



The background report will be released in sections over the next few days. Use the links at right to download sections of the report that are now available.

Introduction

The background report provides a backdrop to *The Prescription for Prosperity*, explaining the logic behind the policies recommended in the agenda and how they fit together. Comments on both the agenda and on this "discussion draft" of the background document are encouraged and can be e-mailed to agenda@keystoneresearch.org.

The *Prescription for Prosperity* was written with a sense of possibility and optimism about the future. Over the past several decades, new technology and organizational innovations have created an economic foundation for an era of unprecedented well-being. This foundation is evident in recent productivity statistics, which show the highest sustained productivity growth since the 1950s. It is even more apparent in case studies of leading companies, from Southwest Airlines to Costco, the Wolf Company (a York-based building materials distributor) to Lancaster General Hospital. In industry after industry, the best companies are achieving levels of productivity, quality, and service that far outstrip those of previous decades. Helping more businesses to match their high-performing peers and creating conditions that enable leading companies to continue pushing the performance envelope will make our economy stronger still.

Realizing the potential that exists for an era of unprecedented well-being, however, requires Pennsylvania (as well as the United States) to distribute the gains from a strong economy more broadly. This broader distribution of the benefits of growth will not happen automatically, through the magic of the market. It will require focused and sustained attention from state (and federal) government. So far, it has received little attention at all. The Prescription for Prosperity aims to change that.

The Great Disconnect Between Wages and Productivity: A Story of Growing Inequality

In American and in Pennsylvania, the rising tide of a strong economy once lifted all boats. For the past three decades, except for 1995-2000, a strong economy has lifted but a few boats. The link between a strong economy and the well-being of the middle class forged in the 1930s and World War II—a period that economist Paul Krugman labels "the Great Compression"—has been broken.

In today's economy, we have instead the "Great Disconnect" between productivity and wages. Earnings growth has stalled even for college-educated workers. Profits are at record levels, yet the share of workers with health and pension benefits through their job has fallen. The economy has been expanding for five-and-half years but family income has fallen, concentrated poverty has grown in our most vulnerable urban neighborhoods, more of our inner suburbs teeter on bankruptcy, and one out of every four working families with children in Pennsylvania does not earn enough to cover the costs of a bare bones family budget.

A few years ago, a strong sentiment still existed in Washington to look at our economy through rose-colored glasses, to point to productivity, profit, and GDP growth and to ignore the question of who was benefiting from growth. But now a broad consensus that these benefits are highly skewed exists across the political spectrum and among economists both conservative and liberal, and that this level of inequality is a major problem. To wit:

- Henry Paulson, President Bush's Treasury Secretary noted in August 2006: "Amid this country's strong economic expansion, many Americans simply aren't feeling the benefits."
- *The Economist* magazine stated on June 15, 2006: "Growth is fast

- *The Economist* magazine stated on June 13, 2006: "Growth is fast, unemployment is low and profits are fat... [Yet] Only one in four Americans believes the economy is in good shape. While firms' profits have soared, wages for the typical worker have barely budged."
- At the end of January, President Bush himself commented that: "Some of our citizens worry about the fact that our dynamic economy is leaving working people behind...We have an obligation to help ensure that every citizen shares in this country's future. The fact is that income inequality is real; it's been rising for more than 25 years"(1)

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Beyond acknowledging the reality of inequality, economists and other opinion leaders, again across the political spectrum, have begun to wonder about its negative consequences and how inequality threatens America's values. For example, Alan Greenspan, President Reagan's appointee as Federal Reserve Board Chairman, told Congress on July 21, 2005 that growing inequality of income and wealth are "very disturbing." He added that "...a free market democratic society is ill-served by an economy in which the rewards of that economy [are] distributed in a way which too many of our population do not feel is appropriate...I think it is a major issue in this country."

Paul Krugman, Princeton economist and *New York Times* columnist has noted "we're living in a time when most Americans are seeing little if any benefit from overall income growth..." On February 27, 2006, he declared himself to be "with Alan Greenspan" in expressing concern about the threat that growing inequality poses to a democratic society. Krugman observed that "...we're seeing the rise of a narrow oligarchy: income and wealth are becoming increasingly concentrated in the hands of a small, privileged elite."

And, on February 6, 2007, current Federal Reserve Board Chairman Ben Bernanke observed that "rising inequality is not a recent development but has been evident for at least three decades." (2) Bernanke also suggested that high levels of inequality could undermine the beliefs that hard work should be fairly rewarded and that opportunity should be widespread.

The broken link between productivity and wages is old news to most American families—and to most Pennsylvania ones. Long before it was officially acknowledged that the domestic war—for a strong middle class – was not going well, the middle class itself knew it. That is why the economy has consistently ranked near the top of voters concerned for most of the past 30 years.

As well as explaining to Wall Street the mood on Main Street, many middle class Americans could happily (or at least easily) enlighten opinion leaders about the basic reason that the economy in recent times benefits the few more than the many. The world has changed, most visibly because of globalization and the shrinkage of the manufacturing sector. In Pennsylvania, manufacturing accounted for 47% of all jobs in 1944 and 29% in 1969. It accounts for 11.5% today.

