

An Economy That Works for All Americans

Jeffrey Frankel

Harpel Professor of Capital Formation and Growth



HARVARD Kennedy School
JOHN F. KENNEDY SCHOOL OF GOVERNMENT

Harvard Institute
for Learning in Retirement
February 24, 2017

“An Economy That Works for All Americans” *

- I. Are ordinary Americans being left behind in the modern economy?
- II. If so, why?
- III. And what is to be done about it?

* The title comes from a session at the Harvard Bipartisan Program for Newly Elected Members of Congress, HKS, December 7, 2016.

But first, the current state of the economy

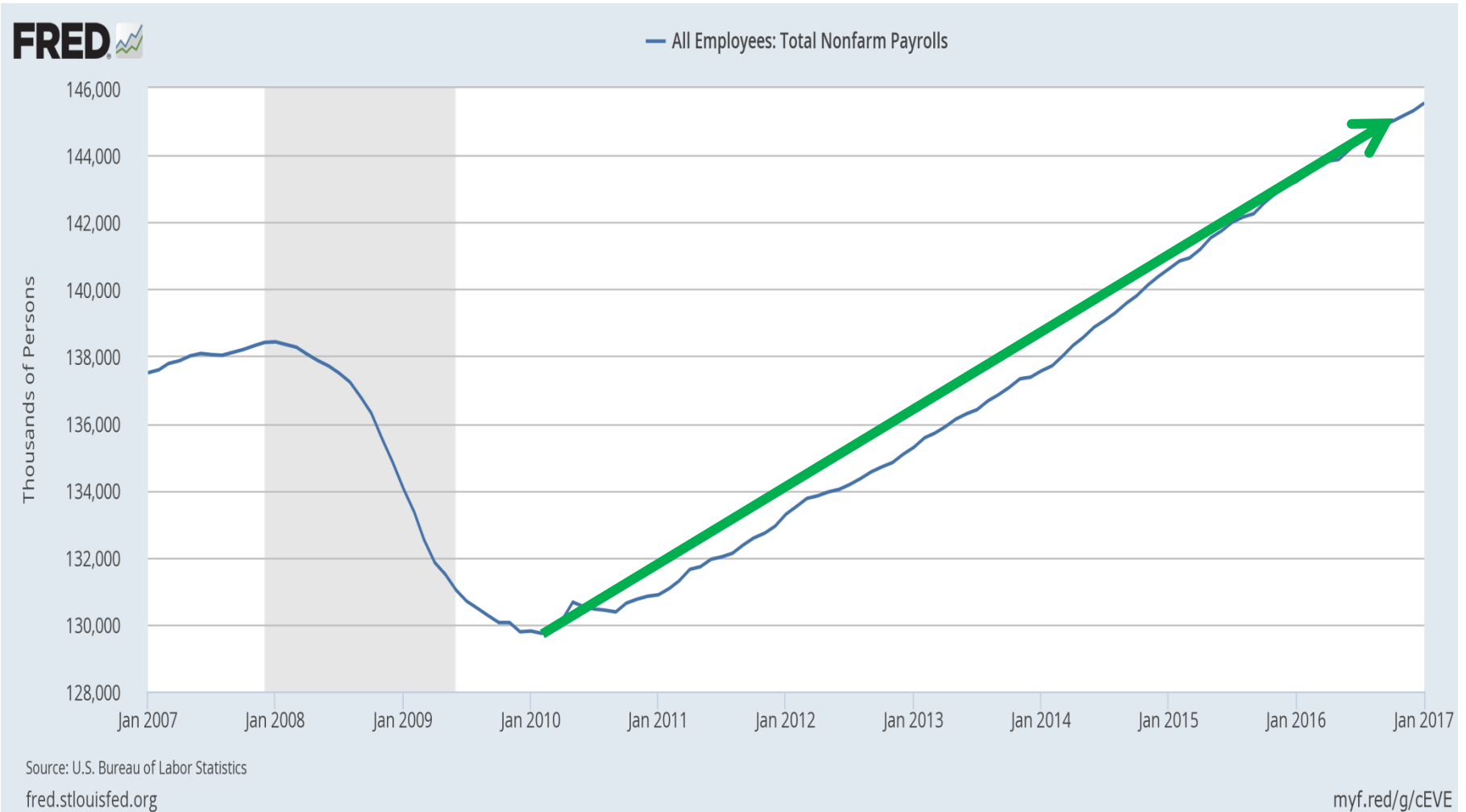
The Fed is expected to raise interest rates
3 times in 2017. Why?



The most recent stats are positive:

- Real GDP rose 1.9% in 2016 (Q4/Q4), and in 2015.
- Employment growth has continued stronger:
 - January continued the longest streak of job growth on record.
 - Altogether, almost 16 million jobs added since early 2010.
 - Unemployment rate down to 4.7%, close to full employment.
- Wages rose 2.9 % during 2016.

Altogether, the economy has added almost 16 million jobs since early 2010.



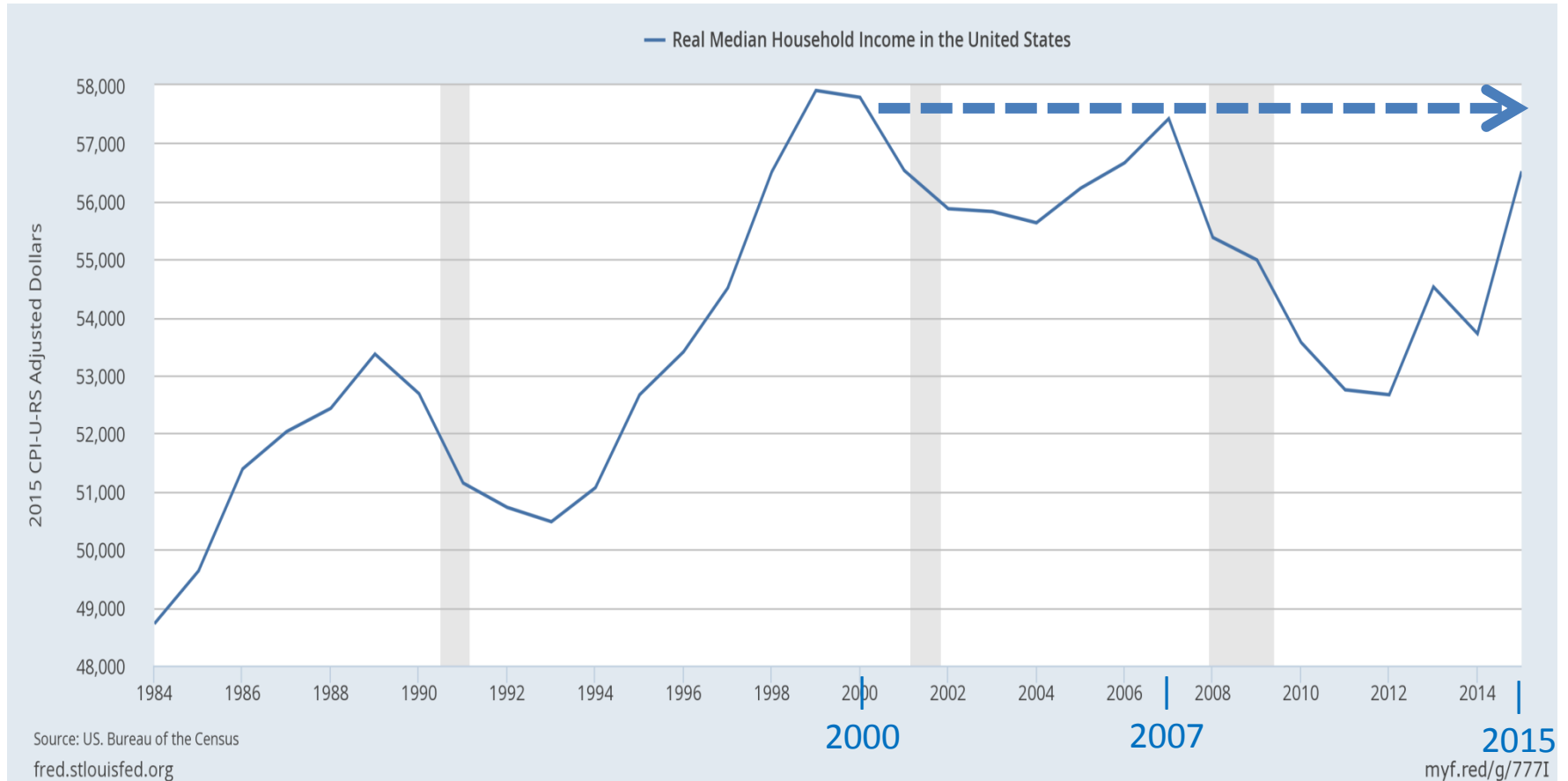
(I) If the economy is in such good shape,
why has there been such discontent?

