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# Inclusive Prosperity Without the Prosperity: the Limits of the “Middle-Out” Strategy

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BY ROBERT D. ATKINSON | MAY 2015

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To grow or to redistribute, that is a question up for debate heading into the 2016 presidential campaign. Many are urging the next Democratic standard-bearer to embrace the latter—redistribution and fairness—not only as the best political strategy, but also as the best economic strategy. Emblematic of this impulse is the Center for American Progress (CAP), which recently convened a group of prominent, left-leaning economists to produce a weighty report that is sure to provide foundational guidance to Democratic presidential aspirants.<sup>1</sup> Issued in January 2015, the “Report of the Commission on Inclusive Prosperity” lays out a narrative that has become the received economic wisdom for many on the left: that the central challenges of our time are inequality and dwindling opportunity; that economic policy must focus on more equitable distribution of output; and, importantly, that doing so will result in superior rates of economic growth. But, on close inspection, the commission’s “middle-out” policy agenda actually will do very little to move the needle on the most important drivers of economic prosperity: productivity, innovation, and competitiveness. What Democrats (and Republicans) really need is a growth strategy that boosts enterprise demand for productive investments in research and development, skilled workers, and new machinery, equipment, and software.

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The report focuses primarily on reducing taxes paid by the bottom 80 percent of Americans and ensuring they receive significantly expanded job benefits (through higher wages and more overtime pay, profit sharing, more unionization, and other employee benefits) and subsidized goods and services (from housing to infrastructure to education). The lion's share of the commission's recommendations are thus redistributionist in spirit and, if enacted, would likely improve the near-term economic condition of the bottom 80 percent (while raising prices and taxes for the top 20 percent). It is not the goal of this paper to pass judgment on the desirability of these policies, although the Information Technology and Innovation Foundation (ITIF) views the principal goal of economic policy first and foremost to be accelerating overall economic growth, not improving fairness, as the left supports, or freedom, as the right supports.

The fact is that, at its heart, the debate over U.S. economic policy today is not about the efficacy of certain policies to drive growth, but about what should be the country's highest priorities. On this matter, reasonable people can and do hold different views, with the advocates of the middle-out strategy prioritizing fairness. It is quite another matter, however, for the commission to assert that its policies are the best way to drive growth, for this is an empirical assertion. This report argues that the commission's agenda—and the middle-out strategy more broadly—is a decidedly flawed growth strategy, because, in the longer term, its proposals would have little or no positive impact on the “100 percent”—in other words, on America's overall economic health. Moreover, because the middle-out strategy would do little to grow the overall GDP “pie,” it would likely do significantly less in the long term for middle-class living standards than would a robust growth strategy focused on enterprises. As this report details, CAP's commission report falls far short of providing a growth agenda, and it therefore should not be the next blueprint for Democrats.

To be sure, the CAP report gets some things right. Income inequality certainly has grown—but, as discussed below, not to the extent the report claims. It is also true that the government has an important role to play both in alleviating inequality and in promoting growth. In terms of promoting growth, the government has a larger role than the report acknowledges—and that role has less to do with reducing inequality and spurring consumer demand and more to do with actively promoting productivity, innovation, and competitiveness by expanding enterprises' demand for investments in R&D, skills, machinery, and software.<sup>2</sup>

This report first summarizes three competing economic doctrines that provide the contextual backdrop to the current debate. It then identifies five key flaws in the premises of CAP's report. It then shows why almost none of the commission's proposals would spur productivity, innovation, or competitiveness. Finally, it suggests an alternative approach based on “innovation economics” that would drive broadly shared growth and higher living standards.

## **COMPETING ECONOMIC DOCTRINES**

What distinguishes the CAP report in particular—and middle-out framing generally—is its attempt to reposition liberal redistribution as mainstream growth policy. Knowing that

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more voters value growth over redistribution, proponents of the middle-out strategy understand that a redistribution strategy will not win elections. As Nick Hanauer writes in *Democracy*, “[I]f the economic cosmology most Americans accept holds that fairness and prosperity are in zero-sum conflict, then progressive polices are intuitively and inherently unfriendly to economic growth. When they say prosperity and we say fairness, we are arguing from a position of weakness.”<sup>3</sup> So the rhetorical goal of middle-out economics is to re-brand a redistribution strategy as a growth strategy.

Advocates of the middle-out program go to great lengths to cast economic policy as a Manichean choice: between the dark side of conservative supply-side economics and its focus on lower taxes on the wealthy and smaller government, and the light side of their redistributionist demand-side agenda. As the report notes, “Those on the right who argue for a return to laissez-faire, trickle-down economics—cutting taxes at the top, stripping out regulation, and making deep cuts to public services—do not provide a viable alternative... A race to the top is the only route to inclusive prosperity.”<sup>4</sup> Of course, the right paints the choice in similarly stark terms. As Steve Conover has written for the American Enterprise Institute, “Which path to job creation and prosperity do we prefer: A continued emphasis on trusting government with top-down economics, or greater emphasis on trusting consumers and entrepreneurs with trial-and-error bottom-up economics?”<sup>5</sup> But the fact that conservative supply-side economics, focused as it is on financial capital accumulation and lower taxes on wealthy individuals, is a flawed model for driving growth does not make a middle-out Keynesian demand-side economic approach the preferred model.<sup>6</sup> There is a “third way.”

