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The American Way of Welfare: Political-Economic Consequences of a Consumer-Oriented Growth Model[1]

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INTRODUCTION: LAND OF TOO MUCH

European countries have lower levels of poverty and inequality than the United States, in any way that we can measure poverty and inequality.[2] The conventional explanation for this has been that Americans are reluctant to use government to intervene in the market, even to help citizens escape poverty. But recent scholarship has revealed a great deal of governmental intervention in the United States throughout the twentieth century, in many cases surpassing Europe. For example, the American tax system has historically been more progressive than the tax systems of European countries (Lindert 2004; Prasad and Deng 2009; Prasad 2012), and, for most of the twentieth century, the U.S. was marked by higher taxes on capital than other countries, and lower taxes on labor (Mendoza, Razin, and Tesar 1994; Carey and Rabesona 2004; Lindert 2004; Cusack and Beramendi 2006). American regulations separating investment and commercial banking were never adopted in Europe (Benston 1994), nor were the regulations that historically prevented American banks from engaging in branch banking across state lines (Grossman 1994). U.S. bankruptcy laws have been much more favorable to debtors and remain so today, even

after the bankruptcy reform of 2005 (Tabb 2005). Food and drug regulation and health and safety regulation have been systematically more stringent in the U.S., although increasingly less so since the 1980s (Lundqvist 1980; Brickman, Jasanoff, Ilgen 1985; Jasanoff 1991; Badaracco 1985; Wilson 1985; Braithwaite 1985; Benedick 1998; Verweij 2000).

These examples of state intervention are not exceptions or anomalies; rather, they are characteristics of a model of political economy that can best be described as "consumerist," in contrast to the "producerist" model found in many countries of Europe. The American state is not necessarily smaller or less interventionist, it is merely organized on different lines than the states of Europe—specifically, American state intervention promotes consumption, while European state intervention restrains consumption. For example, the American tradition of progressive taxation has constrained the development of taxes on consumption, so that American consumption taxes (including those levied at the state and local level) are less than one-half of the average OECD level.[3] American regulations against branch banking worsened the crisis of finance during the Great Depression, and politicians resuscitated finance by developing a political economy based on consumer debt, while European countries developed policies designed to help consumers save.[4] Even at the height of the current economic crisis, European countries refused Keynesian methods of promoting consumption, preferring to continue their embrace of producers, particularly exporters. Meanwhile, the United States has been in the vanguard in the argument for stimulating consumption as the way out of crisis. Europe exports; America consumes.[5]

Contrary to what one may immediately assume, these differences are not the result of different cultural traditions. In fact, which countries have been more oriented to consumption has varied over time, and we can find values in the national traditions of all countries that both promote saving and promote borrowing. Just as there has been cultural receptiveness to consumption and credit in Europe, there have been cultural attempts to promote savings throughout American history.[6]

Rather, these distinctions between Europe and the United States originate in the nineteenth century, when American productivity began to overwhelm world markets, and—because of the gold standard—caused price declines throughout the world, particularly in agricultural products. In Europe, the response was to appease farmers by closing borders through protectionism. Americans were also protectionist, but it was American farmers' own productivity that was causing the problem, and protection could not help them. Instead, the United States saw a powerful political movement emerge from agrarian areas that succeeded in establishing a form of agrarian state intervention.

These precedents—American productivity and agrarian state intervention, and European struggles with American productivity—had very different consequences after the Great Depression and the Second World War. In Europe, the question was how to rebuild war-devastated economies that were producing too little. European planners explicitly chose a policy of *restraining consumption and subsidizing production,* and channeled profits toward export industries, the secret of Europe's post-war economic miracle. For example, in France, Jean

Monnet and his famous group of planners decided that "capital investment was the key" to recovery, and therefore "the planners wanted to lower the output of consumer goods as much as possible without arousing opposition to the [plan]…The planners chose investment over consumption, modernization over reconstruction, or the future over the present…financial resources would be available, it was held, if consumption were controlled through such means as rationing. Then personal savings would accumulate and furnish the necessary investments" (Kuisel 1981, 222, 225, 233-234). Similarly, Germany was doing everything in its power to try to restrain inflation, including restricting consumer credit (Eichengreen and Mitchener 2003), reducing lending by banks (Voth 2003), and channeling funds to investment (Overy 1996, Logemann 2007). German politicians "subordinated domestic demand to the needs of industrial capital" (Allen 1989, 263). The German growth model was: "moderate wages [which] enabled the buildup of plant and equipment to take place, ensured the stability of the new currency, and permitted Germany's return to the world market through competitive exports" (Hardach 1980, 171).

In the United States, however, the problem came to be seen as one of producing too much: particularly in the early 1930s, when the government embarked on a policy of destroying crops to maintain agricultural prices, horrified observers asked how it could be that the capitalist machinery was producing so much that we now had to explicitly destroy what had taken so much effort to produce. Although analysts now believe the problem was one of restricted money supply, at the time the problem came to be understood as one of maintaining purchasing power. Instead of restraining consumption and subsidizing production as in Europe, *increasing consumer purchasing power* became the paradigm that drove policy in the United States. Labor leaders and economists argued that the nation "must increase consumption and reduce savings" (quoted in Garon 2012, 327; Cohen 2003). Government officials proclaimed that the country's "rich abundance of natural resources and an undreamt-of capacity to convert this natural wealth into useful goods and services" required that "the consumers of the Nation are able to buy the output of goods and services which industry can produce" (quoted in Garon 2012, 327). President Franklin Roosevelt agreed: "Our task now is not discovery, or exploitation of natural resources, or necessarily producing more goods. It is the soberer, less dramatic business of administering resources and plants already in hand, of seeking to reestablish foreign markets for our surplus production, of meeting the problem of underconsumption, of adjusting production to consumption, of distributing wealth and products more equitably" (quoted in Kennedy 1999, 373).

In the United States, policies to increase consumer purchasing power often focused on increasing consumer credit (Trumbull 2010; Hyman 2011). The centerpiece of the effort was the attempt to increase homeownership by encouraging citizens to borrow heavily for the purchase of homes. Observers from all areas of the political world agreed that supporting housing was the best way to support the economy. The Chairman of the Federal Reserve wrote: "almost a third of the unemployed were to be found in the building trades, and housing was by far the most important part of that trade. A program of new home construction, launched on an adequate scale, not only would gradually help put those men back

to work but would act as the wheel within the wheel to move the whole economic engine. It would affect everyone, from the manufacturer of lace curtains to the manufacturer of lumber, bricks, furniture, cement, and electrical appliances. The mere shipment of these supplies would affect the railroads, which in turn would need the produce of steel mills for rails, freight cars, and so on" (quoted in Quinn 2010, 149–150; Gotham 2000, 299; Radford 1996, 179). The American Federation of Labor agreed that "home reconstruction provides the broadest single base for production and re-employment in major industries. In keeping with other plans for an economy of abundance, we should carry on slum clearance and re-housing of families whose incomes keep them out of reach of the private building markets" (quoted in Logemann 2007, 245).

During the Great Depression both Herbert Hoover and Franklin Roosevelt experimented with policies to provide credit for the housing sector. Early experiments culminated with the Federal Housing Administration (FHA) and the Federal National Mortgage Association (FNMA), programs to support the economy by underwriting loans for housing (Radford 1996; Green and Wachter 2005; Quinn 2010; Hyman 2011, 49–70).