One obvious answer:

The longer-term trend for typical
Americans has not been good.

Since 2000, the gains have gone to those at the top.

Real median family income is still below 2000!

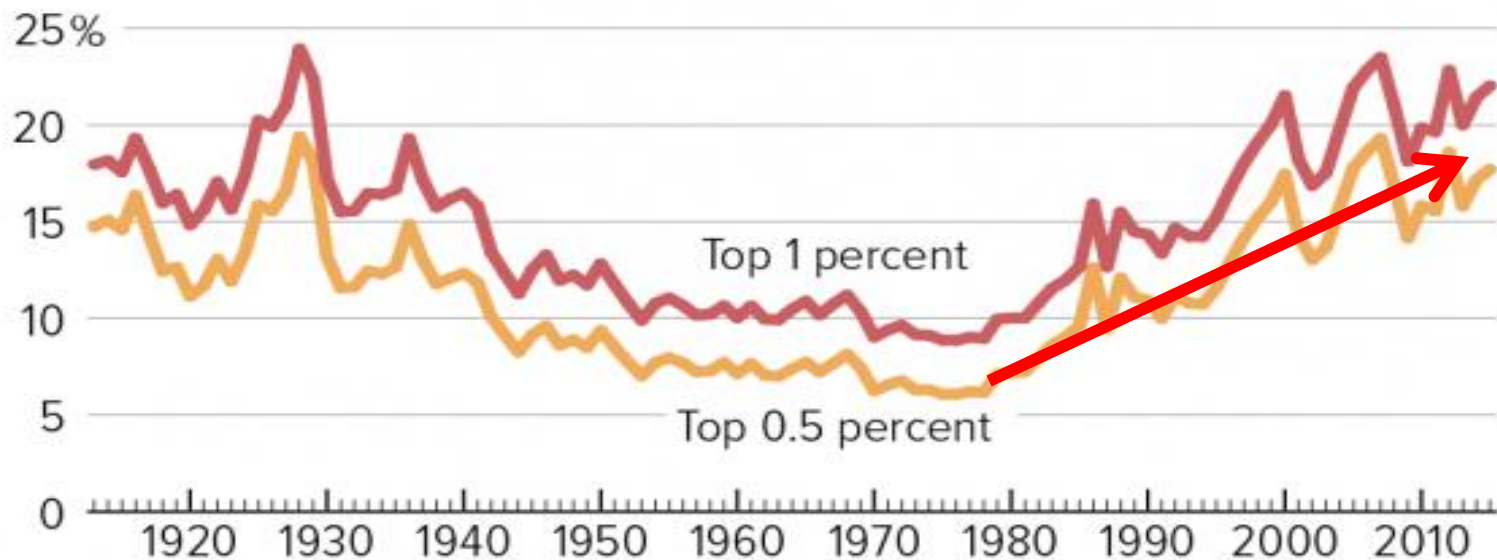


even though median income rose 5.2% in 2015, the fastest ever;
and the poverty rate fell from 14.8% to 13.5%, the largest drop since 1968.

The share of US income going to the top has been rising since 1980, and is now back to the 1920s level.

Income Concentration at the Top Has Risen Sharply Since the 1970s

Share of total before-tax income flowing to the highest income households (including capital gains), 1913-2015



Source: Emmanuel Saez, based on IRS data

CENTER ON BUDGET AND POLICY PRIORITIES | CBPP.ORG

Overview

- I. So, yes, ordinary Americans have been left behind in the modern economy.
- II. Ten reasons why US inequality has risen.
- III. Ten policy proposals to help share a growing economic pie more equally.

(II) Why has inequality risen in the US? Ten reasons.

1. Trade probably does play a role, along with:
2. technological change raising demand for skilled workers,
3. outpacing education that raises the supply;
4. “winner-take-all” labor markets,
5. “assortative mating,”
6. more corporate monopoly power (higher “rents”),
7. and “excessive” executive compensation.
8. Piketty: wealth accumulates faster than income.
9. Possibly the decline in union power & minimum wages.
10. The tax cuts for the rich in early 1980s & 2000s.

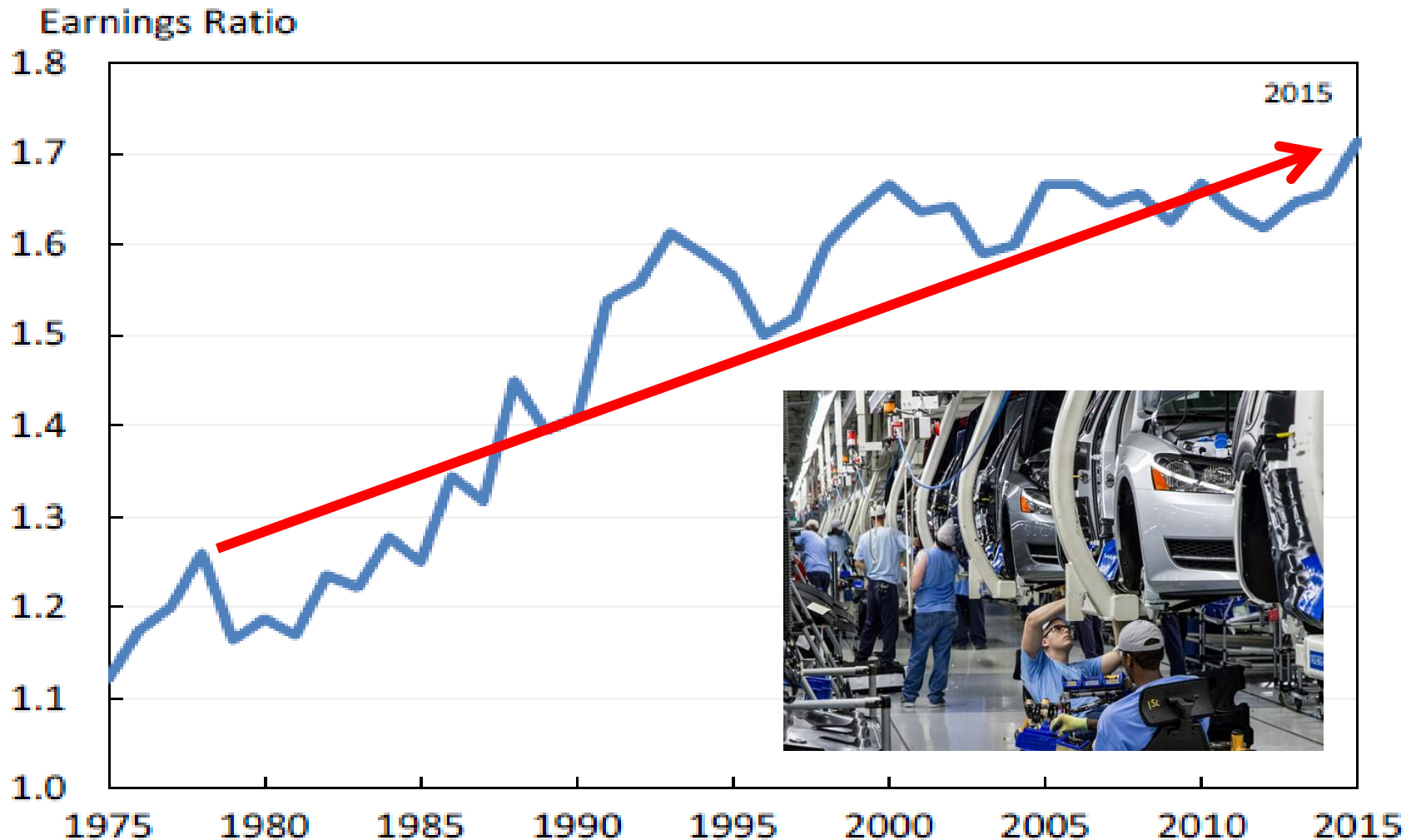
1. Trade probably does play a role



- Import competition has certainly hurt some workers,
 - as in the clothing & steel industries.
- But trade also has benefits:
 - Imported goods lower costs to consumers, especially low-income consumers.
 - Imported components keep costs low for US firms,
 - e.g., allowing US autos to remain globally competitive.
 - Exports create new jobs
 - which tend to pay 12% more than average jobs.

