I

Faster Growth, Fairer Growth

A NEW POLICY SYNTHESIS

PART I. A NEW POLICY SYNTHESIS

"To elevate the condition of men — to lift artificial weights from all shoulders, to clear the paths of laudable pursuit for all, to afford an unfettered start and a fair chance, in the race of life."

Abraham Lincoln
First Message to Congress
July 4, 1861

In December 2018, the Niskanen Center released a paper we co-authored with two colleagues entitled "The Center Can Hold: Public Policy in an Age of Extremes."[1] In that paper we sought to articulate a new and distinctive policy vision that combines and builds on the best ideas of conservatism and progressivism. While traditional ideological battle lines pit a "pro-market" right against a "pro-government" left, we reject this choice as a false dichotomy. In our view, addressing the daunting challenges facing the country today requires simultaneous moves in both directions. We need greater reliance on entrepreneurship and competition, *and* we need more robust provision of social insurance and other public goods. In other words, we need a "free-market welfare state."[2]

In this paper, we seek to translate this broad policy vision into a concrete, wide-ranging agenda for policy reform. We are not attempting to present a comprehensive program: Many pressing issues, from the opioid crisis and rising suicide rates to police violence and mass incarceration, lie beyond the scope of this effort. Our goal here is to apply our principles to the problem of restoring inclusive prosperity — revitalizing flagging economic dynamism while ensuring that the rewards of such dynamism are broadly shared. In other words, as the title says, faster

1 Brink Lindsey, Steven Teles, Will Wilkinson, and Samuel Hammond, "The Center Can Hold: Public Policy for an Age of Extremes," Niskanen Center Policy Essay, December 2018.

2 See Samuel Hammond, "The Free-Market Welfare State: Preserving Dynamism in a Volatile World," Niskanen Center Policy Essay, May 2018.

growth and fairer growth. And while the agenda outlined here does not exhaust the possible reforms that push in the desired direction, we believe that it represents a bold and well-targeted response to the challenge that confronts us.

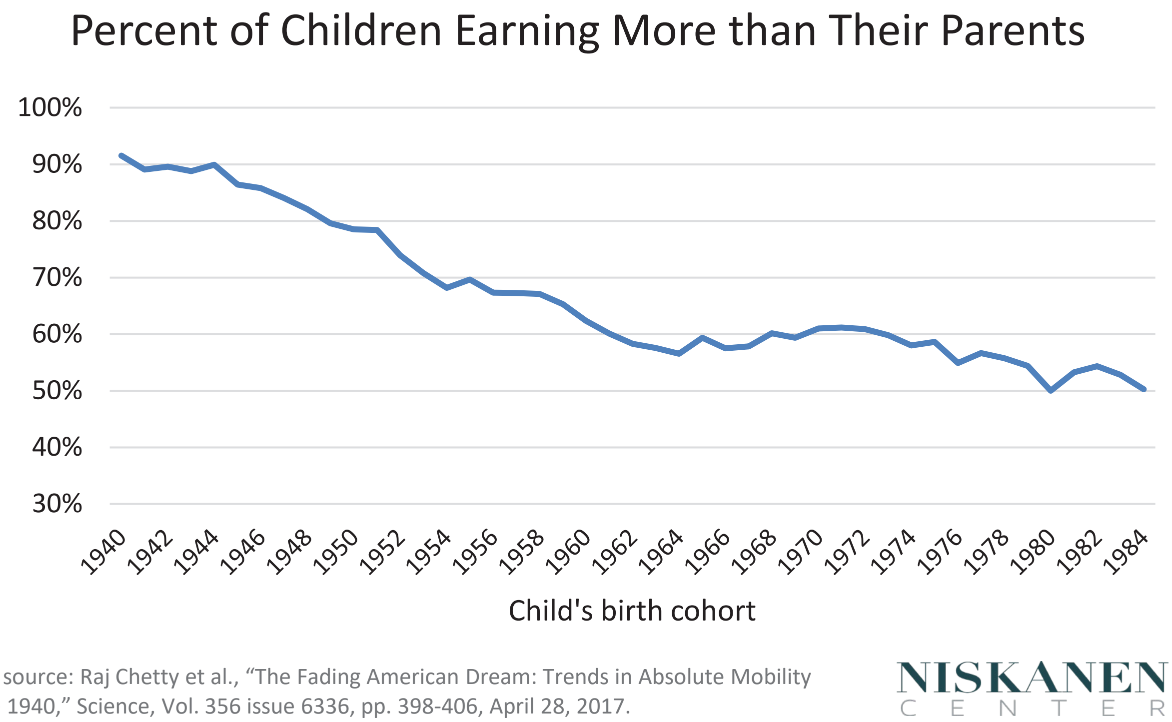
Although we started work on this paper last year, the project has taken on new importance in the wake of the COVID-19 pandemic. As one of us argued at length in a recent series of essays, the United States' tragic bungling of this public health emergency has simultaneously revealed the ongoing need for skepticism about government power and the great dangers of carrying that skepticism too far.[3] On the one hand, the FDA's foot-dragging on approving new tests, along with the slew of state and local regulations that had to be waived to avoid worsening the catastrophe, illustrate vividly that — even under these highly unusual circumstances when the case for sweeping government action is at its strongest — the problems of government overreach and heavy-handedness remain critical obstacles to good governance. Still, however, by far the most serious breakdowns in the government response to the pandemic have been sins of omission, not commission — in other words, the failure to perform the tasks that only government can manage. As when a lightning strike reveals that an apparently mighty oak is really just a rotten, hollow shell, the pandemic has exposed an alarming and ruinous deterioration in American state capacity.

