American Political Economy: Forty Years of Metastatic Normality

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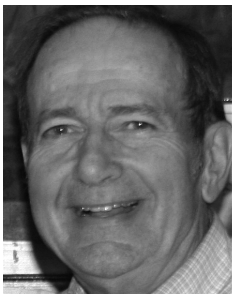
2018 Paxton Award Winner



Roland F. Moy earned the Ph.D. in political science from Ohio State University. After teaching for 30 years, primarily in the field of international studies, he retired from Appalachian State University in 1998. In addition to participation, presentations, and office holding in professional organizations, he was active in organizing Model United Nations events each year for both high school and college students.

A lifelong singer, he continues a century-long family tradition of quartet singing. He has also been active with the local Arts Council in organizing and producing musical shows to raise funds for music scholarships, and in producing fifteen annual summer community chorus events.

Since joining the Torch Club in Boone, NC in 2007, Moy has developed several papers that apply a core political science concern about abuse of power to the related field of economics. One of these won the 2012 Paxton Award.

This paper, his second Paxton-winning effort, was originally presented to the Wyoming Valley Torch Club. Some details were updated for its presentation at the Torch Convention in San Antonio this past summer, and for its publication here.

The election of 2016 produced a national administration that promised to accelerate annual economic growth from a modest 2 percent to a more robust 3 or 4 percent, using a combination of less regulation plus tax cuts on personal and corporate incomes. The evolution of economic activity over the past four decades offers evidence that this undertaking will face severe headwinds from previous changes in regulation and economic practice that severely curtail the possibilities of improving either overall economic production or productivity per worker.

Recent publications have described the contours of the past two centuries of economic growth patterns, which place the mid-twentieth century as a high point in reaping the economic rewards of earlier inventions and production innovations unlikely to be repeated in this century. By contrast, American economic and production patterns over the past forty years have resulted from globalization and were enabled by government policy changes on financial manipulation, and have metastasized into the sclerotic conditions that will greatly impede any major departure from the current political economy normality. The following presentation will expand upon these trends and concepts and conclude with a proposal for gaining momentum that would move America toward a new normal.

Long Term Trends

Robert J. Gordon's detailed presentation of data and discussion of living standard changes from 1870 to the present in his *The Rise And Fall Of American Growth* reveal the contours of change that support the conclusion of the book's title. The annualized growth rate of output per person reached 2.41% per year from 1920 to 1970, and the output per hour grew at 2.82% annually (14). This fifty year bulge in productivity significantly exceeds the 1.84% per person growth rate in the 1870 to 1920 period and the 1.77% figure from 1970 to 2014, as well as the output per hour of only 1.79 in the first period and 1.62 in the recent time frame. A chart displaying the three major components of productivity growth reveals that while the contributions of education and capital investment average about the same for the three time periods, the residual reflecting the underlying input of innovation and technological change is almost

triple for the middle 50-year period of 1920 to 1970 (16).

Multiple innovations during this time frame revolved around the many creative applications to be made of the two primary technological inventions of the nineteenth century that came into universal use during the mid-twentieth century decades: mass produced electricity and the internal combustion engine. Both inventions inspired innovative applications in workplace and farming productivity as well as improvements for household comfort and transportation. Providing the force multiplier that replaced animal and steam power across the country, electrical power and the internal combustion engine supported new powered tools and household appliances as well as new toys and entertainments.

The overview information provided by Gross Domestic Product changes do not capture the many improvements in living standards that occurred during this time, such as the elimination of the household need to haul water, wood, or ice; the value of instant communication; the improvement in health and life expectancy; or the availability and time for personal travel. By 1970 the rapid pace of conversion of the economy and household living to modern standards was slowing down as nearly universal participation was approached, and a variety of one-time changes were effected: the end of child labor, the broad expansion of secondary education, completion of a national and Interstate highway system, jet airplanes in common use, and the emergence of large scale female employment.