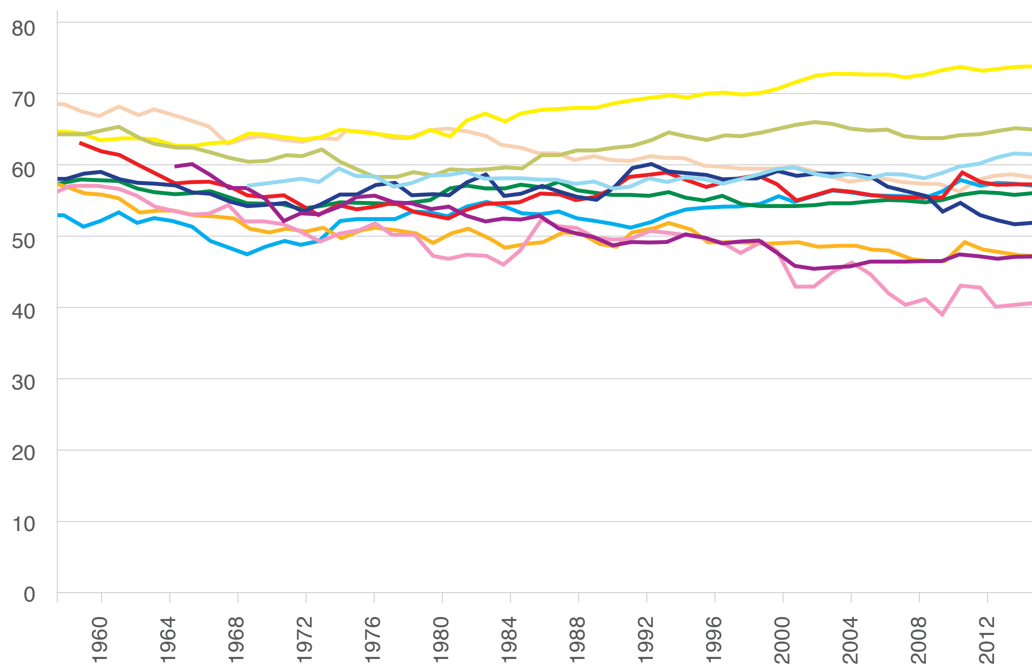
Thus, Europe and the United States found themselves on two diametrically opposed economic paths, and followed these paths for the next several decades. As one astute observer noted in the 1960s: "President de Gaulle not long ago 'declared that France's economic future depended on more savings, more investment, and less consumption.' By contrast, the United States Treasury, at almost the same time, emphasized that its recent tax moves—the Revenue Act of 1964 and the Excise Tax Reduction Act of 1964—'provided a substantial stimulus to consumer demand.' What the United States seeks to achieve is exactly what France seeks to avoid" (Norr 1966, 390).

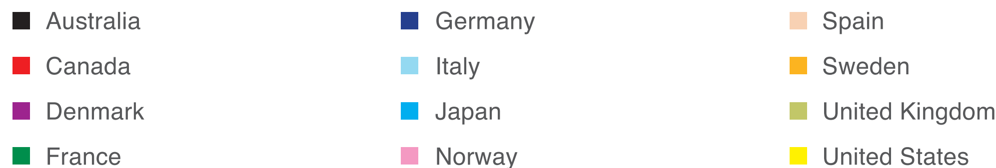
Over the next decades the countries' commitment to these different growth models only increased, and several other aspects of American politics came to support the consumer bias. For example, American foreign policy increasingly focused on securing access to low-cost oil, without which the oil-dependent American consumer economy would have ground to a halt; and in the mid-twentieth century a legal tradition emerged that began to support consumer rights in the U.S. at the same time as laws supporting producerism were being consolidated in Europe (Whitman 2007). Other less visible but extremely consequential policies and practices arose to support homeownership, such as the policy of "fractional assessment," assessing property taxes on only a fraction of the true value of a home. By the 1970s fractional assessment was costing governments $39 billion annually, an amount second only to outlays on Social Security and Medicare (Martin 2008, 9-10).

The most obvious consequence of these inter-related policies has been higher consumption in the United States compared to Europe. Figure 1 shows the role that private consumption plays in 19 OECD economies. In the United States, consumption has played a larger role than in France, Germany, Sweden, the United Kingdom, or indeed, most other advanced industrial countries, since 1960. The post-war economic miracle in Europe convinced Europeans that they should not stray too far from the model they had adopted.

And the U.S., for its part, became even more committed to a kind of "mortgage Keynesianism" by which debt-fueled homeownership underwrote the economy. Whereas Europeans thought—and still think—that restraining consumption and focusing on production and exports is the way to generate growth, Americans focused—and continue to focus—on increasing consumption as the way to generate growth.