As Table 1 shows, there are in fact three, not two, economic doctrines and broad political ideologies competing for supremacy today: liberal middle-out, conservative supply side, and centrist innovation economics. The middle-out strategy is focused first and foremost on promoting fairness, which liberals attempt to link to growth through the assertion that increased consumer demand drives growth. To spur consumer demand, policies are needed to cut taxes, increase wages, and reduce prices for low- and middle-income consumers and workers. But among those for whom fairness is the highest value for economic policy, most would be willing to support policies that improve fairness, even if they reduce growth.<sup>7</sup>

In contrast, the conservative supply-side version is grounded first and foremost in promoting freedom—in this case, freedom from government confiscating individuals’ property (including through taxes) or limiting their choices (through regulation)—and more broadly letting markets alone dictate economic outcomes. Conservatives’ assertion is that when that happens, individuals, especially wealthy ones, will accumulate more capital, invest more, and take more risks, which will maximize growth. Those who put freedom first will clearly sacrifice fairness for more freedom, but they will also often put freedom ahead of flourishing, if for example, that flourishing requires government action.<sup>8</sup>

Neither of these two strategies meets the needs of the 21st-century American economy. The better alternative to both strategies is a new set of policies grounded in “innovation economics.” The overriding goal for innovation economics is neither fairness nor freedom, but flourishing.<sup>9</sup> In this sense, flourishing refers to an economy that has high rates of

*What America ultimately needs is neither a Keynesian demand-side program nor a conservative supply-side one of lower taxes on individuals and smaller government, but a set of policies grounded in “innovation economics.”*

productivity growth, robust innovation in a wide range of industries and technologies, and strong global competitiveness.<sup>10</sup> Innovation economics holds that the U.S. economy will only experience flourishing and the robust increases in living standards stemming from it when there is rising demand by producers for investment in capital equipment, knowledge creation and innovation, and skills, which lead in turn to increased productivity, innovation, and global competitiveness. Among those who believe that the most important goal for economic policy should be to enable flourishing, most would be willing to accept policies that modestly reduced fairness or freedom, as long as they drive flourishing.

|                                       | <b>Conservative Neoclassical</b>  | <b>Neo-Keynesian Middle Out</b>                             | <b>Innovation Economics</b>  |
|---------------------------------------|---|---|--|
| <b>Locus of economic growth</b>       | Supply side (individuals and organizations)                                       | Demand side   | Supply side (organizations and entrepreneurs)  |
| <b>Principal economic policy goal</b> | Freedom   | Fairness  | Flourishing (productivity, innovation, and competitiveness)  |
| <b>Ultimate objects of policy</b>     | Consumers   | Workers   | All residents  |
| <b>Key drivers of growth</b>          | Accumulation of capital   | Consumer spending   | Investment to drive productivity and innovation  |
| <b>Key economic process</b>           | Allocative efficiency   | Consumer demand and full employment                         | Productive efficiency and adaptive efficiency  |
| <b>Principal means</b>                | Spur more capital through lower top marginal tax rates and lower rates on capital | Public spending, progressive taxes, and stronger regulation | Tax, expenditure, and regulatory policies to boost innovation, skills, and investment in new equipment |

**Table 1: Theoretical underpinnings of the competing economic doctrines**

## THE REPORT’S FLAWED PREMISES

The CAP report features a number of flawed premises common to much of mainstream progressive economics discourse, including a focus on the demand, rather than the supply side of the economy; a decidedly mixed view of the benefits of productivity; a general disregard of the importance of innovation and innovation policy; and a deterministic view of globalization’s current state.

### The Report Mistakenly Sees Growth Stemming From Consumer Demand

Regardless of the label it is wrapped in, middle-out economics is still fundamentally Keynesian in its logic, emphasizing consumption and the demand side of the economy while giving little attention to production and the supply side. Indeed, the report’s entire policy framework rests on a central, but ultimately flawed assumption: that increased demand for goods and services is the primary driver of economic growth. According to this logic, spending—not investment—drives growth. This means that, because higher-income people save more, there is a compelling argument for funneling a greater share of economic output to the “middle class” (a catchall term for roughly the bottom 80 percent of the income distribution). The political genius of this framing is that it marries the progressive

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cause of fairness with the political imperative of framing any economic agenda in growth terms.

Postwar Keynesian demand-side framing argued that robust demand was needed to keep the economy at full employment and avoid recessions. But in the past 15 years, the Keynesian left has attempted to modernize this narrative around long-term growth. In 2000, in their book *Growing Prosperity: The Battle for Growth with Equity in the Twenty-First Century*, liberal economists Barry Bluestone and Bennett Harrison were among the first to recast the rationale, arguing that increased demand spurred increased business investment: “[W]hat initially energized the post-WWII economy boom had less to do with supply-side factors [like technology] and more to do with extraordinary buoyant demand.”<sup>11</sup> But they went on to argue that consumer demand led companies to invest more in growth-enabling factors like machines.

