

Raising Our Game

A National Competition Strategy

by *Edward Gresser, Paul Weinstein, Jr., and Will Marshall*

America has been the world's leading economic power for a century: the largest and most innovative economy; the world's laboratory, the world's workshop, and the world's market. So long has the United States been on top, in fact, that many Americans take economic preeminence for granted. They should not—because the country is now facing a challenge to its leadership as profound as any in its history.

Whether you call it globalization, the information age, the post-industrial economy, or a "flat world," the new regime is radically changing the terms of economic competition. Powerful new competitors are quickly rising—and the costs of weaknesses and flaws in U.S. policy are being magnified.

At such a moment, the nation needs wise public policies that encourage entrepreneurship, innovation, and smooth adjustment for workers. Yet in place of such policies the Bush administration offers financial vandalism, mismanagement of science (even denigration of it), small-bore trade policies, and indifference to the stress of change.

Most striking is the absence of a coherent White House plan for enhancing America's ability to win under the new rules of global competition. U.S. presidents are required by law to develop a National Security Strategy to guide the nation's defense and foreign policies. Yet the nation's leaders are not required to devise a strategy for sustaining

America's economic strength. This makes no sense because a dynamic, growing economy is the foundation on which America's high living standards, military power, and global influence rest.

Congress, therefore, should require the White House to produce regularly a comprehensive National Competition Strategy to help Americans compete in world markets. While the main burden of meeting this competitive challenge will fall on America's firms and workers, government must play a strategic role in identifying and strengthening the country's new sources of comparative advantage.

In this paper, the Progressive Policy Institute offers a template for such a National Competition Strategy. It aims to achieve four broad goals: regain America's lead in innovation; strengthen the world trading system; create a new compact for worker security; and restore the nation's financial health.

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“One person with a belief is a social power equal to ninety-nine who have only interests.”

—John Stuart Mill

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The New Global Challenge

America now faces what Thomas Friedman, in his book *The World is Flat*, calls “globalization on steroids”—a quickening pace of global integration, driven by information technology and economic reform, that is blurring national boundaries and “flattening” the global economic playing field. The PPI has been studying the phenomenon, too. Consider these developments:

In East Asia, an informal “Asian Union” is growing as the end of Cold War hostility between China and its neighbors, and the opening of China’s economy to the world, merges China’s low cost manpower reserves with the financial and technological strength of Japan, Korea, Taiwan, Hong Kong and Southeast Asia. The result, where we once competed with a series of sophisticated smaller economies, is a single Asian economy of \$12 trillion—easily comparable to the GDP of the United States—as well as deep pools of capital, abundant scientific talent, and some of the world’s most efficient trade infrastructure.¹

India, meanwhile, is using the deployment of a global fiber-optic cable network, hundreds of communications satellites, a rapidly growing economy, an educated, English-speaking middle class, and a talented worldwide Diaspora to find its own niche in high-tech industry, services, and sophisticated research; India’s major IT firms are growing at a rate of over 40 percent per year.

Asia’s giants—benefiting from policy reforms, their people’s propensities for education and savings, and unchallenged mercantilist trade and financial policies—are thus quickly evolving beyond manufacturing assembly and back-office centers to become creative economies in their own right.

The pressure from abroad coincides with unwelcome developments in the U.S. economy. Since the end of the 2001-2002 recession, reasonably strong growth, falling unemployment, and rising productivity have gone together with stagnant and sometimes declining wages. The benefits of growth, therefore, have gone principally to those already comfortable; and the risks of the new economy fall mainly on those who are not.

In daily headlines, Americans see flagship companies go under and traditional sources of security—pension systems, unions, and adjustment programs—begin to buckle, while new and old competitive rivals capitalize on America’s lackluster market-opening and trade-enforcement efforts to bend the rules of trade. It is no wonder that public anxieties are high.

But Americans need not, and should not, respond with fear and pessimism. This is the temptation to which many on the left are yielding, by turning inward and looking backward. There is a great irony here. Globalization is the outgrowth of the success of good U.S. policies dating back to World War II—policies crafted for the most part by Democrats. It has been shaped powerfully by Europe’s post-war recovery and integration, the spread of market democracy in the Far East, the collapse of socialism, the open trade policies of the 1990s, the exponentially growing power of information technology, and the spread of high-speed Internet, a quintessentially American invention. Americans are living in a world this country has made—and benefit from higher living standards, low unemployment, and steady, almost inflation-free growth—yet many progressives seem to be having second thoughts.

