Keeping America's Edge

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The United States is in a tough spot. As we dig ourselves out from a serious financial crisis and a deep recession, our very efforts to recover are exacerbating much more fundamental problems that our country has let fester for too long. Beyond our short-term worries, and behind many of today's political debates, lurks the deeper challenge of coming to terms with America's place in the global economic order.

Our strategic situation is shaped by three inescapable realities. First is the inherent conflict between the creative destruction involved in free-market capitalism and the innate human propensity to avoid risk and change. Second is ever-increasing international competition. And third is the growing disparity in behavioral norms and social conditions between the upper and lower income strata of American society.

These realities combine to form a daunting problem. And the task of resolving it turns out not, by and large, to be a matter of foreign -policy. Rather, it compels us to consider how we balance economic dynamism and growth against the unity and stability of our society. After all, we must have continuous, rapid technological and business-model innovation to grow our economy fast enough to avoid losing power to those who do not share America's values — and this innovation requires increasingly deregulated markets and fewer restrictions on behavior. But such deregulation would cause significant displacement and disruption that could seriously undermine America's social cohesion — which is not only essential to a decent and just society, but also to producing the kind of skilled and responsible citizens that free markets ultimately require. Moreover, preserving the integrity of our social fabric by minimizing the divisions that can rend society often requires -government policies — to reduce inequality or ensure access to jobs, education, -housing, or health care — that can in turn undercut growth and prosperity. Neither innovation nor cohesion can do without the other, but neither, it seems, can avoid undermining the other.

Reconciling these competing forces is America's great challenge in the decades ahead, but will be made far more difficult by the growing bifurcation of American society. Of course, this is not a new dilemma: It has actually undergirded most of the key political-economy debates of the past 30 years. But a dysfunctional political dynamic has prevented the nation from addressing it well, and has instead given us the worst of both worlds: a ballooning welfare state that threatens future growth, along with growing socioeconomic disparities.

Both major political parties have internal factions that sit on each side of the divide between innovation and cohesion. But broadly speaking, Republicans since Ronald Reagan have been the party of innovation, and Democrats have been the party of cohesion.

Conservatives have correctly viewed the policy agenda of the left as an attempt to undo the economic reforms of the 1980s. They have therefore, as a rhetorical and political strategy, downplayed the problems of cohesion — problems like inequality, wage stagnation, worker displacement, and disparities in educational performance — to emphasize the importance of innovation and growth. Liberals, meanwhile, have correctly identified the problem of cohesion, but have generally proposed antediluvian solutions and downplayed the necessity of innovation in a competitive world. They have noted that America's economy in the immediate wake of World War II was in many ways simultaneously more regulated, more successful, and more equitable than today's economy, but mistakenly assume that by restoring greater regulation we could re-create both the equity and prosperity of that era.

The conservative view fails to acknowledge the social costs of unrestrained economic innovation — costs that have made themselves -powerfully apparent in American politics throughout our history. The liberal view, meanwhile, betrays a misunderstanding of the global economic environment.

To grasp the difficulty of this moment for America, we must see more clearly the pain involved in economic innovation, the price we would pay for stifling innovation, and the daunting social obstacles that stand in the way of balancing the two.

THE COST OF PROSPERITY

An economy built upon constant and relatively free innovation is inherently difficult to sustain in a democracy. This is not so much a matter of anti-market ideology as of the painful realities of economic change. Innovation forces change, and the pain involved tends to be felt immediately while the benefits are usually diffuse and harder to perceive in the short term.