The CAP report carries on this tradition, arguing, albeit with no evidence, that:

Sustainable aggregate demand is the virtuous cycle that is the engine of growth and innovation ... when firms know they will face predictable, rising demand for products in the future, they invest in their future profits. Without the promise of future aggregate demand, we cannot count on firms to invest in innovation to increase productivity and drive up aggregate supply over the long run.<sup>12</sup>

In other words, it is not the rate of return on investments (e.g., tax rates on business, interest rates, regulatory climate, etc.), nor the supply of investment opportunities (e.g., the pace of technological innovation) that drives investment; it is the expectation of growing demand. No need for an enterprise-focused growth policy; simply enact policies to transfer output to the bottom 80 percent, which will happily spend it, thereby leading business to increase output.

But this demand-side formulation fails on two counts. First, to the extent companies respond to growing demand, it is by investing in more of the same machines, used by workers doing similar jobs to produce the same goods and services for more customers. If the economy is not at full employment, this increase in demand would increase output and GDP, but it would likely do little to increase productivity (e.g., output per hour worked). If the economy is at full employment, stimulating more spending will only increase inflation and interest rates, likely reducing investment.

Second, this framing does not explain the long-term per-capita growth patterns of the last half century, which have been driven more by the development of and investment in productive technologies rather than growing demand. In fact, over the last half century, years with high consumption growth are actually associated with lower productivity growth three to five years later.<sup>13</sup> Productivity growth slowed considerably in the 1970s despite continued increases in the workforce size and growing demand that followed. (See Figure 1.) In the late 1980s and early 1990s, employment growth moderated, but productivity increased in the following decade. This pattern might be expected given that higher consumption is likely to mean less investment. In fact, new growth theory shows that most

growth in productivity and per-capita income stems from innovation (the development and adoption of new technologies).<sup>14</sup>

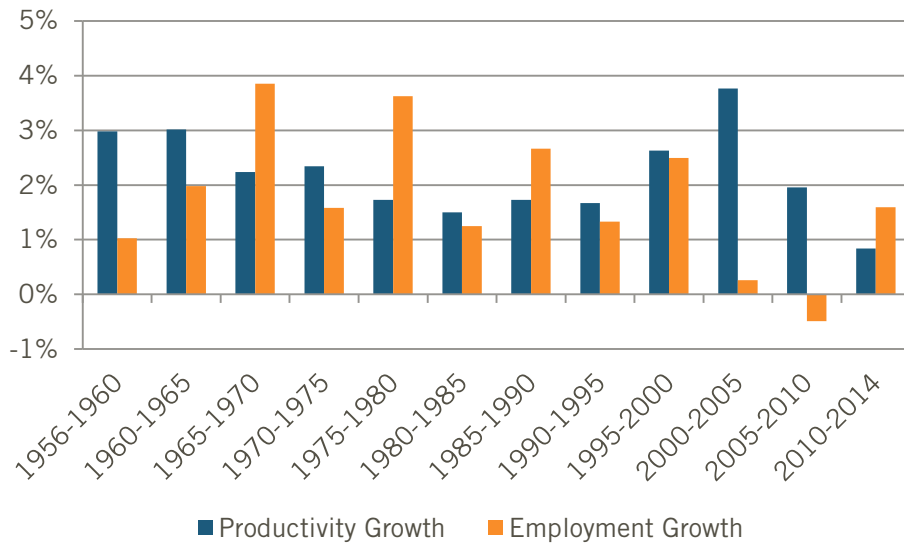


Figure 1: Average annual U.S. productivity growth and employment growth, 1956–2014.<sup>15</sup>

*To be sure, income growth of the top 1 percent and 10 percent have grown even faster, but to assert that virtually none of the gains of growth have gone to the middle class is simply wrong.*

### The Report Overstates Growth in Inequality

Even if the demand-side narrative were correct, which it is not, the rationale for the report’s fundamentally redistributionist policies hinges on a further step in logic: that while overall growth is robust, income is not adequately distributed, and, therefore, spending by the bottom 80 percent is less. As the report states, “[W]e need new social and political institutions to make 21st century capitalism work for the many and not the few.”<sup>16</sup>

If in fact the U.S. economic engine were running on all cylinders and few of the gains were going to the middle class, then the commission’s strategy would have more to commend it. But the commission overstates both growth and inequality. Labor productivity growth over the last decade has been anemic at 1.16 percent, compared with 2.29 percent in the prior decade.<sup>17</sup> Moreover, as ITIF has argued elsewhere, it appears that U.S. productivity growth was overstated by approximately 30 percent in the 2000s.<sup>18</sup> In other words, the commission’s assumption that the growth engine is healthy and the only issue is the distribution of those gains is incorrect. Slow productivity growth has been a major reason for slow median income growth.

