THE ONGOING ECONOMIC CRISIS
AND WHAT TO DO ABOUT IT

(A talk to the Capital Area Progressives Forum held in East Lansing, MI, on 2/18/12)

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OUTLINE

1. WHAT'S HAPPENED TO THE U.S. ECONOMY?
   A. The ongoing "Great Recession" (2008 – ??) page 1
   B. The "Great Divergence" in the U.S. Economy (since 1980) page 2

2. SOURCES OF THE ONGOING ECONOMIC CRISIS
   A. Recent history leading to the Great Recession page 3
   B. Underlying reasons for the economic crisis page 4
   C. Inadequate efforts to overcome the crisis page 5

3. THE KEY ROLE OF INEQUALITY
   A. Economic inequality in comparative perspective page 6
   B. Sources of growing inequality page 6
   C. Why does growing inequality matter? page 8

4. WHAT NEEDS TO BE DONE
   A. Reduce inequality, immobility and individual risk page 9
   B. Regulate the financial sector more fully and effectively page 10
   C. Deal with the mortgage & housing crisis page 11
   D. Pursue a pro-employment macro policy, not austerity page 12

N.B.: All charts can be found at the end of the paper after page 12.
I. WHAT'S HAPPENED TO THE U.S. ECONOMY?

A. The ongoing "Great Recession" (2008 – ??)

(1) Key economic indicators

a) The total output of the U.S. economy (real GDP) declined sharply (by more than 15%) over the last quarter of ’08 and the first quarter of ’09; since then the recovery has been very slow – reaching the previous peak only recently. [chart 1]

b) The official U.S. unemployment rate rose from 4.6% in mid-'07 to 6% in Aug. '08, then reached 10% in Oct. ’09 and stayed above 9% until well into 2011; only recently has it fallen to 8.3% (in Jan. '12). [chart 2]

   The official unemployment rate greatly understates the extent of unemployment, for it ignores all those who are underemployed or have given up searching for a job.

   The average duration of unemployment varied between 8 and 20 weeks until 2008; for the last 3 years it has remained at about 40 weeks.

c) The employment rate – the proportion of working-age adults who are working or looking for a job – was 67% in 2000; it was down to 64% in 2011.

   In 1967, 97% of men 30-50 years old with only a high-school diploma were working; that proportion was down to 76% in 2010.

d) Since 2008 roughly 4 million homeowners have lost their homes through foreclosure; another 4 million or so homeowners are now undergoing foreclosure proceedings.

   Roughly 11 million home mortgage holders (about 20 % of all mortgage holders) are currently "underwater" – they owe more on their mortgage than the home is worth.

(2) Comparison of the current Great Recession (GR) to earlier recessions

a) The Great Recession is the deepest U.S. recession since the Great Depression, when the unemployment rate peaked at 25% and it took 10 years before a real recovery began.

b) In the early 1980s the U.S. experienced a double-dip recession in which the: unemployment rate reached 10%, but a fairly rapid recovery ensued.

c) Keynesian policies of aggregate demand stimulus have helped to spur recovery from all ten of the U.S. recessions since World War II.

d) After the last three recessions (in the early 1990s, the early 2000s, and since 2008), employment has risen more slowly than after earlier postwar recessions.

e) The Great Recession is the first since the Great Depression to involve a major financial crisis; such crises make it especially hard to recover from recession.
B. The "Great Divergence" in the U.S. Economy (since 1980)

(1) Key indicators of major changes since 1980, as compared to the earlier postwar period

a) The growth rate of real GDP and real family income has been much slower. [chart 3]

b) Inequalities of income and wealth have increased rapidly. [chart 4]

c) Intergenerational mobility has declined, after rising slowly before 1980.

d) The size of the financial sector has grown very rapidly since 1980, rising to account for 8% of GDP by 2007.

   The share of financial corporations in overall corporate profits rose from roughly 15% in the 1970s to more than 40% in the 2000s.

   The concentration of financial institutions increased substantially from the 1970s to the 2000s: the five biggest banks now hold roughly two-thirds of all banking assets

e) Since 1980 there has been a "great risk shift" (Jacob Hacker's term), which has moved much risk from corporations and governments to workers and households.

