Inequality in America: Achieving An Economy That Works for All

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I. Are ordinary Americans being left behind in the modern economy?

II. If so, why?

III. And what is to be done about it?
Current state of the economy

The economic statistics are positive:

– Real GDP has grown \(\approx 2\%/\text{year}\), steadily since mid-2009.

– Employment too:
  • August continued the longest streak of job growth on record.
  • 17 million jobs added since early 2010.
  • Unemployment rate down to 4.4%, \(\approx\) full employment.
Altogether, the economy has added 17 million jobs since early 2010.
(I) If the economy is in such good shape, why has there been such discontent?

An obvious answer:

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

Since 2000, the gains have gone to those at the top.
US Real Median Family Income has been flat since 2000, even with strong gains in 2015-16.
The share of US income going to the top has been rising since 1980, and is now back to the 1920s level.
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 plays a role. But also:
2. Technological change raises demand for skilled workers;
3. education lags in raising the supply of skilled workers.
4. “Winner-take-all” labor markets,
5. “Assortative mating,”
6. More corporate monopoly power (higher “rents”),
7. and “excessive” executive compensation.
9. Possibly the decline in union power & minimum wages.
10. The tax cuts for the rich in early 1980s & 2000s.
1. Trade may play a role

• Import competition certainly has hurt some sectors, such as clothing & steel.

• But trade also has benefits:
  – Imports 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.

Jason Furman, CEA, Oct. 17, 2016, Fig.10.
3. The trend in years of education slowed during 1981-2012. So the supply of skilled workers has not kept up with the demand.

Average Years of Schooling at Age 30, U.S. Native-Born, by Year of Birth, 1876-1982
Taylor Swift earned $170 million in 2016, making her the world’s highest paid celebrity (according to *Forbes*).
5. “Assortative mating”

Crudely put: educated & highly paid male professionals used to marry their secretaries, but now are more likely to marry 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.
7. Excessive compensation?
Many top-1%-ers are executives and/or in finance.

Composition of Top 1 Percent Income Share by Primary Occupation

Jason Furman, CEA, Oct. 17, 2016, Fig.4a.
8. Supporting Piketty:
The share of *wealth* at the top has also been rising.

![Wealth Concentration Has Been Rising Toward Early 20th Century Levels](image-url)
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 shared prosperity

1. Expand, don’t reduce, the health-insured population.
2. Strengthen, don’t weaken, US financial regulation.
3. Reform the tax system (staying revenue-neutral)
   – Expand the EITC, not the estate tax exemption.
   – Make the payroll tax more progressive, not less.
   – Corporate: lower the tax rate, but offset by eliminating deductions.
4. Put social security on a sound footing.
5. Improve education, esp. universal pre-school education.
6. Increase infrastructure spending.
7. Address the long-term rise in household debt.
8. Energy:
   – Start a carbon tax; don’t subsidize fossil fuels.
   – But allow fracking (regulated).
9. Consider wage insurance.
10. Keep US global economic leadership, including trade agreements.
1. Keep the Affordable Care Act which has sharply reduced the percentage of Americans lacking health insurance, and is fully funded.
2. Retain intelligent financial regulation

• Keep the “fiduciary rule” for financial advisers.

• 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
  – Consumer Financial Protection Bureau.
3. Reform the tax system
   (staying revenue-neutral)

• 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.

• Reform corporate income tax but stay revenue-neutral:
  – lower rate,
  – but cut distorting deductions,
    • e.g., oil subsidies & interest deductions.
4. 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 $127,000).

5. Improve education,
   -- esp. universal pre-school education.

6. Increase infrastructure spending.

(1) It’s good for growth

(2) and makes jobs for construction workers
   (though we could have really used it 5-7 years ago,
    when unemployment was twice as high.)
7: 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 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 privatizing Fannie Mae & Freddie Mac.
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.
  • Especially many 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.
The last 3 of the 10 policy proposals

8. Energy:
   – Start a carbon tax; don’t subsidize fossil fuels.
     • Energy taxes are the most efficient
   – But allow states to frack (regulated).

9. Consider wage insurance,
   – which compensates those who lose jobs (not just due to trade)
   – and does not penalize taking a new job at lower wage.
   – Pay for costs by proposal #8.

10. Keep US global economic leadership, including abiding by trade agreements.
Inequality in America: How Do We Achieve An Economy That Works for All?

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Appendices

1. Turnaround from recession in 2009.


3. Policies targeted toward individual causes of inequality.

4. The stagnation in earnings for non-college-educated men and the role of manufacturing

5. Five trade fallacies.
Appendix 1: More on macroeconomic developments

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

Real GDP Growth, 2007-2016

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 17 million jobs.
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.

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.  
   – 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.
Appendix 4

The stagnation in earnings for non-college-educated men and the role of manufacturing jobs.
Real Wage Earnings of Median Worker (1970-2015): Almost No Growth for Non-College Men over 45 years!