But the report also overstates the growth in inequality. Rising income inequality has taken center stage in the wake of the Great Recession, particularly since the publication of Thomas Piketty’s *Capital in the Twenty-First Century*. While it is true that income inequality has grown in the past decades, the data that accompanies Piketty’s book has been used to argue that wages have stagnated entirely for the bottom 90 percent of earners. The CAP report claims that “the bottom 90 percent of incomes have even stagnated or declined in recent years.”<sup>19</sup> This claim is overblown, resulting from incorrect assumptions about what the underlying data actually represent.

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As Stephen Rose has shown for ITIF, Congressional Budget Office (CBO) data show clearly that average pre-tax, pre-transfer income for the bottom 90 percent has actually risen by 42 percent since the 1970s.<sup>20</sup> To be sure, income growth of the top 1 percent and top 10 percent have grown even faster, but to assert that virtually none of the gains of growth have gone to the middle class is simply wrong. This does not mean that policies should not address the growth of inequality. But a policy package focused almost exclusively on redistribution will in fact not accomplish the goal of increased growth for the middle since that is ultimately dependent on a “rising tide” of economic growth.

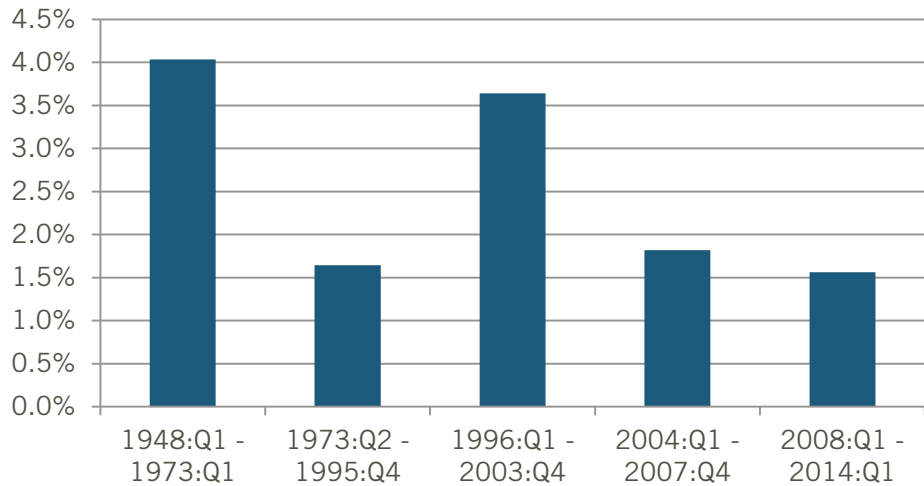
### **The Report Sees Productivity not as a Solution, but as a Problem**

A third flaw in the report is its conflicted approach to productivity. Because full employment and worker welfare are so critical to neo-Keynesians, the commission has a decidedly schizophrenic view of productivity: grudgingly recognizing that it is needed for growth, but disparaging its purported negative effect on workers. The report claims, for example, that a “fundamental challenge” that advanced economies face is “the profound technological changes that ... are also replacing traditional middle-income jobs.”<sup>21</sup> The report goes on to claim, “The rapid pace of innovation in computer automation of routine tasks has rightfully worried policymakers, as this scale of automation has little precedent in industrialized economies.”<sup>22</sup> It then states that there has been “disruptive technological change in the form of information and computer technology that is rapidly allowing machines to replace even complex forms of human work.”<sup>23</sup> This is now a common framing by advocates of the middle-out strategy.<sup>24</sup> Indeed, for many progressives, economic change has become “red in tooth and claw,” leading to more destruction than creation and more pain than gain, especially for workers swept up or swept aside by change.

In other words, advocates of the middle-out approach look upon investments to boost productivity not with favor, but with skepticism. Policymakers are left with the distinct view that robust productivity gains should be resisted, not encouraged. And indeed, if the strategy is fundamentally not about growing the pie, but ensuring that workers get a bigger share of it, why embrace technological change when it can lead to workers getting laid off, or if you believe that none of the gains of productivity go to the “middle”?

In fact, if anything, the much vaunted and feared disruptive technological change remains a fantasy promoted by techno-utopians (and dystopians) claiming that “this time is different” and that we are on the cusp of a new industrial revolution.<sup>25</sup> There is no evidence of this happening. As noted above, U.S. productivity growth has been at its lowest levels in decades, hardly evidence of disruptive technology. (See Figure 2.) One reason is that business investment is down as share of GDP by over three percentage points since 1980.<sup>26</sup> In other words, rather than automation without precedent, what is without precedent are low rates of investment and productivity growth. Recent rates are clear evidence that recent labor market difficulties have not been due to fast productivity growth, but rather to slow productivity growth. It’s hard to lift all boats when the tide is barely rising.





**Figure 2: U.S. labor productivity growth (nonfarm business sector: real output per hour of all persons, average annual growth rate)<sup>27</sup>**

Moreover, the scholarly and historical evidence is unambiguous that, in the medium run, increased productivity, including from automation, has no negative effect on unemployment rates.<sup>28</sup> Policymakers ought to have no doubt that productivity should be one of the top goals of economic policy.