The truth is that America has most of the things it needs to meet the challenge. It has the world’s best universities, the deepest pools of capital, the intellectual property laws, and environmental quality of life to attract high-quality investment. All over the country, therefore, businesses and workers are struggling to make the shift—and in the main, doing so inventively and successfully.

What the country lacks is good national policy. The Bush administration has not only failed to match the efforts of workers and businesses, but often actually undermined them. In a brief five years it has broken the country’s public finances, driven cutting-edge

scientific research abroad, mishandled trade and financial engagement with the world, and refused to give workers the tools they need for a more demanding world. The result, for good reason, is tremendous anxiety and stress

The PPI offers a different approach, rejecting both conservative complacency on one side and economic pessimism and protectionism on the other. We propose a clear recognition of the challenge and a vigorous response; America must raise its game, as it did under John F. Kennedy after the Sputnik launch and as it did again under Bill Clinton when the pace of globalization began to quicken in the 1990s. What is needed now is a National Competition Strategy designed to ensure that, measured against all other economies, the United States remains the most innovative, most productive, most able to create high-value added jobs, and best suited to lead the world. Such a strategy should entail at least four fundamental sets of reforms:

- ❑ **Put innovation first.** Refocus national tax, regulatory, and investment policies to encourage research, innovation, investment, productivity, and enhanced education and skill development.
- ❑ **Strengthen the world trade system.** Launch an ambitious program of trade negotiations and financial reform to reduce the global trade and financial imbalances, open markets more rapidly, and enforce agreements more effectively.
- ❑ **Establish a new compact for worker security.** Reshape unemployment insurance, job training, and other national programs to give all workers the training, job placement, and transitional supports they need to build successful careers as the economy changes.

❑ **Restore fiscal sanity in Washington.**

Regain control of national finances through tough measures to eliminate spending, raise revenue, reduce public borrowing, and spur private savings.

The Administration's Inadequate Response

Late in the day, aware of the public's justified unhappiness, the Bush administration has proposed a so-called "American Competitiveness Initiative."² At first glance, it seems a step in the right direction. But closer examination finds it more like a man sheepishly shuffling his feet while standing in place, or even moving slowly backward.

To begin with, this initiative comes in the larger context of a decidedly retrograde economic agenda—a revival of supply-side policies that were misguided in the past, and are all the more so today. Indeed, the administration and its Republican allies in Congress seem bent on establishing a new politics of conservative redistribution—transferring wealth from working and middle-class families to the affluent and favor-seeking corporations. As in the Gilded Age, today's conservatives have put government squarely on the side of entrenched wealth and unearned privileged. And as in the 1980s, the justification for it has ostensibly been to free up capital and thus spur job-creating entrepreneurship and investment. But it's a one-note song; little thought has been given to any other economic input. Indeed, all other thoughts have been practically forbidden. A glaring example of this has been the administration's pervasive hostility to science—including the muzzling of government scientists by a 24-year-old political appointee, and a ban on stem cell research—which has helped drive research and innovation abroad.

Even apart from this context, the American Competitiveness Initiative is wholly inadequate. It calls for a 10-year, \$136 billion expansion

of support for research and development. But almost two-thirds of this, or \$86 billion, goes to making the Research and Experimentation Tax Credit permanent—a meritorious proposal as far as it goes, but not exactly a bold one, since Congress has consistently renewed the credit for the past 20 years and was likely to continue doing so. A proposed \$50-billion commitment to funding the physical sciences over 10 years also seems an important step forward, but is again less impressive under careful scrutiny: The president's proposed 2007 budget actually cuts federal basic and applied research by 3.4 percent, after two years of decline; it calls for the elimination of NIST's Advanced Technology Program and large cuts in the Manufacturing Extension Partnership; it cuts basic and applied research in the Defense Department by \$867 million; it even cuts the budget for the National Nanotechnology Initiative, a physical sciences project, by 2 percent. Finally, a proposal for investing \$380 million in new federal support to improve the quality of math, science, and technological education in K-12 schools comes in the context of an overall \$2.1 billion cut in the Department of Education budget.

