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The End of Loser Liberalism: Making Markets Progressive

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> It is possible to identify at least three distinct stimulus packages since the downturn began. The first consisted primarily of a tax cut. President Bush signed this package into law in February 2008 at a time when the unemployment rate was just 4.8 percent. President Obama proposed the second package just as he was taking office in January 2009, and Congress approved roughly $700 billion in new tax cuts and additional spending, mostly over calendar years 2009 and 2010.[6] The third stimulus, approved at the end of 2010 at a point when most of the money from the second stimulus had been spent, extended President Bush's 2001 tax cuts for another two years, reduced the payroll tax by 2 percentage points for a year, and continued extended unemployment benefits through 2011. These stimulus packages were explicitly designed to offset the effect of reduced private-sector spending. The resulting rise in the deficit stemming from the stimulus packages was not an accident – it was a deliberate goal of the policy. Together the packages added more than $1.5 trillion to the deficits over the fiscal years 2008-2011. However, the spending almost certainly boosted the economy; it increased growth and created jobs.[7] A smaller deficit in these years would have meant slower growth and fewer jobs. In this sense, the deficit is part of the solution, not the problem.

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> The impact of the collapse of these two bubbles on the demand for goods and services in the economy was enormous, and continues to be felt. The residential housing sector fell from a peak of 6.2 percent of GDP in 2005 to just 2.2 percent in the first quarter of 2011. The loss of $7 trillion in housing equity (the bubble had not yet fully

> deflated by the spring of 2011, so there was still about $1 trillion to be lost) led to a sharp fall in consumption. As a result of this lost housing wealth, the savings rate rose from near zero in the years 2004-2007 to over 5 percent by the first quarter of 2009.[9] This corresponds to a loss of more than $500 billion in annual consumption (and reinforces the similar estimate derived from a calculation of the housing wealth effect). It is worth noting that this reduction in spending (and implied increase in savings) has little to do with consumers being pessimistic or wary about the future, though they likely are. Rather, consumers are spending in line with their wealth. Now that their wealth has been hugely reduced by the collapse of the bubble, they have adjusted their spending accordingly. The overbuilding and collapse of the bubble in nonresidential real estate led to a further loss in annual demand of roughly $250 billion. Adding together the $600 billion in lost residential construction demand (the 4 percentage-point drop in GDP noted above), the $500 billion in lost consumption demand, and the $250 billion in lost demand in nonresidential construction gives a total drop in annual demand of $1.35 trillion.

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> When President Reagan took office in 1981, he had an explicit policy of putting the country on a different sort of growth path, and he largely succeeded. While President Reagan's tax cuts – which disproportionately benefited higher-income taxpayers – are widely remembered, they are the less important part of the story. The upward redistribution of before-tax income in the years since 1980 has had far more impact on inequality and the living standards of the bulk of the population than the changes toward a more regressive system of taxation. Making money flow upward This upward redistribution was not the result of the natural workings of the market. President Reagan and his successors put in place a variety of measures that had the effect of weakening the bargaining power of ordinary workers. Together these measures had the effect of driving down the wages of those at the middle and the bottom of the income distribution, to the benefit of those at the top. Heading this list of policy changes was the tighter monetary policy pursued by the Federal Reserve Board in the years after 1980. Fighting inflation became the Fed's overwhelming concern, and it was willing to tolerate high unemployment rates to reduce inflation to levels it

> considered acceptable. This was clearly demonstrated by Paul Volcker in 1982 when he pushed the unemployment rate to almost 11 percent in order to rein in inflation. His successor, Alan Greenspan, was similarly committed to low inflation. The modest acceleration in the inflation rate at the end of the 1980s was sufficient to prompt a round of interest rate hikes that eventually led to the 1990-1991 recession. The current Fed chairman, Ben Bernanke, has committed the Fed to a 2.0 percent inflation ceiling, implying that he would raise interest rates and push up unemployment if he believed that core inflation might exceed this level. This focus on inflation represents a sharp shift from the Fed's policy in prior decades. While the Fed was always concerned about inflation and had brought on recessions in the past as part of its effort to control it, Volcker began a new era in which fighting inflation became a much greater priority than sustaining high employment, the other half of the Fed's mandate. The policy of raising unemployment to fight inflation has the effect of redistributing income upward because it is overwhelmingly less-educated workers who lose their jobs when the unemployment rate rises. The unemployment rate for all categories of workers rises during a recession, but the largest increases will be for workers with less education. The percentage of factory workers and retail clerks who lose their job in a downturn is far higher than the percentage of doctors and lawyers. As a result, the workers who end up taking the biggest pay cuts in a downturn are those without college degrees and especially those without high school degrees.[18] High unemployment is a class-biased mechanism for fighting inflation. In effect…