### **The Report Presents Resistance or Blind Acceptance as the Only Responses to Globalization**

It would be difficult to write a report on the U.S. economy without addressing globalization and trade. Yet the commission frames globalization as a choice of either “isolationism” (which it properly rejects), or passive acceptance of the current structure and function of globalization, which it fatalistically embraces. For the commission the structure of globalization is a given and the task of economic policy is to help those hurt by it.

But again there is a “third way.” It is to reject isolationism but to actively work to reshape the current structure of the global economy so that it is less grounded in foreign mercantilist practices. It is not globalization that is hurting American workers; it is rampant and growing foreign mercantilism, particularly practiced by China. It is striking that in a report bemoaning the stagnation of worker wages, particularly workers in industries exposed to international competition, the commission gives almost no attention, other than a cursory discussion of currency manipulation, to the rampant foreign mercantilist practices that have hurt U.S. companies and U.S. workers.

Related to this, the report does not discuss the fact that the U.S. economy has been losing ground competitively to other nations, including in advanced technology-based industries. While the report does mention the term “competitiveness” several times, it is in the context of recommendations for expanded infrastructure investment, a standard Keynesian policy. The report is silent on any other policies that would drive competitiveness—and it does not consider carrying out a national innovation and competitiveness strategy. Moreover, many of the report’s proposals actually would reduce, not increase, U.S. global competitiveness. For example, the report calls for increasing corporate taxes in order to



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ensure a “stable source of revenue to provide for a stronger, smarter, and fairer society.”<sup>29</sup> But this will require corporations in the United States, including those facing stiff international competition, to pay significantly more in taxes, thereby losing competitive advantage and reducing U.S. jobs.

### The Report Largely Ignores Innovation

It is striking that in an “era of innovation,” where it is increasingly clear that innovation is central to the future of American prosperity, the commission is virtually silent on the need for innovation or innovation policies. At a deeper level, however, such an omission should not be all that surprising because conventional economics (whether supply-side or Keynesian) has ignored innovation, treating it as exogenous to their models.<sup>30</sup> To be sure, the report pays lip service to innovation—how could it not?—stating that “innovation drives productivity growth.” But despite these few sops, the report’s sole proposal on innovation is to give cities and regions “the tools to make their own local decisions to drive growth.”<sup>31</sup> Besides the fact that it is unclear what this proposal would actually do, at best it would barely move the innovation needle because local innovation efforts, even if dramatically expanded, play only a small role in the national innovation ecosystem. Nowhere does the report advocate proposals such as expanding the R&D tax credit, increasing federal funding for scientific research and engineering, supporting STEM education, expanding high-skill immigration, removing regulatory barriers to innovation, or policies to ensure federal government agencies become more innovative.<sup>32</sup> One is left with the distinct impression that the commission realized it had to mention innovation, but beyond that nothing more was needed. Of course, this neglect may be due to the all-too-common view that innovation is like “manna from heaven” that “just happens,” and moreover that it is at best orthogonal to spurring increasing consumer demand.

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### THE REPORT’S PROPOSALS WOULD DO LITTLE TO BOOST PRODUCTIVITY, INNOVATION, OR COMPETITIVENESS

The report’s policy proposals cover a wide range of ground, but, on the whole, if implemented, they would do little to drive productivity, innovation, and competitiveness.<sup>33</sup> Thus, they would do little to increase rates of economic growth or middle-class standards of living in the medium to long term.

As noted above, being for redistribution and not growth is a political non-starter: What presidential candidate with a chance of winning the general election wants to be seen as only for redistributing the pie? As a result, all the CAP proposals, even ones that could hurt growth, are cast in pro-growth terms.

### Proposals With No Likely Positive Effect on Productivity, Innovation, nor Competitiveness

The report embraces a number of proposals that would do little or nothing to spur productivity, innovation, or competitiveness.

- The report aims at *restoring residential spending* by relaxing mortgage rules, creating new targeted lending programs, and creating benchmarks for government-sponsored enterprise lending. Given the disastrous experience with reduced

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mortgage standards of the late 1990s and early 2000s leading to the housing bubble and subsequent financial collapse, it is surprising that the commission wants to risk bringing this world back. But for them, government-subsidized consumption, including housing, is a key way to improve middle-class living standards. Regardless of how the report frames it, housing is (capitalized) consumption, not investment.<sup>34</sup> If anything, the effect of increased housing spending on productivity, innovation, and competitiveness is likely to be negative, not only because productivity growth has been particularly low in the construction sector, but also because more money spent on housing means less money invested in machinery and software that truly does drive growth.<sup>35</sup> In fact, over the last quarter century, the United States has spent too much on residential construction, which has diverted resources from investment that truly enhances productivity, innovation, and competitiveness.<sup>36</sup>