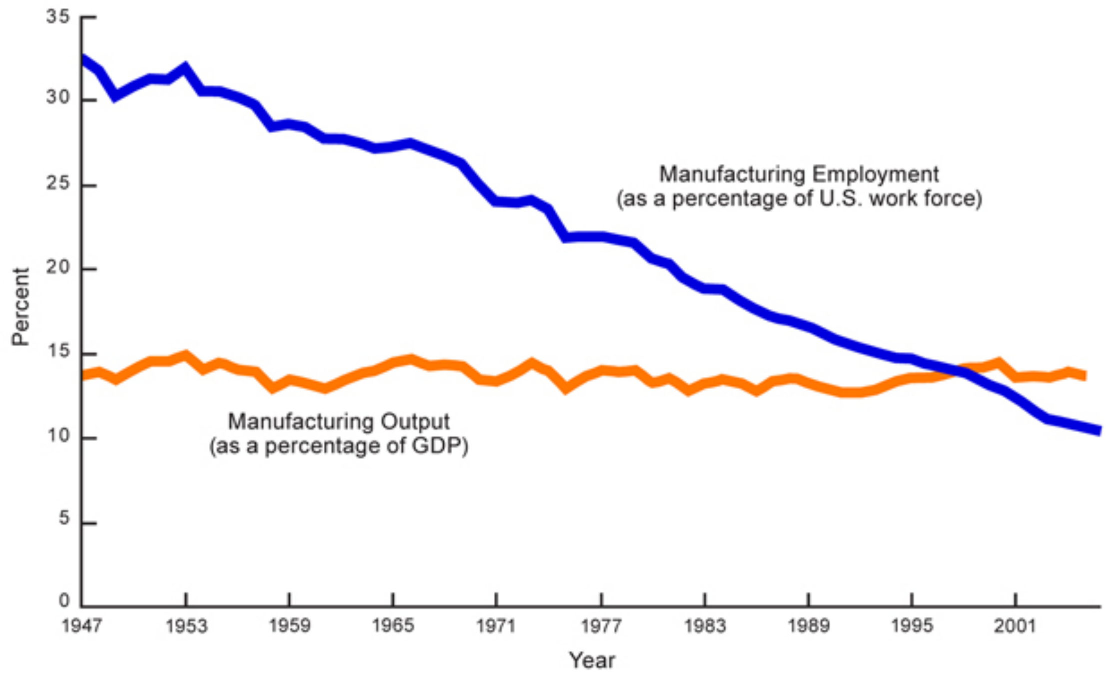
It is therefore natural for people to organize to prevent the spread of significant innovation. The original Luddites were cotton weavers who, in the throes of Britain's Industrial Revolution, responded to their displacement by automated weaving technology directly: They smashed looms. In America, people in similar situations rarely assault property en masse, but they do form political coalitions to pass laws that restrict innovation. It is understandable that the enormous waves of innovation always sweeping over a dynamic free-market economy will arouse great unease and opposition. But for that economy to prosper, the unease and opposition must be overcome.

This dynamic is often easiest to see at a distance. Consider, for instance, our country's transition from an agricultural to an industrial economy. In 1800, America was a nation of farmers: About three-quarters of the labor force worked in agriculture. Since then, this share has been in almost continuous decline. By the eve of the Civil War, it was a little over half; by 1900 it was about one-third. Today, agriculture employs less than 3% of the work force. This has been great for consumers: Farming is now incredibly efficient, and food is cheaper and more plentiful in real terms than ever before in human history. American agriculture today is also a successful industry; in 2007, the U.S. exported more than $75 billion in agricultural products, and it has maintained a positive trade surplus in food for decades. But agriculture is no longer an industry that can provide employment for very many people.

The transformation described by these statistics was not easy. It produced enormous flux in social, political, and family relationships, and the instability lasted for generations. One of the most painful things about markets is that they often make fools of our fathers: Sharp operators with an eye for trends often outperform those who carefully learn a trade and continue a tradition. And the Industrial Revolution combined material deprivation for people who had known only farming with -radical uncertainty about the future for much of the country. The appeal of political resistance to such change — like that embodied by the populists and William Jennings Bryan at the turn of the 20th -century — is easy to see. But their approach would have meant propping up emotionally resonant family farms while retarding the development of the industrial economy.

The industrial economy itself has witnessed a similar drama over the past 60 years. America has a very productive manufacturing sector, but that sector doesn't employ much of the population anymore. At the end of World War II, manufacturing accounted for about one-third of the American work force. Today it accounts for about one-tenth. In terms of -employment, we are no longer transitioning to a service economy; we are there. Over the same period, however, manufacturing has consistently represented about 15% of rapidly growing U.S. economic output. The chart below presents the classic image of massive economic transformation.

Real Manufacturing Output and Employment



Source: Bureau of Economic Analysis; Bureau of Labor Statistics.

Ever-increasing productivity involves the use of human capital in new and constantly evolving ways. This is great for growth, but can be very hard on the people displaced. It is impossible to know, moreover, what new sectors will actually be productive and how they will develop. That is why the free play of markets with limited intrusion by the government is so essential. Almost all industrial policy ends up protecting existing institutions; this is a function of human nature and is not fixable by clever program design. As a result, industrial policy normally preserves jobs that a ruthless market would eliminate, and subsidizes the kinds of new technological developments that can be exploited by -existing large firms. But these favored developments are rarely the sources of new high-wage jobs — and so such policy is more often a recipe for controlled stagnation than for continued growth. The attempt to protect ourselves from the pain of change ends up creating a sclerotic economy that, in the long run, puts everyone at greater risk.