Figure 1. Private Consumption as % GDP

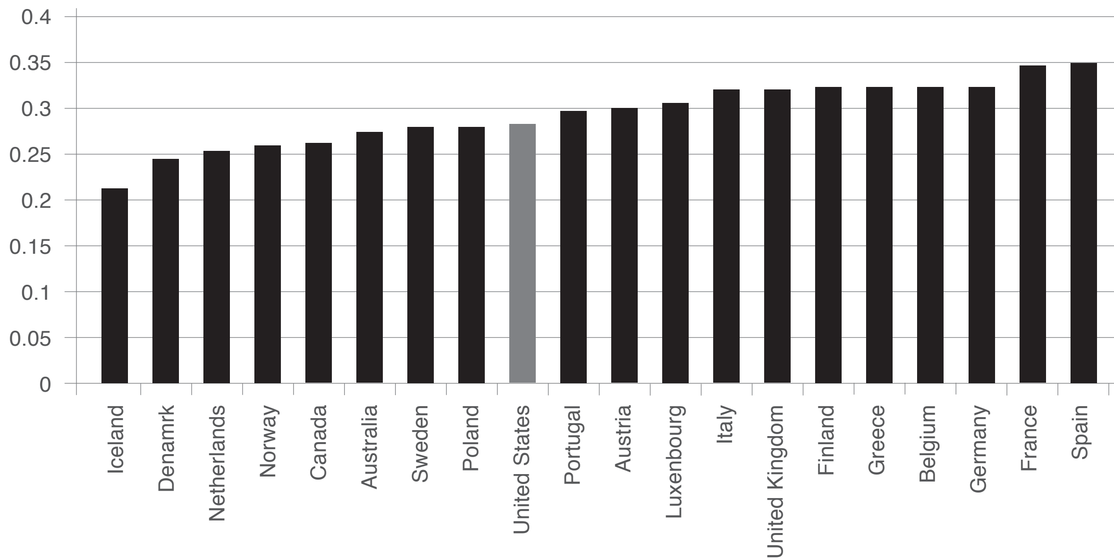




CONSEQUENCES OF THE CONSUMER-ORIENTED ECONOMY

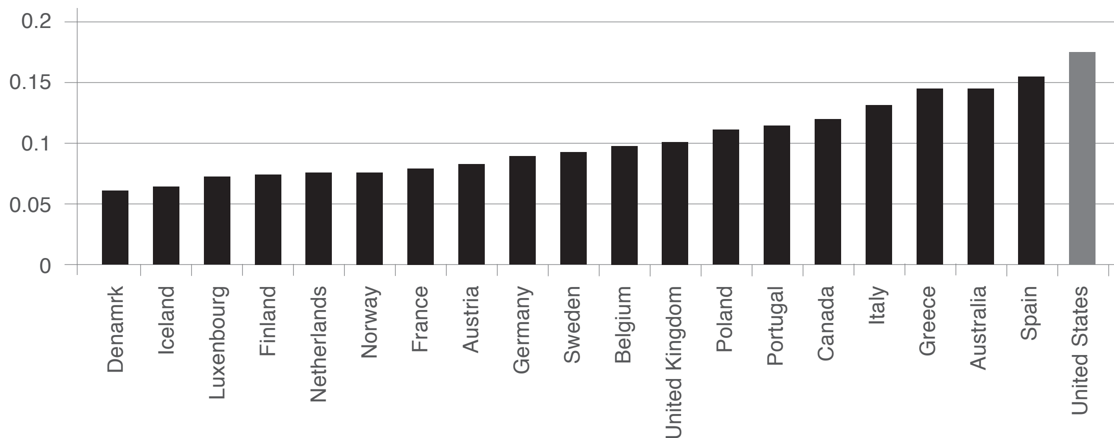
Although an economy biased toward consumption brings low-cost goods to citizens, over the years several negative consequences of such an orientation have become visible. First, producerist and consumerist growth models have very different effects on poverty and inequality. European and American poverty rates diverge dramatically. This divergence is not the result of a market that produces more poverty in the United States, however. Surprisingly, if we look at poverty rates *before* government intervention—that is, before the government steps in and takes taxes from some and gives transfers such as welfare and unemployment and pension benefits to others—then the United States has much lower poverty than many other European countries, including Italy, the U.K., Germany, and France (figures 2a-2b).

Figure 2a. Poverty Rate Before Taxes and Transfers, 2010



† *OECD stats.oecd.org, "poverty rate before taxes and transfers, poverty line 50%"*

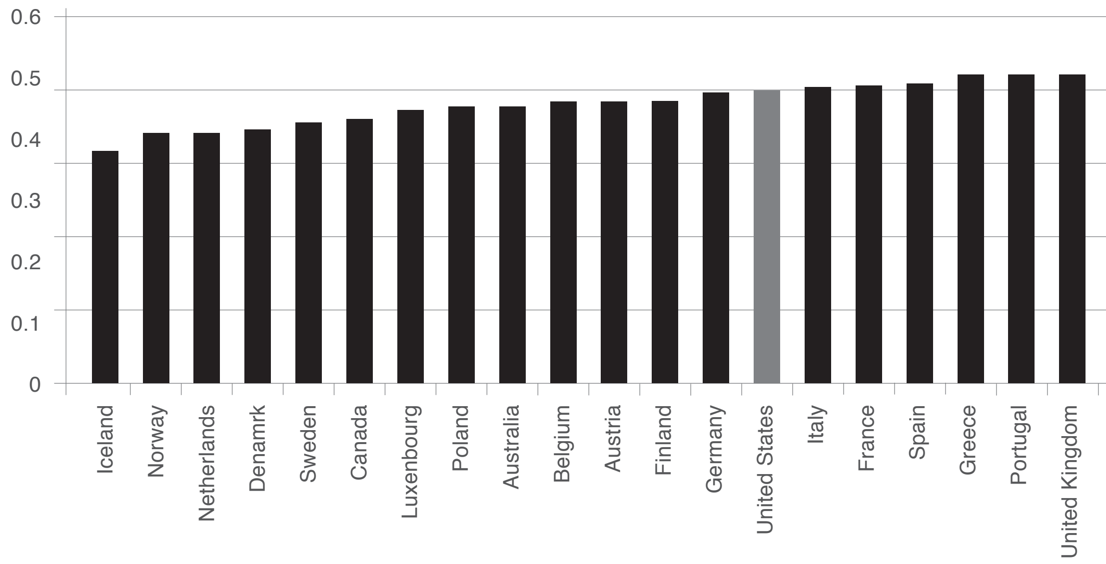
Figure 2b. Poverty Rate After Taxes and Transfers, 2010



† *OECD stats.oecd.org, "poverty rate after taxes and transfers, poverty line 50%"*

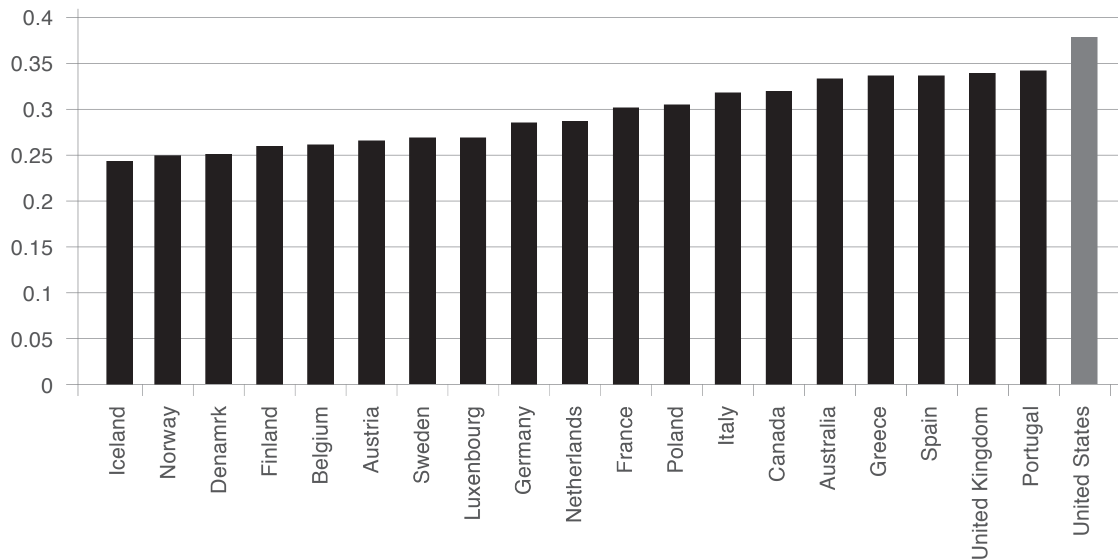
Only after governmental intervention does the familiar picture of greater poverty in the United States emerge (figure 2b). The picture is similar if we use different definitions of poverty, including absolute or relative measures of poverty; and the picture is similar if we examine inequality rather than poverty (figures 3a-3b): while the U.S. has the highest disposable income inequality, that is, inequality after taxes and transfers, *market* income inequality in the U.S. is only slightly higher than in Germany, Finland, and Belgium, and actually slightly lower than in Italy, France, Spain, and Great Britain.