Accordingly, we believe the case for the Niskanen policy synthesis — dedicated both to liberating the private sector from unnecessary restraints and to expanding and upgrading the public sector's capacity to provide social insurance and other public goods — has taken on new and critical urgency in light of the events of 2020. In the pages that follow, we will attempt to illustrate in detail how that synthesis can be applied so that our country can rebound from the current crisis stronger, more hopeful, and more united than before.

What Went Wrong

America's 21st-century malaise of dimming economic vitality and deepening social divisions has spurred a desperate search for radical alternatives to the status quo. But the way forward is not to be found in either the ideological fantasies of democratic socialists or the reactionary sputtering of neonationalists, integralists, and other assorted "post-liberals." The best hope for a brighter future in the 21st century lies in revising and updating the basic model that emerged as the clear

3 Brink Lindsey, "What the Pandemic Revealed," Niskanen Center, June 9, 2020; Brink Lindsey, "The Dead End of Small Government," Niskanen Center, June 16, 2020; Brink Lindsey, "Free Markets and Limited Government Reconceived," Niskanen Center, June 23, 2020.



worldwide winner in the great ideological struggles of the 20th century: the liberal democratic capitalist welfare state. Whatever real and vexing problems they are experiencing today, the countries that have successfully adopted that model are the richest, healthiest, best educated, and freest societies that have ever existed. This is a legacy to be proud of and to build upon.

But long before the arrival of the novel coronavirus, something had clearly gone wrong. From 2000 through 2018, growth in real (i.e., inflation-adjusted) gross domestic product per capita — the best overall measure of economic output — averaged just a bit over 1 percent a year, down sharply from the 2 percent annual growth rate that persisted over the whole course of the 20th century. Meanwhile, the woes of this growth slowdown have been compounded by high levels of income inequality, with income gains at the top of the pay scale far outpacing those of everybody else. Put those two things together, and the result is that median household income peaked in 1999 and did not again exceed that peak until 2016, a full 17 years later. Research by Raj Chetty and others helps to put this stagnation in larger perspective: In 1970, over 90 percent of 30 year-olds were making more money than their parents; as of 2010, only 50 percent of 30 year-olds could still say the same.[4] For more and more of our fellow citizens, the American Dream is becoming a faded memory.

4 Raj Chetty et al., "The Fading American Dream: Trends in Absolute Mobility since 1940," Science, Vol. 356 issue 6336, pp. 398-406, April 28, 2017.

The same may be said for more and more parts of the country. Throughout much of the 20th century, different regions of the United States experienced economic convergence, with incomes in poorer areas rising faster than those in richer ones and gaps falling over time. This dynamic contributed significantly to the overall compression of incomes: Some one-third of the decline in hourly wage inequality between 1940 and 1980 was due to cross-state convergence. In recent decades, however, catch-up growth by lagging areas has broken down completely. Economic vitality is now increasingly concentrated in big cities, especially on the coasts. Since 2008, job gains in metro areas with populations over a million (53 metro areas out of a total of 384) accounted for nearly three-quarters of employment growth.[5] Meanwhile, 80 percent of U.S. counties, home to 149 million Americans, suffered outright decline in prime working-age population between 2007 and 2017, and 65 percent can expect to undergo further decline in the coming decade.[6]

“Over the past several decades, the American Dream has been caught in a pincer movement.”

