

THE THIRD WAY MIDDLE CLASS PROJECT



**THE NEW RULES ECONOMY:
A Policy Framework for the 21st Century**

A Third Way Report

by

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Overview

This world is going too fast. Improvements, politics, reform, religion—all fly. Railroads, steamers, packets, race against time and beat it hollow.... Oh, for the good old days of heavy post coaches and speed at the rate of six miles an hour!¹

Philip Hone, former mayor of New York, 1844

In 1993, the Internet contained 130 websites. Today it holds 100 million. At every level of American society—geopolitically, technologically, economically and socially—there has been vast and dramatic change. Just as Philip Hone and his contemporaries debated the deep and rapid structural change that accompanied the Industrial Revolution, conservatives, liberals and moderates today are grappling with the shifts brought on by the Information Age and how, or whether, government should respond.

Conservatives would leave it up to individuals to decipher and navigate the new rules on their own. As for government's role, their answer is a modern echo of 19th-century laissez-faire economic policies: "Government is not the solution... government is the problem,"² in the words of President Ronald Reagan.

Over the past six years, conservatives have had their shot at coping with the economy's new rules. In keeping with Reagan's philosophy, they have tried to shrink government's reach in the economy with massive tax cuts for mostly the wealthy, wholesale deregulation, and attempts to eliminate or privatize safety net programs for the elderly and those at lower incomes. By any objective standard, the results have been a disappointment. On the plus side, economic growth during this time of change has been generally steady. But it has also been alarmingly uneven: average wages have been flat, income disparity has widened, and there is widespread anxiety about the nation's economic future. Other measures of economic security, such as health care and pension coverage, have declined.

On the other side of the political spectrum are a growing number of progressives whose philosophy can best be described as "neopopulism." Neopopulists see change as mainly a threat that requires American economic policy to turn inward. They believe that the tide of change will bring an unfettered race to the bottom, in which the rich get inexorably richer while the rest of America works harder to earn less. Capitalism, they argue, must be vigorously restrained, and workers shielded from the risks of competition and from corporations in search of a better, cheaper, faster way to produce goods and services. Reviving old suspicions about capitalism and markets,

neopopulists want government to rewrite the rules to recapture a bygone era. It's an idea that itself is deeply conservative—to turn back the clock “to reinvent the managed capitalism that thrived between the late 1940s and early 1970s,” as leading neopopulist Robert Kuttner recently wrote.³

Both sides see change through an ideological prism that pits markets implacably against government. As a consequence, both conservatives and neopopulists overstate the power of their chosen “side” to rewrite the rules of the economy. And while economic conservatism is premised on the myths of an infallible market and incompetent government, neo-populism is premised on the myths of a failing middle class, a declining America, and omnipotent corporations.

We urge a different approach, which we call “progressive realism.”

Realism means recognizing and understanding the economy's new rules while accepting the limits of government's power to stop the forces of change. But as progressives, we also believe that government policies—if modernized and adapted to the rules of the 21st century—can create the optimal conditions for increasing economic growth, expanding middle-class prosperity and protecting those who fall behind.

As progressive realists, we do not doubt that change is disruptive and, for many people, painful. Globalization has made many jobs obsolete, and both companies and individuals have been hurt by its impact. As the neopopulists note, all is not well with the middle class. But we also see the current era of change as one of tremendous opportunity and potential for the middle class.

In addition, we view the challenges faced by today's middle class as very different from the ones that most progressives believe them to be. We perceive the middle-class as struggling to *get ahead*, not—as the neopopulists argue—struggling to *get by*. Middle-class anxiety does not stem from broad dissatisfaction with capitalism but from the shifting terrain beneath their feet and the increasing irrelevance of an outdated government.

In an earlier Third Way paper, *The Politics of Opportunity*, we argued that 21st century economic policy—to be both politically resonant and substantively meaningful—should reflect the hope and optimism of the American people. Thus, unlike both conservatism and neopopulism, our approach is also profoundly optimistic. In contrast to conservatism, we have a positive belief in government's ability to foster new middle-class opportunity. And in contrast to neopopulists, we have faith in the basic strength of the American economy to grow and in the ability of middle-class Americans to succeed.

In the following sections of this paper, we take a hard, objective look at the data to expose the myths harbored by neopopulists and conservatives. We then define nine ways in which the rules for success in the economy have changed—for individuals, for

families and for business. We do this to isolate the gaps in current public policy and to set out guideposts for modernizing and updating government. By laying out the core truths of today's economy—the “New Rules”—we take the first steps toward defining a *progressive realist* framework for re-imagining public policy in the 21st century.

In the past, successful forward-thinking government policies have harnessed economic progress in ways that increased America's prosperity while creating a fairer society. From the passage of the Homestead Act to the creation of land grant universities, Social Security, the GI bill, rural electrification and the interstate highway system, government programs have helped the nation capitalize on change, navigate new rules and spread prosperity. As President Clinton said in his second inaugural address: “At the dawn of the 21st century a free people must now choose to shape the forces of the Information Age and the global society, to unleash the limitless potential of all our people, and, yes, to form a more perfect union.”⁴ His aim of building a “bridge to the 21st century” was not just rhetoric but a governing philosophy to prepare America for a radically changing world. We agree, and we think the progressive realist approach can best replicate those successes today.

The Myths of Neopopulism

The neopopulists enter the modern debate in possession of certain truths. They are correct that all is not well with the middle class, and they have appropriately shed a light on middle class anxiety. They are rightly concerned about relatively flat wages for men—and in particular, low-skilled men. They are right that left to its own devices, unfettered capitalism creates too many losers to go along with its winners. They are right that the widening gap between the rich and the middle class is troubling. And there is good reason to be outraged by certain corporate behavior—whether it's cooking the books at Enron, giving movie-star salaries to poorly performing CEOs, or persuading lawmakers to write into law rifle-shot tax breaks that have no business in the tax code.

However, neopopulism is undergirded by three tenets that are, in actuality, myths: the myth of the failing middle class, the myth of a declining America, and the myth of corporate omnipotence.

These myths allow neopopulists to tell a compelling story about the economy and the economic state of the middle class, but one that—due to its oversimplicity—is inaccurate. Furthermore, these myths lead to an economic philosophy that is resistant, not resilient, in the face of change and that is overwhelmingly pessimistic.

The Myth of the Failing Middle Class

To counter this first myth, we take an objective look at the four areas most cited by neopopulists to account for middle class failure: personal income, household debt, income volatility, and public sentiment.

Income

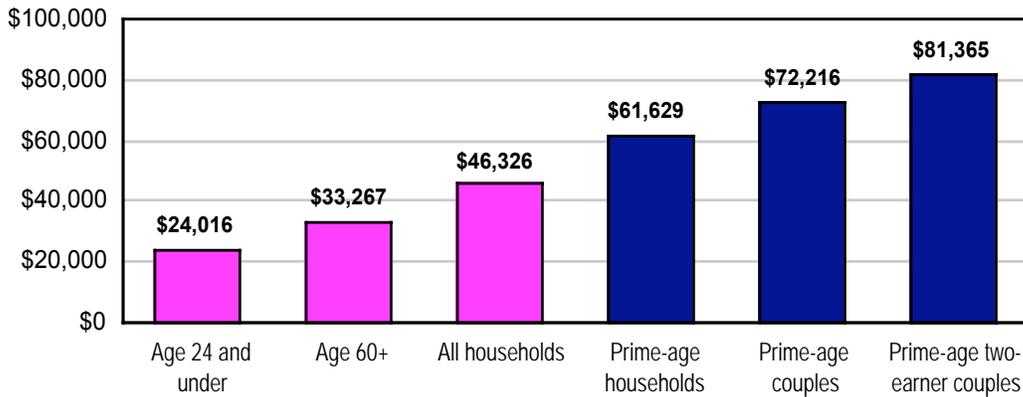
America's middle class is far wealthier than neopopulists believe or say.

In 2005, the Census Bureau reported that the national median household income was \$46,326.⁵ This income figure (or figures similar to it) forms the starting point of the neopopulist narrative. It is a level of income that means life is led, at best, paycheck to paycheck. But this number obscures rather than illuminates.

One-third of American households are headed by someone who is either very young and earning an entry-level paycheck or by someone who is of retirement age and likely to be earning no paycheck. These households are barely part of the workforce and have a unique set of goals, pressures, and desired outcomes that differ from those of working-age people.

From the perspective of designing economic policy to increase wages and create growth, the “real” middle class is made up of households in their prime working years, ages 25-59, 75 percent of whom are couples and 56 percent of whom are couples with two earners. The median income of these prime age households is more than \$61,000. If it is a married-couple household, the median is more than \$72,000. And if both spouses work, the median is more than \$81,000. This is not an exuberant standard of living, but it is a comfortable one. And it is the difference between struggling to get by (as the neopopulists posit) and struggling to get ahead.