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- *Protecting underemployed workers*, such as “independent contractors,” who are essentially employees without benefits, is another goal of the report. This would surely increase these workers’ income (while raising prices for the consumers of their goods or services), but there is no evidence or logic that this would spur productivity, innovation, and competitiveness.
- In true Keynesian fashion, the report sees *increasing the size of the labor force* as a primary goal, including increasing support for young people facing long-term unemployment and encouraging more mothers to work. While these proposals could boost GDP by increasing the size of labor force, they would have no effect on productivity since they would raise labor inputs the same amount as labor outputs. It is even possible that subsidizing child care (and raising the incomes of child-care workers) would worsen productivity. This would happen if the output of the new entrant to the workforce was lower than the output of the child care worker (per child). And, despite the widespread consensus on the left that the state, rather than parents, should care for preschool age children, human capital would in fact be increased more by having a preschool child’s own parents, rather than institutions, taking care of them, at least for families whose parents are not socioeconomically disadvantaged.<sup>37</sup>
- *Increasing worker voice through unionization and other measures*, as the report proposes, should raise wages, but the impact on productivity is not clear. Expanded worker voice can help workers contribute to workplace improvement; however, increased worker power may be used to block productivity upgrades as it often has in the past.<sup>38</sup>
- The report proposes *facilitating new models of employee-owner relations*, such as profit-sharing arrangements, worker councils, or other labor practices, would result in higher incomes for workers (with lower profits or higher prices). But these are unlikely to change incentives for productivity growth in those workplaces.

- The report prioritizes *increasing financial stability* through enhanced global cooperation, continued implementation of the Basel III agreements, and eliminating purported too-big-to-fail subsidies. These policies are unlikely to have much impact on productivity, however, except in the sense of reducing the risk of productivity-damaging crises. When it is working properly, the financial sector plays a necessary and crucial role by allocating capital toward productive investments, and making sure those investments go toward high-productivity economic projects. But reduced financial risk does not translate easily into productivity figures, and steps taken to mitigate risk are unlikely to spur growth.
- The report advocates *using tax policies to support demand and promote fairness*, such as eliminating tax rules that shelter high-income households and corporations.<sup>39</sup> While the evidence is fairly clear that raising the effective tax rate on high-income individuals would have little negative effect on growth (it wouldn't have a positive one either unless the increased revenues were largely devoted to true public investment),<sup>40</sup> higher taxes on business would reduce growth by raising the after-tax cost of investments and reduce competitiveness by raising the costs of producing in the United States.
- No center-left economic agenda worth its salt can ignore *tackling climate change*. The report argues that addressing climate change is important, not so much to save the planet but to help “those most exposed to the costs of climate change,” who “are the lower- and middle-income households that are the focus of this commission.”<sup>41</sup> While the report's proposals are vague, they are based largely on increasing the costs of fossil fuels. As ITIF has argued,<sup>42</sup> mitigating and adapting to the effects of climate change is certainly needed, but packaging it as productivity growth is misleading. Raising the prices on dirty fuels will increase prices and decrease productivity unless the revenues are used to provide incentives for investment in cleaner technologies.<sup>43</sup> And any economic benefits from reduced climate change damage will accrue to the entire world, while the costs of action will be borne by U.S. consumers. Not only will these steps lower productivity, but they will also do very little to reduce climate change. As ITIF has argued, any climate agenda must put a proactive clean energy innovation policy at its center, for the world will only adopt clean technologies at scale if they cost less than dirty ones.<sup>44</sup>
- The report advocates *using immigration policies to counteract the slowdown in domestic population growth*, again reflecting its Keynesian focus on overall GDP rather than per-capita GDP. The report states that “as population growth slows so does expected demand for goods and services. This reduces investment demand.”<sup>45</sup> What the report gets wrong is that it is the expansion of investment in terms of more capital per unit of output or better capital that matters, not simply a one-to-one expansion of machines to match expansion in demand. There is no evidence that incomes are higher in larger nations or that population growth spurs per-capita income growth. Moreover, while there is evidence that in contrast to attracting more high-skilled workers to the United States, especially STEM workers,<sup>46</sup> allowing higher rates of low-skill immigration will lower productivity as

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it becomes cheaper for companies to substitute workers for machines and lower wages for less skilled Americans as they face more competition.<sup>47</sup>

### Proposals Likely to Have a Small Positive Effect on Productivity Growth

Some of the report's proposals could have a small positive effect on productivity if they were implemented, but as a group they do not constitute a robust national growth strategy.

- *Raising take-home pay for low-wage workers* through minimum-wage increases and other means, could, as ITIF has argued, help raise productivity by making labor more expensive, therefore encouraging the greater use of labor-saving technologies.<sup>48</sup>
- *Supporting apprenticeships and better vocational education* builds useful skills for those who need them and could help raise productivity by increasing the average skill level of workers.
- *Increasing early childhood education* could boost future growth, but only if targeted at children from disadvantaged families where human capital development in the home is sometimes more limited.
- *Achieving “a world-class school system,”* which includes spending more on education at all levels, could boost growth, depending on how the policy was structured. There is little evidence that U.S. workers are not educated enough or that more years of schooling overall would have a material impact on productivity, innovation, or competitiveness. Nor is it clear what a “world-class school system” means. If it means that Americans score better on standardized tests without increasing other skills such as critical thinking and entrepreneurial capabilities, the effect on growth might be minimal or even negative. Finally, more education spending, especially at the college level, could be wasteful as increased college attainment in excess of what is required by the labor market may simply change social occupational sorting and inflate certification requirements. What is needed much more than additional money for education is significant institutional reform at all levels to spur more competition and innovation in education.
- *Encouraging cluster development.* As noted, the report gives lip service to innovation policy, and only lays out one modest innovation policy proposal, supporting regional innovation clusters. As the most explicitly innovation-oriented policy in the report, cluster policy is distinctly underwhelming advice. Clusters do play a role in increasing innovation, but supporting clusters is just one of many steps a government must take to drive higher innovation rates.<sup>49</sup>