The administration's response has been inadequate in part because Republican fiscal profligacy has saddled the federal government with crippling debts, which are already blocking expanded public investments in science and technology, education, and skills. Moreover, the growing national debt means that America is turning to foreigners, especially foreign governments, to finance its government. That is leading to a much stronger dollar—and a much higher trade deficit—than would otherwise be the case.

A New Progressive Strategy

America deserves better—and in the past it has done better. From the Founders' day through the 20th century, progressives have offered successful models and lasting

principles that can shape a response to the modern challenge.

As early as the 1790s, Alexander Hamilton was suggesting productivity and technology—patent laws, rewards for innovators, use of labor-saving machinery—as answers for low-wage manufacturing competition. In response to the challenges of Sputnik and European integration, John F. Kennedy offered federal support for education, investment in scientific research, and an ambitious trade negotiating program. In the 1980s, in the face of a growing competitive threat from Japan and other nations, America's leaders forged a bipartisan consensus and acted to put in place a host of policies and programs to boost U.S. economic competitiveness—from the Research and Development Tax Credit (later renamed the Research and Experimentation Tax Credit), to the 1984 Cooperative Research and Development Act and the 1989 Omnibus Trade and Competitiveness Act, to the budget reforms of 1993 and the market-opening trade agreements of the 1990s. Today's challenges require an agenda of equal ambition.

1. Put Innovation First

Innovation is a prime source of U.S. comparative advantage in today's global competition. Yet the United States is losing ground in technological innovation and scientific research and has been playing catch-up in the deployment of "fat" broadband technologies as later adopters in Asia and northern Europe have raced ahead. Bush administration trade policy has, meanwhile, focused on small trade agreements with small countries rather than enforcing major existing agreements and opening the big markets to U.S. goods and services. Instead of strengthening programs to help workers cope with a dynamic economy, the administration has weakened them and left workers to stand—and often fall—on their own. Fiscal policy has rewarded wealth, at the expense of financial

stability and growth.

Over a longer period, the federal government has stepped away from its role as the underwriter of broadly beneficial research. America spends 2.5 percent of GDP annually on research and development (R&D) and thus ranks sixth or seventh in the world. But with the exception of life sciences and defense, funding for research has steadily declined relative to GDP since the 1970s, with a particularly steep fall—from 0.33 percent of GDP to 0.21 percent—in support for physical sciences such as chemistry, physics, engineering and computer science. If America is to regain its lead in the innovation economy, the federal government must step forward to partner with the private sector in making investments that the economy needs but the private sector cannot afford on its own.

Foreign competitors are not waiting for America to shape up. Their increasing sophistication is evident in the growing share of patents issued in the United States to foreign companies: forty-seven percent of total patents issued in 2004 went to foreign firms and individuals, a higher proportion than any in the 170 years of Patent Office records.³

The right policy response to all of this is a return to basics, including steps to spur a research-intensive economy and foster a new generation of excellent young scientists and engineers.

Spur a Research-Intensive Economy

There are a number of ways that government can stimulate innovation in the U.S. economy. It can, for example, create powerful tax incentives to encourage new scientific and technological breakthroughs, and it can help bring together industry and academia so that new developments can be readily commercialized. Here are two such proposals:

□ Create a “Super” Research and Experimentation Tax Credit.

The Research and Experimentation Tax Credit (RETIC) has stimulated billions in incremental spending by U.S. companies on research and development, which in turn has increased the pace of innovation, raised productivity, and added to economic and job growth. The Bureau of Labor Statistics has estimated that every dollar of tax benefit has spurred an additional dollar in private research and development.⁴ Smaller companies, in particular, rely on the RETIC to undertake groundbreaking research. They are the sparkplugs in an innovation-driven economy: Companies with revenues less than \$100 million are responsible for a disproportionate share of all new technology research and experimentation. The fruit of that labor is shared widely as new technologies and other developments revolutionize everything from telecommunications to medicine, creating economic activity and jobs in the process.

Congress has extended the RETIC 11 times since it was created in 1981, but the extensions have always been temporary, and on several occasions the credit has been allowed to lapse. For companies investing in risky research and experimentation, this unpredictability has caused tax-compliance problems and made long-term planning unnecessarily difficult. In that narrow respect, the administration’s proposal to make the credit permanent is sensible—but only modestly so. Given its proven track record of producing tangible economic benefits, it is time to not only make the RETIC permanent, as the administration has proposed, but to go further by dramatically expanding the credit.