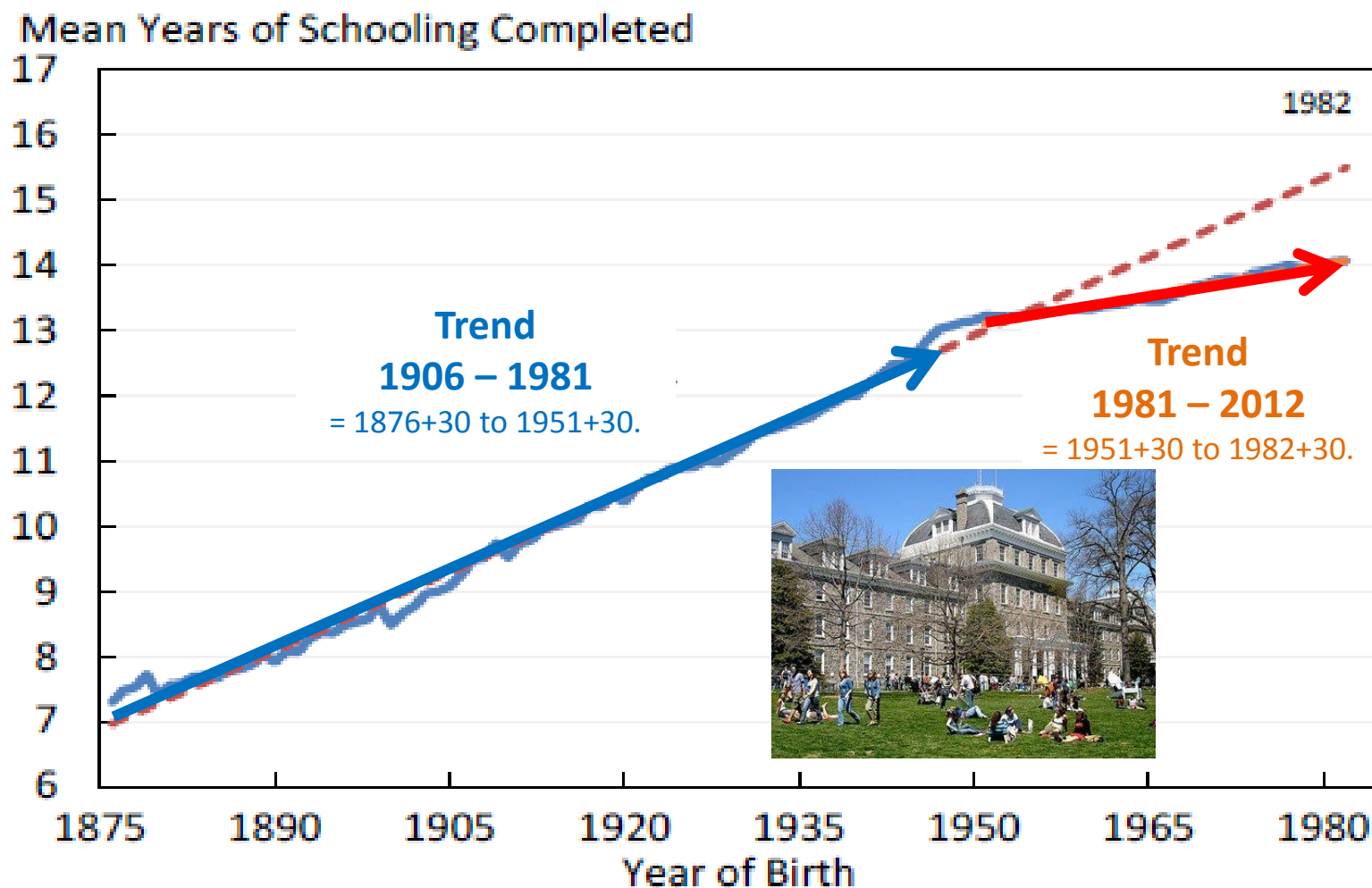
2. Technology raises demand for “skilled” vs. “unskilled” workers, as shown by widening wage gap.

College Earnings Premium, 1975-2015



3. The trend in years of education slowed during 1981-2012.

Average Years of Schooling at Age 30, U.S. Native-Born, by Year of Birth, 1876-1982



4. “Winner take all” labor markets



Taylor Swift earned \$170 million last year, making her the world’s highest paid celebrity (according to *Forbes*).

5. “Assortative mating”

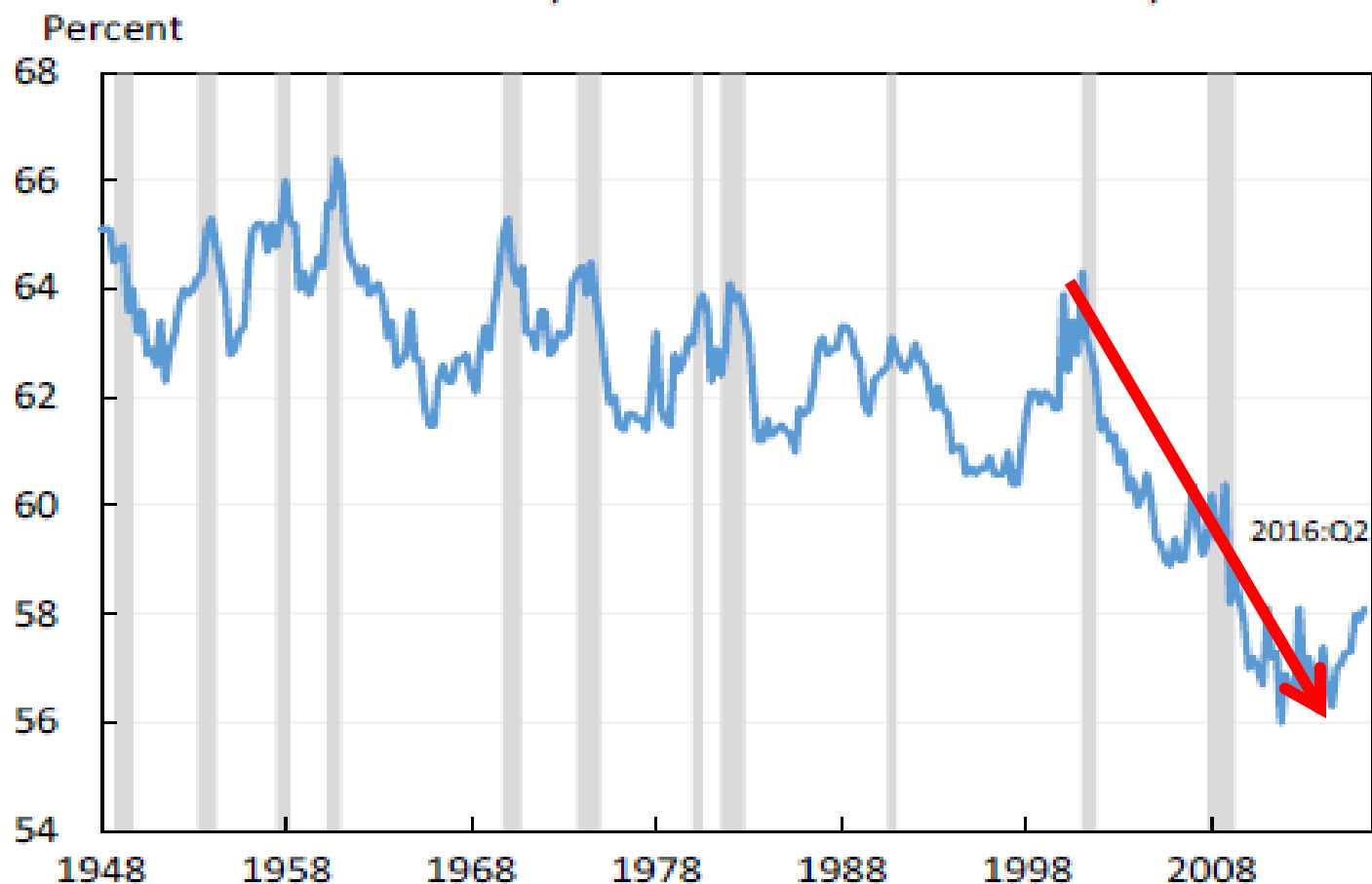
Crudely put: highly educated ,
highly paid, male professionals
used to marry their secretaries,



but now are more likely
to marry highly educated & (relatively) highly paid women.
The couple passes the advantages on to their children.

6. The share of US national income going to labor has declined since 2000 in part due to increased market power of firms, says Furman.

