

# Public Investment Works

*Since 1993, balanced budgets have been liberals' holy grail.  
It's time to reconsider.*

**A**n important debate over fiscal policy is beginning to take place within the Democratic Party. For the past 15 years, deficit hawks within the party have argued that addressing America's fiscal challenges should take priority over our public investment needs, suggesting that, in effect, we cannot afford to increase public investment until we have reduced the federal deficit.

But there is an alternate view, holding that the deficit hawk position neither accurately reflects America's true economic strength nor represents good policy in light of the very significant changes that have occurred in the economy over the past decade and a half. In fact, the nature of the American economy today

---

BERNARD SCHWARTZ *is chairman and CEO of BLS Investments, the chairman of Third Way, and the retired chairman and CEO of Loral Space & Communications.* SHERLE SCHWENNINGER *is director of the Global Economic Policy Program at the New America Foundation and a senior fellow at the World Policy Institute at the New School.*

is radically different than it was in the early 1990s, when the current notion of fiscal responsibility took shape. Over the past decade and a half, the economy has become more globalized, knowledge-based, and wealth-driven. Behind this transformation have been major structural developments in the world economy, most notably the increased integration of the world's financial markets; the dramatic improvement in productivity growth associated with the information-technology revolution; and the expanded supply of labor, savings, and productive capacity that has resulted from the integration of China, India, and the former Soviet Union. Together, these developments allow the American economy to grow more rapidly with lower wage and goods inflation than was possible in the supply-constrained, slower-growth period of the early 1990s.

Deficit hawks seem not to have fully incorporated these changes into their understanding of the U.S. economy, nor have they changed the way they measure the economy's output to reflect the increased importance and value of wealth and intangibles. As a result, they underestimate the capacity of the economy. Misjudging the economy's potential, much like misunderstanding the economy's challenges, can lead not only to bad policy choices but also to missed opportunities for policy reforms that would help ensure future economic prosperity. This is the case today when it comes to the question of public investment in our physical and innovation infrastructure.

Contrary to the opinion of the deficit hawks, the United States can comfortably afford a robust public-investment program without first reducing the deficit. Indeed, given excess global savings and historically low interest rates, increased spending on productive public investment is a fiscally responsible and effective way to put excess global savings to work to ensure future economic prosperity. It is also a proven way to stimulate private investment and job creation and, at the same time, distribute more widely the capital and skills for wealth creation, thus achieving a fairer and more balanced society with higher living standards for all Americans.

## **New Economic Realities**

The current conventional wisdom within the Democratic Party regarding deficit reduction is an outgrowth of the successful experience of the Clinton Administration. Faced with congressional opposition to its initial fiscal package, which included some added public investment spending, the Clinton White House opted for measures that would reduce the budget deficit in a bid to gain the cooperation of Federal Reserve Chairman Alan Greenspan to lower interest rates. No doubt the Clinton years produced outstanding results in terms of job creation, economic growth, and business investment. But how much the Administration's

measures to cut the deficit contributed to this economic performance is open to debate. Arguably, structural changes in the economy—such as improving productivity associated with the information revolution and the coming online of massive new production capacity in Asia—were more significant to the economy's performance than were any of the Administration's budget measures.

But even if one accepts that the budget deficit was a problem in the early 1990s and needed to be addressed, it does not follow that putting deficit reduction ahead of public investment is the correct policy today. Economic conditions are far different than they were in 1993, and what was appropriate 15 years ago is wholly inappropriate for 2008.

### **DEFICIT REDUCTION IS LESS IMPORTANT IN TODAY'S ECONOMY**

To start, the federal government has much more room to run deficits than it did 15 years ago, when the budget deficit stood at 4.7 percent of gross domestic product (GDP). By comparison, the 2006 budget deficit of 1.9 percent of GDP is relatively small, and it is projected to decline further to about 1.5 percent of GDP this year. Even with President Bush's tax cuts and the escalating cost of the war in Iraq, the deficit is below America's norm of 2.2 percent of GDP over the last 40 years. Likewise, the federal debt held by the public is below its average for the 20-year period since 1987 and lower than it was in 1993. Gross federal debt in 1993 was 49.4 percent of GDP; by 2006, it had fallen to 36.8 percent.