Earlier this year, a bipartisan coalition of senators led by Jeff Bingaman (D-N.M.), Pete Domenici (R-N.M.), Barbara Mikulski (D-Md.), and Lamar Alexander (R-Tenn.) introduced the Protecting America’s Competitive Edge Act

(PACE), which would not only make the RETIC permanent, but also double it (from 20 percent to 40 percent of qualifying R&D expenditures) and allow all research expenditures to qualify when the research is conducted by consortia or small businesses, or when the research is conducted in federal laboratories or universities. (Under current law, all expenditures associated with energy research qualify for the credit, but only some expenditures associated with other types of research qualify.)

We believe Congress should adopt the changes to the RETIC proposed in the PACE bill. While expensive (making the RETIC permanent will cost \$27 billion over the next five years), these measures are an important investment in America’s economy that will pay real dividends in the long run.

□ Create a network of university-based venture capital funds.

New ideas are the key to economic growth and job creation. Unfortunately, new ideas can also die in the lab or an entrepreneur’s basement—or migrate elsewhere—if researchers and inventors do not have access to capital and credit.

To spur economic development and help create the jobs of the future, policymakers in Washington should follow Michigan’s lead and create a network of regionally focused, university-based venture capital funds that finance loans for startup companies trying to commercializing new scientific and technological advancements.

The University of Michigan at Ann Arbor’s Wolverine Venture Fund (WVF) has been making strategic investments in those kinds of early-stage, technology-oriented companies since its inception in 1997. Investing primarily in companies affiliated with the university, WVF has helped vastly improve the relationship between the university and the surrounding business community.

To promote effective entrepreneurship, the WVF is run as a collaborative effort between the private sector and the university's faculty and students. Here is how it works: When a local entrepreneur submits a funding request, the largely student-run WVF creates an investment proposal that must be defended before an advisory board comprised of seasoned professionals in the venture capital market. With the board's approval, WVF invests in the company, giving funds—typically totaling between \$50,000 and \$200,000—for seed and first round expenditures in the project.

Among the most noteworthy aspects of WVF is its innovative funding method. "Seeded" with a one-time University of Michigan endowment, the proceeds of the fund funnel directly back into its own reserves. Alternative methods of funding could include low-interest loans to be paid off by the royalties of the fund, or contributions made by alumni or private-sector sources, with government matching funds.

To spur the creation of new university venture funds, the federal government should provide seed money to be matched by state governments, universities, and the private sector. The federal investment could be relatively small, approximately \$50 million per year, but could over time leverage billions of dollars in investments in new technologies that will help drive economic growth.

Foster a New Generation of Scientists and Engineers

Increasing the technical skills of future generations of American workers is critical to future economic growth. But in the last three decades, the United States has plummeted from number 3 to number 17 in global rankings of countries with college students earning science and engineering degrees.⁵ Moreover, fewer foreign students—now an important source of S&E graduates—are coming to the United States for their degrees, and fewer are staying

here after they graduate.⁶ To reverse these trends, policymakers should:

❑ *Fund a national network of 250 science and technology public charter academies.*

Unless more students enter college with an interest in and aptitude for science and engineering, it will be difficult to significantly boost America's pool of science and engineering talent. To expand the pipeline into higher education for homegrown scientific talent, we propose the creation of 250 new public charter high schools focused specifically on math, science, engineering, and computing. In keeping with the experience of existing charter schools, a significant share of these academies should be focused on serving disadvantaged youths.⁷ The academies can be modeled on schools like the nationally renowned Thomas Jefferson High School for Science and Technology in Alexandria, Va..⁸ Congress should provide the Department of Education, which already supports charter school innovations around the country, with a new stream of funding for these new science and tech-oriented schools.

❑ *Streamline visa checks for universities.*

Efforts to improve American graduation rates in science will take years to pay off. In the meantime, America must be able to recruit the best international science and engineering talent. According to the National Science Foundation, a fifth of all science and engineering graduates working in the United States—and over a third of doctorate holders—are foreign-born. Examples include 57 percent of PhDs in computer science and electrical engineering; 52 percent of PhDs in mechanical and chemical engineering; 37 percent in chemistry and biology; 43 percent in mathematics; and 40 percent in

physics and astronomy. The talent of these foreign-born workers helped spur growth and competitive success in the 1980s and 1990s.