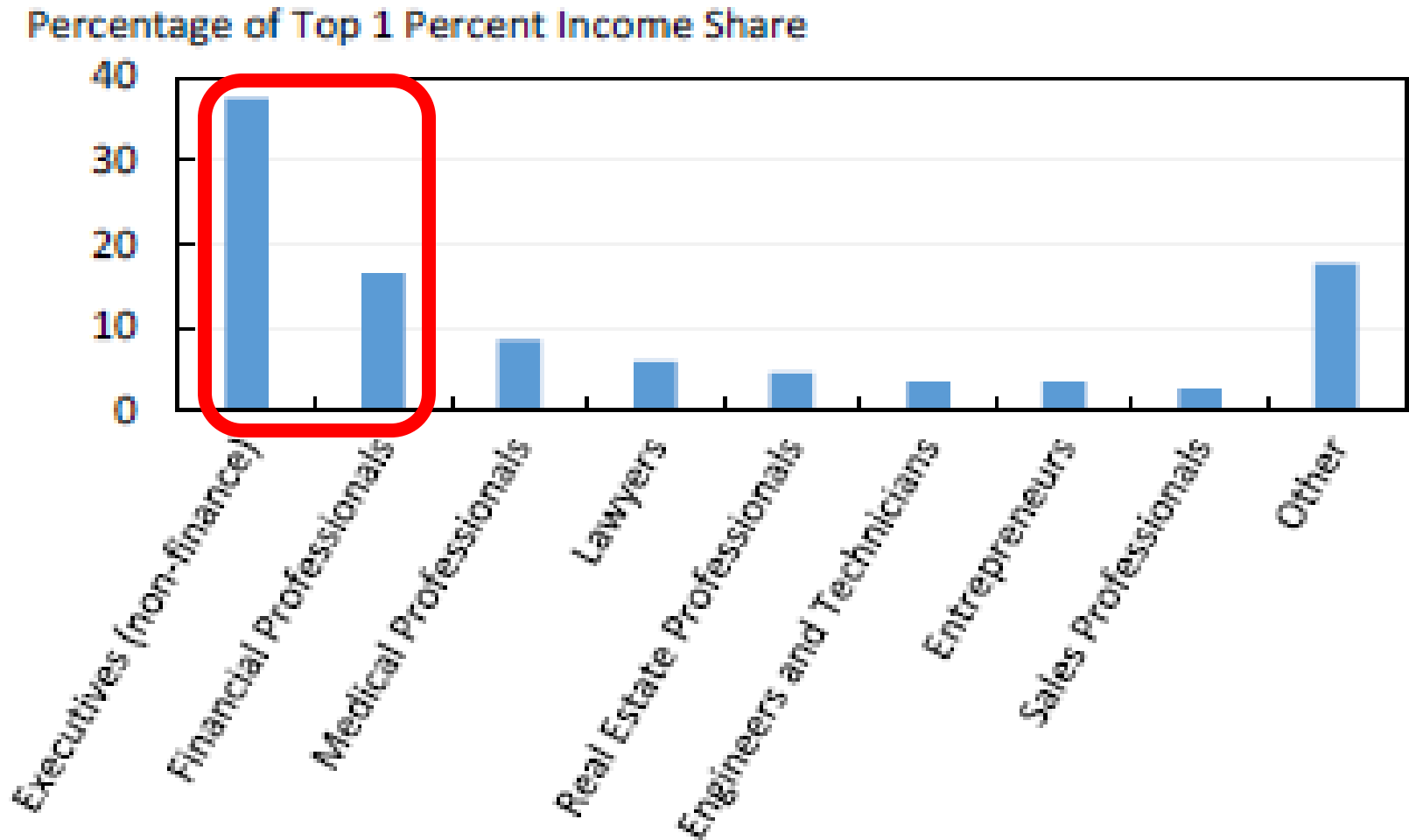
Labor Share of Income, Nonfarm Business Sector, 1948-2016



7. Excessive compensation?

Many top-1%-ers are executives and/or in finance.

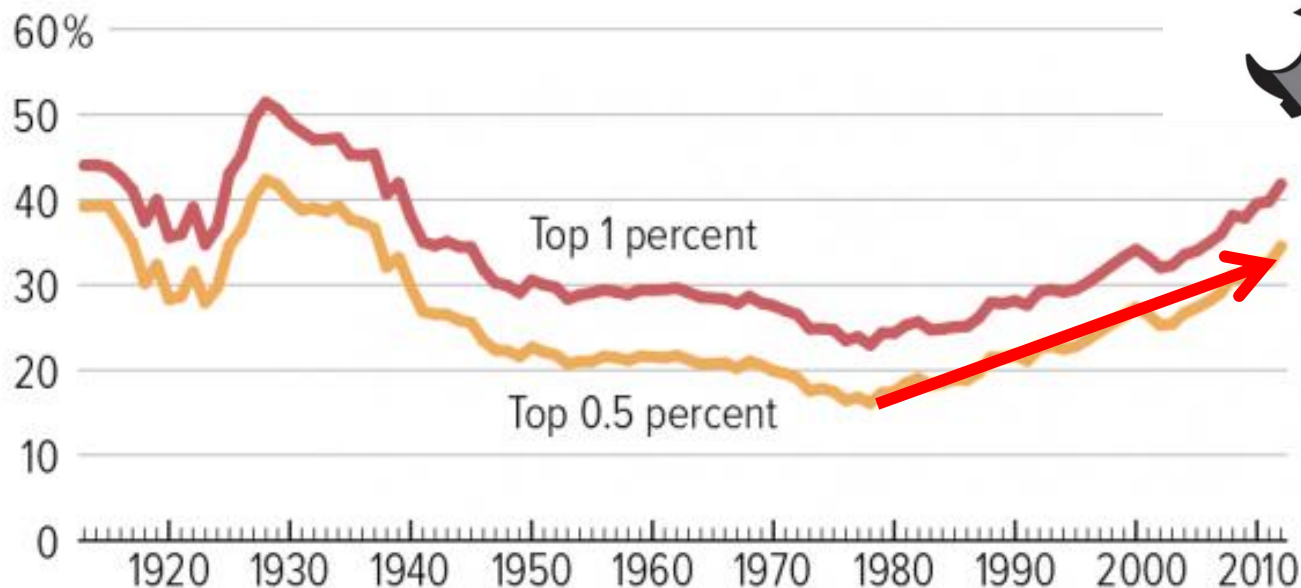
Composition of Top 1 Percent Income Share by Primary Occupation