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> The high dollar, coupled with U.S. trade policies of the last three decades, is also an important tool for redistributing income upward. A conscious goal of trade agreements like the North American Free Trade Agreement (NAFTA) is to make it as easy as possible for U.S. manufacturers to relocate their operations to Mexico and other developing countries. This has the effect of putting U.S. manufacturing workers in direct competition with low-paid workers in the developing world. The predicted and actual result of this policy is to eliminate jobs in manufacturing in the U.S. and to put downward pressure on the wages of the workers still employed in the sector.

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> However, free-trade agreements are not designed to free trade in professional services. In drafting NAFTA, U.S. trade negotiators eagerly sought out the opinion of manufacturers, asking them to identify obstacles that prevented them from relocating operations to Mexico and other developing countries, but there was no comparable outreach to hospital administrators or law firms to determine the barriers that prevented them from hiring low-paid (but highly qualified) doctors and lawyers from India or Mexico. This apparent discrepancy was again the result of a conscious decision to design policy in a way that redistributes income upward. The

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> The result is that top corporate management in the United States has come to be paid far more than its counterparts in Europe and Asia, primarily over the last three decades. Essentially, the structures (either dominant shareholders or social norms) that had previously placed a check on the pay of top management broke down. With no policy response to create new checks on management pay, top managers have been freed to write their own paychecks at the expense of the employees, shareholders and other corporate stakeholders.

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> last three decades, as patent protection has become both easier to obtain and stronger. Patent monopolies allow firms to charge far more than the competitive market price for their products. This price advantage can be seen most clearly in the case of prescription drugs. In 2010, spending on prescription drugs amounted to almost 2 percent of GDP, compared to less than half a percent in 1980. The higher expenditures are almost entirely a function of patent protection. Then, as now, drugs are cheap to produce, and it is only patent monopolies that make them expensive to buy.

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> The upward redistribution of income since the early 1980s laid the

basis for the bubble economy. This can be seen by looking at two important implications for the larger economy which had resulted from the broad sharing of the benefits of productivity growth in the three decades after World War II. First, since most workers could be counted on to spend most of their income, the pattern of distribution ensured that demand would keep pace with productivity growth. The income generated by productivity growth was spent rather than saved. When ordinary workers stopped sharing in the gains of productivity growth, inadequate demand became a problem. The second implication was that rising wages could lead to inflationary pressures. If wages generally rise in step with productivity growth, there is always a risk that wages will occasionally outstrip it. For example, if a contract provides for real wage increases of 2 percent, but productivity growth is only 1 percent, firms will either see a reduction in profit margins or be forced to raise their prices by more than the overall inflation rate. This response can lead to the sort of wage-price spiral the country experienced in the 1970s, when productivity growth lagged real wage growth for a short period. However, in a climate where workers have considerably little bargaining power, a wage-price spiral is a less serious threat. This diminished risk was the reason Alan Greenspan felt so comfortable in the 1990s with allowing interest rates to remain low and for the unemployment rate to fall to levels unseen since the 1960s. With the weak bargaining position of workers in the 1990s, inflation simply was not a problem, and Greenspan was an astute enough observer of the economy (unlike most academic economists) to recognize this fact. Low interest rates have a positive but limited impact in increasing demand. They do lead to somewhat higher investment, but a large body of research shows that investment is not very responsive to lower interest rates. Low interest rates can lead to a fall in the dollar, which would boost net exports, but there were other factors keeping the dollar high during this period. In fact, the main effect of the low interest rates sustained through the late 1990s and the 2000s was to create the possibility for the bubble economy, the dynamics of which are explored in the next chapter.

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There is another important chapter of the Clinton morality tale that turns out to be more fiction than fact. Nominal interest rates indeed fell, but the decline in the real interest rate from the high-deficit

> years of the 1980s was quite modest. And the small decline had little effect on investment. The investment share of GDP at its peak in the 1990s cycle (which was in 2000) was somewhat higher than it had been in the 1980s but was still below its 1970s' peak (Figure 4-2).[25] Furthermore, the uptick in productivity growth in the 1990s, which many associate with an "investment boom," began before investment had recovered even to the 1980s level.

