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What is going on?

When important events happen as suddenly as they have in our financial markets, it's hard for a newsletter editor to know how to react. This fall, no sooner was a story found than it became obsolete. But, as usual, there is one place people don't go when looking to explain the current fiasco: the past.

Sure, we know by now that lots of mortgage borrowers have made unwise choices and we also know that mortgage lenders have been even more stupid, as have the many statisticians who created the models on which the credit insurance schemes now bringing down our financial system were based (see **RIPR** issue 30). We also know that many of the shenanigans were abetted by then-Senator Phil Gramm, the odds-on favorite for John McCain's Treasury secretary (see box, page 2).

Seeing through the murk is a challenge, but it's fairly easy to see that we are awash not just in bad debt, but also in bad explanations of what happened. To begin with, it's clear that poor people defaulting on bad mortgages aren't what "caused" the problem, except in the specialized sense in which a gentle evening zephyr might cause a badly-built house to collapse. Until late last year, mortgage payments in arrears were no worse than they were in previous slowdowns. The difference is that structural problems in the mortgage market, along with the bankruptcy "reform" measures of 2005, made foreclosure much more likely than in the past (see RIPR issue 27).

Twenty years ago, a payer in arrears might miss a couple of payments, but might then be able to work it out with their bank. Today, that option is seldom available,



Figure 1: US before-tax corporate profits divided by household wages and other labor income. Corporate profits were on a decline until the 1980's, and have been on the upswing since, though early gains were nothing compared to the Bush II years. You can also see that Republican administrations seem to be better for corporate profits and Democratic administrations seem to be better for wages. (Source: Federal Reserve Flow of funds report, September 2008)

since the mortgage is likely held by 300 investors who all bought shares of it via some other investment instrument. There isn't even a way to contact all the lenders, let alone get them to agree on something. So the borrower defaults, putting the property for sale onto a glutted market, and destroying the value of the mortgage in the process.

While these problems were appearing among mortgages, the mortgages themselves were the base of a vast tower of leveraged investments that all purported to "insure" the mortgage-backed securities (and other investments) against default. These are the "credit-default swaps" (CDS) and other byzantine derivative investments we've heard so much about. They work like this: If

I sell you an insurance policy on a \$1000 bond, then if the bond goes broke, I owe you \$1000. I tell you I think the bond has 10% chance of going

All the Wall Street insurance schemes were essentially insuring against the same risk.

bust, so I charge you \$100 for the policy. But privately, my statisticians are saying the likelihood of default is only 5%, so I predict I'll make money on the deal.

Multiplied by thousands, this is roughly how insurance companies work. One big difference: real insurance companies are the subjects of a vast array of regulations designed to make sure they don't insure risks they can't pay off. Insurance company regulations are designed to keep companies solvent. Compare this to the credit swap market, which was completely deregulated in 2000 by Phil Gramm's surprise 262-page amendment to a Congressional budget bill (see box, page 2).

One crucial twist was that a CDS could be sold to someone who did not own the underlying bond. That is, I sold you the bond and the insurance. But my friend comes along and wants to bet with me that I've underestimated the default risk, so he buys a policy, too, just like yours. Now I stand to make \$200, investing little besides my credibility to do it. Of course I stand to lose \$2000 if the bond defaults, but hey, what's life without a little risk?

Another problem. Because of the changes in the bankruptcy law and the new structure of the mortgage market, historic foreclosure rates are no longer a good predictor of what will happen. Bankers wound up hoist on their own petard. They lobbied heavily for the new bankruptcy laws, but those laws turned around and bit them by increasing the number of foreclosures.

And here's the real key: real insurance companies typically insure against many different risks in many different places, and so protect themselves from default. Some places are at risk for tornadoes, and other for floods or fire. The likelihood of having tornadoes, floods and fire

all at once is low. But all the CDSs and the colossal pile of associated derivatives were all insuring *against the same risk*: a slowdown and the puncturing of the real estate bubble. Continuing the analogy to the insurance business, insurance accounting is very technical, and uses a lot of peculiar specialized jargon. One term they use for this is "risk overexposure." Another equally technical term is "\$\%#*! insane."