### Proposals With Greater Impact on Productivity, Innovation, and Competitiveness

Finally, the report makes a few recommendations that are likely to have unambiguously positive effects on growth.

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Reforming corporate governance in order to shift investment priorities from the shorter term to the long term is perhaps the most important step the commission advocates.

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- The report supports *proceeding with the Transatlantic Trade and Investment Partnership (TTIP) and Trans-Pacific Partnership (TPP) trade agreements*. As ITIF has argued, these agreements could grow productivity, innovation, and competitiveness if they are able to hold our trading partners to high standards when it comes to mercantilist practices such as IP theft, abuse by state-owned enterprises, forced localization, and other practices.<sup>50</sup> Increased trade is also conducive to innovation because global markets offer a larger reward for innovative products.
- The report's emphasis on *reducing foreign exchange rate manipulation* would boost productivity, innovation, and competitiveness, as devalued exchange rates lead to substitution of low-wage workers for capital while also hurting the growth of U.S. innovation and competitiveness by subsidizing foreign production.<sup>51</sup>
- *Reforming corporate governance* in order to shift investment priorities from the shorter term to the longer term is perhaps the most important step the commission advocates. Corporate investment in workforce education, early stage research, and machinery and equipment has decreased in the past 30 years, which has hurt U.S. competitiveness and reduced productivity growth.<sup>52</sup> A U.S. economy composed of firms geared toward longer-term firm performance will be better able to make the kinds of investments central to driving productivity, innovation, and competitiveness.

## WHAT SHOULD THE COMMISSION HAVE RECOMMENDED?

A report truly focused on boosting U.S. productivity, innovation, and competitiveness would have listed many other proposals designed specifically to address these areas. While not an exhaustive list, the following are examples of what any growth report should address.

- *Reducing the digital divide* is one way to help increase U.S. productivity growth. Broadband and other information technologies have been proven to benefit productivity growth.<sup>53</sup> The United States is falling behind other developed countries, not in our broadband network, but in the percentage of citizens who own computers and therefore use broadband.<sup>54</sup> Expanding support for computer ownership and subsidized broadband for low-income American households marries progressive goals with innovation ends.
- *Spurring digital transformation in key industries and on key platforms*: While the United States is moving ahead in many digital infrastructure areas such as the Internet of Things, proactive policies are needed in these areas. For example, major federal agencies such as HUD, DOT, EPA, and Interior should develop Internet of Things and data innovation strategies to infuse these technologies in economic areas they influence.
- *Strengthening the manufacturing sector* will help the United States maintain traded-sector competitiveness and continued productivity growth. Current initiatives to

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create a system of National Manufacturing Institutes are a good start, but they should be greatly expanded along with increasing funding for the Manufacturing Extension Partnership, designating at least 20 “manufacturing universities” across the country<sup>55</sup> and funding a manufacturing skills standards initiative (similar to President Obama’s just-announced TechHire initiative).

- *Increasing public R&D expenditures and private R&D incentives* is a sine qua non for maintaining robust technological innovation and productivity in the future. Businesses underinvest in R&D due to a number of market failures, and extensive evidence has shown that both public spending on R&D and private-sector incentives have large economic returns. Expanding the R&D tax credit and making it permanent,<sup>56</sup> along with expanding public R&D, particularly R&D related to industrial technology needs, are two of the best ways to encourage private sector R&D.
- *Reforming the corporate tax system* by lowering the rate and maintaining strong incentives for investment is a necessary step to get U.S. productivity back on track. Not only are U.S. headline tax rates uncompetitive, but so are effective rates.<sup>57</sup> Lowering the statutory rate and expanding key investment incentives, such as accelerated depreciation for machinery and software investment, will boost productivity, innovation, and competitiveness.<sup>58</sup>
- *Establishing a National Traded-Sector Strategy* will help the United States get its bearing in an increasingly competitive world. Other countries are making the investments now that will position them to dominate high-value-added industries in the future, and the United States cannot be caught flatfooted. Having a traded-sector competitiveness strategy is not tantamount to picking winners, which is the smokescreen often thrown up to prevent such a strategy. Rather, it is an approach to level the playing field for all of our sectors, particularly traded sectors.
- *Expanding high-skill immigration* is an important step that the United States must take if it wants to remain competitive. High-skill immigration has been shown to be win-win: High-skill immigrants are so beneficial to an economy that more immigration actually raises income for everyone—even “native” high-skill workers that would otherwise be their competitors.<sup>59</sup>

