

The American Dream
vs.
The Gospel of Wealth

The American Dream
VS
The Gospel of Wealth

The Fight for a Productive
Middle-Class Economy

NORTON GARFINKLE

Yale University Press New Haven and London

Published with assistance from the Mary Cady Tew Memorial Fund.

The Future of American Democracy series aims to examine, sustain, and renew the historic vision of American democracy in a series of books by some of America's foremost thinkers. The books in the series present a new, balanced, centrist approach to examining the challenges American democracy has faced in the past and must overcome in the years ahead.

Series editor: Norton Garfinkle.

Copyright © 2006 by Norton Garfinkle. All rights reserved. This book may not be reproduced, in whole or in part, including illustrations, in any form (beyond that copying permitted by Sections 107 and 108 of the U.S. Copyright Law and except by reviewers for the public press), without written permission from the publishers.

Library of Congress Cataloging-in-Publication Data
Garfinkle, Norton, 1931–

The American dream vs. the gospel of wealth : the fight for a productive middle-class economy / Norton Garfinkle.

p. cm. — (Future of American democracy series)

Includes bibliographical references and index.

ISBN-13: 978-0-300-10860-6 (alk. paper)

ISBN-10: 0-300-10860-5 (alk. paper)

1. United States—Economic conditions. 2. United States—Economic policy. 3. Middle class—United States. 4. Supply-side economics—United States. 5. Democracy—United States. I. Title. II. Series: Future of American democracy.

HC103.G32 2006

330.973—dc22

2006013529

A catalogue record for this book is available from the British Library.

The paper in this book meets the guidelines for permanence and durability of the Committee on Production Guidelines for Book Longevity of the Council on Library Resources.

10 9 8 7 6 5 4 3 2 1

Contents

Preface vii

Introduction 1

ONE The American Economic Vision 12

TWO Lincoln's Economics: The Origins
of the American Dream 27

THREE The Gospel of Wealth 47

FOUR The Age of Reform 69

FIVE The Business of America Is Business 88

SIX The Renewal of the American Dream 107

SEVEN The New Gospel of Wealth 144

EIGHT The Current Debate: Supply-Side
vs. Demand-Side Economics 163

NINE The Way Forward 189

Appendix 201

Notes 205

Index 221

Preface

Americans today confront a choice between two fundamentally different economic visions for America. The historic vision of the American Dream is that continuing economic growth and political stability can be achieved by supporting income growth and economic security of middle-class families without restricting the ability of successful businessmen to gain wealth. The counterbelief, based on the Gospel of Wealth, is that providing maximum financial rewards to the most successful businessmen is the way to maintain high economic growth to benefit all Americans. Both visions claim to support the goals of maximum economic growth and maximum benefit for the society as a whole, but they present radically divergent programs to achieve these goals. One approach claims that the engine of economic growth can best be sustained by a progressive tax system that supports the purchasing power of middle-class Americans. The other claims that the engine of economic growth can best be sustained by a regressive tax system that increases the wealth of the highest income families to support business investment. This book draws on the historic record and a detailed analysis of economic data to demonstrate that the middle-class American Dream not only supports the

democratic ideals of our society but also provides the best path to maximum economic growth.

The American Dream vs. The Gospel of Wealth is a volume in the Yale University Press Series on the Future of American Democracy. Yale University Press has joined with the Yale Center for International and Area Studies and The Future of American Democracy Foundation to sponsor this series of books by some of America's foremost thinkers. These books, together with articles, lectures, conferences, and television programs, are designed to stimulate historically informed analysis of contemporary public policy issues and to help Americans build a shared, sensible, and positive vision of the future of our democratic society.