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> In short, the good economic news in the 1990s had little to do with the deficit reduction measures of the Clinton administration. The fuel for the business cycle was consumption, not investment, which was in turn the result of the wealth effect attributable to $10 trillion of stock bubble wealth. This ephemeral wealth increased annual consumption by $300-400 billion a year, or 3 to 4 percent of GDP. The household savings rate fell to what were at the time record lows. Net national savings actually hit their lowest levels of the postwar period, in spite of the large budget surpluses at the end of the decade. In fact, the switch from federal deficits to surpluses was more than offset by a reduction in private-sector savings. By the end of the decade, the country was engaged in large-scale borrowing from abroad, even as it was running huge budget surpluses.

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> The more important channel through which the plunge in the market affected the economy was through its impact on consumption. The savings rate had fallen to 2.9 percent at the peak of the bubble in 2000. The destruction of $10 trillion in paper wealth would theoretically lead to a reduction in annual consumption of $300-400 billion, as mentioned above. Consumption did in fact fall sharply in response to the drop in the stock market. The adjusted savings rate rose by roughly 3 percentage points between 2000 and 2002, corresponding to a drop in annual consumption of more than $250 billion.[27]

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> One aspect of the weak recovery is the pattern followed by the trade

deficit. Usually the trade deficit shrinks in a downturn, as the country buys fewer imports along with less of everything else. The trade deficit declined modestly in 2001, but it began to rise rapidly in 2002 and continued to rise until 2006. This outcome was more fallout from the overvalued dollar. The turnaround that eventually allowed the economy to grow fast enough to create jobs was primarily due to the growth of the housing bubble. Like the alcoholic who recovers from the effects of a hangover by drinking again in the morning, the economy used the growth generated by the housing bubble to recover from the collapse of the stock bubble. By 2002 it was already possible to recognize that the housing market was in a bubble.[28] In the years since 1996, home prices had risen by more than 30 percent after adjusting for inflation. This rise followed a 100-year trend in which nationwide home prices had just tracked the overall rate of inflation.[29] The U.S. housing market was valued at more than $14 trillion in 2002, making it the largest market in the world. When there is a longstanding trend in an enormous market, it is reasonable to expect it to persist unless some large change in the fundamentals justifies a departure from the trend. A quick examination of the fundamentals showed there to be no plausible explanation for the sharp run-up in prices. On the demand side, neither population growth nor income growth provided helpful explanations. Population growth had actually slowed considerably from prior periods. It might have been reasonable to expect some pressure on home prices when the huge baby boom cohort was first forming its own households, but this would have occurred in the 1970s and 1980s, not 2002, when the youngest baby boomer was already 38 and the oldest was 54.

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The supply side also offered no plausible explanations. In testimony before Congress in 2002, the Federal Reserve Board chairman commented on the run-up in home prices and mentioned the limited supply of available land and environmental restrictions on building.[30] Neither of these seemed plausible as explanations for an increase in home prices beginning in the mid-1990s. There had always been a limited supply of land in especially attractive places to live; this was not a new feature of the housing bubble. As far as environmental restrictions on building, Republicans had taken over Congress in 1994 (and many state houses as well), so the late 1990s could hardly be viewed as the heyday of environmental legislation.

> Furthermore, it was only necessary to look at the data on construction, which showed housing starts at a near-record rate. While there may have been obstacles to building, they were not impeding supply in any important way.

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> Lacking any explanation for the price run-up on either the supply or demand side of the market, it was also possible to turn to rents for evidence that fundamentals were not responsible for the rise in home prices. If the rise were being driven by the fundamentals of the housing market, there should be a comparable increase in rents, since owning and renting are loose substitutes. If the fundamentals of the housing market were driving up sales prices, then they should also be driving up rents. But rents showed no remotely comparable rise. They did outpace the overall inflation rate by about 1 percentage point annually from 1996 to 2000, but from that point forward they were flat in real terms until the bubble finally burst. This should have been a big warning sign that the run-up in prices was driven by a bubble.[31] One other item that economists could have checked to determine whether home prices were driven by fundamentals was the vacancy rate. The Census Bureau publishes data on vacancy rates every quarter,[32] and these data are a very basic measure of the slack in the housing market. If the run-up in home prices had been due to a shortage of housing, then vacancy rates ought to have been at very low levels. In fact, the opposite was true: the vacancy rate had already hit a record high by 2002 (and it continued to rise through the later bubble years). The fact that the big increase in vacancies was in rental units, not ownership units, still reflected an excess supply of housing that could be expected to exert downward pressure on rents, which would in turn also put downward pressure on sale prices as people opted to take advantage of cheap rents rather than buying. In addition, if rents are falling while sale prices are rising, landlords will convert rental units into ownership units. This can be costly in some cases (many cities have laws protecting renters from being displaced), but if the gains are large enough, landlords can and do find ways to make these conversions. Furthermore, almost a third of rental units are single-family homes that require little work to convert to ownership units. In sum, by 2002 the housing market was experiencing a bubble that should have been apparent to policy makers. Instead, all the people in top policy-making positions ignored

> the evidence and insisted that everything was fine with the housing market and the economy.