One obvious response is to use the political process to both slow down the rate of innovation to an acceptable pace and redistribute the country's economic output in a manner designed to maintain social -harmony. That way, the pain of innovation is avoided and the pain of stagnation is mitigated — especially for the middle and lower classes, who are most vulnerable to the effects of both. This is the logic of the welfare state, and the direction pursued by much of Western Europe since the Second World War.

The problem, however, is that the United States does not exist in a vacuum, and making our internal economic changes less stressful is far from our only concern. We also face external challenges, especially rising competition from abroad. And our position in the global order means we cannot afford to go easy on ourselves and constrict -innovation. Quite the opposite: We need rapid growth just to keep up.

A NATION AMONG NATIONS

American economic policy in the wake of World War II was developed by a generation of statesmen who dealt themselves a great hand of cards, and then played it brilliantly. It is hard to exaggerate the strength of America's competitive position in the world economy in September 1945: The United States accounted for an absolute majority of all global manufacturing output, had the world's most technologically advanced economy with ample supplies of natural resources, and could protect this state of affairs with an essentially invincible military that possessed a nuclear monopoly. Most of the rest of the world was in ruins, pre-industrial, or under the control of communist regimes that smothered economic initiative.

Most great powers throughout history would have reacted to such circumstances by seizing direct, long-term control over as much of the globe as possible. Instead, the United States established itself as first among equals in a loose coalition of nations that came to be known as the Free World. It also established a set of political and economic institutions and programs — the North Atlantic Treaty Organization, the Marshall Plan, the Bretton Woods system, the International Monetary Fund, the World Bank, and so forth — that encouraged rapid economic development within this coalition. Combined with the policy of containment toward the Soviet Union, this approach to geopolitics turned out to have huge strategic benefits for America.

Indeed, the fact that this strategy worked in the decades after World War II is precisely our problem today. The wealth-creation engine of the post-war world was designed in America, but available to other nations too — and so in time those that had more advanced economies before the war (predominantly Western Europe and Japan) re-industrialized to the point that, by the 1970s, they began to challenge America's position. This revived competition, along with the oil shocks of the '70s, dramatically changed the global circumstances that had allowed the United States to have it all: high rates of economic and wage growth along with a high degree of economic equality.

Ronald Reagan's solution to the '70s crisis proceeded from two diagnoses. The first was that macroeconomic pump-priming was merely creating inflation, not growth. The second was that America's economy had large untapped potential for growth, but that this potential went unrealized because of the restrictions on markets intended to promote social harmony as part of the post-war economic consensus. These included everything from price controls to government encouragement of private-sector unionization to zealous anti-trust enforcement. Reagan's strategy, therefore, was to promote sound money plus deregulation. He succeeded, and America re-emerged as the acknowledged global economic leader. Economic output per person is now 20 to 25% higher in the U.S. than in Japan and the major European economies, and America's economy dominates the world in size and prestige.

But it is important to see that this robust growth means only that America has not lost ground in global economic competition, not that it has gained much. From 1980 through today, America's share of global output has been constant at about 21%. Europe's share, meanwhile, has been collapsing in the face of global competition — going from a little less than 40% of global production in the 1970s to about 25% today. Opting for social democracy instead of innovative capitalism, Europe has ceded this share to China (predominantly), India, and the rest of the developing world. The economic rise of the Asian heartland is the central geopolitical fact of our era, and it is safe to assume that economic and strategic competition will only increase further over the next several decades.

It is common to think of the post-war global economy as a baseline of normalcy to which we wish to return. But it seems more accurate to see that era as an anomaly: the apogee of relative global economic dominance by the West, and by the United States within the Western coalition. The hard truth is that the economic world of 1955 is gone, and even if we wanted it back — short of emerging from another global war unscathed with the rest of the world a smoking heap of rubble — we could not have it.

Yet the strategy of giving up and opting out of this international economic competition in order to focus on quality of life is simply not feasible for the United States. Europeans can get away with it only because they benefit from the external military protection America provides; we, however, have no similar guardian to turn to. We do not live in a Kantian world of perpetual commercial peace. Were America to retreat from global competition, sooner or later those who oppose our values would become strong enough to take away our wealth and freedom.

