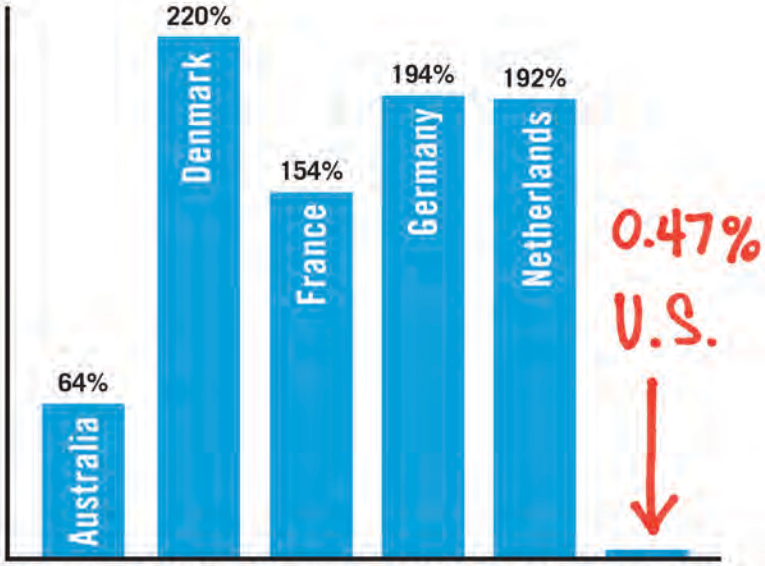
What Went Wrong

HOW THE 1% HIJACKED THE AMERICAN MIDDLE CLASS

... AND WHAT OTHER COUNTRIES GOT RIGHT



GROWTH IN TOTAL EMPLOYEE COMPENSATION SINCE 1985

GEORGE R. TYLER

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COVER CHART

The chart on the front cover shows the changes in total labor compensation between 1985 and 2008 for production employees in manufacturing, adjusted for inflation using the Consumer Price Index. Total compensation is comprehensive employer costs including: wages, bonuses, benefits, government taxes, and fees. This time series was chosen because it is the most uniform international data set on wages covering the past three decades. A chart depicting the time series for wage data alone would be similar.

Source: "International Hourly Compensation Costs for Production Workers in Manufacturing (wages, all benefits, social insurance expenditures, and labor-related taxes)," Department of Labor, Bureau of Labor Statistics, Washington, http://www.bls.gov/fls/pw/ichcc_pwmfg1_2.txt, March 2011, and "Consumer Price Index," OECD.StatExtracts Organisation for Economic Co-operation and Development (OECD), Paris, December 2012, http://stats.oecd.org/Index.aspx?DatasetCode=MEI_PRICES#.

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CHAPTER 1

FACING REALITY

"We have forgotten that the economy is a tool to serve the needs of society and not the reverse. The ultimate purpose of the economy is to create prosperity with stability."[1]

SIR JAMES GOLDSMITH,
CEO, the Goldsmith Foundation, 1994

"While America's super-rich congratulate themselves on donating billions to charity, the rest of the country is worse off than ever. . . . Millions of Americans are struggling to survive. The gap between rich and poor is wider than ever and the middle class is disappearing."[2]

THOMAS SCHULZ,
***Der Spiegel*, August 19, 2010**

"That was the old curve. Then I drew the new one. It curves down: wages don't rise; you can't get on the property ladder. Fiscal austerity eats into your disposable income. You are locked out of your firm's pension scheme; you will wait until your late 60s for retirement. . . . This generation of young, educated people is unique—at least in the post-1945 period: a cohort who can expect to grow up poorer than their parents."[3]

PAUL MASON,
***The Guardian*, July 2012**

Americans have long been proud of their economy. And why shouldn't we be? From the time we were children, we've been told that we live in the best country in the world, with the most expanding and dynamic economy. We've been told that our economy allows Americans to enjoy a lifestyle that is the envy of the world. And we've been told that we live in the home of the American dream, a country that—more than any other—allows people to rise up from poverty into the ranks of the rich. But is it really true?

Unfortunately, the answer is no. These things haven't been true for a long time. But they used to be true.

In the period from 1946 to 1972, America experienced the longest and most robust period of wealth creation the nation has ever experienced.

Year after year, the economy grew substantially. Productivity growth was equally dramatic. Businesses experienced strong profits, and employees experienced steady growth in wages. It was a golden age for America, and, throughout this book, I'll refer to this period of time as the golden age.

Most of the major industrialized countries experienced similar growth. Because of the rebuilding after World War II, and the aid afforded by the Marshall Plan, many European countries grew even faster than the United States. Every country's experience was unique, driven by their particular circumstances, but, overall, the trend was up. Economies grew, businesses thrived, and wages expanded.

Moving into the mid-1970s, America's economic performance suffered. Stagflation—inflation combined with minimal economic growth—eroded wages and profits, weakening business and consumer confidence. Escalating energy prices and an overly loose monetary policy were the major causes. In August 1979, President Jimmy Carter appointed Paul Volcker as Chairman of the Board of Governors for the Federal Reserve System. Volcker is widely credited with ending stagflation by tightening credit, and by 1983 inflation was back to a relatively healthy 3.2 percent. In November 1980, Ronald Reagan was elected president and took the economy in a dramatic new direction, a direction that, with some twists and turns, has continued to this day. Throughout this book, I call this new direction Reaganomics, in honor of the man identified most closely with this new economic direction. But Reagan isn't alone. As we'll see, Presidents George H.W. Bush and Bill Clinton did very little to change this direction. President George W. Bush doubled down on Reaganomics, and President Barack Obama, amid a gridlocked Washington, has been stymied in efforts to change it.

We've been living under Reaganomics since the 1980s, a span I call the Reagan era. Please be clear that I'm referring to the entire period from 1980 until now, and not just the duration of Reagan's presidency.

I'll define Reaganomics in detail later in the book, but for now, this brief description will suffice. Reaganomics is a version of *laissez-faire* capitalism that emphasizes a minimum of regulation, especially in the financial sector; a lowering of taxes, especially on the wealthiest individuals; rapid growth in government spending, especially on national defense; and an indulgent attitude toward the business community.

The Impact of Reaganomics

Economists are critical of the overall impact of Reaganomics on productivity and family prosperity. Yet millions of ordinary Americans believe it

has been a positive recipe for the country, a perspective I believe ignores the big picture. As we shall see throughout this book, Reaganomics has been unkind to most Americans.

The failure of Reaganomics is not limited to income erosion. The growth in American productivity dropped precipitously over the Reagan era. Productivity growth is not discussed much in the United States (it is in some other countries, as we shall see), but it's the single most important measure of economic performance. Productivity is commonly defined as total production divided by the number of labor hours. Raising productivity is the only way that inflation-adjusted salaries can increase on a per capita basis. During the golden age, productivity grew an average of 2.8 percent per annum; it slumped during the stagflation of the 1970s and then averaged a third lower, at 1.9 percent through 2011.

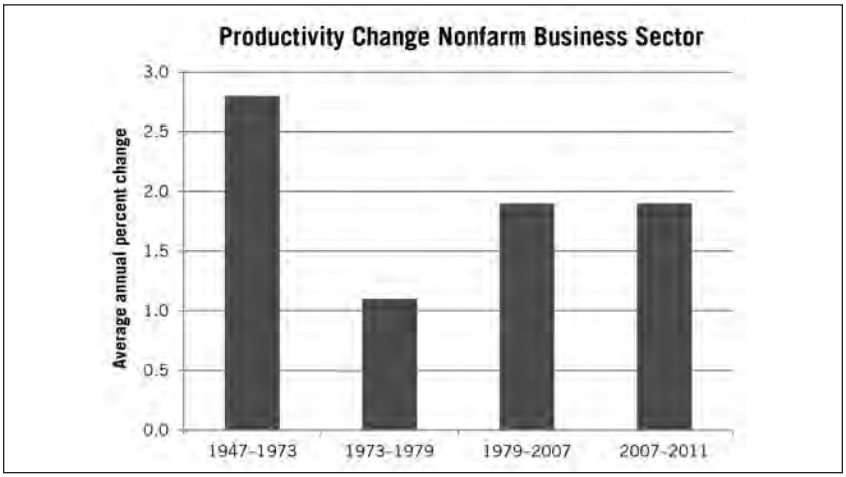

Chart 1.1.
Source: "Productivity Change in nonfarm business sector, 1947–2012, Bureau of Labor Statistics, Washington. http://data.bls.gov/cgi-bin/print.pl/lpc/prodybar.htm.

Despite the slowdown in productivity growth during the Reagan era, there was still room for both wages and profits to grow, although at more modest levels than in previous years. But that didn't happen; average wages went flat or worse in the Reagan era. So where did the gains from rising productivity growth go? Virtually all of the gains flowed into corporate profits and into earnings at the very top of the income pyramid. To be precise, economists Emmanuel Saez and Thomas Piketty have concluded that only 5 percent of earners enjoyed income gains exceeding inflation during the Reagan era, and most of that was concentrated in the earnings of the top 1 percent. That is why income disparities widened noticeably.[4,5]

Such a skewing of incomes over a span measured in decades is unlikely to be a chance event. Rather, it was the outcome of Reaganomics, a replay of the Gilded Age of the 1920s when the business community was also weakly regulated. Here is how Harvard professor Alexander Keyssar summarized Reaganomics:

> "It's difficult not to see a determined campaign to dismantle a broad societal bargain that served much of the nation well for decades. To a historian, the agenda of today's conservatives looks like a bizarre effort to return to the Gilded Age, an era of little regulation of business, no social insurance and no legal protections for workers."[6]

Pundits have come up with explanations for the economic outcomes of the Reagan era, including technological change and globalization. But these explanations make little sense when we consider that labor compensation in other rich democracies rose briskly.

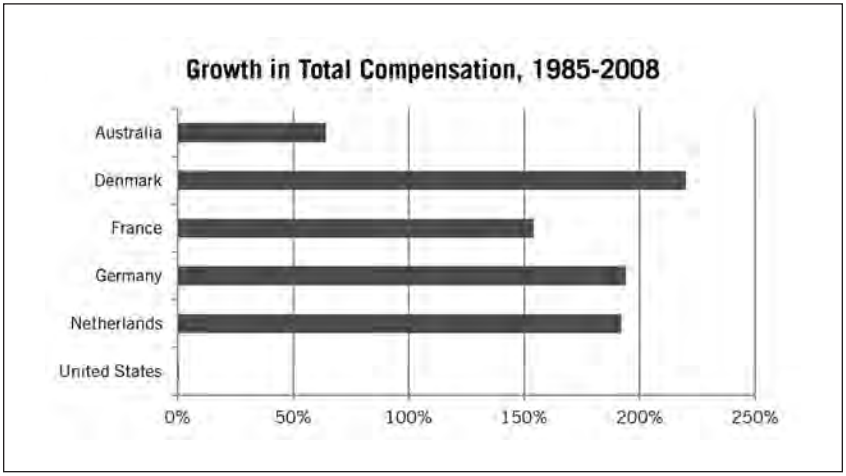

Chart 1.2. Inflation-adjusted total labor costs per hour in dollars.
Source: "International Hourly Compensation Costs for Production Workers in Manufacturing (wages, all benefits, social insurance expenditures and labor-related taxes)," Department of Labor, Bureau of Labor Statistics, Washington, http://www.bls.gov/fls/pw/ichcc_pwmfg1_2.txt, and "Private Consumption Deflators," Economic Outlook No. 90, December 2011. OECD, Paris, http://stats.oecd.org/Index.aspx?QueryId=32463#.

The problem with this line of reasoning is that other countries were also affected by these phenomena. Technology change impacted Australia. Germany, France, and Denmark are far more exposed to globalization than America is. Yet none of these countries experienced the stagnant wages that America is still facing.

The lesson is that the different outcome in America has nothing to do with these various economic forces like globalization. Instead, it has

everything to do with the economic choices America's leaders in Washington made in responding to these forces. They made different choices than leaders abroad, and so the outcomes were different. The experience abroad confirms that there is an alternative to Reaganomics. I call it "family capitalism," and it's what America practiced with great success in the decades following World War II.

The Alternative: Family Capitalism

Family capitalism, like Reaganomics, is based on free-market economics. But it recognizes that the market isn't perfect. In particular, family capitalism:

- Understands the importance of selective government regulation, particularly in the financial sector.
- Puts a premium on long-term productivity growth.
- Recognizes and modulates the dangers of corporate influence on government.
- Puts a priority on long-term growth in wages as the key to family prosperity.

Based on the above principles, there are more than a dozen rich democracies around the globe practicing family capitalism. Because of data availability, I focus on eight of them: Austria, Australia, Belgium, Denmark, France, Germany, the Netherlands, and Sweden. Throughout this book, we'll compare the Reagan-era performance and practices of these eight countries with those of the United States. The results, I warn you, won't be pretty.

I don't claim that these eight countries all follow the same practices. They don't. There are distinct difference in their economies and their politics, ranging from Sweden, where the government plays a very large role in the economy, to small-government Australia, which the conservative Heritage Foundation rates as "more free" than the United States.[7] Even so, there is a similarity in economic policies and outcomes, which allows me to classify them all as Family Capitalist countries.

Further, I don't claim that these eight countries get everything right. For example, all but Australia belong to the free trade zone embodied in the European Union, an alluring but incomplete concept that jeopardizes the future of the northern European economies. The lessons reviewed in

this book are not related to these macroeconomic troubles, however, but are drawn from the internal mechanisms that Australia, Germany, and others successfully utilize to broadcast the gains from growth broadly among families within national borders. There are definitely things each of them can learn from American approaches. But, overall, the data on wage growth forces me to conclude that they get it right more often than we do. Once you review the data, I think you'll agree.

Because most of the Family Capitalist countries are European, it's easy to conclude this is a review of the big government aspects of northern Europe. Certainly, conservative politicians frequently caution Americans of the danger posed by the European social welfare state, and delight in accusing political targets of harboring secret ambitions to transplant that model to America. I am advocating no such thing, as the inclusion of low-tax Australia evidences. With the world's highest median wealth, it shows that economic outcomes rather than the size of government are determinant in this book.[8] As you will see, the lessons they offer have nothing to do with high or low tax rates or big or small public sectors. Moreover, family capitalism is as American as apple pie. It's the system we practiced from the end of World War II until the 1970s, the most prosperous period of our nation's history. If not invented here, America's golden age certainly put wind beneath its wings as a goal eagerly adopted overseas.

How I Got Here

I bring a practical amalgam of training, background, and experience to the analyses of national economic goals and structure in *What Went Wrong*. My insight about the different outcomes in the United States and abroad was reached partly as a byproduct of helping establish a nonprofit organization in Europe to conduct medical research. Despite the ease of travel, few Americans beyond a tiny number of executives at multinational firms and banks have reason to develop familiarity with the Australian or northern European economies. And even fewer American scholars bother since the demise of the Cold War demoted the US study of comparative economic systems to an academic backwater.

My experiences over more than a decade of travel and consultation in Europe have provided a rare opportunity for a seasoned American economist with a background in international economic issues. I became immersed over this period in the structure, nuances, and current operation of the northern Europe economies, particularly their wage mechanisms, corporate governance, and labor market policies. I began applying typical professional standards of observation and analysis in gathering and

synthesizing the information about the European economies presented here, later adding the Australian economy as well.

My career provided me a leg up in this analysis, beginning with several decades as an economist in the US Senate working for the admired Hubert Humphrey toward the end of his fruitful life. Later I joined Senator and then Treasury Secretary Lloyd Bentsen, a trade and tax expert. My work involved analysis of a wide variety of issues ranging from budgets to energy policy, taxes, and trade policy. And that experience broadened further during my several years early in the Clinton Administration at the Treasury Department. I worked primarily on budget issues involving international financial institutions including the International Monetary Fund (IMF); the development banks for Eastern Europe, Latin America, and Asia; and on international trade legislation (the North American Free Trade Agreement, or NAFTA). The months of work on NAFTA, in particular, sparked my interest in wages and outsourcing issues, which continued during my subsequent work at the World Bank. Work with the development banks provided me with an intensely useful education in the various models of capitalism across the globe.