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According to Gordon's analysis, the innovations in information and communication technology of the post-1970 period have had a narrower impact, mostly in entertainment and convenience, rather than in continuing improvements in productivity. There was a small spike in productivity during the 1995 to 2004 decade with growth averaging 2.05 percent, but the decade after that averaged only 1.30 percent in productivity growth while reaching just 0.6 percent in 2014 (Gordon 328). This same general shape of twentieth century improvement-and-slowdown in economic and social wellbeing is also described in two chapters of *American Amnesia* as moving over the "Great Divide" of previous living standards and "Coming Up Short" in recent decades (Hacker). There are a variety of explanations about why recent decades have been sclerotic in economic growth and living standard improvement, with Gordon emphasizing a lack of game changing invention and Hacker focusing more on the lack of cooperative endeavor between government and the marketplace (see also Shapiro). Another recent publication, however, provides a detailed analysis in support of the conclusion that financial factors present major headwinds that both curtail private sector innovation and forestall cooperative nudges from government policy.

Metastatic Headwinds For Growth

The past forty years have witnessed many changes in financial sector operations and in the financial structure of business operations. These are described with great detail by long time business and economic journalist Rana Foroohar in *Makers And Takers: The Rise Of Finance And The Fall Of American Business*.

Up to the 1970s, major economic and workplace patterns were still largely shaped by the 1933 Glass-Steagall Act, which had separated commercial and consumer banking from speculative investment banking. Employee rewards and workplace standards were undergirded by union contracts that encouraged business decisions made with the interests of workers as stakeholders in mind, plus a wage floor provided by an adequate minimum wage.

The creep of toxic challenges to these established financial patterns began in the 1960s when First National City bank blurred the line

between lending and trading by inventing the negotiable certificate of deposit or CD. These began to function as a limited time savings account for companies and the rich who could afford the $100,000 buy-in and thereby reap the higher than normal interest rate. The bank also cashed in by trading the CDs on a secondary market that likely violated the Glass-Steagall rules, but neither the government nor the Federal Reserve offered any push back.

Then, in 1967, First National City introduced the first credit card, which helped start the trend that eroded the regulations regarding interest rates and the price of credit. The success of these profit sources led to a name change to Citibank in 1976 and to emulation among other financial institutions seeking high-yield products. Further innovation brought the first mutual funds, the packaging of mortgages into securities, and the first derivatives in the form of futures trading. The lure of higher yield from these securitization options helped to turn finance and banking into a more self-contained high-stakes Wall Street sector, rather than a utility that facilitated Main Street business. There was also a gradual erosion of the Regulation Q interest rate ceiling that was designed to curb the unbridled credit growth that leads to speculation, bubbles, and financial crises. Gradual credit growth is needed on Main Street to facilitate consumer spending and home buying, but the corporate desire and lobbying to grow the trade in CDs and other submarkets prompted the government and the Federal Reserve to "let the market decide" the rate of credit growth, rather than to confront the political challenge of establishing, by law or by stipulation, reserve requirements that prioritized lending to individuals over lending to corporations. This challenge is still with us.

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The 1970s also saw the first steps to broaden financial speculation globally. In 1974, Wall Street lobbying induced the government to overturn a law forbidding US commercial institutions to make loans to risky third world nations in need of development cash. By the end of the decade, many of these loans were in default, leading to US government bailout packages for countries in trouble (such as Mexico) and for American banks (such as Citi), thereby confirming that in practice some market firms are too big to fail. Despite this newly confirmed political economy challenge, the risks and volatility of the domestic market were further increased when in 1980 the Carter administration was prompted to abandon Regulation Q entirely, thereby opening "a whole new world of variable-rate mortgages, ever more complex securities, derivatives to hedge them all, and the rapidly swelling financial institutions that would make vast fortunes on them […]" (Foroohar 52). For the Main Street consumers baffled and disadvantaged by this new reality, and as a replacement for the governmental regulatory standards that had been adopted in response to the free-wheeling financial manipulations of the 1920s that had led to the Great Depression, the financial industry's answer was to preach the need for more "financial literacy."