   This has resulted in more volatility in personal incomes, employment, and access to medical care, as well as fewer guaranteed retirement pensions.

(2) Qualitative changes in institutions and norms undergirding the US economy

Excerpted from George Packer, "The Broken Contract" (Foreign Affairs, Nov/Dec 2011):

[Since the late 1970s] the surface of life in the US has greatly improved, at least for educated, reasonably comfortable people…Yet the deeper structures, the institutions that underpin a healthy democratic society, have fallen into a state of decadence…[around 1978 the US moved] away from the social arrangement that had been in place since the 1930s and 1940s.

What was that arrangement?…It was an unwritten social contract among labor, business, and government – between the elites and the masses. It guaranteed that the benefits of the economic growth following World War II were distributed more widely, and with more shared prosperity, than at any time in human history….Labor law and government policy kept the balance of power between workers and owners on an even keel, leading to a virtuous circle of higher wages and more economic stimulus. The tax code restricted the amount of wealth that could be accumulated in private hands and passed on from one generation to the next, thereby preventing the formation of an inherited plutocracy. The regulatory agencies were strong enough to prevent the kind of speculative bubbles that now occur every five years or so…Commercial banking was a stable, boring business.

At the same time, the country’s elites were playing a role that today is almost unrecognizable. They actually saw themselves as custodians of national institutions and interests…By the mid-1970s, chief executives…became a special interest; the interest they represented was their own…
II. SOURCES OF THE ONGOING ECONOMIC CRISIS

A. Recent history leading to the Great Recession (2001-2008)

(1) The economic crisis began in U.S. housing market, quickly spread to U.S. financial sector, then overtook the whole U.S. economy – and became a global financial crisis.

(2) The U.S. housing crisis was set off by spread of sub-prime mortgages – loans made to home-buyers who simply did not have the means to meet their payment obligations. The ratio of sub-primes to all mortgages rose from an historical level of less than 8% to about 20% in 2004-06.

(3) Why would any financial institution lend to such borrowers?

   a) Economic actors became increasingly confident that economic good times would last forever, and that serious recessions were a thing of the past;

   b) There was a huge world-wide build-up of pools of savings, increasingly in search of new kinds of profitable investment outlets;

   c) Financial institutions developed lots of new financial instruments they thought would protect them against risky ventures –and/or that enabled them to pass the burden of risk onto other institutions or investors;

   d) Governmentss adopted increasingly laissez-faire policies toward business in general and financial institutions in particular, weakening regulatory policies set up in 1930s (to deal with the Great Depression) and allowing new financial instruments to operate without regulation.

(4) As a result:

   a) mortgage brokers were encouraged to lend to borrowers with no serious questions asked about their ability to pay

   b) initial lenders would quickly sell the mortgage contracts to financial institutions, escaping any exposure to risk of default;

   c) financial institutions would in turn "securitize" the acquired mortgage contracts;

   d) credit-rating agencies, afraid of losing business by refusing to go along with the whole scam, would accord undeservedly high credit ratings (indicating low-risk).

(5) This left many high-risk investments – "toxic assets" – in the hands of major financial institutions who had bought the complex securities in a profit-raising strategy that included a very high level of financial leverage (ratio of investments to liquid assets).

(6) This whole mortgage & finance structure – in effect a global Ponzi scheme – was bound to come to a crashing end, as it did in 2008 with onset of the current crisis.
B. Underlying reasons for the economic crisis

(1) De-regulation and non-regulation of significant parts of the U.S. financial sector, starting in the '80s and accelerating in the '90s & 00's.

a) Since the late 1970s U.S. economic policy has been increasingly informed by a pro-free-market economic ideology – advanced by ever more mainstream economists as well government policy-makers.

b) The old structure of financial regulation developed in response to the Great Depression was restrictive, designed to protect the public and stabilize the economy – for example, the Glass-Steagall Act, which separated (speculative) investment banking from (routine) commercial banking.

c) The new structure facilitated innovation and managed risk very light-handedly – for example, by failing to make new financial instruments like derivatives transparent and subject to regulation.

d) The result was much more stock market volatility and periodic crises (the savings-and-loan crisis in the late '80s, the Long Term Capital Management hedge fund collapse in the late '90s, the dotcom boom and bust shortly thereafter, etc.).

e) Also, the amount of undetected corporate fraud grew to unprecedented magnitudes in the '90s and '00s.

