Reversing the "Upside-Down" Economy
Faster Income Growth Necessary for Strong and Durable Growth

A Center for American Progress Policy Brief
Christian E. Weller, Senior Economist, Center for American Progress

May 10, 2004

I. Introduction

The current economic recovery often has been described as a "job-loss" recovery, which is meant to capture a new quality to this recovery – a shrinking labor market among a growing economy. But there is another new quality that distinguishes this recovery from prior ones. It is an "upside down" economy, meaning the distribution of typical gains during a recovery in favor of personal income is reversed in this recovery. Profits are soaring to record heights and the share of additional income that has gone to profits is at a historic high. All the while income grew at the slowest rate in any recovery.

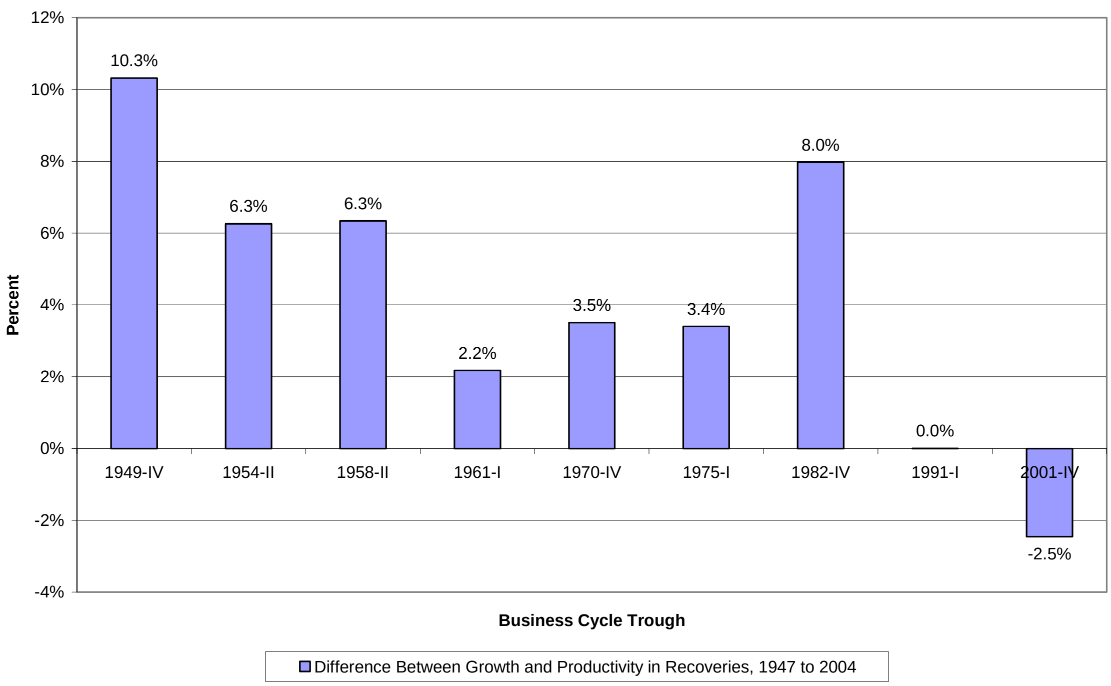
While Wall Street celebrates the continuation of record high profit rates, Main Street frets over the lack of job and wage growth. More importantly, though, while economic growth is beginning to accelerate, the lack of income growth threatens the durability of the recovery. So far, households have compensated for the lack of income growth by borrowing more to finance their consumption. But households will not continue to increase their borrowing endlessly. Consequently, other factors are needed to propel economic growth forward. One such factor is increased government spending. But government spending is hampered by deficits. Alternatively, more exports could help, but they are slowed by a rise in the dollar and slow growth overseas. And lastly, investment is slowed by sluggish demand increases everywhere. Unless consumption is financed out of income, economic growth is likely to slow.

Historical precedent supports the notion that stronger income growth is also associated with stronger economic growth and, equally important, with stable growth. When income growth was stronger in a recovery, households increased their debt less, governments borrowed less, and the trade balance improved more. In sharp contrast, this recovery has seen comparatively low economic growth rates, record household debt, deteriorating government finances, and record trade deficit levels. In essence, because the distribution of national income gains was upside down, the recovery is debt driven and hence less sustainable than otherwise would be the case.

II. The "Upside-Down" Recovery Reverses Distribution of Economic Gains

What distinguishes this recovery from previous ones is, among other things, a growing gap between supply and demand. That is, economic growth and employment diverged because demand growth did not keep pace with productivity growth. In fact, this is the first recovery where two years after the start of the recovery, productivity growth had outpaced real economic growth (figure 1)[1]. Aside from the last recovery, when both productivity and demand grew at the same rate, demand typically outpaced productivity growth. Consequently, firms had to hire new workers to meet the additional demand, even though their existing workforce had become more productive. Not so in this recovery, when firms could meet demand with a shrinking workforce.

Figure 1: Difference Between Growth and Productivity in Recoveries, 8 Quarters after the Start of the Recovery



Sources: BLS, 2004a; BEA, 2004a.