Needed: A Practical Long-Term Plan for Economic Growth in the Global Economy

Faced with seismic shifts in the structure of our economy and job market, what America's middle class has been waiting for, at the federal and state level, is a comprehensive response. How, in these new conditions, can public policy and institutions restore the connection between a strong economy and a better quality of life?

People want a long-term plan for Pennsylvania's future—and for the future of it's middle class. They want to know how in the face of the unprecedented challenge of globalization their political leaders plan to make the economy respect our values rather than undercut them.

People want a real and practical plan, one that is equal to the scale of the pressures bearing down on the middle class. If they get that and they get a serious and sustained effort at implementation, we believe there is strong evidence – from history and from polling-- to suggest that voters will be patient. They will allow time for an approach that passes the common sense test to markedly change economic outcomes. Good policy will turn out to be good

politics.

We think that recent Pennsylvania experience illustrates that good policy is good politics and that voters will respond positively to a long-term agenda. For example, the poll released by IssuesPA on February 27 noted that Pennsylvanians are more optimistic than Americans about the economy and its future. (3) Since economic statistics that measure the well-being of working families are not yet discernibly better in Pennsylvania than other states, we interpret the optimism of Pennsylvanians as a response to leadership. Cynicism and apathy are turning to greater confidence because, for the first time in a long time, Pennsylvanians sense that the state has a sense of direction.

Under Governor Rendell, and with the support of the legislature, Pennsylvania has begun to make investments in the future in ways that resonate with common sense. These areas include

- education and skill development from cradle to adulthood
- renewable energy
- job creation and manufacturing innovation, and
- health care (even before the 2007-08 proposal for comprehensive health care reform).

Health care, job creation, and education and skills are the three areas that the IssuesPA poll finds to be policy priorities for Pennsylvanians. Not only are they areas in which Pennsylvania has begun to show leadership. They are also (along with comprehensive tax reform, the fourth-ranked priority according to IssuesPA) the core areas of our economic agenda.

In sum, *The Prescription for Prosperity* outlines how to build on the progress Pennsylvania is already making by crafting, on a bipartisan basis, a more comprehensive and explicit long-term plan that is equal to the challenge of the global economy, a plan able to boost competitiveness and improve the lives of all Pennsylvanians. (This plan will be even more critical if Pennsylvania finds it must weather the stormy seas of a global and national recession. As of this writing, global stock markets are plunging and a GDP decline for the last quarter is anticipated.)

Pennsylvanians' emerging confidence in state government's ability to take action to ensure a better future turns around the conventional wisdom that Pennsylvania is backward, stuck, in the past, and a follower not a leader.

Pennsylvania is well positioned to lead for reasons that go beyond recent policy initiatives. Pennsylvania has a more egalitarian and communitarian culture than many other states. The state's middle class and anti-poverty groups have a stronger voice (which is not to say strong) in state and local policymaking than in many other states. And the state has a history of social and institutional innovation. This history is a resource that has allowed the state to translate economic strength into a better life for the middle class in the past and could help do that once again.

Join the Growing Pragmatic Discussion

This background document is, in one sense, a Keystone Research Center (KRC) document but, in another sense, a collective document. It is a KRC document in that, unlike the economic agenda itself, it has not been endorsed by other organizations and KRC alone is responsible for any errors of fact or judgment.

This is a collective document in the sense that many other people deserve credit for any useful ideas or recommendations contained here. Included among those people are, of course, the individuals who engaged with the planning of the Prescription for Prosperity agenda around which the report was structured. Also included are the many economic stakeholders and policymakers that KRC staff have had the privilege to work with and interview over the past decade: managers and workers, economic development practitioners and workforce development; Cabinet officials, program managers, and state government statisticians; union and industry association officials; non-profit partners and foundation program officers; state lawmakers and their staff; and coordinators of industry training partnerships and members of their steering committees.

To the best of our ability, we have tried to make sense of what each of these many people has taught us, and to use that knowledge to explain and to elaborate the Prescription for Prosperity. Throughout the process we have tried to be relentlessly non-ideological and pragmatic, to be guided simply by the idea that we need policies that will make our economy compatible again with our values as well as stronger than ever before.

The hope that this document might be one step in a deepening dialogue is one reason we are calling it a discussion draft and inviting feedback via agenda@keystoneresearch.org. (We will also make it possible to engage in public discussion of the agenda at www.keystoneresearch.org/agenda.)

Let us try, finally, to be clear. There is no hidden agenda here. The agenda is out in the open. We are trying to lure other Pennsylvanians into a conversation. If you don't like some of the recommendations in the Prescription for Prosperity, or in this background report, fine. Tell us what yours are. But one way or another, we need to repair to reverse the growth of economic inequality and find our way back to a Pennsylvania economy that works for all.

Endnotes

1. Remarks by President George Bush on the State of the Economy, Federal Hall, New York, NY, January 31.

2. Remarks by Chairman Ben S. Bernanke, "The Level and Distribution of Economic Well-Being," before the Greater Omaha Chamber of Commerce, Omaha, Nebraska, February 6, 2007.

3. A four-state (NY, NY, PA, OH) economic poll conducted in August and September 2006 as part of the project leading to *The Prescription for Prosperity* also found that Pennsylvanians were more optimistic than voters in other states about the current economy and about its future. Since that poll was conducted to inform the development of economic agendas in each state, and had a relatively small sample in each state (400 in PA), its results are not being made public.