What happened to the land of opportunity? Over the past several decades, the American Dream has been caught in a pincer movement. On the one hand, deep-seated social forces have combined to slow down growth and accelerate inequality. At the same time, sustained and dramatic changes in public policy have worked not to counteract those forces, but to exacerbate them.

The growth slowdown reflects the progressive exhaustion of factors that propelled rising output and incomes in years past. First, the Baby Boom, together with rising rates of female participation in the paid work force, drove a steady increase in labor inputs over the last third of the 20th century: Average annual hours worked per capita rose 27 percent between 1964 and 2000. But the percentage of women in the work force plateaued at the end of the 1990s, and the overall labor force participation rate nosedived with the Great Recession. Despite some modest recovery recently, the LFPR at present is down at levels last seen in the late 1970s.[7]

Growth is powered not just by more workers, but by workers with more valuable skills — and skill levels soared in the 20th century thanks to huge investments in secondary and then postsecondary education. In 1900 only about 6 percent of American kids graduated high school; by 1970 that number had soared to 76 per-

5 Clara Hendrickson et al., “Countering the Geography of Discontent: Strategies for Left-Behind Places,” Brookings Institution, November 2018; Richard Florida, “The Growing Inequality between America’s Superstar Cities and the Rest,” City Lab, November 19, 2018.

6 Adam Ozimek et al., “From Managing Decline to Building the Future: Could a Heartland Visa Help Struggling Regions?”, Economic Innovation Group, April 2019.

7 See Brink Lindsey, “Why Growth Is Getting Harder,” Cato Institute Policy Analysis no. 737, October 8, 2013.

cent. As of 1940 only 6 percent of young Americans had college degrees, but by 1980 the figure had quadrupled to 24 percent. Put these together, and average years of educational attainment for American workers rose from 9.01 in 1940 to 12.46 in 1980 — for an average increase of 0.81 percent a year. Since then, however, the growth motor of rising educational attainment has stalled. Between 1980 and 2005, the rate of increase was only 0.33 percent a year, and since then average years of schooling have been more or less flat.[8]

"The ultimate driver of long-term economic growth is rising productivity."

The ultimate driver of long-term economic growth is rising productivity: technological or organizational changes that increase the amount of output that can be produced from a given level of inputs — in other words, innovation and its diffusion. Measured growth in so-called total factor productivity surged during the quarter-century after World War II, but it slumped in the mid-1970s and — except for an Internet-fueled boom from the mid-1990s to the mid-2000s — has remained disappointingly sluggish ever since.

While the accuracy of productivity measurements is contested and the various determinants of rises and falls in productivity growth are difficult to pin down, there is good reason to think that output-expanding innovation is getting more and more difficult to accomplish. Economists from Stanford and M.I.T. make the case in a recent paper that the productivity of research itself is in long-term decline. As they put it in the title of their paper, good ideas are getting harder to find. One striking example illustrates the larger trend: The number of researchers needed today to fulfill another cycle of Moore's Law (which posits that the processing power of computer chips doubles every two years) is 18 times greater than the equivalent number back in the early 1970s.[9] Over the long term, then, innovation — and thus economic growth — appears to be a kind of Red Queen's race, where you must run ever faster just to get anywhere.

At the same time that the major factors expanding the economic pie were losing momentum, other powerful forces emerged that would push toward dividing the pie more unequally. The information technology revolution ushered in what economists call "skill-biased technological change," raising relative demand for highly skilled workers while thinning out jobs in the middle of the skill spectrum. The combination of IT and globalization, by vastly expanding the size of markets, created winner-take-all dynamics with windfall gains for top-performing "superstars."

8 See ibid.

9 Nicholas Bloom et al., "Are Ideas Getting Harder to Find?," National Bureau of Economic Research Working Paper no. 23782, September 2017.

Rising economic opportunities for women, in tandem with a trend toward assortative mating (i.e., marriages between partners with similar educational levels and earning potential), increased inequality yet further by putting two top earners in the same household. And the huge influx of less-skilled immigrants over the past several decades has increased the spread between incomes at the top and those in the middle by dragging down the median.

Here then is one half of the story. America's liberal democratic capitalist welfare state has faltered in fulfilling its promise because times have changed. The task of delivering inclusive prosperity has grown much more difficult.