A HOUSE DIVIDED

If the pain of innovation calls for some mitigation of its effects, but the demands of global competition require that we not unduly stifle innovation, clearly some balance must be found. The task of striking such equilibrium, however, is made far more difficult by the internal deterioration of our society — which harms both our ability to compete and our capacity for social cohesion.

Of the many social and cultural changes that have rocked American society over the past half-century, the most relevant to the state of our political economy today may be the growing bifurcation of America. Increasingly, our country is segregated into high-income groups with a tendency to bourgeois norms, and low-income groups experiencing profound social breakdown.

This breakdown did not happen overnight. Longstanding academic and *avant garde* attacks on traditional social norms exploded into a political and popular movement identified with the left in the 1960s. In the '70s, American attitudes and behavior began to change on a mass scale. This cultural shift naturally stimulated a response in defense of tradition from the right. At the time, it was often characterized as a call for "law and order" — but this pushback also incorporated resistance to evolving sexual mores and gender roles, to racial equality, and to the decriminalization of drugs and other activities previously considered anti-social.

This resistance movement — which in a sense came to power with the Nixon administration — was clearly concerned with questions of social cohesion and stability, even to the point of implementing highly interventionist economic policies directed to such concerns. (The wage and price controls Nixon imposed on much of the economy are proof enough of that.) But others on the right disagreed, arguing that the natural ally of traditional morality was libertarian economics, and vice versa, because long-term economic success rested on a foundation of traditional cultural mores. An important part of Ronald Reagan's political genius was his determination to unite social and economic conservatives behind this integrated vision, making them key components of a governing coalition by the time he became president in 1981.

But while conservatives could make a strong case for the notion that cultural stability and cohesion were essential to economic growth, most preferred to ignore the opposite side of the coin: the worry that economic dynamism was harmful to social cohesion. And in the 1990s, a neutral observer could have been forgiven for believing that, despite the economic successes of the 1980s, the cultural foundations of democratic capitalism were collapsing. Crime rates, illegitimacy, drug use, and many other measures of social dysfunction were all on the rise, seemingly without limit.

Fortunately, starting later in that decade and continuing through today, America seems to have renormalized to some degree. Many of these trends — particularly the spike in crime — reversed course.

The new normal, however, is different from the old normal. To begin with, certain strands of the old bourgeois consensus have frayed, and others have simply disappeared, at least for some parts of the population. The wealthier and better-educated segments of our society, for example, have re-established the primacy of stable families and revived their intolerance of crime and public disorder. But they have combined this return to tradition with very non-traditional attitudes about sex, masculinity, and overt piety.

More important, while affluent and educated Americans are returning to the traditional family model, the poor and less educated are not. The gap between rich and poor today is also a gap in cultural norms and mores to a degree unparalleled in our modern experience. The overall divorce rate, for example, exploded in the 1970s, but has since returned to just about its 1960 level for those with a college education. For the less -educated, however, the rate has continued to climb — and women without high-school diplomas are now about three times as likely to divorce within ten years of their first marriage as their college-educated counterparts.

Child-rearing has seen a similar split. In 1965, almost no mothers with any level of education reported that they had never been married. Today, this still holds true for mothers who have finished college: Only 3% have never been married. But that figure stands in stark contrast with the nearly 25% of mothers without high-school diplomas who say that they have never been married. In fact, last year, about 40% of *all* American births occurred out of wedlock. And about 70% of African-American children — as well as most Hispanic children — are born to unmarried mothers. But this situation obtains for low-wage, non-college- -educated whites as well: It is estimated that about 70% of children born to non-Hispanic white women with no more than a high-school education and income below $20,000 per year were born out of wedlock.

The level of family disruption in America is enormous compared to almost every other country in the developed world. Of course, out-of-wedlock births are as common in many European countries as they are in the United States. But the estimated percentage of 15-year-olds living with both of their biological parents is far lower in the United States than in Western Europe, because unmarried European parents are much more likely to raise children together. It is hard to exaggerate the chaotic conditions under which something like a third of American children are being raised — or to overstate the negative impact this disorder has on their academic achievement, social skills, and character formation. There are certainly heroic exceptions, but the sad fact is that most of these children could not possibly compete with their foreign counterparts.

