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Economics

The Hamilton

Approach to

Economic

Growth

and Policy

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Preface

This book does not provide any important new facts. It sets out no new economic theories. It offers no analyses of new data sets. It uses no new statistical tools. If, accidentally, we do any of these, we have in some sense failed. And we will definitely have failed if this book is not accessible, readable, and enjoyable.

Everything this book presents is—or at least was—well and widely known.

Recently, however, much seems to have been forgotten. So this book tries to do something important. It tries to remind us, in simple, concrete terms, of how the American economy, again and again, was reshaped and reinvigorated by a loveless interplay of government making broad economic policy and entrepreneurs seeking business opportunities.

This book, therefore, is about government and entrepreneurship. But it will not rehash the sturdy and well-known arguments that, to thrive, an entrepreneurial economy needs an environment characterized by a broad range of freedoms, protections, and incentives. Consider that argument axiomatic.

We are here to talk about the other important interplay of government and entrepreneurship. And it is very important.

Repeatedly, government in the United States opened a new economic space, doing what was needed to enable and encourage entrepreneurs to rush into that space, innovate, expand it and, over time, reshape the economy. Each time, and there were many, this was done pragmatically. The choice of economic space seemed obvious, and the means—while powerful interests usually had a leg up—was never the bright idea of some smart economist or

distinguished committee; it was never guided by ideology, whether pure or in the guise of theory. And each time in America's long economic history—except for the most recent one, which was based on ideology rather than pragmatism—the results have been very positive indeed.

From a global, bird's-eye view, three centuries ago the world's high civilizations were roughly equal in prosperity. Today the North Atlantic nations (including a few “honorary” North Atlantic countries like Japan and Australia) are richer by a factor of at least five. And the overwhelming bulk of that divergence is due to economic policy. The post–World War II reinvigoration of Western Europe, the post-1975 rise of China, and the post-1913 relative economic decline of Argentina were, no serious thinkers dispute, predominantly driven by good and bad economic policy.

That policy matters most is clear from this global record. In successful economies, economic policy has focused on what works for people who are trying to increase productivity on the ground, not on the voices heard by madmen in authority or the doctrines of academic scribblers. That is the lesson we draw from our reading of economic history. Getting economic policy right—and getting the political economy right, so that the country can get its economic policy right—is and has been of overwhelming importance in generating prosperity. But a global, bird's-eye view cannot provide us with enough detail to understand how, exactly, or what “getting the economic policy right” really means.

For that, we have to focus.

And so this book will focus on the United States, which is, fortunately for us, the place where economic policy has been, without a doubt, the most successful over the past couple of centuries.

When we look at the United States, we find not one design of economic policy, but rather sequential redesigns as the economic environment and the policies that offer the best chance of

successful medium-term growth shift.

Beginning with Alexander Hamilton, the architect of the first and most important redesign, and moving on to Abraham Lincoln and the Republican ascendancy, to Teddy Roosevelt, Franklin Roosevelt, and Dwight Eisenhower, the US government is always there, taking the lead, opening new economic spaces. It is doing so consciously. And it is doing so pragmatically—not ideologically. And it is doing so very successfully, at least until recently.

We have forgotten our history. This book seeks to remind us of our history.

Introduction

In successful economies, economic policy has been pragmatic, not ideological. It has been concrete, not abstract.

And so it has been in the United States. From its very beginning, the United States again and again enacted policies to shift its economy onto a new growth direction—toward a new economic space of opportunity. These redirections have been big. And they have been collective choices. They have not been the emergent outcomes of innumerable individual choices aimed at achieving other goals. They have not been the unguided results of mindless evolution. They have been intelligent designs.

And they have been implemented by government, backed and pushed by powerful and often broad-based political forces, held together by a common vision of how the economy ought to change. They have then been brought to life, expanded, and transformed in extraordinary ways by entrepreneurial activity and energy. The new direction has always been selected pragmatically, not ideologically, and presented concretely. You could see it in advance—as in, “This is the kind of thing we are going to get.”