After developing real estate projects for some years, I collaborated in 1998 with a senior official at the Institute of Medicine, in crafting an innovative concept to stimulate the development of medicines for neglected tropical diseases. That process included a period of conferences and meetings abroad, with the concept eventually being embraced in 1999 by the international aid group Doctors Without Borders.[9] Several years of collaboration followed as the *Drugs for Neglected Diseases* initiative took shape.

Helping establish a nonprofit in Geneva with a €15 million budget and serving over the last decade on its audit committee involved considerable research of and exposure to uniquely European wage and business practices. I learned firsthand the nuts and bolts of European capitalism, an education that took on a life of its own. It has become enriched in the years since with serious scholarship, a heavy dose of statistics, and interaction with international financial and labor economists. That has enabled me to take the full professional measure of the starkly different economic goals and wage determination schemes in Reagan-era America and in the family capitalism countries.

The bottom line is this: Voters in nations such as Germany, the Netherlands, or Australia expect everyone—from the corner grocer to government officials and corporate CEOs—to prioritize family prosperity. They demand government standards and rules that prioritize rising wages nationwide, quality education and upskilling opportunities, and the creation and maintenance of high-quality jobs. Enterprise serves

families—not the other way around. The three most important topics on voters' minds are: wages, productivity, and how much of the rise in labor productivity growth flows to families.

While the family capitalism countries are rich democracies like the United States, their goals and outcomes are so dissimilar from America since the 1980s that they seem to be operating on different planets, as you will see.

Can This Be Right?

This book argues that, beginning in the 1980s, America took a wrong turn. That is why, over the next thirty years, our economy has delivered substantially less to its citizens than the eight family capitalism countries that avoided the pitfalls of Reaganomics.

That may be difficult to accept. Virtually every American has grown up believing in the superiority of our economy. We've felt almost contemptuous of "old Europe" and its sclerotic economic system. Surely these countries cannot be delivering what America has not—higher wage growth, higher productivity growth, and more economic opportunity?

I'll begin making this case by addressing several issues.

First, the statistics I use are publicly available through US and foreign government agencies, including: the Organization for Economic Cooperation and Development, the IMF, United Nation agencies, peer review professional journals, and books by respected economists from Niall Ferguson to Paul Krugman.

Second, I conclude that families in the family capitalism countries have economically overtaken American ones, a puzzling assertion since American Gross Domestic Product (GDP) per capita is higher. Like oil-rich Norway or banking center Luxembourg, US GDP per capita is higher than the family capitalism countries, but that reveals nothing about whether that output translates into compensation for ordinary employees and families. Indeed, all nonpartisan economists acknowledge that growth in the economy since the 1980s has gone almost entirely into corporate profits and the incomes of the very richest Americans. Having relatively large energy and banking sectors adds to US GDP, but only a portion is translated into wages.

Third, some might argue that this skewed allocation of the gains from growth is temporary. The major principle of Reaganomics is that by freeing up business to maximize profitability, wealth will be created, which—ultimately—will benefit all. If you are old enough to remember the beginning of the Reagan era, you'll recall that this was once called "trickle-down economics." Well, thirty years on, most families are still waiting for trickle down to deliver.

It's Not Reaganomics, It's Globalization

Another argument is that globalization and outsourcing of jobs, not Reaganomics, are responsible for weak wages. But as I noted previously, this argument is belied by the experience of the family capitalism countries. In fact, globalization strengthens my argument. Due to the relatively high international trade intensity of the family capitalism countries, globalization has impacted them much more severely than the United States. So the difference must not be in globalization itself, but in the policies crafted in reaction to it.

The unfettered international flows of capital, technology, and goods characteristic of global integration have dramatically improved global economic efficiency. Overall, this is a good thing. But the American experience demonstrates that those same forces pose an existential threat to the high wages and living standards of the rich democracies if not remediated. This book reveals that policies to ameliorate the dangers of globalization and to maximize its benefits can succeed. And the evidence is provided by the different outcomes of policies pursued during the Reagan era by an indifferent Washington in contrast to policies by leaders in cities like Berlin, Canberra, Copenhagen, Paris, and Vienna.

Washington officials in the throes of Reaganomics refused to ameliorate the forces of global integration, leaving families like deer in the headlights; they abandoned American families to become mere commodities in hostile labor markets. Washington rejected intervention, such as reformed corporate governance or upskilling of workforces, to instead honor the dictates of the marketplace as interpreted by US multinationals and Wall Street. The impact on virtually all Americans was severe.

The erosion in US wages is mostly a consequence of quite profitable firms across America demanding large-scale wage and benefit concessions across the board, freezing total employee costs in real terms, adjusted for inflation. Nearly unique among rich democracies, American executives have been on a tear for decades, aggressively capping employee costs because—well, because they can. For a while, rising outlays for health care and other fringe benefits offset some of the wage erosion, but that ceased to be true nearly a decade ago. In contrast, overseas in the family capitalism countries (and during the golden age in America) there is an aversion by healthy companies to arbitrarily freezing or lowering the compensation of good employees.

For example, the beverage conglomerate Dr. Pepper Snapple Group in 2010 demanded $3,000 wage concessions, froze pensions, and reduced fringe and health care benefits at its Mott plant in Williamson, NY. These givebacks were demanded despite Dr. Pepper Snapple earning

profits of $555 million in 2009 on sales of $5.5 billion, an enviable 10 percent profit margin during a soft year.

Like many other US employers now, Dr. Pepper Snapple didn't bother even to intimidate employees by threatening to export jobs. Instead, the company warned of hiring replacement workers for as much as one-third less from the same Williamson area. The message was take it or leave it. What happened to the costs savings from these lower wages? Dr. Pepper Snapple increased its dividend by 67 percent in May 2010.[10] Indeed, the profits of Dr. Pepper Snapple are indicative of a remarkable aspect to this dispiriting wage trend of the Reagan era. Families have experienced falling wage offers from profitable firms for the first sustained period ever in American history; yet voters, and thus Washington officials, appear indifferent to highly profitable firms like Mercury Marine or Harley-Davidson cutting wages to bolster profits.[11]

With little public debate, Washington policy allowed American jobs to become disposable, which allowed family prosperity to become vulnerable. Iconic firms like Apple shifted millions of jobs to cheap and subservient labor forces abroad willing to work 12-hour, six-day-a-week schedules, the ideal docile and disposable labor force in the eyes of Reagan-era American executives. This outcome was facilitated by the pecuniary foundation of US politics and an increasingly marginalized trade union movement.

When challenged, firms that have exported jobs obfuscate the facts. When the impact of offshoring jobs is pointed out, executives frequently blame the victims. They blame American employees. As an example, one Apple executive mendaciously justified his Chinese labor force this way: "The US has stopped producing people with the skills we need."[12] Well, it's theoretically possible that Apple is really responding to the superior training of Chinese workers, rather than their $145 per month salaries, but I seriously doubt it.

In contrast, the family capitalism countries were proactive, prospering despite the tumult of global integration. They rejected trade controls, the commoditization of workers, and market fundamentalism in favor of canny mechanisms to maximize productivity and family income growth. Unhampered by ideology and buttressed with centuries of vigorous economic debate between the likes of Adam Smith and Friedrich Hayek, they focused on meeting election mandates demanding family prosperity.

It wasn't that difficult to accomplish, because these rich democracies came armed to the existential struggle with better tools than America. They have political systems dominated by voters instead of donors, a superior hyper-competitive corporate governance structure, and an

electorate strongly appreciative of the wealth free trade creates and keenly sensitive to the role of wages in driving the prosperity of the family.

Leaders in these nations reacted with dispatch, transforming the dangers of global integration into broadly based prosperity. Protectionism was avoided and even aggressively attacked when identified abroad. These nations didn't experience an American-style stagnation of wages and offshoring of jobs. Instead, Australia and northern Europe pursued policies informed by the best and brightest trade economists of our age.

Drawing on the theories of David Ricardo, for example, economists Paul Samuelson and Wolfgang F. Stolper had concluded as early as 1941 that international trade creates long-term losers as well as winners. So leaders abroad crafted remediation: a balance of clever mechanisms maximizing the gains from globalization and broadcasting those gains to families, while minimizing its harm to jobs and wages.

This reality reveals the hollowness of complaints by American firms such as Apple that routinely warn about high American labor costs and mediocre skill levels. Adam Smith, whose book, *The Wealth of Nations*, marked him as the father of capitalism, had heard the same thing when writing back in the eighteenth century. Like today, profits were high, but British business leaders in 1776 nonetheless vented about high wages harming sales. Smith would have none of it.

"Our merchants and master-manufacturers complain much of the bad effects of high wages in raising the price, and thereby lessening the sale of their goods both at home and abroad. They say nothing concerning the bad effects of high profits. They are silent with regard to the pernicious effects of their own gains. They complain only of those of other people."[13]

In the end, we are forced to conclude that the gap between US outcomes and those of the family capitalism countries is real. It isn't an artifact of the data. It isn't a sensible tradeoff between conflicting beliefs. It's not a short-term problem that will go away. And it's not an inevitable result of globalization. The United States simply made a fundamentally wrong turn. What could have been a temporary sidetrack became the main track—and American families are still paying the price decades later.

CHAPTER 2

WHAT IS REAGANOMICS?

"We are a low-wage country compared to Germany."[1]

KRISTIN DZICZEK,
Director, Center for Automotive Research, Detroit

"In the great days of the USA, Henry Ford stated that he wanted to pay high wages to his employees so that they could become his customers and buy his cars. Today, we are proud of the fact that we pay low wages."[2]

SIR JAMES GOLDSMITH,
CEO, the Goldsmith Foundation, 1994

"The idea that markets are self-regulating received a mortal blow in the recent financial crisis and should be buried once and for all. . . . Markets require other social institutions to support them. They rely on courts and legal arrangements to enforce property rights and on regulators to rein in abuse and fix market failures. . . . In other words, markets do not create, regulate, stabilize or sustain themselves. This history of capitalism has been a process of learning and relearning this lesson."[3]

DANI RODRIK,
Harvard University, *The Globalization Paradox,* 2011

The period from 1946 to 1972 created the great American middle class. Breadwinners returned from World War II to a vibrant economy. The boom extended for decades, creating good jobs for farmers' sons like Augustine Powell, profiled by Jonathan Mahler in the June 2009 *New York Times Magazine*.[4] Augustine and his wife, Marva, arrived in Detroit in the 1960s; they were fresh off the farm and Augustine eventually ended up on the assembly line at General Motors.

Wages rose steadily, thanks to laws like the Wagner Act that helped open the door wide to solid union jobs for millions of men and women. As in Australia today, the United Auto Workers (UAW) and other trade unions had taken care of the rest—winning regular wage hikes that matched rising productivity and kept pace with profits—while also providing health insurance and the promise of a secure retirement.

Moreover, heavy manufacturing—autos, for example—set the standard across America's industrial heartland for livable wages, enabling tens of millions of hardworking Americans like Augustine to earn their way into the middle class.

A few years before coming to Detroit, Augustine and Marva had married. Two sons soon followed, joining millions of others in the post-war baby boom that became the largest cohort in American history. Almost all of these families rented for a while and remained careful with their spending as they held onto their hardscrabble habits from the Great Depression. But with wages rising faster than inflation, most could soon afford the down payment on a home like the one Augustine and Marva bought on Curtis Street, in a good school district with stores close by. Fishing boats rested on trailers and nearly new cars sparkled in carports. They were living the dream envisioned by Adam Smith and Henry Ford.

Your parents or grandparents were probably raised in homes on streets just like Curtis and, perhaps like Augustine, went vacationing to visit relatives all over the South and Midwest, or perhaps as far away as Niagara Falls or even exotic California. And the best part was the future for their children: college was affordable and the sky was the limit. It was a period your parents or grandparents cherish, and for good reason: it was the most miraculous period of broadly rising prosperity in American history.

Perhaps the best part of this magical era was that Augustine's grit and determination paid off back then, with regular wage increases arriving like clockwork. He—and millions of others—gave their hearts to corporations and most received a piece of the American Dream in return, creating a golden age for aspiring men and women from even the meanest roots. And, importantly, executive suites saw men like Augustine as their partners in that prosperity, critical to driving firms forward. CEOs viewed themselves as collaborators in the footsteps of Henry Ford in creating prosperity and the best America possible, investing heavily in new plants and in upskilling, and paying rising wages, because higher productivity meant even higher profits in the future. American income distribution grew more equal than ever in history.

Importantly, banks were corralled. Federal Reserve System chiefs William McChesney Martin, who retired in 1970, and later, Paul Volcker, had taken the lessons of the Great Depression to heart. Regulations were tough. Wall Street and local bankers were forced to be cautious and methodical, careful with your money, not jittery financial entrepreneurs seeking windfalls, eager and able to gamble with your deposits. And they earned far less than executives at firms such as GM, which actually generated real wealth. Manufacturing careers were the ticket to a bright

future back then, rather than the financial engineering jobs of today, conjuring opaque securities. That same prudent mentality carried over to the government, where federal budget deficits were tiny, with taxes and spending nearly in balance and the national debt from World War II shrinking steadily under both Democratic and Republican presidents.

Not all Americans benefited, though. There was plenty of poverty, especially among discriminated minorities. Poll taxes and literacy tests restricted the right to vote across the South until 1964. Too many schools were poor and the economic safety net was weak. Michael Harrington's 1962 book *The Other America* provides a sober and accurate portrayal of desperation amid the rising plenty back then. Yet, with the gains from trade and growth being broadly enjoyed, the economic life for virtually every American improved. Income wasn't being redistributed by government, but instead simply flowed to those like Augustine who increased productivity, rewarding hard work. It was a slow grind, with real incomes inching ahead 1 percent or so year after year—the only way vast middle class prosperity can improve. It was a wondrous time in America, where the system of wage settlements enabled hardworking families to realistically aspire to the middle class and expect prosperity as an American birthright. Here is how *Harper's Magazine* writer Ben Austen described the roots of the golden age:

> "The auto industry came to symbolize blue-collar upward mobility and empowerment. The real incomes of autoworkers doubled from 1947 to 1973; and because many other unions as well as nonunion firms adopted auto-industry pay rates, the bottom half of American earners saw their incomes increase during this period at the same pace as that of the top 10 percent of wage earners."[5]

By 1972, rising prosperity had increased weekly wages to an annual average of $7,300 per employee. That paycheck was certainly worth more than the 3,360 francs averaged in France, which translated to about $4,500 that year. That year—1972—was the high-water mark for the American middle class. With inflation, that $7,300 paycheck was equal to $40,200 in 2012, an above average wage today.

The Fairytale Ends

It must all sound like a fairytale to you.

Twenty-first century America is something altogether different from the golden age. The experience of your parents or grandparents and men

like Augustine doesn't remotely resemble experience since. The common outcome instead is the experience of folks like Tim Slaughter, a friend of Augustine's son. Along with nearly all of America's 150 million employees, he's been caught up in the disappearance of good jobs in Detroit and across the nation. Tim became flotsam, reeducating himself to be a computer technician, but at $20,000 less than he earned at Ford, as rising middle-class prosperity ground to a standstill in an America evolving to a low-wage nation.

The American economy since then has morphed into a repetition of the Gilded Age of the Roaring Twenties, a transformation that would startle and repel our parents or grandparents from the golden age. It has left folks like Tim Slaughter on the crack end of a whip powered by dimly understood forces in the wake of the collapse of rules and expectations that crafted the golden age. Stagnant and declining wages are the new reality that makes Tim's experience a common one, including surprisingly low wages, even in union shops or for higher technology jobs requiring college degrees and intensive training.