Figure 3a. Inequality (Gini Index) Before Taxes and Transfers, 2010



† *OECD.Stat, "Gini before taxes and transfers"*

Figure 3b. Inequality After Taxes and Transfers, 2010



† *OECD.Stat, "(Gini at disposable income, post taxes and transfers)"*

These graphs cast doubt on one of the most common storylines in recent American political economy: that rising poverty and inequality are a consequence of stagnant wages, and that the answer to poverty and inequality is therefore a push for higher wages. If poverty and inequality rates before governmental intervention are not so different in the United States and Europe, then market wages are not responsible for the higher poverty and inequality in the U.S. It is true that minimum wages in the U.S. are less than the OECD average (although not the lowest of the OECD countries), and that market incomes at the very top are high in the U.S. But when we examine the labor force as a whole, not just at the top and bottom ends, it is *governmental* policies of taxes and transfers—the "welfare state"—that create the pattern of divergence between the United States and Europe.

Welfare states grew in Europe as a byproduct of the producerist growth model. To purchase acquiescence to this model of growth, which required lower wages and restraint of consumption, European countries developed extensive welfare states, in many cases in an explicit quid pro quo with labor, trading lower wages for social benefits. For example:

> In Belgium, the first postwar government adopted a social security scheme in return for labor's adherence to a 1944 social pact limiting wage increases. In return for the unions' promise of wage restraint, the Norwegian government offered legislation mandating paid vacations and limiting the length of the workweek. The Dutch government introduced unemployment insurance and old-age pensions, while extending social security coverage, as a quid pro quo for wage moderation. Starting in 1955, the Swedish government offered compulsory health insurance, an expanded system of disability insurance, and an array of retraining programs in return for labor's acquiescence to policies of wage restraint and solidarity. The Danish government offered an expanded system of sick pay in 1956, when the agreement to link wage increases to productivity negotiated during the reconstruction phase showed signs of breaking down. .... The Austrian government extended tax and social insurance concessions to labor in return for wage moderation" (Eichengreen 2007, 33–34).

Such bargains were not necessary or possible in the United States, because there was no overarching focus on wage restraint in the service of growth. Instead, the purchasing power paradigm demanded high wages, bolstered by expansionary credit, to underpin the strategy of consumption-driven growth.

The consumer economy that arose after the Great Depression and Second World War undermined the welfare state in the U.S. in two specific ways, one direct and one indirect. First, several studies have shown that homeownership has negative effects on citizens' willingness to support redistribution (Kemeny 1980; Conley and Gifford 2006; Ansell 2013). We do not yet have a full understanding of why this might be the case, but analysts have suggested that homeownership functions as a form of economic security that makes homeowners less dependent on the welfare state, and also that homeowners may be more resistant to taxes because they compete with mortgage payments. Second, the United States emerged from the Second World War with low taxes on consumption; but one of the lessons of scholarship of the last several decades is that consumption taxes are much more

solid bases of revenue generation than taxes on income (Lindert 2004). One reason is that consumption taxes do not penalize savings, as income taxes do: "If you are subject only to a 15 percent consumption tax now and forever, with no income tax, your incentive to save is not strongly affected…Income taxes, by contrast, take from your saved income twice, both when you initially earned the income you decided to save and again when your savings earns new capital income" (Lindert 2004, 241–242; Hines 2007). A higher savings rate is in turn correlated with higher growth. There is a remarkable degree of consensus in the discipline of economics that consumption taxes are more compatible with economic growth than income taxes (see e.g. Summers 1981; Pecorino 1993; Pecorino 1994; Kneller, Bleaneay, and Gemmell 1999; Jorgenson and Yun 1986; Widmalm 2001). Consumption taxes are also less susceptible to the effects of globalization, as they do not wither in the face of capital flight (Ganghof 2006, 2007, 2008). Moreover, income taxes also seem to provoke more political resistance than consumption taxes (Wilensky 2002), and income taxes are more prone to the proliferation of tax preferences, which have encouraged the development of a private rather than public welfare state (Prasad 2012). Ultimately, if counter-intuitively, the comparative evidence suggests that calls for more progressive income taxes in the United States may be misplaced if the goal is to reduce poverty and inequality. In fact, many countries with much lower poverty and inequality have regressive-leaning tax systems in which consumption taxes play a major role. These taxes are more efficient than progressive income taxes, and European states have thus been able to spend much higher amounts on social benefits without damaging their economies.

For all of these reasons, one of the consequences of the consumer-oriented economy has been greater poverty and inequality in the United States.

Of course, many Americans are not convinced that poverty and inequality are problems at all. But even citizens unconvinced of this should be worried, because the second problem with the consumer bias of the American economy is that it produces financial volatility.

Most analysts of the financial crisis of 2007-2008 have understood it to be the result of the increasing role that finance capital and credit play in the American economy, and how this creates debt bubbles that have the power to bring down the whole economy. The process of financialization is generally understood to have begun in the 1970s, when savings rates began to fall and debt levels to rise. One view that has become prominent recently—if under-appreciated in its deep implications—is that financialization was an easy way to avoid difficult distributional questions during the economic crisis of the 1970s, because expansions of consumer credit provided households with a way to make ends meet without needing to expand the welfare state (Krippner 2011, Rajan 2010). As the economy slipped into crisis, policymakers discovered that expanding access to consumer credit was a cheap and easy way to avoid making more fundamental changes. Greta Krippner writes: "as conditions supporting broadly based prosperity in the economy eroded…policymakers transformed an era of capital scarcity and perennial credit shortages into apparent prosperity, obviating the need for an emergent social consensus" on issues of distribution (2011, 147-149). Krippner notes

that "a series of unresolved distributional questions lurk just below the surface of the credit expansion that has occurred in the U.S. economy in the decades since the 1970s" (165).

The problem with this argument is that, by the 1970s, the United States was already more financialized on several dimensions than the countries of Europe. For example, in credit to the private sector as a share of GDP, the United States ranked second after Switzerland in 1970 (Demirgüç-Kunt and Levine 2001, and associated database), and third as far back as 1948 (International Monetary Fund, 2009, ratio of lines 22d + 42d to line 99b following Djankov, McLiesh, and Shleifer 2007). In 1968, compared to France, Germany, and Sweden, the U.S. was already more financialized in terms of stock market capitalization and various other measures (Rajan and Zingales 2003, 14-15). Since the 1940s, credit in the household sector had been rising as a percent of GDP (James and Sylla, 2006a). In 1971, one-half of Americans but only one-tenth of Germans used installment credit (Logemann 2008, 525). In 1965 consumer credit represented 6 percent of GDP in the U.S., but only 2 percent in France (Effosse 2010, 79).

Financialization was not just a response to economic crisis in the 1970s: it was a deeper outgrowth of the consumer-oriented model that emerged from the Great Depression, a model that depended on expansive credit as a kind of safety net for growth. Something new did happen in the 1970s, in that savings rates plunged. Whereas the credit model of the post-war period was one in which consumers borrowed often, and then repaid quickly, in the 1970s consumers continued to borrow as they had always done, but did not repay as promptly (Hyman 2011). As Lewis Hyman writes, "A credit system premised on rising wages and stable employment [before the 1970s] was reappropriated to shore up uncertain employment and income inequality [after the 1970s]" (2011, 4). Growing from an already divergent baseline, by 2012 domestic credit provided by the banking sector in the U.S. equaled approximately 230 percent of GDP, compared to rates of 124 percent in Germany, 136 percent in France, and 145 percent in Sweden.[7]

To understand the origins of today's financialization, we need to examine why the credit-driven model had become so popular by the 1970s that it was used to "shore up" an economy in crisis.