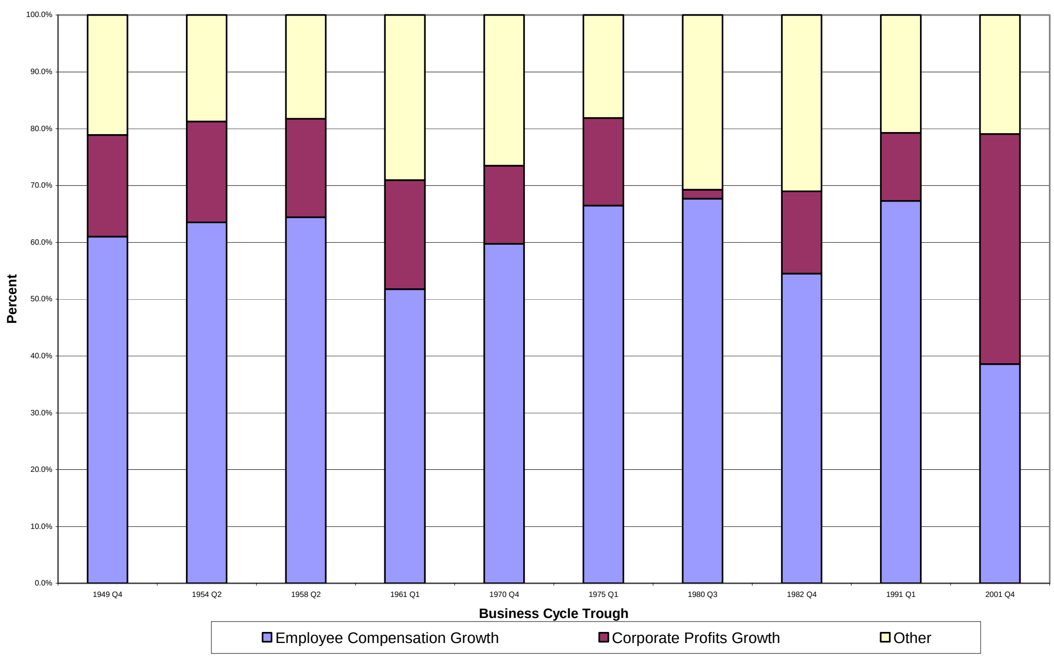
This is not attributable to extraordinarily strong productivity growth, but to weak demand growth. Productivity, measured as how much a worker can produce in an hour, rose by 9.9% from the end of 2001 to the end of 2003. It also increased by 9.9% in the late 1940s and by 9.5% in the mid 1960s. However, in these other two instances, demand grew 10 percentage points and 2 percentage points faster than productivity, respectively. Because demand outpaced productivity gains, employers needed to hire more workers to meet the additional demand. In contrast, inflation adjusted gross domestic product (GDP) grew just by 7.4% from 2001 to 2003, compared to a typical increase of 12.0% in the first two years of a recovery. In other words, people were not buying new products fast

[1] All comparisons are for eight quarters or 25 months after the start of the recovery. Lengthening this time frame would make historical comparisons harder since in some cases this would span more than the length of time from trough to the next peak.

enough relative to the rate at which companies were producing them. Consequently, employment actually declined in this recovery.

The consequences of sluggish demand were not shared equally. The burden fell almost entirely on workers, rather than companies. Companies' profitability soared, as wage and employment gains lagged. This recovery is the first time that the share of additional income that has gone to profits is larger than the share of additional income that has gone to employee compensation. Profits made up 41% of the increase in national income from 2001 to 2003, whereas compensation made up only 39% (figure 2). Typically, the share that goes to employee compensation is 3-4 times larger than the share that goes to profits, thus boosting demand for new products.

Figure 2: Components of National Income Growth Over 8 Quarters Following Business Cycle Troughs



Notes: The figures are calculated as the difference in national income components relative to the difference in national income. Source is the BEA, 2004a.

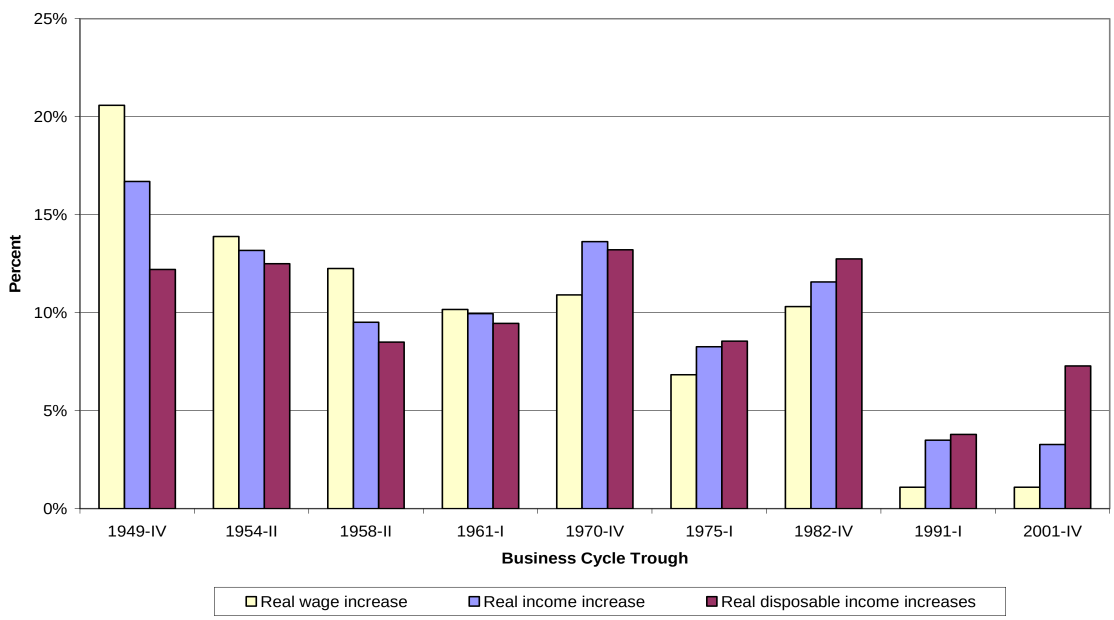
This radical reversal in the typical distribution of economic gains is mirrored by the fact that after tax profit rates have soared to record highs, while inflation adjusted gains in wages and salaries hit historic lows. After reaching their last peak in 1997, profit rates declined in the late 1990s and throughout the recession in 2001 (figure 3). They recovered quickly in 2002 and 2003, helped by rising corporate profitability and lower corporate taxes. While after tax profits reached record highs, before tax profit rates did not. Thus, corporate tax liabilities were reduced adding to their positive earnings outlook.