The Future of American Democracy Foundation is a non-profit, nonpartisan foundation dedicated to research and education aimed at renewing and sustaining the vision of American democracy that has unified Americans throughout the nation's history. The goal of the Foundation is to clarify the domestic and foreign policy choices facing the United States in the years ahead. A distinguished group of scholars and experts serves as the Foundation's officers and as members of the Foundation's Board of Advisors, including Jonathan Brent (Editorial Director of Yale University Press), John Donatich (Director, Yale University Press), Fredrica S. Friedman (President of Fredrica S. Friedman & Co., Inc.), Norton Garfinkle (Chair of the Foundation), William R. Griffith (Reed Smith LLP), Richard D. Heffner (Host, "The Open Mind"), Thomas E. Mann (The Brookings Institution), Norman Ornstein (American Enterprise Institute), Hugh Price (Former President of the National Urban League), Jeffrey Rosen (George Washington University), Ian Shapiro (Sterling Professor and Director of the Yale Center for International and Area Studies), Alan Wolfe (Boston College),

Ruth A. Wooden (President, Public Agenda) and Daniel Yankelovich (Chairman, Public Agenda). Please visit www.futureofamericandemocracyfoundation.org for the latest information on the Foundation's activities.

I would like to thank my colleagues Daniel Yankelovich, Richard Heffner, Ian Shapiro, and my wife, Sally Minard, for their sage advice on the substance of this book. Shivaun McDonagh worked tirelessly to create the final manuscript. Our agent, Fredrica Friedman, a consummate publishing professional, made a major contribution to the success of this volume. And finally I want to express my gratitude to Jonathan Brent, Sarah Miller, and their excellent editorial and production team at Yale University Press for a superb job in bringing this book to the public.

Introduction

As the new millennium dawned in 2000, the American economy presented an extraordinary portrait of success. For the previous four years, Gross Domestic Product (GDP) had grown at an average real rate of 4.2 percent, a figure well above the 3.2 percent average for the post–World War II era. Unemployment, at 4.2 percent, was well below the postwar average. Inflation was minimal. Yearly growth in business investment was at levels not seen since the 1960s. Indeed, to find a similar run of robust economic growth, low unemployment, low inflation, and high business investment, one would have to go back to the mid-1960s—and back then, inflation was showing signs of increasing. To top it off, by the end of 2000, the federal government had produced surpluses for three consecutive years—a minor miracle, not seen since the late 1940s. Moreover, federal surpluses in the multi-billions were projected as far as the eye could see. From 1993 through 2000, the U.S. economy created over 23 million new jobs, an average of more than 2.9 million a year.¹ Americans were enjoying an unprecedented level of prosperity. Govern-

ment's fiscal house was in order. The federal government was not only able to pay down trillions in accumulated debt; it had money left over to help cope with looming crises in Social Security and Medicare.

But all this was to end.

First came the inevitable. In March 2000, an inflated technology stock market crashed, setting the stage for the onset of a recession a year later. Then came the policymakers. President George W. Bush came to office in 2001 with a minority of the popular vote, a razor-thin electoral vote margin, and a radical plan to slash federal taxes. Tax cuts, the president and his advisers said, were the key to increasing investment. Tax cuts were the key to increasing jobs. Tax cuts were the key to getting the economy back on a pathway of growth. Between 2001 and 2003, the Bush administration pushed through major cuts in the income tax, the estate tax, corporate taxes, and taxes on dividends and capital gains. By 2004, the administration's tax cuts had trimmed over \$200 billion from the federal government's annual revenues, with most of the money going to those in the top 12 percent of the income scale.²

Yet the results were not what the president and his advisers predicted. First to disappear were the projected federal surpluses. From a surplus of \$256 billion in 2000, the federal budget went to a deficit of \$413 billion in fiscal year 2004 and \$319 billion in 2005. The number of new jobs created fell far short of economists' estimates of the minimum of 150,000 per month needed to accommodate new entrants to the labor force. Indeed in the five years of the Bush administration from 2001 to 2005, the economy created only 31,000 new jobs per month compared to 240,000 per month during the eight years of President Bill Clinton's administration. The promised business investment boom was slow to materialize. Business investment

growth during the first five years of the Bush administration averaged only 1.2 percent per year compared to 9.9 percent per year during the Clinton presidency. From the combined standpoint of employment, business investment, and real GDP growth, the Bush administration presided over one of the slowest recoveries of the post–World War II era. During these five years of the Bush administration the average annual GDP growth of 2.6 percent was considerably lower than the average annual growth of 3.7 percent during the eight Clinton years. Annual employment growth was anemic at 0.3 percent compared to 2.4 percent during the Clinton years. And even in 2005, three years into the recovery, GDP growth was only 3.5 percent and employment growth remained anemic at 1.5 percent.³