But the lengthy checks on student visa applications instituted on national-security grounds in 2002, though understandable as a reaction to the trauma of 9/11, have had an unexpected and corrosive effect. Foreign-student enrollment dropped in both the 2003-2004 and 2004-2005 academic years, as lengthy delays in the visa application process blocked enrollment for thousands of Asian and other foreign applicants who should have been granted admittance. The NSF says new science and engineering enrollment fell by more than 10 percent in these two years, with the sharpest drops in new computer science and engineering enrollment. Lengthy visa checks need to be streamlined, focused on the small number of people who raise actual national security concerns, and sped up in other cases to ensure that America does not lose access to the next generation of computer scientists, mathematicians, and engineers it needs to retain its status as the world's most innovative economy.

2. Strengthen the World Trading System

America needs to take full advantage of the global economy once again, not only as a consumer of low-cost imports, but as an exporter and provider of goods and services. This in turn requires a revitalized, focused, and serious global economic policy that reduces U.S. and global trade and financial imbalances, protects American rights and the integrity of the global trading system, and opens major markets to American manufactured goods, farm products, and services.

Restore Stable U.S. and World Finances

The growth of America's trade and current account deficits has little if any precedent in modern economic history. Now at 6 percent of GDP, these deficits are certainly higher than any America has run before, and probably higher than those of any leading economy in modern history. Though they have coexisted with slowly returning job growth and manufacturing production increases, they present threats to financial stability, guarantee a long-term buildup of debt, and also, of course, affect the broad willingness of the American public and Congress to support a liberal trade order.

Restoring stability and balance will require policymakers to address two separate problems. One is home grown, and the second is the result of the policies of foreign governments:

The home-grown problem is the de facto import-led growth strategy pursued by the administration through the tax bills of 2001 and 2003. These bills have converted a government surplus that was 2 percent of GDP to a deficit that is 3 percent of GDP. Together with falling household savings, the result has been to cut U.S. gross savings to 13.5 percent of GDP—a lower rate than at any time since the Great Depression. The figure compares to savings rates of 20 percent or more of GDP in Europe and Latin America, and 30 percent to 40 percent of GDP in East Asia. The resulting high fiscal deficits, combined with the exceptionally low interest rates adopted to spark growth during the 2001 recession, have boosted consumption, cut savings, limited the natural market decline of the dollar, contributed to the boom in imports, and depressed exports.

The overseas problem is the determination of a number of Asian countries to support growth through exports, and exports through deliberate currency policies—in violation of

international trade laws. Specifically, under rules established by the International Monetary Fund, each member country has agreed to “avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.”⁹ An unnaturally low pegging of the Chinese yuan, and heavy intervention in currency markets by the Japanese and Korean governments, have prevented their currency rates from increasing in response to their large trade surpluses. The question of whether this is technically “manipulation” of currency—the central controversy surrounding the Treasury Department’s most recent semi-annual currency report¹⁰—is an unnecessarily legalistic and semantic one. The more basic issue which policy must address is the distortion of trade and investment flows such policies create, the widening of imbalances and rising financial risks, and the appropriate reforms in response.

Should either or both of these problems continue to fester, it is likely that all the major economies will be more vulnerable to financial shocks and sharp recessions, protectionist pressures will grow, and debt will rise. But a solution is possible:

❑ ***Forge an “Asian Plaza Accord” to address trade and financial imbalances.***

This should include significant measures by the United States to raise national savings rates, especially—but not only—through reduction of federal budget deficits; commitments by the Chinese and other Asian governments to revalue their currencies, combined with commitments not to intervene in currency markets in order to influence exports; and measures to restore growth in Japan and Europe. China’s modest revaluation of the yuan in mid-2005 is so far only a small step toward the reform necessary to begin rebalancing trade and capital flows.

The Bush administration’s tax and spending policies, meanwhile, weaken our ability to secure reform abroad by demonstrating a lack of commitment to reform in the United States. Both governments must do much better. As a longer-term measure, the G8 should be broadened to include additional Asian nations with global financial influence, notably China. If foreign partners will not agree, America should continue to address its own financial imbalances, and explore options for addressing foreign currency policies through the rules and dispute settlement options of the WTO or IMF.