The current budget deficit and federal debt would be even lower if we properly accounted for national income and the increased importance of wealth and intangibles in today's economy. Business investment in intangibles, such as research and development, are critical to long-term profitability, but most economists don't count them as national output. Yet, according to an estimate by *BusinessWeek's* Michael Mandel, spending on unmeasured intangibles is almost as large as spending on physical capital and software. For the period 2000 to 2003, the annual average of investment in intangibles was \$978 billion, or almost 10 percent of GDP. In other words, if we properly accounted for intangibles, national output would be nearly 10 percent larger, and the budget deficit and federal debt would be proportionately smaller as a percentage of GDP.

The same problem of measurement affects how we view America's current account deficit. At first glance, the U.S. current account deficit, now running at 6.5 percent of GDP, may seem worrying. But as it is currently calculated, this measurement understates America's financial position. For one thing, it misses a big portion of the export of know-how and intellectual property that enable U.S. multinationals to reap high returns on their overseas investments and operations. Mandel estimates these hidden exports may be as high as \$100 billion a

year. Harvard economists Ricardo Hausmann and Federico Sturzenegger argue that they are even larger—large enough, in fact, to bring the U.S. trade deficit in balance. This argument gains further support from the fact that the United States has, until this past year, continued to enjoy net investment income in spite of its external debt.

Nor does the current account reflect the fact that a sizeable portion of U.S. imports are the products of American-owned and -controlled companies that operate worldwide. If those imports were accounted for in the trade figures, the U.S. current account would, again, be much smaller. The McKinsey Global Institute, for example, has calculated that trade with foreign affiliates accounted for one-third of the U.S. current account deficit in 2004. As it is, that unaccounted-for production generates well-paid jobs in U.S. corporate headquarters and shows up as increased profits, and thus as increased wealth. In other words, the current account deficit is less a reflection of a fatal weakness in America's financial position than it is of the fact that American-owned and -operated companies have expanded abroad more quickly than foreign companies have expanded in the United States. It may affect who is benefiting from the new global economy, but it does not portend a major financial crisis.

**Contrary to the deficit hawks, the United States can maintain a robust public-investment program without first reducing the deficit.**

A second reason to worry less about the budget deficit is that the economy's capacity to borrow has increased significantly, largely due to improved productivity growth. In the 1980s, productivity growth was a dismal 1.46 percent. But over the past decade and a half, technological advancements and communications innovations, along with efficiency revolutions in finance and materials, have substantially accelerated U.S. and world productivity expansion: U.S. productivity growth has jumped from an average of 1.53 percent for the period between 1973 and 1995 to 2.7 percent for the period from 1996 to 2006. World productivity has shown a similarly impressive increase, and this has helped tame inflation worldwide and increase the wealth and profitability of American companies operating globally.

Stronger productivity growth means stronger economic growth and lower inflation, which in turn makes it easier to run deficits yet still reduce the overall public debt burden. As long as the economy is growing faster than the budget deficit, as it has in the last two years, the federal debt as a percentage of GDP will decline. Thus, stronger productivity growth has helped give the federal

government room to run deficits to increase public investment and, if necessary, to counter an economic slowdown. (To be sure, productivity growth has slowed in the last three quarters, but some economists attribute this to a mid-cycle slowdown and expect it to pick up again as capital expenditures and economic growth increase.) Moreover, there are a number of reasons to expect further productivity gains from information technology as it diffuses more thoroughly throughout the economy, as workers gain greater competence in using it, as its cost continues to decline, and as its weight in the economy as a whole increases.

A third reason to accord deficit reduction a much lower priority is that there is less risk that increased public borrowing will crowd out private investment. In contrast to the early 1990s, the financial and corporate sectors are awash in capital and liquidity. Take, for example, corporate profits and balance sheets.

**The global savings explosion and the increased integration of world capital markets has altered the rules governing macroeconomic policy.**

Because of improved productivity growth and the introduction of more efficient business practices, corporate profits have increased significantly over the last decade and remain robust, at around 12 percent of GDP. As a result, private companies can more easily finance expansion than they could in the early 1990s. This, together with the

liquidity generated by the new international financial system, has significantly lowered the cost of capital for most businesses. In fact, many firms are sitting on too much cash to invest wisely, and so are using it to buy back stock. Under such circumstances, increased public investment and borrowing may in fact be useful to help “crowd in” private investment.