Median Household Income (2005)

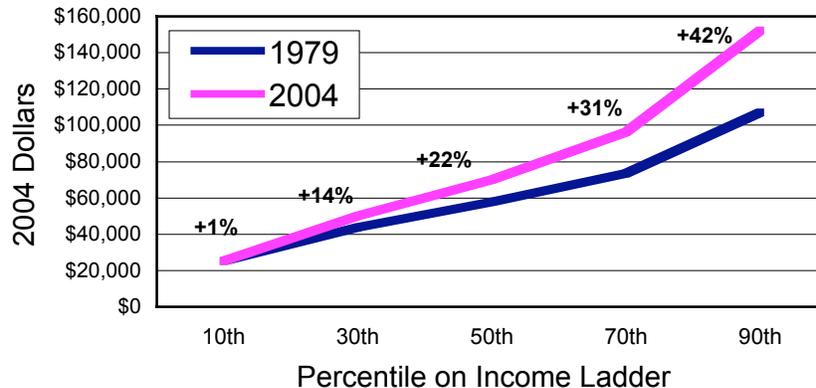


Source: Census Bureau, Current Population Survey, March Supplement⁶

Moreover, the middle class has not stagnated, as neopopulists say. It has grown wealthier over time.

As the next chart shows, family incomes at all levels except the very poor have risen slowly but steadily. Incomes at the bottom tenth percentile have remained flat; those in the middle went up 22 percent; and those at the 90th percentile went up 42 percent in real dollars from 1974.

Income Gains for Married Couple Households

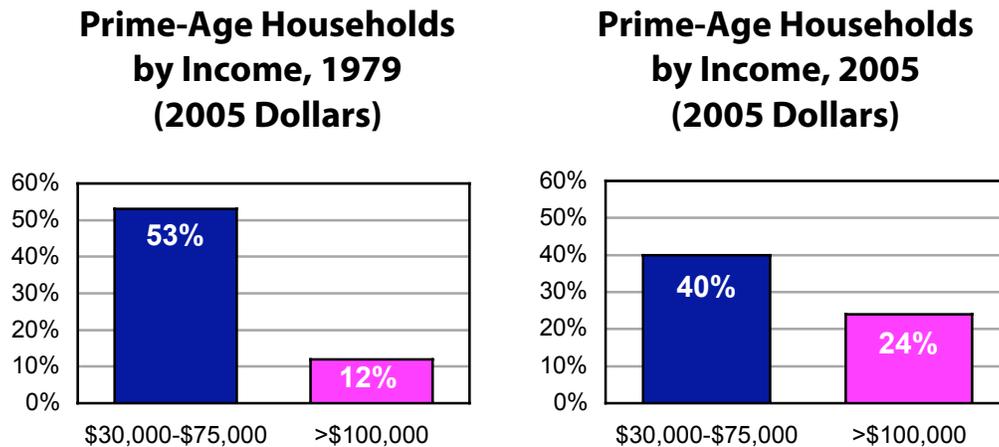


Source: Census Bureau, Current Population Survey, March Supplements

It is true that much (but not all)* of household income gain can be attributed to wives working more, but neopopulists see the increased female workload in an entirely negative context and as a burden on women and families. We suspect many working women want to work.

The bottom line is that the middle class is shrinking but not because the bottom is dropping out; it is because more people are better off.

From 1979 to 2005, the percentage of prime-age households earning over \$100,000 in current dollars grew 12.7 percentage points, while those earning between \$30,000 and \$75,000 shrank 13.3 percentage points.



Source: Census Bureau, Current Population Survey, March Supplement⁷

Debt

Americans, contrary to myth, are not “drowning in debt.”

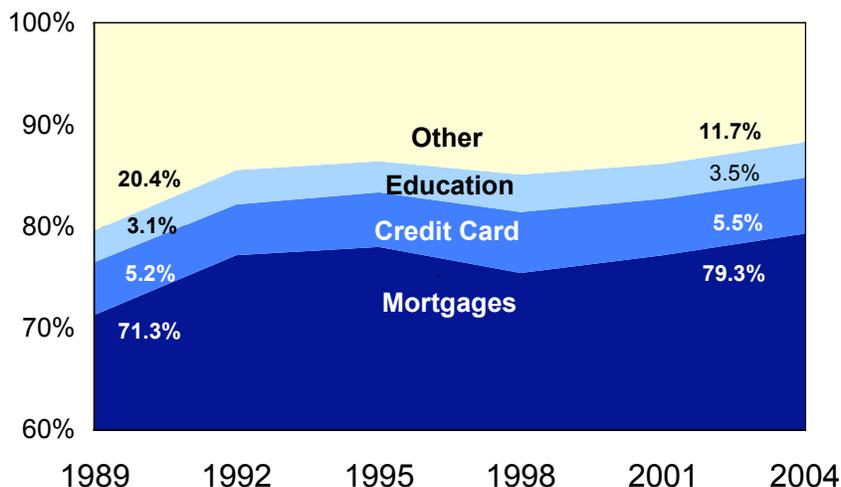
Like all myths, this one contains a piece of the truth. According to the Federal Reserve’s triennial Survey of Consumer Finances, median debts for American households have risen significantly—by about \$29,000 since 1989.⁸ However, much of this new debt is mortgage debt, and most families would consider buying a house an investment, not a negative event.

And while many homeowners have been refinancing their mortgages in recent years to take advantage of lower interest rates, the vast majority of homeowners are not tapping the equity in their homes. In the last major refinancing wave for which data are available, 2001-2002, the Federal Reserve estimates that between 16 percent and 23 percent of homeowners with mortgages refinanced their loans.⁹ And of those

* If the working hours of wives are held constant at 1979 levels, median incomes at the 50th percentile for prime-age couple households would still have risen by 9 percent in real dollars from 1979 to 2004. For households at the 70th percentile, the increase would be 22 percent.

who refinanced, less than half (44 percent) cashed out some equity. (This means approximately 10 percent of homeowners with mortgages cashed out equity.) Moreover, most of this cashed-out equity was spent on purposes intended to improve the borrower's financial situation. 26 percent of the total dollars cashed out in equity went to pay off other debt (i.e., trade expensive debt for cheaper debt), 35 percent went to home improvements (arguably an investment) and another 21 percent went to investments in stock, real estate or other financial investments.¹⁰ Only 16 percent went to consumer expenditures.

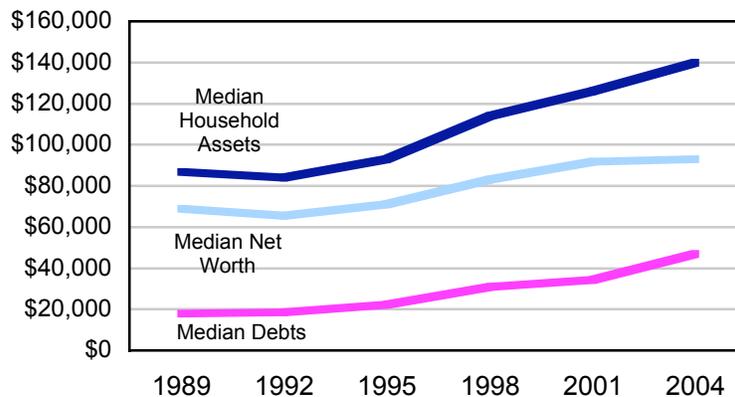
Type of Debt as Share of Total Debt



Source: Federal Reserve Survey of Consumer Finances

Moreover, as the next chart shows, assets have risen faster than debts. As a result, real net worth for middle income families has increased by 35 percent since 1989, and for pre-retirement households (age 55–64), real net worth has risen by a whopping 72 percent. In 2004, the median net wealth for households in this age group was a respectable \$248,000.¹¹

Median Assets, Wealth and Debt (2005 Real Dollars)



Source: Federal Reserve Survey of Consumer Finances

As for credit card debt, which many neopopulists view as among the biggest threats to middle-class financial security, the Federal Reserve's survey found that 54 percent of American households carried no credit card debt in 2004.¹² In other words, the median credit card debt burden in American households is *zero*. Of households that do have credit card debt, the median balance is a manageable \$2,100. Finally, the percentage of households reporting a debt more than 60 days past due rose a scant 1.6 percentage points from 1989 to 2004, while the percentage of families for whom debt is more than 40 percent of income rose just 2.3 percentage points over the same period.

Income Volatility

According to the most widely-cited study on this topic, income instability is reportedly five times as great in the mid-1990s as it was in the early 1970s.¹³

Other researchers using the same data have found a much smaller increase in volatility.¹⁴ But even setting those findings aside, a principal reason for greater income volatility is both simple and benign—motherhood.

In the 1970s, a minority of mothers were in the workforce and their pay was relatively low. By the 1990s, a majority of mothers were in the workforce and their pay was much higher. Because women today have a much more prominent role in the economy, their movements in and out of the workforce to take care of children are having bigger impacts on income volatility. When mothers re-enter the workforce, family incomes *increase*. This also counts as income volatility.

Mood

Neopopulism feeds off of broad economic dissatisfaction and pessimism, but public opinion polls consistently show Americans to be optimistic about their personal

finances. A 2006 Pew poll, for example, found that 68 percent of Americans say they already earn enough money to “live the kind of life you want” or expect to be able to do so in the future.¹⁵ Similarly, a pair of 2006 ABC News-Washington Post polls found that 63 percent of Americans describe their personal finances as “good” or “excellent,”¹⁶ and only 23 percent say they are “falling behind.”¹⁷ Some neopopulists explain away these results by saying that “Americans are reluctant to acknowledge economic problems that might suggest they have failed personally.”¹⁸

We think there’s a simpler explanation: Americans are optimistic about their economic futures because they have reason to be.

The Myth of a Declining America

“A generation ago, this country stocked the edges of the world. Now it’s hard to find a basic American industry in shape for the future.”

