Economic Growth Held Back
by Widespread Income Inequality

by

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I. Introduction

Economic growth and job creation have been modest for the entire economic expansion that started in June 2009 in large part because of high and persistent income inequality. Middle-income and lower-income Americans have seen only modest gains in their incomes, for instance, while high-income families have disproportionately benefited in terms of income and wealth.

Income inequality and slow economic growth appear self-reinforcing. Slow economic growth only slowly creates new opportunities for more and better jobs for America’s middle class. This holds back consumption spending and investment in housing, while increasing the indebtedness of some households. The result then is slower economic growth in the present and the near future than would be the case with stronger job growth. But, corporations use a number of available tools to generate high profits among meager productivity growth. This leaves fewer resources than otherwise would be available to hire new employees or offer better pay for their current employees. It also leaves fewer resources to improve productivity—and, thus, long-term economic growth—by investing in new equipment, such as computers and car parks, as well as in new office space and manufacturing plants. This again means that economic growth falls below where it otherwise would be.

Policy interventions could break this cycle of subpar economic growth. A number of specific policies could help strengthen income gains for lower-income and middle-income workers, such as increases in the minimum wage and more opportunities to join a union. Additionally, regulatory and tax policies could encourage corporations to refocus priorities from primarily generating short-term profits, in order to manipulate stock prices, to investing in long-term economic growth. In the meantime, governments could invest more in infrastructure and education to again lay the foundation for stronger economic growth in the long term. That is, a number of policy options exist for Congress and state governments to boost economic growth and start reducing massive income inequality.

Using policy tools at the federal and state level to create a stronger economy and middle class are feasible, but currently only happening in a limited way. Some cities and states have started to raise the minimum wage, for instance. Policy analysts have started to push more forcefully than in the past for changes in the way corporations are run with no concrete changes to show for it so far. And, while Congress has begun to slowly restore some of the most harmful budget cuts of the past few years, funding still falls short in meeting the U.S. infrastructure and education needs. That is, things are beginning to look up for economic growth and more widely shared economic prospects, but faster and more widespread interventions are needed. The bottom line, though, for the economic outlook for the coming year is that economic and job growth will likely remain modest.
II. **Slow economic growth, corporate priorities and persistent inequality**

The economy is growing slowly as all of its parts are adding only modestly to the expansion. Most importantly, economic growth has not been accelerating in any discernible way over the past few years as its key underlying factor—productivity growth—has also been slow. That is, right now the economy has little forward momentum.

**Economic growth**

Economic growth, while positive, has been uneven and lackluster for years. Gross domestic product (GDP) increased in the third quarter of 2015 at an inflation-adjusted annual rate of 2.1 percent, after an increase of 3.9 percent in the previous quarter. The economy has expanded at an average annual rate of 2.2 percent since the recession ended in June 2009. This is far below the historical average growth rate of 3.4 percent from December 1948—when the first recession after World War II started—to December 2007, when the last recession started.

And, there is little evidence that economic growth has accelerated. Figure 1 shows the annual growth over the past years from 2009 to 2015.

![Figure 1: Annual GDP growth rates, 2008 to 2015](image)

*Notes: Calculations based on Bureau of Economic Analysis. 2015. National Income and Product Accounts. Washington, DC: BEA. Data for 2015 is the annualized growth rate over the first nine months. All calculations based on constant (real or inflation-adjusted) dollars.*
All parts of the economy have been expanding only slowly. Personal consumption, for instance, increased at an annual rate of 3.0 percent and spending on housing rose 7.3 percent—a rather modest rate, considering that the housing market still has a lot of catching up to do. Business investment also only increased by a modest 2.4 percent, highlighting one of the economy’s persistent weak spots.

As domestic economic growth is in the doldrums, overseas demand for U.S. products is not picking up the slack due to a strong dollar, low oil prices and weak economic growth in other countries. Exports increased 0.9 percent in the third quarter of 2015, and imports grew at a rate of 2.1 percent.