Similarly, the U.S. banking and financial system has undergone a sea change since the early 1990s, when banks faced serious capital constraints. America’s capital markets have become more efficient in the allocation of capital, more effective in monetizing wealth for additional investment and consumption, and more resilient in weathering financial crises relating to asset bubbles. A proliferation of new financial instruments—from derivatives to a variety of home-equity loans—allows both individuals and companies to tap previously illiquid assets for working capital and consumption, and private equity firms and hedge funds have added liquidity to the capital markets in new ways. These changes have created new risks, but overall they have effectively unlocked wealth that was previously unavailable for consumption and investment, enabling the financial system to provide lower cost capital to both government and businesses.

These changes are taking place against the backdrop of even more dramatic

shifts in the international financial system. The integration of China, India, and the former Soviet Union into the global economy has created what economists call positive supply-side shocks, resulting in surplus labor, capital, and productive capacity. Their entry into the world economy has doubled the global labor force in the course of a decade, raising the return on capital, lowering inflation pressures, and temporarily slowing wage growth. But even more important has been their influence on the availability of savings. The global stock of savings, as reflected in net capital outflows, has exploded in recent years—from \$691 billion in 2003 to more than \$1.3 trillion in 2006—creating what Federal Reserve Chairman Ben Bernanke has called a global savings glut. The greatest increase in savings has come from emerging Asia (excluding Japan), with China responsible for a large part of it. But the oil-exporting countries of the Persian Gulf and Russia have also increased their current-account surpluses as a result of rising oil prices. And at the same time that the stock of world savings has increased, the globalization of capital markets has unlocked national savings, creating a global pool of capital.

This combination of the global savings explosion and the increased integration of world capital markets has altered the rules governing macroeconomic policy in the United States. For one thing, it has allowed the United States to run larger current account deficits for longer periods than possible a decade ago. The United States may absorb nearly 70 percent of the world's excess savings, but as data from the International Monetary Fund shows, the pool of global savings has also grown rapidly. In fact, the United States has had no choice but to absorb much of the world's savings glut—in part because it is the only economy with capital markets wide and deep enough to absorb savings of this magnitude. Just as important, the increase in global savings has put downward pressure on interest rates nearly worldwide, especially in the United States. Analysts estimate that the flow of money from emerging economies to the United States has alone reduced long-term interest rates by 150 basis points. That helps explain why the real yields on U.S. long bonds, even after the recent increase in yields, are still hovering near the bottom of their 25-year range, and more than 100 basis points below their average in the late 1990s.

Deficit hawks acknowledge the favorable effects of global financial integration on U.S. interest rates, but they worry about a run on the dollar nonetheless. This worry, however, is misplaced given the problem of excess savings and the foreign reserve-currency reserve practices of large surplus countries. Indeed, there are good reasons to believe that excess global savings will remain the central condition of the international financial system for the foreseeable future. In the short to medium term, the weight of high-savings economies, such as China,

in the world economy will grow. China is forecast to become the world's second-largest economy within the next decade, followed by Japan and Germany, which are also high-savings societies. Likewise, demographic shifts will likely prop up savings for at least the next five years, as large generational cohorts in these societies reach their peak savings age before retirement. The McKinsey Global Institute estimates the current account surpluses of these economies will increase to \$2.1 trillion by 2012. In other words, the underlying source of global liquidity is not likely to disappear anytime soon.

There are also reasons to believe that the foreign reserve-currency practices of countries like China will not change enough to cause a real dollar crisis as opposed to the orderly decline in the dollar we have recently experienced. Surplus countries may want to diversify their foreign currency practices, but they still have to make sure the U.S. current account is well-funded, because their own growth depends on it and because they do not want their currencies to appreciate too much. They are thus unlikely to stop financing the U.S. current account deficit for any length of time, as our experience with Japan and other current account surplus countries over the last 20 years suggests. Moreover, there are few reserve-currency alternatives to the dollar other than the euro, and there is a limit to how much even the euro can appreciate before money starts flowing back into U.S.-denominated assets. As the Bank of International Settlements has pointed out, the total reserve accumulation by sovereign investors this year could easily exceed by 100 percent the net new issuance of all U.S. and Euro-zone sovereign and agency debt. In other words, as Terrence Keeley, managing director of Central Bank Services at UBS, has pointed out, "There is simply not enough new, high-quality debt in the world to sate sovereign demand."