Understanding this requires understanding a dilemma that lies at the heart of a credit-driven consumer economy: if private consumption (rather than a public welfare state) is the route towards satisfying needs, then all those who are too poor to engage in significant consumption will be left out of the economic mainstream. On the other hand, if these citizens are brought into the system through the extension of credit, some of them will not be able to repay; this can make the entire financial system vulnerable, because large-scale inability to repay can occur during economic crises, when citizens who are just making ends meet are pushed into default. In a mature financial system in which debts are securitized, the consequences will ripple throughout the economy. Financial regulations such as restraints on securitization can prevent such scenarios, but in a credit-driven consumer economy there are *no constituencies for regulation of the financial sector,* because credit helps

the poor as well as the rich. Of course, there are usually no real constituencies for regulation of finance anywhere, but such regulation is needed much more in credit-driven consumer economies than elsewhere: the credit-driven consumer economy undermines the very regulation that it needs to survive. Thus, with these contradictions, the credit-driven consumer economy leads to *either* high levels of poverty, *or* financial volatility.

In the post-war period, because of the high correlation between race and poverty, racial restrictions on credit served to keep the poor out of the credit system. In the 1970s, grassroots activists were no longer willing to tolerate high levels of poverty and racial exclusion, and they were able to organize and make that unwillingness known to policymakers. Because of rising rates of divorce, feminist groups also worked to increase credit access for women. Activists focused on credit because, as one feminist leader explained in 1973, "Denial of credit is not a one-time action… In our credit-oriented economy, it determines where and how a person lives, what kind of home she lives in, whether she owns a car or can obtain a loan to send her children to college...these practices cause a double hardship on minority women. Denying credit because of marital status, sharply limits the ability of the minority woman who is head of a household—and that includes 57 percent of minority women—to provide for her dependents."[8] Activists pushing for greater credit access for African Americans as well as for women saw equal access to credit as a question of justice. Because credit was how the American economy functioned, excluding groups from credit access meant consigning them to second-class citizenship. This made credit access an issue that gained support from across the political spectrum in the 1970s, from Democrats as much as from Republicans, including those most committed to helping the disadvantaged. The grassroots activists pushing for greater credit access for the economically excluded were drawn into coalitions with representatives of the financial industry who pushed for more expansive credit for their own reasons. Regulations that might have prevented the unstable development of the financial sector were scaled back, with the support of Democrats as well as Republicans.

In other words, financialization is itself an outcome of the American consumer-oriented political economy, because a consumer economy builds political coalitions in favor of easy credit. It is the second horn of the dilemma. In the 1970s, it led to a political situation in which all actors supported measures to make finance more widely available, a situation that persisted for decades and has fed the boom and bust cycles of finance. As technological and policy changes led to more income flowing to upper-income classes who are more likely to save and invest and less likely to spend, consumer demand came to depend on low-income consumers taking on ever more debt (Rajan 2010), to the point that credit outpaced the ability of consumers to repay it.

This suggests that the financial crash of 2008 calls into question not just the financial industry, but indeed, the whole of our consumer-oriented economy, because a consumer-oriented economy builds political coalitions for greater credit access, and weakens incentives to restrain the financial sector and develop the welfare state.

STRATEGIES FOR MOVING AWAY FROM THE CONSUMER MODEL

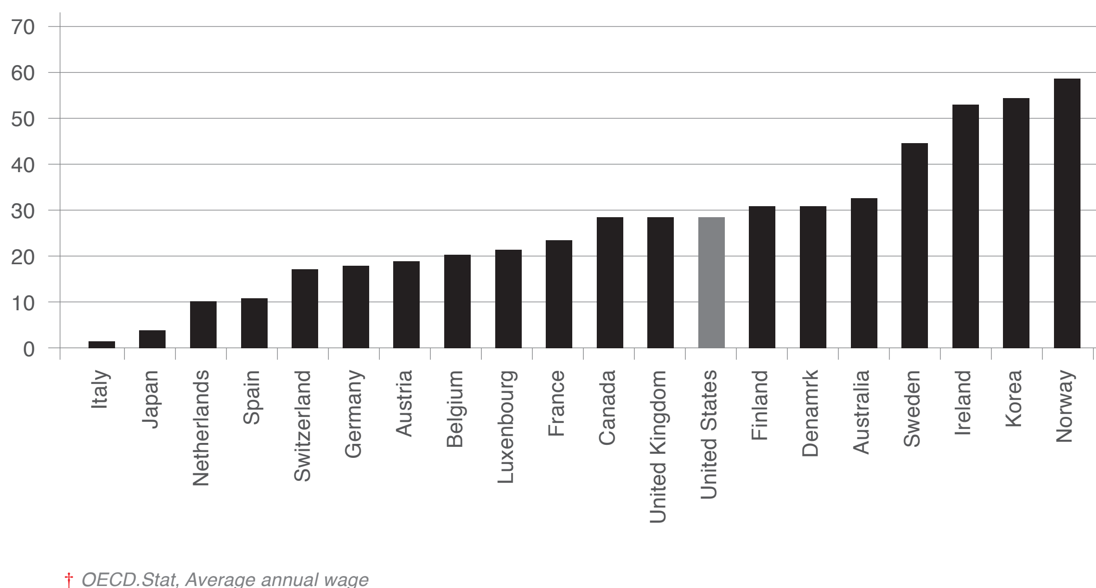
The consumer-oriented economy that we inherited from the post-war period has been an engine of growth not only for the United States, but also for the world. But there are signals that it has outlived its usefulness and is producing negative consequences that may not be worth the price.

What, then, are the policies that could move us away from the consumption model? This section first identifies problems with three popular ideas: that regulation is all we need to avoid financial crises; that wage stagnation is the central problem, and higher minimum wages and collective bargaining the solution; and that demand-driven "middle out economics" is the pathway for restoring American prosperity. Instead, this section proposes two policy strategies that move the focus away from private sector solutions.

The main idea that has emerged as a policy response to the financial crisis is that we need more regulation to prevent credit being expanded recklessly. Regulation is important and necessary to protect against practices such as predatory lending. But regulation treats the symptom, not the disease. I have shown elsewhere that deregulation of finance did not lead to greater credit in other countries (Prasad 2012), because people did not have the same need for credit in other countries. In the U.S., in the absence of developed social welfare programs, new rounds of regulation will simply make credit more difficult to access, leading to hardship for large numbers of families. In this scenario, we will inevitably see a replay of the politics of the 1970s, in which coalitions for deregulation arose from across the political spectrum, from advocates for the poor as much as from the financial industry. Because regulation treats the symptom, and not the disease, in a credit-driven economy financial regulation will never be politically sustainable.

Another idea commonly heard today is that the problem is wage stagnation, to be solved with some combination of higher minimum wages and collective bargaining. As mentioned earlier, several analysts have noted the political nexus between wage stagnation and credit expansion: by expanding credit, business and government avoided taking any responsibility for declining economic security and mobility in a large part of the country (Rajan 2010; Krippner 2011). However, wage stagnation in the United States has not been much worse than wage stagnation in Europe, including in countries that did not embrace American-style financialization; Figure 4 shows growth in the average annual wage (for both full-time workers and part-time workers at a full-time-equivalent rate) for twenty OECD countries. But despite similar levels of wage stagnation in several countries, Europeans have not turned to borrowing to the same extent, suggesting that it is stagnant wages *in combination with an underdeveloped welfare state* that has led to the need for ever greater levels of borrowing in America. In Europe, stagnant wages have led to cutbacks in quality of life, but in the United States, stagnant wages have led to inability to pay for necessities such as health care. Certainly, raising minimum wages and strengthening collective bargaining provisions would help low-wage Americans, but if the question is why Americans are forced to borrow, comparison of the U.S. and Europe points to the absence of a well-developed welfare state as the main difference.