However, in this recovery, the opposite was true for wage and salary and income growth in this recovery. After adjusting for inflation, this recovery tied for lowest wage and salary growth with the last recovery and it was the lowest in terms of real personal income growth (figure 4). While real wages and salaries rose by an average of 12.1% in the recoveries before the 1990s, they grew by just 1.1% in the first two years of the last two recoveries, or about eleven times slower. Real personal income growth was about 4 times slower than in the recoveries prior to the 1990s. The distribution of typical gains during a recovery in favor of personal income is upside down in this recovery.

Figure 3: Before and After Tax Profit Rates, 1952 to 2003

Notes: Profit rates are corporate profits plus net interest relative to fixed assets. Fixed assets for domestic corporations are extrapolated after 2001 at the growth rate of fixed assets of non-financial corporations. Sources are BEA, 2004a, BEA, 2004b, Board of Governors, 2004.

Figure 4: Real Income Increases, Over 8 Quarters after the Start of the Recovery



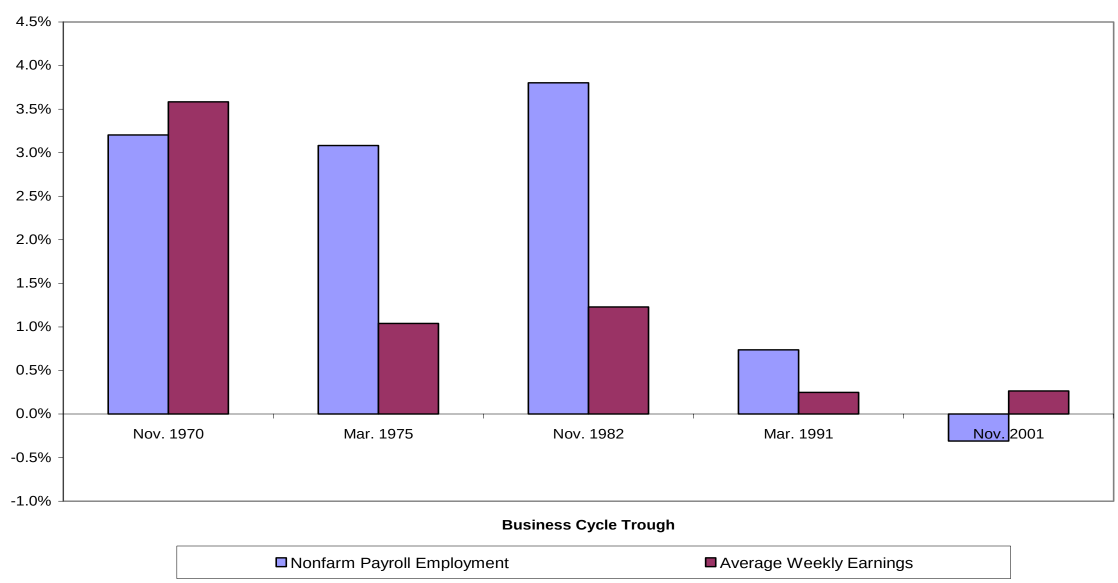
Source: BEA, 2004a.

Policymakers tried to counter this effect by instituting massive tax cuts. However, much of the tax cuts were concentrated among high income earners. In fact, the majority of households received less than the average tax cut over the period from 2001 to 2003 (CTJ, 2003a). Even in the aggregate, the tax cuts could not fully offset the weak labor market performance. While personal disposable income grew faster than personal income in this recovery (figure 4) it was still the second weakest disposable income gain in a recovery since WWII – at a time, when after tax profit rates reached record highs.

As a result of the "upside-down" distribution of economic gains, the current economic recovery is the weakest in terms of personal income growth, and it is the first recovery, where profits as a share of national income have outgrown employee compensation. Moreover, the primary policy response has been to institute large tax cuts for personal income. But the tax cuts were insufficient to counter the effects of the "job-loss" recovery. For one, disposable income growth was still the second lowest in a recovery since WWII (figure 4). Second, the tax cuts were concentrated among high income earners. And third, because of the top heavy nature of the tax cuts, they were inefficient in stimulating the economy (Weller et al., 2004).

Consequently, wage and salary income growth remained comparatively small. Most personal income is in the form of wages and salaries, which grew by a total of 1.1% in 2002 and 2003 (figure 4). This reflects the fact that this is the weakest recovery in terms of employment and earnings growth. For the first time since the 1970s – real earnings data have only been collected since 1964 – employment is negative and real weekly earnings are tied with the previous low of the early 1990s (figure 5). Moreover, to qualify for the tax cuts, workers had to have sufficient income, which meant that many did not benefit from the tax cuts because of the "job-loss" recovery (CTJ, 2001, 2003b).

Figure 5: Average Monthly Percent Change in Employment and Earnings During 25 Months Following End of Recession (Annualized)



Source: BLS, 2004b, 2004c.

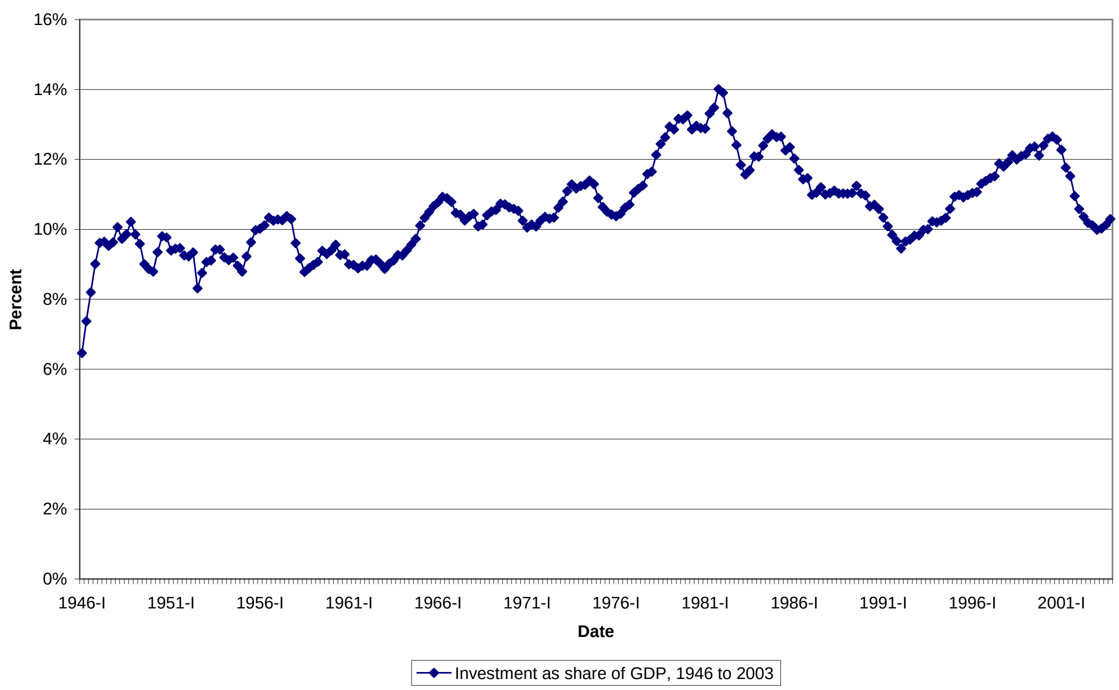
III. Corporate Earnings Not Reinvested in Jobs