(2) Growing economic inequality over the past 30 years.

a) More inequality of incomes tends to reduce the overall demand for goods and services that keeps the economy humming at a high employment level.

b) The major source of aggregate demand – consumption – is depressed, because workers' aggregate wages fall as a % of GDP, and they spend a higher % of their income on consumption than do the rich.

c) When aggregate demand is less than the aggregate productive capacity of the economy, there follow declines in output and in employment.

(3) A huge long-term rise in household debt over the past several decades:

a) The savings rate of the US household sector dropped to virtually 0; now a large % of the US population has outstanding debts well above the value of their assets.

b) The debt rise was due in considerable part to the fact that middle- & lower-income people found it impossible to maintain their standard of living with. stagnating or declining real incomes, so borrowing and going into debt was their only recourse.

c) Much of the borrowing was done via home equity loans, leading to enormous growth in mortgage debt; credit card debt also mushroomed.
d) Since most of the borrowing was used for consumption, not for investment (with the prospect of earning future returns), borrowers found it increasingly difficult to meet their payment obligations and to liquidate their debt burden.

e) When the bubble burst and borrowers started defaulting on payments, the financial sector was stuck with lots of assets that had lost much of their value, ending the optimism that had sustained credit markets through increasingly risky transactions.

Since the onset of the crisis in 2008 there have been:

C. Inadequate efforts to overcome the crisis

(1) The efforts of the U.S. Government starting in September '08 (led by then Treasury Secretary Hank Paulson and Fed Chairman Ben Bernanke) reflected their view that the crisis was largely financial in nature. They hoped that swift and massive action to stabilize the financial sector would avert a major recession in the rest of the U.S. economy.

(2) This was the rationale for the huge financial bail-out bill – TARP – that Congress was pressured to pass in October '08. The Fed took the unprecedented measures of (i) lowering the interest rate it controls to almost 0% and (ii) massive quantitative easing, which increased the supply of credit to businesses.

(3) Such expansionary measures did succeed in loosening up credit markets and avoiding a complete financial collapse, but they did not succeed in averting a major recession.

(4) The Obama stimulus bill passed by the Dem-Party-controlled Congress in early '09 prevented the Great Recession from becoming a Great Depression, but it was not large enough to bring the US economy out of the output & employment doldrums in '09 & '10. Moreover, its stimulatory effects began to wane in '11, and state & local spending cutbacks and layoffs necessitated by reduced revenues in the depressed economy worked against recovery.

(5) The strength of the political Right in the U.S. has prevented any substantial further fiscal stimulus, leaving as the only possibility: far less effective expansionary monetary policy by the Fed.

(6) In the U.S. (and even more so in Europe), financial and business leaders as well as government policy-makers are still wedded to the neo-liberal consensus that precipitated the crisis – a consensus that downplays the need for aggregate demand stimulus and sees excessive government spending as the root of the problem. Hence the widespread call for reducing government budget deficits and cutting back on government spending – precisely the wrong medicine during a deep recession, when aggregate demand is inadequate to keep the economy going strong.

More on this later...
Of all the causes of our present predicament, the most important is the rise in inequality:

III. THE KEY ROLE OF INEQUALITY

A. Economic inequality in comparative perspective

(1) Trends in the distribution of income and wealth in the U.S. since 1980

a) A rapidly rising trend in the share of total income going to the richest 10%. [chart 5]

Before the Great Depression, inequality and finance-related profits were also unusually high.

b) Income growth concentrated among the rich -- especially the top 1% [chart 6]

From 1979 to 2005 almost 2/3 of the rising share of the top 1% in income went to the top 0.1% -- the richest thousandth of Americans, who saw their real incomes rise more than 400%.

Who is in that top 0.1%? Roughly 60% are executives in financial and non-financial corporations. Another 10% are lawyers and real estate people.

d) A growing gap between the growth of workers' wages and overall productivity. [chart 7]

e) A huge rise in the average ratio of CEO to worker compensation. [chart 8]

f) Inequality in the distribution of wealth is much greater than in the distribution of income; and it has also trended upward since the 1970s.