*Vice President Walter Mondale, 1984*¹⁹

From the past to the present, nearly all neopopulist predictions for America’s economic future have been bleak—and wrong. America is constantly falling behind. First Germany, then Japan, and now China are going to pass us. Some economic bubble is about to burst. Our trade deficit is about to drag us down. Americans don’t save enough. We don’t make anything. America is exporting millions of jobs.

Conversely, good economic times are fraught with underlying gloom and skepticism. At the start of the economic boom of the 1990s—the boom that created 18 million jobs²⁰—neopopulists predicted a “joyless recovery” that would be marked by weak job growth and low-quality jobs. And NAFTA, said Ross Perot (America’s leading neopopulist at the time) would cause a “giant sucking sound” of jobs moving across the border.

But after nearly 30 years of gloomy predictions, the economic disasters predicted by neopopulists have never come to pass. We look at the twin pillars of trade and national savings that buttress the myth of the declining America.

Trade’s Impact on Jobs

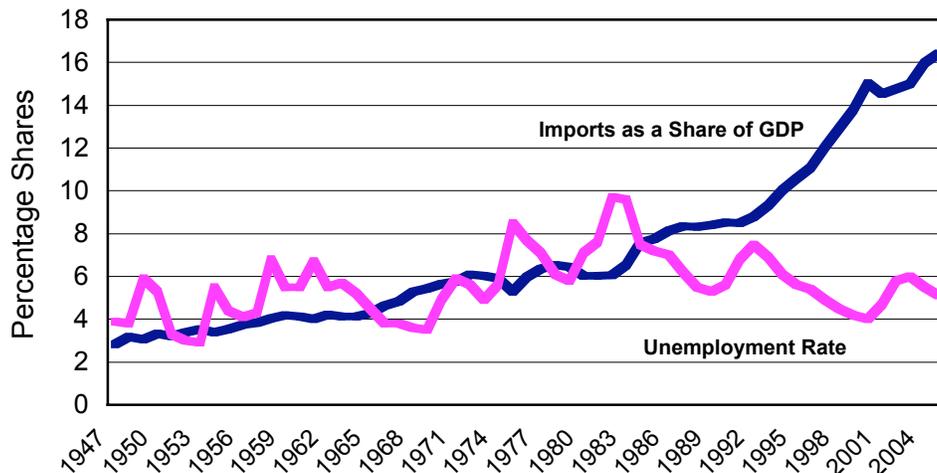
Trade and outsourcing do lead to some jobs migrating overseas. However, neopopulists both consistently underestimate our economy’s ability to adjust and overestimate the impact that trade has on the American labor market.[‡]

[‡] This paper does not attempt to lay out our full position on trade. This topic will be addressed in future Third Way publications.

As the chart below shows, rising imports have not led to fewer job opportunities. As imports as a percentage of GDP have grown over the last 20 years, unemployment rates have fallen.

One prominent neopopulist analysis blamed the loss of 1 million jobs since 1993 on NAFTA.²¹ But this figure, even if accurate, masks the dynamism of the American economy and the immense degree of “churn” in the job market. From 1993 to 2004, 401 million Americans quit or left their jobs—and another 423 million Americans were hired.²²

Growth in Imports Versus Yearly Unemployment Rate



Source: Bureau of Economic Analysis

While the sustainability of large trade deficits is a long-term concern, it has also long been a concern. Commentators have been worrying about the trade deficit since the 1970s. Some respected economists have recently argued that our trade deficit is sustainable even at much higher levels.²³ Even if the deficit is not sustainable, the adjustment process may well be gradual, not cataclysmic. Our country’s ability to adjust positively to economic shocks of all sorts consistently surprises government and academic economists.

Savings

The notion of a national savings crisis simply does not square with the fact that America boasts the largest investment community in the world and that Americans plow billions of dollars into mutual funds and other investments every year.

Our “official” personal savings rate is a blunt and poor measure of savings. It does not include as savings investments in a home (Americans held a total of \$12.9 trillion in home equity 2006),²⁴ college education²⁵ (which increases individual income streams), research and development²⁶ (which creates jobs), or “sweat equity” investments in business (the time that owners put into their business with the hope of

future returns). In addition, some items such as pension income are counted as *dissaving*—that is, counted as a negative against the personal savings rate—rather than as a return on investment. Counting sweat equity toward the savings rate would have boosted the national savings rate from between two and seven percent from 1990 to 2003.²⁷ Changing the treatment of pension incomes would increase the 2003 savings rate to a respectable 8 percent.²⁸

The Myth of Corporate Omnipotence

By this we mean the assumption that underlies many neopopulist proposals that corporations are not subject to the rules of the global economy but are in fact its masters. Thus, corporations are cutting costs to fatten their profits, not because they are in a fierce battle with aggressive competitors or fighting for investment dollars from savvy shareholders.

As with the other myths, neopopulists are in possession of a piece of the truth. There have been too many recent examples of outrageous corporate behavior. Some executive salaries are more than out of line. And there is no doubt that corporate America has had a field day with the American tax code. Nothing in this paper should be construed as condoning this behavior.

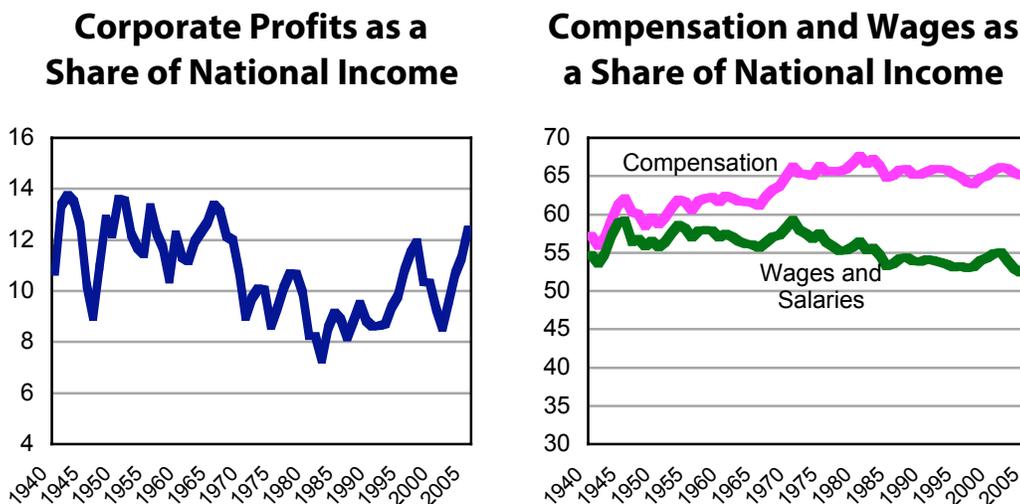
But the corporate story is a complicated one. They exist as business entities in a world that is moving at a much faster pace than in the past. Today's capital markets are global, and investors have an infinite array of choices in deciding where to put their money. As a result, corporations are under constant pressure to perform: to be better, faster, cheaper, newer, and more efficient than the competition.

Slow or inefficient companies are prey to hostile takeovers, which seem to happen almost daily. The 1970s and 1980s saw the rise of leveraged buy-out funds, which are in the business of acquiring and dismantling slow and vulnerable companies. In this ruthless environment, corporations are not so much the rulers of the forces of globalization but rather ruled by them. Just ask the executives of Tower Records who were on top of the world a few years ago and are in liquidation today.

Corporate Profits

The neopopulists argue that while corporations are cutting benefits and worker pay, corporate profits are at their highest levels ever.²⁹ First, they are wrong about corporate profits. Corporate profits as a share of both corporate net income and as a share of national income were higher in the 1940s and 1960s. But that, admittedly, is splitting hairs. What they don't highlight is that in 2001, corporate profits were at one of their *lowest* points in recent history.

As the following chart shows, the corporate profit story is one of cycles. Since World War II, corporate profits have gone through ten cycles of highs and lows. The latest peak in 2004 was about par for the course for the up cycle; the valley in 2001 was also par for the course.



Source: Bureau of Economic Analysis

Second, they are wrong about benefits. The decline in health care coverage has occurred in small firms, not large ones. In 2005, 98 percent of employees in firms with over 200 workers provided access to employer-provided health care.³⁰ Further (as we discuss in greater detail in Section III of this paper), employers are paying far more in health care costs than in the past, which is depressing wages even as total compensation costs have stayed steady.

Executive Pay

There is no doubt that corporate executive pay has gone haywire. According to corporate watchdog Jerry Goldberg, the top five executives from each of the Fortune 500 companies (“the fortunate 2500,” as Goldberg calls them) earned \$14.4 billion in total compensation in 2005. That amounts to \$5.8 million per executive, an increase of 5.7 percent over 2004.³¹

But while overly generous executive pay may be maddening, it is a drop in the bucket compared to the size of these companies and the impact it has on shareholder prices and employee compensation. The top 50 companies alone have a market capitalization approaching \$5 trillion.³² Limiting CEO pay, as some neopopulists propose, would have little to no impact on overall wages or compensation. If every penny of the \$14.4 billion earned by the “fortunate 2500” were distributed to all workers, it would amount to only \$100 apiece.

Conclusion

While there is a germ of truth in all of the phenomena we discuss here—income volatility, the trade deficit, savings, middle class incomes and debt—neopopulists overstate the data to paint an overly negative (and thus inaccurate) view of the middle class.

History has shown that neopopulists have far too little faith in the American economy and the robust institutions that support it. Our strengths—transparent markets, rule of law, intellectual property protection, top-notch universities, stable government, availability of capital, and an educated workforce—are unmatched and are the reasons that America’s economy is the most resilient, flexible, and powerful in the world.