The distribution of national income in the recent recovery reflects supply-side economics in overdrive. However, supply-side logic postulates that if corporations were just given the opportunity to make money, and lots of it, they would invest this extra money and ultimately hire more workers. An important point to keep in mind here is that investment tends to be leading indicator for the economy, both in terms of the start of a recession, but equally important in terms of generating a robust recovery.

Clearly, the rise in corporate profitability has not resulted in a hiring boom. The economy is still several hundreds of thousands of jobs short compared to when the recovery began. Compared to reasonable standards for employment growth in a recovery, the economy actually had 2-5 million fewer jobs in early 2004 than would be expected (Weller, 2004a).

But what about investment? The answer is another historical first. In the most recent recession and recovery, investment experienced its longest decline in post-war history. Inflation adjusted investment declined for nine consecutive quarters starting with the first quarter of 2001. In other words, investment, which is typically a leading contributor to growth in a recovery, was a laggard in this one. It took five straight quarters of economic growth for investment to finally begin to rise. By the end of 2003, investment equaled 10.3% of the economy, a far cry from the 12.6% recorded by the end of 2000 (figure 6).

Figure 6: Investment as Share of GDP, 1946 to 2003

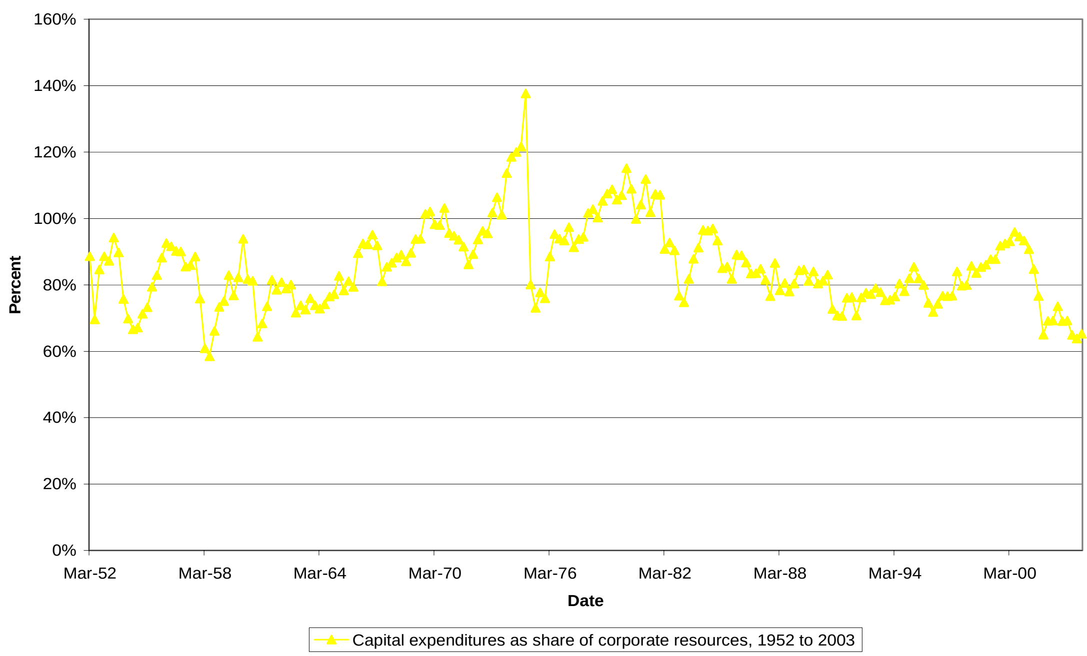


Source: BEA, 2004a.

It was not as if companies had no money to invest more, but that they simply chose not to. In late 2003, non-financial corporations invested the lowest share of their resources, 65%, since the 1950s (figure 7). And the reason for this lackluster investment performance is obvious. Companies had large underutilized capacities, because demand for their products did not rise fast enough to trigger increased investment (Weller et al., 2004).