How did we get here? Knowing how precarious the house was before it collapsed is edifying, but there is a still bigger issue, whose explanation leads to the real causes. The real estate bubble and all the concomitant insanity on Wall Street was fueled by a vast amount of capital looking for somewhere to invest. But *why* was there so much capital, and why was it all liquid? Why wasn't it tied up in the land, machinery, and equipment our economics textbooks told us was so important to the economy?

Maybe it has something to do with the changes in the economy over the past 30 years. The dominant strains of policy-oriented economics focus on grand aggregates, like the "corporate" sector and the "household" sector. But to focus on these grand aggregates overlooks some important changes we've made in the composition of those aggregates.

Our nation once contained the strongest and most productive manufacturing machine the world had ever seen. Now it doesn't. Why?

The ten-cent analyis is that manufacturing moved overseas because of high labor costs here, but that's hardly the

High labor costs are usually blamed for sending jobs overseas, but that ignores...

whole story, and in many ways it's not even the most important part.¹ Direct private foreign investment in countries with weaker cur-

rencies than ours is not just a source of cheap labor, but also cheap capital and cheap raw materials. Plus, governments who had just received a pile of US foreign aid money were delighted to use it to build factories for US

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editor & author of unsigned articles: Tom Sgouros

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Where was Phil Gramm?

A point, no doubt of some pride, Senator Phil Gramm has his fingerprints all over the current financial crisis. As the lead sponsor of the Gramm-Leach-Bliley act, he spearheaded the effort to repeal the Depression-era bank regulations passed as the Glass-Steagall act. Glass-Steagall forbade investment banks from also being insurance companies and insurance companies from also being commercial banks, and so on. Repeal not only paved the way for tremendous conflicts of interest (the same company can now auction your corporate bonds—and attend the auction to buy them), but also eased the creation of yet more companies deemed "too big to fail."

Gramm also slipped a 262-page amendment into a 2000 appropriations bill (after Bush's election, but before he was sworn in) called the "Commodity Futures Modernization Act" that pretty much completely deregulated all kinds of markets. This bill exempted energy trading from regulation—giving us the Enron catastrophe—and exempted credit default swaps from regulation, too. These promptly ballooned into what was a \$62 *trillion* market this past summer, and the betting and counter-betting they represent is the structure that collapsed when the foundation mortgages began to go sour.

Truly these are impressive legacies, even for a two-term Senator. Gramm is now vice-chair of UBS, a Swiss bank that recently sought a bailout from their government.—TS

companies who would bring jobs. Who paid to move those jobs? To a surprising extent, you did.

And the strength of the dollar is not just an accident, either. The US has pursued a strong-dollar policy ever since Richard Nixon abandoned the gold standard. Having a "strong" dollar sounds good, doesn't it? I mean, weak

dollars are for weenies, right? But all this really means is that everyone wants to sell us stuff and no one wants to buy

... monetary policy, tax policy, foreign aid policy, trade policy, and more.

from us. Through the 1980's and most of the 90's, our interest rates were set high enough to keep the dollar strong. This helped attract international investors to finance our national debt, kept our currency the reserve choice of the world, and it kept bankers happy, but it was ruinous for manufacturers who aspired to sell their goods overseas. Policy makers in the 1980's and 1990's made their choice, and they chose finance over manufacturing.