After five years of their ambitious tax-cutting program, in other words, the central claim of President Bush and his advisers—that tax cuts would create a fundamentally new economic environment that fostered historically high rates of investment, job creation, and growth—had not panned out. At the same time, having added nearly \$2.3 trillion to the national debt in the brief span of five years, the administration was still confronted with an array of urgent spending requirements—billions for homeland security following the terrorist attacks of September 11, 2001, a protracted and costly military occupation of Iraq, substantial relief and reconstruction costs after Hurricanes Katrina and Rita, and burgeoning oil prices—all destined to take their continuing toll on both the federal budget and the U.S. economy.

The crowning irony was that the sustained boom of the 1990s had been ushered in by a major *tax increase* during the Clinton administration while the Bush *tax cuts* produced nothing of the kind.

What rationale could the Bush administration have had

for wreaking such havoc on the federal finances? Why insist on deep tax cuts, especially in the post–September 11 era, when security spending was bound to explode and costly disasters awaited right around the corner? How would major tax breaks for the highest-income earners work magic on an economy that had already been growing for several years at faster-than-historical rates—under a progressive tax structure that produced healthy federal surpluses? Why was the Bush administration content to throw away federal surpluses when huge unfunded liabilities for Social Security and Medicare loomed on the horizon, to say nothing of a dizzying array of immediate security, defense, and disaster needs?

The answer lay in the doctrine of supply-side economics, which thoroughly permeated the thinking of Bush and his economic advisers. Supply-side economics was the conservative answer to the demand-side economics that dominated U.S. policymaking from the end of World War II until 1980. To a large degree, economic debate in America for the past quarter century has centered on the conflict between these two economic visions. The health of both our economy and our democracy will be decisively affected by which of these two visions prevails in the future.

Drawing on historical analysis and data-based research, this book shows how Americans today confront a choice between two fundamentally different economic visions for American society, each of which claims to support maximum economic growth and a fair and equitable basis for American democratic society. One vision, based on the American Dream, supports a progressive tax structure that enables the government to implement programs to strengthen the income and economic security of the middle class and ordinary wage earners without restricting the ability of successful businessmen to

gain wealth. The second vision, based on the Gospel of Wealth, seeks to ensure that the few most economically successful citizens reap maximum rewards through an increasingly regressive tax structure.

The data analyzed in this book clearly indicate that regressive tax policies based on a Gospel of Wealth supply-side theory are not helpful to economic growth, while progressive tax policies based on demand-side theory can provide a continuing spur to economic growth consistent with the economic and political vision of the American Dream.

Two Theories, Three Questions

Every important economic policy has three kinds of consequences: factual, moral, and political. In effect, in evaluating economic policy, we have to ask three questions: (1) Does it work? (2) Is it fair? and (3) Will it sustain the democratic structure of our society?

Today our debate tends to focus almost exclusively on the first question, at the expense of the other two. It was not always so. A generation ago, most Americans would have instinctively understood the relevance of all three questions—factual, moral, and political. That is because public views of government economic policy were shaped by memories of the Great Depression. The Great Depression brought dramatic policy failure on all three levels. When the economy nosedived after the Great Stock Market Crash of 1929, the federal government literally did not know what to do. By and large, the federal government stood by almost helplessly as unemployment rose to catastrophic levels, eventually as high as 25 percent. Some of the steps the government took, including a tax increase in 1932, actually made conditions worse. Perhaps most gallingly, the