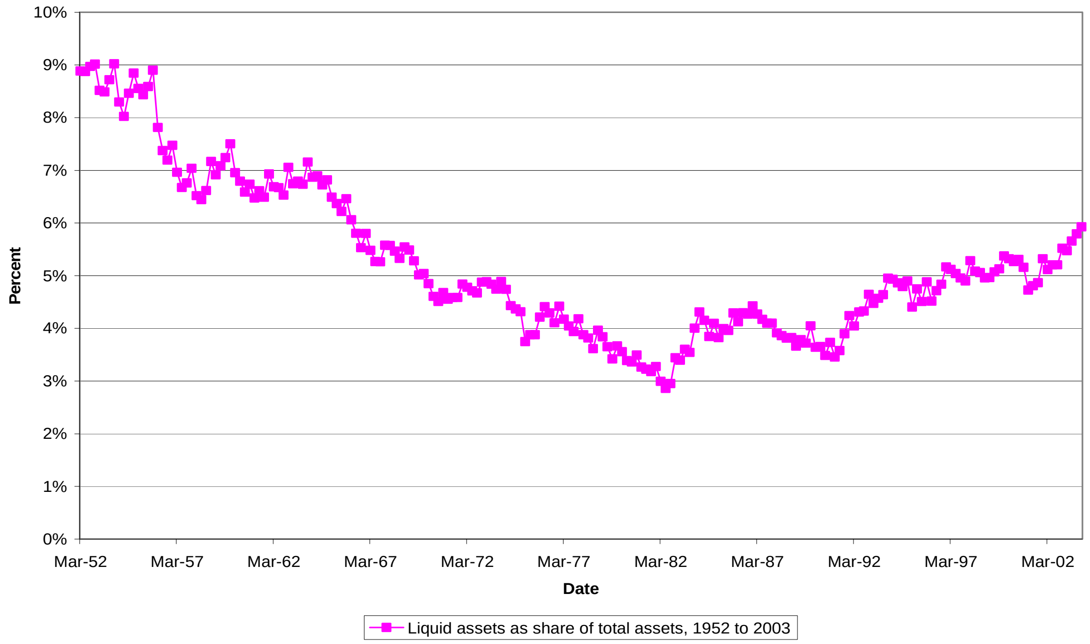
Because corporations have been exceedingly profitable, but reluctant to hire and invest, they were awash in cash. Total liquid assets as a share of total assets of non-financial corporations amounted to almost 6% at the end of 2003 (figure 8). This was the highest level since 1966. Companies have cash, but they need to expect more customers in the future to invest it. This will only occur if consumption becomes income driven and not debt driven.

Figure 7: Capital Expenditures as Share of Corporate Resources, 1952 to 2003



Notes: Corporate resources are defined as after tax profits plus capital consumption allowance, foreign earnings retained abroad, inventory valuation adjustments, and net capital transfers. Source is Board of Governors, 2004.

Figure 8: Liquid Assets as Share of Total Assets, 1952 to 2003



Notes: Total liquid assets are the sum of foreign deposits, checkable deposits and currency, time and savings deposits, money market fund shares, security RPs, commercial paper, U.S. government securities, municipal securities, and mutual fund shares. Source is Board of Governors, 2004.

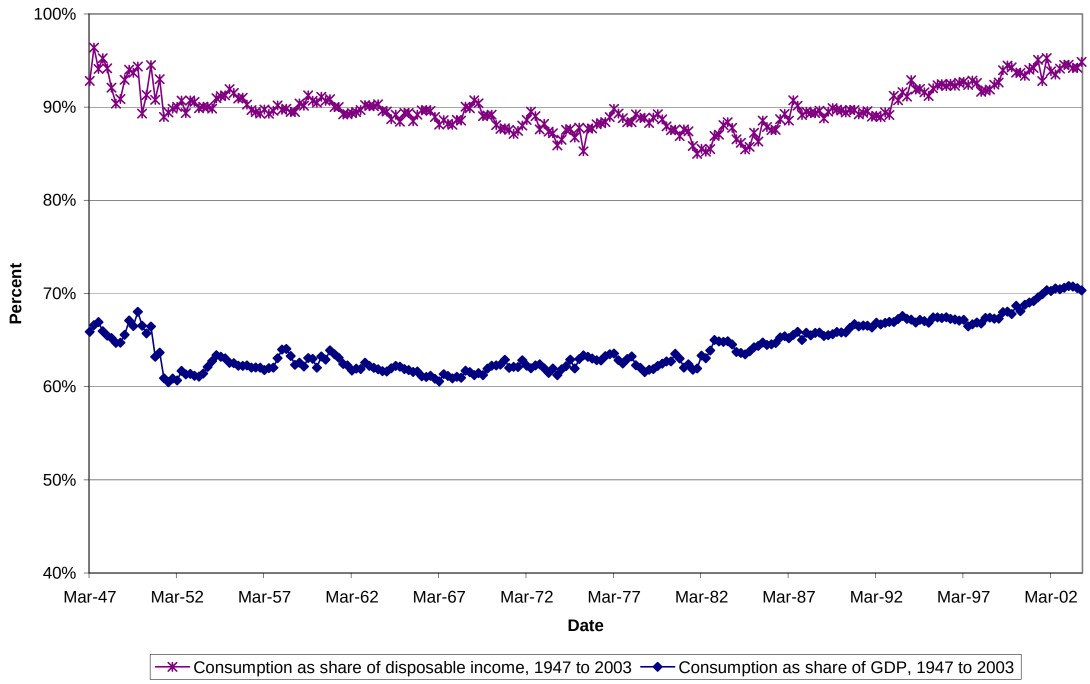
IV. Debt Driven Recovery Unsustainable

Reversing the "upside-down" economy through faster income growth, in the form of faster employment and wage growth, makes economic sense. Specifically, it would allow consumption to continue growing on a more stable level without relying on a refinancing boom.

For the past few years, households have financed consumption by borrowing more, especially by refinancing their mortgages in a low interest rate environment. Logically, this cannot go on forever. At some point, the debt burden will put downward pressure on households' ability to increase their consumption. And as cited above, other factors that might normally be considered catalysts of faster growth, such as government spending, rising exports, and business investment, have all been stymied due to a worsening budget and dollar situation. Thus, faster income growth needs to substitute for debt growth, if strong consumption growth is to continue.

As the economy experiences its first "job-loss" recovery since the Great Depression, consumption remains strong. Relative to GDP, consumption has reached record highs of more than 70% throughout the recovery (figure 9). But because income growth has been slow in the recovery, the share of consumption out of disposable income accelerated to 95% by the second half of 2003, the highest level since 1947 (figure 9).