Consider that in the last six years we’ve dealt with the bursting of the tech bubble, devastating terrorist attacks on our financial hub, an expensive war, a hurricane that was perhaps the greatest natural disaster ever on American soil, rising oil prices, a slowing housing market and (we would argue) inept political leadership—yet our economy is still chugging forward.

We have had low inflation, near-full employment, and available investment capital for the last 15 years. Recessions are shallower⁵ and shorter, and expansions are longer and deeper than in the past. Productivity remains strong.

In terms of living standards, America is still far and away the richest in the world, with gross domestic product per capita that is 64 times that of India’s and 26 times that of China’s. It will take decades for these competitors to catch up to America—if they ever do. And even if they pull closer to us in economic wealth, it will be of more help than harm to our economy and our workers. Our strengths are enduring.

⁵Neopopulist economists labeled the Clinton recovery “joyless” because the pace of job growth did not match prior recoveries. However, this results from the fact that modern recessions, on average, are shallower than they were in the period before World War II. Because the pace and extent of job losses are now less severe than in the past, the pace of recovery is similarly slower.

The Myths of Conservatism

Starting with the Reagan Administration, tax cutting became the cornerstone of conservative economics. The theory was that businesses and the wealthy were the engines of the economy, so public policy should get out of the way: large reductions in top individual tax rates, a retreat of government regulation and taxation of business, and the privatization of government services. These policies were based on the “trickle down” principle that when the wealthy do better, the rest of America will eventually benefit. They argued that tax cuts for the wealthy would prime the pump on the economy and lead to investments in new and existing businesses, real estate, and consumer goods that create jobs and opportunity for the country.

In addition, these same economic conservatives viewed the safety net as a trap for the poor. Welfare, unemployment insurance, food stamps, housing assistance, and Medicaid discourage work, reward laziness, and stifle ambition.

Like the neopopulists, conservatives are in possession of certain truths. Taxes can be too high to support growth and wealth creation. Certain subsidies and entitlement programs can create moral hazards that lead people to make poor choices. Regulations can be too onerous, and for the most part, when we have deregulated industries like telecommunications and transportation, innovation has exploded.

And like the myths of neopopulism, the central myths of conservatism are on their face appealingly simple: the power of the market will solve all problems, while government can only make things worse.

But also like the myths of neopopulism, these conservative myths lead to an oversimplified and ultimately pessimistic view of the nation’s economic future. By leaving no role for government, conservative mythology leads to both a Darwinist view toward the economy’s losers and a fatalistic attitude toward change. This section takes only a very brief look at these myths, since even among conservatives, there is a growing consensus that it is time for a new economic philosophy.

The Myth of Incompetent Government

Conservative policies, which profess to be rooted in a small-government philosophy, have accomplished exactly the opposite. Under President George W. Bush, government as a share of the economy has grown by nearly 2 percentage points since 2000, after it had fallen under President Clinton. In 2005, federal expenditures made up 21.1 percent of GDP.³³ And under President Reagan, government was even bigger, at 22.9 percent of GDP— a level higher than under Democratic Presidents Clinton, Carter, Johnson, and Kennedy.³⁴

While certain organizations within the conservative movement, like the Cato Institute and the National Taxpayers' Union, have steadfastly stood by the principle of smaller government, successive Republican Administrations and Congresses have not. Budget cutting oratory has far exceeded budget cutting results. Republican Congresses successfully eliminated some of the most sublimely ridiculous and outdated government programs (like the wool and mohair subsidy) but have spared or increased most of the rest while also creating new ones.

President George W. Bush and a Republican Congress created the Medicare Part D program, arguably the largest expansion of the safety net in forty years. No Child Left Behind not only increased spending for public school education, but created the most extensive federal involvement in local education curricula ever. These measures passed less than ten years after then-Speaker Newt Gingrich pledged to allow Medicare to “wither on the vine”³⁵ and to abolish the Department of Education.

Some forward-thinking conservatives have already outright rejected this myth and have frankly embraced big-government solutions. The health care proposals of Gov. Arnold Schwarzenegger of California and Gov. Mitt Romney of Massachusetts are two of the most prominent recent examples.

The conservative pillar of government-as-incompetent is a myth, because even conservatives no longer believe it themselves.

Reaganomics may, in fact, be dead.

The Myth of the Infallible Market

The aspects of the markets that conservatives most admire would not exist without the intervention of government. Trust, transparency, liquidity, entrepreneurship, infrastructure investment—these are some of the key ingredients that make the American economy as strong as it is. They all exist because of government intervention in what would otherwise be a very fallible market.

Trust, for example, is a significant benefit that accrues from standardizing transactions through regulation. It enables anonymous counterparties in disparate areas of the country or the world to sell millions or even billions of dollars in stock or assets to each other in the ordinary course of business. This extraordinary degree of

confidence in the reliability of transactions is not a market creation. Rather, it results from the rule of law and the imposition of government regulations. In countries where the rule of law is weak, trust in the marketplace is often limited to business partners who are family or known associates. In a system such as ours where trust is more universally ingrained, the commercial network (and its attendant opportunities) is potentially infinite. This trust would not exist, however, without a mature statutory and regulatory framework and a strong legal system that ensures the enforcement of contracts.

Likewise, the strength of America's legal and regulatory system is what enables entrepreneurs to take on the risks of starting a new business, for example by protecting intellectual property through patents.

The list of additional examples is endless.

During the first decades of our country, farsighted leaders realized that markets alone would inhibit our growth. Treasury Secretary Alexander Hamilton championed the first national bank to provide needed liquidity to growing businesses. In this century, the creation of government-sponsored entities, like Fannie Mae and Freddie Mac, created liquidity in the mortgage market and broadened the availability of mortgage credit. As a result, homeownership is now attainable by the majority of Americans and has created trillions of dollars in wealth.

In the 19th century, New York State raised the then-enormous sum of \$7 million to construct the Erie Canal to facilitate commerce from the Great Lakes to the Atlantic Ocean. The Erie Canal and other government infrastructure projects were the reason the North was economically superior to the South. In the 20th century, the interstate highway system and rural electrification expanded economic growth and spread prosperity to the general population.

The anti-trust laws of the last century broke up oil, steel, and transportation trusts that were stifling innovation. Most recently, the invention of the internet was as much due to government as private innovators. Public education and efforts such as the GI bill are largely responsible for creating the talented and innovative workforce we have today.

Government Mechanisms that Optimize Conditions for Economic Growth

Mechanism	Result
Securities laws	Trust and transparency in capital markets
Patent, copyright and trademark laws	Innovation and entrepreneurship
Federal Reserve Bank	Liquidity in capital markets; moderation of business cycle
Public education	Talented workforce
Interstate highways, railroads, and other infrastructure	Lower costs for production and access to markets
Freddie Mac/Fannie Mae	Widespread homeownership and middle-class wealth

Conclusion

The American economy fared better under the progressive realist presidency of Bill Clinton than under the conservative economic presidencies of Ronald Reagan, George H.W. Bush, and George W. Bush.

During the years of President Reagan and the first and second Bush Administrations, average household incomes for the top five percent of households grew at an annual rate that was more than three times the rate for families in the middle three quintiles. Under 17 years of conservative economic rule, average yearly real income growth for the middle three income quintiles was a sluggish 0.4 percent compared to 1.3 percent for those in the top five percent.*

During the eight Clinton years, the wealthy continued their upward march, growing by 2.2 percent per year, but the middle class also benefited greatly—a real growth rate of 1.6 percent per year and four times the rate of growth under conservative rule. From 1993 to 2001, the average household income for the middle three quintiles grew from \$43,692 to \$49,602—or nearly \$6,000.³⁶ The Clinton era was, in fact, the most prosperous period our nation has seen in modern times. It was brought about not by shrinking government’s role but by prudent policies—fiscal discipline, investments in human capital and openness to trade—that worked with the markets, not against them.

*If only the first twelve Reagan and Bush years are tabulated, the three median income quintiles grew by 0.7 percent and the 95th percentile grew by 1.7 percent.

Indeed, the remarkable growth of the U.S. economy in the 20th century coincided with a period of enormous government growth, broad new regulation of business and financial markets, and the development of the modern safety net among other governmental activities. That is not to say that when it comes to government, more is always better, but it does show that less isn't necessarily best.

The New Rules

In this section, we set out what we see as the new rules of today's economy—the all-encompassing ways in which the path to success in the 21st century economy has changed. In defining the rules, our principal purpose is to lay out the guideposts for modernizing public policy to match the realities of today's economy.

These rules fall into three broad categories.

The first set describes the changing prerequisites for individual success. The old rule was that hard work was sufficient to succeed. But today hard work is not enough. Workers must work “smart” as well. They must be educated, nimble and ready to seize opportunities when presented. In the past, successful workers took a lunch pail to the job. Today, it's more likely a laptop.

The second set outlines how the rules have changed for families to succeed. In this new world, women are leaders in the workforce and often need to—and want to—work. For these families, time was once in abundance; now it is a scarce resource. The old family was the Cleavers; the new family is too busy for television.

The third set of rules describes the new environment for business—now marked by merciless competition and new requirements for success—and the effect of this changed environment on the middle-class. In the past, businesses could afford to be fat and generous because competitors were limited or inferior. Today, corporations must be lean and innovative to survive. The old company was IBM, which once manufactured computers; the new company is—well—IBM, which now largely provides consulting services and is out of the PC business. The result is new demands on workers and a rethinking by companies of how they structure their traditional role as the provider of the middle-class safety net.