8. Supporting Piketty: The share of wealth at the top has also been rising.

Wealth Concentration Has Been Rising Toward Early 20th Century Levels

Share of total wealth held by the wealthiest families, 1913-2012

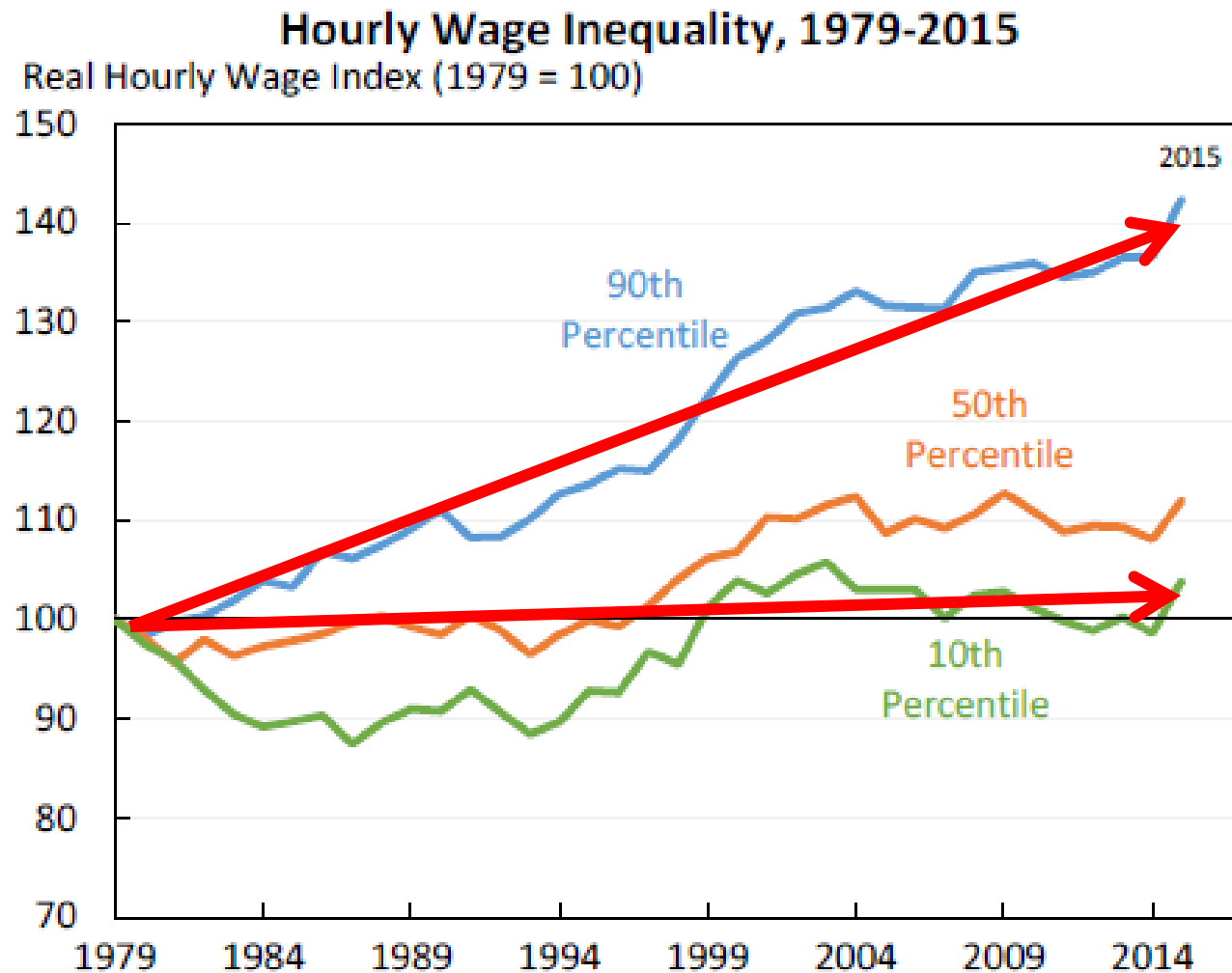


Source: Saez and Zucman, May 2016

CENTER ON BUDGET AND POLICY PRIORITIES | CBPP.ORG



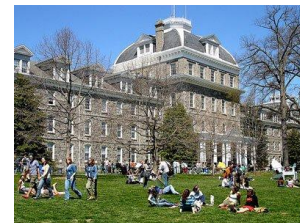
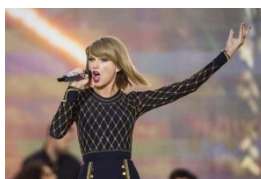
On the other hand, the big increase in inequality has been *within* labor (and within capital).



What weights should we place on each of these factors in explaining increased inequality?

- I don't know.
- Probably all merit some weight:

- Trade,
- technology, education,
- winner-take-all,
- assortative mating,
- rents, executive compensation,
- and wealth accumulation.



- Surely one must diagnose the cause before deciding on the corresponding remedy?
- No, I don't think one has to.

(III) Ten policy proposals to promote An Economy That Works for All Americans

1. Expand, don't reduce, the health-insured population.
2. Strengthen, don't weaken, US financial regulation.
3. Address the long-term rise in household debt.
4. Reform the tax system
5. Put social security on a sound footing.
6. Increase infrastructure spending.
7. Allow fracking (but with careful regulation).
8. Improve education, esp. universal pre-school education.
9. Keep US global economic leadership.
10. Consider wage insurance.

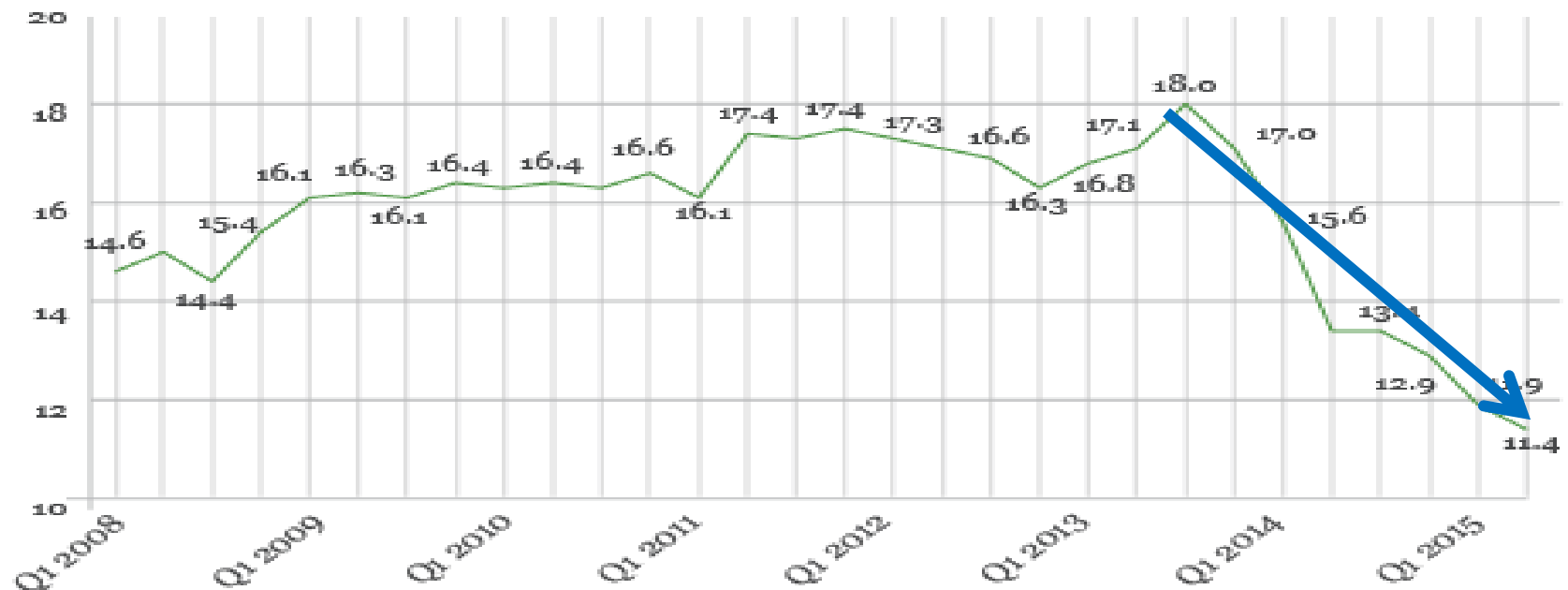
1. Keep the Affordable Care Act which has sharply reduced the percentage of Americans lacking health insurance, and is fully funded.

Percentage Uninsured in the U.S., by Quarter

Do you have health insurance coverage?

Among adults aged 18 and older

■ % Uninsured



Quarter 1 2008-Quarter 2 2015

Gallup-Healthways Well-Being Index

GALLUP

2. Retain intelligent financial regulation

- Let the “fiduciary rule” on financial advisers go into effect in April.
- Don’t gut Dodd-Frank financial reform, esp. its:
 - higher capital requirements for banks,
 - tough stress tests on banks,
 - designation of Systemically Important Fin. Institutions,
 - enhanced transparency for derivatives, and
 - the Consumer Financial Protection Bureau.

3: Address the long-term rise in household debt: housing, auto, & student loans

- Reduce the policy tilt toward getting American families up to their eyeballs in mortgage debt they can't afford.
 - It led to 2007-09 financial crisis. And it drives up housing prices
 - without even much raising home ownership rates.
 - Specific policies:
 - Require a serious minimum down payment, as other countries do.
 - Require “skin in the game,” on the part of mortgage-originators.
 - Curtail tax deductibility of mortgage interest,
 - which mainly benefits the well-off.
 - » It generally saves less than \$200 for households earning \$65,000.
 - Reduce deductions at the upper end,
 - especially if loan is used other than for purchase of residence
 - » i.e., 2nd home or “cash out” for spending.
 - Don't repeat the mistake of privatized Fannie Mae & Freddie Mac. ²³

Address household debt: housing, auto & student loans, continued

- Auto dealers should not have been exempted from the Consumer Finance Protection Bureau.
 - A rising share of sub-prime auto loans are now delinquent.
- Although *most* college educations are still a good deal, and worth going into debt for if that is the only way, *some* enterprises are bad deals.
 - In particular, a majority of for-profit universities.
 - Government should expand student grants & loans,
 - but tighten requirements that the college or university have a decent record regarding rates of graduation & gainful employment, not loosen them.

4. Reform the tax system

- Reform the corporate income tax .
Stay revenue-neutral:
 - lower rate,
 - but cut distorting deductions,
 - e.g., oil subsidies & interest deductions.
- Reform personal income tax to make it more progressive, not regressive.
 - E.g., expand EITC,
 - and abolish the carried interest deduction.
- Don't eliminate the estate tax.
- The most efficient taxes are on energy:
 - Gasoline & carbon taxes, as proposed by Feldstein & Mankiw.

5. Put social security on a sound footing

- (1) Gradually raise the retirement age. Meanwhile,
- (2) Make payroll taxes more progressive:
 - Exempt low-income workers and
 - raise the cap on payroll taxes (now at \$117,000).

6. Increase infrastructure spending.

- (1) It's good for growth
- (2) and creates jobs for construction workers
though we could have really used it 5-7 years ago,
when unemployment was twice as high.

The last 4 of the 10 policy proposals

7. Allow fracking
but with careful regulation.
8. Improve education,
esp. universal pre-school education.
9. Keep US global economic leadership,
including abiding by past trade agreements
and pursuing new ones... like TPP!
10. Consider wage insurance,
which compensates those who lose jobs (not just for trade)
and does not penalize taking a new job at lower wage.