Open World Markets and Enforce Trade Agreements

An open trade policy helps the United States ensure that low unemployment coexists with low inflation. But as the country has put up its worst export record in more than two decades and intellectual property theft has spread, public skepticism about an open international market and liberal trade order has grown.

In each of President Clinton’s two terms, U.S. exports grew by over \$200 billion, accounting for one-third of America’s growth in the 1990s. Since then, export expansion has come to a halt as efforts to open foreign markets have declined, and industry analysis finds losses to copyright piracy nearly doubling since 2000. Meanwhile, the United States has concluded no multilateral agreement on a major area of U.S. commercial interest since 1997, and reached no significant bilateral agreement with any of our top seven trading partners since the turn of the 21st century. Even efforts to enforce existing WTO agreements have flagged, with the Bush administration filing an average of two WTO cases per year as compared to the Clinton administration’s 10.

In the next five years, the U.S. government must do better on both enforcement and market-opening counts.

With respect to enforcement, the next administration must rededicate itself to defending American rights in the global trading system. The dispute settlement mechanisms the United States fought to create 10 years ago are critical to address overseas trade abuses ranging from Europe's Airbus launch aid to failures of Chinese implementation of WTO commitments—for example, those on copyright and patent protection, or discrimination in telecommunications and other services industries—and similar policies of major partners such as Brazil, India, Japan, and others. As Sen. Max Baucus (D-Mont.) has suggested, the next president should appoint an ambassador-level trade prosecutor, who would work under the U.S. trade representative to give enforcement the priority it deserves.

Simultaneously, a new approach must include a strong effort to open markets, with less reliance on small bilateral trade agreements and more on strategic initiatives dealing with major markets and the world as a whole. Three initiatives in particular should be priorities:

- ❑ The WTO's Doha round needs to move faster. The American government needs to push it beyond the current focus on agricultural subsidy issues to tariff and non-tariff barriers to foreign markets—with a special focus on the large middle-income countries such as India, Brazil, and China—as well as services trade, discriminatory tax and regulatory policies, and other issues.
- ❑ America needs to match China's ambitious new trade agenda in Asia, building upon the recent launch of free trade agreement talks with Korea to consider a similar initiative with Japan and the major ASEAN markets. These are major markets with considerable trade barriers and governments seeking to balance China's rise. They are likely to prove more willing partners than they were in the past.

- ❑ America's western hemisphere trade diplomacy needs to be revived. Integration among the hemispheric democracies is a chance to raise exports, and, on a larger scale, a way to meet the Asian challenge by merging the different strengths of the democracies of the Americas—just as China is using its market-opening and regional trade initiatives to take advantage of the strengths of Korea, Japan, Taiwan, Hong Kong, and Singapore.¹¹ But as the acrimonious end of the 2005 Summit of the Americas in Argentina showed, the hemisphere is far more divided today than it was five or 10 years ago. The United States needs to restore its own leadership—and arrest the drift toward populist authoritarianism in much of South America—through an ambitious program to unite our piecemeal free trade agreements, boost exports by ending the embargo on Cuba, and help reestablish the vision of shared values, mutual benefit, and common destiny inherent in the Free Trade Area of the Americas.

3. Establish a New Compact for Worker Security

Entrepreneurship, innovation, and global trade are vital ingredients of a comprehensive National Competition Strategy. But they are also disruptive. They create and destroy firms and jobs at a more rapid clip than in the pre-global era, making labor markets more volatile, too. They undermine arrangements between government, unions, and companies that have been designed to promote economic security for working families—like “defined benefit” pensions, rigid work rules, and employer-paid health care. In fact, the old, industrial-era “safety net” is unraveling under pressure from fierce global competition, resulting in a massive shift of economic risk to individual workers. This helps to explain

why Americans seem to be so worried about their own economic prospects even as the nation's economy grows briskly and corporations reap big profits.

Unlike the Bush administration, progressives grasp the essential paradox of global competition: The more powerful global markets become, the more governments must lean against the disruptions and inequities that inevitably accompany fast economic change. To sustain public support for a dynamic, entrepreneurial economy, government needs to offer working families new tools for managing economic risk. In short, America needs to replace the old safety net with a new contract for worker security—a set of policies aimed at enabling workers to enhance their skills and social mobility; rebound from job and financial losses; control health care, pensions, and other critical sources of economic security; and acquire capital assets.