Until the latest redesign, beginning in the 1980s.

Yes, there was an “invisible hand,” and enormous entrepreneurial innovation and energy. But the invisible hand was repeatedly lifted at the elbow by government, and re-placed in a new position from where it could go on to perform its magic. Government signaled the direction, cleared the way, set up the path, and—when needed—provided the means. And then the entrepreneurs rushed in, innovated, took risks, profited, and

expanded that new direction in ways that had not and could not have been foreseen. The new or newly transformed sectors grew, often quickly. In growing they pulled other new activities into existence around them. The effect was to reinvigorate, redirect, and reshape the economy.

This is how things have been, not just in the United States but worldwide, since even before the National Economic Council staff of Croesus, King of Lydia, came up with the game-changing idea of *coinage*. What governments have done and failed to do has been of decisive importance—even in America. Underneath the rhetoric and perpetual conflict, there is a critical though often unspoken interdependence of entrepreneurship and government—a coming-together that reshapes and grows the economy. It is a bit like tigers mating: They don't stay together and cuddle very long. But it is how America has managed to have such a successful entrepreneurial-driven economy.

The choice of new direction was based on a general perception of where America's economy ought to be going and what would be needed to move the economy in that direction. There was, always, an unsightly tangle of interests and compromises. But eyes stayed on concrete reality. Higher ideological truths or abstract theories did not direct. They were not seen as providing ready-made answers. Nor did they even frame issues. Intellectual concern and practical politics focused on how to get the new growth going—and, of course, on paying off the best-positioned interests. Changing the shape of the economy to renew and grow it was the object. The object was not to instantiate the unchanging, a priori, providential truths of any left or right political economy doctrines.

It was all very concrete, very pragmatic, very American.

Beginning in the 1980s, and continuing across a generation, the United States once again redesigned its economy. But this last time its choice of policy was not at all concrete. And it was not at

all smart. For it was done very differently.

For starters, the US government was not the only government targeting the shape of the US economy. On one side, the policies of East Asian governments—first Japan, then South Korea, and then, with quickly accelerating force and scale, China—pushed their economies onto a manufacturing-export development path. On the other, the United States accommodated their export-manufacturing push by pulling resources out of import-competing sectors and implementing a set of targeted policies to shift them elsewhere, into a new growth direction, toward what were supposed to be the higher-value industries of the future. It was ideology that told us these industries were out there. It was newly minted abstract theories that told us that they were the higher-value industries of the future. But no concrete sketch of what that future shape for the economy would be was forthcoming. The invisible hand of economic magic was to pick up and realize what the stealth hand of politics had set in motion.

The two teams, Asian and American, performed a kind of cosmetic surgery on the US economy—a body-sculpting. The American accommodation of the Asian export-manufacturing push—steel, shipbuilding, automobiles, machine tools, electronics—was sold as a liposuction, fat removal. It cut away a lot of muscle. Indeed, the weight of manufacturing in the economy dropped by 9 percent: from 21.2 percent of GDP in 1979 to 12.0 percent at the peak of the last business cycle in 2007.¹ That's a big number—almost two full Pentagons: call it a Nonagon.

The Washington team performed the implant: deregulating both high and low finance; fueling real estate transaction processing; multiplying the share of economic activity devoted simply to the processing of health-insurance claims; and so forth. These sectors that were supposed to be the high-productivity, leading sectors of the economy increased by 5 percent of GDP—one full Pentagon.

Today they account for a full one-fifth of the entire economy.² This is pure economic bloat. Impure flab. Much of it, when all goes well, is close to a zero-sum activity: no net gain.

The decline in American production of manufactured goods was not completely or primarily due, as some like to think, to a shift to a post-industrial society. That shift accounted for at most a third of the relative decline in manufacturing. We can see this by simply noting that the relative consumption of manufactured goods in no way declined proportionally to production. We still wanted the manufactures. And so we imported them. And these imports of manufactures constitute the lion's share of America's trade deficit—5 percent of GDP before the Great Recession cut imports as well as almost everything else.