The other half of the story is policy failure. In recent decades, boosting economic growth has been a cause largely associated with the political right. And from the Reagan to the Trump administrations, the main prescriptions have been tax cuts and rolling back health, safety, and environmental regulations. Back in the 1980s, this seemed like a plausible approach: The top marginal tax rate was very high at 70 percent, and the rapid expansion of social regulation in the 1970s had coincided with the collapse in productivity growth. But by now, it is clear that this policy agenda is more about paying off big donors than advancing the common weal. The connection between tax rates and incentives for innovation is modest at best, and in an economy dominated by services, the impact of regulations aimed mostly at heavy industry is likewise marginal. The energy and efforts of the "supply-side" movement and its successors have been largely misdirected.

" The task of delivering inclusive prosperity has grown much more difficult."

Meanwhile, policymakers from both parties — working at the federal, state, and local levels — have pushed for and defended policies that simultaneously worsened the growth slowdown by squelching or distorting competition *and* worsened inequality by artificially inflating income and wealth at the top. Here we are talking about the phenomenon of regulatory capture, in which privileged insiders manipulate the rules to benefit themselves at the expense of everybody else. Although barely noticed until quite recently, this insidious corruption of both democracy and capitalism has led to staggering misallocations of resources that deform the whole macro structure of the economy.

As we discuss in more detail in Part III of this paper, three important sectors of the economy have been badly distorted by insider manipulation: finance, housing, and health care. In all three, rules written for the benefit of a privileged few have inflicted enormous damage. The resources consumed by the financial sector have almost doubled, and the main thing we got to show for it was an economically and politically ruinous global financial crisis. The resources consumed by health care are nearly double what is the norm in other rich countries, yet our health outcomes lag badly behind theirs and we still can't provide reliable, affordable access for all. The resources consumed by housing are now far higher than they should be in many big metro areas, with the result that our most productive places cannot attract all the human resources they need to maximize their potential. In the first two cases, multiple percentage points of GDP are being misspent every year; in the last case, multiple percentage points of GDP have gone unproduced. And as a result, the distributions of income and wealth are now much more top-heavy than would otherwise be the case

This dismal record of regulatory capture and colossal waste is the major development in American political economy over the past generation. At a time when the headwinds impeding innovation and growth have been gathering force, and trends that pamper winners while narrowing opportunities downscale have been building momentum, the primary policy response has been to render the major structures of the U.S. economy even less dynamic, and even less equitable. Having wandered into a hole, our response has been to dig.

High Performance on the High Road

The Niskanen Center's vision for a free-market welfare state demands an ambitious, full-spectrum campaign of policy change to undo the damage caused by regulatory capture and counter the social forces pushing against inclusive prosperity. Our strategy is premised upon the deep complementarity between vigorous, market-mediated entrepreneurship and competition, on the one hand, and generous government provision of social insurance and other public goods on the other. What makes our approach so distinctive is that this complementarity remains widely ignored, if not actively denied, on both sides of the conventional left-right divide.

We start with the proposition that widespread prosperity and ongoing social progress are impossible in the modern world without a vibrant, innovative, competitive private sector. And the private sector functions at its best when it is organized around free markets — in other words, markets that feature free entry, free exit, free trade across national boundaries, freedom to hire and fire, freedom to take a job or quit, freedom to introduce new products or production methods without prior permission, and freedom to invest. These are the institutional arrangements that maximize the generation of potentially useful new ideas, provide for their rigorous testing, and ensure that better ideas are imitated while worse ideas are abandoned.

Unlike many others who embrace the cause of free markets, we recognize clearly that these institutional arrangements are neither self-executing nor self-sustaining. It's true, per Adam Smith, that trucking, bartering, and exchanging are natural human activities that occur just about everywhere. But the vast, impersonal markets that deliver modern economic growth are profoundly unnatural. They do not simply pop up in the absence of government. On the contrary, markets capable of mobilizing and sustaining large-scale, long-term investments and uniting vast numbers of complete strangers in organized, collaborative activity are elaborate social constructions and inseparable from the modern states that create and house them.

"The private sector functions at its best when it is enabled and supported by a strong, capable, effective public sector."

In other words, the private sector functions at its best when it is enabled and supported by a strong, capable, effective public sector. It needs government to write and enforce the rules that align private profit-seeking with the public welfare. It needs government to fund or supply the public goods — education, infrastructure, research and development — that enable people to participate in the marketplace at a high level and push the whole system to new heights by advancing the frontiers of knowledge and technology. It needs government to provide social insurance against various hazards of life — poverty, sickness, and joblessness — and thus protect well-being against downside risks, prevent the mass waste of human potential that would otherwise occur, and sustain support for economic dynamism even in the face of its incessant disruptions of people's plans and expectations.