Accompanying each new rule is a suggested set of goals for modernizing public policy. While some of these can be realized in the short-term, many are intended as long-term ideas. Specific policy prescriptions will also be spelled out in detail in future Third Way publications.

Old Rules

1. Success required a high school diploma
2. “Good” jobs were in factories
3. Climbing the ladder meant rising up the ranks within a single company
4. The American dream meant owning a home
5. Wealth was managed on behalf of workers
6. Most mothers expected to stay home
7. A family raised its children
8. Successful companies built
9. Competition was limited

New Rules

1. Success requires a college degree
2. “Good” jobs are in offices
3. Climbing the ladder means chasing opportunities with multiple employers
4. The American Dream means owning a home and a stock portfolio
5. Workers need to manage their wealth
6. Most mothers expect to work
7. A family now raises children and cares for parents
8. Successful companies create
9. Competition is fierce

The New Rules for Individuals: Working Smart

In the past, a high school diploma was the ticket into the middle class and even into the wealthiest quintile. A “good” job was in a factory, and climbing the ladder meant loyalty to, and rising up the ranks within, a single employer.

Today, the price of admission into the middle and wealthy classes has gone up. It’s no longer enough to work hard and play by the rules. In today’s economy, Americans must work smart and play by new rules if they are to increase their earnings and wealth. Workers need to be educated, flexible and have the ability to chart a career that spans multiple employers or industries. They also need help with a new requirement: the ability to grow and manage some degree of wealth.

Public policies, however, are still designed for an era when high school was sufficient, manufacturing dominated the economy, the workforce was less mobile and only employers were investors.

Old Rule #1

Success required a high school diploma

New Rule #1

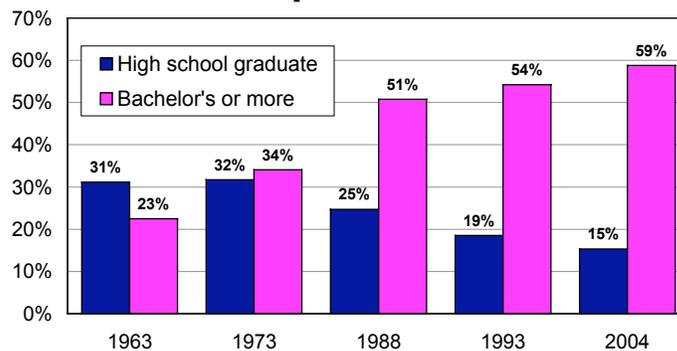
Success requires a college degree

As recently as 1960, high school graduates were a minority of American workers—49 percent. Today, more than 90 percent of American workers have at least a high school diploma.

While this achievement is a triumph of 20th century public policy, it is based on an old model for success. Under the old rules, workers could do quite well with only a high school degree. Under the new rules, they probably won’t.

In 1973, the top income quintile was populated with as many high school grads as college grads. By 2004, the ratio of college degrees to high school diplomas in the top quintile was four to one.

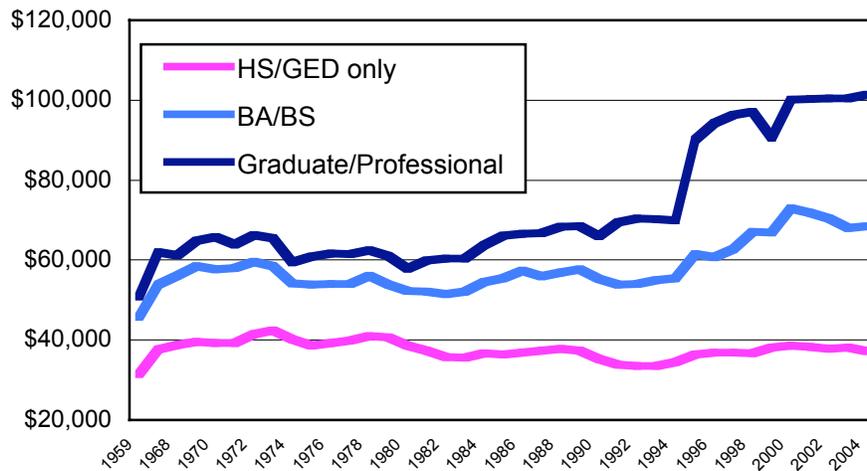
Educational Attainment of Households in the Top Income Quintile



Source: Census Bureau, Current Population Survey, March Supplements

For men with high school diplomas, median real earnings peaked in 1974. High school graduates earn 13 percent less today than they did 30 years ago while college graduates make nearly 20 percent more.³⁷ Over the course of the typical career, college graduates will earn about \$900,000 more than high school graduates.

Male Earnings by Educational Attainment, 1959–2004



Source: Census Bureau, Current Population Survey, March Supplements; 1960 Census

Despite the growing advantages conferred by a college degree, less than one-third of today's workers are college graduates. It's a percentage that has risen by only nine percentage points in the past 25 years.³⁸

For more Americans to succeed today, government must shift its focus to a new goal of increasing college participation and graduation rates.

Its first task is to deal with costs. College tuition has risen faster than inflation every year for the last 26 years.³⁹ In 1993, 50 percent of students graduated with debt, the median amount of which was \$12,100 (in 2004 dollars). In 2004, 64 percent of students graduated with student debt at a median amount of \$19,300—a 58 percent real increase.⁴⁰

Second, public policies must address college dropout rates. Nearly two-fifths of those who matriculate never graduate—a failure rate that resembles those of broken urban high schools. While finances are a factor for some students, research shows that college preparedness is equally if not more critical.⁴¹

Third, opportunities for higher education shouldn't end at age 22. In today's economy, a college degree is valuable regardless of the age at which it's earned. This is particularly true in today's economy, when the demands of globalization are requiring more workers to reinvent themselves to succeed by upgrading or adding new skills.

Finally, parents must want to and intend to send their children to college. Government must encourage and raise the expectations of parents for themselves, their children and their schools.

Policy Goals for the New Rules Economy:

- Address college affordability through tax deductions and credits aimed at middle class families.
- Determine causes of and propose solutions for lowering college drop-out rates.
- Continue to reform public K-12 education, and make college preparation the goal of every high school.
- Address the barriers to college, such as teen pregnancy, that lead teens to make short-term choices.
- Make college graduation a universal aspiration for all families, and encourage parents of school age children to make the home a learning environment.
- Eliminate the term “non-traditional students,” and encourage adults to go back to school to gain a degree and learn new skills by offering generous grant or loan programs for adults who want to—or are forced to—pursue a second career.

Old Rule #2

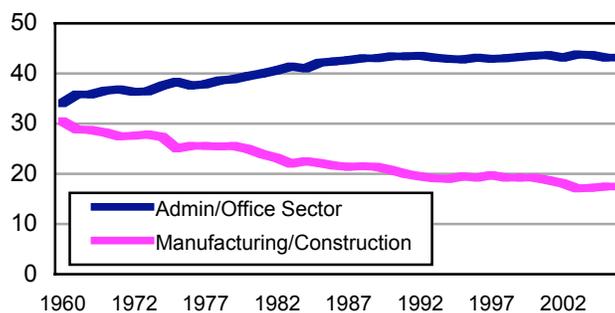
“Good” jobs were in factories

New Rule #2

“Good” jobs are in offices

Under the old rules, a place on the assembly line was at least as good as a desk. Under the new rules, a job in an office holds far more promise than a job at the plant. In 1960, manufacturing accounted for more than one-third of American jobs. Today, manufacturing employs less than 15 percent of Americans.⁴²

Rise of the Office Economy: Office and Manufacturing Jobs as a Share of Total Employment, 1960–2006



Source: Census Bureau, Current Population Survey, March Supplements; 1960 Census⁴³

In the same way that America once led the world in manufacturing, it now leads the world in services. In 2005, U.S. services exports totaled \$396 billion,⁴⁴ far above the \$183 billion in services exports from the second-ranked United Kingdom.⁴⁵ High-

skilled services workers (office, education and health care workers) outnumber factory workers by a ratio of seven to one, and these new jobs are increasingly well-paid. In 2005, the average office job paid \$51,814, compared to \$39,437 in manufacturing.⁴⁶ Most of the growth in services jobs has occurred in high-skilled “smart” jobs, such as finance and management, computers and information technology, not low-skilled services such as retail. Since 1979, the economy has created 23 million new office jobs, accounting for 53 percent of all new job growth, while low-skilled service jobs have grown by 10 million and construction and blue-collar manufacturing jobs have declined by 70,000 over the same period.⁴⁷

America will always have a manufacturing base, but it is unlikely ever to enjoy its former pre-eminence. Since the fall of the Berlin Wall, the world has added several billion new low-skilled workers. By some estimates, it could take as long as thirty years to absorb the additional labor. Moreover, because of productivity gains, American manufacturers are able to produce the same amount of goods with increasingly fewer numbers of people. In 1970, the American steel industry employed 570,000 workers to produce 91 million short tons of steel. In 2004, the industry employed 156,000 workers to produce 103 short tons of steel.⁴⁸

Nevertheless, while hands are fungible, brains are not, and that is America’s advantage. While past government policies have supported and nurtured the manufacturing sector, there is a dearth of equivalent policies geared to helping services sector workers cope with change and prosper. Government should help workers invest in themselves so they are better equipped to take advantage of service-sector job opportunities. And for those workers whose livelihoods have been casualties of the decline in manufacturing, we should provide a modernized and robust set of transitional services designed to better equip those workers for future employment.