Unionization has been integral to higher wages, and still is; in 2010, for example, unionized manufacturing workers in Indiana earned 16 percent more than nonunion employees. Union membership began eroding in 1965. But the benefits to the middle class of collective bargaining began to fall most sharply after 1980 as a new breed of executives began utilizing the Taft-Hartley Act to weaken unions and wages while stepping up the offshoring of high-value manufacturing jobs.[6] Desperate to attract new jobs amid recession and rising imports, the UAW and other industrial unions reluctantly began to accept two-tier wage structures during the 1980s. That trend ended temporarily as these labor contracts expired in the robust 1990s amid tight labor markets and rising wages. But two-tier reemerged in contracts during the jobless recovery of the George W. Bush years. The UAW accepted them again beginning in 2003, with new hires earning $14–$19 per hour. Including benefits, that was not much above one-half the wages and benefit cost of grandfathered employees.[7] And real longtimers like Augustine made even more.

Even so, these auto firms are the premier employers for Americans lacking college degrees. Starting wages are one-third lower still in most of the rest of the United States, including Walmart or McDonald's, the largest employers. For example, production jobs at the Suarez Corporation Industries plant in North Canton, Ohio, pay no more than the Ohio minimum wage of $7.70 per hour, in contrast to the former $20-an-hour jobs there that Hoover long ago offshored to China.[8] Even worse, firms

like Suarez are increasingly refusing to pay fringe benefits such as health insurance and pensions, insisting that employees technically work for outside contractors. This also shifts the full cost of Social Security and Medicare payroll taxes onto employees while saving the firm other taxes as well, such as unemployment insurance.

New jobs at hotels or factories promising something better than minimal wages attract thousands upon thousands of hopefuls drawn from the shadows of the American economy, little realizing the odds are far better of being accepted at Harvard than landing a $15-an-hour job. And leading the wage compression are blue chip firms like GE and Caterpillar. When Toyota opened its Georgetown, Kentucky, plant over twenty years ago, it was deluged with 142,000 applicants for the 3,000 openings—most lured by wages about double those in a state where industrial pay averages $8 per hour.[9] It is the same today. VW was overwhelmed with 83,000 applicants for 2,500 jobs paying around $15 an hour in Chattanooga in 2011.[10]

Down the way a bit in one of the most beautiful spots in the South, in the Chattahoochee Valley, 43,000 Georgians applied for 2,600 jobs in the new Kia auto plant at West Point paying no better.[11] In Indiana, the C.R. England trucking company received 500 applications in the summer of 2009 for a single clerical job paying even less, rejecting many for being vastly overqualified.[12] And over in Danville, Virginia, new employees at the IKEA plant receive $8 per hour, far lower than wages paid by the same company in Scandinavia.[13] In all these plants, employees will top out many years from now at wages about equal to the inflation-adjusted starting wage for their parents or grandparents during the golden age. And the retirement of senior, higher-wage employees will exacerbate the deterioration in wages. For example, Chrysler is projecting that the share of its lower-tier employees will quickly double from 13 percent in 2011, to at least 25 percent by 2015.[14]

The golden-age American wage structure where pay rose with productivity is in tatters. American firms have become so fixated on compressing the incomes of employees and their families that higher wages are no longer even an option in addressing worksite issues. In 2007, for example, a survey of employee retention programs by the US staffing firm Spherion found that workers predictably prioritized issues like growth and earning potential, higher salaries, and better health insurance. Yet American managers didn't even rank wages among their top five retention tools; instead, they prioritize ephemeral steps such as enriched "supervisor relationships" and improved "workplace culture."[15]

Similar findings are noted in the Society for Human Resource Management's 2007 Job Satisfaction Survey Report.[16]

The American judiciary has added to the downward spiral of wages, indifferent to enforcing employee protections or the right to organize and refusing even to establish guidelines on burgeoning issues including independent contractors. Among others, Nissan and SuperShuttle exploit the resulting gray area to routinely misclassify employees as contractors or franchisees. SuperShuttle, for example, shifts traditional routine firm costs (equipment purchases, fringe benefits, and Social Security/Medicare fees) to employees, while also dodging traditional obligations (minimum wages, overtime pay, and workers' compensation fees). Emma Schwartz with the Center for Public Integrity in Washington quotes SuperShuttle's stated goal of shifting "hard to manage variable costs from the company" to the drivers.[17]

Nissan pursues the same strategy. Most new jobs at Nissan's Smyrna plant in Tennessee are temporary, low-wage positions working for an entity called Yates Services. Yates contractors comprise up to 60 percent of shop-floor employees in some sections of the plant and perform the same work as ordinary Nissan employees.[18] The difference besides lower pay and benefits? While performing identical tasks, they're the ones wearing brown, not Nissan blue or gray.

This downward spiral in wages has caused many reliable employees with solid job skills, but without college educations, to fall from the middle class to the ranks of the working poor. As labor economist Harley Shaiken at the University of California, Berkeley noted, family incomes for many now hover around the eligibility level for food stamps.[19] Eroding wages has made this cohort of working poor enormous, as described by MIT economist Paul Osterman in August 2011:

> "Last year, one in five American adults worked in jobs that paid poverty-level wages. Worker displacement contributes to the problem. People who are laid off from previous stable employment, if they are lucky enough to find work, take a median wage hit of over 20 percent."[20]

The plight of today's generation of Americans is defined by such wage compression. Every downturn sees fewer good jobs emerge in the subsequent recovery.[21] Some 79 percent of the six million jobs lost in the deep recession of 2008–2009 paid more than $13.84 an hour, for example, but barely half that share (42 percent) of the four million jobs created in 2010–2012 paid as well. The rest—mostly service jobs—paid less.

This wage compression has deeply affected the morale of America. Polling by the Pew Global Attitudes Project in 2011 delivered this shocker: Fewer than one-half of Americans still believe the US culture is superior to others; that's down from 60 percent in 2002, meaning the decline has been precipitous.[22] And other polling fingers economics as the culprit. The survey firm Gallup, for example, found that a majority of Americans in April 2011 agreed—for the first time—that it was unlikely their children would ever live as well as themselves. Their pessimism is justified, because the youngest members of the American workforce are bearing the heaviest burden of the Reagan era: while overall unemployment (including labor force dropouts) was around 15 percent in 2010, 37 percent of working men and women between 18 and 29 were either unemployed or labor force dropouts—a rate reminiscent of the Great Depression. A third lack health insurance and many continue living at home after schooling, cursed to come of working age amid a recession. On top of that, the cost of college continues to climb, leaving many with crippling student loan debts.

America has had blighted generations before, like those born in the decade after 1835 and especially the decade after 1905, which was cursed by both war and the Great Depression. The children of today's baby boomer generation have joined that discouraging list, beset by weak wages and wealth erosion.

Worse, they are poised to become the template for future generations. Like baby boomers, today's youth will become another generation destined to squander decades of toil and savings to retire with little more than their parents or grandparents. How severe is it? Their wages are flat. And good jobs are dwindling: Indeed, too many youths are being outmuscled for scarce job openings by their economically anxious grandparents, who are forced into working retirements at Walmart or laboring under the golden arches of McDonald's in their golden years. Despite the recession, the number of seniors working rose by 700,000 between 2007 and 2009, while the number of youths sixteen- to twenty-four-years-old working fell by 2 million.

Unsurprisingly, these trends have elicited a sober reappraisal of American capitalism among eighteen- to twenty-nine-year olds. Pew found that fewer American youths believe in the superiority of the US culture (37 percent) than youths in Germany, Spain, or Britain who view their own cultures as superior, even amid the European sovereign debt turmoil.[23] Reaganomics has caused America's children to conclude that their nation is no longer the exceptional land of opportunity it was for their grandparents.

It has also sparked a much more dramatic reappraisal. Extrapolating these trends, political scientist and author Francis Fukuyama has grown alarmed that the decline of the American middle class poses an existential threat to democracy itself. By widening income disparities and shrinking the middle class that anchors societies, he frets that global integration threatens the very foundation of Western democratic institutions and practices. Frustrated and angry voters from the devolving middle class might well demand that leaders emulate Chinese state capitalism—or worse. This ignores the lessons provided by the family capitalism countries. But American-centric Fukuyama is certainly correct about one thing: the three decades of the Reagan era darkened the American Dream for most Americans.

The discouraging economics of young workers today means they frequently turn to their parents for help against the backdrop of stagnant wages. Fully one-half of all first-time buyers can afford a home of their own only with parental loans. Parents would like to do even more, but baby boomers are too hard-pressed themselves, confronting delayed retirements and the prospect of having to help their children, instead of the other way around.

At one level, this anxiety reflects a perceived rupture in the social pact that many Americans feel had bound them firmly to the nation's fabric. That pact now seems tattered: debt-free corporations juxtaposed with a record amount of household and national debt. Corporate profits and Wall Street bonuses are measured in the hundreds of billions of dollars, while wages remain stagnant. The image of the middle class as a sanctuary that inspired our parents' love of American capitalism, along with the expectation of steadily rising wages and a comfortable retirement, has proven to be a mirage for baby boomers and their children. Unlike their parents who prospered with age, baby boomers will be fortunate to pass away in a home nicer than the one in which they grew up. As columnist Harold Meyerson of the *Washington Post* concluded in 2009, "What emerges is a picture of a nation in decline. The first nation in human history to create a middle class majority looks increasingly to be losing it."[24]

In contrast to the fortunate few atop the income pyramid, the net wealth of most other households in America has dwindled in recent years. Different groups compile different statistics. But their conclusions mirror research by the dean of American economists on wealth issues, Edward N. Wolff of New York University. Wolff has concluded that median household net worth in 2009, adjusted for inflation, was lower than in 1983; American families have less wealth today than their parents or grandparents a quarter of a century ago. Median wealth is the

net value of assets including homes, financial assets, and so forth owned by the household in the precise middle of the asset distribution. This outcome, depicted in Chart 3, was derived by Wolff from Federal Reserve Board survey data.

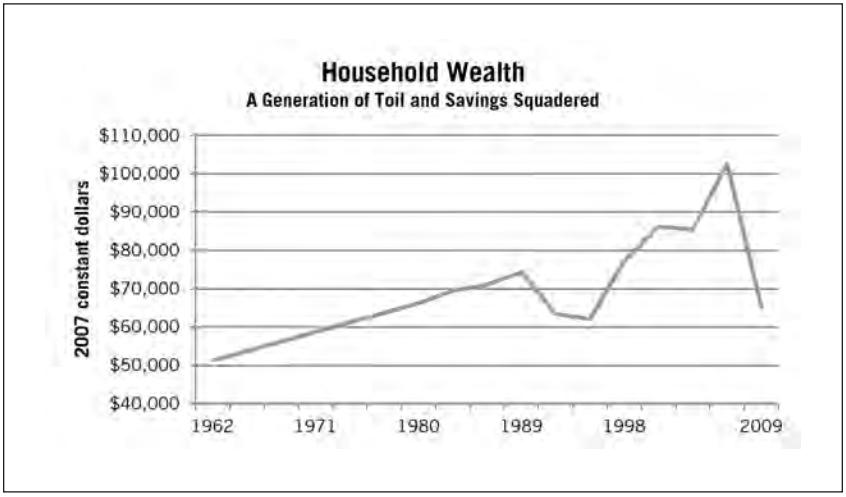

Chart 2.1. Median household wealth.
Source: Edward N. Wolff, "Top Heavy," p. 11, The New Press, NY, 20012; Edward N. Wolff, "Recent Trends in Household Wealth in the United States: Rising Debt and the Middle Class Squeeze," Levy Economics Institute at Bard College, March 2010, and Survey of Consumer Finances, Federal Reserve Board, Washington, various issues. 1965–1980 smoothed trend.

Wolff believes that almost all families are worse off, and rising stock prices has not altered that conclusion. Homes comprised 65 percent of assets held by the three middle income quintiles in 2007, while mutual funds, stocks, and the like comprised only 3.6 percent. The sobering conclusion is that American families have seen three long decades of work and savings squandered, lost forever.

Not Everyone Suffered in the Reagan era

Not all suffered, however, which is why Virginia Commonwealth University economists Robert Trumble and Angela DeLowell term the income shifts during the Reagan era "the largest peacetime transfer of wealth in history."[25] Employees at every income level—except the pinnacle—felt the deterioration. Judith Warner captures the feeling in her evocative book, *Perfect Madness: Motherhood in the Age of Anxiety*:

> "In the 1970s, even in New York, it had been financially possible for a middle-class family to survive if parents—even one parent—built

a professional life around something other than purely making money. . . . But by the late 1990s, in New York, if you weren't in the financial industry, it was hard to survive. As so it went in a more general way, throughout the country, in the whole winner-take-all era . . . life got harder and scarier and more confusing. The feeling of injustice wasn't just about money, though it was partly about being more than solidly middle class and still struggling to pay the bills. . . . It was rather that the wrong people had inherited the earth. Many of us who'd proudly decided to pursue edifying or creative or 'helping' professions, woke up to realize, once we had families, that we'd perhaps been irresponsible. We couldn't save for college. We could barely save for retirement . . . so like just about everyone, we worked hard and treaded water, but felt we were entitled to do better. And if we lived in the New York area, or another wealthy place where the spoils of the new Gilded Age were constantly thrust in our faces, we felt a little something more: we knew that we were losers."

The winners in the American wealth derby during the Reagan era have been corporations and a thin slice of American families, the oft-referenced 1 percent. While American firms fret about regulation, labor costs, and taxes, globalization opened profitable new horizons for many since 1980. That was especially true when executives proved willing to delink productivity and wages by capping labor costs. That decision enabled most of the rise in productivity to flow through to enterprise bottom lines, causing profit margins to rise from 27 percent in 1980 to 35 percent in 2009; corporate profits as a share of GDP increased from 6 percent in 1982 to 14 percent of GDP in 2006 and 2007.[26] Little wonder the Swiss investment bank UBS described the Reagan era as America's "golden era of profitability."[27] These trends made executives and shareholders the big winners.

I noted earlier that economists Piketty and Saez determined only 5 percent of Americans beat inflation during the Reagan era, but economists have parsed that figure further. And it turns out that the real winners were folks in that top 1 percent, composed of people like legacy wealth holders, entrepreneurs, athletes, Hollywood stars, and especially those like hedge fund managers or senior firm officials connected to American enterprise. This 1 percent received nearly one-half of all the economic growth in the 1990s and its share has risen sharply since then, as noted in Chart 2.2. An update in 2013 by Saez found that they received all of the gains from growth 2009–2011.[28]

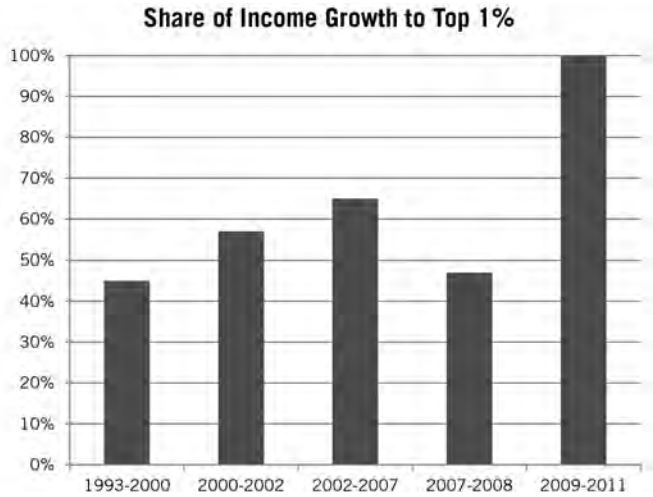

Chart 2.2.

Source: Emmanuel Saez, "Striking it Richer: the evolution of Top Incomes in the United States (updated with 2011 Estimates)," University of California, Berkeley, Jan. 23, 2013. http://elsa.berkeley.edu/~saez/saez-UStopincomes-2011.pdf. See also Robert Frank, "The 1 % Captures most Growth from recovery," Wall Street Journal blog, The Wealth Report, 3-6-12, http://blogs.wsj.com/wealth/2012/03/06/the-1-captures-most-growth -from-recovery/.