otherwise compassionate president Herbert Hoover adamantly opposed any federal spending for relief of the millions of unemployed. It is hard for Americans today to imagine unemployment at such levels, or what unemployment could be like in the absence of any federal unemployment insurance program. Millions of Americans were literally homeless and starving. Men rode the rails from town to town in vain search of employment. Hundreds of thousands of families, ejected from homes and apartments for which they could no longer pay mortgages or rent, lived in camps of tents and shanties that popped up in vacant lots of major cities—popularly called Hoovervilles. Most Americans became convinced of three things: that the government under Hoover did not know what it was doing, that the fate meted out to ordinary workers and their families was patently unfair, and that unemployment and spreading poverty threatened the very basis of American democracy.

After the economy recovered in World War II, Americans were still thinking within this framework. Demand-side economics, which became a kind of unofficial economic policy for the nation in the postwar years, reflected this understanding. It integrated technical economic insights developed by the British economist John Maynard Keynes with the moral and political imperatives that had grown out of the Great Depression. In a book written in 1936, Keynes showed policymakers a way out of the Depression. Keynes's key innovation was to shift the focus of economists from production, or supply, as the engine of economic growth to the importance of consumption, or demand. The main lesson economists drew from Keynes was that government could restore growth to an economy suffering from high unemployment by engaging in deficit spending to expand "aggregate demand." Expanded demand would get the economy moving again, provide customers for business, give investors a reason to invest, and bring down unemployment.

By the beginning of President Dwight Eisenhower's administration in 1953, demand-side economics had become the basis for a bipartisan consensus. The post–World War II economy was understood to be “Everyman's economy.” By broad social consensus, the purpose of the economy was to provide economic opportunities as well as a measure of economic security for ordinary workers and their families. Government was understood to have an active role—indeed, a responsibility—in this process.

The demand-side consensus constituted the basis of an economy that saw a remarkable growth of the American middle class. It was an economy in which ordinary workers in ordinary jobs could expect to better their conditions, own homes and automobiles, send their children to college, and retire in relative security. It was an economy in which the vast majority of citizens had a stake. It was an economy that promoted a strong faith in democracy.

Beginning in the mid-1960s, however, the demand-side consensus began to go awry. President Lyndon Johnson embarked simultaneously on massive federal spending to pay for a rash of Great Society antipoverty programs and equally massive spending to pay for the Vietnam War. The resulting huge expansion in the federal deficit (combined with the president's pressure on the Federal Reserve to keep money “easy”) resulted in the emergence of high inflation. For roughly fifteen years, inflation remained a problem that would not go away. As inflation grew, the only alternative seemed to be restrictive policies that would create high unemployment—but preventing unemployment was the central goal of demand-side economics. By the 1970s, the economy began to experience “stagflation”—high inflation together with high unemployment. For middle-class Americans, stagflation represented the worst economic crisis since the Great Depression. Prices became unpredictable.

Raises in salaries and wages were eaten up by price increases. Savings eroded as the value of money declined. Mortgage interest rates went through the roof. Moreover, Americans experienced ever-higher taxes as inflation drove them into higher and higher income tax brackets, brackets originally intended for the very rich.

Supply-side economics arose in direct reaction to the inflation crisis. The architects of supply-side economics—most of them political commentators rather than trained economists—created, in effect, a mirror image of demand-side theory. The real engine of growth in an economy was not demand, said the supply-siders, but rather supply. The problem was that the government was pumping too much demand into the economy via its deficits, while its high taxes were inhibiting supply, by killing off economic “incentives” to produce. Taxes were too high to encourage investors to invest. Fewer products and services were being generated. Demand therefore had nowhere to go, which is why inflation was so high. Only the private sector could generate economic growth, and the private sector needed to be set free to do its job. Supply-siders saw tax cuts—and especially tax cuts for the highest-income taxpayers—as the key to generating new investment and production and, so they argued, eliminating inflation.