Figure 4. Growth in Average Annual Wage, 1991–2001



† *OECD.Stat, Average annual wage*

Third, there has been much talk these days of what some people are calling "middle out" economics. As a reply to "trickle down" theory, which is a nickname for the argument that tax cuts for business will benefit workers, progressives recently have developed the argument that "national prosperity does not trickle down from wealthy businesspeople or corporations; rather, it flows in a virtuous cycle that starts with a thriving middle class….Rich businesspeople are not the primary job creators; middle-class customers are. The more the middle class can buy, the more jobs we'll create" (Liu and Hanauer 2013). Even President Obama has adopted the middle-out rhetoric: "when middle class families have less to spend, businesses have fewer consumers…an economy that grows from the middle out, not the top down, that's where I will focus my energies not just for the next few months but for the remainder of my presidency" (speech at Knox College, July 24, 2013).

As we have seen in this paper, this "middle-out" idea is not a departure from post-war American patterns. Indeed, these current phrases are strong echoes of the arguments quoted above and exemplified by New Jersey CIO leader Carl Holderman's statement in 1947: "Unless a worker's earnings can support his family, we [will] find our whole capitalistic set-up deprived of the market for the great production of which it is capable" (quoted in Cohen 2003, 154).

The "middle-out" idea is essentially advocating a return to the era of the "purchasing power paradigm." And if it is not instantiated carefully, it will have the same results as the purchasing power paradigm. For example, President Obama recently said: "I'm also acting on my own to cut red tape for responsible families who want to get a mortgage but the bank is saying no" (Knox College, July 25, 2013). Certainly, we should continue to eradicate discrimination in lending, but if our attention remains on mortgages, and home mortgag-

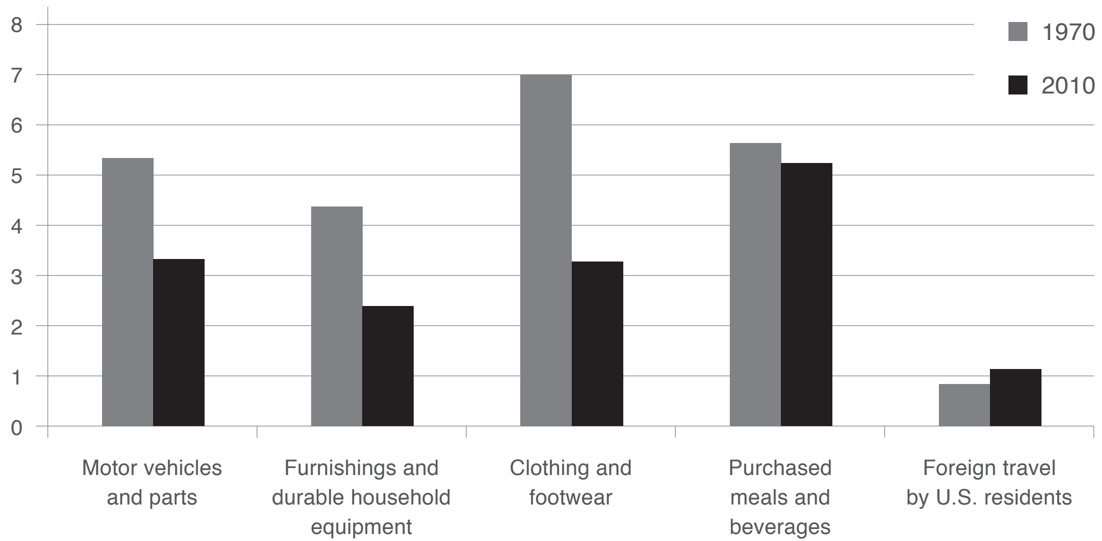
es remain the central economic strategy for the middle class, political coalitions will once again arise to make credit more and more easily available. Another worry is that middle-out may just mean cutting taxes for the middle class, as when the President says "we locked in tax cuts for 98 percent of Americans" (Obama, Knox College, July 25, 2013). Relentlessly focusing on tax cuts precisely contradicts the central lesson of the recent financial crash: to maintain living standards without unsustainable borrowing, we need more public support for households, requiring higher public revenues.

Supporters of "middle out" also ignore the problem that businesses are not as dependent on domestic demand as they were in the post-war era, given the ability to market worldwide. They are less likely to sign on to such a paradigm today. Relatedly, some of the consumption of "middle out" will come from abroad, weakening the effects on the domestic economy. Even where it does affect domestic businesses, greater consumption might simply end up increasing profits rather than feeding back into more or higher-paying jobs. Most importantly, greater consumption does not necessarily increase productivity, which is the surest recipe for long-term growth.

The greatest danger of "middle out," however, is that it will create categorical distinctions between "middle class" workers who are deserving of benefits, and others who are relegated to more peripheral and unpopular welfare programs. This situation allows those who would cut back all government programs to find a powerful political foothold in demonizing the recipients of peripheral programs. Anti-statist rhetoric is extremely potent when residual programs that do not benefit the middle classes can be held up as (exaggerated, but symbolically powerful) exemplars of government waste and used to discredit all government action.

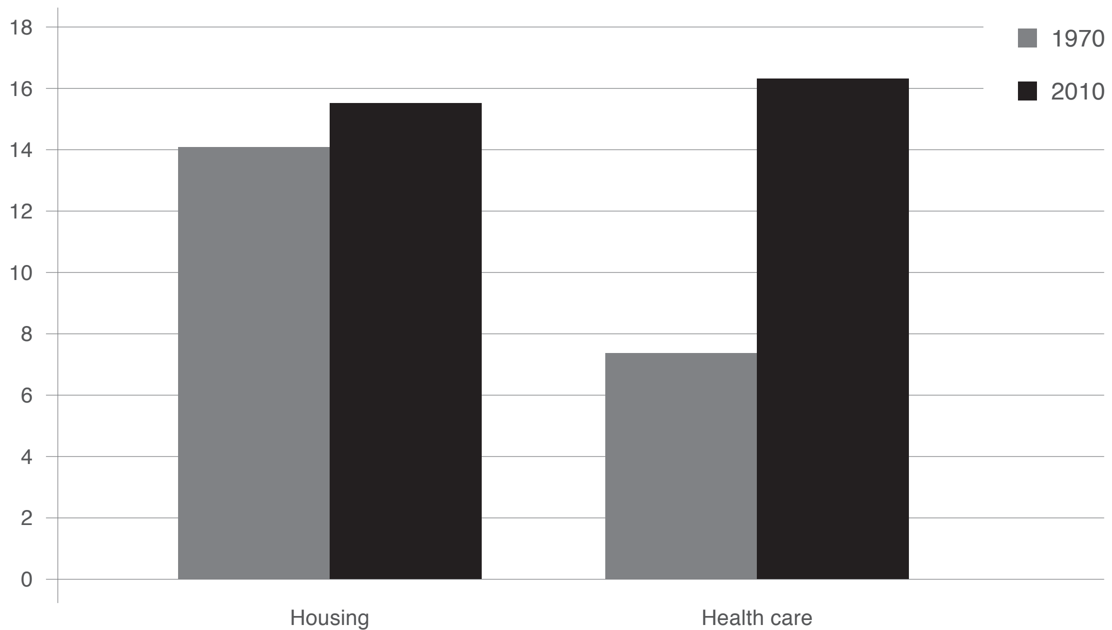
If these three strategies are problematic, we can develop a better strategy by understanding what the main problem is. To get at the heart of the issue, we need to consider why borrowing and indebtedness are so popular in the United States, and why savings are so anemic. There is a stereotype of the American consumer that says if consumers are over-indebted, it's because they're throwing away money on flat screen TVs. But this is not true at all. In fact, consumption expenditure has gone *down* in most luxury categories (as a percentage of total consumption) since the 1970s (figure 5), including furnishing, clothing and footwear, motor vehicles, and purchased meals and beverages; the one exception is foreign travel, which has seen a tiny rise from .8 to 1.1 percent. Instead, the two largest categories of consumer expenditure are housing and health care (figure 6), with health care spending having seen a big increase since 1970.