Figure 9: Consumption as Share of Disposable Income and GDP, 1947 to 2003

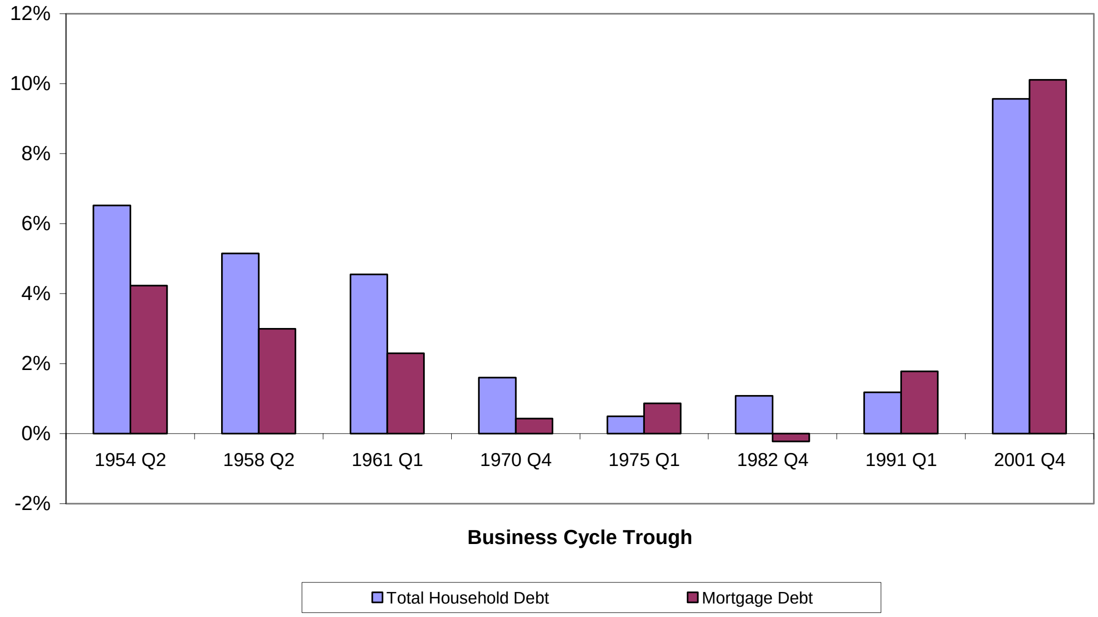


Source: BEA, 2004a.

However, it was not just a greater propensity to consume out of income that made consumers the "Energizer bunnies" of the recovery. Households also borrowed more. In particular, households increased their mortgages more than they did in any previous recovery. In this recovery, households increased their total debt relative to disposable income by10 percentage points, from 106% at the end of 2001 to 116% in 2003 (figure 10). Reflecting the refinancing boom, mortgages increased by more than 10 percentage points relative to disposable income in the first two years of the recovery.

Although mortgage refinancing in 2002 and 2003 reduced mortgage payments for households due to lower interest payments, the much bigger effect resulted from households borrowing more money against the equity in their homes. Starting in the 1980s, households increased their mortgage debt faster than they raised their spending on their homes. Thus, mortgage refinancing freed up liquidity, held in the form of equity in families' homes. In the 1980s, households gained at maximum an additional 2% of their disposable income by cashing out of their home equity. The recent recession and, even more so, the recovery saw an unprecedented surge in home equity cash-outs (figure 10). By the end of 2002 and in the middle of 2003, home equity cash-outs reached a record high of 5%. In the recovery, home equity cash-outs alone funneled an additional $521 billion into the pockets of households.

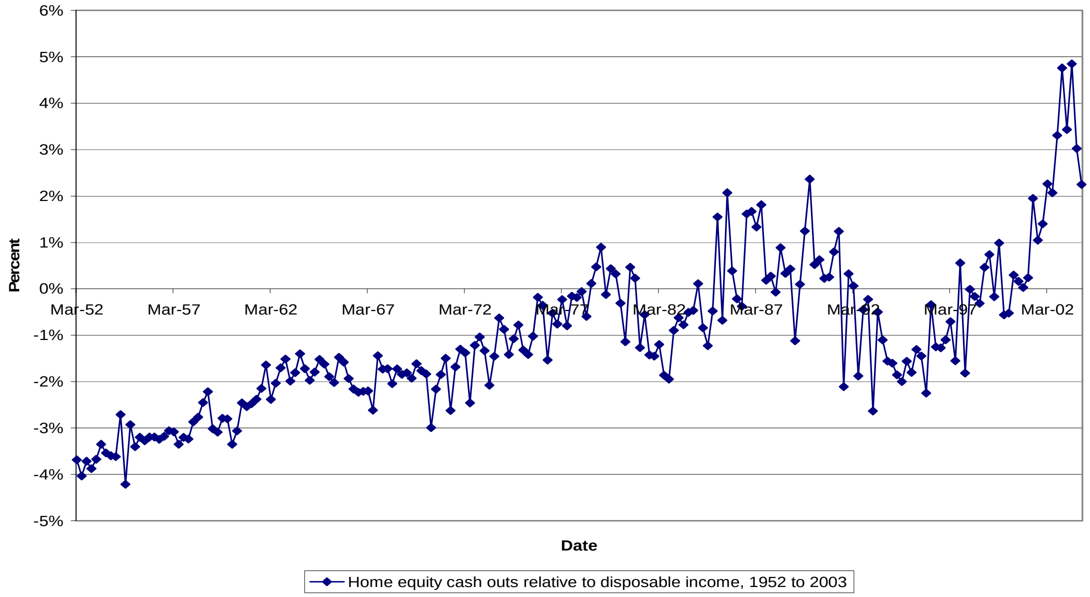
Figure 10: Change in Household Debt as a Share of Personal Disposable Income Over 8 Quarters Following End of Recession



Source: Board of Governors, 2004.