The Reagan administration added fuel to the financialization fire. The 1981 tax reform sharply lowered the tax on capital gains, setting the stage for the current practice of Wall Street transaction income being declared "carried interest" to avoid the higher income tax rate. In 1984 Reagan signed the Secondary Mortgage Market Enhancement Act, which exempted mortgage-backed securities from state regulation of new financial products, removed restrictions against institutions like pension funds from investing in these risky financial instruments, and required ratings agencies to play a role in ensuring low-risk quality for investors. What could possibly go wrong? As was revealed after the 2008 economic crash, the ratings agencies were put in the moral

hazard position of being paid for their services only if the security sold, leading to an abundance of AAA and other undeserved ratings.

The 1980s also witnessed U.S. support for relaxing international currency controls, allowing a huge increase in capital flow around the world, making it easier to invest in cheap labor production in third world countries and to place speculative bets on currency values. Globalization was now on steroids. This decade also saw tax rule changes that fueled a booming business in Leveraged Buyouts (later called Private Equity transactions): short-term money-makers that used tax-deductible borrowed money to buy targeted companies. In many of the leveraged buyouts, dividend payouts and fee earnings for the Wall Street investors were boosted for a few years by laying off workers deemed surplus and slashing research and development expenses (Kosman). The depleted company would then be sold and be at risk as another Main Street bankruptcy.

The relaxation of rules for investment banking continued into the 1990s. The Gramm-Leach-Bliley Act, passed in 1999, repealed the remnants of the 1933 Glass-Steagall Act that had separated investment from commercial banking. The following year, the Commodity Futures Modernization Act exempted most derivatives and credit default swaps from regulatory scrutiny. Rewards for the financial sector continued in 2003 when the capital gains tax rate was cut to 15%, and in 2004 the Securities and Exchange Commission (SEC) was successfully lobbied to remove rules that capped leverage at fifteen to one. That same year the SEC also lifted a rule specifying debt limits and capital reserves, allowing firms to police themselves (self regulation) in the marketplace using their highly touted mathematical risk models. The stage was thereby set for huge profits to be made on Wall Street through financial instruments little known to regulators or to the general public and through proliferation of off-the-books "shadow banking" practices using "structured investment vehicles" to hide the actual level of risk in play, thereby evading the remaining capital requirement rules (Foroohar 60). These practices also led to the economic crash reality check of 2008, the subsequent bailout of firms too big to fail, and the current huge profits still acquired by these same firms despite efforts at supervision under the Dodd-Frank legislation passed in 2010.

The financial sector still represents only 7% of the economy, but manages to acquire 25% of all corporate profits while creating only 4% of all jobs (Foroohar x). The low percentage of jobs relative to profit results in part from the current practice of computerized arbitrage-trading, which "...us[es] flash programs designed to trade on fractional price changes over split-second time intervals, reducing the average holding period of a stock from about eight months in the 1960s to just four months by 2012" (Forhoohar 113). The plethora of pathological practices still in place in the financial sector have turned Wall Street trading and related activities into an economy-dominating profit center, rather than a utility serving the larger corporate economy based on Main Street. This skewed situation will impede any attempt to boost broadly based economic growth. Efforts to undercut Dodd-Frank regulations will continue (Merle), as in the successful last minute amendment to the must-pass spending bill of December, 2014, that allowed Wall Street banks to eventually add up to $10 trillion in risky swaps trades to their books (Warren 155).

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Corporate Pathologies

The dysfunction of American corporations in recent decades is primarily a result of the metastatic growth of shareholder value rewards to the detriment of all other considerations, coupled with the decline of labor union pushback. The primacy of shareholder value gained legal standing with the 1919 Michigan Supreme Court

case *Dodge v. Ford Motor Co.*, in which the Dodge brothers successfully sued to force the Ford Motor Company to use profits to pay dividends to them and other shareholders instead of investing in more and better production. This precedent gained more importance with the 1982 SEC decision to allow stock buybacks to boost their value for shareholders, a group that now included corporate executives rewarded with stock options; this pattern was embellished in the 1990s when executives were allowed to buy company stock at below market rates. Instead of providing longer term value by improving products and production efficiency, the short term interest in rewarding shareholders and executives has induced a pathological desire to artificially boost share prices such that:

> S&P 500 companies have spent $4 trillion on buybacks between 2005 and 2015, representing at least 52.5 percent of their net earnings, and another $2.5 trillion on dividends which amounted to 37.5 percent. In 2014, buybacks and dividends represented 105 percent of net earnings of publicly traded American companies; in 2015, they reached above 115 percent. (Foroohar 131)

The low interest rates of the post-2008 years were meant to encourage Main Street business growth and home ownership. Instead the low rates have encouraged stock buy-backs on borrowed money, investor domination of the stressed housing market, and a booming stock market, developments which have all primarily benefited Wall Street and harmed Main Street savings account earnings. This pattern in corporate America shortchanges the other economic elements that help to make a thriving economy and long-term growth including, investment in research and development; higher wages that boost consumer spending; and investment in worker training to match (the missing) capital goods improvements.

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Our primary competitors in Europe and Asia do not follow this pattern of misapplying net profit, so the competitive prognosis for future American growth is problematic. Too many American firms have boosted profits by cutting costs and investment, rather than by selling more and better products. The result is that the current recovery is based not upon organic growth, but from government policies influenced by corporate lobbying plus corporate contrivances that have caused profits to peak in 2015 and then to flatten and fall (Foroohar 145). And now we are privileged to observe how a CEO President attempts to reshape government to work more like a corporate business.

A New Normal?

Proposals for improvement must cope with the toxic headwinds described above. Forty years in the making, they have not only held back economic production and productivity improvements, but also fostered less economic parity and more political unrest. Both production and productivity may continue to improve with robotic automation in the workplace and artificial intelligence applications for driverless cars and trucks, among other things; these innovations would increase efficiency and wealth for those owning the technology, but not provide dignified work and security for the masses. An optimist can call for improved education and training to take advantage of accelerated changes in technology, globalization, and climate change (Friedman). Following this advice may produce extraordinary results for the select few who succeed on this path, but it will not provide a floor for a living wage across the economy nor make the game-changing innovations that could jump-start a higher sustained level of economic growth or of productivity gains.

It is more likely that workers will be displaced by automation and, if we accept the notion advanced by some that people

are worth only what they earn[1], become part of a class of useless poor people. This depressing possibility, plus misplaced faith in tax cuts as an economic fix (Hassett)[2], provide little reason to be optimistic about significant change for the better within the current economic sclerosis and the civic religion framework that blames poor people for being poor.

Another response is the movement calling for a paradigm shift: Universal Basic Income support in a "post-work society" (Livingston). This support would provide enough for a non-poverty existence, with each adult choosing how much employment income they desire to supplement it. Some libertarians like it as a way to reduce the welfare state. Most liberals view it as a living wage platform that might ensure well-being, secure greater freedom to choose career options, and provide leverage to negotiate suitable employment conditions. A step in that direction might include a transformation of the Earned Income Tax Credit into a full negative income tax that provided income to all poor households. One estimate of cost places it at $250 to $300 billion, which might justly be paid for with a Wall Street financial transaction tax (Block). If such a program is ever initiated, it would help not only to overcome the income inequality divide, which would boost both consumer demand and production, but also to promote the solidarity that undergirds our constitutional stability.

The political mobilization that has been evident since early in 2017 would be a necessary starting point for such a new normal to emerge. But it would have to overcome the 2016 winning election strategy that cleverly misdirected legitimate grievances away from the actual problems, as discussed above, while being financially backed by the Wall Street and corporate interests that have benefitted from the forty year metastatic concentration of wealth and power. We may yet undergo a validity test of the famous observation by jurist Louis D. Brandeis: "We may have democracy, or we may have wealth concentrated in the hands of a few, but we cannot have both."

NOTES

[1] Billionaire administration backer Robert Spencer is reported to believe that "human beings have no inherent value other than how much money they make." (Levitz)

[2] Analyses of data from 1945 to 2012 show that reductions in the top capital gains tax rate and top marginal income tax rate do not appear correlated with savings, investment, economic growth, or productivity growth. Such tax cuts do appear to be associated with increasing concentrations of income at the top of the income distribution. (Hungerford)

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