Friedrich Ebert Stiftung

A Progressive Growth Strategy for the USA

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October 2013

The US economy faces pressing challenges in the short, medium and long term. For the short term, the key policy intervention should be a large increase in public spending. While targeted income transfers can be useful for stabilization, large-scale public investment projects to boost jobs and growth in the near-term have the added advantage of boosting long-term productivity as well.

For the medium term, the key policy intervention should be the aggressive maintenance of full employment, a significant increase in top marginal tax rates and the bolstering of labor market institutions that enhance the bargaining power of low- and middle-income workers (particularly a large increase in the minimum wage and labour law reform that allows willing workers to form unions).

For the long term, the key policy interventions should be to raise the cost of GHG pollution faced by emitters, a reduction in average working hours and efforts – both regulatory and through direct spending – to increase investment in efficiency and carbon mitigation.

The Short-term Challenge: Full Recovery from the Great Recession

June of 2013 marked four full years since the Great Recession officially *ended,* yet full recovery from the Great Recession had not yet happened and it is assuredly *not* guaranteed. Many economic indicators are better than they were two or three years ago: the unemployment rate in May 2013, for example, was a full 2.4 percentage points lower than its peak in October 2009. However, most of the reduction over this time period has not been driven by a jobs boom, but by a reduction in the labor force participation rate.

The 81.8 per cent peak in this measure reached in 2000 was never reached again. At the four-year mark of recovery it had recovered less than a percentage point and sat at 75.9 per cent.

Given how much further the economy still has to grow to get the labour market back to full health, it is distressing that policymakers in both parties have turned far too quickly away from addressing the crisis of joblessness and towards addressing the purely hypothetical menace of large budget deficits. The clearest signal that deficits do *not* pose a pressing danger is that interest rates remained at historic lows even as deficits rose and even as the Great Recession officially ended. What this clearly indicates is that the US economy remains severely demand-constrained, and that extraordinarily accommodative monetary policy will not spur a full recovery on its own.

The freedom from speculative attack enjoyed by the United States means that fiscal policy has been nowhere near as contractionary in the past three years as it has been throughout the Eurozone. Nevertheless, it still clearly fails to meet the need to fill the »output gap« between actual output and what could be produced if all idle resources (including workers) were employed. Government spending has also fallen far behind even the more modest benchmark set by the historical record of past recoveries which needed government spending much less than the current one. If the average trajectory of government spending during the previous three recoveries had been sustained in the past four years, the output gap would nearly be closed today and the unemployment rate would be much closer to 5 per cent than today's 7.6 per cent.[1]

1. For more details on public spending in the current recovery relative to historical trends see Josh Bivens and Heidi Shierholz (2013): How Much Has Austerity Held Back Recovery So Far? Economic Policy Institute.

The economics of using fiscal stimulus to secure a full recovery are quite clear. Unfortunately, it is equally as clear that current US politics will not let this happen. This raises a number of issues concerning whether or not other policy levers can help secure such a recovery.

The Federal Reserve has been by far the most aggressive major macroeconomic policymaking institution in the world in addressing the Great Recession and its aftermath. By the middle of 2008 its conventional short-term interest rates were set to essentially zero to boost spending, and by the end of that year it was engaged in unconventional »quantitative easing«, long-term asset purchases to drive down interest rates. These measures have clearly aided recovery; researchers at the San Francisco Federal Reserve Bank have estimated that the unemployment rate would have been roughly 1 to 1.5 percentage points higher at the end of 2010 had these long-term asset purchases not occurred.[2] However, it seems unlikely that such aggressive monetary policy can by itself secure a full recovery, and the beneficial effect of the Fed's programme is fairly fragile.

The most sweeping financial regulatory reform in years – the Dodd-Frank Act – was passed in 2010 in response to the financial crisis that accompanied the Great Recession. How it will succeed in preventing future crises remains extremely uncertain. Key details of implementation remain unresolved even today and the real test of counter-cyclical financial policy will come when asset markets boom again. Since the crash of 2008, there has been little evidence that financial markets are making excessively risky bets; the extraordinarily high prices of US treasuries, for example, is a clear sign that these markets continue to remain fairly risk-averse.