But as mortgage rates shot up in the summer of 2003, refinancing slowed down quickly to about 2% by the end of 2003. The result was, while households received a jolt of an additional $99 billion from home equity cash-outs in the second quarter of 2003, they only received an additional $47 billion in the fourth quarter. Mortgage rates increased again in April 2004 and it can be expected that the pace of home refinancing will slow as a result of higher rates. Consequently, households will likely see smaller additions to their spending power. With fewer home equity cash-outs, though, the consumption boom will be hard to sustain, without substantial income growth (Lilly, 2004). Moreover, as noted above, since there currently does not appear to be another factor that could replace consumption as the primary driving force of growth, growth could likely slow down (Lilly, 2004).

Figure 11: Home Equity Cash Outs Relative to Disposable Income, 1952 to 2003

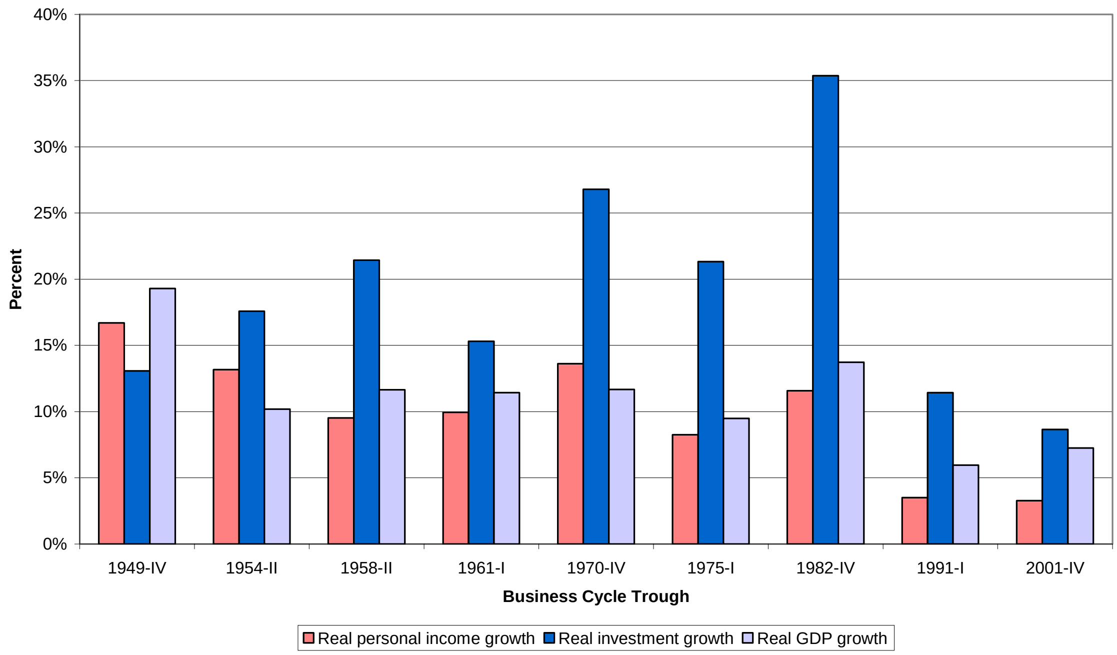


Notes: Home equity cash-outs are the difference between new mortgages minus the change in capital expenditures for residential real estate. Source is Board of Governors, 2004.

A look back over the experience of all prior post-war recoveries shows that recoveries with stronger income growth also had earlier investment growth and ultimately stronger overall growth (figure 12). Unfortunately, the current recovery is the weakest in terms of income growth, regardless of which measure is used. And the lack of substantial income growth has resulted in a disincentive for firms to invest more. Historically, recoveries with stronger income growth had larger investment increases and stronger economic growth (figure 12). The last two recoveries stand out for their lackluster performance by the end of the second year of the recovery.

Although the last two recoveries may appear similar in their performance two years out, there are important distinctions. Most importantly, employment and wages had already grown at a substantial rate by the end of the second year of the recovery in the 1990s. That is, the recovery in the early 1990s had already gained some momentum in the labor market that ultimately sustained it throughout the rest of the decade. This momentum is missing from the current "job-loss" recovery.

Figure 12: Real Income, Investment, and GDP Growth, Over 8 Quarters after Start of Recovery



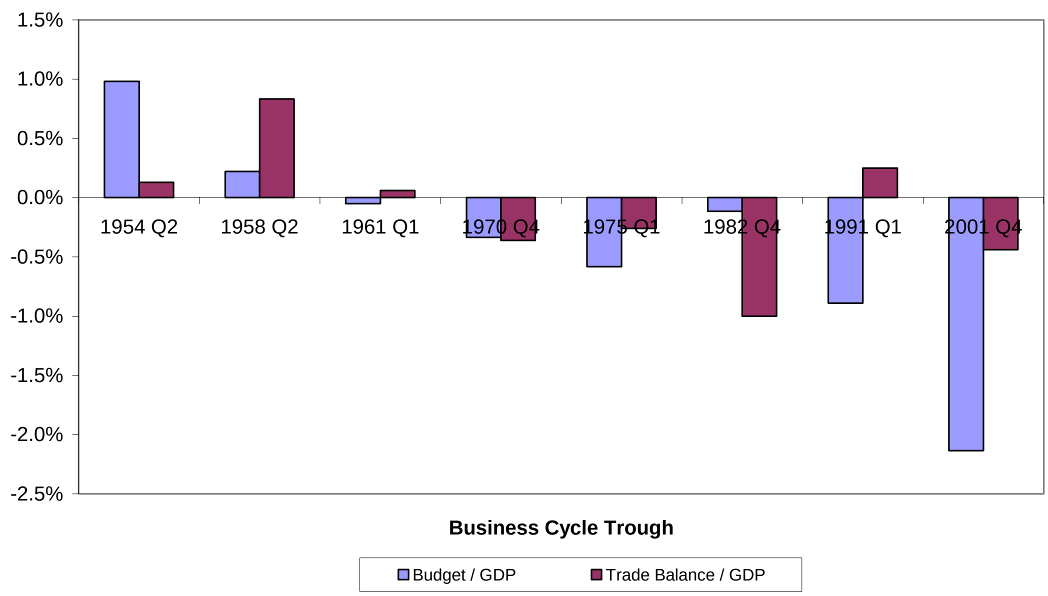
Source: BEA, 2004a.