To better understand our conception of combining energetic government with a free-market economy, it is useful to borrow an idea from labor markets — namely, the idea of "high road" versus "low road" employment strategies. "High road" employers invest heavily in training their workers and then pay well and offer a long-term career path in order to keep them in-house. "Low road" employers, on the other hand, pay as little as they can, offer only limited training and no clear career progression, and expect high turnover. The high road strategy, then, is to view workers as assets, to be invested in and carefully maintained. The low road strategy, by contrast, is to view workers as costs that need to be minimized.

In a big, diverse economy, there is a place for both strategies. High road employers will be more selective, looking for workers with stronger qualifications and higher perceived long-term potential. So for less-skilled workers who lack credentials and experience, the existence of low road employers creates accessible employment opportunities that otherwise wouldn't be there.[10]

But when we move from thinking about how private employers treat workers to thinking about how public policy treats citizens, both our liberal democratic values and our best reading of the evidence lead us to choose the high road. The foundational principle of republican self-government is the commitment to the equal moral significance of every individual: No one is born better or more deserving than any other, and therefore none are born to rule over others and none are born to labor for others' benefit. In this view, society is to be understood not as the instantiation of some immutable natural hierarchy, but as a common enterprise for mutual benefit. And the proper role of government is to advance the welfare of all, by supplying the conditions that allow free people to flourish in lives of their own choosing.

Liberal democracy thus amounts to a bet on the capacities of ordinary people — to shoulder the shared responsibilities of self-rule, and to thrive when given freedom and a fair chance to make their own way. This democratic confidence in ordinary people contrasts with autocratic and oligarchic contempt for and fear of the same: contempt for their supposed inferiority, fear of their greater numbers and the possibility that they could rise up and topple their rulers.

"Liberal democracy amounts to a bet on the capacities of ordinary people..."

Liberal democracy, in other words, takes the high road. It views all citizens as assets to the republic, potentially valuable contributors to the common enterprise of society — not as costs or burdens or threats to be minimized and contained. Liberal democracy, at its best, offers the politics of uplift — of expecting more from people and bringing out the best in them. In the words of America's greatest and wisest statesman, it is "that form and substance of government whose leading object is to elevate the condition of men — to lift artificial weights from all shoulders, to clear the paths of laudable pursuit for all, to afford an unfettered start and a fair chance, in the race of life."[11]

Moving from principles to practice, we believe that achieving the politics of uplift in 21st-century America requires expansive and energetic government. Just as a high road employer invests heavily in its workers, a government committed to the high road needs to make big investments in its citizens — investments in sound regula-

10 Although there is a role for both strategies, we prefer the high road strategy to be the rule rather than the exception, as it is more conducive to individual flourishing and social progress over the long term. We therefore see the apparently ongoing shift of American employers to a low road strategy as a troubling development. See Martin Baily and Barry Bosworth, "Explanations for Slow Long-Term Growth," in Brink Lindsey, ed., Understanding the Growth Slowdown (Washington, D.C.: Cato Institute, 2015), pp. 49-71.

11 Abraham Lincoln, Message to Congress, July 4, 1861.

tion, education, infrastructure, conservation, research and development, and social insurance, as well as national security and the criminal and civil justice system. Contrary to the wishful thinking of many libertarians and small-government conservatives, we cannot rely on private businesses and charities to make these investments at adequate levels.[12] Free markets are truly amazing, but they cannot supply their own enabling conditions. In the modern world of high social complexity and extreme interdependence, externalities, uninsurable risks, and other collective action problems are a widespread and unavoidable fact of life — and the only social agency capable of dealing with them properly is government.[13]

"To realize the promise of the high road, noble aspirations are not enough."

In employing the metaphor of the high road, embracing activist government, and describing government spending as investment, we recognize that we are using rhetoric with distinctly progressive connotations. So we must take pains to clarify that our vision of good government diverges sharply from progressive practice. In particular, we are acutely aware that lofty rhetoric and declarations of good intentions are not enough — and all too often serve as whitewash for government waste and dysfunction.

Consider California in 2019, before the pandemic struck. Here was a rich state with the Democratic Party and progressive cultural values utterly dominant. There was little ideological opposition to expansive government, and state and local government spending was high by national standards. Yet housing was unaffordable, homelessness was rampant, human feces littered the streets of San Francisco, teachers went on strike in Los Angeles to protest deteriorating conditions, out-of-control wildfires destroyed thousands of homes and forced tens of thousands of people to evacuate, and the electric utility left millions without power for days at a stretch in rolling preemptive blackouts. This is a picture of big government gone wrong. This is not the high road.