To finance the purchase of all the manufactured goods we were no longer making, we did not produce other goods we could export. Instead, we accumulated debt—mountains of it. The East Asian economies were eager to build up their manufacturing capacity and capability, and our ideologically motivated redesign of the American economy told us that we didn't really care, because we didn't really want those sectors. The Asian governments were eager to extend credit and hold growing piles of dollars that were likely to depreciate. In exchange, they got the immense treasure of industries and their associated engineering communities of technological practice.

We're still living with the consequences of this last, damaging redesign.

And so America needs another redesign—and it needs it right now.

The purpose of this book is to suggest that our history has a lot to teach us about how to think about undertaking this next, necessary redesign. It is important to understand how the US government has repeatedly and intelligently redesigned the

economy in the past, because the market does not undergo an intelligent redesign by itself.

In this, government once again will have to lead. It does not matter whether the US government thinks it should not lead, or whether it can't. Government—somewhere—will in any case lead the reshaping of the American economy. It might be best if that government were the American government.

Who is going to draw the new design—or even select the new design principles? A few guys who think they are smart, like us? A beltway think tank? A blue-ribbon commission? Of course not—that's not how we did it in the past. An effort at redesign is never the result of a single bright idea, with a quantitative plan for how it will ramify through the economy. No one can ever know the complex configuration that a redesign effort will eventually yield, let alone its extent. But determining the broad direction, and some enabling measures, is another, much easier undertaking.

A Little History

The history of America's imperfect but largely successful redesigns is simple and clear. Yet we have managed, over the past generation, to forget much of it and to remove it from economics courses and public debates. It is worth reviewing, for the United States should soon have another debate over whether government should take a lead in reshaping the economy or just stand back and let it evolve. Proponents of unguided evolution will claim as strongly as they can that what is good in America's economy has always just evolved via purely unguided, molecular movements, and only what is bad has been designed by the government. They will forget, for starters, Alexander Hamilton. They will forget President Eisenhower too, not to mention both Roosevelts, and presidents Lincoln and Reagan. Like or regret the outcome, that is how it happened: through deliberate efforts to reshape, selected by discussions of outcomes, not just processes. There are things that matter immensely for an economy that only government can do. If it hesitates, refuses, or botches the job, the problem does not just go away and the economy does not advance as it should.

Alexander Hamilton

Alexander Hamilton set out to redesign the agrarian economy that Britain's mercantilist policies had imposed on the North American colonies and for which America's unlimited land and limited population density so well suited it. The colonies provided tobacco and grains from their farms, furs and wood from their forests, and cotton from their plantations, and Britain provided higher-value-added manufactured goods and services such as banking and shipping. The founding fathers set out to substitute their own vision of how the American economy should develop and, in the language of modern economics, deliberately change

over time the structure of America's comparative advantage. They set out to reshape the economy.

Hamilton, the founding father of the American economy, led the way, intellectually and politically, pushing policies to promote industry, commerce, and banking. Central to his view on how to redesign the American economy was the necessity of protecting America's infant industries from more competitive English producers. The playing field had to be tilted. So up went the tariff: about 25 percent in 1816. Given the huge costs of early nineteenth-century shipping, this was a formidable exercise in protectionism, as well as a major source of federal government revenues. And up it stayed—over the opposition of a nation of agriculturalists who were buyers, not producers, of manufactured goods—and to the extreme displeasure of the British.

Hamilton's party, the Federalists, was replaced by Jefferson's and Madison's small-government Democratic-Republicans. But Jefferson, Madison, and their successors quickly decided that their small-government, agriculture-first principles had been an out-of-power luxury. So policies to promote industry stayed in place, as did the tariff, rising and falling as political balances shifted. They were augmented by several decades of policies to enable and subsidize canal and later railroad building. And pre-Civil War America, safe from foreign military threat, channeled Department of War money to fund the development of promising high-tech industries at the Springfield Arsenal and elsewhere.