The gains from growth were far more widely enjoyed before the Reagan era. Based on data from Saez and Piketty, tax expert and former journalist David Cay Johnston determined that during the golden age until 1975, $4 of income accrued to each of the top 1 percent of earners for every $1 that reached each American in the bottom 90 percent. Yet, between 1981 and 2005 during the Reagan era, nearly $5,000 of additional income flowed to each member of the elite 1 percent for every $1 going to each of the bottom 90 percent of American earners.[29] Even within that elite group, income flowed still higher; the real winners in recent decades have been the 13,400 families comprising the top 1/100th of the 1 percent at the tip of America's income pyramid. Johnston concluded that for every $1 of additional income earned by the bottom 99 percent of Americans since 1970, each member of these dynastic families received $7,500 additional; collectively, in 2000, these families received as much income as the poorest 96 million Americans.[30]

How We Got Here

America arrived here as a result of choices made at the polls; specifically the elections of Presidents Ronald Reagan, George H.W. Bush, George W. Bush, and (to a lesser degree) Bill Clinton. Not until the election of President Obama was an effort made to address at least some symptoms

of Reaganomics like financial deregulation. But why would Americans make these earlier economically harmful choices?

Part of the answer rests with the nature of economic information. Economic results are slow to accumulate in the mind's eye of voters. Excepting recessions, it takes many years before hindsight can actually distill fiction from facts about the quality of economic leadership.

And when the facts become clear sometimes years later, even well-informed voters have difficulty linking their plight to seminal trends such as the regulatory capture of Washington by the business community, or the devolution of the American executive suite culture. The fog of busy, complex, and immediate lives is too enveloping for most to discern responsibility amid the cacophony of contradictory political narratives. That is especially true in America recently when a pronounced external event—globalization or technological change—can credibly be blamed for their plight. Finally, American voters have lacked information about the continued economic success of families in Australia and northern Europe or choices at the polls based on that success.

In retrospect, Reaganomics has been an enormous gift to corporations and the wealthiest Americans—a gift from the other 95 percent of Americans. The greatest redistribution of income ever in peacetime. But voters didn't knowingly vote to give this gift. Weary of stagflation, they accepted the assurance of President Reagan and his team in 1980 that Reaganomics would lead to prosperity. And the two most important figures behind this narrative were economist Milton Freidman and philosopher and novelist Ayn Rand.

Milton Friedman and the Chicago School

The late Milton Friedman is rightfully considered one of America's leading monetary economists. Drawing on Irving Fisher's influential work, University of Chicago economists Friedman and Anna Schwartz popularized the role of money in creating and establishing price stability as an important precondition for economic growth. Their 1963 book, *A Monetary History of the United States 1867–1960,* is considered a seminal work of economics, even though Friedman's monetarism theory was hopeless as a practical guide to action.[31]

But Friedman didn't stop with economic theory. He blended ideology with his economic research to emerge as a persuasive architect who credentialed Reaganomics. In doing so, he veered into the ideological realm far beyond what his research could support.

It's worth acknowledging a bit of background information here. Milton Friedman was a vociferous opponent of regulating the business

community. Yet, economists have long believed that some measure of market regulation is essential to sustain a productive, stable economy. Regulation prevents business interests from combining to create exploitative monopolies. Regulation ensures that externalities such as pollution are managed. Regulation creates minimum worksite standards for employees. Regulation avoids the problem of financial speculation by banks, a problem ever since credit was conceived centuries ago. And regulation enforces a basic level of honesty and integrity on the part of business interests. Regulations are appropriate, because the business community will not only adopt policies in conflict with the public good; centuries of experience teach that it will seek to capture and bend government regulations to its parochial goals.

The Economic Basis of Democracy

Justification for regulating the business community is most strongly identified with Adam Smith, but its roots stretch back 2,300 years to Aristotle, where the nexus of democracy and economics was formed. We look to ancient Greece as a governance touchstone, because the philosophers Socrates, Plato, and his pupil, Aristotle, pioneered exploring the nuances of secular governance and were the first to lift mankind with dreams of societies that would enrich all. In an era when slavery was widespread and tyrants touted their relationships to the gods, Aristotle's vision of a democracy pooling the wisdom of many to manage society was revolutionary. It took two centuries of darkness, the Renaissance, and the Reformation, however, for philosophers like Thomas Hobbes, John Locke, and Jean-Jacques Rousseau to fully resuscitate the classical Greek ideal of collective governance. The inspirations they drew on were Plato's *Republic* and especially Aristotle's *Politics* and his humanistic *Ethics*.[32]

Economics was considered central to the creation and preservation of democracy, making Aristotle one of the first economists two thousand years before Adam Smith. They both were market *aficionados* favoring competition; when it was limited through collusion by those whom Aristotle or Smith viewed as special interests—large land owners or dominant merchants in their day—the collusion always came at the expense of small business, farmers, and families. Here is how the Canadian economist Thomas J. Lewis explained Aristotle's concern in 240 BC:

> "If the number of producers of a given type of commodity is small, they can be expected to engage in familiar oligopolistic behavior; that is, to attempt to extract a maximum return through hard bargaining,

> strengthen their bargaining position through collusion to restrict supply, and restrict the entry of new producers into the market."[33]

Responsible for Aristotle's great interest in economics was the realization that such collusion produced dangerous economic and political elites he called "oligarchs," whose self-aggrandizing behavior subverted democracy. The stark outcome he described, and which remains relevant today, is that a society achieves stability only once it evolves to become either a democracy or a tyranny of a rich elite. After much contemplation, in fact, Aristotle eventually settled on the degree of economic power held by what he called the "unpropertied" as a seminal measure of political freedom.

> "What differentiates oligarchy and democracy is wealth or the lack of it. The essential point is that where the possession of political power is due to the possession of economic power or wealth, whether the number of persons be large or small, that is oligarchy, and when the unpropertied class have power, that is democracy."[34, 35]

Aristotle established a bright-line for whether democracy exists: Do law and regulation constrain the economically powerful and thus enable the broad diffusion of economic gains? Adam Smith, ironically championed by conservatives as the conceptualizer of free-market capitalism, understood this clearly. Perhaps his single most evocative conclusion emphasized his distrust of the business community for chronically placing their own interest above all others.

> People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the publick, or in some contrivance to raise prices.[36]

Drawing on the example of Bengali-based East India Company factotums, Smith explained at length in book IV of *The Wealth of Nations* how the business community's motivation chronically and directly contravenes sound government policy. They aren't amoral folks necessarily—just greedy. His writings make clear that Smith was fashioning the seminal philosophy and goals of family capitalism, not *laissez-faire* Reaganomics. He believed that improving consumer and family prosperity through lower prices and a greater variety of goods was the goal of economics. Smith explicitly rejected the *laissez-faire* deregulation version of capitalism popular during his day and during the Reagan era that prioritizes the prosperity of the business community. He endorsed

placing the prosperity of families above the interests of the self-absorbed business community in the clearest possible language, explaining that "the welfare of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer."[37]

As much as we identify the concept of the invisible hand with capitalism, Smith's most seminal contribution to economics was to channel Aristotle in clarifying that the goal of market capitalism is to enrich families at the expense of the business community. And one of the sharpest lessons offered by this book is that Reaganomics abandoned Smith's goal, even as the family capitalism countries tightened their embrace of it.

Excessive regulation can, of course, be an economic problem as well. That is why mainstream economists today seek to strike the right balance: a degree of regulation that ensures stability and fairness while allowing businesses freedom to innovate, invest, and flourish. Achieving those goals demands that government practice a carefully monitored capitalism where competition is kept vibrant by being free from regulatory capture by any economic interest.

Friedman would have none of it. Distrustful of government, he disagreed with Adam Smith, the Englishman John Maynard Keynes, and most mainstream economists on the appropriate scope of regulation in the economy. His suspicions of government regulation obligated him to conjure a sufficiently orderly economic world, where government regulation is virtually unneeded.

Appointed by President Reagan to be chairman of the Federal Reserve System in 1987, Alan Greenspan joined Milton Friedman and other advisors in minimizing the lessons drawn by Keynes from the Great Depression regarding the dangers lurking in mankind's animal spirits. Indeed, their rejection of mainstream economics was more far-reaching than just ignoring greed; it went to the heart of how gains from growth should be allocated within capitalism. I suspect President Reagan never actually understood this point. In the place of the carefully regulated market capitalism envisioned by Adam Smith and Keynes, his advisors urged with fervor a return to nineteenth-century market fundamentalism. That appeal was politically alluring to conservatives, including Ronald Reagan, who coalesced in the 1960s around the late Senator Barry Goldwater of Arizona and his inspiring themes of small government, low taxes, and self-regulation of industries. Their notion was that history was wrong and markets don't require adult supervision, after all.

Famously, in President Reagan's resurrection of Gilded Age deregulation, government became the problem—not the solution. And too many American macroeconomists at least temporarily and often to their later regret, supported an economic theory that didn't comport with reality.

As Wall Street economist Robert J. Barbera explained in his book, *The Cost of Capitalism*,

> "We embraced the wrong paradigm. The events of 2008 revealed that using simple-minded free-market rhetoric as a policy guide is a recipe for disaster."

The imperfectability of markets and man means that deregulated Reaganomics has feet of clay. It seems that the president's advisors came to believe that Reaganomics somehow suspended the laws of human behavior, that this time was different. It wasn't. It never is. The outcome was 2008. Whether its tulips or South Sea shares in seventeenth- and eighteenth-century Europe or Wall Street in the Roaring Twenties, deregulation always fails spectacularly.

Reaganomics ignores the fact that markets, especially financial ones, are beset by imperfections ranging from the impact of leverage to central bank manipulation to front running by intermediaries to woeful information discontinuities, and many other flaws. It assumes that people behave with perfect rationality, which is an absurd notion. As has long been recognized by most economists and by the psychology profession, people chronically suffer from irrationalities including: the confirmation bias (we give more credence to information that reinforces our viewpoint); the availability bias (we act inordinately on the latest if not necessarily the most accurate information); the herd instinct; thinking the future will be like the present; or overrating our abilities on a broad range of activities.[38]

None of the key assumptions undergirding Reaganomics are valid in the real world, and the irrational behavior that Smith and Keynes warned about is omnipresent. We know this deregulation spasm turned out badly just like the Gilded Age before it, and the signals were evident even as President Reagan's term ended, with the Savings and Loan crisis erupting and the 1987 market crash. Here is how *Financial Times* columnist John Kay put it:

> "Much of what . . . causes instability in the global economy results from the failure of these assumptions. Herd behavior, asset mispricing, and grossly imperfect information have led us to where we are today."[39]

Columbia University economist Joseph Stiglitz, the 2001 recipient of the Nobel prize in economics, noted in September 2007, that the self-regulation policies of Reaganomics:

> "were never based on a solid empirical and theoretical foundation, and even as these policies were being pushed, academic economists were explaining the limitations of markets—for instance, whenever information is imperfect, which is to say always."[40]

Deregulation flourished after 1980 and, unsurprisingly, the consequence has been serial speculative credit bubbles in a reprise of the Roaring Twenties or eighteenth-century London, Paris, or Edinburgh. What were the Bush I and II and Clinton Administrations thinking when they deregulated finance? And what were officials like Alan Greenspan, N. Gregory Mankiw, or Glenn Hubbard thinking as the housing bubble inflated during the 2000s, when they permitted fully half of the American banking sector to go unregulated—while allowing leverage at investment banks to double? Here is how Michael Lewitt, an American money manager, explained the consequence of their regulatory lapse to John Plender of the *Financial Times* in September 2008:

> "Allowing investment banks to be leveraged to the tune of 30 to 1 is the equivalent of playing Russian roulette with five of the six chambers of the gun loaded. If one adds the off-balance-sheet liabilities to this leverage, you might as well fill the sixth chamber with a bullet and pull the trigger."[41]

The outcome was that officials and families relearned the age-old lessons first clarified by Adam Smith. New York University professor Nouriel Roubini—one of the few who predicted the Wall Street meltdown—concluded that:

> ". . . the Anglo-Saxon model of supervision and regulation of the financial system has failed. . . . [it] "relied on self-regulation that, in effect, meant no regulation; on market discipline that does not exist when there is euphoria and irrational exuberance; on internal risk management models that fail. . . ."[42]

Behind Friedman's Influence

Market fundamentalism was pretty thin gruel for economists schooled in history. It quickly attracted as sharp critics the British economist Andrew Smithers and Yale economist Robert J. Shiller, who as early as 1984 judged the underlying theory "one of the most remarkable errors in the history of economic thought."[43] It actually faded in popularity quickly as the profession came to terms with its unreal assumptions. So

an obvious question is this: How did *laissez-faire* economics, discredited as recently as the 1930s and lacking any theoretical basis, actually re-emerge as American economic dogma?

The answer is that the business community, as early as the 1970s, grasped the implications of deregulation and the profits to be gleaned from a return to Gilded Age economics. All they needed to do was expand the tiny circle around Senator Goldwater and then Governor Reagan to convince Washington and voters that supporting a reintroduction of *laissez-faire* economics was somehow in the interest of families. That challenge was captured in a remarkably candid, if indelicate, comment by *Business Week* in 1974:

> "It will be a hard pill for many Americans to swallow—the idea of doing with less so that big business can have more. Nothing that this nation, or any other nation, has done in modern economic history compares in difficulty with the selling job that must now be done to make people accept the new reality."[44]

A showman of extraordinary ability, ideally unschooled in economic history, was required if families were to be convinced to vote against their own economic interest. That leadership was provided by the charismatic and trusted Ronald Reagan. Much of the subsequent success in stripping economic sovereignty from families that we discuss shortly lies with the advocacy role of Friedman and his powerful ability to appeal to wealthy executive suites and, through them, to Ronald Reagan. Similar to prominent twentieth-century scientists such as Francis Crick or Linus Pauling, Friedman's professional accomplishments lent undue weight to his personal philosophical musings. With the test of time, however, his Reaganomics has proven no more credible than Crick's flirtation with eugenics or Pauling's belief in megadoses of vitamin C.

The courtship of the economic neophyte Reagan beginning in the 1970s was built on three elements:

- First, Milton Friedman's philosophy was appealing to Reagan in his role as General Electric's corporate spokesman to generally affluent shareholders. The notions of deregulation and the demonization of government were alluring to upwardly mobile Americans like Reagan and to major Republican Party business contributors like the ITT Corporation.

- Second, supporters conflated the cause of Reaganomics with that of democracy during the Cold War era, arguing powerfully that

only laissez-faire economics was consistent with the American ideals of capitalism and democracy. They exploited the Cold War to toss mainstream economics and Aristotle under the bus.

- Third, it was argued that Reaganomics was an aspect of American exceptionalism reflecting individualism and the nation's frontier spirit. Exceptionalism was originally conceived by Alexis de Tocqueville who argued (erroneously, as it turned out) that the melting pot of America without class or religious distinctions would enable it to soar and avoid internal strife. In economics, that has morphed into a truth that optimism, risk-taking, and the courage to challenge the present are features of America's DNA. A revolutionary democracy, the United States was created by the daring and bold, and our open society fortunately has continually been replenished over the centuries with some of the most clever and bold from across the globe. Yet, as we will see, the outcome of Reaganomics has been to erode—rather than enhance—opportunity and diminish American exceptionalism.