To realize the promise of the high road, noble aspirations are not enough. We must understand the pitfalls that come with expansive government and take proper measures to avoid them. To achieve the high road in real life, we must also insist on high performance for government.

Two big pitfalls in particular command our attention: capture and "kludgeocracy." The former, which we discussed in the previous section, is an ever-present risk. The powers of government are always vulnerable to being diverted from le-

12 See Samuel Hammond, "It (Still) Takes a Nation: Why Private Charity Will Never Replace the Welfare State," The Independent Review Vol. 23, no. 4, Spring 2019.

13 See Joseph Heath, "Three Normative Models of the Welfare State," Public Reason Vol. 3, no. 2, pp. 13-44, 2011.

gitimate public purposes and manipulated for private gain. These vulnerabilities skyrocket when policymakers try to address problems at excessive levels of complexity and detail (see, e.g., financial regulation), as they can easily get bamboozled by industry representatives who will almost always have superior knowledge of the relevant intricacies. Likewise, the risks of capture soar when decision-making venues are remote and inaccessible (see, e.g., local zoning hearings); it's much easier to roll other affected interests when they don't show up and aren't effectively represented.

Kludgeocracy, a malady of democracy diagnosed and named by our colleague Steven Teles, refers to the breakdown of policy coherence amidst a pileup of compromised, indirect approaches with unclearly shared responsibilities for execution.[14] See, for example, the welter of tax preferences and subsidized loan programs that ineptly substitute for straightforward taxes and transfers; the mind-numbingly byzantine rules that govern payments for physicians and hospitals; and the unadministrable mush of countless different education and social welfare programs.

"Small government is not the answer; what is needed is simpler, more legible government."

To take on the ambitions of the high road and translate them into high performance, we need big changes in how government manages its weighty responsibilities. Wherever possible, we need to maintain a dogged preference for simple, clear rules and standards over multifactor balancing tests; for big, blunt interventions over subtle nudges; for on-budget direct payments to beneficiaries over tax preferences and empowering bureaucratic intermediaries; and for decision-making venues that force rent-seeking insiders to face effective representation of the broader public. Small government is not the answer; what is needed is simpler, more legible government.

And although ensuring good processes is absolutely necessary, it is not remotely sufficient. We must make big, substantive shifts in policy as well as procedural overhauls, changing the "what" of government as well as the "how." In the sections that follow, we outline a wide-ranging agenda for reforming and redeeming the promise of the liberal democratic capitalist welfare state. To lift up America and create a high road, high performance economy, to expand opportunities for all Americans while also bolstering their security, we propose three major goals of policy change. First, to revive a healthy, vibrant labor market geared toward full employment by reforming monetary policy and overhauling our patchwork, byzantine social insurance system. Second, to unwind and dismantle the insidious struc-

14 Steven Teles, "Kludgeocracy in America," National Affairs, Fall 2013.

tures of insider privilege created by regulatory capture, liberating wasted resources to be redeployed to the betterment of all. And third, to reignite economic dynamism and innovation with a combination of public investment and regulatory reform.

With the first goal, we aim to restore the American economy to the high road — by improving employment prospects for workers and upgrading social insurance to better protect families from downside risks. With the second and third goals, we seek to retool the economy for high performance —by wresting control of key economic sectors from rent-seeking insiders and correcting the huge misallocations of resources that their misrule has engineered, and by providing the public goods and rules of the road that encourage and incentivize innovation and dynamism.

This is our agenda for returning America to inclusive prosperity. A recurring feature of the reforms we propose below is that they tend to advance both aspects of this goal simultaneously — that is, they promote both greater equity *and* greater efficiency. Our proposals to improve social insurance bolster economic security in a way that encourages entrepreneurship and growth, while our proposals to unleash market competition also serve to roll back economic inequality. In other words, our proposals that aim for the high road also encourage high performance, while our proposals focused on eliciting high performance do so in a way that provides uplift to the high road. This is no accident, but rather evidence of the soundness of our underlying policy vision. As supporters of a free-market welfare state, it is our contention that a vibrant public sector and a vibrant private sector are not antagonists, but instead complement and reinforce each other. The policy agenda we offer here is an illustration of that principle at work.