They picked some big winners: one was a way to assemble guns from standardized parts using relatively unskilled labor because America lacked skilled gunsmiths. This innovation shaped far more than America's gun industry; it became the basis for the powerful approach to manufacturing called the *American System*. Tariffs stayed high, and as steel ships radically reduced the costs of transatlantic freight, America raised them still further to effectively offset the impacts of greater efficiency. We didn't

even honor the intellectual property of British authors, their copyrights: Dickens was unable to collect royalties on US sales of his best-selling novels.

After Hamilton: Democrats, Whigs, and Republicans

Again and again, America renewed this high-tariff industrialization policy—over the opposition of its farmers and the Southern planters—for the higher purpose of distorting market outcomes in America’s favor, protecting its infant industries. It worked very well: the country industrialized at a very rapid pace. By the end of the nineteenth century, those infants had grown to be the largest firms in the world, and America had overtaken free-trade Britain as an industrial power. And it kept those protectionist tariffs, the highest in the North Atlantic, with occasional very short-term drops, right up until World War II.

The nineteenth-century US government took the lead in creating the transcontinental railroads. Railroad expansion reshaped the economy by opening vast regions to profitable farming and settlement and by accelerating the development of feeder industries such as steel and complementary industries such as telegraph. Unforeseeable entrepreneurial industries also developed on the railway, such as the Sears, Roebuck catalog sales, or Swift’s meat, which slaughtered out in the Midwest stockyards, not in downtown Boston or Baltimore, and shipped the steaks, not the cattle, east. The government did not tax and spend to do this. It didn’t have to. Instead, the government gave railway companies huge tracts of valuable land. Government spending as calculated by national income accountants was a small share of GDP in the nineteenth century. But any government that builds infrastructure and allocates land title on the scale of the nineteenth-century US government is big government incarnate.

The US government even engaged in social design on a big scale. In the mid-nineteenth century, when the federal government sold off millions of acres in what we now call the Midwest, it did not auction the land to the highest bidders. Instead, under the Homestead Act, it entailed the land rights precisely to prevent giant landholdings (and the extension of slavery) and ensure that only a family actually living on and farming the land could get it and hold it. The alternative—an auction, which might now seem the normal and right way to privatize government assets—would likely have resulted in a social structure more like that of Latin America, of very large estates and great masses of landless agricultural laborers, with all its drear consequences.

These were the policies that intelligently designed nineteenth- and most of twentieth-century America. They were pragmatic and concrete in conception—by and large, you would get what you saw—and of course, they were realized with more than just a tiny bit of corruption.

Teddy Roosevelt

The next redesign was the important course correction led by President Teddy Roosevelt. Toward the end of the nineteenth century, giant corporations—*trusts*, as they were then called—came to control their markets rather than being controlled by them. Remedial action began to seem imperative, at least to a great many Americans. If you are to have a private enterprise economy regulated by the forces of market competition, when markets prove unable to regulate themselves—for among other reasons, when firms become too monopolistic—you have three choices: nationalize, regulate, or restore some real degree of competition.

Nationalization, an ideological choice, was off the agenda. So America pragmatically set out to regulate some of the “natural

monopolies,” such as the all-important railroads, passed antitrust laws to break up some of the most conspicuous unnatural monopolies, such as Standard Oil, and even passed a constitutional amendment establishing the income tax to address the outrageous concentration of wealth of the first Gilded Age.

No revolution; no need for new economic theory to guide or legitimate. A lot of political conflict, yes; but, all in all, a very pragmatic correction to deal with deep structural economic problems.

FDR

When Franklin Delano Roosevelt took office in 1932, the stock market had lost about four-fifths of its 1929 value; the banks were defaulting on their depositors; about half the mortgages in America were in default; about one-third of non-farm workers were unemployed. The New Deal, Roosevelt’s wildly pragmatic response to the economic emergency, was the least ideological response of any nation confronting the economic disaster. In many less fortunate lands, ideological solutions from both the left and the right were fought over, usually to the victory of the right, and implemented—to the great grief of their people and neighbors.

