Economic Policies to Raise Median Incomes

Douglas W. Elmendorf
Harvard Kennedy School
December 2017
19th Annual Neemrana Conference

Notes for slides can be found at the end of the presentation.
When we think about the global economy ...

... we often think about changes in countries’ **total output or income**. And when we design macroeconomic policies, we often focus on raising total income, leaving the distribution of income to be addressed by other policies.

That approach relies on the idea that “a rising tide lifts all boats” far enough that macroeconomic policies should be used just to create a strong tide and other sorts of policies should be sufficient to address any distributional concerns.

Unfortunately, for many countries in recent decades, that idea is not supported by the evidence. Instead, the evidence should make us think about “when growth is not enough,” to use the title of a recent speech by Ben Bernanke.
Why should macroeconomic policies focus on raising median income?

Market forces have been holding down median income in many countries and making the distribution of income much less equal – and those forces will probably continue to do so. Left unchecked, the economic, social, and political consequences of slow growth in median income and increasing inequality can be severe.

Therefore, we should make the explicit goal of macroeconomic policies be to raise median income, rather than total income (or mean income). That different focus will affect the macroeconomic policy discussions we have and the policies we design.
In the US over the past few decades, growth in median wages and income has been quite limited, especially relative to growth at the top.
In the US over the past few decades, the share of wealth going to the top of the distribution has increased markedly.
The US is an extreme example, which illustrates the importance of policy choices.

**Pie around the world**

- Top 1% in the U.S.: 40 slices of pie
- Top 1% in Germany: 25 slices of pie
- Top 1% in France: 18 slices of pie
- Top 1% in the U.K.: 18 slices of pie
- Top 1% in Canada: 16 slices of pie
- Top 1% in Finland: 12 slices of pie

Source: OECD
Differences in income and wealth in the US are generating a growing difference in life expectancy

Mortality rates for US non-Hispanic whites are rising

... in sharp contrast with mortality rates for other groups in the US and for people in other rich countries.
In particular, deaths from drugs, alcohol, and suicide are rising for Americans with less education.

“Deaths of Despair” for White Non-Hispanics, Age 50-54

- Men, high school or less
- Women, high school or less
- Men, bachelor’s degree or more
- Women, bachelor’s degree or more

Year
Deaths per 100,000
175 160 150 140 130 120 110 100
80 70 60 50 40 30 20 10 0
Labor force participation by less educated American men is falling significantly

Income gains across birth cohorts are falling substantially in the US
The market forces that have produced these changes will probably persist

Even as technological progress and business investment tend to push up average productivity and overall income ...

... the further dissemination and application of existing IT, the rise of autonomous vehicles, and the development of artificial intelligence and machine learning will impose continuing downward pressure on incomes across much of the distribution in many countries.
Rising tides do not necessarily lift all boats very far ... so what should policymakers do?

Discussions of macroeconomic policy often focus on aggregate economic variables and leave distributional issues to the side. But that approach is not sufficient when the distribution of income is being skewed so strongly and persistently by market forces.

Therefore, macroeconomic discussions and policies should focus explicitly on distributional issues as well as on overall economic growth.

That means rejecting policies that would boost total income but reduce living standards of lower- and middle-income people, and supporting policies that would diminish total income but raise living standards of lower- and middle-income people.
An important example: US tax reform of 2017

The House and Senate have passed similar but not identical versions of broad tax reform. There are two related economic debates underway.

What would be the effect on overall economic growth?

*Answer:* Probably positive over the next decade, but nil to negative thereafter unless spending is cut to match.

What would be the effect on people at different income levels?

*Answer:* Positive for higher-income Americans and negative for lower-income Americans.
Direct effects of tax changes are much more positive for higher-income people than others.

FIGURE 1
Percent Change in After-tax Income of the Tax Cuts and Jobs Act as Passed by the Senate
By expanded cash income percentile, 2019, 2025, and 2027

The revenue loss will ultimately require spending cuts -- and the effect on overall output will turn negative in the 2030s without such cuts.
Government benefits go mostly to lower-and middle-income people

Average Transfers, Taxes, and Transfers Minus Taxes for Nonelderly Households, by Income Group, 2006

(Dollars per household)

Source: Congressional Budget Office.
For lower- and middle-income people, lost benefits and other government spending will offset most, or more than all, of the direct gains from the tax cuts.

**Figure 1**

Percent Change in After-tax Income of the Tax Cuts and Jobs Act as Passed by the Senate

By expanded cash income percentile, 2019, 2025, and 2027

Effect of tax reform on overall economic growth will not substantially change the picture

The positive story: Lower tax rates on business investment lead to greater capital accumulation, which boosts wages.