The Role of Pecuniary Politics in the Rise of Reaganomics

Wealthy businessman and Senator Mark Hanna defined the pivotal role of corporate funding of politicians and political parties a century ago. You may recall his comment that three things are important in politics; the first is money—and he couldn't recall the others. Money has always played a relatively large role in our nation's politics. Donations from executives were helpful in the political career of Ronald Reagan and contributed to the Chicago School's success in promoting deregulation. Friedman allowed his ideology to be exploited by executive suites, providing a fig leaf of respectability for their emerging narcissism. Writer Naomi Klein explains Friedman's role in resurrecting *laissez-faire* economics this way:

> "If Friedman's close friend Walter Wriston, head of Citibank, had come forward and argued that the minimum wage and corporate taxes should be abolished, he naturally would have been accused of being a robber baron. And that's where the Chicago School came in. It quickly became clear that when Friedman, a brilliant mathematician and skilled debater, made those same arguments, they took on an entirely different quality. They might be dismissed as wrong-headed, but they were imbued with an aura of scientific impartiality. The enormous benefit to having corporate views funneled through

academic, or quasi-academic, institutions not only kept the Chicago School flush with donations, but, in short order, spawned the global network of right-wing think tanks to churn out Reaganesque propaganda."[45]

President Reagan was an American success story of the first order, a self-made man who harbored strong sentiments for working class families by drawing on his own troubled childhood. The idealistic Ronald Reagan was ill-served by his trusted advisors. Even though he presented himself as president-turned-pitchman for a resurrected Gilded Age, the popular and charismatic Reagan was a complex figure. He was perhaps the most powerful politician of his time. Yet his was a thematic personality, inattentive with details, leaving the implementation of Reaganomics to underlings. He practiced what historian David E. Hoffman describes as a "passive management style, often more focused on performing than the details of governing."[46]

The engaging Reagan was inclined to swapping stories during business meetings with folks like one of my employers, the late Texas Senator and Treasury Secretary Lloyd M. Bentsen. Like most folks of every political persuasion, Bentsen found the garrulous President Reagan extraordinarily likeable. Handing me a card with Reagan's talking points after one White House meeting, the Senator noted that it contained the Administration's position, but most of the meeting was spent swapping stories, he said.

Reagan's unfocused intellect has dimmed his luster a bit, as noted by President George W. Bush's speechwriter David Frum: "The most dangerous legacy Reagan bequeathed his party was his legacy of cheerful indifference to detail."[47] Yet detail is vital in the zero-sum game of economics.

Reagan's failures are significant, but so are his successes. Ronald Reagan was an admired president, a genuine American success story who adroitly maximized his skill set to become leader of the Free World. He indexed income tax rates, which ceased drawing the middle class into higher and higher brackets. He simplified the tax code, an extraordinarily difficult chore. And he was a master at compromise, which is a skill in short supply nowadays among his party's officials in Washington. Few Americans would disagree that the nation would be better off if he still championed the conservative cause. Additionally, he proved as committed as any Democratic president to world peace.

But he was dazzled by articulate economists like Friedman, Secretary of State George Schultz, and Martin Feldstein, chairman of the Council of Economic Advisors, who married Reagan's distaste for taxes

and regulation with his indifference toward deficits and disinterest in details. Reaganomics was subsequently nurtured by ideological think tanks, such as the Washington-based Heritage Foundation, attuned to the profits to be gleaned by fronting for firms and wealthy conservatives in advocating deregulation. They provided a gloss of *faux gravitas* in classic Madison Avenue style: Reaganomics was sold to Americans as some sort of gauzy new-age economic *wunderkind* discovery of untold promise, when it was nothing more than Gilded Age *laissez-faire* economics repackaged with new lipstick and a glossy wig.

For their part, always thinking about money gives economists finely tuned financial antennae, and some from prominent universities wasted little time in seizing the opportunity to moonlight as advocates of deregulation. Milton Friedman and Alan Greenspan were not the only prominent economists whose reputation suffered greatly from the notion of market perfection. The bankruptcy of the hedge fund Long Term Capital Management in 1994 humiliated Myron Scholes and Robert Merton, both Nobel laureates and champions of flawed economic theory. Other academicians closely identified with Reaganomics, including Hubbard, Mankiw, and Martin Feldstein, became controversial as well.[48] Europeans even have a name for them, calling such American economists "the secret lobbyists."[49]

The economics profession owes you an apology for permitting Reagan and George W. Bush to be misled by a key subset of our colleagues, who at least in some instances too readily blended self-interest with ideology.

The business community's lavish support of Reagan also linked it firmly to his political party, a marriage that has persisted for decades. Research by Cornell University economist Jin-Hyuk Kim, for example, found that donations by the most powerful and largest American firms markedly favor Republican politicians. Using a panel data set comprised of companies from the Standard & Poor's 500 Index from all sectors of the economy, covering the period 1998–2004, Kim found that one-quarter of the firms donated little to politics and 10 percent favored neither political party, while 6 percent favored Democrats and ten times as many, or 60 percent, favored Republicans.[50]

Do corporate donations pay off? There is some disagreement about this, but the weight of scholarly evidence is that Hanna had it right.[51] Kim found that by doubling donations, firms on average boosted equity returns by 2.4 percent compared to all firms, and by 1.3 percent compared even to peers in the same industry. These sorts of returns translate to serious profits for firms with equity measured in the billions for the investment of a few million dollars. Steven Brill, writing in *Time Magazine* in July 2010, calculated that hedge fund and other money

managers invested perhaps $15 million, successfully diluting the Obama Administration's Wall Street reform legislation known as Dodd-Frank. That saved their industry an estimated $10 billion in taxes annually—an astronomical return of about 660 percent.[52] And a study by researchers at the University of Kansas identified a tax loophole crafted by lobbyists during the George W. Bush administration that involved the repatriation of profits sequested in foreign tax havens, which returned $220 for every lobbying dollar spent.[53] With such returns attainable, only a remarkably tin-eared CEO would forgo having an effective lobbying shop in Washington. Exploiting the pay-to-play American system to seek a specific policy change affecting profits is perhaps the single best investment an American corporation can make. Yet, as the 2012 Presidential outcome indicates, benefits from direct lobbying of Congress are not necessarily reproducible for national elections.

The Rise of Ayn Rand

President Reagan and his advisors—notably, Alan Greenspan—drew much of their staunch commitment and faith in deregulation from the Russian émigré and novelist Alisa Rosenbaum, better known to her fans as Ayn Rand. She authored best-sellers like *Atlas Shrugged* and *The Fountainhead* in the period during and after World War II that were paeans to individualism, self-regulating Reaganomics, and above all, self-absorption.

Her protagonists were Nietzschean superheroes—smart and strong entrepreneurs dismayed by civil servant Lilliputians constraining innovative American capitalism. These formulaic novels are great reads even today. In them, Rand popularized and legitimized the demonization of government which appealed so strongly to Ronald Reagan and became a seminal element of the era that later took his name.

Moreover, Rand vigorously rejected religious piety and the teachings of Christian charity in her personal life and extrapolated that to society—urging rejection of the wisdom of altruism and self-sacrifice for the greater good. Referring to altruism, Rand argued, as Kim Phillips-Fein explained in the December 2009 *Harper's Magazine*, that Christianity mistakenly, "had taught people to sacrifice themselves in the name of a false ideal."

As an alternative, she fabricated objectivism, a made-up ethical structure based on what she labeled rational selfishness, which exalted the selfish pursuit of individual satisfaction.[54] In essence, she promoted what the early twentieth-century American sociologist Thorstein Veblen would have termed a culture of exploitation where riches are "the basis

of conventional esteem." Altruism was dismissed, replaced with the primacy of narcissism and self-absorption.[55]

Ayn Rand's contribution to American economics was to mute the traditional national guilt toward greed. If the market rewarded behavior, it was morally acceptable, even if it violated community norms or one's conscience formed by parents, biblical teachings, and society at large. This made-up philosophical construct provided psychological support for *laissez-faire* economics and justified the greed undergirding Reaganomics. Rand urged acolytes to reject as immoral any religious or ethical discomfort they might feel from the ensuing growing disparities in wealth or the human condition, certain to follow from the abandonment of altruism in executive suites or in the public square. Phillips-Fein concludes:

> "Her work offers a way of making sense of a profoundly unequal society, of making it tolerable, even virtuous."

Ayn Rand's philosophy spread throughout much of the financial and political elite in the Reagan era. Even many who never heard of Rand came to hear of and embrace her philosophy, as embodied by Gordon Gekko, a character in Oliver Stone's 1987 film, *Wall Street*:

> "The point is, ladies and gentleman, that greed, for lack of a better word, is good. Greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge, has marked the upward surge of mankind. And greed, you mark my words, will not only save Teldar Paper, but that other malfunctioning corporation called the USA."

Ayn Rand's associate during this period was Alan Greenspan, then a neophyte learning the ways of Wall Street. His deregulatory ethos, drawn from Ayn Rand's philosophy, led to the serial credit bubbles, the 2008 credit crisis, and the biggest economic calamity in three generations. The system he crafted is described in these terms by *Washington Post* columnist Steven Pearlstein:

> "It rewards manipulation over innovation and speculation over genuine value creation, resulting in massive misallocation of capital and the accumulation of unheard-of wealth in the hands of money managers and top corporate executives who are more lucky than they are skilled."[56]

The Elements of Reaganomics

The Reaganomics described by Pearlstein has eleven characteristics, each of which represents a departure from the political, cultural, and economic thinking of the golden age.

A Culture of Selfishness

Beginning in the 1980s, Ayn Rand's philosophy of self-absorption was increasingly adopted in the management and financial communities; greed was no longer embarrassing. There was a feeling of contempt for those who were unwilling or unable to enrich themselves or for the trusting souls fleeced by the market—men and women like you that Goldman Sachs financiers began calling "muppets."[57]

Government Is Invariably Dangerous

Americans have always been relatively independent and self-reliant, suspicious of both Big Business and Big Government. With Reaganomics, the notion took root that big government needed to be starved of resources with tax cuts. Simultaneously, the business community was transformed into a victim needing to be set free from government regulation. As Reagan said many times, "Government is not the solution to our problems; government is the problem."

An important economic debate on the role of government regulation in the early twentieth century involved the Austrian economist and philosopher Friedrich Hayek, author of *The Road to Serfdom*, who famously wanted dangerous government constrained.[58] His opponent was John Maynard Keynes, who was in "deeply moved agreement" with Hayek's concern, argues economic historian Sylvia Nasar, although much more willing to endorse careful government initiatives and regulation of business.[59] Hayek's concern was not targeted just at the collectivists, among them Karl Marx, but more broadly at the dangers posed by regulatory capture of the sort which emerged later in the Reagan era. He and Keynes feared the economically powerful of any persuasion including communists or the merchant class seizing the apparatus of the state to insulate themselves from market forces and competition.[60]

Their fears played out during the Reagan era; the regulatory machinery of Washington was utilized by executive suites to redirect the nation's income stream upward, upsetting the careful regulatory balance marking the golden age. Here is the *New York Times'* stark editorial assessment after a generation of deregulation delivered in January 2009:

> "The decades-old ways—in which . . . federal regulators have relied less on rules and enforcement and more on faith in market discipline to limit risk to the system—have been a manifest failure."[61]

Regulatory Capture

Regulatory capture describes a seizure of the tools of government by special interests; in this period, by the business community. As Adam Smith had concluded, the business community always seeks to influence government, and there was remarkable progress toward that goal during the Reagan era. The tone of government shifted; government was no longer supposed to be a check on the power of big business. Instead, it was supposed to get out of the way, or—even better—facilitate the goals of that community.

Senior government officials whose job it was to regulate industry became increasingly drawn from the ranks of industry itself, with plans to return when their stint in government was complete. These circumstances were rife with conflicts of interest as regulatory oversight weakened, especially in finance. Longtime civil servants were on the defensive, now considered to be part of the problem. And self-regulation prevailed whose inevitable outcome was described by Martin Wolf, chief economic columnist for the *Financial Times*, in December 2007:

> "What is happening in credit markets today is a huge blow to the credibility of the Anglo-Saxon model of transactions-oriented financial capitalism. A mixture of crony capitalism and gross incompetence has been on display in the core financial markets of New York and London. From . . . subprime lending to the placing (and favourable rating) of assets that turn out to be almost impossible to understand, value or sell, these activities have been riddled with conflicts of interest and incompetence."[62]

The rather dire consequences for the real economy of regulatory capture were also noticed in Asia. Kishore Mahbubani, dean of Singapore's Lee Kuan Yew School of Public Policy, argues that the lessons taught by history were cast aside after 1980: "Do not liberalize the financial sector too quickly, borrow in moderation, save in earnest, take care of the real economy, invest in productivity, focus on education. . . . While America was busy creating a financial house of cards, Asians focused on their real economies."[63]

Shareholder Capitalism

There are two general goals that enterprise managers can pursue. In stakeholder capitalism, executives balance the needs of shareholders

with that of employees and other stakeholders: customers and debtors, even job seekers, and the national prosperity. They considered themselves duty bound not only to their shareholders, but to the community at large. Stakeholder capitalism flourished during the golden age in America, featuring steadily rising wages and job creation that translated to improving family prosperity. Think Henry Ford paying double or more the prevailing wage. Stakeholder capitalism is practiced in the family capitalism countries today.

In contrast, one of the hallmarks of Reaganomics was a transition from stakeholder capitalism to shareholder capitalism since the 1980s, in which executive suites nominally seek to maximize shareholder value. Here is how economists Isil Erel, René Stulz, Reena Aggarwal, and Rohan Williamson explained the difference:

> "Corporate governance differs across countries. In some countries, many view the objective of corporations to maximize the welfare of a collection of stakeholders, while in others, especially the UK and US, it is more commonly believed that corporations should be run to maximize the wealth of shareholders."[64]

The pursuit of these different goals produced the profoundly different outcomes we are exploring. To crystallize the transition in corporate goals wrought by Reaganomics, I compare two mission statements from the Washington-based corporate lobby called the Business Roundtable; its membership is CEOs of the largest American firms. The golden age orientation is reflected in its October 1981 mission statement, promulgated still early in the Reagan presidency:

> "Balancing the shareholder's expectations of maximum return against other priorities is one of the fundamental problems confronting corporate management. The shareholders must receive a good return, but the legitimate concerns of other constituencies also must have appropriate attention. Striking the appropriate balance, some leading managers have come to believe that the primary role of corporations is to help meet society's legitimate needs for goods and services and to earn a reasonable return for the shareholders in the process. They are aware that this must be done in a socially acceptable manner. They believe that by giving enlightened consideration to balancing the legitimate claims of all its constituents, a corporation will best serve the interest of the shareholders."[65]

That statement in support of stakeholder capitalism sounds hopelessly out of tune with the Randian narcissism and self-absorption fashionable today, exemplified by its 1997 mission statement:

> "In the Business Roundtable's view, the paramount duty of management and of boards of directors is to the corporation's stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders. The notion that the board must somehow balance the interests of stockholders against the interests of other stakeholders fundamentally misconstrues the role of directors."[66]

Weak Corporate Governance

Shareholder capitalism reduces a nation's competitiveness. Despite its name, shareholder capitalism disproportionately empowers management to prosper at the expense of everyone else. That is a problem because, in combination with stock options, it incentivizes what economists call *short-termism* in executive suites. Eyeing windfalls from stock options should stock prices rise, managers prioritize policies such as unwise mergers to spike stock prices and cuts in overhead to boost profits. That means wage compression, but it also means less research and development (R&D), lower investment, less workforce upskilling, and the offshoring of production to cheaper locales. Each of these behaviors weakens attributes that are vital to long-term firm success and to productivity growth. They incentivize precisely the wrong corporate strategy. In a climate of self-absorption and a focus on growing personal wealth, too little responsibility to the distant future (anytime beyond the end of the current quarter) has been evident in executive suites.

Short-termism is an anchor slowing the American economy. As the powerhouse German economy exemplifies, one of the most important advantages a nation can muster in this fiercely competitive era of globalization is the quality of enterprise governance. Weak corporate governance is America's Achilles heel.

Tax Cut Cultists

The Republican Party has rebranded itself in recent decades to emphasize tax cuts over its traditional focus on fiscal probity. Such cuts are now routinely posed as a solution to every problem, causing budget deficits and the national debt to soar. Moreover, this transformation has featured abandonment by that Party of the age-old tax principle of ability-to-pay, where those of similar incomes are treated similarly and higher incomes have higher tax rates.