Because of the lagging labor market, among other reasons, the economy has experienced greater macro economic imbalances in this recovery than in previous ones. Both the federal government's budget situation and the trade balance have eroded in this recovery, as have household finances (figure 10).

The federal budget deteriorated as the economy entered the latest recession in more than a decade. Because of the economy's weaknesses, the need for stimulative macro economic policies further added to the deterioration of the federal budget (figure 13). The fact that most fiscal stimuli in 2001 and thereafter came in the form of poorly-designed tax cuts only added to these woes, dampening economic growth further and eroding fiscal balances more than would have otherwise been the case (Sperling, 2004; Weller et al., 2004).

Moreover, the federal government's increasing appetite for new money had to be fed. Since households already were borrowing money to finance consumption, the U.S. required additional debt from overseas. Consequently, international capital flows kept the value of the dollar high for some time, or least kept it from sliding very quickly. From November 2001 to December 2003, the dollar lost about 11% in value, at a time when many observers considered a decline in the value of the dollar by more than 30% necessary in order to regain some semblance in the trade balance (Weller and Singleton, 2002). Hence, it is not surprising that the trade deficit actually worsened, while the economy experienced a recession and weak recovery. Typically, the trade balance would improve, as was the case in the early 1990s, when the economy enters a recession since typically imports shrink. However, the decline in imports was offset by a decline in exports due to high demand for the dollar fuelled by government borrowing.

Figure 13: Average Year-Over-Year Change in Budget and Trade Balances as a Percent of GDP, Over 8 Quarters after Start of Recovery



Source: BEA, 2004a.

As a result of the lack of income growth, the macro economy has incurred three large imbalances in this recovery, which ultimately make the recovery less stable than previous ones (Weller et al., 2004). Households have incurred record levels of household debt, the federal budget balance has deteriorated rapidly, and trade deficits are quickly reaching unsustainable levels (Weller, 2004b).

V. Conclusion

This recovery is upside-down in terms of the distribution of economic gains, compared to previous recoveries. Contrary to prior recoveries, profits have seen a larger increase, as share of national income, than employee compensation. This is a historical first. However, because compensation has lagged behind profit growth, demand has fallen behind productivity growth – another historic first. The fact that the economic recovery still produced some economic growth is due to a rising indebtedness of households, the government, and the country as a whole. This means, though, that growth in 2002 and 2003 was achieved at the costs of long-term stability.

To maintain and stabilize economic growth, the U.S. needs faster income growth for working families. This could come from more employment, faster wage growth, or both. In a historical perspective, there is sufficient room for larger employment and wage growth, especially when the extraordinarily large profit rates – aided by corporate tax cuts – and profit accumulation are taken into consideration.

Without a serious improvement in income growth, the U.S. economy will have difficulties sustaining the growth of the past few months. Much of this growth resulted from a spurt in consumer activity, which was largely fuelled by a growing indebtedness. Households borrowed record amounts of money to pay for rising costs, e.g. for housing, medical care, and education, among other things, in the weakest labor market recovery since WWII. And there currently is no other sector that can serve as the primary driving force to sustain economic growth. That is, without sustained income gains, consumption will likely falter as the refinancing boom is coming to an end.

The goals for public policy intervention are clear. For one, the incomes of those workers who lost their jobs in the recession and the "job-loss" recovery need to be strengthened. This could be accomplished by extending unemployment benefits and improving the levels of unemployment benefits. Second, the income situation for those who already have a job needs to be improved. This could be accomplished through a range of policy options, such as higher federal or state minimum wages, local living wage ordinances, and a stronger labor law to raise the chance for unionization.

References

Board of Governors, Federal Reserve System, 2004, Flow of Funds Accounts of the United States, Washington, D.C.: Board of Governors.

Bureau of Economic Analysis (BEA), 2004a, National Income and Product Accounts, Washington, D.C.: BEA.

Bureau of Economic Analysis (BEA), 2004b, Fixed Assets, Washington, D.C.: BEA.

Bureau of Labor Statistics (BLS), 2004a, Productivity, Washington, D.C.: BLS.

Bureau of Labor Statistics (BLS), 2004b, Employment, Washington, D.C.: BLS

Bureau of Labor Statistics (BLS), 2004c, Average Weekly Earnings, Washington, D.C.: BLS

Citizens for Tax Justice (CTJ), 2003a, Details on the Bush Tax Cuts So Far (as of Fall 2003), Washington, D.C.: CTJ.

Citizens for Tax Justice (CTJ), 2003b, One in Six Families with Children Would Gain from Increasing Child Credit Refund Percentage, Washington, D.C.: CTJ.

Citizens for Tax Justice (CTJ), 2001, 51 Million Won't Get Full Rebates from 2001 Tax Bill, Washington, D.C.: CTJ.

Lilly, S., 2004, How Does the Current Jobs Recovery Compare with its Predecessors?, CAP Report, May, Washington, D.C.: Center for American Progress.

Sperling, G., 2004, Do Deficits Matter? The Impact of Long-Term Deficits on Economic Growth and Job Creation, Testimony before the Senate Democratic Policy Committee, January 20, Washington, D.C.: U.S. Senate.

Weller, C., 2004a, How Do We Know When the Job Loss Recovery is Over?, CAP Economic Policy Column, April 02, Washington, D.C.: Center for American Progress.

Weller, C., 2004b, Is the Trade Deficit a Train Wreck Waiting to Happen?, CAP Policy Brief, April, Washington, D.C.: Center for American Progress.

Weller, C., Bivens, J., and Sawicky, M., 2004, Missed Opportunities and Rising Instabilities: Macro Policy Lessons from the Recession and the Job Loss Recovery, Challenge, forthcoming.

Weller, C., and Singleton, L., 2002, Reining in Exchange Rates, EPI Briefing Paper No. 131, September, Washington, D.C.: Economic Policy Institute.