Supply-siders believed that demand-siders had put too much emphasis on the issue of fairness and in the process they had neglected job 1—which was to make the economy grow. One could engineer fairness, the supply-siders believed, only at the expense of economic growth. The government had been trying too hard to control the economy; now the government had to learn to obey the laws of economics. If the laws of economics brought lower wages or greater income inequality, so be it. The important thing was to ensure growth. That meant

getting government out of the way. Government should not be worrying about how economic goods were being distributed; it should not be worrying about ensuring an Everyman's economy or building up the middle class. It should simply get its hands off business and the economy and let business and the economy generate growth. The most important way for government to get its hands off the economy was to lower taxes, especially on the highest earners, the most productive citizens who would invest their increased revenue in their own businesses. Many supply-siders claimed that such tax cuts would so powerfully unleash the forces of supply that the tax cuts would not even produce a deficit: they would pay for themselves.

The Republican candidate Ronald Reagan made supply-side tax cuts the center of his presidential campaign in 1980, and once in office President Reagan implemented the supply-side program full-bore, pushing through the largest tax cut in history, including a deep reduction in the top marginal income tax rate—eventually cutting the top rate down from 70 percent to 28 percent.⁴

By the end of the Reagan administration, however, few mainstream economists regarded the supply-side tax cut “experiment” as a success. In the first place, the tax cuts had obviously not “paid for themselves” (almost no mainstream economist expected they would). The Reagan administration's taxing and spending policies produced the largest peacetime federal deficits in American history. Nor did the cuts in taxes for the highest-income earners bring the promised investment boom. In the seven years following the 1981 *tax cut* (1982–88), growth in new business investment averaged a weak 3.1 percent. Compare that to the 10.1 percent average growth in new business investment in the seven years following the Clinton administration's 1993 *tax increase* (1994–2000).⁵ To be sure, the economy

showed healthy growth during the later Reagan years. But economists generally agree that the recovery was primarily a result of gaining control over inflation. This had nothing to do with tax cuts (indeed, the tax cuts aggravated the situation by contributing to large deficits). Rather, the recovery was mostly the result of a decisive shift toward a more disciplined monetary policy by the Federal Reserve.

It was one thing for supply-siders to claim to emphasize the factual dimension of economic issues at the expense of the moral and the political questions. That was simply a debating posture. It was another thing to actually have a factual basis for their claims (see chapter 8). Absent such factual support, it is interesting to ask why supply-side economics made such a powerful comeback under President George W. Bush.

Today we are at a crossroads. Not only has the supply-side program failed to deliver the promised higher levels of investment and faster-than-historical rates of economic growth. It has once again produced outsized deficits. It has intensified already burgeoning income inequality. And it has gone hand in hand with an economy that year after year has brought sluggish employment growth, stagnant wages, increasing job insecurity, and millions of citizens slipping below the poverty line. The federal government is in debt up to its ears, and so are many Americans, as ordinary citizens max out their credit cards and borrow against their home equity in a desperate effort to maintain a middle-class standard of living in an economy apparently no longer defined by a commitment to support such a living standard.

The word “economics” comes from a Greek term meaning “household management.” But economics in America has always been about more than managing the national household.

It has always been about more than dollars and cents. It has been about defining who we are, and what kind of a nation we seek to be. The promise of the American economy and the promise of America itself have always been closely bound up together. What kind of an economy do we seek, and what kind of a nation do we wish to be? Do we want to be the kind of country in which, as an old song from the 1920s went, “The rich get rich, and the poor get poorer”? Or do we want to be the kind of country we set out to be at the end of World War II, committed to an economy that provides for the common good, offers ready entry to the middle class, supports a middle-class standard of living, and provides generous opportunities for all? When the richest nation in the world has to borrow hundreds of billions to pay its bills, when its middle-class citizens sit on a mountain of debt to maintain their living standard, when the nation’s economy has difficulty producing secure jobs or enough jobs of any kind, something is amiss.