(2) Comparison of inequality growth in the U.S. and in Europe

a) The U.S. is by far the most unequal among affluent countries. [chart 9]

b) The U.S. also shows the sharpest increase of inequality over the last 30 years. [chart 10]

B. Sources of growing economic inequality in the U.S.

(1) Explanations preferred by most economists

a) Skill-biased technical change: skills that high-income people have a lot of — thanks to better education — have become more highly remunerated.

b) Shrinkage of the manufacturing sector and growth of the service sector of the economy, destroying many well-paying semi-skilled jobs, generating a distribution of jobs that involves "twin peaks" of high-paid and low-paid jobs.
c) **Globalization**: workers in the U.S. are competing to a greater extent with workers elsewhere – within poorer countries, or having immigrated therefrom. The willingness of such workers to accept low wages (due to lack of better alternatives, lack of citizenship, or lack of documentation) puts downward pressure on all wages.

Such explanations preferred by economists do account for some of the growing inequality since 1980; but they do not explain:

- (i) why *inequality is so top-heavy* – so many of the economic benefits go to a tiny minority of individuals, among those with apparently similar skills; or

- (ii) why there is so much *cross-national variation* – stark differences in inequality among affluent countries exposed to similar global changes.

(2) **Explanations too often neglected by economists**

a) The **decline in the strength of trade unions**, which that has reduced the power of workers to bargain for good wages and benefits

b) The **decline in the real value of the minimum wage**, which has depressed wages overall.

c) **Income tax cuts and loopholes strongly favoring the rich.**

d) **Erosion of generally accepted norms of fair pay**, which helps to explain the extraordinary rise in the ratio of CEO to worker compensation.

(3) **The key role of government policy**

a) U.S. Government policy has contributed most directly to (2a,b,c,d), and probably indirectly to the other explanations listed above.

This is most obvious under Reagan and G.W. Bush, but it's true under all regimes since 1980.

(4) **The importance of politics**

a) To quote Jacob Hacker & Paul Pierson (in *Winner-Take-All Politics*, 2010): "The sources of American economic inequality are largely political – the result of deliberate political decisions to shape markets in ways that benefit the already-privileged at the expense of a more-or-less unaware public."

b) To quote Kevin Drum (reviewing Hacker & Pierson in *Mother Jones*, Sept 2010): "[Since the 1960s] liberal money and energy focused mostly on non-economic concerns, and the country moved steadily leftward on social issues. Conservative money & energy focused mostly on the interests of corporations and the rich – and with few (e.g. weakened unions) fighting back – the country moved steadily rightward on economic issues."
C. Why does such growing economic inequality matter?

(1) A high level of inequality is bad for the economy

   a) It's a myth that more inequality leads to more economic growth. In fact greater income inequality is not correlated with higher economic growth rates – either over time within countries or during the same time periods across countries.

   b) The rise of inequality to a very high level helped to cause the Great Recession. It's no accident that the two worst periods for the modern US economy came in the 1930s and in recent years – after the two periods in which inequality rose to heights long unseen. In both cases there was a boom in the financial sector, poor people borrowed a great deal, and a huge financial crisis ensued.

   c) High incomes and low tax rates on top earners hamper an economy's resource allocation and utilization by attracting too many of the best and the brightest into the financial services industry. Many of the smartest, most hard-working & most talented people do not go into science and engineering, teaching, public administration, etc., where they would contribute much more to the economy and the society.

(2) It's a myth that a high level of inequality provides more opportunity and mobility

   a) A century ago social mobility was much higher in the U.S. than in Europe; now it is considerably lower.

   b) As noted earlier, US intergenerational mobility has trended downward since 1980.

   c) Inequality and mobility are negatively correlated.

      Greater inequality in income and wealth means greater inequality in educational opportunity, as the rich carve out advantages (via private schools, etc.).

      Low-ability children with high economic status do much better than high-ability children with low economic status.