An Economy That Works for All Americans

Jeffrey Frankel

**Harpel Professor of Capital Formation and Growth
Harvard University**

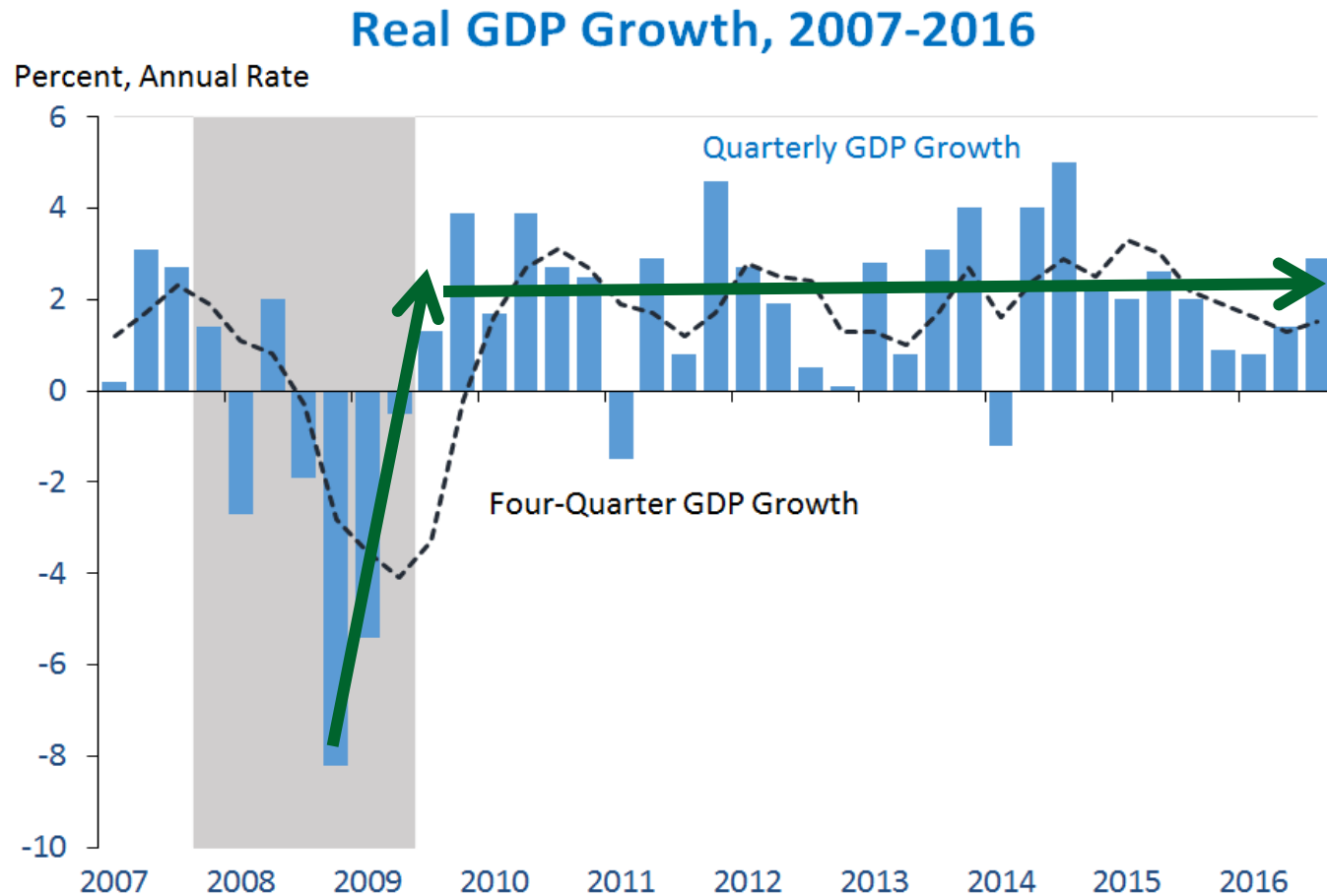


Appendices

1. More on macroeconomic developments
2. Long-term job losses in some sectors:
manufacturing, agriculture, & coal
3. Policies targeted toward 8 individual
causes of inequality

Appendix 1: More on macroeconomic developments

The economy turned around in June 2009,
but the recovery was slow and long.



Note: Shading denotes recession.

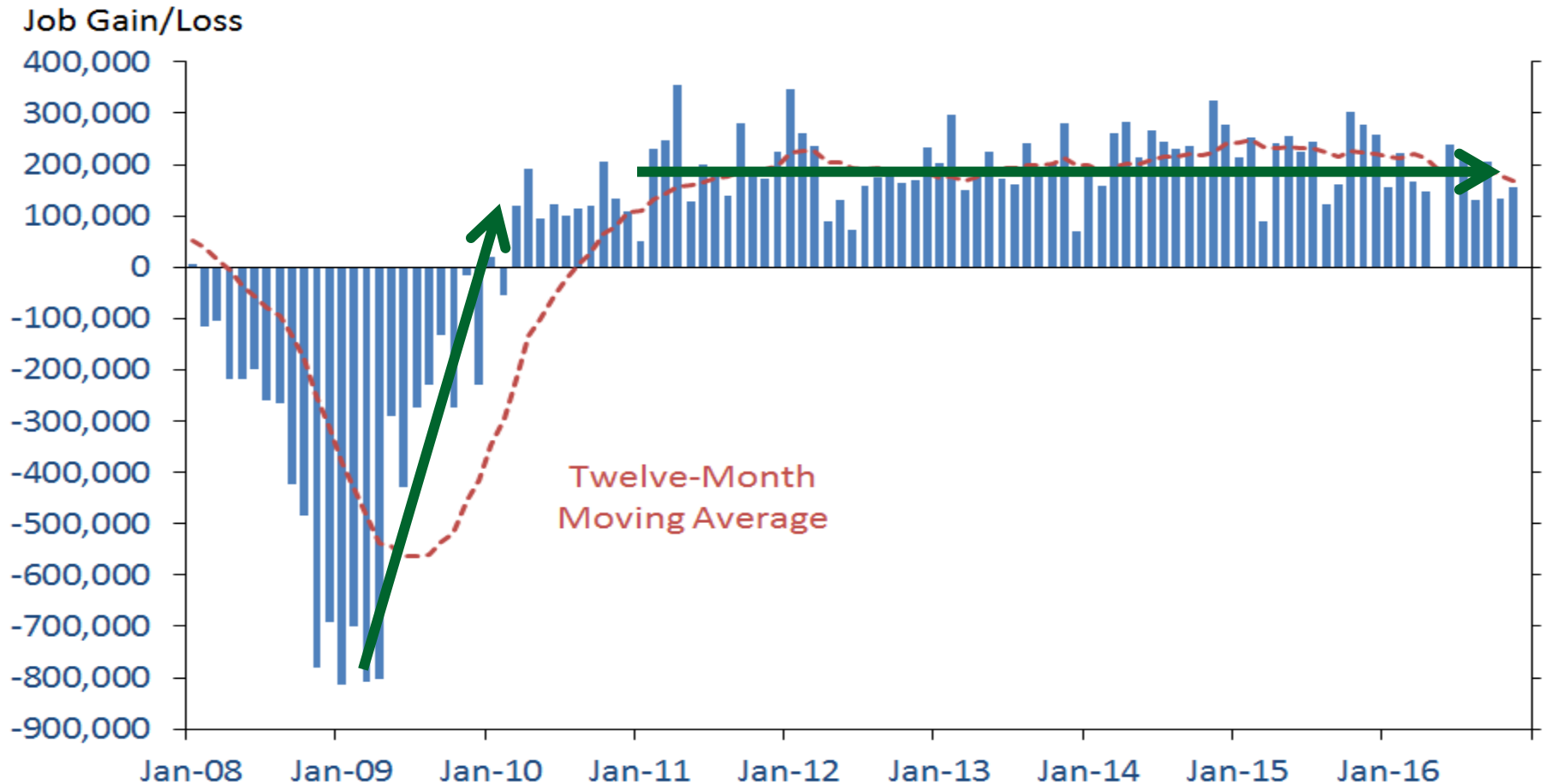
Source: Bureau of Economic Analysis, National Income and Product Accounts; CEA calculations.

Employment growth has been steady since early 2010.

The private sector has added 15 ½ million jobs in the last 81 months.