Let's not forget trade policy, either. Why are jobs in places like China? Because it's cheaper to make stuff there, obviously. But why is it cheaper to import them? Free trade agreements like GATT and NAFTA, of course. But if you look closely at these, you'll see that "free trade" is largely a crock. Like the strong

 $^{^1}$ After all, production labor simply isn't that big a part of manufacturing costs, averaging 10.4% in 1982, and about 8.6% in 2002, according to the Census Bureau's Economic Census from those years.

dollar, it has an appealing sound—who'd be against something free?—but it's simply not what it sounds like. I checked out the list of tariffs we impose recently, and it's still nearly 3,000 pages long, with lots of high tariffs and thought-provoking entries.² For example, sugar is still highly protected. Why? Well, the US sugar industry has no labor cost issues. It largely relies on temporarily-imported Caribbean laborers who have no labor rights in America. Instead, sugar farmers

Starting in the early 1980's, federal policy favored profits over wages, often by a lot...

have competition issues. So we still charge 34¢ to import a kilo of sugar, even in the grand new world of free trade.

Turning to households, the graph on page 1 is informative. It shows the total corporate profits earned, divided by the wages collected by America's households. There are a couple of interesting features of the graph. First, you'll see that from the 1950's until the early 1980's, profits declined relative to wages fairly consistently, if erratically. In the early 1980's, this trend changed, and the share of GDP going to profits has risen significantly, especially since the ascension of George W. Bush when profits spiked.

After noticing the dramatic effects of Bush's policies, it's hard not to notice the effect of political party control on that same line. Starting in 1960, it seems that the two parties find ways to reverse the directon of the line. Democratic administrations find ways to make wages go up at the expense of profits, and Republican administrations find ways to make profits go up at the expense of wages. But the overall trend since the 1980's is up, despite its fits and starts. Our economy used to be the world's best at making stuff, but now it's the world's best only at making money—a profit-accumulating machine.

The problem is that the profit accumulated at the same time that the manufacturing investment opportunities fled or dried up. What's more, median wages have been pretty much stagnant since the 1970's, barely keeping up with inflation, if they have at all. Along with that, tax policy (state and federal) has shifted dramatically to favor the top few percent: capital gains tax cuts, cuts in the top tax rates, investment credits, depreciation credits and more and more and more are all ways in which the burden of funding our government is shifted from the top echelons down to the lower. Most of these policies were established to help investors accumulate still more funds to invest, as if that were the problem.

So what happens to that accumulated profit at the top? There may not be many profitable manufactuing opportunities, but it's got to go somewhere, so it gets loaned to people who aren't getting by, and it chases financial in-

vestments, driving up their prices and and creating bubbles. Since the 1980's, we've had a S&L real-estate bubble, the internet stock bubble and then another real estate bubble. They are fun while they last, but ultimately any bulimic will tell you the binge-and-purge rhythm is exhausting and destructive.

It's not fashionable to mention this, but Karl Marx pointed out that a society that depends on mass consumption as its economic engine can't work when wealth is too concentrated. It's a pretty simple concept: if mass consumption is what's required to make the engine run, then it's important that the mass of people have income to

consume with. Our economy won't work without capital accumulated to invest, but if all the capital settles in too few places, it

...it's like skimping on gasoline in favor of a better air filter.

won't work either. These days, policies to promote still more accumulation—capital gains tax cuts, investment incentives, upper-end income tax cuts and all the rest of the supply-side gimcrackery—are like skimping on gas to buy better air filters for your car. An efficient and well-functioning machine to get you places is an admirable thing, but it's just not going to work without fuel.

The Medicaid Waiver: Does how it's said affect what you hear?

DAVID A. ROCHEFORT & KEVIN P. DONNELLY

Like a number of states in New England and elsewhere in the country, Rhode Island finds itself in a period of painful budgetary distress. A fiscal "perfect storm" has descended, the confluence of a faltering economy, disappointing revenue receipts, and rising public expenditures. Although a major restructuring of the state's tax system remains a theoretical option in approaching this predicament, in practice official attention has concentrated on an array of lesser fixes including cuts in existing social programs. As one of the fastest rising components of the state budget, health care has emerged as an obvious target in the ongoing search for savings. Last January, Governor Carcieri unveiled the latest—and potentially most far-reaching—proposal in this area. If approved by Washington, a "global demonstration waiver" could give the Carcieri administration unprecedented control over the design and management of the state's Medicaid program for poor children and adults while capping federal contributions for these services.