Political scientists Jacob Hacker and Paul Pierson explain how this emphasis on lower taxes, especially on the wealthy, has changed the American socioeconomic landscape:

> "A generation ago, the United States was a recognizable, if somewhat more unequal, member of the cluster of affluent democracies known as mixed economies, where fast growth was widely shared. No more. Since around 1980, we have drifted away from the mixed-economy cluster, and traveled a considerable distance toward another: the capitalist oligarchies, like Brazil, Mexico, and Russia, with their much greater concentration of economic bounty."[67]

"Deficits Don't Matter"

With economic growth underperforming, Presidents Reagan, George H.W. Bush, and George W. Bush, resorted to traditional monetary and fiscal policies to spur growth. In so doing, they abandoned prudence in government finance, ushering in decades of big government spending resulting in unprecedented peacetime budget deficits. (The Democratic President Bill Clinton added little to the national debt.) They increased the national debt a startling tenfold; that caused each family's portion of the national debt to rise from about $4,000, when Ronald Reagan was elected, to $34,750 by the end of the second Bush Administration in 2008—a stunning increase engineered by Republican presidents promising balanced budgets. The ensuing jump in national debt left the Obama Administration poorly positioned to respond to the economic downturn it inherited, the worst since the Great Depression. Among the harshest critics of the Reagan-era debt splurge from 1981 to 2008 have been Republican debt scolds. President Nixon's Secretary of Commerce, Peter G. Peterson, billionaire cofounder of Blackstone private equity and a prominent Republican, pulls no punches about his party's leaders:

> "The conservative stewards of Reaganomics, ironically, have themselves created the Keynesian nightmare—large and permanent deficits—they so much feared. . . . To find the proper historical parallel for the United States in the 1980s, we . . . must look to those rare historical occasions when an economy's large size, its world class currency, and its open capital markets have allowed it to borrow immense sums primarily for the purpose of consumption and without regard to productive return. The illustration of lumbering, deficit-hobbled, low-growth economies that come most easily to mind are Spain's in the late sixteenth century, France's in the 1780s, and Britain's in the 1920s."[68]

Reagan-era America fits readily into this group of feckless spendthrifts brought low by credit binges. But America isn't alone: other far smaller democracies have also borrowed excessively in recent decades, mostly nations around the Mediterranean, the UK, and Ireland. Like the US, all faced serious sovereign debt challenges and years of slow growth. These nations were perhaps following the example of President Reagan who nearly tripled the national debt himself. But maybe not: Politicians scarcely need role models from abroad to spend more than they collect in taxes.

Illusory Prosperity

As the budget deficits document, America embarked on an unprecedented credit binge during the Reagan era. Easy credit was adopted, featuring financial sector deregulation and expansive central bank monetary policy. When combined with rising corporate debt, rising household debt (to sustain living standards amid stagnant wages), and rising national debt, American credit outstanding grew from $5 trillion, when President Carter left office, to $53 trillion when President George W. Bush departed, easily the worst credit blowout in world history. It was possible only because President Nixon abandoned the gold standard and because investors abroad viewed the dollar as a key currency and proved willing to hold American debt as a precautionary reserve against their own economic troubles.

Little of this splurge benefited American families, however, and it certainly didn't bolster productivity or investment, either. Mindful of the slump in American productivity and stagnant wages characterizing the Reagan era, Michael Pascoe, a business editor at the *Sydney Morning Herald*, put the credit blowout in perspective:

> "It wasn't the subprime crisis and the subsequent GFC [Global Financial Crisis] that flat-lined the US—it was already going nowhere but no one noticed because the stagnation was papered over by its debt explosion. The World's biggest economy was like an individual on a fixed income who runs up a big credit card debt buying the new car, the new boat, and a flash holiday. The individual looks richer and has more stuff, but in reality is not richer. . . . Much of America's middle and working classes didn't even get to share in the illusion while it lasted—their incomes have grown little and the debt-fueled jobs growth proved as illusionary as George Bush's 'mission accomplished' and Fannie Mae's balance sheet."[69]

Rising Income Disparity

By compressing wages and seeing that virtually all the gains from growth are being redistributed upward, Reaganomics has caused

income disparities to widen to levels not seen since the Roaring Twenties. Some of the best scholarly research on American income inequality was performed by economist Larry Bartels of Vanderbilt University. During the decades of the golden age, incomes at the top of the middle class were about three times greater than at the bottom of the middle class. It takes a dramatic shift over many years to change income disparities, but events during the Reagan era proved sufficiently powerful that Bartels has determined the ratio is now close to four times larger.[70] A poster child for this new Gilded Age is former Walmart CEO Lee Scott, Jr. who in 2005 received 900 times the paycheck of his typical employee. He earned in two weeks what an average Walmart employee will earn in a lifetime.[71]

The speed, enormity, and perseverance of this jump in income disparity has fascinated observers in the family capitalism countries. Here is German journalist Thomas Schulz, writing in Hamburg-based *Der Spiegel* in August 2010:

> "One in eight American adults and one in four children now survive on government food stamps. These are unbelievable numbers for the world's richest nation. . . . They face a bitter reality of fewer and fewer jobs, decades of stagnating wages, and dramatic increases in inequality. . . . Income inequality in the United States is greater today than it has been since the 1920s."[72]

This reads as though Schulz is writing about some misfiring society in a far-off land. America today has by far the most severe income disparity of any rich democracy, nearly identical to the income disparity in Turkey and more than twice as skewed as other rich democracies like Australia. How severe is it? Well, the wealthiest 400 have come to own more than the poorest 150 million Americans, marking a resurrection of the Gilded Age. It's no wonder that foreign media, *Der Spiegel*, for example, regularly feature such headlines as "Has America become an Oligarchy?"[73]

Reducing Opportunity

America is the land of opportunity, the land of Horatio Alger, where pluck, education, and ability are a certain ticket to prosperity. Stout advocates invoked that promise repeatedly during the Reagan era, like President George W. Bush in November 2008: "Free market capitalism is . . . the engine of social mobility, the highway to the American Dream."[74]

And it used to be that way, as your ambitious ancestors, along with millions of other immigrants, made their way to American shores and

prosperity. That magical epoch was brought to an end by Reaganomics. Wage compression, shareholder capitalism, job offshoring, tax changes, and sharply rising incomes at the top have knocked the props from beneath the opportunity society. Here is MIT professor Paul Osterman:

> "One objection we hear is that these bad, low-wage jobs are transitory, that people just move through them on their way up. But that's not true. Overwhelmingly, adults stay in these jobs for years and years. It's not Horatio Alger."[75]

With quality jobs drying up, economic mobility since the 1980s has diminished by about one-third. It is now so weak that America has become distinguished for having the worst—rather than the best—opportunity among rich democracies. Analyses have concluded that 42 percent of sons in poor families (in the bottom 20 percent of families by income) will be poor themselves as adults a generation later, while 40 percent of sons from rich families will themselves be rich as adults. That means the most important economic decision any American makes is to pick parents very, very carefully. Rags to riches? It still happens, but the odds are vanishingly small for sons from poor families, where only 6 percent manage to become rich. That means your odds of being rich are almost seven times better if born rich than poor. The America of Horatio Alger has devolved to become the best rich democracy in which to be born rich, but the worst in which to be poor. Opportunity in America resembles that in struggling Third World nations, not Australia or Germany.

Economic Mythmaking

The consequences we are exploring make Reaganomics an economic disappointment for families and voters. Economic myths have been important in sustaining it. Three of them are noted above, including the canards that government is inevitably dangerous, that deficits don't matter, and that Reaganomics has enhanced American economic opportunity. But other important myths have also been nurtured during the Reagan era, including erroneously blaming wage compression on globalization.

Another myth is that education and pluck are the answers to wage stagnation. In reality, real wages for college graduates are lower today than a generation or more ago. Education and pluck are obviously not sufficient keys to riches; if they were, computer scientists and other engineers, mathematicians, and Harvard professors would be reaping millions of dollars a year rather than financial engineers and corporate executives.

Another myth is that the economies of northern Europe are misfiring

and sclerotic. Yet, these are economies where productivity has grown one-third faster than America's for three decades. In fact, those in the best position to know—American corporations—are enthralled with rich old Europe, where they have created many thousands of jobs paying $10 an hour more than at home.

The Shift

While the shift in political, cultural, and economic directions embodied by Reaganomics was profound and dramatic, it failed to improve middle class living standards. In fact, one study by the nonpartisan Pew Research Center concluded that eroding wages caused the middle class to shrink in size from 61 percent of adults in 1971 to 51 percent in 2011.[76] In contrast, the middle class has continued to prosper in those nations such as Australia and Germany under family capitalism, as we see in the next chapter.

CHAPTER 3

THE TRIUMPH OF FAMILY CAPITALISM

"There are important lessons to be learnt from the Netherlands and Germany, and the effective collaboration between . . . employers and the workers—that actually allowed companies to find the best way to respond to what was a very large shock."[1]

STEFANO SCARPETTA,
OECD, *Financial Times*, August 2011

"The Findings set out in this report suggest that rapid deterioration in the face of global economic forces is not inevitable, and that states, firms and workers have some ability to influence and affect this relationship."[2]

JESS BAILEY, JOE COWARD, and MATTHEW WHITTAKER,
***Painful Separation*,**
Resolution Foundation, London, October 2011

Family capitalism draws its sharpest distinctions with Reaganomics in five areas:

REAGANOMICS	FAMILY CAPITALISM
Shareholder Capitalism	Stakeholder Capitalism
A Culture of Selfishness	A Culture of Responsibility
Regulatory Capture	Wariness of Corporate Influence
Weak Corporate Governance	Codetermination
Illusory Prosperity	Genuine Wealth Creation

Let's consider each in turn.

Shareholder vs. Stakeholder Capitalism

The stakeholder capitalism practiced in the family capitalism countries has more beneficial outcomes for families than American shareholder capitalism. It symbolizes that the rules and procedures in such nations

are intended to maximize wages and the number of high-quality jobs that justify those high wages. Family prosperity is the covenant in these nations, with voters demanding that enterprise management hew to it. In contrast to Reaganomics, real wages rise, domestic production rather than imports are emphasized, and few quality jobs are offshored while executive suites adopt a host of practices such as R&D, workforce upskilling, and investment to nurture productivity growth. It is the same orientation common in the golden age where, for example, the pay of US CEOs rose less than 1 percent annually, which meant their wages about kept pace with employee real wages. The top three executives at America's largest firms back then earned about 30 times more than the average of their employees.

Under shareholder capitalism today, they earn about 300 times more than the average employee. That contrast symbolizes how American voters in recent decades have *de facto* prioritized the prosperity of the business community rather than families. Executives have been exploiting this notion, combining supine corporate boards and stock options to game shareholders and seize most of the gains from growth. At the same time, pay-for-performance in executive suites has collapsed, as noted by columnist Gideon Rachman of the *Financial Times*:

> ". . . a link between virtuous effort and just reward has been effectively destroyed by the spectacle of bankers driving their institutions into bankruptcy while being rewarded with million-pound bonuses and munificent pensions."[3]

Worse, as noted a moment ago, shareholder capitalism incentivizes a set of lushly remunerative behaviors by executives quite destructive to broader American economic progress. Shareholder capitalism promotes management over shareholders, management over the firm, and the firm over employees, families, and society. Dismayed by Milton Friedman's harmful vision, criticism of shareholder capitalism has become sharp, exemplified by Cornell law professor Lynn A. Stout, author of *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public:*

> "In the quest to 'unlock shareholder value,' they sell key assets, fire loyal employees, and ruthlessly squeeze the workforce that remains; cut back on product support, customer assistance, and research and development; delay replacing outworn, outmoded, and unsafe equipment; shower CEOs with stock options and expensive pay packages to 'incentivize' them; drain cash reserves to pay large dividends and

repurchase company shares, leveraging firms until they teeter on the brink of insolvency; and lobby regulators and Congress to change the law so they can chase short-term profits speculating in high-risk financial derivatives."[4]

Little wonder American productivity growth is so weak.

A Culture of Responsibility

While Reaganomics endorses a culture of self-absorption, executives and financial leaders in the family capitalism countries reflect a culture of responsibility. As we shall see, Reagan-era America features executive suites receiving the grandest remuneration in the world despite mediocre productivity performances, with pay-for-performance all but abandoned. The American market for executive compensation is a classic example of market failure.

In contrast, voters in the family capitalism countries expect executives to strike a balance between their own compensation, employee compensation, growing productivity, and nurturing long-term enterprise success with investment and research. Additionally, they expect that government officials will carefully monitor and reinforce those expectations. Nowhere is this vastly different perspective more evident than in wage outcomes. For example, the highest US industrial wages are in the auto industry, where wage and benefit costs averaged $36.34 per hour in 2008 before the recession.[5]

These wages became a flash point when GM was poised in 2009 on the brink of bankruptcy, with Republican politicians withholding succor and demanding wage cuts. Executives in family capitalism countries must have found that focus on wages baffling. American autos face their toughest competition from German firms, BMW, VW, and others, where employee costs are considerably higher.

Moreover, American firms in northern Europe pay those same high wages to their employees there. In 2009, for example, Ford's German employees at the giant Saarlouis complex had a comprehensive cost of about $62 per hour, according to Barclays Capital.[6] And despite the slowdown in Europe, Ford continues to prosper. "It has done very well to contain costs, and the products are pretty good," explained Peter Wells, codirector of the Center for Automotive Industry Research at Cardiff University in Wales, in April 2012.[7] Indeed, tens of thousands of German autoworkers at Daimler/Mercedes, VW, Ford, and other firms earn more than unionized US autoworkers, which indicates that wages and benefits had nothing to do with GM's threatened bankruptcy. Firms

like Daimler can pay higher wages and benefits because German executives in a number of sectors simply have outperformed American management in recent decades.[8]

Regulatory Capture: The Relationship of the Business Community with Government

Like Americans, voters in the family capitalism countries are dubious of government. In contrast, however, that wariness also extends to its relationship with the business community; voters expect their politicians to prevent regulatory capture and to move aggressively when abuses become evident. In America, for example, during the housing bubble, Goldman Sachs and other firms sold financial instruments to customers, while betting at the same time that those instruments would fail. They made billions of dollars betting against their own clients in that fashion, yet few if any sanctions followed. The same abuse occurred to a lesser degree in Germany, but the outcome has been remarkably different, and informative.

Like Goldman Sachs, Deutsche Bank sold complex financial instruments to its customers such as the Ille paper firm in Hesse, while simultaneously taking positions against them. Deutsche Bank's self-dealing was contrary to German voter expectations of morality in commerce, however, and the courts agreed. In March 2011, the highest German court for civil cases ruled against Deutsche Bank's practice and imposed harsh penalties. Even worse for this giant bank, their behavior shocked enough people sufficiently to induce broad remedial legal action by the German political system, creating legislation similar to the original Dodd-Frank in the United States, but with teeth and without loopholes.

Such self-dealing is now illegal in Germany, and banks must clearly and explicitly warn potential investors and customers about risks or when institutions take positions designed to profit when customers incur losses. *Die Welt* explained:

> "This ruling has far-reaching consequences. After all, it does not only apply to Deutsche Bank. . . . This verdict contributes more to investor protection in this country than many of the well-intentioned laws that have been introduced by the Germany government since the financial crisis. . . . The new requirement, laid down by the court in its ruling, [is] that customers have to have the same level of knowledge as the bank. . . ."[9]

Australian officials react similarly to their own instances of corporate abuse. In a 2011 guilty verdict, a court concluded that the giant Centro

Properties' board of directors had breached the national Corporation Act by rubber stamping incorrect financials, thus misleading investors. As evidence unfolded in court, it turned out that directors had approved misleading accounts which did not disclose the imminent maturation of billions in short-term debt that would require expensive refinancing. An ensuing class action suit flowing from the verdict against the shopping center owner wiped out eighteen months of earnings.[10] The presiding Judge John Middleton explained the Australian expectation that corporations will behave responsibly, noting that boards of directors "have a profound effect on the community and not just shareholders, employees, and creditors." He elaborated:

> "The whole purpose of the directors' involvement in the adoption and approval of the accounts is to have the directors involved in the process at a level and responsibility commensurate with their role."[11, 12, 13, 14]

The Australian judicial system is more protective of the public interest than US courts, which tend to view economic issues through the lens of the business community. In that sense, the Australian legal system more accurately reflects Adam Smith's skepticism toward that community. While the marketing of addictive nicotine is legal in both, for example, the tobacco industry there is corralled; unlike in the United States, cigarettes can only be packaged in drab brown wrapping without brand logos, and they are dominated by vivid pictures of oral cancer victims and the caution that smoking causes mouth and throat cancer.[15] US courts rejected similar steps in August 2012.

