THE SOURCES OF THE ECONOMIC CRISIS

AND WHAT NEEDS TO BE DONE

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I. THE ONGOING ECONOMIC CRISIS (2008 – ??)

A. Comparison of the current “Great Recession” to earlier recessions

(1) The Great Recession (GR) 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.

(2) 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.

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

(4) 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.

(5) The GR is the first since the Great Depression to involve a major financial crisis; such financial crises make economic downturns much worse and make it especially hard to recover from them.

B. The "Great Divergence" in the U.S. Economy (since the late 1970s)

The GR came at the end of 3 decades of significant divergence from prior economic trends:

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

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

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

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

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

   b) 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

(5) 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.

   a) This has resulted in more volatility in personal incomes, employment, and access to medical care, as well as many fewer guaranteed retirement pensions.
II. SOURCES OF THE 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 homebuyers 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 (that’s what many economists were saying!);
   b) There was a huge world-wide build-up of pools of savings – e.g. from booming emerging market economies – in search of new and more profitable investment outlets;
   c) Financial institutions developed lots of new financial instruments they thought would protect them against risky ventures – often by passing risk onto other investors;
   d) Governments 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 late 1970s U.S. economic policy has increasingly been influenced by a pro-free-market economic ideology – pushed by ever more right-wing think tanks & mainstream economists.

b) The old structure of financial regulation developed in response to the Great Depression was 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 transparent and subject to regulation. And the Federal Reserve Board failed to make use of its available regulatory powers over banks so as to reduce the growth of systemic risk.

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.) leading up to the huge crash of 2008.

(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 workers 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 average savings rate of the US household sector dropped to virtually 0; and a large % of the US population has been weighed down by outstanding debt.

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” – i.e., purchasing of financial assets to supply more money to the economy.

(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 Democratic-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 and employment doldrums in 2009 & 2010. Moreover, its stimulatory effects began to wane in 2011, 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 historical perspective

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

a) Rapidly rising trend in the share of total income going to the richest 10%.  [chart 5]
   (Before Great Depression, inequality & 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 real incomes rise more than 400%.

d) 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 much greater than in the distribution of income; it has also trended upward since the 1970s.

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 – puts downward pressure on all wages.

   Such explanations account for some of the growing inequality since 1980; but they do not explain why inequality is so top-heavy – huge gains by a tiny minority of individuals.

(2) Explanations too often neglected by economists

a) Decline in the strength of trade unions, which that has reduced the power of workers to bargain for good wages and benefits
b) **Decline in the real value of the minimum wage**, which has depressed wages overall.

c) A series of **huge income tax cuts and loopholes strongly favoring the rich**.

d) **Erosion of generally accepted norms of fair pay** (cf. CEO/worker compensation).

(3) The importance of politics

a) U.S. Government policy since 1980 has contributed most directly to (2a,b,c,d), and probably indirectly to the other explanations listed above -- most obviously under Reagan and G.W. Bush.

b) Hacker & Pierson (*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."

C. **Why does such growing economic inequality matter?**

(1) It's a **MYTH** that more inequality leads to more economic growth.

a) 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.

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

a) US intergenerational mobility has trended downward since 1980, as inequality has increased.

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

(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?
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 -- starting, but not ending, with allowing the Bush tax cuts for those making >250K a year to expire.

   b) end tax loopholes and subsidies benefiting millionaires and big corporations – such as the favored treatment of capital gains and carried interest and oil industry subsidies.

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

(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 – via income redistribution and welfare programs that help stabilize the macroeconomy by raising aggregate demand in recessionary times.

B. Regulate the financial sector more fully and effectively

(1) Separate investment banking from commercial banking (as did Glass-Steagall).

   a) Routine commercial banking provides socially necessary financial functions; its depositors should have gov’t protection, but such banks should engage in innovation and speculation.

   b) Investment banking institutions may engage in financial innovation and speculation, but not with gov’t guarantees – they must succeed or fail on their own. (Hence the Volcker rule.)

(2) Break up financial institutions that are "too big to fail"

   There will always be danger of a huge financial collapse if big financial institutions are free to take on excessive leverage and risk, which they are bound to do if they know they will be bailed out by gov’t 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.

(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.

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 (20% of all) are underwater, amounting to a total of $700 b. in debt exceeding home values. 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.

(2) **What can be done?**

a) It makes good economic sense to enable most homeowners to stay in their own homes.

b) But the basic problem in doing so is that somebody has to absorb the loss in asset value of the homes, whose prices have fallen sharply. Lenders don't want to take a hit; and borrowers most often cannot repay their loan under the original contractual terms.

c) Two basic ways to enable distressed homeowners to make their mortgage payments are: (i) reduce the principal balance owed, or (ii) refinance the loan at a much lower rate of interest. In these cases, lenders have to take a hit – unless government steps in to help them out.

d) A big obstacle is that 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.

e) 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 (iii) borrowers who are financially able to repay their loans.

f) It’s very hard to solve the problem unless gov’t can (i) force lenders to take hit – e.g. via court action against fraudulent behavior – or (ii) bear much of the cost of bailing out borrowers.
d) One solution 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 Dean Baker’s “Right to Rent” proposal, which would increase the bargaining power and security of homeowners by temporarily changing the rules on foreclosure and allowing homeowners to remain in their homes as renters for a substantial period of time. During this time, homeowners would pay the market rent for the home as determined by an independent assessment.

g) All such proposals have some advantages & some disadvantages; none alone can resolve the housing crisis. We need 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 huge financial institutions and rich individuals who are responsible for precipitating the crisis and/or can most easily bear the burden.