The Carcieri administration has launched its Medicaid

David A. Rochefort & Kevin P. Donnelly are at Northeastern University, where they are Arts & Sciences Distinguished Professor of Political Science and a doctoral candidate in Public and International Affairs, respectively.

²See for yourself: www.usitc.gov/tata/hts/.

waiver plan with a curious PR strategy: a high-profile announcement followed by intermittent public comment and limited disclosure of information. It is the rhetoric of this effort that is of interest here. What is responsible for rising health care costs in the state? Which social values should guide the development of solutions to this problem? What kinds of trade-offs are acceptable in achieving the goal of budgetary control? How does this programmatic change align with larger political currents

The Carcieri rhetoric about Medicaid is revealing, but not about program changes ahead.

in Rhode Island and the nation? Who should be trusted in making decisions of this nature on behalf of the public and by what means? In sup-

plying answers to such questions as these, the governor and his team have composed a political narrative that simultaneously packages their bold policy departure, justifies its necessity, courts popular support, and asserts the credibility of the Administration and its leadership. The overall effect is one of a "political spectacle" that is both "tactic" and "mystification," a blending of policy substance with symbolism, ideology, and emotion in the formulation of a policy agenda that could shape one of Rhode Island's most pivotal social programs for years to come.

A Review of the Medicaid Waiver Proposal

Despite the previous year's spending cuts and the adoption of mid-year changes that slashed fiscal year 2008 spending by an additional \$168 million, the approach of FY 2009 brought with it a \$425 million budget deficit, the largest in nearly two decades. To deal with this latest shortfall, the state budget this year includes a freeze in municipal aid, a reduction of the state's workforce, cuts to public universities, and cuts that impact the elderly, poor, and disabled. Much of this new budget reflects what the governor had requested of the Assembly, including a plan for \$67 million in reduced Medicaid spending.

Since 1965, Medicaid has served as the nation's health insurance program for low-income parents, children, seniors, and people with disabilities. Currently, about 180,000 Rhode Islanders receive Medicaid benefits. States are given considerable autonomy to administer their own Medicaid programs, but must follow certain minimal coverage guidelines outlined by the Centers for Medicare and Medicaid Services (CMS). Medicaid costs paid by the state have grown, on average, between six and seven percent over the last six years. In 2007, the state's Medicaid expenditures totaled \$826 million, or 26 percent of the General Revenue budget.⁴

The proposed mechanism for achieving the Medicaid savings is a global waiver from the federal government. The governor first announced his savings plan in January during his State of the State Address, proposing to transform Medicaid from an annual matching grant program to a five-year block grant. In return for the state agreeing to this capped dollar amount, the federal government would allow much greater flexibility in running of the program. Projected savings are expected from three main components. First, the Administration intends to "rebalance" the long-term care system by redirecting beneficiaries—on a voluntary basis—away from nursing homes, residential care, and other high-end services to community-based care settings. Second, all Medicaid beneficiaries will be enrolled in a managed care program. Third, beneficiaries will be required to assume greater costs of care.

After the release of the waiver proposal on July 29th, the General Assembly held a hearing on the waiver before it was sent to the federal government. Administration officials, led by Deputy Secretary of Health and Human Services Adelita Orefice, presented information about the waiver before the House and Senate Committees on Finance. The proposal has since been submitted to CMS for review. The federal agency's involvement will likely include negotiations with the Carcieri Administration on key points, which could result in changes being made to the design of the waiver, or produce a "walk away" point where the state or federal government chooses not to proceed further. If the proposal survives, the General Assembly will have a final opportunity to decide whether to reject the waiver.