Average Annual Real Wages of Median Worker

- College Women  +51.7%
- Non-College Women  +47.6%
- College Men  +23.8%
- Non-College Men  +8.6%

Data Source: BLS Current Employment Survey

Robert Lawrence, HKS
US Manufacturing employment 1990-2011: down almost 6 million since 2000

Robert Lawrence, HKS
US manufacturing jobs were especially important for men....
...and especially for men without college

Men employment share in manufacturing

Robert Lawrence, HKS
The negative trend in US manufacturing share of employment goes back to 1961, well before China, NAFTA, etc..

**Manufacturing share in establishment employment, 1961–2010**

Source: Bureau of Labor Statistics

Robert Lawrence, HKS
In fact the manufacturing share of employment levelled off after 2010.
US is not unusual. Decline in manufacturing share of employment is similar across advanced economies including in countries with habitual trade surpluses.

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Robert Lawrence, HKS
Appendix 5: Five Trade Fallacies

Regarding:
1. Negotiators;
2. Bilateral trade deficits;
3. Causes of the overall trade deficit;
4. Effects of the trade deficit on GDP;
5. Trade & Inequality
Fallacy #1: “US trade negotiators have been out-negotiated by those from other countries.”

Wrong.

- In most trade negotiations, such as TPP, NAFTA, and the Uruguay Round, the US has been able to get most of what it asked for – as leader of the international order.

- Trade agreements have required high-tariff trading partners to reduce barriers against US goods.

- US demands have also driven deeper integration
  – in such areas as labor rights, the environment, investor-state dispute settlement and intellectual property rights.

- How could NAFTA usefully be modernized & expanded? TPP.

- One of the funniest things that Trump has said: "The negotiators for Germany have done a far better job than the negotiators for the US."
Fallacy #2: “Bilateral trade imbalances reflect bad trade agreements.”

Wrong.

• If country $A$ runs a bilateral trade deficit with country $C$, it generally signifies some combination of 3 causes:
  – (i) $A$ currently has a trade deficit overall,
  – (ii) $C$ has a trade surplus overall,
  – (iii) $C$ needs to earn a structural surplus with countries like $A$, to pay for a structural deficit with, e.g., oil exporters.

• If we stop importing consumer electronics from China, we will import them from other Asian countries.

• The guy who cuts my hair insists I pay him with money. He refuses to accept as payment a lecture in economics.
Fallacy #3: “A trade deficit indicates the absence of a level playing field.”

Wrong.

- There is no (positive) correlation between countries’ tariff rates and their trade balances. [See Figure 1.]

- Trade deficits are macroeconomic phenomena,
  - influenced by national incomes and exchange rates,
  - and determined in a deeper sense by national saving & investment.

- The US has run current account deficits since 1982 because national saving has been low [see Figure 2],
  - both low private saving and low public saving.
  - The famous twin deficits: increase in the budget deficit leads to an increase in the trade deficit (e.g., 2001-07).

- China, Germany, Japan, & South Korea run current account surpluses because they have high national saving rates.
Fig. 1: High tariffs do not improve a country’s trade balance.

Average applied tariffs and average trade balances from 2012 to 2015 for 183 countries

Source: World Bank, World Development Indicators.

Caroline Freund, PIIE, May 8, 2017 “Public Comment on Trump Administration Report on Significant Trade Deficits.”
Fig. 2: Current account ≡ national saving - investment

Fallacy #4:
“Trade deficits are bad, subtracting from growth. Cut the trade deficit to add to GDP & create jobs.”

• Well, not *always* wrong.
  – An export boost when there is excess capacity in the economy can add nicely to output & employment. (We are no longer there.)
  – Also chronic current account deficits imply rising international debt
    • which, for normal countries, eventually impairs creditworthiness.

• But trade deficits are not always bad news and trade surpluses are not always good news:
  – E.g., the rise in the trade deficit in the late 1990s (post-NAFTA) accompanied the longest US economic expansion on record.
    • Originating in an investment boom,
    • it brought unemployment as low as 3.8% by 2000, with rising real wages & incomes for the median family.
  – Conversely, a sudden trade balance rise is usually due to recession.
    • E.g., the US deficit fell by half in 2009. [See Figure 3.]
Figure 3: The trade balance need not add to growth. Indeed the balance “improves” in recessions like 2007-09.

From: Menzie Chinn & Michael Klein, “Is the Trade Deficit a Drag on Growth?” Econofact, Jan.20, 2017

Probably wrong.

• Yes, imports create both winners and losers.
  – So do all changes. *Keeping out* imports does too.
  – Take the example of Trump moves against imports of steel & aluminum.
    • Even ignoring the flimsy national security claim (under Section 232),
    • loss of these imports would raise costs to US manufacturers that use the products as inputs (such as autos). This would both raise the cost of living at home and make US exports less competitive abroad.
  – Further costs of import protection: We would lose exports through
    • (1) foreign loss of dollar earnings with which to buy goods from us,
    • (2) dollar appreciation, and
    • (3) foreign retaliation against US products.