Here are some steps government should take to begin forging a new social contract for the age of global competition:

Create a new economy scholarship program.

Current efforts to help laid-off workers boost their skills are inadequate to the need. As a result, we need to create a scholarship program to help dislocated workers make the transition to reemployment. Such a program should make access to training and outplacement services for dislocated workers who are collecting unemployment insurance as universally available as access to college. It should provide dislocated workers with a scholarships worth up to \$4,000. Moreover, it should allow people seeking retraining or reemployment assistance to apply for aid directly from certified training providers, rather than through government entities. To protect workers, service providers should be certified and required to report results to an annual

report card that identifies the best lifelong learning programs. Funds currently spent on a number of existing training and job search assistance programs for dislocated workers can be transferred to this program.¹²

Modernize the trade adjustment and unemployment insurance systems.

Unemployment insurance (UI) is an industrial era program that is in dire need of reform and modernization to make it work in the New Economy. While approximately one-half of all unemployed workers received UI benefits in the 1950s, today approximately one-third do. As a result, UI now plays a diminished counter-cyclical role in helping to moderate recessions and reduces the safety net for workers. Trade Adjustment Assistance, too, is outdated at a time when Internet-based services competition is making swathes of the services economy internationally competitive. Former Federal Reserve Governor Alan Blinder, for example, suggests that the Internet may mean as many as 30 million services workers are exporting and competing against foreign producers—twice as many as America's 15 million manufacturing and resource workers combined. It is time, therefore, to reform the UI system so that it: 1) gives workers the right incentives to get back to work, but also provides them with adequate benefits, such as health and training benefits equal to those available through TAA, when they lose their job; 2) recognizes that all employees who lose their job through no fault of their own should be eligible for UI, even if they have only been working a short time or are making low wages; 3) makes UI a trampoline, not just a safety net, by ensuring that when workers collect UI benefits they can meaningfully upgrade their skills, and 4) recognizes the advantages of state-administered programs but provides a federal floor above which all states must operate.¹³

Provide transitional health insurance benefits for all unemployed workers.

One of the scariest things about losing a job is the risk of losing health insurance coverage. In fact, over one-half of the 3.5 million workers receiving unemployment benefits every year are likely to need transitional health coverage because they do not have coverage through a spouse or other outside source. Indeed, 46 percent of unemployed workers lose their health insurance.¹⁴ This is one reason why in 2002 Congress created a 65 percent refundable and advanceable tax credit for dislocated workers eligible for Trade Adjustment Assistance benefits.¹⁵ The credit is designed to help all workers collecting unemployment insurance purchase health coverage, either through COBRA continuing coverage from ex-employers, a purchasing pool or other state-sponsored health plan, or individually. The program does not cover all UI-eligible workers, however, and even among eligible workers the take-up rate for the program remains quite low.¹⁶ Fixing the program will require streamlined eligibility procedures, more prompt payments of the tax credits, and incentives and penalties to states to boost enrollment among eligible workers.¹⁷ Most importantly, the program should be expanded to cover all workers collecting unemployment insurance, letting workers file one form with the UI office.¹⁸ Transitional health benefits are an important step toward the ultimate goal of a distinctly American approach to universal health care—a bottom-up system of shared responsibility that uses tax incentives, individual mandates, subsidies for low-income Americans, and purchasing pools to ensure that everyone can get basic health care coverage.¹⁹

Create a universal pension system for all Americans.

As workers shift jobs more rapidly, and as companies move away from defined benefit retirement plans, a growing number of

Americans are worried about retirement security. It is time to overhaul the current system to let workers decide how much they can save (up to some uniform limit), give workers greater control over their investment choices, and consolidate the alphabet soup of retirement account provisions in the tax code into a single, portable Universal Pension. Over the past 30 years, Congress has created 16 separate savings provisions—roughly one per Congress. Yet during that same period, the national savings rate has plummeted from an annual rate of approximately 10 percent nearly into negative territory. It is time to start over with a simple, clear approach, as PPI recommended in its 2002 report, “Universal Pensions: A Commonsense Approach to Retirement Security in the New Economy.”²⁰

4. Restore Financial Responsibility in Washington

The relationship between deficits, interest rates, and economic growth has long been understood to operate according to a basic economic axiom. It is, as Greg Mankiw, President George W. Bush’s second chairman of the Council of Economic Advisers (CEA), described in his 1998 textbook *Principles of Economics*: “When the government reduces national saving by running a budget deficit, the interest rate rises, and investment falls.”²¹ The idea was so widely accepted by economists on the right and the left as recently as the end of the 1990s that it helped create the bipartisan consensus to eliminate the deficit during the Clinton administration.