Analyzing the Rhetoric of "Reform" From the outset, the plan to recast the state's Medicaid program has relied on a mixture of fact-based and symbolic appeals. First put forward in the State of the State speech as part of a rousing call to action "to cut the cost of government," the proposal was also portrayed in the governor's State of the State address in populist terms as a means of

transforming the Medicaid program "from one centered on institutions and agencies to a system that focuses on the people who use it:

"Responsibility,"
"Competition," and
"Pay for Performance,"
all sound positive.

our children, elderly, and those with disabilities."⁵ The rhetoric also hit core social and economic values ("Competition") to the latest health care management nostrums ("Pay for Performance").

³See Murray Edelman, Constructing the Political Spectacle (Chicago: The University of Chicago Press, 1988).

⁴Exec. Office of Health and Human Services, Medicaid Global

Waiver Presentation, June 2008.

⁵Unless noted, the quotes in this discussion come either from the Governor's State of the State address, or the waiver application itself.

Clearly, Governor Carcieri has sought to position the waiver proposal as a response to circumstances of the direst kind, declaring the state to be "at a tipping point. It is teetering, ready to move dramatically in one direction or another." The growth of government spending is not just a problem of economics under the conservative interpretation, but also one of waste and irresponsibility, as George Lakoff, has highlighted.⁶ Consider the governor's lecturing tone: "Our government has been spending beyond its means, and has been depleting its savings to pay the bills. It's just like anyone of you out there tonight who has been spending beyond your income, using a credit card to support yourself, and then paying off the credit card by taking money from your savings account. When the savings account is empty, you have to stop the spending!"

Lakoff emphasizes that the concept of "trust" is integral to a paternal-moralistic view of government. Although critics of the waiver plan have complained repeatedly about a paucity of detail about how Medicaid would change, the official response has been to stress the need for administrative flexibility with a promise to use it responsibly and appropriately. Thus, when the waiver proposal document was released in late July, HHS deputy secretary Orefice warned: "You're going to see some of the larger concepts in here about the direction and the values and that sort of thing, but not a whole lot of detail about programs specifically, in part because we want to be able to preserve that flexibility." Edelman calls this the strategic use of ambiguity, pointing out that the avoidance of specifics hinders the organization of opposition.

Rallying of opposition has also been made difficult by the Administration's linkage of the waiver proposal to the state's recurring budget shortfalls. The Medicaid waiver is characterized as a vital response to the state's fiscal "crisis." While there is no doubt that Rhode Island's increasingly difficult budget situation has been cause for concern in recent years, active cultivation of a sense of "crisis" can be used in politics to support a plan of ac-

tion that might not otherwise be viewed as necessary or acceptable. [Ed. note: As in the rush to the \$700 billion bailout.] In this way, crisis rhetoric serves as one of the most effective tools for "problem definition"⁸ and for elevating some issues above others on the political agenda.

During the legislative waiver hearing, deputy secretary Orefice described the reform package as a "21st century" idea, thereby depicting the current Medicaid program as an outdated relic of the past. Much like the "crisis" narrative, this past-versus-future dichotomy is often used

to justify wholesale change. The Administration builds upon this "old versus new" comparison by depicting the current

The existing program is "fragmented," "inefficient," and "old."

program as the archetypical rigid bureaucracy. In its words, Medicaid is "fragmented," "prone to inefficiencies," and difficult for beneficiaries to "navigate and understand." Moreover, while the Administration has mentioned "fiscal cross pressures" and "service demands" as contributing factors to the Medicaid problem, each of these has been subordinated to the issue of an inflexible bureaucracy, reinforcing the case for the waiver by connecting it with popular anti-government sentiments.

