Review of Seeds of Destruction: Why the Path to Economic Ruin Runs through Washington, and How to Reclaim American Prosperity

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Finally, I am not convinced that Farmer's model really helps us understand major economic events like the Great Depression or the economic boom during World War II. During the Depression, Hoover tried to prevent nominal wage cuts in the face of deflation while Roosevelt sought to raise them. Both of their policies lead to substantial gains in real wages. During World War II, Roosevelt reversed course and sought very aggressively to limit wage increases in order to stimulate production. Consequently, it seems that government interventions in the labor market lead to high wages and low employment and output during the Great Depression and low wages and high employment and output during World War II.[5] Since standard fundamentals based models seem increasingly able to explain both the Great Depression and World War II when we properly account for the government's intervention in the economy, I do not see the big appeal of an indeterminacy based story.

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[5] As I noted in a footnote in my discussion of his model, too high wages can also be bad in his model. However one does not need to appeal to a model like his to have a government policy of setting high real wages distort labor markets and thereby lower output. For this reason, I do not find the basic mechanism in his model helpful in explaining exactly the kinds extreme events that one would have a priori thought it best suited.

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Seeds of Destruction: Why the Path to Economic Ruin Runs through Washington, and How to Reclaim American Prosperity. By Glenn Hubbard and Peter Navarro. Upper Saddle River, N.J.: Pearson Education, FT Press, 2011. Pp. xix, 266. $26.99. ISBN 978–0–13–702773–6. *JEL 2010–1213*

The United States has just gone through the worst financial crisis since the Great Depression. Our financial system came to brink of collapse, saved only by a massive intervention by the federal government. Although officially the Great Recession is now over, high unemployment and slow growth persist. Deficits that were ballooning in the 2000s with the weight of tax cuts, increased health care expenditures, and defense spending related to Iraq and Afghanistan, even before the financial crisis, have continued to climb, as lower tax receipts, automatic stabilizers, and fiscal stimulus kicked into gear.

Against this backdrop, Glenn Hubbard and Peter Navarro attempt to explain what went wrong and what policymakers should do going forward. In this breezily written volume, the authors move quickly through the "four growth drivers," the "ten levers of growth," and policy prescriptions for fiscal and monetary policy; tax, trade and energy; Social Security and health care reform; and banking and housing. The book is written for a general audience, not a scholarly one. Each topic is touched upon so briefly that there is little time for the authors to wrestle with alternative viewpoints, complicated evidence, or nuanced positions. Instead, the authors explain in rapid-fire fashion why the reader should join them in believing that "virtually every policy that President Obama has adopted, or has sought to adopt, has perversely accentuated, rather than ameliorated, the American economy's pernicious structural imbalances" (p. 4). Unfortunately, they muster little evidence to support this view.

In part 1, the authors describe the "four growth drivers" (p. 7): consumption, business investment, government spending, and net exports. The authors point out that consumption has stalled, as consumers continue the "deleveraging" process in the wake of the financial crisis and face uncertain job and income prospects. Business investment has picked up, but many businesses are still sitting on excess cash, given uncertainty about the economic climate. Government spending is significantly up, but the authors argue that it is too high—rather than too low. And the United States continues, as it has for decades, to suffer a significant trade deficit, the twin of our long-running capital deficit from foreign borrowing. These four growth drivers lead to "ten levers of growth" (p. 29). These include: free markets, free and fair trade, entrepreneurship, savings, stable banking, innovation, human capital, sound energy policy, a healthy population, and manufacturing.

Part 2 sets out policy prescriptions for monetary and fiscal policy. To wit, the authors argue that the Federal Reserve contributed mightily to the housing bubble by an overly easy monetary policy in the mid 2000s. The authors contend that the Fed extended this policy error, and compounded it, when the Fed dramatically expanded its balance sheet in the midst of the financial crisis. The authors also argue that the 2009 federal stimulus legislation was not well targeted to short-term activity and in any event that fiscal stimulus generally does not work. They conclude with eleven principles for sound fiscal stimulus policy—such as focusing on tax cuts, transfers to state governments, and automatic stabilizers, including unemployment insurance.

