains (1.9 percent). As baby boomers retire, labor-force growth will shrink. By the mid-2020s, the Social Security Administration expects economic growth of about 2.1 percent, with scant labor-force increases (0.4 percent) and higher productivity gains (1.7 percent). Because productivity reflects many influences—technology, management, workers' skills—even that projection could be optimistic. If productivity falters, as in the 1970s, the U.S. economy would virtually stagnate in the face of growing claims on people's incomes.

A dilemma for the new president is how to reconcile the needs of the present with those of the future. The immediate need is to revive confidence—to rev up demand and spending, thereby absorbing the jobless and increasing the production of underutilized businesses. But the long-term problem is different. It is to mediate between all the competing demands on the nation's income and to expand the economy's capacity to produce the output that satisfies those demands. The closer the economy comes to stagnation, the more Americans will succumb to distributional struggles—not just between the rich and the poor, but also between the young and the old and between immigrants and natives.

Down that path lies "affluent deprivation." To use an old but apt cliché: people will fight over pieces of a fairly fixed economic pie rather than sharing ever-larger pieces of an expanding pie. The winners may be pleased, but the losers will feel short-changed—and so the conflicts may

intensify, with yesterday's winners possibly becoming tomorrow's losers. Politics, which is often about rewarding some and punishing others, may become more so. Nor is this prospect merely theoretical. Already, Americans face far more claims on their incomes than can be easily met.

Start with government. It's overcommitted in the sense that it's made more promises than can be sensibly afforded. The largest of these involve retirement costs. As is well known, three programs for the elderly dominate the federal budget: Social Security, Medicare (health insurance) and Medicaid (nursing-home care for the elderly poor). These programs now represent more than two fifths of the \$3 trillion budget, and as baby boomers retire, they could nearly double—measured as a share of the economy, gross domestic product (GDP)—in 2030. The tough questions are obvious. How much will we permit spending on retirees to raise taxes or crowd out the rest of government?

Health care compounds the difficulty. About three quarters of the projected increase in federal spending for the elderly involves Medicare and Medicaid. As a society, we haven't learned how to control health spending. Most Americans think that people should get all the medical care they need. Spending controls—for government and private insurance—haven't worked, because Americans don't want them to work. Health spending has gone from 5 percent of GDP in 1960 to 16 percent now and may hit 20 percent by 2015. For workers with employer-paid insurance, that's depressed take-home pay by diverting dollars from wages into premiums. For everyone, health spending puts upward pressure on taxes and downward pressure on other government programs.

Finally, there's energy. Despite their recent drop, oil prices at about \$65 a barrel remain well above the \$29 average of 2003. Combating global warming would also raise prices. Many Americans imagine that greenhouse gases can be cut painlessly—just order companies to do it. This is a fantasy. Most anti-global-warming policies aim to "put a price on carbon"—carbon dioxide is the main greenhouse gas—through a carbon tax or a "cap and trade" program. Under cap and trade, companies would receive permits to emit greenhouse gases; firms needing more permits would buy them from firms willing to sell. Prices of carbon-based fuels would rise, forcing people to use less or making costlier noncarbon energy, such as solar, more competitive.

The truth is that neither Barack Obama nor John McCain addressed these issues candidly. Oh yes, they had proposals, but most aimed (not surprisingly) at winning votes and not clarifying choices. Although both support cap and trade, for example, neither forcefully pointed out that to succeed these plans would have to impose higher energy prices. Each had a major health-care proposal that, though claiming to control costs, promised to expand insurance coverage and seemed more likely to increase spending. And naturally, each candidate endorsed new tax cuts and spending programs that, according to independent evaluations, would raise the already swollen budget deficit. There was a "something for nothing" aspect to both campaigns.

For a seriously flagging economy, bigger deficits might be the right medicine. They're classic "pump priming." For fiscal 2009, some economists expect the deficit to approach \$1 trillion, up from \$455 billion (3.2 percent of GDP) in 2008. But the usefulness of deficits is purely temporary, whereas they have become a semipermanent feature of American government—there have been only five budget surpluses since 1961. The deficits are simply another indicator of the mismatch between what people want from government and are willing to pay for through taxes.