These policies would spur increased competitiveness, innovation, and productivity and also increase median incomes for Americans. Other policies would also do the same. For example, rather than subsidizing housing, the United States could dramatically expand highway throughput, particularly in congested metropolitan areas, enabling workers to live farther from work on lower-priced land. This could be done by significantly increasing the gas tax and supporting tolls, the costs of which would be significantly less than the reduced monthly mortgage payments for housing farther from a metropolitan core. Taking steps to reduce foreign currency manipulation as well as abandoning federal policy to defend the dollar would help raise wages as traded-sector wages are suppressed largely because the dollar is so overvalued. Policies to boost productivity in industries where middle-class



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workers spend increasing amounts of money can help increase their real incomes. In particular, Congress should embrace reforms to restructure higher education and health care to bring more innovation to those sectors.

## CONCLUSION

It would have been refreshing for the CAP to lay its cards on the table and state, “We think inequality is too high, and we want the next president to embrace a set of policies that, while they may not do much to spur overall growth, will definitely improve the economic well-being of the bottom 80 percent.” Had CAP done so, it would have been following in the intellectual footprints of the late John Rawls, a Harvard social philosopher. Rawls’s influential 1971 book, *A Theory of Justice*, sought to establish bedrock principles that people could agree would lead to a just society. One of them was the principle of “original position,” where Rawls postulated that we should judge the ethical value of a particular economic arrangement based on no knowledge of our own individual economic or social position. In this position, Rawls argues that a reasonable, moral, and self-interested person would support an economy that led to two people getting \$1,000 more, and that this outcome would be just. What if one person gets \$1,000 more and the other nothing? To Rawls, this is an unjust outcome, even though society is \$1,000 better off, and the allocation of that \$1,000 is based on chance. Rawls’s philosophy is a cornerstone of liberal Democratic thinking and the source of its focus on distribution, for it sees income growth as bad if it leads to inequality.

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*The Commission’s “middle-out” agenda would almost certainly reduce the Gini coefficient and improve the economic lot of middle-income Americans, at least in the short run. But any gains from redistribution are temporary without continued robust growth.*

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When he was secretary of labor in the Clinton administration, liberal icon Robert Reich reflected the Rawlsian view. Leading a discussion with some college students, he stated: “I am concerned about the direction that the country is heading with regard to inequality. Let me ask you for a show of hands. Let’s assume that I could offer you a deal, and I want to know how many of you would accept [it]. ... You have a choice either between the current economy, with all the good news and all the problems it has ... or I will offer you a deal in which the top fifth of income earners get a 25 percent raise and the bottom fifth get a 10 percent raise. Now the net result is more inequality than we have today, but everybody is better off. ... How many like that deal? Put up your hands. Have the courage of your convictions... OK. There are twenty-eight. How many of you do not like that deal? That’s interesting. Sixty-three.”<sup>60</sup>

Sixty-four, if Reich’s vote is counted. In other words, even though low-income Americans are better off today than they were in 1970, this is not an acceptable outcome because upper income Americans are even richer. Clearly, of Rawls’s choices, the first one, with both groups getting the same amount or even more, is the best. However, to reject an economy where everyone gains, but where those on the bottom gain less, is to lose sight of the fact that the progressive goal should be to raise incomes of the less advantaged, not reduce the Gini coefficient out of a sense of outrage. Again, this is not to suggest that the current unequal distribution of incomes and wealth is fair or even necessary—it clearly is not. To reiterate, inequality is too high in America, and policies should address it. However, being ambivalent about growth is not the answer.



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To be sure, the Commission's middle-out agenda would almost certainly reduce the Gini coefficient and improve the economic lot of the bottom 80 percent, at least in the short run. But any gains from redistribution are temporary unless there is continued robust growth. Without growth, policymakers will soon run out of income to redistribute.

Efforts like the CAP commission report—and the middle-out strategy more broadly—that assert that their agendas will advance overall economic growth should be held accountable when they lack policies that take productivity, innovation, and competitiveness seriously. Boosting productivity, innovation, and competitiveness is a complex, unpredictable process, but it is far from an enigma and can call on a wealth of well-researched policy ideas. Policymakers who ignore proven successes in favor of a narrow set of ideologically constrained ideas about how economic policy is powerless to boost the most critical drivers of economic growth do so at the peril of our nation's economic prosperity.

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## ENDNOTES

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## ABOUT THE AUTHOR

Dr. Robert Atkinson is the founder and president of the Information Technology & Innovation Foundation, a Washington, DC-based policy think tank. He is also author of *Innovation Economics: The Race for Global Advantage* (Yale, 2012); *Supply-Side Follies* (Rowman and Littlefield, 2006); and *The Past and Future of America's Economy: Long Waves of Innovation That Power Cycles of Growth* (Edward Elgar, 2005). Dr. Atkinson received his Ph.D. in city and regional planning from the University of North Carolina at Chapel Hill in 1989.

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