"Greater personal responsibility for health care" is a central goal of the Global Waiver Plan. It's an appealing abstraction that would, in practice, be implemented by two principal initiatives: first, the creation of Healthy Choice Accounts that supply Medicaid beneficiaries with information about the amount and costs of services they use while providing modest incentives for "targeted healthy behaviors"; and second, the adoption of increased co-payments by beneficiaries. The second measure is the more controversial and has been put forward via various linguistic formulations. Co-payments have been equated with "cost-sharing" and the assumption of a "fair share" of costs by beneficaries. "Smart payments" is the label used to describe the coupling of co-

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 $^{^6\}mbox{George}$ Lakoff, Moral Politics: How Liberals and Conservatives Think (University of Chicago Press, 2002), chap. 10.

⁷Steve Peoples, "Governor Seeks Waiver to Cap Medicaid at \$12.4 billion," The Providence Journal, July 30, 2008.

⁸David A. Rochefort and Roger W. Cobb, The Politics of Problem Definition: Shaping the Policy Agenda (Lawrenceville, KS: University of Kansas Press, 1994), pp. 21–22.

pays with increased monthly premiums. Of course, what is also taking place is a deliberate effort at cost-shifting, from the coffers of government to the pockets of individuals, in a fashion similar to the erosion of insurance that has taken place in the private insurance marketplace.

In his original announcement in January, the governor, framed the waiver proposal as a "Consumer Choice Reform Plan." But this only symbol, not reality. In fact, the bulk of the Global Waiver Plan concerns an idea that can hardly be called "innovative" in 2008, the extension of

Rhetorical strategies apparently work, and make the fight happen on the Governor's turf.

managed care to all Medicaid beneficiaries. Managed care and consumer choice are strategies seldom seen as compatible within the larger

world of health policy reform.

The rhetoric has been effective. In an editorial titled "Waiting for a Waiver," The Providence Journal took the Carcieri Administration to task for missing "several selfimposed deadlines for filing the waiver application,"9 but otherwise followed Carcieri's lead. Most notable was the fact that the Journal's commentary focused solely on the process by which details of waiver were being released, not on the plan's *substance*. One could argue that no substantive critique could have been offered until the proposal and its potential impact were made clear. If that were the case, an editorial position should have been off limits. However, after echoing the Administration's message concerning Medicaid's "unsustainable annual rate" of cost increases and the state's "sluggish revenues," the Journal declared that "it's vitally important the governor succeed with the waiver," an endorsement sans analysis.

In his classic work Language in Thought and Action, S.I. Hayakawa tells us that human beings operate in two worlds: the verbal world and the existential world. 10 The verbal world represents all that we come to know through words, whereas the existential world embodies all that we learn through experience. The verbal world stands in relation to the existential world much as a map does to the territory it represents. Although important details regarding a restructured Medicaid are still lacking, the verbal map drawn by the Administration to guide people in their decision about this proposal is plain. Compared to the current system, Medicaid under the global waiver would be "stronger and more streamlined." Its functioning would be according to a "different business model," in which beneficiaries would seem to operate not as citizens with entitlements, but as consumers with choices and risks. The map also reveals a "defined," that is, limited, state commitment to the program. Throughout, the private sector provides inspiration for officials, not only in management strategy, but also in the willingness to choose not to meet public needs. In the evolving political economy of the state, government increasingly emerges as an imitator of, not counterweight to, the private market.

Conclusion Would adopting the global waiver be a wise move for Rhode Island? We don't know. Implementation of the plan potentially could bring about important benefits to Rhode Island residents, including the expansion of various types of community-based care. Yet, as both proponents and critics acknowledge, there would be significant risks concerning adequacy of funding and the maintenance of current standards within the state's Medicaid program. One thing is certain, though: Symbolism, ideology, and euphemistic labels may indeed be evocative ways to frame the waiver initiative, but they do little to clarify the real issues at stake in this debate. Caveat emptor.

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⁹"Editorial: Waiting for A Waiver," PJ, July 29, 2008.

¹⁰S. I. Hayakawa and Alan R. Hayakawa, Language in Thought and Action (San Diego: First Harvest, 1990), chap. 2.