Probably no plausible rate of economic growth could satisfy all Americans' desires for private and public spending. But some outcomes would be worse than others. If we can't reduce projected Social Security and Medicare spending, we may face unprecedented tax burdens that depress economic growth even more by reducing the rewards to work and risk-taking. Estimates by the Congressional Budget Office indicate that taxes might have to rise 50 percent (more than \$1 trillion annually in today's dollars) by 2030 to cover existing benefits. The alternatives are equally undesirable: draconian cuts in other government programs or massive deficits that would ultimately become unsustainable.

We have not modernized these programs to reflect changed social conditions. Eligibility ages should be raised gradually. People live longer (life expectancy was 62 in 1935 when Congress passed Social Security; now it's 78) and can work longer. Most jobs, having moved from factories and farms to offices, are less physically grueling. Many retirees have adequate savings that would allow them to rely less on Social Security and Medicare. Benefits could be scaled back for wealthier retirees. Our present system has in part created a reverse Robin Hood effect—it transfers income from the struggling young to the relaxed old.

We also need to be sensible about global warming. With today's technologies—which can change—little can be done. This is the harsh, perhaps tragic, reality. Four fifths of the world's energy

comes from fossil fuels: oil (35 percent), coal (25 percent) and natural gas (20 percent). By 2030, global energy consumption may increase 55 percent from 2005 levels, says the International Energy Agency. China, India and other poor countries would represent three quarters of the increase. These countries understandably won't sacrifice economic growth—reducing their poverty—to curb energy use. In India alone, about 400 million people still lack electricity. Expensive policies to reduce U.S. emissions could be a fool's errand: costly to our prosperity but barely affecting global warming.

Just producing cleaner, high-cost energy for its own sake makes no sense. Our main emphasis should be on research and development. The greatest hope of combating global warming lies in new technologies that would eliminate greenhouse emissions and produce, at acceptable costs, the energy that rich and poor countries need for economic growth. Carbon "capture and storage" would be one; battery-powered autos would be another. We could also adopt policies desirable on other grounds—such as reducing oil imports—that might slightly cut greenhouse gases. Higher fuel taxes, for example, would prod consumers to buy the more-fuel-efficient cars that Congress has mandated. (New vehicles are supposed to average 35 miles per gallon by 2020, up from 25mpg now.)

Whatever happens, the future of American affluence will be a state of mind as much as a state of production. So much of our national identity is wrapped up in economic progress that the failure to achieve it in palpable quantities would sap Americans' self-confidence. There have been other moments when the outlook seemed grim, but enduring American strengths—a widespread work ethic and strong entrepreneurial spirit—asserted themselves and disproved the conventional wisdom. After World War II, there were widespread fears of another Great Depression or, at best, a future of meager economic growth. What actually happened was just the opposite: a great boom that involved mass suburbanization and a prodigious outpouring of consumer goods—cars, appliances, televisions. Perhaps today's anxieties will prove equally misconceived.

But there's no doubt that the new president—Barack Obama or John McCain—arrives at a crucial juncture and not simply because the financial crisis seems so unfamiliar and threatening. It is not just domestic but global in scope; managing it will involve economic diplomacy as much as economic doctrine. As important, the great forces that propelled the economy forward for the past quarter century, fed by disinflation and the accompanying rise in personal wealth and borrowing, have clearly spent themselves. If the economy is to retrieve faster growth in the future, it will need to nurture new sources of advance.

Given the scope and scariness of the financial crisis, it has already stimulated massive government intervention—and there will be more. But there is a parallel danger that too much intervention, or the wrong kind of intervention, will suppress the impulse for expansion, investment and risk-taking. There will be scapegoating and plenty of plausible targets. But if the reaction and retribution, in the form of new regulations and taxes, are too repressive, they could also undermine the prospects for growth. For better or worse, the next president will sit at the eye of this storm. To advance American affluence will require the right balance between the past and future.

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