The New Deal might be called *pragmatic experimentalism*. The FDR administration tried one thing after another: what didn’t work was dropped; what did seem to work was reinforced and expanded. It found its way into almost every corner of the US economy from farms, to bridges and parks, to stock exchanges and banks, to river basins, and to social insurance. It did not focus on opening a new economic space; it initially sought to revive a moribund economy—the first frantic hundred days of the New Deal constituted pre-modern emergency-room resuscitation. This pragmatism, and little else, is what the New Deal shared with the

other American redesigns, previous and subsequent.

The New Deal largely imposed its redesigns and as often as not just went forth and implemented them itself. And always quickly: this was emergency action. Never before or since has a peacetime US government commanded and legislated to this extent. It established its own bureaucracies and regulatory authorities: the Social Security Administration; the Securities Exchange Commission, the National Labor Relations Board, the Tennessee Valley Authority (TVA), and the Works Progress Administration (WPA), not to mention the National Recovery Administration, an attempt at industry-led corporatism that was shot down by the Supreme Court. And it hugely and quickly expanded others, such as government mortgage insurance. It taxed and spent, redirecting money flows through the economy at an order of magnitude greater than any peacetime federal government had ever done.

Little of the New Deal was focused, as previous redesigns were, on growing the economic pie in a new direction. Nevertheless, among its very many initiatives were several that clearly tried to open a new economic space for growth, such as the TVA and the huge program of dams in the dry West that opened vast areas for farming, industry, and even cities. The focus was first on overall economic stimulus—recovery, not new capacity. It then turned to issues of security and fairness in the form of farm price supports and subsidies, Social Security, welfare proper, direct employment (as in the WPA and the Civilian Conservation Corps [CCC]), labor unions—the “safety net,” as it was later called. It was clearly what the times demanded.

Though the New Deal was not itself ideological but rather the ultimate in pragmatic policy experimentation, it became the definition of the ideology that was post–World War II American liberalism: the regulation of finance, a social safety net, mortgage insurance, high marginal tax rates, and big, active government. It

became the model of what government could do and should do.

Dwight D. Eisenhower

After World War II, under Republican president Dwight D. Eisenhower (who defined the center of American politics) and his successors, both Democratic and Republican, it was again government that led the next reshaping of the US economy in four major ways:

First, by preserving the New Deal—the regulation of finance, Social Security, mortgage insurance, infrastructure spending and more generally, big, active government along with high marginal tax rates—over the wishes of a large part of the Republican majority that wanted to dismantle it.

Second, by huge housing and highway programs that promoted a nation of homeowners and enabled the massive suburbanization that drove the economy and reconfigured the physical and the social landscape.

Third, by financing the large-scale development of world-leading research universities, which have been major contributors to the best American economic performance ever since.

Fourth, by directly supporting the development of new technologies, mostly through the huge and now permanent defense budget, American dominance was established in such areas as commercial jet aviation and especially semiconductors, computing, and packet switching, the core technologies of what grew to be the digital era.

This was a big-time exercise in hands-on direction, in deliberate winner-picking, and it was a very big winner for the United States. But it was not a major exception in the history of the US government's involvement in economic redesign, nor was this big-scale effort particularly controversial. Support was broad and deep; opposition, weak. It was concrete economics—what

you see is what you'll get. It was not abstract or ideological. It embodied a national sense of where we should be going, what was good and desirable, and what Americans expected their government to do.

There was something for everyone who counted: nice houses with lawns and affordable long-term mortgages for average Americans. These, in turn, necessitated automobiles and highways and refrigerators and washing machines and furniture (which was ideal for the automobile, oil, white goods, home furnishings, and construction industries); a steadily growing and secure market for mortgages and automobile loans; and municipal bonds for infrastructure and schools to please the regulated and respectable finance industry.

Massive and targeted government spending generated the advanced technologies that provided the seed corn for America's continuing technology preeminence. Government involvement did not stifle innovation and entrepreneurship; quite the opposite, it opened to them vast new futures into which they predictably and promptly surged, innovated, and soared.