#### **PUBLIC INVESTMENT: A MORE IMPORTANT POLICY PRIORITY**

While changes in the way the economy works have made it easier for the United States to finance both private and public borrowing at a lower cost, many of the same changes have made public investment more important. In a globalized economy, public investment has become more critical to creating good jobs, enabling American-based companies to compete with lower-wage economies, and ensuring the strength of our increasingly knowledge-based economy. Indeed, what should be America's most worrying deficit is not the budget deficit, but rather the deficit we have been slowly accumulating in public investment. As economist Jeff Madrick has noted, much of the economic growth of the past generation has depended on previous high levels of public investment in everything from transportation systems to high technology to high school and college education. Indeed, the productivity boom of the 1990s would not have

been possible without the earlier government investment in areas like telecommunications and computer development.

But we are now in danger of exhausting much of the public capital we created in earlier decades of healthy public investment spending. From 1950 to 1970, for example, we spent more than 3 percent of GDP on public infrastructure. Since 1980, we have spent less than 2 percent. As a result, we are beginning to experience the effects of a backlog of public investment needs. Not surprisingly, infrastructure bottlenecks—traffic-choked roads, clogged-up ports, an antiquated air transportation system—are undercutting our nation's efficiency and costing our economy billions in lost income and economic growth. The Department of Transportation reports, for example, that freight bottlenecks cost the American economy \$200 billion a year—the equivalent of more than 1.6 percent of GDP. And the 2005 report of the American Society of Civil Engineers offers an array

of other examples of underinvestment in infrastructure: 27.1 percent of our nation's bridges are structurally deficient or functionally obsolete, a fact that painfully came to the fore with this summer's bridge collapse in Minneapolis; most of our airports are not

equipped to accommodate the new super-jumbo jets scheduled for introduction later this decade or to handle the expected growth in small regional jets necessary for commerce in smaller business centers; and nearly 50 percent of the 257 locks operated by the U.S. Army Corps of Engineers are functionally obsolete. Perhaps most worrying, because of these and other problems, uncertainties about the future reliability of our energy, water, and transportation systems are beginning to impede investment in some parts of the United States.

The American economy also is being hurt by the fact that we are now lagging behind on the deployment of the infrastructure of the information age. The United States now ranks 16th in the world in broadband penetration, according to the International Telecommunications Union. Only 33 percent of U.S. households have access to broadband, which is increasingly critical for successful commercial and educational applications. And the costs of broadband in the United States are rising relative to those in other countries, putting American-based companies at a growing disadvantage. American consumers, for example, are forced to pay nearly twice as much as their Japanese counterparts for connections that are 20 times slower.

The fact that we have not kept up with the training of skilled workers, par-

**In an age of globalization, public investment is the best way to help American-based companies compete against lower-wage economies.**

ticularly scientists and engineers, is also beginning to create problems for the economy. The United States now graduates fewer engineers per capita than nearly all other advanced industrialized countries. American firms are beginning to complain about the shortage of skilled workers in some sectors of the economy, forcing them either to import the talent or rely more than they would like on offshore outsourcing. We have also underinvested in basic science and research and development. Such efforts make possible the technological breakthroughs that historically revolutionize the economy and the way we live, and they are responsible for the innovation from which American companies derive premium returns on capital. But research and development spending as a share of GDP has declined over the last two decades, caused by steady declines in the federal government's support for research and development. To date, these problems have had only a modest impact on our robust economy. But given the nature of today's global economy, the more we delay correcting this shortfall in public investment, the more vulnerable we will become to more serious problems in the future.

First, in an age of globalization, public investment is the best way to help American-based companies compete against lower-wage economies—which they now must do if we are to maintain the standard of living of American workers. Public investment allows the United States to pursue a “high road,” non-protectionist strategy toward international competition. By providing businesses with a better high-tech infrastructure, more skilled workers, and access to cheaper and cleaner energy, it lowers the cost of doing business and increases the efficiency of investment in the United States. Without more public investment, our choice is more protectionism or the loss of more good jobs.

Second, public investment is even more important in today's global economy because knowledge, wealth, and innovation contribute a far greater share to our national income than they did 15 to 20 years ago. Adequate public spending on research and development is especially important at a time when many private companies are cutting back to reduce costs and increase short-term profits. As noted earlier, to an unacceptable degree, we have been living off the investments of the past that helped seed our aerospace, computer, and biotech industries, and we will need to make comparable levels of public investment now to ensure future technological advancements that generate new wealth.