While it is hard to disagree with the authors that low interest rates and global capital flows contributed to global housing and asset bubbles, the roots of the crisis lay much deeper—in basic failures in the financial system and in financial regulation (including by the Fed), as discussed further below. The authors are off-mark regarding the Fed's actions in 2008 to 2009; without the Fed's intervention during 2008–09, the financial crisis would—without any doubt—have been devastating to the entire U.S. economy. There was really no plausible alternative, once the crisis hit, to the massive liquidity provision (not just by the Fed through asset purchases, but also by the FDIC through guarantees) and the Treasury-orchestrated public and private recapitalization of the financial sector. With respect to the fiscal stimulus bill, it would be hard to find anyone who would call it a flawless piece of legislation—yet bipartisan observers credit the stimulus plan with saving 2.7 million jobs and increasing GDP by 3.4 percent (Alan S. Blinder and Mark Zandi 2010). Overall, the fiscal stimulus and financial interventions by the government were estimated to save a staggering 8.5 million jobs and increase GDP by 11.5 percent (Blinder and Zandi 2010). What the Obama administration and the Congress will need to negotiate in the coming years is a path to long-term deficit reduction that is not a short-term drag on the economy.

Part 3 of the book takes up tax, trade, and energy policy. On tax policy, the authors point out familiar problems with the tax code: that it is complex, that it taxes income rather than consumption, that it double taxes some forms of income while providing tax expenditures of dubious utility, that it encourages corporate leverage by expensing interest income, and has high nominal corporate tax rates. The authors argue that the nation should move to a "progressive consumption tax" (p. 97), under which capital income earned by individuals is exempt and business investment is fully expensed, with protections for lower-income households.

As the Obama administration and the Congress debate tax reform and consider ways to reduce the federal deficit, some form of consumption tax is likely to be in the mix, and the authors are right to suggest that protecting the progressivity of the tax code is an important policy goal. However, it would be quite difficult to maintain current progressivity with a pure consumption tax, and the United States is likely to rely instead on a mix of corporate, personal income, and consumption taxes going forward.

On trade, while acknowledging the need for the United States to save more and increase its productivity, the authors lay most of the blame for America's trade deficit at the feet of the Chinese government. They argue that most of China's competitive advantage comes from an undervalued currency, protectionist policies, and mercantilism, together with weak legal protections for intellectual property, the environment, and other factors. The authors, however, do not suggest a diplomatic strategy to overcome these problems. More critically, they do not articulate a coherent strategy for improving productivity, enhancing U.S. entrepreneurship, or expanding exports beyond their China policies.

On energy, the authors argue for using an "oil import substitute price floor fee" (p. 139) to reduce dependence on imported oil. Under this approach, the federal government would set the desired price of oil that would yield the desired reduction in use of imported oil and tax oil at the rate necessary to hit the government's price. Although the government would set the desired price and impose a tax to hit it, market forces would determine what mix of domestic drilling, nuclear power, alternative energy sources, conservation or other activity would occur. The authors argue that this form of tax would be more politically palatable than a carbon tax, although it is unclear as a matter of political economy that this is the case; it will not be lost on the political system that this is a form of carbon tax, and the idea that the government will set the proposed level of usage (and price) for oil is likely to elicit the same objections that many conservatives had to "cap and trade." If the United States is to go down this route, a straightforward carbon tax would be more efficient, easier to administer, and no more politically difficult to achieve than the "oil import substitute price floor fee" (that is to say, in either event, quite hard to get done).

In part 4, the authors take on Social Security, Medicare, Medicaid and the Obama administration's Affordable Care Act. The authors rightly point out that with the aging of the "baby boom" and rising health care costs, health and retirement expenditures will continue to grow as a share of the economy and of government spending. With respect to the solvency of Social Security, the authors argue that raising revenue through increasing the payroll tax or lifting the cap on taxed wages would be counterproductive because tax increases reduce work and investment. Instead, they argue that raising the retirement age to reflect greater longevity, and indexing benefits for prices (rather than wages), would slow Social Security's growth to a sustainable path. The authors suggest that Medicaid become a block grant program, and an annual Medicare budget be set, within which retirees would get "support for a basic health plan, which individuals could supplement at their own expense" (p. 169)—presumably some form of voucher to buy private insurance.

The authors then devote a chapter to explaining "Why ObamaCare Makes Our Economy Sick" (p. 173). The authors contend that the Affordable Care Act will increase health care costs because it expands coverage and provides subsidies for more generous health insurance coverage, including prescription medications. Rather than saving nearly half a trillion dollars, as the administration argued, the authors contend that the legislation will cost about that amount, and result in a number of unintended consequences. The authors argue that cost containment requires patients to be more sensitive to the cost of health care—with higher deductibles and co-payments, and lower subsidies for the purchase of expensive employer-provided health insurance plans. In particular, they argue that either the deduction for employer-provided health insurance should be repealed or, more plausibly, that there should be greater deductions for health savings accounts or other individually purchased health insurance plans. They also argue for a range of additional measures: caps on medical malpractice damages and the use of alternative dispute resolution to adjudicate claims, reform of various state insurance laws, and the like.