Voters and the Australian government demand corporate accountability, with courts routinely pinning blame and punishment for ineptness, fraud, or mendacity at the very top, on CEOs and directors. The builder conglomerate James Hardie, for example, was a significant and profitable purveyor of asbestos-heavy products since the 1930s. Liability claims have risen sharply with improved science in recent decades, and Hardie's board and CEO faced an ethical dilemma. Looming accounting law reforms would saddle the firm with well more than a billion dollars in compensation costs over two decades. The board in 2001 had a choice: put up the money or decamp abroad. Members chose Plan B and announced a corporate relocation to the Netherlands, claiming the pursuit of lower taxes. To placate public opinion, it spun off a (severely underfunded) foundation intended to address victims of asbestos and related diseases.

But this strategy unraveled under investigation by the Australian Securities and Investment Commission (ASIC). For one thing, it seems

taxes were higher in Holland than in Australia (Hardie has since relocated to the tax haven of Ireland). Moreover, the compensation fund quickly became threadbare, funded with A$293 million ($300 million) intended to cover claims now exceeding $1.5 billion.

The national press has excoriated Hardie for "leaving a rapidly-emptying pot for the victims of asbestos disease," according to *Sydney Morning Herald* reporter Leonie Lamont. "Public sentiment turned on what was seen as an act of corporate bastardry," added Lamont with Australian color; the supreme High Court and ASIC agreed. Hardie's CEO and board members were banned from other boards for as long as fifteen years and heavily fined.[16]

The contrast with Wall Street CEOs guilty of comparable amorality clarifies the higher expectations for responsible firm leadership in the family capitalism countries. Further, the public sector reaction to Deutsche Bank, Centro, and Hardie are indicative of a generalized wariness toward regulatory capture. And when it becomes an issue, voters respond quickly, as demonstrated by the plight these days of the Free Democratic Party (FDP) in Germany.

An excited FDP received 15 percent of the vote in September 2009, enough to join Angela Merkel's Christian Democratic (CDU) governing coalition as a junior partner. Its leaders became the German Foreign Minister and the Environmental Minister. Without missing a step, the FDP exploited its pivotal position in the new government to force through a significant tax cut for hoteliers, only later to admit the loophole was a *quid pro quo* for donations from the Mövenpick hotel magnate.

Sordidly, it turns out that the donor, Baron von Finck, Germany's richest man, is a tax dodger closeted in a Swiss castle.[17] That revelation quickly proved toxic in a sober Germany scandalized by this homegrown version of pay-to-play US politics. The reaction was swift and severe. Since 2010, the FDP has been on life support. It may even fall below the 5 percent threshold required to hold any parliamentary seats in the 2013 elections.[18]

Corporate Governance: Codetermination

The differences between the family capitalism countries and Reagan-era America is not just seen in attitude, voter expectations, outcomes, or executive morality. There are quite significant structural differences as well. The most important is the device at the center of the black box of corporate governance in northern Europe, which accounts for Germany in particular being the globe's most competitive economy. I mentioned earlier that shareholder capitalism places America at a competitive

disadvantage, in part because it empowers short-termism. Germany avoids short-termism with *codetermination*, an accident of history that emerged in the wake of World War II, with employees holding a minority of seats on corporate boards. As we learn in later chapters, this device affords a considerable competitive advantage to German and northern European enterprises and certainly accounts for some of the outcomes we are reviewing.

In the family capitalism countries of northern Europe, voters insist that employers prioritize family prosperity. That expectation is enforced with codetermination. It produces long-term horizons featuring innovation, investment, rising real wages, and workplace upskilling. Voters have insisted that codetermination be complemented and reinforced with public policies that include quality education, extensive school to work transition, and intensive career-long upskilling, all proven to drive productivity and economic growth. The combination of such public policies and codetermination has yielded superior private sector innovation, investment, and entrepreneurship, and enabled the family capitalism countries of northern Europe to increase productivity for the past thirty years one-third faster than Reagan-era America. Broadly based and rising prosperity has been the consequence, exemplified by nations paying the world's highest real wages even as America devolved to be a low-wage nation.

Illusionary or Real Wealth Creation

Americans have come through an era in which decades of toil and savings produced what has turned out to be only illusionary wealth, built on a breathtaking $48 trillion credit expansion. The history during this era of wage stagnation is no better. In contrast, as we've discussed, real wages have multiplied smartly for decades in the family capitalism countries. Certainly, some segments of these societies have done better than others, but, as we'll see later, economists have documented that these income gains have been broadly based. America may be the best nation on earth in which to be born rich, but the best nations on earth to be born poor are Australia and France. They and the other family capitalism countries explicitly operate a version of capitalism that successfully treats an impoverished birth as a temporary condition to be cleverly remediated, not a lifelong curse that it too often is in America.

As a result of these trends, America has become a low-wage nation, where both wages and total employer costs for labor, once the highest in the world, have been surpassed by many other rich democracies.

As we see depicted in Chart 3.1, comprehensive costs for all private sector workers, including benefits paid by employers in shops, offices, and plants across northern Europe, are about 30 percent higher than in America.

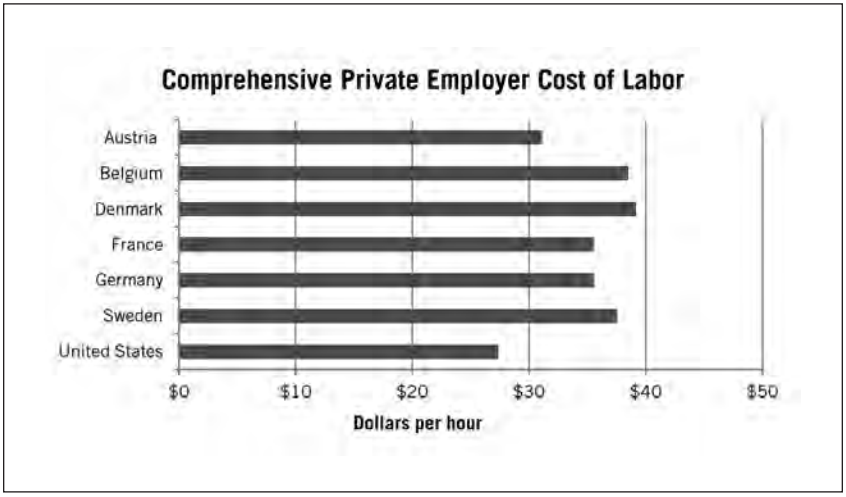

Chart 3.1. 2008, cost adjusted for purchase power parity. All private sectors including non-farm business industry, construction, and services. European data includes part time and employees at firms > 10 employers, but excludes annual bonuses generally equal to one month pay. Germany includes the former German Democratic Republic.

Source: Hourly Labor Costs, Eurostat 2011, Marie Visot, "The Debate on Labor Costs Revived," Le Figaro, February 28, 2011, OECD.StatExtracts, "Employer Costs for Employee Compensation, Bureau of Labor Statistics Historic listing (December 2008), and "The Cost of Labor Divides Senators," Le Monde, March 9, 2011.

The slowdown of recent years has not affected this pattern. In Germany, for example, the Düsseldorf-based Macroeconomic Policy Institute determined that employers incurred a gross cost per private sector employee in 2010 of €29.10 ($35.80) per hour, including fringe benefits and contributions to social security and other taxes.[19] And costs in Belgium, Denmark, France, and Sweden were higher still and higher than in the US. Domino's, for example, pays its drivers in Australia three times what it pays in America, but still manages record profits year after year.[20] Writing about Long Beach, California, port truckers, *Sydney Morning Herald* columnist Malcolm Maiden explains, "By our standards, they get a pittance."[21]

That disparity is emphasized by comprehensive employer cost data from the key manufacturing sector, reproduced in Chart 3.2. That sector is the fount of most productivity growth, typically pays the highest wages aside from finance, and is the sector most stressed by globalization. The actual wage component of these figures ranges from about one-half in Belgium to two-thirds or so in Australia and the US.

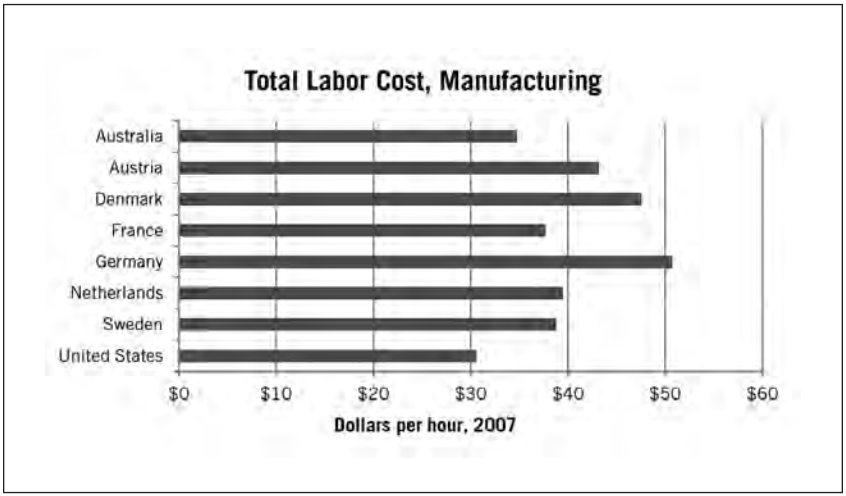

Chart 3.2. Private sector, US dollars adjusted for purchase power parity, 2007.
Source: Hourly Compensation Costs, Competitiveness in Manufacturing, Bureau of Labor Statistics, Department of Labor, 2010, Washington, table 3.1.

These high wages are the consequence of the family capitalism countries achieving steadily rising real wages. That means workers have received a notable portion of the gains from growth for decades. Americans are justly proud of the nation's genuine entrepreneurial and innovative culture and presume that the US economy remains fundamentally potent. The key measure of economic prowess is the growth rate of productivity, the value of output for each hour of work. America certainly enjoyed superior performance in the post-war golden age, when labor productivity growth averaged 2.8 percent annually. But, as we learned earlier, since 1979, productivity growth has averaged nearly a percentage point less per year. In contrast, international statistics show that productivity growth in northern European nations like France and Germany, for that same sustained period of three decades, has averaged one-third higher than America. Wages have risen to overtake America, because employees in the family capitalism countries have been receiving 30 percent or more of the gains year in and year out from that growth in productivity, while all but a few Americans received none. That is why European multinationals now view America as a low-wage nation and Americans as low-wage workers.

Family Capitalist Firms Abroad

Enterprises in the family capitalism countries face a community expectation that families will share in their success and obviously, they have

pursued wage and other policies to meet those expectations—at home, anyway. But those same firms readily abandon domestic standards—particularly on wages—when investing abroad. They unabashedly pay local scale overseas, which is always lower than at home. Indeed, they are so aggressive in compressing wages to the extent permitted by foreign rules that they occasionally are targets of criticism.

For example, on September 2, 2010, Human Rights Watch fingered ten of the largest northern Europe firms, including Siemens, Deutsch Telekom, Gamma, Kongsberg, and Sodexo, for exploiting workers in a foreign market, where voters endorse weak local laws that were "less protective of freedom of association of employees." Human Rights Watch highlighted that these firms in the foreign market were "adopting practices common [there] but banned in Europe." Their goal was to maximize profits by suppressing wages, and they were duplicitous about it, as Human Rights Watch pointed out:

> "These companies proudly state their commitment to international labour standards, but in practice they have taken steps to create a culture of fear about organizing. . . ."[22]

The European firms, viewing employee activists urging wage hikes as threats, were guilty of a variety of practices not permitted in northern Europe. They included: intimidating employee organizers with "interviews akin to interrogation," firing labor organizers, refusing to negotiate with unions, changing job classifications to deprive employees of organizing rights, deploying misinformation, and hiring replacements for striking workers. Deutsche Telekom demurred, noting accurately: "We respect all [local] rules and laws. . . . It's baffling that we are named in this context and firmly reject all the allegations." As it transpired, the firms could legally commit these abuses because laws in this low-wage nation permitted it; their American, Japanese, and Korean competitors were doing precisely the same thing.

Families in what nation were being victimized by this employee abuse? Was it Cambodia, Nigeria, China, or perhaps Tajikistan?

It was being done in . . . America.

Low-wage America. The *Financial Times* reports that Daimler had settled on a new location to shift some C-Class sedan production from Sindelfingen, Germany, in order to exploit cheap foreign wages:

> "The Tuscaloosa plan was a blow to the 94-year-old Sindelfingen plant and underscored how managers are looking to expand plans in regions with low labour costs and weak currencies."[23]

European firms have eagerly taken advantage of the low-wage culture empowered by Reaganomics. Corporations content to pay the world's highest wages at home ruthlessly exploit the low wages permitted in the US. Volkswagen, for example, offered jobs at $14.50 per hour at its new Chattanooga plant—one-quarter its labor costs in lower Saxony.[24]

Richard Voorberg, director of projects for Siemens Energy, explained to reporter Joe Nocera of the *New York Times* that his firm is locating a new plant in North Carolina rather than China in part because "the labor cost differential wasn't very big."[25]

Here is how former Federal Reserve Board chairman Paul Volcker described the situation in December 2009 to *Der Spiegel*: "I think the labor cost is higher in Germany than it is in the United States, but you can somehow maintain that export edge. Tell me the secret of how the Germans keep this going."[26] The secret is hidden in plain view: superior corporate governance from codetermination that incentivizes corporate management to focus on productivity growth and the long-term prosperity of the firm.

Critically, European firms can afford to pay higher wages domestically because the labor component of most industrial goods across the globe is small, less than 20 percent. "Wages and benefits account for 15 to 20 percent of our costs," explained John Surma, CEO of United States Steel.[27] In autos, labor costs comprise 10 percent or even less in America.[28, 29] A host of other factors, including materials and energy costs, management competence, product styling, efficiency and customer service, are significantly more determinant than labor costs to enterprise success. Labor cost in many emerging industries, high-tech batteries, for example, is so insignificant that Korean LG Chem Power invested in a Michigan plant despite wages far above Asian levels. "Only 5 to 10 percent of the cost of a battery cell comes from labor; materials account for the bulk of expenses," explained CEO Prabhakar Patil in August 2011, to reporter Jon Gertner of the *New York Times Magazine*.[30] Moreover, as noted, annual productivity growth in a number of other rich democracies has averaged one-third higher than the US since President Reagan's election, enabling European enterprises to raise wages year after year without impinging on profits, dividends, or investment needs.

It was perhaps the Germans who first noticed that the US had become a low-wage nation and what had consequently happened to Americans. Here is Gabor Steingart, editor of the Dusseldorf-based business newspaper *Handelsblatt*, writing about baby boomers in 2006:

> "For many blue- and white-collar workers, this decline is already absolute because they have less of everything than they used to. . . . They're the losers in the world war for wealth."[31]

Australian Family Capitalism

American conservatives consistently list Australia among the most admired capitalist economies. The Heritage Foundation's *2012 Index of Economic Freedom* placed it third, behind the city-states of Hong Kong and Singapore and just ahead of egalitarian New Zealand.[32] America is tenth. It's conceivable that American conservatives are infatuated by solidly rising Australian wages and the high voter expectations for responsible corporate behavior, but more likely they are poorly informed. Australia pursues the same family capitalism model as Northern Europe, and, in some instances, is the country of origin of its important elements, like their highly effective national wage setting mechanisms.