But:

Decline in effective tax rates is much smaller than decline in the statutory rate.

A large share of current corporate profits is not basic return to capital but supernormal returns (rents); cutting taxes on rents does not raise investment.

Even if lost revenue is offset by spending cuts, additional investment will be financed primarily from outside the US. That will delay the effect and raise the trade deficit substantially. It also means that income from the additional capital will flow out of the US, so GNP will rise much less than GDP.
What should policymakers do instead?

First, try to ensure that “median workers” can find good jobs with good compensation.

Second, ensure that government tax and spending policies support people with median income.
How can we help median workers find good jobs with good compensation?

First, keep unemployment as low as possible using vigorous monetary and fiscal policies.

US unemployment was greatly elevated by weak demand, not structural factors, and less-educated workers bore the brunt of that problem.
How can we help median workers find good jobs with good compensation?

Second, increase education and training for people who do not have good access today. Evidence for the US suggests we can do better than we are doing now:

More spending on pre-kindergarten through secondary education improves outcomes: Cascio and Schanzenbach (2013); Lafortune, Rothstein and Schanzenbach (2017); Jackson, Johnson and Persico (2016).

Better use of spending on pre-kindergarten through secondary education improves outcomes: Murnane; Lesaux and Jones; Pianta; Jacobs; West.

After secondary education, focus should be on school-to-work transitions, two-year colleges, and subsequent training.
How can we help median workers find good jobs with good compensation?

Third, protect workers without creating a sclerotic labor market:

Block unreasonable non-compete provisions.

Reform occupational licensing rules: The fraction of jobs covered by such rules in the US has increased from 5 percent in 1950s to one-quarter today (Nunn, 2016).

Develop rules covering workers in the gig economy.

Provide access to affordable health insurance outside of employer-based system.

Make retirement benefits portable.
How can we help median workers find good jobs with good compensation?

**Labor Share of Income**

**U.S. Nonfarm Business Sector**

Index: 2009=100

Source: U.S. Department of Labor. Shaded areas represent recessions.
We also need tax and spending policies that support people with median income

But not all public leaders understand this point, include some leaders who were elected with explicitly populist rhetoric.

For example, in the US, the changes to tax and spending policies proposed by the Trump Administration and Congressional Republican leaders would hurt, not help, people with median income.

I have already noted the effect of the tax bills (and consequent spending cuts).

Spending proposals would have similar, but more dramatic effects, on lower- and middle-income people.
Reminder: government benefits go mostly to lower- and middle-income people

Average Transfers, Taxes, and Transfers Minus Taxes for Nonelderly Households, by Income Group, 2006

(Dollars per household)

Source: Congressional Budget Office.
Government benefits provide long-term advantages as well as short-term support for beneficiaries

Recent research suggests that benefit programs focused on children not only help the children today but raise their future incomes. As summarized by Furman:

Head Start / preschool programs increase school completion and eventual earnings (Heckman et al. 2010, Ludwig and Miller 2007)

Medicaid benefits received by children leads to higher earnings in adulthood for women (Brown, Kowalski, and Lurrie 2015)

Nutrition assistance leads to reduced chronic disease in adulthood and higher earnings for women (Hoynes, Schanzenbach, and Almond 2016)

Housing vouchers lead to higher college attendance and earnings in adulthood (Chetty, Hendren, and Katz 2016)
In the US today, federal taxes and benefits have an important (but limited) effect on income distribution.
Public infrastructure is especially helpful for lower- and middle-income families

Higher-income people can use private cars when mass transit is poor, can arrange for more home deliveries when roads are congested, and can buy private water when public water is unhealthy. By contrast, lower- and middle-income people have fewer private substitutes for public services. So, poor infrastructure tends to divide well-off and less-well-off people, while good infrastructure brings them together.
Conclusion

Market forces have been holding down median income in many countries and making the distribution of income much less equal – and those forces will probably continue to do so. Left unchecked, the economic, social, and political consequences of slow growth in median income and increasing inequality can be severe.

Therefore, we should make the explicit goal of macroeconomic policies be to raise median income, rather than total income (or mean income). That different focus will affect the macroeconomic policy discussions we have and the policies we design.
Notes

Slide 2—See https://www.brookings.edu/blog/ben-bernanke/2017/06/26/when-growth-is-not-enough/.
Slide 4—Sources: Congressional Budget Office (2011) and Congressional Budget Office (2016).
Slide 21—Source: U.S. Labor Department.
Slide 24—Source: U.S. Labor Department.