      For cross-country evidence that higher inequality is associated with lower mobility (= higher intergenerational earnings elasticity), see the "Great Gatsby Curve." [chart 11]

(3) Greater inequality means greater maldistribution of political power, less democracy

   a) Can anyone deny that our political system is being warped by the influence of big money, and that the warping is getting worse as the wealth of a few grows ever larger?
b) To quote Francis Fukuyama ("Can Liberal Democracy Survive the Decline of the Middle Class?" in *Foreign Affairs*, Jan 2012): "Stagnating wages and growing inequality will soon threaten the stability of contemporary liberal democracies… the current form of globalized capitalism is eroding the middle-class social base on which liberal democracy rests."

c) It's not just campaign contributions; **lobbying** is even more important. As Senator Dick Durbin of Illinois has put it: "The banks are the most powerful lobby on Capital Hill…they frankly own the place."

*Excerpted from George Packer, "The Broken Contract" (Foreign Affairs, Nov/Dec 2011):*

"Inequality hardens society into a class system, imprisoning people in the circumstances of their birth – a rebuke to the very idea of the American dream. Inequality divides us from one another in schools, in neighborhoods, at work, on airplanes, in hospitals, in what we eat, in the condition of our bodies, in what we think, in our children’s futures, in how we die. Inequality makes it harder to imagine the lives of others – which is one reason why the fate of over 14 million more or less permanently unemployed Americans leaves so little impression in the country’s political and media capitals. Inequality corrodes trust among fellow citizens, making it seem as if the game is rigged. Inequality provokes a generalized anger that finds targets where it can – immigrants, foreign countries, American elites, government in all forms – and it rewards demagogues while discrediting reformers. Inequality saps the will to conceive of ambitious solutions to large collective problems, because those problems no longer seem very collective. Inequality undermines democracy."

**IV. WHAT NEEDS TO BE DONE**

... to climb out of the deep hole in which 35 years of neo-liberal restructuring has left us?

**A. Reduce inequality, immobility, and individual risk**

(1) **Make taxation truly progressive again:**

   a) raise taxes on the income and wealth of the rich – especially the super-rich (taxes on income from capital and on estates have fallen greatly since the late 1980s; it is best to raise tax rates on these sources substantially, while reducing corporate tax rates.)

   b) end tax loopholes and subsidies benefiting millionaires and big corporations (such taxes currently reduce tax rates on corporations in a highly arbitrary manner).

(2) **Turn back the anti-union thrust**, which has contributed significantly to the growing gap between wage growth & productivity growth.

(3) **Promote greater opportunities for social and economic mobility** of the less well-off via greater public investment in improved health care and education for those without access to generous health insurance and well-endowed private schools.
(4) Shift risk back from workers and households to corporations and government:

To avoid job loss, foreclosures, bankruptcies, loss of savings, etc., the state must play a much greater role in risk management – both via income redistribution and via welfare state programs that help stabilize the macro economy by increasing aggregate demand in recessionary times.

B. Regulate the financial sector more fully and effectively

(1) Separate investment banking from routine banking (once again, as did Glass-Steagall).

   a) Routine ("boring") banking: the socially necessary infrastructural functions of the financial system, with limited scope for financial innovation – but with government guarantees.

   b) Investment banking: the hopeful ventures of speculators, with full scope for financial innovation – which must be free to succeed or fail on their own merits.

(2) Break up financial institutions that are "too big to fail" – or create much stronger regulatory oversight of such institutions.

   There will always be danger of a huge financial collapse if big financial institutions are free to take on excessive leverage & risk, which they are bound to do if they know they will be bailed out by government because their failure would cause so much harm to the whole economy – as in 2008.

(3) Bring derivatives into the light:

   Derivative contracts should be traded like stocks on public exchanges, with transparent accounting and careful regulation, including limits on the amount of leverage and liquidity requirements to reduce the risk of meltdown.

   No system of financial regulation can survive if some firms are guaranteed and regulated, but may deal on a large scale with others that are not.

(4) Levy a small tax on all financial transactions:

   a) Such a tax is known as the "Tobin tax" (having been proposed long ago by the Nobel-winning economist James Tobin), and also as a "Robinhood tax," by proponents who would like to see the proceeds used to fight poverty and global warming.

   b) President Sarkozy is promoting a 0.1% financial transaction tax in France (and Europe).
C. Deal with the mortgage and housing crisis

(1) How bad is the situation?

a) In the U.S. 4 million homes have been foreclosed and another 4 million are facing foreclosure proceedings; 11 million mortgages are underwater. Past efforts to address these problems have had little effect, and housing prices continue to fall.

b) Foreclosures and defaults hurt not only individual homeowners but entire neighborhoods and the whole economy; they result in diminished purchasing power and declining home construction that place a huge drag on recovery from the recession.

c) There are two basic ways to enable distressed homeowners to make their mortgage payments: (i) refinance the loan at a much lower rate of interest, or (ii) reduce the principal balance owed.

d) The basic problem is that somebody has to absorb the loss in asset value of homes whose prices have fallen. Lenders don't want to take a hit; and borrowers cannot – or don't want to – repay their loan under the original contractual terms.