Policy Goals for the New Rules Economy:

- Improve workforce development for service-sector workers, such as by broadening opportunities for continuing education.
- Provide more robust transitional assistance to people who lose jobs in manufacturing so they are able to renew their careers in other fields.
- Create pre-emptive training and education policies to help workers in manufacturing and low-skilled service jobs gain new skills in better-paid growth industries while they are still in their current jobs.⁴⁹

Old Rule #3

Climbing the ladder meant rising up the ranks within a single company

New Rule #3

Climbing the ladder means chasing opportunities with multiple employers

Under the old rules, seniority was synonymous with success, and workers sought lifetime security with a single employer. Under the new rules, individuals are just as likely to be free agents.

Since 1983, median job tenure for men has plummeted—down 44 percent for male workers between the ages of 55 and 64, 39 percent for workers ages 45 to 54, and 34 percent for those between the ages of 35 and 44.*

Median Job Tenure, Employed Men⁵⁰	1983	2006
Ages 55 to 64	16.9 years	9.5 years
Ages 45 to 54	13.2 years	8.1 years
Ages 35 to 44	7.7 years	5.1 years
Employed men over 55 with job tenure over 10 years	68.2%	49.5%

While some of this is due to layoffs and downsizing, it's also workers who are expecting to move. Nearly half of all workers say they expect to change careers in the future. 61 percent of Americans say they've switched from one type of work to another, and 39 percent of workers say they've switched at least twice.⁵¹ Moreover, a small but significant number of high-skilled workers are opting for alternative work arrangements as independent contractors, consultants or as employees with temporary placement firms.⁵²

But while most workers are moving onward and often upward, government policies are still geared toward a model of static and permanent employment. Affordable health insurance is lacking for workers in transition; COBRA is expensive and limited. Pensions and retirement accounts are far less portable than they should be, and nearly half of all workers cash out their 401(k)s when moving from one job to another. Even the unemployment insurance system is largely aimed at full-time, permanent workers. Most part-time workers are ineligible for benefits, and many

* Job tenure for women is up across the board as more women enter the workforce and have longer job histories within the workforce.

states disallow benefits for workers enrolled in school or training programs.⁵³ Self-employed contractors and consultants do not have easy access to affordable health insurance because they are outside the employer-based system.

Government should eliminate all barriers to employment mobility—an outcome that makes sense for individuals who should not be penalized for seeking to further their careers.

Policy Goals for the New Rules Economy:

- Provide full health care portability for workers in transition and independent contractors and better access to low-cost transitional health insurance instead of COBRA.
- Eliminate pension vesting requirements for defined contribution plans (currently 3 years).
- Create mandatory, automatic and portable 401K accounts that are owned by the worker and to which employers contribute.
- Reform unemployment insurance to allow for reeducation, retraining, and labor mobility.

Old Rule #4

**The American dream
meant owning a home**

New Rule #4

**The American Dream
means owning a home
and a stock portfolio**

In 1940, when homeowners were a minority, owning a home was the American Dream. Under the new rules, homeowners are in the majority, and the new American Dream is to own stock as well.

While homeownership will remain an important source of wealth, security and comfort, the full benefits of the economy are available only to those who are able to get a piece of the rock.

Between 1960 and 2005, real median home values grew by 2 percent per year, versus the real value of shares in an S&P 500 index fund, which grew by 7 percent per year. Thus, a home bought in 1960 for the median price of \$11,700 (\$65,600 in 2005 dollars) would be worth \$166,000 today. The same \$11,700 invested in an S&P index fund would be worth \$1,364,000 today.⁵⁴

Despite the importance of equity ownership to wealth, it is still only the wealthy (and in particular the very wealthy) who are the owners of significant amounts of stock. While stock ownership has increased in the last 15 years, less than half of

households headed by adults under the age of 45 had stock holdings of any kind. And of those who did, the median value was only about \$10,000.⁵⁵

In the 19th and 20th century, government policies successfully created broadly shared wealth and security. In the 19th century, it was the Homestead Act, which created a new generation of landowners. In the 20th century, policymakers set their sights on expanding homeownership and enacted a concerted set of government policies to achieve that goal, such as the mortgage interest tax deduction and the creation of a secondary mortgage market via Freddie Mac and Fannie Mae. As a result, homeownership rates today are just shy of 70 percent, and among households headed by adults over the age of 40, the homeownership rate is 80 percent.⁵⁶

In the same way that 20th century government policies succeeded in making most Americans homeowners, 21st century government policies should aim to turn all Americans into investors—a Homestead Act for the 21st century. And to take advantage of compound interest, these efforts should be available to Americans as early in life as possible.

Policy Goals for the New Rules Economy:

- Establish estate builder, or “worth at birth,” accounts for all newborns (to be used for wealth-building activities such as college tuition, affording a home, starting a business, or cashing in at retirement).

Old Rule #5

Wealth was managed on behalf of workers

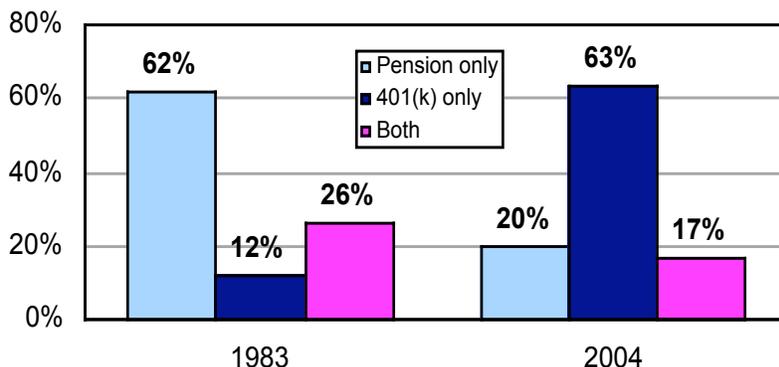
New Rule #5

Workers need to manage their wealth

Under the old rules, decisions about retirement security rested largely in the hands of professional money managers who ran pension funds for big companies. In 1975, defined-benefit pension plans were the most common employer-sponsored retirement benefit, with 87 percent of covered workers participating.⁵⁷ For long-tenured workers at financially healthy companies, pensions were ideal. So long as the company stayed in business, the individual risk was low.

Today, almost everyone has to act as their own investment expert with responsibility for their retirement security. Between 1985 and 2004, the number of defined benefit plans fell by more than 82 percent.⁵⁸ There are only about 31,000 traditional plans active today, and nearly half (46 percent) are for public employees.⁵⁹ Most workers today participate instead in defined contribution plans, most commonly a 401(k). In 2004, 63 percent of workers were covered by a defined contribution plan only, while only 20 percent still had only an old-style pension.⁶⁰

Worker Retirement Coverage by Type



Source: Center for Retirement Research⁶¹

Some policymakers see this shift as an unequivocal negative for workers, but success largely depends on knowing and navigating the new rules. For those who invest early, invest wisely and let the nest egg grow, a defined-contribution retirement plan can bring returns as good as or better than a pension. For young workers and women who tend to change jobs or move in and out of the labor force, a defined-contribution plan also avoids the penalties imposed by long vesting periods that are typical of old-style pensions.⁶² And in today's economy, when corporations often merge into and out of existence, and many large pension funds are shaky or already broke, severing workers' fortunes from that of a single company can in some instances offer more security.

But too many workers don't know the new rules and are in danger of coming up short in their retirement. Government policies are still geared toward an era when pensions were far more common; aside from Social Security, the Pension Benefit Guaranty Corporation is the only major government institution dedicated to middle-class retirement security.

As a consequence, American workers aren't getting the help and basic knowledge they need to maximize their retirement wealth. One in five American workers eligible for a 401(k) chooses not to participate.⁶³ And as many as 45 percent of workers who switch jobs cash out their 401(k)s—despite the 10 percent penalty. The cumulative impact of these kinds of errors can be costly. A study by the Center for Retirement Research shows that if a typical worker invests in a 401(k) early and wisely, this retirement nest egg should equal about \$380,000.⁶⁴ But the real median retirement savings for workers between 55 and 64 is \$60,000.⁶⁵ And with the typical retirement lasting upwards of 18 years, careful planning is becoming increasingly important.

21st century government policies must guide workers through the new rules of building retirement wealth. Saving should be easy, automatic and early.

Policy Goals for the New Rules Economy:

- Mandate minimum employer/employee pension contributions and make maximum 401(k) contributions the default option.
- Encourage more companies to provide investment advice to their workers.
- Provide financial education in schools and provide greater access to basic financial education and investment planning for adults.

The New Rules for Families: The Scarcity of Time

If the 20th century belonged to men, the 21st century belongs to women. Between 1975 and 2005, the U.S. economy created a net of 56 million jobs, 32 million of which went to women. Whereas real wages for men without a college degree have declined since 1974, wages for women at all education levels have increased. Very shortly, American women will be more educated than American men, holding a majority or supermajority of college and professional degrees. Women are not just participants in the workforce; they are its new leaders.

Public policies, however, are decades behind and still rooted in a single-earner model. Women with young children now routinely work outside the home, which has created a new set of pressures for families. Child care is expensive and its quality uneven. And in addition to caring for children, many families now have the added responsibility of caring for aging parents. For many families today, time is their scarcest resource.