This book is an effort to illuminate the road ahead in economic policy by using the historical record to clarify not only the factual consequences of alternative policy choices but also the moral and political consequences of these choices. Only by understanding all three dimensions can we sustain our historic commitment to a productive economy, guided by principles of fairness, that helps sustain the middle-class basis of our political democracy.

Can we regain our political, moral, and economic compass? To recover it we need to go back to the beginning and ask what kind of nation and what kind of economy America was intended to be.

Chapter I

The American Economic Vision

Is there an American economic vision? Is there some guiding principle of economics implicit in our Declaration of Independence, our Constitution, and our form of government? There is—though at first glance this principle might appear to have little to do with the modern debates over fiscal and monetary policy, the size of government, or the degree of government regulation of economic life. But underlying these modern debates is an economic vision familiar to virtually all Americans: the American Dream—the dream that all Americans will have the opportunity through hard work to build a comfortable middle-class life.

To a large degree, the history of American economic policy making is the story of the waxing and waning of this middle-class ideal. When Alexis de Tocqueville visited America in the 1830s, he was struck by the middle-class character of the country and the conspicuous absence of very rich people. In Tocqueville's eyes, inured as he was to the sharp divisions between wealth and poverty in monarchical France, Americans seemed to be remarkably equal economically. Some were

richer, some were poorer, but within a comparatively narrow band. Moreover, individuals had opportunities to better their economic circumstances over the course of a lifetime, and just about everybody seemed to be busy pursuing these opportunities. People who started as servants could end up as farm owners or professionals or business owners. Tocqueville believed that this combination of relative economic equality and high social mobility in some sense held the key to the American system. It was this combination of factors that defined American democracy's promise and simultaneously underwrote its stability.

President Abraham Lincoln came of age in the nineteenth-century America that Tocqueville described. Lincoln was perhaps the first American leader to fully grasp that this condition of economic opportunity was, in truth, the defining feature of America, its very essence and its justification for existing. He was the first to fully grasp the meaning of what was later called the American Dream.

The freedom guaranteed by the Declaration of Independence and the Constitution was of value, in Lincoln's view, precisely because it enabled humble individuals to attain an independent, middle-class standard of living by the work of their own hands. America was the first nation on earth to offer this opportunity of economic advancement to all, even to the humblest beginner, and this was what made the nation unique and worth preserving. Ultimately, it was the largest reason for Lincoln's willingness to fight the Civil War.

Significantly, Lincoln also believed that government had an active role to play in sustaining and underwriting this "system." If the core meaning of freedom, if the very purpose of liberty, was to enable individuals to advance economically, to improve their condition, then government's role under the Con-

stitution must be understood in light of this principle. Government's role, in Lincoln's words, was to "clear the path" for the individual's economic advancement. In the political debates of his day, Lincoln was firmly on the side of what today we would call activist government. He favored large government expenditures for what were then called internal improvements—canals, bridges, and railroads. He believed in a strong national bank to stabilize the currency. As president, he presided over the vast federally underwritten expansion of the national railroad system and provided the first major federal funding for education with the creation of the land grant colleges. He believed, in the famous words of his Gettysburg address, that government should be not just "of the people" and "by the people," but also "*for the people.*"

Yet in the era of industrialization following the Civil War, a challenge arose to this vision based on a very different view of the meaning of freedom. This new view had its roots not in a political understanding of the Declaration or the Constitution, but in the *laissez-faire*, or "free market," thinking of British and other European economists. The new vision saw freedom not primarily as a universal promise of social mobility, but rather as an economic mechanism to produce national prosperity. Lincoln's focus was always on the fate of the ordinary worker. The new vision shifted focus to the extraordinary entrepreneur, the business owner, the industrial magnate as the engine of the new industrial prosperity. Lincoln thought government could and should enhance Americans' economic freedom by clearing the path for ordinary Americans to get ahead. The new view saw any government intervention in the economy as a severe violation of freedom and argued that government should stand aside and let business do its job. Lincoln stressed the universality of the American promise—prosperity and bet-