(2) What can be done?

a) A big obstacle is that so many mortgages have been sliced and diced into complex securities, so they are not in the hands of a single identifiable lender with whom to renegotiate payment terms.

b) Another problem is the potential for setting up bad future incentives: in principle, we should not bail out (i) unscrupulous lenders pushing bad loans or (ii) borrowers who should have known better than to take a big risk, or borrowers who are financially quite capable of repaying their loans.

c) It is very hard to solve the problem unless government can (i) force lenders to take hit – e.g. via successful court action against fraudulent behavior or (ii) bear much of the cost of bailing out borrowers.

d) The best solution in principle would be reform of personal bankruptcy laws to allow bankruptcy judges to modify home mortgages for bankrupt borrowers – as is the case for commercial real estate borrowers. Mortgage lenders and holders would then have a strong incentive to renegotiate.

e) Or government could buy out unaffordable primary residence mortgages at full value from mortgage servicers and then provide homeowners with less onerous fixed-rate mortgages that keep them in their homes. This was approach of the Home Owners' Loan Corporation adopted to deal with similar problems in the New Deal era.

f) Another alternative is a debt-for-equity swap in which banks agree to reduce mortgage principal (and hence mortgage payments) in exchange for getting a share of equity in the house; thus they – along with the homeowner – will get a share of future increases in house value.
g) All such proposals – and many others – have some advantages and some disadvantages; none alone can resolve the housing crisis. So what is needed is a multi-pronged strategy and – most challenging – the political will to implement the strategy in a way that imposes the lion's share of the burden of bailing out financially stressed homeowners on the kinds of financial institutions and individuals with responsibility for precipitating the crisis (who have largely gotten out while the going was good).

D. Promote more economic activity & employment, via a macro policy of stimulus, not austerity

(1) Stimulus vs. austerity:

a) A policy of fiscal stimulus means increasing government expenditures or reducing revenues – mainly taxes, which means running a larger government budget deficit (or a smaller surplus).

b) A policy of monetary stimulus means that the central bank (the Fed in the U.S.) reduces interest rates and/or increases the supply of credit.

c) Austerity (of either kind) is just the opposite of stimulus, and has the opposite effects.

d) In recessionary times, stimulus promotes the growth of output and jobs, at a small risk of increasing inflation; in deep recessions, monetary stimulus is much less effective than fiscal stimulus.

e) In boom times, stimulus sets off inflation, with little gain in output or jobs.

f) Thus it makes sense to pursue stimulus in recessionary times – especially fiscal stimulus in deeply recessionary times – and austerity in boom times.

g) But many politicians (and too many economists) object that fiscal stimulus will cause major problems because large government budget deficits require corresponding government borrowing that will raise the national debt – which is the sum of all past deficits minus all past surpluses.

For example:

"We must live within our means." -- Obama (in summer 2011)

We have a moral responsibility not to spend more than we take in.” -- Romney (campaigning)

In both cases "we" refers to the U.S. Federal Government.
But the Federal Government is in a very different position than any household.