As the lower classes in America experience these alarming regressions, wealthier and better-educated Americans have managed to re-create a great deal of the lifestyle of the old WASP ascendancy — if with different justifications for it. Political correctness serves the same basic function for this cohort that "good manners" did for an earlier elite; environmentalism increasingly stands in for the ethic of controlling impulses so as to live within limits; and an expensive, competitive school culture — from pre-K play groups up through graduate school

— socializes the new elite for constructive competition among peers. These Americans have even re-created the old WASP aesthetic preference for the antique, authentic, and pseudo-utilitarian at the expense of vulgar displays of wealth. In many cases, they live in literally the same homes as the previous upper class.

Such behavior enables multi-generational success in a capitalist -economy, and will serve the new elite well. But what remains to be seen is whether this new upper class will have the nerve, wit, and sense of purpose that led the old WASP elite to develop a social matrix that offered broadly shared prosperity to generations of Americans.

Their task will be made very difficult by the growing bifurcation of social norms in America. A welfare state can best perform its basic -function — buffering the human consequences of the market, without unduly hampering its effectiveness — where enough widely shared social capital exists to guide the behavior of most people in a bourgeois direction. But as it performs that function, the welfare state creates incentives that push people toward short-term indolence, free riding, and self-absorption — thus undermining the very norms, and consuming the kind of social capital, it needs to operate. (The market often does the same thing: relying on rules and behaviors made possible by traditional morality even as it undercuts it.)

Post-war America had much more widely shared bourgeois norms, and so was better able to contend with the negative side effects of the welfare state. Today's American underclass, however, is increasingly developing in the absence of such norms — to a large degree as the result of the welfare state itself. Meanwhile, the need for innovation and the pressures of a global economy only continue to reinforce the causes of our social bifurcation.

INEQUALITY AS SYMPTOM

Perhaps the best illustration of these pressures — to innovate and deregulate without coming apart at the seams — is found in widening economic inequalities. It has often been noted that American society has become increasingly unequal in economic terms over the past 30 years. As Federal Reserve chairman Ben Bernanke noted in a 2007 speech, "the share of income received by households in the top fifth of the income distribution, after taxes have been paid and government transfers have been received, rose from 42% in 1979 to 50% in 2004, while the share of income received by those in the bottom fifth of the distribution declined from 7% to 5%. The share of after-tax income garnered by the households in the top 1% of the income distribution increased from 8% in 1979 to 14% in 2004." A typical senior partner in a high-end -investment-banking, corporate-law, or management-consulting firm can now expect to make upwards of $1 million per year. In the stratosphere of the economy, the increases in wealth have been mind-boggling: Even after the recent market meltdowns, there are about 30 times as many American billionaires today as there were in 1982.

The growth in inequality that began in the 1970s was driven by the social and economic forces outlined earlier. In 1970, "non-distributive services" (finance, professional services, health care, and so on) became for the first time a larger part of the private economy than goods-producing industries. This shift to services tended to enhance the prospects of the cognitive elite at the expense of traditional industrial workers. At the same time, as we have seen, the combination of changes in cultural mores and the growth of social programs began to disassemble the traditional family — ultimately leading to a class-based divide in family structure, which privileges the better-educated Americans already reaping the benefits of the shifting economy. The social capital transmitted by intact families has therefore become a more and more relevant source of competitive advantage.

Two exogenous shocks were also important. First, American domestic production of oil peaked in 1971; oil imports doubled between 1970 and 1975; and OPEC was able to drive large price increases. This oil shock was directly regressive, but it also tended to disproportionately harm those industries that were the source of high-wage union jobs. Second, the percentage of the U.S. population born abroad — which had reached its historical minimum in 1970 — began to rise rapidly as mass immigration resumed after a multi-decade hiatus. This development increased inequality further by introducing a large low-income group to the population, and by intensifying wage competition among lower-skill workers.

The Reagan economic revolution exacerbated the problem. Its success resulted, in part, from forcing extremely painful restructuring on industry after industry. One critical consequence of this restructuring was a new compensation paradigm — one that relies on markets rather than on corporate diktats, regulation, or historical norms to set pay. This new regime also accepts a much higher degree of income disparity based on market-denominated performance, and it expects that most people will exploit the resulting demand for talent by moving from company to company many times during a career. Growing inequality was a price we paid for the economic growth needed to recover from the '70s slump and to retain our global position.

Rising inequality would have been easier to swallow had it been merely a statistical artifact of rapid growth in prosperity that substantially benefited the middle class and maintained social mobility. But this was not the case. Over the same period in which inequality has grown, wages have been stagnating for large swaths of the middle class, and income mobility has been declining.