Figure 5. Luxury Consumption (as % of total consumption)



† *Bureau of Economic Analysis, 2012, National Income and Product Accounts, Table 2.4.5 ("Personal Consumption Expenditures by Type of Product").*

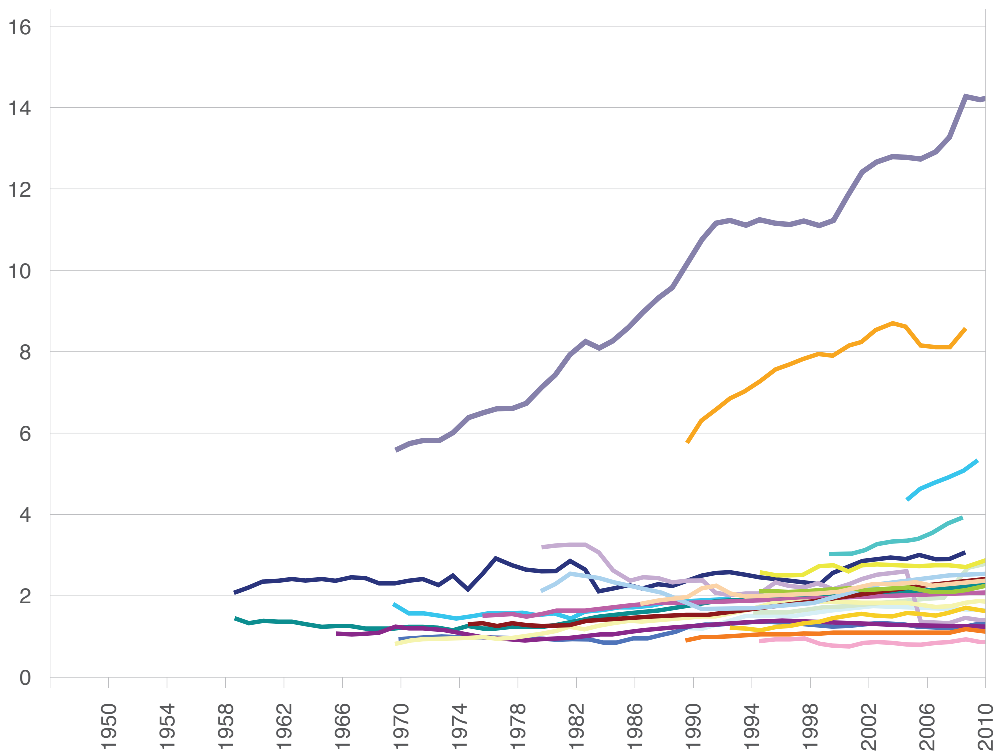
Figure 6. Housing and Health Care (as % of total consumption)



† *Bureau of Economic Analysis, 2012, National Income and Product Accounts, Table 2.4.5 ("Personal Consumption Expenditures by Type of Product").*

If we look comparatively, it is clearly health care that is the outlier (figure 7). Consumers in other countries spend 2-4 percent of their income on health care, whereas in the U.S. in recent years they have spent 14 percent of their income on health care. The reason for lower savings rates and higher debt since the 1970s is no mystery. Since home mortgages and other loans secured by residential property make up over half of consumer credit, we can conclude with only slight exaggeration that since the 1970s Americans have been taking out loans on their homes to finance private health care.

Figure 7. Household Expenditure on Health as Percentage of GDP



† *OECD Dataset on Final Consumption Expenditures*

The reasons for this spending on health care are also clear: first, because there has been less comparative spending on public health care, consumers are forced to pay privately for health care; and second, because costs cannot be controlled by a private health care industry as well as by a program of public health care, the absolute amounts that consumers pay to the health care industry are much higher than in other countries.

It should be obvious from this that if the goal is reduction of American reliance on credit, expanding the public welfare state is a key component of that goal. Indeed, although many analysts worry about the costs of the recent health care reform, these graphs suggest that such measures will benefit the economy by smoothing out the financial volatility caused by private borrowing to finance health care needs. Although health care has been the major driver of the patterns seen above, education costs are also a significant factor, particularly the explosion in recent years of college debt, and child care costs have also recently strained family budgets. High-quality public education, from preschool through college, would not only help improve the human capital of low-income students, but would also directly improve households' savings.

A second set of policies to shift resources away from unsustainable consumption is to focus on directly promoting savings over borrowing. Currently, savings accounts with low balances are penalized with minimal balance policies and a host of fees and charges for falling below the minimum. Banks justify these fees with the argument that they cannot otherwise afford to service those with small savings. Every other developed country has resolved this conundrum by using the state to subsidize small savings. Instead of subsidizing borrowing, as the American state does now, we should be subsidizing savings. The most straightforward way would be to imitate the "postal savings accounts" common in Europe and Japan, which are savings accounts limited to those with very small savings (Garon 2012). The United States Postal Savings System was discontinued in the 1960s, on the argument that banks had begun to provide the services and guarantees that postal savings had once provided. However, without the competition from the postal service for small accounts, in the intervening decades banks have increased their fees on small accounts, which suggests that a return to postal savings could be useful. An alternative would be to regulate the fees that banks can charge small savers.

A similar strategy would be to reduce or eliminate penalties on IRA account withdrawals for those with limited income or assets. Those of limited means need liquid assets, and the ironclad nature of IRA contributions prevents them from choosing this important savings vehicle.

Exempting savings from taxation is an idea that has already received some policy attention. Recently, Robert Frank of Cornell University has suggested a "progressive consumption tax," essentially an income tax that exempts savings from taxation. Frank's intention is to incentivize savings, but also to limit what he calls "expenditure cascades," in which all consumers have to ratchet up consumption; the strongest example of such a cascade is in housing, where consumers have to pay higher and higher housing costs in order to

remain in districts with good public schools. A consumption tax of this sort also has the revenue-raising potential of the value added taxes seen in Europe, because it may be able to avoid the economic distortions of income taxes (Lindert 2004); but by exempting savings rather than directly taxing consumption, such a tax sidesteps the issue of insufficient transparency in the European value added taxes.