See below...
(2) What's the problem with running government deficits and increasing national debt?

a) Total U.S. federal government debt (~15 b. in 2011) is not what matters, but that part of U.S. Federal Government debt held by the public (~10 b. in 2011) rather than another branch of government (~5 b. in 2011) – e.g. U.S. Treasury debt to the Social Security System.

b) What matters most is not the size of the publicly-held debt (PHD), but the debt/output ratio PHD/GDP (~70%) – because the cost to U.S. taxpayers depends on the ratio of Federal Government interest payments to service the debt in relation to Federal Government tax revenues, which rise along with GDP.

c) The burden of federal debt on the U.S. economy is equal to the interest rate paid times PHD divided by GDP; it has been limited by the low interest rates on U.S. Government bonds – close to 2% – ever since the onset of the crisis. As long as the U.S. economy is in recession, there is little likelihood that the relevant U.S. interest rates will rise much.

d) Since in recession fiscal deficits boost GDP, they work to lower the PHD/GDP ratio by adding to the denominator even as they add to the numerator. If the long-run Keynesian "multiplier" – the sum of all additions to GDP attributable to an increase in the government deficit – is 2 (a reasonable estimate now), an increase in deficit spending adds twice as much to GDP as to the debt. This means that the PHD/GDP ratio in the US would fall from its current level of 70%.

e) The multiplier will be bigger to the extent that the fiscal stimulus takes the form of government spending rather than tax cuts, because tax cuts – especially to the rich – are not fully used for private spending.

f) Just as it pays a business to borrow if it can expect a real (inflation-adjusted) rate of return' higher than the real rate of interest on borrowed funds, so it pays the federal government to run a deficit as long as it can expect a real rate of return (in higher real GDP, hence a higher tax base with which to service debt) than the real rate of interest at which it borrows.

g) Interest rates on U.S. Government bonds are currently at historically low levels – actually less than zero in real terms. So this is an ideal time to undertake public investment in infrastructure, education, etc., which will not only create millions of jobs and expand output in the short-run but also restore and expand the national infrastructure – thereby raising GDP in the long-run.

h) There are ultimately limits to the use of fiscal stimulus. A government must not allow national debt to rise to a level where it cannot borrow at a reasonable interest rate – as has happened in some European countries recently. In general, this tends to happen when the PHD/GDP ratio rises well above 100%.

i) The U.S. Federal Government will face a real long-run debt problem if the rapid rate of growth of Medicare and Medicaid costs cannot be significantly slowed down. (This is much more of a problem than the rising costs of the Social Security System). So the real key to avoiding U.S. debt problems is not only to undertake fiscal stimulus now and austerity later, but to improve the U.S. medical system – by far the most inefficient and costly among the world's rich countries.
United States

Real Gross Domestic Product

Percent Growth, Annual Rate

Percent
CHART 3

Family income growth in two eras
Real annual family income growth by quintile, 1947–79 and 1979–2010

<table>
<thead>
<tr>
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<tr>
<td>Lowest fifth</td>
<td>2.6%</td>
<td>-0.4%</td>
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<tr>
<td>Second fifth</td>
<td>2.3%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Third fifth</td>
<td>2.4%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Fourth fifth</td>
<td>2.5%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Highest fifth</td>
<td>2.2%</td>
<td>1.2%</td>
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CHART 4

The share of the richest 10% of the American population in total income

Share of total income to richest 10%, 1917-2006
(Emanuel Saez, University of California, 2006. Income includes capital gains)
Figure 4: CBO Estimates Show Much Faster Income Growth for the Top 1%

Growth in Real After-Tax Income, 1979-2007

Percent Change

300%

250%

200%

150%

100%

50%

0%

Lowest Quintile  Second Quintile  Middle Quintile  Fourth Quintile  81st-99th Percentiles  Top 1 Percent

15%  28%  35%  43%  65%  278%

Source: CBO

January 12, 2012
U.S. Actual Wages vs Productivity-Enhanced Wages

Source: Author's calculations using BLS data
CHART 8

Ratio of average annual CEO compensation to average worker compensation, 1965–2010

Figure 5.5. **Share of the top 1% of earners in total taxable income, 1980 and 2008**

Note: The pre-tax income data exclude capital gains for all countries except Australia and Finland. The data are based on tax returns.


[StatLink](http://dx.doi.org/10.1787/888932566554)
CHART 10

Top income shares. 1914-2008


- Top 1% income share (Australia)-Atkinson & Leigh (2007)
- Top 1% income share (Japan)-Moriquchi & Saez (2010)
- Top 1% income share (France)-Piketty (2001, 2007); Landais (2007)
- Top 1% income share (United States)-Piketty & Saez (2007)
Figure 7: “The Great Gatsby Curve”
Higher income inequality associated with lower intergenerational mobility

Source: Corak (2011), OECD, CEA estimates