Evaluating the real change in economic circumstances of a typical American family over the past 30 years is extremely complicated. To begin with, the typical family is smaller than it was three decades ago. Further, how we adjust for inflation has an enormous impact on any comparative calculations. Finally, family budgets must increasingly account for previously unpaid work — like child care, or attending to sick relatives.

Despite these complicating factors, a few trends still emerge rather clearly. First, average living standards have continued to rise since 1980. Second, the real hourly wages for a typical non-supervisory job have not increased very much over this period. Third, this wage stagnation is at least partly explained by the rising costs of health care — which, because of the American system of employer-based health insurance, are usually deducted implicitly from what workers see as wages. Fourth, personal indebtedness has risen dramatically over the same period and accelerated rapidly during the past decade — so that at least some of the increased consumption was simply borrowed. And last, income mobility — the likelihood of an individual's moving up the relative income distribution — appears to have declined slightly over the past three decades, according to multiple studies by the Federal Reserve Banks of Boston and Chicago.

Furthermore, the divisive effects of this cluster of trends — rising income inequality and reduced income mobility, some degree of middle-class wage stagnation, increased personal debt, and increased class stratification of stable social behavior — are only intensified by climbing rates of assortative mating and residential segregation, as well as an increasingly crude and corrosive popular culture combined with the technology-driven fragmentation of mass media.

So economic inequality is likely to cause problems with social cohesion — but far more important, it is a symptom of our deeper problem. As the unsustainable high tide of post-war American dominance has slowly ebbed, many — perhaps most — of our country's workers appear unable to compete internationally at the level required to maintain anything like their current standard of living. And a shrinking elite portion of the American population, itself a shrinking fraction of the world population, cannot indefinitely maintain our global position.

We are between a rock and a hard place. If we reverse the market-based reforms that have allowed us to prosper, we will cede global economic share; but if we let inequality and its underlying causes grow unchecked, we will hollow out the middle class — threatening social cohesion, and eventually surrendering our international position anyway. This, and not some world-is-flat happy talk, is what the challenge of globalization means for America. But unfortunately, by a combination of carelessness and design, we appear now to be embracing a counterproductive response to this daunting dilemma.

TOWARD SOCIAL DEMOCRACY

The past year, spanning the final months of the Bush administration and the opening months of the Obama administration, has produced a stunning transformation of America's political economy. The first major initiative of the new president and Congress was the artfully labeled stimulus bill, which will have the federal government spend nearly $800 billion over the next ten years — less than 15% of it in fiscal year 2009. More than a short-term emergency measure, the stimulus represents a medium-term transformation of the character of federal spending — and government action — in America.

Only about 5% of the money appropriated is intended to fund things like roads and bridges. The legislation is instead dominated by outright social -spending: increases in food-stamp benefits and unemployment -benefits; various direct and special-purpose spending relabeled as tax credits for renewable-energy programs; increased funding for the Department of Health and Human Services; and increased school-based financial assistance, housing assistance, and other direct benefits. The objective effect of the bill is to shift the balance of U.S. government spending away from defense and public safety, and toward social-welfare programs. Because the amount of spending involved is so enormous, this will be a dramatic material shift — not a merely symbolic gesture.

Meanwhile, the federal government has also intervened aggressively in both the financial and industrial sectors of the economy in order to produce specific desired outcomes for particular corporations. It has nationalized America's largest auto company (General Motors) and intervened in the bankruptcy proceedings of the third-largest auto company (Chrysler), privileging labor unions at the expense of bondholders. It has, in effect, nationalized what was America's largest insurance company (American International Group) and largest bank (Citigroup), and appears to have exerted extra-legal financial pressure on what was the second-largest bank (Bank of America) to get it to purchase the country's largest securities company (Merrill Lynch). The implicit government guarantees provided to home-loan giants Fannie Mae and Freddie Mac have been called in, and the federal government is now the largest de facto lender in the residential real-estate market. The government has selected the CEOs and is setting compensation at major automotive and financial companies across the country.

On top of these interventions in finance and commerce, the administration and congressional Democrats are also pursuing both a new climate and energy strategy and large-scale health-care reform. Their agenda would place the government at the center of these two huge sectors of the economy, sacrificing some economic vitality for public -control. The latter program would also create an enormous new federal entitlement.