But in recent years, as economist Gene Sperling notes, “the political landscape has been turned upside down,” with conservatives having walked away from the discipline of “pay-as-you-go” budgeting.²² As a result, since President Bush entered office, he and the Republican led-Congress have added more than \$3 trillion to the total U.S. debt.

Fiscal discipline is integral to competitiveness. Balanced budgets can help keep long-term interest rates down, and thus encourage private investment, but fiscal responsibility plays another important role in competitiveness. By raising national savings, it can help ensure that the United States is able to finance its own growth rather than relying on overseas borrowing. This would reduce the upward pressure on the dollar and help keep trade and current accounts, as well as international financial markets, in balance.

Despite Republican spin efforts to disconnect the impact of deficits on interest rates and the economy, the facts show the opposite. In 2002, Brookings Institution economists Peter Orszag and William Gale reviewed all the available academic studies on the subject, and showed that 16 out of 17 found a connection between interest rates and deficits.

Because of the relationship between interest rates and deficits, the cornerstone of any competitiveness strategy must be to put into place a plan to restore fiscal discipline. An immediate course of action should include the following measures:

Cut the Bush budget deficit by \$2 trillion over 10 years.

America needs a balanced approach to restoring fiscal responsibility. It should include spending reductions, budget reforms, and sensible revenue increases. Policymakers should start by rolling back the Bush tax giveaways to families earning more than \$200,000 a year and reinstating the inheritance tax, with a higher exemption for family farms or small businesses. These steps would save roughly \$550 billion over the next 10 years while shifting the tax burden back from middle-class families to the wealthy. In addition, as previous PPI reports have shown, targeted spending cuts, tougher budget enforcement rules, and tax reforms can add additional savings of nearly \$1.5 trillion.²³

Another key to fixing the federal budget mess is entitlement reform. With the baby boom headed into its golden years, the nation was already facing a fiscal tsunami of retirement costs before the Bush administration's fiscal policies made matters worse by all but bankrupting the government. While Democrats were right to question the merits and the phony accounting of Bush's Social Security plan, they need more than a "just say no" approach to entitlement reform in general.

Democrats have rightly called for reversing significant portions of the administration's tax giveaways. But a credible deficit reduction plan must also leave entitlement reform on the table. One place to start—as Bob Greenstein and Peter Orszag have suggested—is to adopt the Bureau of Labor Statistics "superlative" Consumer Price Index. It measures inflation more accurately than the traditional Consumer Price Index, and could thus save tens of billions of dollars a year. That would go a long way toward shoring up the financial foundations of Social Security, Medicare, and Medicaid for the future.

Institute budget process reforms.

In addition to specific cuts in spending and tax reforms, Congress needs to restore tough budget process controls that have been abandoned in recent years, and add new measures, too. To keep appropriations in line, the full package of reforms should include: "pay-as-you-go" rules that effectively constrained spending and tax cuts in the 1990s; "present value accounting" to accurately calculate the full cost of legislation; a supermajority vote requirement for emergency spending and tax breaks for special interests; a constitutionally valid line-item veto; a "rainy day fund" to hedge against economic downturns; and a rule that gives Congressional budget resolutions the force of law.²⁴

Conclusion

America is at a critical point in its economic history. As new powers rise in the world, and as the Internet both creates opportunities and brings competition to new fields, the country's past performance is no guarantee of future success. So far, facing a profound challenge, the federal government has offered a deeply flawed response.

Shifts in policy—large, but manageable—can make sure that in this new world economy, government policy supports

rather than hinders workers and businesses as they adjust and raise their game. As policy changes, the ingenuity and work ethic of the American people can once again ensure the world's highest standard of living for American families and preserve America's role as the world's paramount source of new industries, new products, and new ideas.

At each juncture in the 20th century, progressives from Wilson and Roosevelt to Kennedy and Clinton, accepted challenges of comparable scale and complexity. Each time they rose to the occasion. In the 21st century, Americans should expect no less.

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