American conservatives may be surprised by how dramatically the Australian economy differs from Reaganomics, despite the many superficial similarities between the two nations. Both were settled by British colonists intent on seizing land and wealth and making a better life, regardless of the cost to indigenous populations whose rights were homicidally flouted. Each featured vast frontiers rich in natural resources to be won by force of arms and grit, which nurtured individualism, a strong sense of community, and distrust of central authority. Each subsequently exhibited a frontier legacy of communal effort and, over time, a reliance on government to temper emergent corporate excesses.

In the United States, Washington took a number of steps to manage and regulate corporate abuses beginning in the Teddy Roosevelt period a century ago and again during the New Deal, but the outcome has been mixed. The reforms reached a strikingly greater maturity in Australia, which, along with New Zealand, proved to be a major incubator of family capitalism. New Zealanders conceptualized the minimum wage in 1894, for example.

In 1907, the first conceived minimum standard of living, or a livable wage, was institutionalized by Australia's Harvester Judgment . The reverence for this historic role in the evolution of capitalism is captured by a June 2010, editorial in the *Sydney Morning Herald*:

> "Australia pioneered the living wage, the principle that pay should sustain a standard of living that was reasonable for 'a human being in a civilized community.' That principle has underpinned the nation's prosperity and stability for a century."[33, 34, 35]

The spread to near-universal appreciation of the concept of livable wages accounts for voter determination there and in the other family capitalism countries that all economic actors should strive for ever-rising family prosperity. Prioritizing family prosperity also drives the

Australian focus on education and upskilling. Here is how Australian Treasury Secretary Martin Parkinson explained it:

> "As competition intensifies globally, as the global economy transforms and as our population ages, we are going to only be able to deliver rising living standards if we are going to be able to deliver greater productivity. . . . Productivity is not about working harder or working longer, it's actually about working smarter. This requires . . . top-notch management skills that would innovate and capture opportunities."[36]

The urgency of upskilling drives an inclusive education system where "every Australian is offered the opportunity to succeed and reach their full potential," explained Chris Evans, Australian Minister for Tertiary Education, Skills, Jobs and Workplace Relations in November 2010. And it drives a business culture in which expectations are a "fair day's work for a fair day's pay, the right of employees to collectively bargain with their employer and the right to safe and fair working conditions."[37]

For nearly a century, Australian voters have repeatedly made clear they want those expectations to be met by the business community and to be monitored by an alert trade union network and public sector. They demand that conservative and liberal governments alike implement those expectations, with a nationwide comprehensive bargaining and wage system overseen by the federal government as the day-to-day guarantor of Australian family prosperity. Voters understand the role of the market in facilitating this system, but would view an American-style transfer of economic sovereignty from families to firms as a betrayal of their most sacred economic principle: family prosperity.

In contrast to US voters, Ross Garnaut, Vice-Chancellor's Fellow at the University of Melbourne, explains that Australians reject "the treatment of labor as a commodity." In the most fundamental way economies can differ, Australia is the polar opposite of Reagan-era America. Its family capitalism model has ensured that productivity gains are shared by employees and employers alike in annual wage agreements. That goal is not attained mystically, but through a collaborative effort by business, government, and employees using a mechanism adopted in most other rich democracies.

Trade union activism has been important to achieving that goal. That activism led to paid four-week vacations, paid holiday leave, a cap on maximum working hours, and other worksite protections such as higher pay for evenings, nights, and weekends. Supported traditionally by both major parties, but initiated by the Labour Party, what emerged many decades ago is a national consensus: noninflationary wages are best

achieved by a blend of trade federation and employer negotiations carefully monitored by the public sector. The Australian Bureau of Statistics describes the widely emulated mechanism this way:

> "In Australia, the 1983 Wage Accord established a centralized wage-fixing system that took into account economic policies and the Consumer Price Index. By 1987, the replacement was a two-tier system that distributed a flat increase to all workers and made further increase provisional on improvement in efficiencies. In 1988 and 1989, efficiency provisions were replaced by award restructuring and training provisions."[38]

In exchange for certainty in real wage growth linked to productivity, the 1983 Accord removed some labor protections in order to strengthen employer flexibility. This centralized wage determination structure is responsible for Australians enjoying real wage growth for decades, while Americans received none. Two quasi-independent entities comprise this structure, Fair Work Australia and the Australian Productivity Commission; similar institutional arrangements exist in the other family capitalism countries.[39]

These institutions enjoy powerful support from voters and enforce government rules supporting broadly based prosperity. On a spectrum of income disparity, the Reagan-era US income distribution leans toward the crony capitalism of nations such as China, with wide disparities. At the other end of the spectrum are Australia and the other family capitalism countries, where families broadly enjoy economic sovereignty and garner a considerable portion of the gains from growth. As I have emphasized, it's not the quantity of government regulations, taxes, or the size of government that distinguish Australia or Germany from the US, but whether government rules broadcast the gains from growth widely or narrowly. In Australia, this evolution to contemporary family capitalism occurred gradually with relatively modest conflict over nearly a century. Not so in Europe, as we see now.

Evolution of the Grand Bargain Undergirding Family Capitalism

The eighteenth-century industrial revolution launched an unprecedented wave of productivity growth and increases in wealth. But the ensuing income disparity provoked bitter debate. As Jeremy Rifkin noted, "Although Europe was the seedbed for advancing a private property regime, there was opposition from the start," mostly farmers and

the urban working class—subsisting in such squalor that they fled the dreadful conditions of the early Industrial Revolution by the millions for opportunity offered by new lands in the Americas, Australia, South Africa, and Canada.[40]

Dickensian eighteenth- and nineteenth-century societies demonstrated that joint stock entities and the rising merchant bourgeois class could easily outmuscle families to seize economic sovereignty. Rising income disparities gave voice to collectivists; Jean-Jacques Rousseau, for example, who published *Discourse on the Origin of Inequality* in 1755, and Karl Marx, whose dense *Communist Manifesto* was published nearly a century later.

Mainstream critics sought to temper the increasingly evident excesses of poverty, wage suppression, and the amorality endemic with *laissez-faire* capitalism, as popularized by Charles Dickens and others, and later, by American writers such as Upton Sinclair and John Steinbeck. It was a battle first waged in England, featuring the Chartist laborers' uprisings in 1838–1848 promising class warfare.[41] Forced by public opinion to acknowledge the validity of long-suppressed employee grievances, Parliament launched study commissions and soon crafted a middle ground between conservatives like Thomas Carlyle and socialists like John Stuart Mill that became a continent-wide template. The Parliament's Factory Acts of 1844 addressed a host of issues—industrial accidents, hours of work for women and children, and child labor—and was a milestone amid the long grind to family capitalism.[42]

The philosophy undergirding these reformers evolved and spread from the first industrial states of England, the Low Countries, and Germany. It included contributions from socialists and compromises from powerful market advocates; even the stoutest market defender accepted the principle espoused by philosopher Jeremy Bentham and others, for example, that capitalism should not abandon the poor.[43] It drew on capitalist writings from Adam Smith, well aware of the flaws of unfettered *laissez-faire* enterprise and deeply suspicious of the merchant class. It was Smith, for example, who publicized that the East India Company had profited by harming its own farmers. The EIC restricted supply and raised food prices during the Bengali famine—a famine that played such a pivotal role in the 1773 Boston Tea Party.[44, 45] And it was Smith more than any other economist, who gave lift to the remarkable concept that the brutal hand-to-mouth conditions of mankind throughout history weren't immutable. He believed they were amenable to reform and human intervention and improvement, through the careful exploitation of the ancient concept of markets and the human impulse of greed. That made him a great admirer of the grand experiment unfolding in the American colonies, especially in New England, which he praised in *The Wealth of Nations*:

> "There is more equality, therefore, among the English colonists than among the inhabitants of the mother country. Their manners are more republican, and their governments, those of three of the provinces of New England in particular, have hitherto been more republican, too."[46]

Led by the German Chancellor Bismarck and other crafty politicians, European nations devised the clever bargain that still attains today: purchasing the support of employees and the landless for open trade, for free enterprise, and for capital accumulation by ensuring that families prospered as well as traders, capitalists, and entrepreneurs. Vital elements were publicly funded economic safety nets, workplace cooperative agreements, and labor unions that mobilized and coalesced public opinion in support of job and wage stability. As the Industrial Revolution matured, this grand bargain emerged as a family-focused market economy. It is impossible to overestimate its importance, for the evolution of that *de facto* bargain enabled the free-market concept to become the seminal feature of European economies and, eventually, the American economy, driving global prosperity. Here is how Rifkin describes it:

> "It was a grand compromise, a way to appease the rising *bourgeois* class and the remaining aristocracy on the one hand, and Europe's working class and poor on the other hand. The idea of a private property regime would be upheld in return for a promise that some of the excesses of unbridled market capitalism would be redistributed, in the form of government social benefits. The welfare state would become a way to balance the books and prevent class divisions from turning into open warfare and revolution in the streets. For the most part, the great European compromise succeeded."[47]

But the default setting remained dictatorship and disrupted commerce, which reemerged in the wake of World War I as inflation, starvation, and the bloody flag of revolution stalked Europe, especially Germany.[48] During the disastrous Weimar inflation of the early 1920s, a streetcar ride that had cost a single mark before the war became priced at 15 billion.[49] Germany was the world's third largest economy at the time, and the failure of capitalism there in the early Bolshevik era would have had profound implications, irresistibly thrusting Lenin and later Stalin into the heart of an enfeebled Europe.

The armed Bolshevik threat Europe faced down in the tumult following World War I was an existential tipping point for capitalism. There was a pitched uprising in Berlin, bloody insurrections featuring a homegrown

Red army occupying the Ruhr in 1920, Saxony, and Thuringia under Bolshevik governments in 1923, and an attempted Communist revolution in conservative Bavaria.[50] The westward march of the Red Army itself stalled at the Vistula, thanks to Józef Pilsudski, and southward at the Caucasus, thanks to Kemal Atatürk.[51] The weapons were bullets and social reforms, including laws like the eight-hour workday (France 1919) and mandated corporate work councils in 1920, along with unemployment insurance, health, and welfare subsidies. Professor François Furstenburg of the Université de Montréal explains:

> "The Gilded Age plutocrats who first acceded to a social welfare system and state regulations did not do so from the goodness of their hearts. They did so because the alternatives seemed so much more terrifying."[52]

Europe was the battleground against collectivist ideology. Among others, Englishmen John Maynard Keynes and the journalist George Orwell, who authored *Animal Farm*, were passionate critics of collectivism. Yet deregulated capitalism was its own worst enemy. Washington officials, for example, proved unwilling to regulate bankers in the Roaring Twenties with strict caps on loans for stock speculation. Weak regulation and mismanaged credit causing the Great Depression deeply besmirched capitalism.

Staggering losses from panic selling beginning on Black Thursday, October 24, 1929, nearly equaled 50 percent of GDP. Even leaders like Winston Churchill were nearly wiped out personally; his home, Chartwell, had to be sold in 1929.[53] Tribally bound to honor the terms of the gold standard, central bankers took leave of their senses: despite deflation of 7 percent, the Fed doubled interest rates to 3.5 percent (to lure capital from abroad)—raising real rates into double digits even as industrial output was collapsing at a 25 percent rate. Less than one year later, national income was down 45 percent and nearly 30 percent of all Americans had no apparent source of income.* And the need for cash under the gold standard was so severe abroad that the Bundesbank

*Contrary to popular legend, it was not the Smoot-Hawley tariffs that caused the Great Depression, but the evaporation of credit. In fact, American import taxes redirected domestic consumption to domestic producers, stimulating demand and offsetting the loss of exports. Liaquat Ahamed explained it this way: "Far more damaging that the effect of the protectionist Smoot-Hawley Act was the collapse in capital flows. . . . It was the hoarding of gold by the United States and France and the resulting shortage in the rest of the world that had brought on the Depression." *Lords of Finance*, pp. 375, 431, 436, and 448.

officials also amazingly raised interest rates, hoping to lure capital home from America despite double-digit unemployment.

The Great Depression presumably forever tattooed *laissez-faire* economics a failure, with Keynes among the visionaries crafting the emerging European family-market capitalism in the 1930s. They realized that it was bad rules and inept management, rather than inherent fatal flaws, that had discredited capitalism. And they planned for a rebirth of family capitalism even as World War II raged, drawing inspiration from Franklin Roosevelt. His January 1944 fireside chat encapsulated the wisdom that human fulfillment has an inescapable economic component: "True individual freedom cannot exist without economic security and independence. People who are hungry and out of a job are the stuff of which dictatorships are made."[55] Drawing on Adam Smith, their alternative was to remediate the flaws of *laissez-faire* capitalism with careful regulation, creating a twentieth-century grand bargain, with government maintaining prudent regulations on commerce and labor markets and expanding the safety net with retirement and unemployment support.

As explained by his biographer, Robert Skidelsky, Keynes supported regulation to "redress the failings of society not because he loved it, but because he saw it, in the last resort, as the savior of capitalism from the temptations of collectivism or worse."[56, 57] In clarifying a capitalism that sanctified family prosperity, Keynes and others fended off the Bolsheviks and provided the intellectual heft and insights vital to victory later during the Cold War. As much as Adam Smith, Keynes created the moral high ground enjoyed by free-market capitalism today by explaining how the abusive greed of markets could be ameliorated and corralled to avoid the unemployment and periodic financial panics of *laissez-faire* Reaganomics. As Yale economist Robert Shiller explained, Keynes'

> ". . . General Theory also had a deeper, more fundamental message about how capitalism worked, if only briefly spelled out. It explained why capitalist economies, left to their own devices, without the balancing of government, were essentially unstable. And it explained why, for capitalist economies to work well, the government should serve as a counterbalance. . . . Its role is to ensure a 'wise *laissez-faire*.'"[58]

Family capitalism was born in the wake of World War II, as western European officials clarified the role that enterprises should play in marshaling and deploying the risk capital needed for productivity growth and production. The vision of Smith, with his jaundiced eye on the

merchant class, inspired European officials determining how best to prioritize family prosperity. They combined Adam Smith with mainstream Biblical verities drawn from the Catholic communitarian theology and the Protestant Social Gospel to alleviate poverty, hunger, and economic injustice. That is why some of the least religiously observant nations on earth have the most religiously grounded capitalism.[59]

The consensus was that the artifice of corporations shouldn't be imbued with the rights of man; there would be no American-style cult of the corporation in Europe. Paul Rayment, former Director of Economic Analysis at the United Nation's Economic Commission for Europe, explained the philosophy governing the role of business in Europe this way: "In a democratic political system, the activities and institutions of the corporate sector derive their legitimacy from the political sphere, not the reverse."[60] Firms are mere devices to efficiently marshal resources, spread investment risks, and create wealth, not entities capable of self-regulation, much less endowed with constitutional rights mimicking those enjoyed by genuine citizens. They are a subservient contrivance yoked by the counterbalancing rules of government to empower broad societal prosperity and enrich families, tools to be modified or even discarded when no longer useful to society.

In America, a European-style safety net was also gradually crafted beginning in the nineteenth century, inspired by worker activism including the Molly Maguires, the national railroad strike of 1877, the Haymarket affair in 1886, and the murderous Homestead strike in 1892. The safety net was weak, however, an outcome of the pecuniary nature of American politics, which—then, as now—bestows outsized influence on the affluent donor class including the business community.

And so we arrive at 1981. A wave of new politicians crowded into Washington, determined to unravel this grand agreement so painfully and thoughtfully pieced together in the 1930s and 1940s. Suffering with cognitive dissonance toward economic history, unwilling to learn from the Great Depression, and enthralled by the certitude of powerful personalities pursuing an ideological agenda, they launched the Reagan era. What was their biggest mistake? They threw Adam Smith under the bus, ignoring his warning that "The government of an exclusive company of merchants is, perhaps, the worst of all governments for any country whatever."