Regardless of how Dodd-Frank performs in restraining future excess, it does very little to boost economic activity in the near-term. Housing policy that allows for substantial restructuring of mortgages to boost potential consumer spending could help boost recovery. The inability of many American homeowners to take advantage of historically low interest rates and refinance their mortgages, however, has hamstrung the effectiveness of monetary policy. But even an extraordinarily aggressive programme of mortgage refinancing was estimated to potentially boost GDP by about 50 billion dollars.[3]

The Medium-term Challenge: Reversing the Generation-long Rise in Inequality

For the first three decades following the end of the Second World War economic growth was rapid and broadly shared across the income distribution. Between 1979 and 2007, growth has been slower, much more concentrated at the very top of the income distribution and, except for the late 1990s, has left low- and middle-income households' living standards barely creeping upwards.

The implications of this difference in growth rates between the very top and low- and moderate-income Americans are startling. Between 1979 and 2007, 38.3 per cent of total income growth in the American economy was attributable to growth of the highest 1 per cent of households. The bottom 80 per cent of households saw barely a quarter of overall income growth over this period (25.5 per cent).[4]

On the whole, policy makers' decisions – including decisions *not* to act – over the past generation have tilted the balance of economic power away from low and middle-income families towards the already-affluent. For example, tax rates faced by the richest American households have plummeted in the past generation.[5] The deregulation of financial markets opened up a much wider range of activities for financial institutions and most of this activity hid risk and increased rents in the sector rather than boosting overall growth.[6]

At the same time, domestic labour law has failed to keep pace with rising employer hostility and with aggressive

2. For this estimate, see Hess Chung, Jean-Philippe Laforte, David Reifschneider and John C. Williams (2011): Have We Underestimated the Likelihood and Severity of Zero Lower Bound Events? Working Paper 2011-01, Federal Reserve Bank of San Francisco.

3. For this estimate, see Alec Philips (2011): Revisiting the Potential for Large Scale Mortgage Refinancing, *US Daily,* 26 August, New York, N.Y.: Goldman Sachs.

4. For more on the growth of income and wage inequality over the past generation see Lawrence Mishel, Josh Bivens, Elise Gould and Heidi Shierholz (2012): The State of Working America, 12th Edition. Ithaca. ILR Press, Cornell University and Economic Policy Institute.

5. For the influence of lower top marginal tax rates on inequality see Andrew Fieldhouse (2013): Rising Income Inequality and the Role of Shifting Market-Income Distribution, Tax Burdens, and Tax Rates. Economic Policy Institute Briefing Paper No. 365.

6. See Andrew Haldane (2010): The Contribution of the Financial Sector – Miracle or Mirage? Speech by Mr Andrew Haldane at the Future of Finance conference, London, 14 July 2010.

tactics against attempts to organize unions.[7] This has had powerful effects on inequality as the direct benefits of unionization for workers are progressive, with wages and benefits being larger for low-wage workers than higher-wage workers. Research further shows that unions actually provide a needed check on excessive executive pay.

Most striking, perhaps, is the tendency for federal policymakers to allow the real value of the minimum wage to be eroded by inflation for nearly a decade at a stretch over much of the past generation. Modest increases in the minimum wage are politically popular and state-of-the-art empirical microeconomics argues they cause no detectable disemployment effect. Nevertheless, they are incredibly hard to actually make happen.

There is no single silver bullet that will reverse the past generation's growing inequality of incomes and wages. Instead, policymakers should look at the whole portfolio of economic policymaking – labour market standards, monetary policy, tax policy, regulatory policy and trade policy, among others – to see where opportunities arise for boosting the bargaining power of low- and middle-wage workers. The past generation's enormous rise in inequality has been driven by a steady accumulation of policy decisions that boosted bargaining power at the top, and reversing it will similarly require a steady accumulation of decisions that reverse this.