Faster government spending—for instance, on infrastructure—could in theory contribute to stronger economic growth, but it remains another weak spot. Federal government spending slightly increased, by 0.1 percent in the third quarter, and state and local government spending increased a modest 2.6 percent. To be clear, these are improvements after years of declining government spending, but they are not enough to pull the economy out of its slow growth pattern in the foreseeable future.

*Productivity growth follows from lackluster investment*

The modest economic growth over the past few years is reflective of a worrisome trend of slowing productivity growth. Productivity growth, measured as the increase in inflation-adjusted output per hour, is key to strong long term economic growth and to increasing living standards for American families, because it means that workers are getting better at doing more in the same amount of time. Slower productivity growth thus means that new economic resources available to improve living standards and to pay for a wide range of services, such as the retirement of Baby Boomers, are growing more slowly than would be the case with faster productivity growth.

U.S. productivity rose a total of 6.9 percent from June 2009, the end of the Great Recession, to September 2015. This is an average annualized quarterly growth rate of 1.0 percent in annual terms, far below the quarterly average of 2.2 percent from December 1948—when the first recession after World War II started—to December 2007, when the last recession started.

Slow productivity growth follows in part from the lack of business investment in new physical structures—offices, manufacturing plants and mining—and equipment, such as computers and trucks. Figure 2 shows the share of total (gross) business investment and the share of investment that goes beyond replacing obsolete structures and equipment (net investment) out of the entire economy measured by GDP for each business cycle. The data show both gross and net investments are trending downwards, such that net investment has averaged less than two percent of GDP for the current business cycle that started with the first quarter of 2008. This is the lowest business cycle average for net investment since World War II (Figure 2). This indicates that the capital base of the U.S. economy is expanding at its slowest pace in more than six decades.
Skewed corporate priorities slow investment spending

The lack of investment is not a result of low profits, but of skewed corporate priorities. Inflation-adjusted corporate profits were 105.8 percent larger in June 2015 than in June 2009. The after-tax corporate profit rate—profits to total assets—stood at 3.05 percent in June 2015. Corporate profits recovered quickly toward the end of the Great Recession and have stayed high since then, even though economic and productivity growth have been anemic. Corporations were able to quickly recover profits only by prioritizing profits and stock market gains over employment and investments in equipment and physical structures.

The data—summarized in Figure 3—highlight corporations' skewed priorities. From December 2007—when the Great Recession started—to June 2015, nonfinancial corporations spent an average of 93 percent of their after-tax profits on dividend payouts and share repurchases. In short, almost all of nonfinancial corporate after-tax profits have gone to keeping shareholders happy during the current business cycle.

Nonfinancial corporations also held, on average, 5.3 percent of all of their assets in cash—a very high rate by historical standards.\textsuperscript{x}

In comparison to the historically high spending on dividend payouts and share repurchases, nonfinancial corporations spent an average of 168.3 percent of their after-tax profits on capital expenditures or investments—by selling other assets and by borrowing.

This was the lowest capital expenditures to after-tax profits ratio since the business cycle that ended in 1957.\textsuperscript{xi} U.S. corporations have prioritized keeping shareholders happy in the short term and building up cash over investments in structures and equipment that create long-term value, thus contributing to lackluster economic growth.

*Slow economic growth and skewed corporate priorities contribute to persistently high inequality*

Weak economic growth and skewed corporate priorities have exacerbated income inequality, which has been rising since lower-income and middle-income Americans
have experienced moderate job and income gains, while high-income earners have seen substantially larger gains.