Old Rule #6

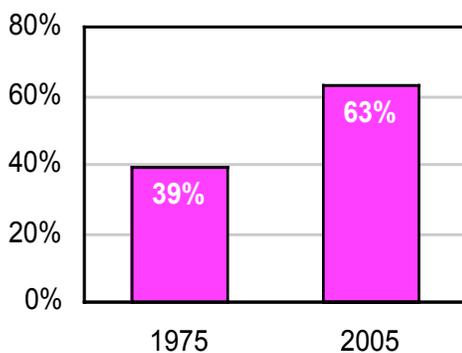
Most mothers expected to stay home

New Rule #6

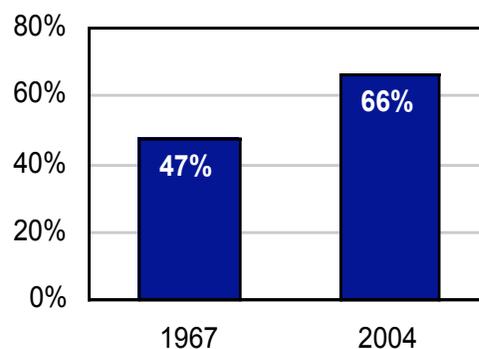
Most mothers expect to work

Under the old rules, opportunities for women were scarce. Today, opportunities are abundant. In 1970, 57 percent of college degrees were awarded to men. In 2004, 57 percent were awarded to women.⁶⁶ In 1970, three out of five masters' degrees were awarded to men. In 2004, nearly three out of five were awarded to women. In 1970, for every professional degree awarded to a woman, eighteen were awarded to men. In 2004, the ratio of law, medicine, and accounting degrees was one to one.⁶⁷

Workforce Participation of Mothers with Children Under Six



Percentage of Two-Earner Households



Source: Census Bureau, Current Population Survey, March Supplements

Government, however, still seems stuck in the debate over whether women should be working or at home. This even though in 2005, 63 percent of moms with children under age 6 worked outside the home (compared to 39 percent 30 years ago).⁶⁸ Few policies are geared to the needs of two-earner families, giving rise to what family policy expert Karen Kornbluh has dubbed “the juggler family”⁶⁹—juggling work and parenthood and balancing cost and quality for child care.

Two out of three working parents say they don’t have enough time with their kids, and nearly two out of three married workers say they don’t have enough time for their spouses.⁷⁰ The time crunch is serious enough that 64 percent of working Americans say they would rather have more time than more money from their jobs.⁷¹

On any given workday, nearly 12 million children under the age of 5 are in daycare. 80 percent of children under one year old⁷² and 63 percent of all kids under age 5 are in some type of regular child care arrangement.⁷³

Moreover, child care is generally expensive and often mediocre. The National Institute for Child Health and Human Development found that the vast majority of day care provided in America is merely “adequate.”⁷⁴ Nevertheless, annual fees for full-time care in a center range between \$4,020 to \$14,225—or more than the average annual cost of tuition at a public university.⁷⁵ In 2004, the median household income of working-age adults in America with children was roughly \$70,000,⁷⁶ which means that child care costs for a single child can consume anywhere from 6 percent to more than 20 percent of total pre-tax household income.

With most families struggling to balance work and child rearing, government policies must catch up. Lesotho, Swaziland, Papua New Guinea—and the United States—are among the few countries in the world without paid family leave. Government provides families with few resources for child care and little assurances of child care quality. Flextime is still relatively rare in the public and private sectors. And marriage penalties in the tax code still disadvantage two-earner families.

Policy Goals for the New Rules Economy:

- Create a universal guaranteed paid family leave benefit for new parents, perhaps as an add-on to the unemployment insurance system.
- Provide new parents with a “new baby tax credit” for the first three years of a child’s life.
- Double the tax break for child care expenses.
- Create a national, voluntary accreditation standard for child care quality.
- Reward businesses that offer their employees flexible work schedules, including flexible schedules for men.

- Permanently eliminate marriage penalties in the tax code, including and especially in the Earned Income Tax Credit.
- Expand the availability of employer-based child care.

Old Rule #7

A family raised its children

New Rule #7

A family now raises children and cares for parents

In 1989, 60 percent of adults between the ages of 41 and 59 had at least one living parent. In 2005, it was 71 percent.⁷⁷ In ten years, the number of senior citizens in America will increase by 10 million. Ten years later, it will increase by another 16 million. Over the next 20 years, the very aged population—those 85 and older—will increase by half.⁷⁸

Under the old rules, parents simply raised their children. When the kids left the house, those prime-age adults may have had some responsibility for their parents. Under the new rules, adults must raise their children and care for their own parents—often simultaneously and for a longer time.

Several factors are creating this “sandwich” generation and its attendant demands: first, people are having children later in life. In 1975, the typical birth mother was 24 years old. By 2004, she was nearly 28.⁷⁹

Second, people are living longer in retirement. In 1975, a person reaching retirement age could expect to live another 16 years. By 2000, a retiree could expect to live another 20 years.⁸⁰

Third, elder care is expensive. In 2002, families spent an estimated \$37.2 billion in out-of-pocket expenses for long-term care.⁸¹

Fourth, younger and middle-aged women who once stayed home and could care for elderly parents are far more likely to work. Two-thirds of family caregivers are also employed, adding yet another source of the time crunch.⁸²

Government policies are ill-suited to helping families shoulder these new responsibilities. Families facing eldercare expenses have few government resources available either to cope with its cost or gauge its quality.

Government is also failing to help families tackle the problem of long-term care. A single year in a nursing home cost an average of \$74,095 in 2005,⁸³ or more than one-third of the entire median nest egg saved by a retiree. Medicare coverage of nursing home care is extremely limited, and Medicaid is unavailable until an elderly person’s financial resources are virtually exhausted. For married couples with a spouse who is ill, long-term care for one spouse comes at the price of financial security for the other. Long-term care insurance is generally prohibitively expensive and not widely

available. As a result, too many middle-class seniors must “spend down” to poverty to qualify for Medicaid if they need significant long-term care.

Policy Goals for the New Rules Economy:

- Provide tax breaks for eldercare expenses incurred by adult children caring for aging parents.
- Create incentives for enrollment in long-term care insurance plans and make long-term care insurance more accessible and affordable.
- Reduce and manage the growing costs for long-term care by increasing the availability of home or community-based care over institutional settings.
- Encourage healthier lifestyles to reduce future medical costs and promote better and more cost-effective techniques for managing chronic ailments.

The New Rules for Business: Succeeding Under Hypercompetition

In the decades following World War II, American companies were virtually unrivalled. While Europe and Japan were struggling to rebuild, other countries were stifled by communism. Still other markets were hobbled by corruption, and in the developing world, industrialization had yet to arrive. At home, many industries enjoyed regulatory protection, and satisfying shareholder demands for returns was easier. International trade was limited; markets were primarily local or regional.

Today, companies must compete or perish. Europe and Japan have regained their former stature, and the death of communism has led to billions of individuals becoming our newest competitors as well as our newest customers. Six decades of relative peace have brought stability to most of the world, and nations that were once undesirable for investment are becoming hotspots for attracting capital. At home, most industries have been deregulated, and shareholders are increasingly demanding. Markets have now gone global, and international trade is an important driver of economic growth worldwide.

Public policy in this new environment must help American companies compete. Businesses should get more support for doing what they do best as global leaders in innovation and technology. And government should work to free American companies from the single greatest drag on their competitive ability: the burden of health care costs.

Old Rule #8

Successful companies built

New Rule #8

Successful companies create

In America's first 100 years, America's chief products were the raw goods produced from agriculture. Over the next 100 years, our leading goods became those manufactured in American factories. Today, the nation's leading products are the innovations, ideas and services that come from its people.

Under the old rules, when businesses primarily excelled in manufacturing, the ingredients for success were mostly tangible. Companies' primary assets were plants and equipment, and growth was dependent on finding the capital to build more manufacturing capacity. Companies relied upon a modestly educated but competent workforce and on a rapid and reliable transportation infrastructure for shipping the goods they made.

Today, the newly abundant global pool of low-skilled labor means that American companies can no longer compete effectively in producing mass-manufactured goods.

Under the new rules, in which American businesses now primarily excel in services, the ingredients for success are mostly intangible. Companies' primary assets are their intellectual property and their people. Growth is dependent on innovation and on

aggressive and effective marketing. Companies now rely upon a highly-educated workforce and on a rapid and reliable telecommunications infrastructure for sharing information.

But while there are now dozens of nations that can competently produce a pair of shoes, America is peerless in its ability to invent new technologies and industries. American companies are the world's leading drivers of innovation in virtually every field: financial services, pharmaceutical and biomedical research, information technology, marketing and sales, advanced manufacturing, entertainment, and an endless list of other sectors.

But government policies have yet to fully recognize how American companies have come to depend on constant innovation as the principal driver of growth. For American companies to continue to lead, government must foster a policy environment that spurs and encourages innovation. 21st century public policies should aggressively promote American innovation by funding research, nurturing talent, protecting intellectual property and maintaining the status of American universities as unmatched for their excellence in the world.

Today's policies should aim to ensure that America maintains its position as the leading global provider of services and that American workers are prepared to take on and excel at these jobs. In the same way that public funding for the construction of canals, railroads and highways was critical in supporting the rise of the manufacturing economy, public funding for the completion of the "information highway" will be crucial to maintaining our competitive edge. Yet in 2005, the government spent more on subsidizing Amtrak—one of America's oldest "highways"—than it did on broadband deployment—our newest one.