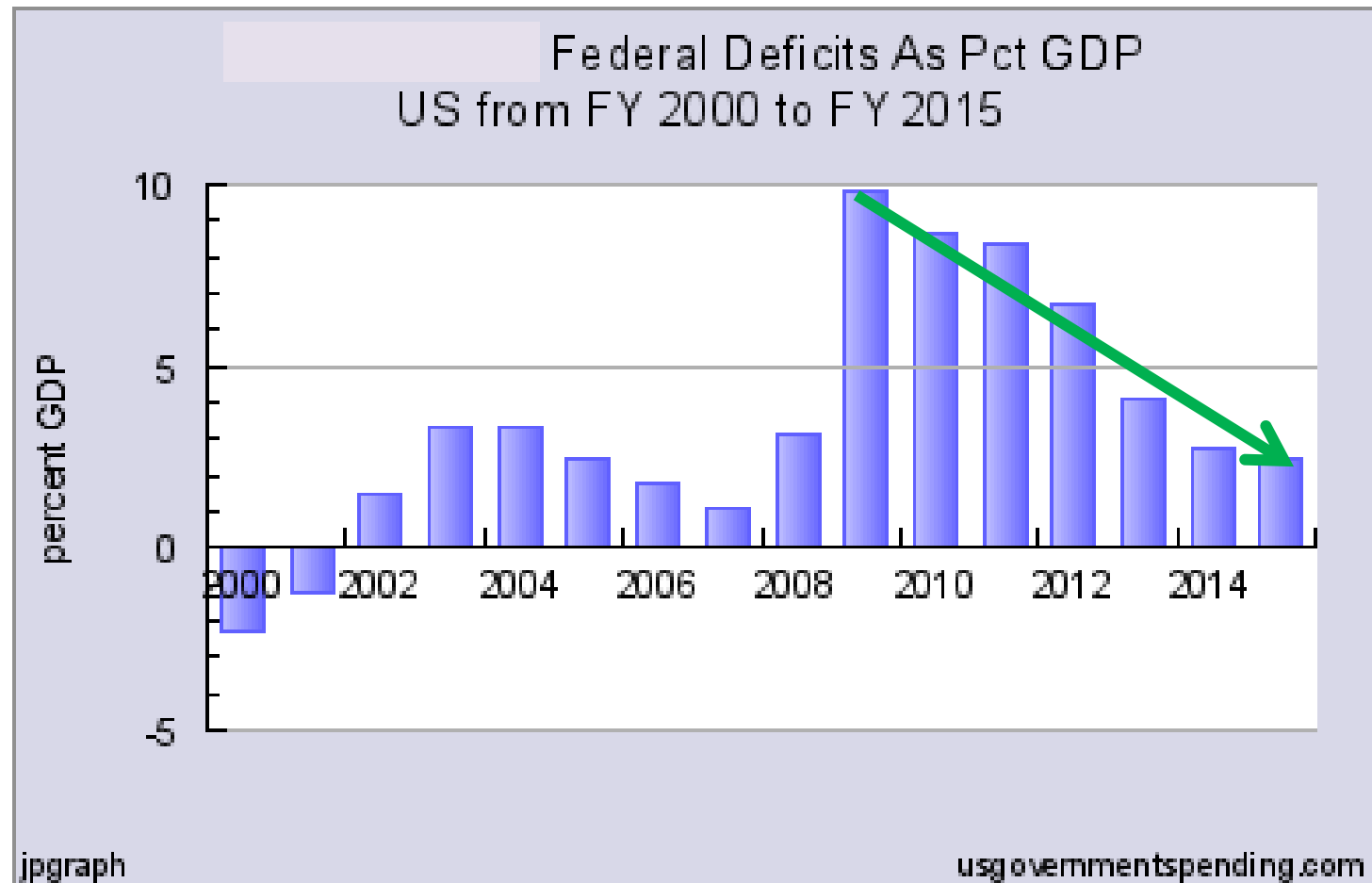
Private-Sector Payroll Employment

Monthly Change, Seasonally Adjusted



Source: Bureau of Labor Statistics, Current Employment Statistics; CEA calculations.

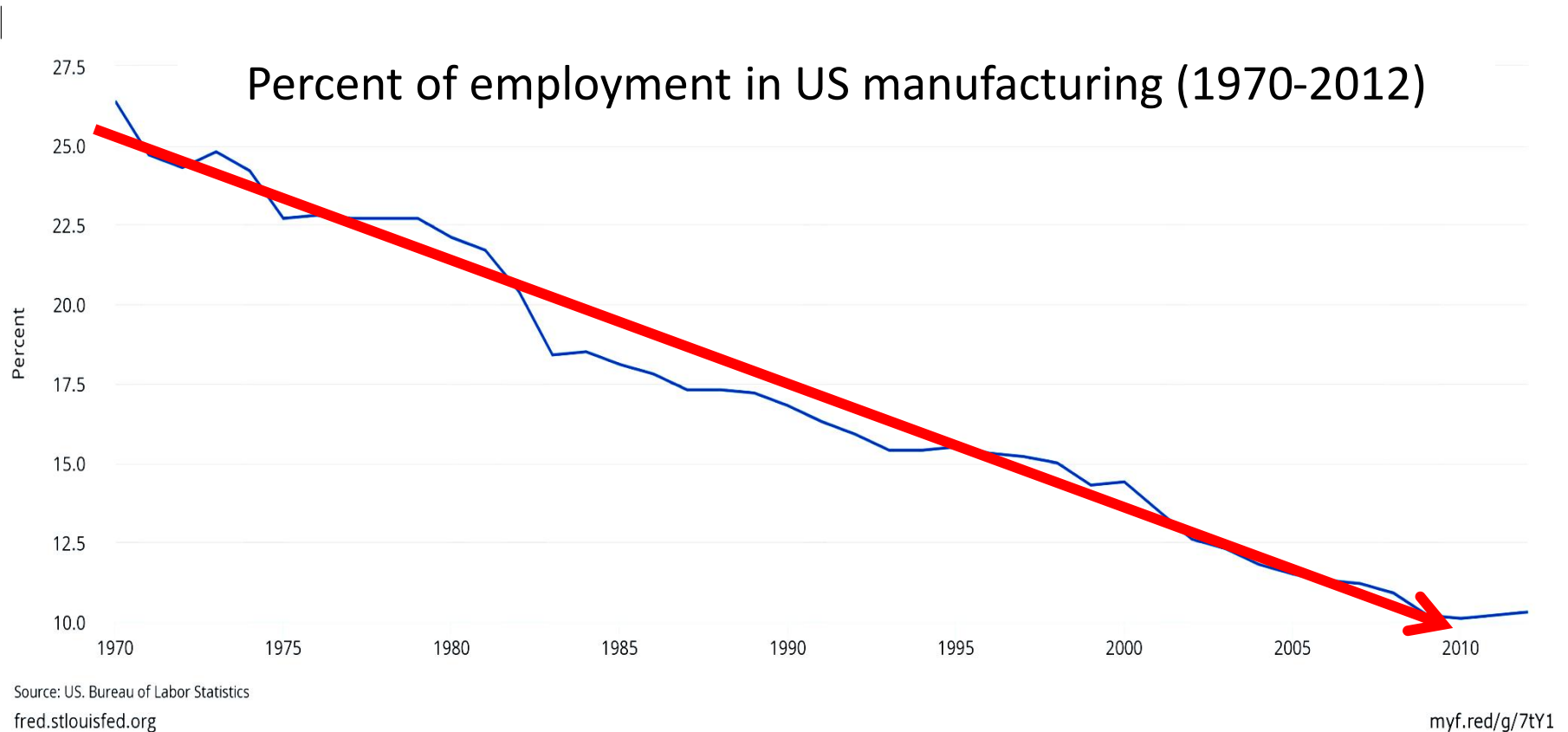
The budget deficit has come down since 2009.