When considering incentivizing savings, a particularly promising area to target is the pension savings of those with limited incomes: the bottom quintile of earners saves about 9 percent of their income in pensions, and matching these contributions with credits can be an easy way to boost the savings rate of those of moderate means. An important principle is that policies on the tax side will only help those of moderate means *if they come in the form of refundable tax credits*. If they come in the form of deductions and exemptions they may not help at all, because many in these categories will not have incomes high enough to be paying a great deal of income tax to begin with.

To find the money to subsidize savings, the flip side is that we need to reduce or take away subsidies for debt; in particular, we need to reduce incentives and benefits for upper-income households that take on debt. The easiest way to begin is by means-testing the mortgage interest tax deduction, and requiring higher down payments for expensive homes and second homes. Karen Dynan (2013) has proposed capping at 28 percent the rate at which retirement savings deductions can reduce tax obligations, as well as adopting measures such as automatic enrollment into retirement savings plans that would increase the proportion of the workforce that benefits.

Some may object that if we focus all of our efforts on increasing savings for the poor and middle classes, inflation will wipe away those savings. However, it seems clear that, as a country, we have committed to fighting inflation over the long term, even if it means pulling the economy into crisis (as occurred in the 1970s). Focusing on savings for the poor and middle classes allows them to benefit from these attempts to hold inflation at bay.

Universal welfare programs (including high quality public education) and a focus on savings are components of a *producerist* strategy, especially when combined with spending on infrastructure and research and development. For these are exactly the investments needed to create sustainable economic growth: infrastructural investments such as smart grids, investments in scientific education, building up households' assets, and welfare expenditures that create a healthy and productive workforce. These policies go beyond the growth strategy of low taxes and deregulation that has driven American political economy for the past three decades; but they also offer a more effective and sustainable alternative to the "demand side" strategies that prevailed in the post-war period. This combination of welfare, wealth-building, and productivity policies is a better foundation for equitable and sustainable growth in the twenty-first century.

CONCLUSION

I have argued in this paper that the unique situation of the United States in the nineteenth century, when abundant agricultural productivity under a gold standard put us on a path to deflation, gave rise, during the Great Depression, to an economic model that focused on countering deflation by increasing consumer purchasing power. The central means to boosting purchasing power was an infrastructure of mortgage debt, a kind of "mortgage Keynesianism." This approach has remained at the core of the American model of political economy, but it has dangerous political consequences: a credit-driven consumer society will lead *either* to higher poverty and inequality, *or* to greater financial volatility. In the 1970s through the 1990s, credit access was expanded to include ever more segments of American society. The consequent financial crisis has led to a politics in which credit may become more highly regulated, but if so, this will come at the cost of greater poverty.

Some readers may be willing to grant that a consumer-oriented economy can worsen poverty and inequality and worsen financial volatility, but may find themselves wondering: if America does not consume, who will? Those exports that underwrote the German economic miracle would have had nowhere to go if *all* countries chose to restrain consumption and increase production as Germany did. We live in a global economic order in which American consumption powers not just the American economy, but the world economy.

It seems evident that in a world in which one billion people live in extreme poverty, consumer demand will have to come from the developing countries. China, in particular, is often cited by many analysts as having overdeveloped savings and underdeveloped consumption. This means that the breakneck pace of Chinese economic growth is largely benefiting firms at the expense of consumers. Particularly at low levels of GDP, consumption is an easy way to increase productivity, because it develops health and human capital. But it is clear that China will only embark on a sustained program of developing domestic consumption if it becomes convinced that the United States is no longer willing to be the world's consumer. Until then, demand in the United States will continue to back Chinese economic growth, but that growth will benefit Chinese industry more than Chinese consumers.

Thus, in the short run, developing countries have the potential to be the locomotive of the world economy. In the long run, however, a more stable scenario would be for all countries to develop more of a balance between exports and imports, with neither perennial trade surpluses nor perennial trade deficits.

For the United States, one might also reasonably ask if the recommended strategies are politically possible. There will be great opposition to programs such as scaling back the mortgage interest tax deduction, of course, but a push to increase savings has the major advantage that it can be backed by both right and left. Historically, it is Republicans who have pushed for programs to increase savings. But Democrats may also be converging on the argument that *savings are a civil rights issue*. The decades-long push towards greater credit access for African Americans and women was successful partly because activists were able

to show how discrimination in credit disadvantaged these groups directly. There is a similar case to be made for savings. For example, although only 8.2 percent of all households lack any kind of deposit account, this number rises to 21.4 percent of blacks, 19.1 percent of households headed by single women, and 20.1 percent of Hispanics (FDIC 2012, 5). The credit rights revolution of the 1970s accomplished only half of the goal by allowing disadvantaged groups to borrow; the other half of the goal is to help them get out of debt and build up savings. There is a narrow but viable path for agreement across the political aisle on strategies to increase savings and decrease consumer debt.

Finally, it is worth stressing that the strategies outlined here are intended as long-term measures for the reorientation of the American economy. In the short term, stimulating consumer demand makes eminent sense in the face of a weak economic recovery. But that short-term measure should not be mistaken for a sound basis for future long-term growth. Moving the United States into a new era of growth requires leaving behind the consumer model, and focusing on the development of public infrastructure and human capital and building household assets. The consumer-oriented economy that arose from the Great Depression was a remarkable motor of capitalist growth. But it has also produced poverty, inequality, and financial volatility. Moving the United States into its next era of growth requires moving beyond consumption.

1. The first part of this paper is adapted from my book The Land of Too Much: American Abundance and the Paradox of Poverty (Prasad 2012). For comments on this paper I am grateful to Bruce Carruthers, Lew Daly, Peter Hall and Ganesh Sitaraman.
2. See e.g. Brady 2009; Buhmann, Rainwater, Schmaus, and Smeeding 1988; Rainwater and Smeeding 2004; Kenworthy 2004; OECD 2008; Smeeding 2005; Smeeding 2006.
3. In the two main political episodes when consumption taxes might have been adopted in America, they were rejected by agrarian politicians for their regressivity (Prasad 2012: 99-124).
4. On the role of regulations against interstate branch banking in worsening the crisis of finance during the Great Depression, see Prasad 2012: 212-221.
5. For example, the American share of worldwide merchandise exports is roughly equal to the German share, even though the U.S. has an economy four times larger than Germany's.
6. E.g. Trumbull (2010) compares surveys in France showing willingness to buy on credit with American reluctance to buy on credit. For an amusing overview of American cultural efforts to promote savings bonds throughout the twentieth century, see http://www.youtube.com/watch?v=9Ysj0L8ODOQ.
7. World Bank data, "Domestic Credit Provided by the Banking Sector (% of GDP)," http://data.worldbank.org/indicator/FS.AST.DOMS.GD.ZS
8. Arline Lotman, Executive Director of the Pennsylvania Commission on the Status of Women, "For Release Sunday, March 25, 1973," Patsy Mink Papers, Box 56, Folder 7, Banking and Currency Credit Unions Sex Discrimination 1972–1976 (1 of 2), Manuscript Division, Library of Congress.

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