And American government did not accept ideological handcuffs. When push came to economic shove, the US government even deliberately devalued the dollar in the interest of national economic prosperity. It did so more than once, each party taking a crack: under FDR, under Nixon, and under Reagan. America used all the tools: infrastructure development, tariff protection, direct picking and promoting of winners, exchange rate devaluation, and, during the first Reagan administration, a return to selective protectionism through naked import quotas in the form of "voluntary" export restraints.

The Most Recent Redesign

And then came the most recent redesign, the body sculpting of the US economy by tandem restructuring teams from both East Asian and American governments, which hollowed out the US economy and then flabbed it up.

The East Asian Side

Pioneered by Japan, adopted with significant modifications by Korea and then taken over at system-shattering scale by China, the East Asian nations practiced a Hamiltonian strategy of protecting and fostering industry. This has delivered unprecedented rapid growth by concentrating resources on the production of manufactured goods for export at ever-greater scale, sophistication, and value added, and on gaming the international system of open trade that America was promoting at all costs. They developed a capability for industrial development—a turbo-powered remake of Hamilton’s strategy—in which government plays a leading and active role.

The principles were straightforward. Rapid economic development could be achieved only through a massive and sustained movement out of low-productivity peasant agriculture and into industrial production, then continued through an unceasing movement up the value-added chain from low-skill, low-capital, low-wage manufacturing (sewing garments and assembling toys, luggage, trinkets, and shoes) and moving up to higher-capital, higher-skill, and higher value-added industries (steel, shipbuilding, automobiles, and electronics). Industries were staunchly protected against imports, provided with cheap capital and assisted in obtaining foreign technology. And year after year, government persevered at financial repression, capital channeling, and industrial protection and promotion. Targeted industries

focused on exports, since until development had proceeded a very long way, the domestic market—struggling small farmers and subsistence-wage factory workers—was too small, too poor, and too downscale to drive a rapid, massive shift to manufacturing and a long-term climb up the value-added ladder. Only exports could lead the economic reshaping. Every instrument was used, in a roughly coordinated manner, to further this goal—cheap investment finance, protection against imports, zealous and active non-protection of foreign intellectual property, currency manipulation and, when needed, subsidies in various forms and guises.

Is there anything wrong in a government zealously, systematically, and unwaveringly protecting its infant industries against foreign competition and pulling out all the stops to support them; in focusing them on exports; holding down consumption; and reinvesting the proceeds into more and better productive capabilities?

No.

And there is indisputably a lot that is right: it works. The East Asian industrial, high-investment, export-focused economies have grown faster than any in the history of the world (omitting the no-work oil sheikdoms, and perhaps the economy of Wall Street's finance sheikdoms).

But the practice pioneered by the Japanese, exporting more than you import and targeting those exports by industry—first clothes and toys, then steel and ships, then automobiles and machine tools, and then electronics, and doing it at world-impacting scale—means that some other big country (for example, the United States) must import more than it exports year after year, run down its foreign assets, go into debt, and shrink the scale and the incomes in those of its industries targeted by the Asian exporters.

Is there anything wrong with that in terms of the welfare of the

world?

No.

More poor people are getting less poor and a much smaller number of richer (but not necessarily rich) people are getting less rich. But that sounds too much like textbook economics, which avoids the question of national borders when speaking of an economy—and the Asian development model is about nothing if not national boundaries.

Right or wrong depends upon whose welfare you are concerned with; that is, unless you feel that the teachings of economics 101 define right or wrong. The textbooks tell us that the operations of a free trade system produce a positive sum game: all sides gain. But in industries of substantial economics of scale, of learning and of spillovers, there is a major zero-sum element to the outcome. Few governments, if any, place the welfare of the rest of the world above that of their own citizens—my gain can well be your loss, and unless things go terribly right, it probably will be.³

Industries, often major ones, rise and fall on both sides of the trade relationship less according to classical free market dynamics, and more according to the choice and determination of the nation doing the industrial targeting and the willingness of the government of the targeted industries to permit it. And that is an essential difference from the automatic balances of the classic presentation of free trade and its mutual benefits, where governments do not figure in the equations that have become rather elaborate in recent years. In terms of the structure of production and employment, the gain of one side comes at the expense of the other side, unless—*unless*—the other side (in this case, the United States) can move its resources and people into still higher-value-added activities, industries of the high-value future. Then the game can continue with everyone prospering.