All told, finance, insurance, real estate, automobiles, energy, and health care account for about one-third of the U.S. economy. Reconfiguring these industries to conform to political calculations, and not market-driven decisions, is likely to transform American economic life. And the fiscal consequences of the spending involved will be enormous. The federal budget deficit for 2009 was about 11% of gross domestic product, which is far higher than any the United States has experienced since World War II. This deficit spending is the real stimulus. Something like 10% of all the economic demand in the United States is supported by government borrowing from the future, which is essential to propping up the current "recovery." Even more important, the Congressional Budget Office projects that existing laws will now lock in a structural budget deficit of more than 3% of GDP every year for the foreseeable future. And this assumes we will escape the current global economic situation without further financial catastrophe (and that America won't be forced into a war or other unanticipated major contingency over the next several decades). The CBO states flatly that this long-term budget path is "unsustainable."

The basic character of America's financial position is changing before our eyes. One year ago, federal government debt held by the public was 41% of GDP. Today, it is about 54% of GDP. The CBO projects that it will approach 70% of GDP by 2020, which is a level not seen since the immediate aftermath of World War II. Unless expenditures are reduced or taxes are raised, this debt will continue to accumulate indefinitely — until we reach the point at which we can no longer find enough lenders to simply roll it over. At that moment, Americans will face exactly three choices: raise taxes, default on debt, or devalue the currency. The most likely outcome is higher taxes, probably including a value-added tax (VAT) — essentially the equivalent of a national sales tax — as it would be hard to find another method that could collect enough revenue to keep our debt under control.

Seen together, these initiatives — shifting government spending away from defense and public safety toward social programs; deeper direct involvement of the government in the operation of large corporations across a substantial portion of the economy; energy rationing in the name of managing climate change; more direct government control of health-care provision; and higher tax rates that probably include a VAT — point in a clear direction. The end result would be an America much closer to the European model of a social-welfare state, which prioritizes cohesion over innovation.

Of course, the European model is not an inherently terrible way to organize human society. It is, however, a model very poorly suited to America's current strategic situation, and would leave us in a far worse position to deal with the challenge of balancing innovation and -cohesion. We do not have the luxury of drowning our sorrows in borrowed money while watching our power and influence wane.

America's challenge is more serious than that: How do we continue to increase the market orientation of the American economy, while helping more Americans participate in it more fully?

A NEW APPROACH

It won't be easy. But along with taking steps to better balance America's government finances and reform our entitlement system, several preliminary ideas can help guide our thinking as we confront, at last, the reality of America's circumstances.

To begin with, we must unwind some recent errors that fail to take account of these circumstances. Most obviously, government ownership of industrial assets is almost a guarantee that the painful decisions required for international competitiveness will not be made. When it comes to the auto industry, for instance, we need to take the loss and move on. As soon as possible, the government should announce a structured program to sell off the equity it holds in GM. Similarly, the federal government should relinquish direct control of banks and insurance companies. Moreover, one virtue of the slow rollout of spending under the stimulus bill is that most of it can be stopped — and should be. Any programs that have been temporarily increased under the terms of the law should be forced back down to pre-stimulus levels, and attempts to make the increases permanent should be resisted in the absence of a sustainable fiscal regime. Avoiding economically extravagant cap-and-trade legislation and, to the extent possible, a government takeover of health insurance would also help us avoid unforced errors.

Second, the financial crisis has demonstrated obvious systemic problems of poor regulation and under-regulation of some aspects of the financial sector that must be addressed — though for at least a decade prior to the crisis, over-regulation, lawsuits, and aggressive government prosecution seriously damaged the competitiveness of other parts of America's financial system. Since 1995, the U.S. share of total equity capital raised in the world's top ten economies has declined from 41% to 28%. We do not want the systemic risks of under-regulation, but we should also be careful not to overcompensate for them.

Regulation to avoid systemic risk must therefore proceed from a clear understanding of its causes. In the recent crisis, the reason the government has been forced to prop up financial institutions isn't that they are too big to fail, but rather that they are too *interconnected* to fail. For example, a series of complex and unregulated financial obligations meant that the failure of Lehman Brothers — a mid-size investment bank — threatened to crash the entire U.S. banking system.

As we work to adapt our regulatory structure to fit the 21st century, we should therefore adopt a modernized version of a New Deal-era innovation: focus on creating walls that contain busts, rather than on applying brakes that hold back the entire system. Our reforms should establish "tiers" of financial activities of increasing risk, volatility, and complexity that are open to any investor — and somewhere within this framework, almost any non-coercive transaction should be legally permitted. The tiers should then be compartmentalized, however, so that a bust in a higher-risk tier doesn't propagate to lower-risk tiers. And while the government should provide guarantees such as deposit insurance in the low-risk tiers, it should unsparingly permit failure in the higher-risk tiers. Such reform would provide the benefits of better capital allocation, continued market innovation, and stability. It would address some of the problems of cohesion by allowing more Americans to participate in our market system without being as exposed — or unwittingly exposed — to the brutal effects of market -collapses. It would also help get the government out of the banking business and preserve America's position as the global leader in financial services without turning our financial sector into a time bomb.