As the authors acknowledge, these problems and proposals are not new, but there is renewed urgency on tackling them. Some mix of changes, not only in benefits, but also in revenue will be required to put Social Security, Medicare, and Medicaid on a more sustainable path. Relatively modest adjustments in benefits and in payroll taxes are required for Social Security, and there is nothing in the volume to support the authors' claims that over the long term a modest increase in payroll taxes or raising the wage cap would be harmful to growth. With respect to health care, the problems are more daunting. There is little reason to believe, however, that block-granting Medicaid or providing vouchers for Medicare will be politically palatable (witness reaction to the "Ryan plan"), or that either approach would be more efficient, reduce society's overall medical care costs, or produce better health outcomes than current policy. Similarly, there is little evidence that patient-driven cost containment, such as increasing deductibles or co-payments, leads to better health outcomes (as opposed to simply lowering usage of preventive or other care) or societal reductions in overall health care costs; caps on the deductibility of high-priced health insurance can help somewhat, as can incentives for coordinated and quality care, and are contained in the Affordable Care Act.

Part 5 of the book contains the authors' views on the financial crisis and the Dodd–Frank Act. According to the authors, risk built up in the financial system because borrowers and mortgage lenders had insufficient "skin in the game" (p. 202). That is, borrowers put too little in as a down payment, and lenders did not retain sufficient risk in the loans they were making. Moreover, lenders offered exotic loan products, with balloon payments, teaser rates, and complicated features. Risk further built up in the system as these bad loans were securitized, packaged into mortgage-backed securities (MBS), and sold to investors. MBS, in turn, were packaged into collateralized debt obligations. Credit default swaps were used to offset the risk inherent in these MBS and CDOs, and eventually were used to create "synthetic" CDOs. The top tranches of these structured products were highly rated by the credit rating agencies, which enabled a broad range of investors to ignore their inherent risks—until it was too late. The system had too little capital and the capital it had was pro-cyclical. When a major nonbank financial firm failed, there was no way to wind it down. And the fragmented regulatory structure made effective regulation and crisis coordination difficult.

While their general account of many of the key problems leading up to the crisis is on point, the authors' policy analysis is not. They contend that the Dodd–Frank Act is "yet another massive piece of legislation by the Obama administration that widely misses the mark" (p. 200). Yet the act takes up the key reforms the authors themselves suggest: underwriting standards in the qualified residential mortgage definition; risk retention standards for securitizers and originators; a consumer financial protection bureau that can improve disclosures and restrict or prohibit "high-risk mortgage products and lending practices" (p. 208), rather than always playing catch up with legislation to correct past particular abuses; securitization and credit rating reforms, including transparency and governance provisions like those the authors favor; fundamental reform of the over-the-counter derivatives markets, including centralized clearing and exchange trading, rules on margin and capital, and business conduct rules for swaps dealers and major swap participants; and a clear resolution authority for failing nonbank financial firms. While the authors are correct to point out continued regulatory fragmentation, a new Financial Stability Oversight Council is charged with ensuring consistency across agencies, and watching out for risks in the system; the Fed is given authority to supervise all major financial firms, regardless of their corporate form; and a new Office of Financial Research will be able to collect data and analyze the entire financial market on behalf of the Council. Lastly, the United States has led the global effort to improve the quality and quantity of capital in the financial system, through stress tests, required infusions of private capital, and reforms to the Basel standards for capital going forward. Perhaps because the act was, in the authors' words, "too big to read" (p. 247), they missed its key features.

The book concludes with a summary of the key policy prescriptions discussed above. Those looking for a fresh approach to persistent problems in America's economic scene will be disappointed. But for those looking for a quick, one-sided take on the current economic debate in Washington, the book may provide a useful introduction.

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Product Variety and the Gains from International Trade. By Robert C. Feenstra. Zeuthen Lecture Book Series. Cambridge and London: MIT Press, 2010. Pp. 133. $30.00. ISBN 978–0–262–06280–0. *JEL 2010–1225*

In his recent book, Robert Feenstra masterfully synthesizes trade theory and evidence in a volume that provides the foundation for how