Appendix 2: Long-term job loss in some sectors

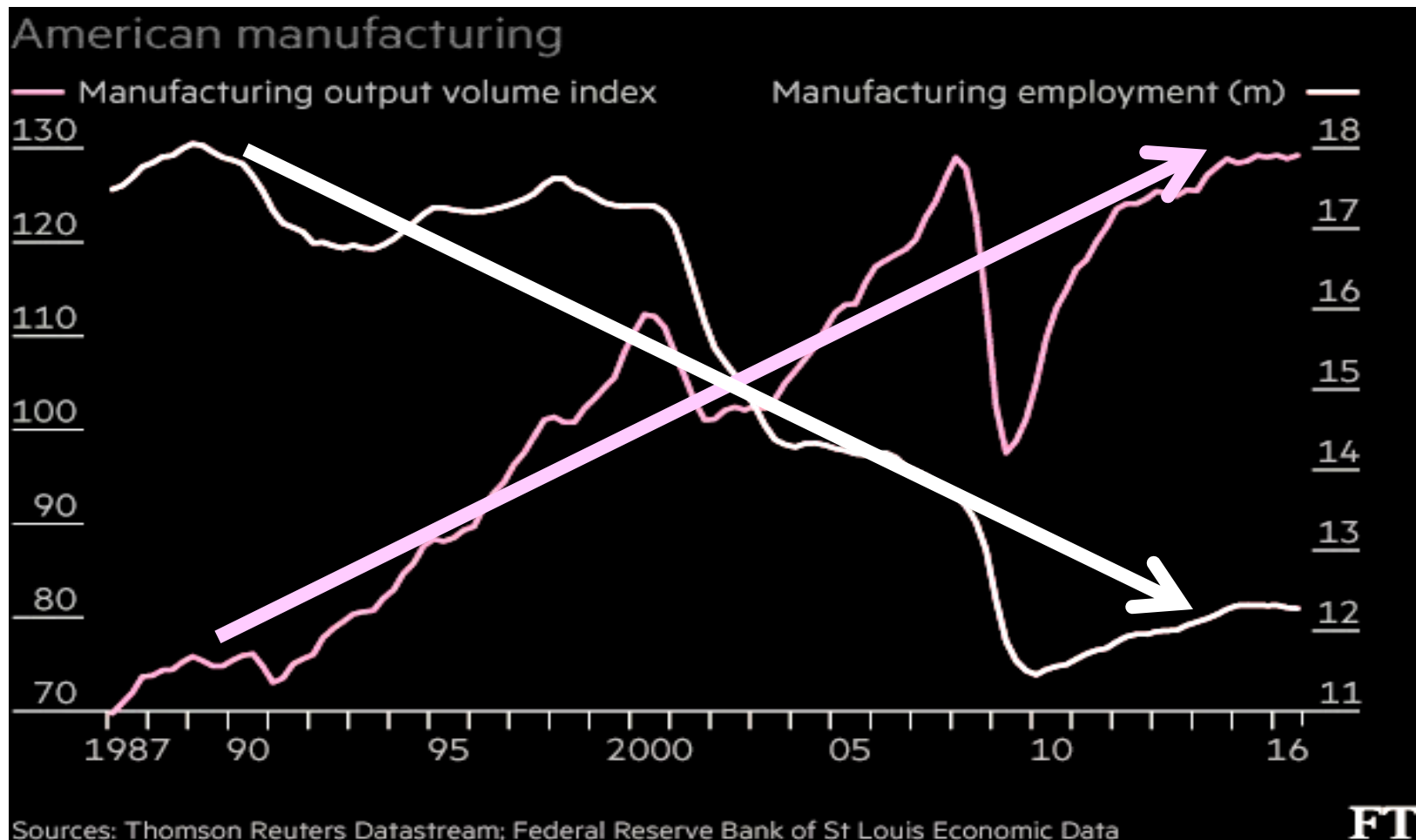
- Manufacturing employment has been falling as a share since 1950,
 - conspicuously in such sectors as autos, steel, and apparel,
 - while leaving efficient viable cores today.
- Due to international trade?
 - Yes, in part, in some sectors.
- Also, *manufacturing output continues to rise*, even as employment falls.
 - That means productivity has gone up a lot:
 - It takes fewer workers to produce one auto today than 65 years ago,
 - not to mention that the cars are much higher-quality.
- By analogy, farmers were 90% of national employment in 1790
 - vs. 2% today.
- Or consider coal miners.

Manufacturing jobs were 32% of the national total in 1950, and had declined to 10% by 2010.



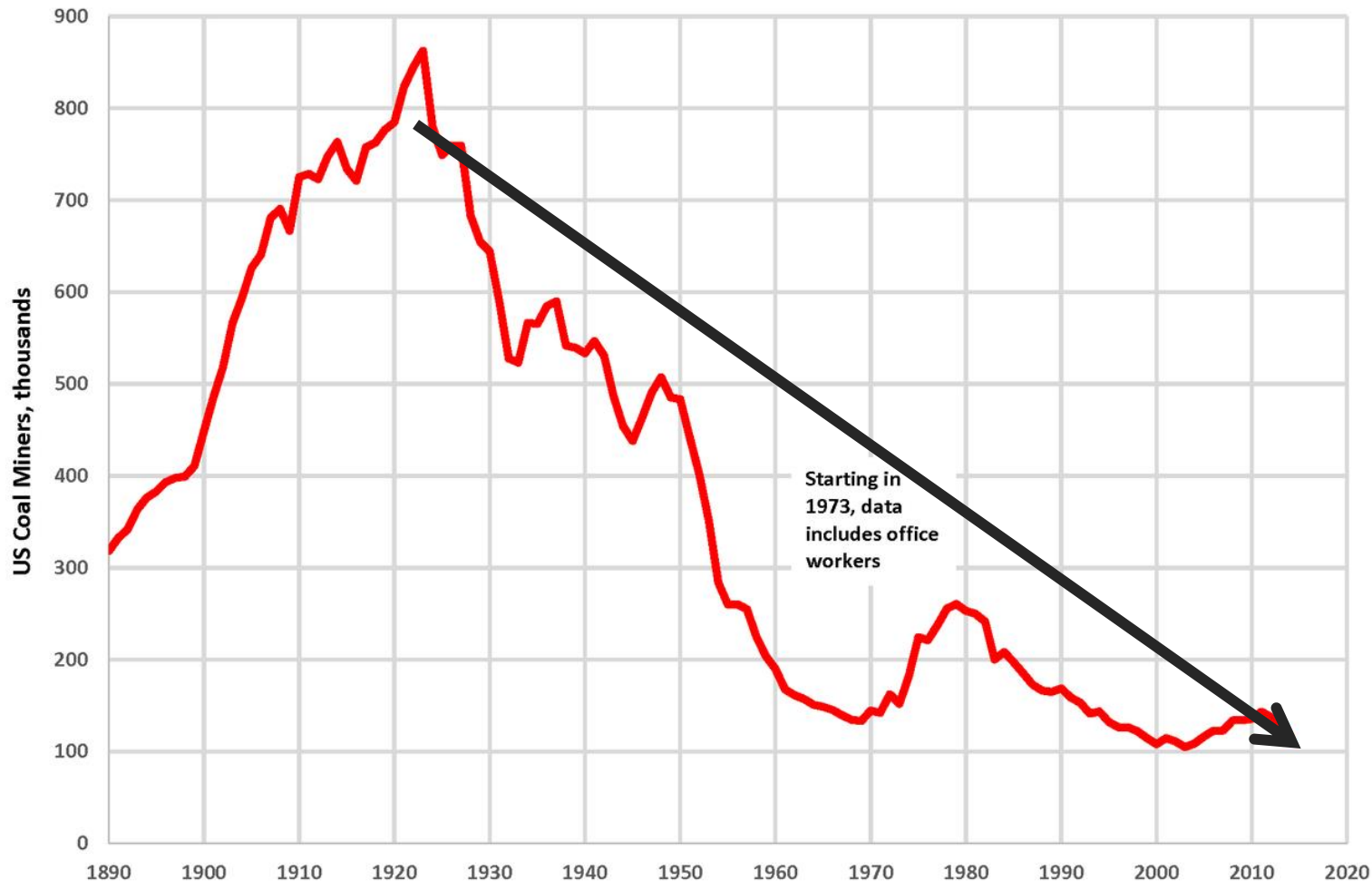
Those jobs are not coming back.

Manufacturing output rises
as employment falls, reflecting productivity growth.



“What role for the workers in Trump’s American factory revival?” *Financial Times*, Nov. 23, 2016.

Similarly, we are not going back to the number of coal miners that were employed in 1923.



Some reasons for employment shifts

- Trade? It works *in favor of* the US agricultural and coal sectors.
- Even regulation has not been the big source of job loss in coal.
 - Rather, in recent years, it has been cheap natural gas from fracking;
 - and, before that, the shift from Appalachian underground mining to Wyoming open-pit mining.
- In the case of all 3 sectors, *the biggest reason for the decline in jobs has not been trade, but rather productivity growth*,
 - particularly arising from technological progress, including automation.
 - The demand for labor has shifted toward high-skill jobs.
 - Meanwhile the supply of high-skilled workers has not kept up.
- But regardless the causes of rising inequality, good policies can share income gains more widely.

Appendix 3: For each of the 8 inequality diagnoses, one might think of a targeted policy response:

1. Trade

- Trade Adjustment Assistance or, better yet, wage insurance.

2. Technology and 3. education

- Make college more accessible to lower-income students.

4. “Winner-take-all” labor markets.

- Raise income taxes & payroll taxes for the upper 0.1%.

5. “Assortative mating”

- Education again, especially universal pre-school.

...

For each of the 8 inequality diagnoses, a targeted policy response continued:

...

6. Corporate monopoly power

- More aggressive anti-trust action.

7. Executive compensation, especially in finance

- Reforms such as “say on pay,” separating the function of CEO & Chairman of the Board, “claw-back provisions,” and so on;
- Continued financial reform, begun under Dodd-Frank
 - e.g., risk-tax on large financial institutions.
- Higher tax rates on the upper 0.1% and, very specifically, eliminating the carried-interest deduction.

8. Piketty’s wealth accumulation:

- Inheritance tax, at least on estates above \$5 million.