The Long-run Challenge: Global Climate Change

Experts agree that anthropogenic climate change has already begun. The clearest policy lever for mitigating carbon emissions is to price the currently free externality imposed by these emissions. A carbon tax and a hard cap on emissions accompanied by the rights to emit below the cap to be traded are two of the most-often mentioned mechanisms for raising the cost of emissions. Direct government regulation of carbon emissions is another possibility.

Lastly, a comparison of economic and emissions histories in the United States and its advanced-country peers is interesting. Because many of the latter have made the social decision to take some portion of productivity increases in the form of increased leisure rather than increased consumption, this means that the pace of carbon emissions in the non-US developed world has been much slower.[8] If succeeding decades sees the United States move closer to its global peers in shortening average annual hours worked – devoting a portion of coming productivity gains to increased leisure rather than increased consumption – then the challenge of slowing and reversing carbon emissions would be much less daunting.

Synergy in Policy Solutions for the Short, Medium and Long Terms

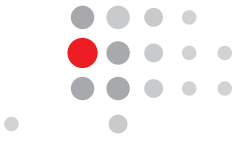
Each of the problems identified in various time-horizons so far seem extremely daunting, particularly given the dysfunctional state of American politics. However, from an economic perspective all of these problems are solvable. And while political constraints bind tight, they are nothing compared to genuine economic constraints.

Many of the proposed solutions addressing challenges within each time horizon dovetail and can lead to genuine synergy in addressing challenges across time horizons. Take, for example, using policy to reduce average annual hours worked. If undertaken in the near-term, it could reduce the gap between potential and actual GDP, which is the primary barrier to restoring the labour market to pre-Great Recession health. And in the longer term, getting American workers used to allocating productivity gains to increased leisure could reduce carbon emissions relative to the »business as usual« base-case that currently makes climate change look so dangerous.

A key barrier to selling Americans on reducing working hours in the longer-term is the simple fact that increasing working hours was one of the key coping mechanisms households used to achieve higher living standards in the face of nearly-stagnant hourly wages. Giving American households confidence that they will see substantial living standards gains as overall productivity rises would be

7. On the gap between unionization rates and the share of American workers who say they would like to be in a union see Richard Freeman (2007): Do Workers Still Want Unions? More than Ever. Agenda for Shared Prosperity Briefing Paper. Washington, DC. Economic Policy Institute.

8. See David Rosnick and Mark Weisbrot (2006): Are Shorter Work Hours Good for the Environment? A Comparison of U.S. and European Energy Consumption. Washington, DC. Center for Economic and Policy Research.



key to convincing them that some of these gains should go to increased leisure.

Or take measures either providing a market price for carbon or directly regulating (and hence increasing the costs of) carbon emissions. These obviously are laser-focused on reducing carbon emissions. But if they are done while substantial output gaps remain (and to be clear – this could well be half a decade or more), the investments in carbon abatement they spur will provide a Keynesian boost to the economy and close output gaps in the short term.

Federal Budget Deficits are Not the Main Problem

We should finish by acknowledging that we have not identified large federal budget deficits as a pressing economic challenge, over any time horizon. This is because they are not. Before 2008, even with the deeply unwise fiscal policy decisions made in the 2000s, these deficits were small and manageable. After the Great Recession, cyclical factors made these deficits rise significantly – but these large deficits were useful shock absorbers. In the long term, projected deficits are driven mainly by rapidly rising health care costs. But these costs have slowed in recent years, and major new reforms to American health care have been passed and have already begun to take effect. In short, the source of these long-term budget problems may well already have been solved; and at the very least it would make sense to wait and see their long-term effect before rushing to lock-in policies that could reduce the deficit only by inflicting widespread pain through cutting valuable social insurance programmes.

The economic challenges identified in this paper are much more serious and potentially harmful than budget deficits. As such, they should claim a much larger share of policymakers' attention than they currently do, and much of this attention should be diverted from the misguided obsession with reducing federal budget deficits.

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ISBN 978-3-86498-682-6

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