The nation's trade policies should also be focused on lowering barriers to the export of American services. Many countries set up unfair regulatory barriers, such as onerous capital requirements or opaque licensing regimes, that prevent American firms from entering those markets.

Most importantly, public policy should aim to accomplish in tandem the policy goals outlined in Rules #1 and #2—to encourage all individuals to aspire to a college education and to a job in the innovation economy.

Policy Goals for the New Rules Economy:

- Invest in building and supporting the infrastructure of the service economy, such as broadband and better and more reliable mobile phone service.
- Reduce regulatory barriers in foreign countries that bar or limit American companies' ability to sell more services abroad.
- Expand public funding for pure and applied research.

- Protect American intellectual property from international piracy and modernize the patent system.
- Reform the H-1B visa program to keep highly-educated foreign graduates of American universities in the U.S.
- Reform and make permanent the R&D tax credit for businesses.
- Increase federal funding to public universities to improve their quality and support research.

Old Rule #9

Competition was limited

Under the old rules, competition was limited. Regulation protected a large swath of the economy, including transportation, financial services, telecommunications and even retail (through “blue laws”). The devastation wreaked by World War II left American companies unrivalled as global suppliers.

Under the new rules, competition is fierce. Companies are under pressure to restructure (even when times are good) to satisfy the demands of investors who are constantly in pursuit of the highest returns. Information technology has not only enabled the creation of a global market for capital but global means of production and global markets for goods. Moreover, it has dramatically lowered the barriers for competitors to enter the market. In the manufacturing economy, entrepreneurs needed to raise the capital to buy equipment and build a factory. Today, an entrepreneur can compete with eBay just sitting at a laptop from home. Companies can no longer count on the lack of competition to help them succeed. They must be better, faster, more innovative and more efficient than their competitors to survive.

In this new environment, perhaps the single greatest drag on American competitiveness is the increasing burden of health care costs (although this is not intended to diminish the impact of high energy costs, lack of infrastructure investment and other factors that affect particular industries).

America is one of the few countries in the world today in which business is the primary provider of the middle class safety net, financing health care and retirement for working people.

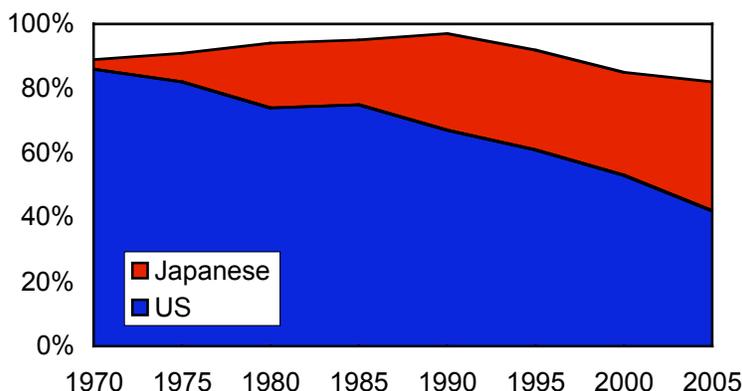
Under the old rules, this system was workable. Today, it is anachronistic.

Employer-provided health and retirement benefits were largely accidents of negotiation. Because of government-imposed wage controls during World War II, employers resorted to creating non-wage benefits (exempt from these limitations) to compete for and retain scarce labor. At the time, American companies faced little competition, and the provision of these benefits was cheap.

New Rule #9

Competition is fierce

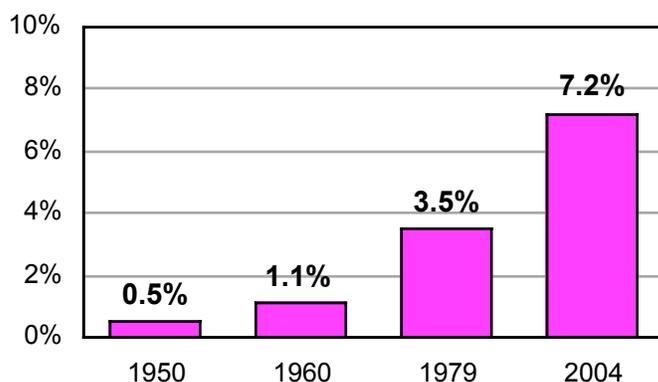
Relative Shares of US Auto Market, Japanese and US Automakers



Source: *Automotive News Data Book*⁸⁴

What companies did not anticipate in the time of World War II was the modern explosion in health care costs. In 1988, an employer typically paid \$2,603 in today’s dollars to cover a worker’s family health care policy.⁸⁵ In 2006, it was \$8,380.⁸⁶ That’s a real increase of 322 percent in less than 20 years. As a share of total compensation, health care costs have doubled since 1979.

Health Care Costs as a Share of Worker Compensation



Source: *Bureau of Economic Analysis*⁸⁷

For workers, more money spent on benefits means less money available for wages. Health care costs sheared worker wages by as much 4.6 percent from 1979-2004. For the typical two-earner working-age household, that is a pay cut of \$3,250 for 2005 wages alone.

For companies, the additional cost of health care is a drag on their ability to compete, both at home and abroad. Internationally, most of America’s competitors are not burdened with health care costs. At home, companies with generous benefits are at a disadvantage to companies that can cut costs, thereby creating an incentive for a

race to the bottom that ultimately hurts workers' access to care. Second, more money spent on benefits means less money available for other critical uses, such as marketing, research and development and even higher wages to attract better top-notch talent. Third, the additional money now being spent on health care isn't buying better outcomes or better care. If anything, companies and workers are paying more and getting less. While the employer share of health care costs has remained constant, more workers are being asked to pay more of the costs in the form of larger co-pays and deductibles.

Companies should retain the flexibility to offer their workers a health insurance benefit, but public policy must also find a way to shift a significant portion of the burden of health care costs away from businesses and onto government.

In the realm of retirement security—the other half of the middle-class safety net traditionally provided by business—Social Security and Medicare serve as critical publicly funded backstops to private retirement benefits (a safety net for the safety net, as it were). But there is no equivalent backstop in health care, since Medicaid is aimed at the poor. If employers do not provide insurance, workers must face those costs—typically \$11,000 a year for family coverage—alone.

21st century public policy should have two goals: first, to rein in costs so the burden does not grow yet further; and second, to create a means of access to affordable health insurance for middle-class workers that is independent of the employer-sponsored system.

Policy Goals for the New Rules Economy:

- Use health IT, chronic care management, preventive health and end-of-life care management to slow the rate of growth in health care costs to the overall rate of inflation.
- Promote greater reliance on evidence-based medicine so that treatments and new technologies are deployed cost-effectively.
- Shift some of the burden of providing health insurance for middle-class workers from business to government (for example by making coverage of catastrophic or preventive health care costs a government responsibility).

Conclusion: Progressive Realism – Optimism Rooted in Reality

We are both realistic and optimistic in our firm belief that the American economy will continue to grow. In many respects both the world and the American economy have never been better. Only 60 years ago, over half the world played by the rules of Lenin and Marx; today they play by America's rules. 21st century economics rewards innovation, marketing and technology; no country comes close to America in these areas. Only 60 years ago, regional and world wars routinely wiped out the wealth of entire mature economies. Today, although we still live in a very dangerous world, the wealth of mature economies is no longer easily destroyed.

As progressive realists, we believe the American economy is on a journey forward toward increasing prosperity and opportunity.

From 1980 to 2005, real GDP growth was 3.1 percent per year. If this pace of growth continues—a realistic prospect—our economy will grow from the \$13 trillion it is today to \$26 trillion over the next twenty five years and to \$44 trillion in 2045 in constant dollars. Assuming federal government expenditures remain at their current level of 21 percent of GDP, the anticipated growth of the economy will mean that an additional \$4.6 trillion in federal resources will become available annually. In the same way that the growth in our economy allowed us to afford Social Security, Medicare, the GI Bill and the interstate highway system, future growth will allow us to pay for entitlement reform, health system reform and a host of other critical priorities.

New Labor in the United Kingdom has already pioneered a similar strategy. The voters re-elected Tony Blair and Gordon Brown three times on a platform which clearly stated that after steadily growing the economy, New Labour would aggressively invest in expanding and restructuring government programs.

As progressive realists, we believe a similar long-term political contract can be reached with the American public. If progressives steadily grow the economy, we can take the incremental financial resources created and invest prudently in government programs that address the challenges faced by individuals as they confront the Information Age. This starts with a reality based, not ideologically exaggerated, assessment of how the economy's new rules are changing the daily lives of individuals, families and businesses.

There have been two great eras of progressive policymaking in our past, and we think progressives now have an historic chance to usher in the culmination of the third.

The first progressive era, led by President Teddy Roosevelt, used the whip of regulation to tame the excesses of an unfettered economy. The second progressive era, led by Presidents Franklin Roosevelt and Lyndon Johnson, created the foundation for economic security with the safety net programs of the New Deal and Great Society. The third progressive era was arguably begun by President Bill Clinton, the first progressive realist, with his bridge to the 21st century; his policies principally focused on understanding the new rules to create a ladder to opportunity and wealth for the greatest number.

We hope this paper can help to bring about the culmination of this new progressive era and with it, new opportunities and greater prosperity for America's middle class.

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