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> The Fed's banker-friendly organizational structure was not an accident; it was first and foremost intended to serve the banks and only secondarily to serve the larger public. The Fed's culture is thoroughly intermeshed with the financial industry. While its legal mandate from Congress places an equal priority on the goals of price stability and full employment,[40] the Fed has maintained a much greater commitment to the former goal than the latter. In fact, current Fed Chairman Ben Bernanke has openly committed the Fed to targeting inflation at 2 percent, a policy which implies that the Fed would be willing to tolerate high jobless rates if it were concerned that more expansionary policy would raise the rate of inflation above its target. Inflation

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> banks lose money as a result of inflation. The bonds and loans they hold will fall in value in response to a rise in the rate of inflation. The price of bonds and long-term loans moves in the opposite direction of interest rates. If interest rates rise, then the price of these assets falls. And so if people come to expect higher rates of inflation, and then interest rates rise in response, the existing bonds and loans held by the banks will be worth less. For this reason, banks and other financial institutions typically face large losses if the rate of inflation increases.

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> While it is good politics and good economics, what it is not is a battle between those wanting regulation and those wanting an unfettered market. The financial sector in its current form is heavily dependent on the government for its survival. The insurance provided by the Federal Deposit Insurance Corporation (FDIC) and comparable government insurers is certainly not a market mechanism, and it can subsidize bank excesses if it is given without proper regulation.[87] In addition, banks enjoy the back-up liquidity guarantees provided by the Federal Reserve Board. The largest banks also have the implicit

> support of the government's too-big-to-fail policy. Virtually no one believes that the government would allow J.P. Morgan or Goldman Sachs to simply go bankrupt. As a result, these huge banks are able to borrow funds at a lower cost than their smaller rivals, an arrangement that amounts to a substantial subsidy from the government to these large banks.[88] The elimination of these subsidies would be a genuine free-market approach, but the financial industry wants to maintain its insurance while removing restrictions that limit the risk to taxpayers. The banks' efforts do not represent a debate between those advocating an unfettered market and those who want government regulation. This is an argument with an industry that wants the taxpayers to provide it insurance but doesn't want to have to pay for the insurance and doesn't want to have any restrictions that prevent it from raising the risk to taxpayers. In other words, the industry wants to set up a fireworks factory in its basement and not even pay the standard homeowners' insurance rate.

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> For this reason, a clear separation between conventional banking and investment banking, like the one imposed by Glass-Steagall, may be the only effective way to keep banks with insured deposits from taking excessive risks. It is worth noting that the repeal of Glass-Steagall did not contribute in any major way to the inflation of the housing bubble or the subsequent financial crisis. Most of the major investment banks did buy up commercial bank subsidiaries that fed them mortgages for securitization, but this was a minor part of the story. Investment banks acquired the vast majority of the junk loans they securitized during this period on the open market. However, just because allowing banks with government-insured deposits to engage in speculative activity did not cause the last crisis does not mean it will not cause the next one. There is no obvious reason that a bank that receives government insurance for a substantial portion of its operations should be allowed to take excessive risks in its other operations. The banks argue that they will keep the insured and speculative portions of their operations strictly separate. If this is so, then why operate them both? There are no economies of scale or scope achieved by bringing them together under a single corporate roof.

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> prescription drugs. Items that would essentially be available at zero cost in a free market can instead command high prices because the government grants copyright monopolies. While the

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> protection is enormous. Including software, the public spends more than $100 billion a year for items that would be available at much lower or even zero cost in a free market.

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> Many of the measures taken are absurd. For example, the government has repeatedly extended the period of copyright (now 95 years after the death of the author) and applied the extensions retroactively. This is bizarre: the purpose of copyright monopolies is to provide incentives for creative work, and it is impossible to provide incentives retroactively. These retroactive extensions are sometimes dubbed the “Mickey Mouse Law,” since Disney, hoping to keep its copyright on Mickey Mouse in force further into the future, was a major proponent of the extensions.

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> in every way we can. It is not by luck, talent, and hard work that the rich are getting so much richer. It is by rigging the rules of the game.

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