Employment growth has been modest. There were 11.7 million more jobs in October 2015 than in June 2009, when the economic recovery officially started. The private sector added 12 million jobs during this period. The loss of some 507,000 state and local government jobs explains the difference between the net gain of all jobs and the private-sector gain in this period. Budget cuts reduced the number of teachers, bus drivers, firefighters, and police officers, among others.\(^\text{xii}\) The average monthly annualized employment growth rate from June 2009 to October 2015 was just 1.4 percent, well below the long-run average of 1.9 percent from December 1948—when the first recession after World War II started—to December 2007, when the last recession started.\(^\text{xiii}\)

The labor market picture is in fact worse for some communities than for others. The national unemployment rate, for instance, was 5.0 percent in October 2015. However, while the white unemployment rate remained at 4.4 percent, the African American unemployment rate remained at 9.2 percent and the Hispanic unemployment rate decreased slightly to 6.3 percent. Meanwhile, youth unemployment decreased to 15.9 percent. The unemployment rate for people without a high school diploma decreased to 7.4 percent, compared with 5.2 percent for those with a high school degree, 4.4 percent for those with some college education, and 2.5 percent for those with a college degree.\(^\text{xiv}\) Amid the weak labor market, population groups with higher unemployment rates have struggled disproportionately more than white workers, older workers, and workers with more education.

But, the rich continue to pull away from most Americans. Incomes of households at the 95th percentile—those with incomes of $206,568 in 2014 (the most recent year for which data are available)—were more than nine times the incomes of households in the 20th percentile, whose incomes were $21,432. Analysis by the U.S. Bureau of the Census shows that income inequality remains at or near a record level: In 2014, the top 5 percent of earners captured 21.8 percent of total income, whereas the bottom 40 percent of earners captured 12.3 percent of total income.\(^\text{xv}\)

*Persistently high income inequality feeds back into slow economic growth*

Aside from sluggish consumption growth, high income inequality also hampers economic growth through only modest gains in the housing market, which is usually a critical contributor to faster economic growth in an economic recovery than was the case in the current recovery.

Although the housing market continues to grow, many counties across the country continue to struggle with negative home equity rates—meaning the average homeowner owes more on the mortgage than the house is worth.\(^\text{xvi}\) This problem disproportionately affects communities of color, which continue to lack access to affordable credit compared with their white counterparts.\(^\text{xvii}\) Yet the housing market is clearly improving,
just not at the same rate for everyone. New-home sales amounted to an annual rate of 495,000 in October 2015—a 4.9 percent increase from the 472,000 homes sold in September 2014 but well below the historical average of 698,000 homes sold before the Great Recession.\textsuperscript{xviii} The median new-home price in October 2015 was $281,500, down from $299,400 one year earlier.\textsuperscript{xix} Existing-home sales increased 3.9 percent in October 2015 from one year earlier, and the median price for existing homes was up 5.8 percent during the same period.\textsuperscript{xx} Despite this growth, home sales have a long way to go, given that homeownership in the United States stood at 63.7 percent in the third quarter of 2015, down from 68.2 percent before the start of the recession at the end of 2007.\textsuperscript{xxi} The current homeownership rates are similar to those recorded in 1996, well before the most recent housing bubble started.\textsuperscript{xxii} A stronger housing recovery could boost economic growth, but that is unlikely to occur unless public policy addresses income inequality in a sustained way.

In the meantime, American households go deeper into debt for large ticket items other than houses and this debt could hold back economic growth in the future.

Household debt is still high. Household debt equaled 107.4 percent of after-tax income in June 2015, down from a peak of 135.0 percent in December 2007.\textsuperscript{xxiii} But non-revolving consumer credit—mainly student and auto loans—has outpaced after-tax income growth. It has grown from 14.6 percent of after-tax income in June 2009 to 18.7 percent in June 2015. This is the highest share of such debt to after-tax income on record, dating back to 1968.\textsuperscript{xxiv}

A return to debt growth outpacing income growth—which was the case for total debt prior to the start of the Great Recession—from already-high debt levels could eventually slow economic growth again, as people would have to focus on repaying loans and financial instability would take its toll. This would be especially true if the U.S. Federal Reserve started to raise interest rates. Consumers would have to pay more for their debt, and they would have less money available for consumption and saving, slowing economic growth and job creation.