Finally, in an age in which there are limits to how much one can redistribute income through the tax code, public investment has become an even more essential tool of social policy. Today, a robust public investment program would help correct income inequality and wage stagnation by creating good jobs. A program to upgrade our transportation and communications infrastructure to

world standards and to lay the foundations for a new energy and water infrastructure for the twenty-first century would alone create millions of higher-skill jobs that would pay above median wages and could not be outsourced. This kind of public investment program would also help correct a labor market that has become overly weighted toward low-wage, low-skilled jobs, and it would be an important complement to the earned-income tax credit, which tends to subsidize low-wage occupations.

Too often, deficit hawks portray public investment as a financial burden. Instead it should be seen for what it is: an economic opportunity to create new middle-class jobs and stimulate new private investment in America's economic future. Indeed, the greatest benefit of a robust program of public investment would be its positive impact on the real productive economy and on future productivity growth.

### **Public Investment First**

Some proponents of a “deficit reduction first” strategy do acknowledge the importance of public investment to the American economy, but they nonetheless argue that it must wait until we have brought our fiscal deficit under control. This brings us to the core question of the debate: Which policy priority is most likely to contribute to a stronger economy in the long term? As should be apparent from our analysis, making a priority of cutting the deficit would do little to meet our most critical economic and social challenges, while contributing relatively little to our long-term financial health. Deficit hawks want to cut the deficit in order to reduce our external deficit and reduce the risk of a dollar crisis. But contrary to current conventional wisdom, cutting the budget deficit would not necessarily lead to a reduction in the current account deficit. As our experience of the last two decades shows, budget deficits do not closely correlate with current account deficits. In fact, the two often move in opposite directions: The budget deficit increased in the early 1990s as the current account deficit narrowed; and the current account deficit increased dramatically in the late 1990s as the budget deficit went into surplus.

Deficit hawks also want to cut the deficit in order to lower interest rates and prevent government borrowing from crowding out private investment. But lower interest rates would not do much to stimulate more investment when the cost of capital is already low by historical standards, or when companies are overflowing with cash and have ready access to relatively low-cost credit. In fact, in such an environment, cutting the budget deficit might lead to more speculation and asset bubbles rather than real investment, as happened in the late stages of the tech boom. And if deficit reduction does little to stimulate new private

investment, it also means it will do little to counter a possible housing-related slowdown, or create better jobs for working Americans, or strengthen America's underlying productive economy.

By contrast, public investment, beginning with a program to rebuild our public infrastructure, is ideally suited to those challenges. It is the fastest and most reliable way to create good jobs. But it is also the best way, in an economy with ample capital and low interest rates, to stimulate new private investment and thus set off a new cycle of investment, innovation, and productivity growth.

A program of public investment, however, need not increase public spending significantly. This is especially true of a program that focuses on public infrastructure investment. If properly structured to involve government guarantees for state and local long-term bonds, this type of program could rely almost exclusively on private financial markets to fund a variety of state and local infrastructure projects. Such a program of government guarantees would lower the cost of borrowing for many infrastructure needs and would thus stimulate important new public infrastructure projects carried out by private contractors. This program might also entail the creation of a federal agency that would select among municipal, state, and regional infrastructure projects that would best meet criteria for cost effectiveness, public need, and job creation. Because such a program would rely mainly on federal guarantees, it would not increase the budget deficit (although it would technically increase the national debt), but rather it would ensure a wise use of public and private resources.

However it is financed, a public infrastructure investment program could be quickly designed, easily implemented, and adjusted to fit the economy's needs. Moreover, such a program would have almost immediate benefits in terms of job creation, income growth, and private investment. This increased economic activity in turn would generate new tax revenues and thus more than offset any increase in public spending. And what is true in the short term is even more so over the longer term—economic activity and innovation build off each other, creating a virtuous cycle.

In this way, increased spending on public investment and stronger economic growth would offer a better way of ensuring America's future standard of living than would a strategy of cutting the budget deficit first. Indeed, the American way of securing our future is not by "nickel and dime-ing" public investment but by investing robustly to improve productivity and grow the economy. That philosophy has worked well in the past, and it will work even better today. ■