D. **Pursue a pro-employment 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 money to the economy.

   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 gov’t budget deficits require corresponding government borrowing that will raise the national debt – which is the sum of all past deficits minus all past surpluses.

(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 \( \text{PHD/GDP} \) (~ 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 debt-output 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.

E. A local perspective: what about Detroit?

(1) Detroit the American Greece?

Similarities: -- Relatively poor region within a much larger economy, subject to huge economic forces it cannot control
-- (We must admit) some mismanagement of available resources in the past
-- Government unable to raise sufficient resources to meet requirements, as outside authorities impose austerity measures, and the rich succeed in keeping tax payments to a minimum
-- Hence government forced to borrow even as spending is curtailed, building up ever big debt, so credit ratings plunge

Differences: -- Detroit is a much smaller entity, more dependent on the outside world
-- Easier for people to leave Detroit, so it faces a much bigger de-population problem, which further aggravates the difficulties
-- Detroit much harder hit by a housing crisis: foreclosures, underwater mortgages
-- Greece could leave the euro zone, even repudiate its debts (at a cost), and take more control over its economic fate;
  But Detroit can’t leave the dollar zone or repudiate its debts (except at a far higher cost); and its economic fate will always depend on outsiders.

(2) What can be done?

a) The national/world crisis since 2008 has made things much worse; so anything that helps resolve that crisis will help Detroit – e.g., economic stimulus, action to stop foreclosures and to help underwater homeowners – which will boost overall demand for goods & services produced in Detroit and thus promote local growth and employment.

b) Federal gov’t financial support is needed to maintain and improve public infrastructure, e.g., to keep public employees – teachers, medical workers, transport workers, community & social workers, police & firefighters, etc. – on the job. (The 2009 Obama stimulus bill did provide some funding to help along these lines for a couple of years; failure to extend such stimulus helps explain why the situation has gotten much worse now.)

c) But support for public infrastructure is to a large extent also the responsibility of state governments. Yet the state of Michigan has been cutting back on support to cities, villages & townships as it has reduced taxes on the rich and on business. [chart 12]
d) Republican governors Engler and Snyder have systematically pursued policies of austerity at the state level; and Democratic governor Granholm couldn’t do much about it, facing Republican majorities in at least one of the two state houses. The current Snyder administration, backed by Republican control of both houses, has continued the austerity policies and -- by cutting revenue sharing and appointing emergency managers – forced further cutbacks on public infrastructure.

e) See Hector Solon’s blog [http://bloggingformichigan.com/author/hector-solon/] for excellent analysis of State of MI financial trends. As he writes “no business will be attracted to a State that can’t fund [its] infrastructure and improvement of its own… assets in our cities, villages, towns and counties and adequately educate its youth and talent in a new, innovation driven economy. Starved, low wage states might be just great for processing chicken, but they are not the sort of states that build out high wage innovation economies.”

(f) If MI state revenues were restored to their pre-crash growth path by a healthier national economy and a more progressive state tax system, there would be far more resources to support public infrastructure at all levels, and the end result would be far better for the economy of the state of MI – as well as Detroit and other MI cities, villages & townships – than the current policy of austerity and lower business taxes.

CONCLUSION

WE KNOW HOW TO FIX THE ECONOMY OF THE NATION, THE STATE, AND THE CITY OF DETROIT.

THE REALLY DIFFICULT CHALLENGE IS POLITICAL: HOW TO BRING ABOUT CHANGES IN THE POLITICS OF THE COUNTRY AND THE STATE SO THAT OUR HUGE ECONOMIC PROBLEMS WILL ACTUALLY BE ADDRESSED IN A SENSIBLE WAY.

SO FAR THE OCCUPY MOVEMENT HAS DONE A GREAT JOB IN DRAWING ATTENTION TO THE WIDESPREAD INJUSTICE AND INADEQUACY OF OUR ECONOMY AND TO THE INEQUALITY THAT UNDERLIES IT.

WHAT WE NEED NOW IS A POLITICAL STRATEGY THAT TRANSLATES UNDERSTANDING OF THE SOURCES OF INEQUALITY AND INJUSTICE INTO ACTION TO OVERCOME THEM!
CHART 3

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

CHART 4

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

CHART 5

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

Source: CBO

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

Weekly wages (inflation adjusted 2008 dollars)

Source: Author's calculations using BLS data
CHART 8

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

“Full funding” assumes that statutory revenue sharing remains a constant % of sales tax revenues.