Third, over the coming decades, we should seek to deregulate public schools. It would be foolish to imagine that we can simply educate everyone in America to be globally competitive. In a nation where about 40% of births occur outside of wedlock, many children will be left behind. Nonetheless, schools remain one of our primary policy instruments for enhancing both social mobility and our competitive position. They are essential to the task of balancing innovation and cohesion. To function effectively, though, America's schools need to be improved dramatically. Our basic model of public schooling — accepting raw material in the form of five-year-olds, and then adding value through a series of processing steps to produce educated graduates 12 (or more) years later — reflects the vision of the old industrial economy. This worked well in an earlier era, but improvements that might have kept this model up to date have been stalled for decades. We now need a new vision for schools that looks a lot more like Silicon Valley than Detroit: decentralized, entrepreneurial, and flexible.

For a generation, many on the right have argued for school choice — especially through the use of vouchers — as the primary means of achieving this vision. Their approach, however, has been both too doctrinaire and too artificial. If school choice ever becomes more than tinker-toy demonstration projects, taxpayers will appropriately demand that a range of controls and requirements be imposed on the schools they are ultimately funding. At that point, what would be the difference between such "private" schools and "public" schools that were allowed greater flexibility in hiring, curriculum, and student acceptance, and had to compete for students in order to capture funding? Little beyond the label.

We should pursue the creation of a real marketplace among ever more deregulated publicly financed schools — a market in which funding follows students, and far broader discretion is permitted to those who actually teach and manage in our schools. There are real-world examples of such systems that work well today — both Sweden and the Netherlands, for instance, have implemented this kind of plan at the national level.

Fourth, we should reconceptualize immigration as recruiting. Assimilating immigrants is a demonstrated core capability of America's political economy — and it is one we should take advantage of. A robust-yet-reasonable amount of immigration is healthy for America. It is a continuing source of vitality — and, in combination with birth rates around the replacement level, creates a sustainable rate of overall population growth and age-demographic balance. But unfortunately, the manner in which we have actually handled immigration since the 1970s has yielded large-scale legal and illegal immigration of a low-skilled population from Latin America. It is hard to imagine a more damaging way to expose the fault lines of America's political economy: We have chosen a strategy that provides low-wage gardeners and nannies for the elite, low-cost home improvement and fresh produce for the middle class, and fierce wage competition for the working class.

Instead, we should think of immigration as an opportunity to improve our stock of human capital. Once we have re-established control of our southern border, and as we preserve our commitment to political asylum, we should also set up recruiting offices looking for the best possible talent everywhere: from Mexico City to Beijing to Helsinki to Calcutta. Australia and Canada have demonstrated the practicality of skills-based immigration policies for many years. We should improve upon their example by using testing and other methods to apply a basic tenet of all human capital-intensive organizations managing for the long term: Always pick talent over skill. It would be great for America as a whole to have, say, 500,000 smart, motivated people move here each year with the intention of becoming citizens.

FACING THE FUTURE

These broad proposals are, of course, mostly ways to stop digging our hole even deeper. At the moment, that would be no small achievement — since we are moving toward a model of social democracy that is likely to dim our long-term prospects.

But more important than these particular steps is the imperative to see our problem clearly, and to shape our political and economic arguments around it in the coming years. An America that wants to keep its global edge cannot afford to neglect the necessity of innovation and growth, or to ignore the necessity of social cohesion and stability. For the moment, the former of these is in special need of defense — since the party in power seems inclined to sacrifice economic dynamism for its vision of social justice. Eventually, however, the challenge of preserving the moral fabric and social unity of America may prove the more difficult problem. Strong families — and the commitments and habits they teach — are essential to both a market economy and a working democracy. More than ever before, the health of America's social institutions must be a priority for all those concerned about our country's future — and especially those who would champion innovation and free markets.

Balancing economic innovation and social cohesion is the challenge of every free nation today — but it is a particularly pressing challenge for the special nation that holds in its hands so much of the fate of democracy and capitalism in our world.

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