The targeted side of such policies has three choices:

1. It can shift its economy into higher-value-added activities.
2. It can ignore what is happening and simply accept having its economy restructured by the Asian developers.

or

3. It can refuse to play the game and either dismantle the strategy and apparatus of targeted exports or simply block them.

The United States chose number 1—deliberately shifting to higher-value industries of the future (with a contorted effort to pretend, to the world and to itself, that it was choosing option 2—doing absolutely nothing and letting free markets shape events). Through this bold, but rather furtive policy, it enabled its economy to expand into new, higher-value-added activities. But it made an exceedingly poor choice of which activities.

This body sculpting of America was supposed to move the country into the industries of the future. Poorer people elsewhere were supposed to sew the seams, pour the plastic into molds, snap the pieces together, and bash the metal while we concentrated on the high-value activities. That is how it happened under Eisenhower and his successors: government tolerated a slow shift out of garments, toys, luggage, shoes, and luxury goods and vigorously moved to shift into advanced technologies—commercial aviation, semiconductors, and computers. These were big investments that, for two generations, continued to generate whole new, high-value industries ranging from the high heavens—satellites and all the communication and military applications they enabled—to deep under the sea and earth—using sound waves and advanced computing to locate oil—and through the countless, economy-transforming applications of communications and computing developments that technology companies continue to mine for their commercial applications. And there were many,

many others.

That was then.

This time, the industries of the future offered no such richness and produced little in the way of valuable derivative activities. Indeed, it is arguable that they produced nothing (or exceedingly little) of value, serving at the end mostly to redistribute income to the top. The big shift this time was into the processing of real estate transactions, the processing of health-care insurance claims, and especially into finance. As we discuss below, between the mid-1980s and 2009, these industries increased by over five percent of GDP (more than a full Pentagon) to account for just over a twenty percent of GDP. And these obese numbers, as we will see, understate the “real” size of America’s chosen growth sectors.

Real estate brokers share a commission, usually six percent of the sale price of a house and the overwhelming majority of houses are sold through brokers. During the prosperous twenty years from 1950 to 1970, with the government-created system of easy mortgage finance functioning smoothly, the average house price rose by about 40 percent—well under 2 percent per year, not even running ahead of inflation. From the mid-eighties to 2006, house prices rose by about 400 percent—and so did brokers’ fees. There was no increase in work, service, or real value to the economy: rising returns to real estate transactions were, as economists say, pure rent.

Policy fashioned the grotesque design of the American health-care system, which constitutes about 17 percent of GDP. Compare that with Germany (11.3 percent), France (11.7 percent), Denmark (11.2 percent), or Japan (9 percent)—all of which have older populations and better health outcomes, even if we confine the comparison of outcomes to white Americans. The United States spends over six times more than the OECD average on health-care administration. Over \$150 billion are spent every year

on the overhead costs and profits of the private health insurance industry, largely to pay for office workers to dispute with workers in other medical offices about which company will pay for medical treatments. The costs must be counted both on the insurance company and on the doctors' office side, where they are probably about another \$150 billion a year. Is that real value-added, as treated in the national accounts? Has that particular form of economic growth, that higher-value-added activity of the new US economy, brought any value at all to that economy, or does the work of all those good people just drain value?