\section*{III. Only limited policy responses to addressing income inequality}

A number of policies at the federal and state level could start to lower income inequality, encourage corporations and governments to reprioritize long-term value creation and thus boost economic growth and job creation in the near term and over time. While some governments have started to move in this direction, these steps tend to be small and tepid, such that high inequality and slow growth will continue to characterize the economy in near term. Consider the following examples of policy interventions:

\begin{itemize}
  \item A higher minimum wage could boost the incomes especially among those groups of households that have been disproportionately hurt by the slow growing economy. Yet, there is no discernible movement towards a higher minimum wage in Congress. Efforts to increase the minimum wage have thus been limited to a few states and cities, for instance, Seattle and San Francisco.\textsuperscript{xxv}
\end{itemize}
• Paid family leaves could similarly improve the economic situation of many lower-income and middle-income Americans, who currently do not have paid leave benefits from their employers. A number of states have expanded disability insurance to include paid family leave.xxvi Only a limited number of workers, though, will benefit from these efforts.

• Giving workers more opportunities to join a union is a proven way to lower income inequality. There are currently no federal legislative efforts to make it easier for workers to join a union and several states continue to undermine workers’ efforts to join a union.xxvii

• The federal government could enact a number of regulatory and tax policies to incentivize corporations to prioritize long-term value creation through investments, research and development as well as hiring and training.xxviii A number of experts have been highlighting the need for policies that encourage corporate reprioritization, but very little is happening right now.

• Federal and state governments could invest more in infrastructure and education to again lay the foundation for stronger economic growth in the long term. The outlook for federal budgets has improved, creating breathing room for policymakers to invest in a stronger basis for long-term growth. The nonpartisan Congressional Budget Office (CBO) estimated in August 2015 that the federal government will have a deficit—the difference between taxes and spending—of 2.4 percent of GDP for fiscal year 2015, which runs from October 1, 2014, to September 30, 2015.xxix This deficit projection is an improvement over the actual deficit of 2.8 percent of GDP for FY 2014.xxx The estimated deficit for FY 2015 is much smaller than deficits in previous years due to a number of measures that policymakers have already taken in order to slow spending growth and raise more revenue than was expected just last year. Congressional negotiators reached a budget deal in November that would restore some of the most harmful cuts to the federal budget, but total spending levels remain low as Congress has not tackled the challenge of insufficient revenues.xxxi

IV. Conclusion
The upshot from this data discussion and policy overview is that the economy and the labor market need more attention from federal and state policymakers than has been the case in the past and that public policy is generally moving in the right direction, but it does so at a snail’s pace. Existing efforts are too limited to have a sufficient effect on inequality and economic growth in the coming year to boost economic growth much beyond its current lackluster pace. Put differently, positive factors such as more jobs and faster wage gains could likely only promote growth enough to compensate for some
known or expected obstacles to faster economic growth in the near term, such as higher interest rates, high household debt levels, a strong dollar and weak overseas growth and thus weak U.S. export growth. Without significant federal policy attention to the overarching challenge of massive income inequality, the current economic recovery will likely continue to stay on a modest growth path.

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6 Calculations are based on productivity growth (output per hour) for nonfarm businesses from Bureau of Labor Statistics, Current Employment Statistics (U.S. Department of Labor, 2015).

7 Ibid.


9 Calculations are based on Board of Governors of the Federal Reserve System, “Z.1 Release—Financial Accounts of the United States.”

10 Calculations are based on Board of Governors of the Federal Reserve System, “Z.1 Release—Financial Accounts of the United States.”

11 Calculations are based on Board of Governors of the Federal Reserve System, “Z.1 Release—Financial Accounts of the United States.”


13 Ibid.


18 The historical average refers to the average annualized monthly residential sales from January 1963, when the census data started, to December 2007, when the Great Recession started. Calculations are based on Bureau of the Census, New Residential Sales Historical Data (U.S. Department of Commerce, 2015).

xxiii Calculations are based on Board of Governors of the Federal Reserve System, “Z.1 Release—Financial Accounts of the United States.”
xx Ibid.