Finance was the leading industry to which government opened the growth gates, as it had done previously for manufacturing, railways, suburban housing, and advanced technology. Beginning seriously in the 1980s, government deliberately, piece by piece, dismantled the regulatory structure that had tamed finance into something of a utility. And as in the past, entrepreneurs rushed in and innovated. The lucrative innovations ranged from collateralized debt obligations (CDOs—called by Warren Buffett “financial weapons of mass destruction”) and the like, on through high-speed trading (to us, a robotized cousin of front-running).⁴

The increase of the weight of finance in America's GDP came about not so much by increasing the numbers of those employed in the sector, but by increasing the take of those high up in the industry. During the 1970s, average pay in finance was roughly the same as in most other industries; by 2002, it was double.⁵ The legions of clerks and tellers remained poorly paid; the gain went to the top, most of it to the top of the top. By 2005, finance accounted for a full 40 percent of all corporate profits. And many of the very most lucrative parts of finance—hedge funds, private equity partnerships, venture partnerships—were not structured and therefore not counted as corporations. Along with the

accountants and consultants, add to this profit-making machine the Wall Street law firms that are part and parcel of finance, although they do not count as finance, but rather as business services. Finance got considerably more than 40 percent.

There is no doubt that a country getting its economic policy right—and getting the political economy right so that the country can get its economic policy right—is and has been of overwhelming importance in producing prosperity. And for most of its first two hundred years, the United States did just that—not always easily, not always smoothly, not always cleanly, and decidedly most imperfectly—but all in all, quite successfully.

But beginning in the 1980s, America has been getting its economic policy wrong. For the first time in American history, what government decided to promote and promised as the industries of the future was driven not by pragmatic assessment, but by ideological vision wrapped in abstract economic theories. It was neither pragmatic nor concrete. And, for the first time in American history, the redesign did not work.

Earlier redesigns of the US economy were presented and engineered by government as specific, concrete, and “image-able.” Beginning in the 1980s, the US government has not proudly presented in such pragmatic, concrete terms its design for a new economy—light in manufacturing, engineering, and exports, and heavy in finance, health-insurance claims processing, real estate transactions processing, and imports. It has talked instead theoretically, abstractly, of its actions to increase freedom and reduce red tape and rigid regulation by dismantling antiquated restrictions on financial markets and of unleashing the invigorating free play of market forces. Deregulation opened the gates for the economy to surge into finance and out of the areas

Asian government policy was so successfully targeting. Because it was the very opposite of concrete economic policy making, the new design enabled policy makers to conceal from the American people—and often from themselves—the likely consequences. And so the country never got to see what it was going to get.

This time, policy makers—and the vast, croaking bog of policy advisers, commentators, opinion leaders, and private-sector power wielders—presented their blinding vision. The government initiatives that led to the new look US economy at the outset of the twenty-first century responded to a vision of how a deregulated global market economy should work. This vision was more than merely ideological; it was positively religious.

This was the pull side: dismantling the barriers, rules, and regulations enabled the metastasizing growth of finance; fighting universal health coverage at all costs enabled the growth of negative-sum health-care administration. This rapid growth produced powerful interests that wholeheartedly support the current configuration of our leading-edge zero-sum and negative-sum sectors, and it supports them. We not only got the economic policy wrong, now we have gotten the political economy wrong—a wrong configuration of power that shapes economic policy.

On the push side, there were Asian governments eager to sell us whatever we want to buy and desperate to promote their own economic development. These are governments that have painfully learned that they cannot afford the ideological indulgence of taking their eye off the ball that is the real economy.

Next

America too must refocus on the real. It is the single most important thing we can do to reboot and reinvigorate our economy, to shift out of ideological incantations and abstract obfuscations and talk concrete economics: Where do we want to go? What will the new economic space look like? Who will inhabit it?

A redesign of the US economy is the policy task as well as the task for economists. The policy debate then becomes a debate about that design and the policy instruments—none perfect, none noncontroversial—to achieve this. And no debate about the country's path forward should be rooted in fairy tales or in theoretical dreams of unfettered markets or in furthering the hollowing-out and flabbing-up body sculpting of the past few decades.

The art of politics is to move the politically possible to overlap the economically sensible. If we look to how the United States repeatedly and successfully transformed its economy, then we must root policy in pragmatism and debate concrete—image-able—designs.