HOW TRUMP ADMINISTRATION TRICKLE-DOWN POLICIES HAVE SOWN THE SEEDS OF THE NEXT RECESSION

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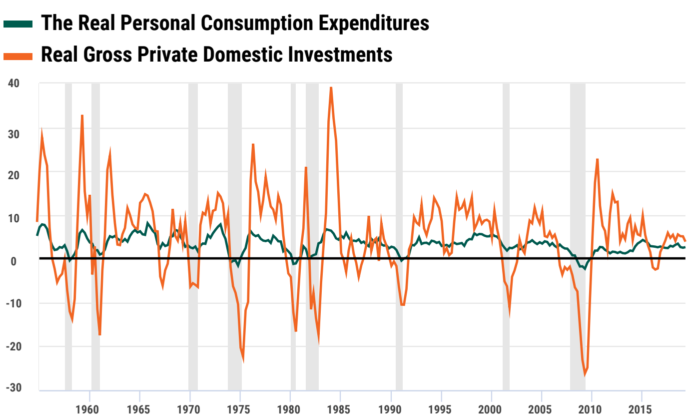
Preparing for the next recession begins with making sound policy choices when recession is not a threat. Unfortunately, the combination of a financial crisis followed by severe austerity has led to an unusually slow recovery in the decade since the start of the Great Recession,[1] and we are no more prepared for the next recession than we were for that shock. After congressional Republicans championed the austerity that impeded recovery from the last recession, the Trump administration made fiscal policy even more pro-cyclical. In following the trickle-down playbook to the letter, the Trump Administration has, at best, failed to plan for the next recession, while sowing seeds that may grow into one by mixing a regressive tax policy, a deregulatory agenda that shifts risk from corporations to those who can least afford it, and a choice to disinvest in public activities that could actually help our economy thrive.

HOUSEHOLD INEQUALITY CREATES MACROECONOMIC RISK — AND TRICKLE-DOWN TAX POLICY MAKES IT WORSE

Absent a significant reversal of existing trends, economic inequality will be higher at the beginning of the next recession than in any previous recession. [2] This inequality has well-documented consequences for real people, which is the reason we must address this challenge head-on. Inequality also creates cyclical risks for the American economy, as a variety or researchers have documented since the Great Recession, and the Chicago Fed recently laid out fairly cleanly. [3]



Source: U.S. Bureau of Economic Analysis, FRED

Growing household inequality is, by itself, a clear economic risk. Household consumption has historically been the most stable part of the economy. And that stability has largely been driven by the broad-based nature of consumption, an issue of growing concern to economists since this relationship broke down during the Great Recession.[4] While business spending has always been volatile, households have, in aggregate, had some savings cushion. So even as belts tightened, families had some ability to cope with shocks. Until the Great Recession, household consumption almost never declined year-to-year. But household savings have grown concentrated at the upper end of the income distribution, and are increasingly tied up in assets like housing, which require a willing lender to unlock.

A household that cannot access its savings or does not have any can go from a source of macroeconomic stability to instability very quickly. The result of a downturn is very different under the circumstances households face today, as many now risk losing their homes or declaring bankruptcy when income shocks hit. This can create a lasting drag on the middle of the economy when recessions hit, a link economists Atif Mian and Amir Sufi meticulously documented in their influential book, "House of Debt," which teases out the devastating effects of household debt in the Great Recession.[5]

Even as changes in the income distribution have left a growing share of households with miniscule financial cushion, economic policy has increasingly been driven by a supply-side focus that ignores these distributional concerns. Essentially, our government has promoted more risk-taking overall, while shifting more of that risk to families in the form of higher housing debt, student loans, and private retirement savings accounts, but an average households' ability to absorb these shocks has not grown fast enough to keep up with an increasingly uncertain economy.[6] Policymakers could embrace this risk and provide more support to workers and families or establish rules that give families more financial security, but this would run afoul of supply-side doctrine.[7] Rather than subsidizing the passive income of the few families that have the means to invest already, government could provide down-payment assistance to homeowners, offer renters more vehicles to build wealth, provide universal basic savings, or a variety of other approaches that promote broad-based savings in a way that raises financial stability rather than reduces it.

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1 For a discussion of the aggregate losses from the Great Recession see, Regis Barnichon, Christian Matthes, and Alexander Ziegenbein (2018). "The Financial Crisis at 10: Will We Ever Recover?" Federal Reserve Bank of San Francisco Economic Letter. no 2018-19. August 13, 2018. For a review of post-recession research on austerity, see Michael Madowitz (2014) "What have we learned about austerity since the great recession?" Washington: Center for American Progress.

2 For historical data on U.S. inequality, see, e.g. Thomas Piketty & Gabriel Zucman (2013). "Capital is Back: Wealth-Income Ratios in Rich Countries, 1700-2010.. Quarterly Journal of Economics, 2014, 129(3): 1255-1310; Emmanuel Saez & Gabriel Zucman (2016). "Wealth Inequality in the United States since 1913: Evidence from Capitalized Income Tax Data.. Quarterly Journal of Economics, 2016, 131(2): 519-578. For more detailed and timely data on recent U.S. inequality, see Survey of Consumer Finances, Federal Reserve Board of Governors.

3 See, e.g Barry Z Cynamon, and Steven M Fazzari Inequality, the Great Recession, and Slow Recovery (October 24, 2014). Available at SSRN, Gene Amromin, Mariacristina De Nardi , Karl Schulze, Inequality and Recessions, Chicago Fed Letter, No. 392, 2018

4 For an overview of consumption spending in the Great Recession see, e.g. Stephanie Hugie Barello, "Consumer spending and U.S. employment from the 2007–2009 recession through 2022," Monthly Labor Review, U.S. Bureau of Labor Statistics, October 2014, https://doi.org/10.21916/mlr.2014.34. For a detailed analysis of the causes that led to low household spending during the Great Recession and recovery, see Mariacristina De Nardi & Eric French & David Benson, 2012. "Consumption and the Great Recession," Economic Perspectives, Federal Reserve Bank of Chicago, issue Q I, pages 1-16.

5 Mian, Atif & Sufi, Amir, 2015. "House of Debt," University of Chicago Press Economics Books, University of Chicago Press, number 9780226271651, November 2015.

6 Mian, Atif & Sufi, Amir, 2015. "House of Debt," University of Chicago Press Economics Books, University of Chicago Press, number 9780226271651, March 2015 [online appendix]

7 Aris Protopapadakis (1981). "Supply-Side Economics: What Chance for Success?" Federal Reserve Bank of Philadelphia Business Review, May/June 1081. Daniel Mitchell (1999) "Time for Lower Income Tax Rates: The Historical Case for Supply-Side Economics" Washington: The Heritage Foundation, February 19, 1999.

Economists increasingly credit inequality and global capital markets with creating huge savings reserves that have changed the nature of modern economies and, in the process, rendered the most tried and true monetary policy tools significantly less effective.[8] There is also a growing debate about whether these trends have fundamentally destabilized the economy, with not only middle-class families, but even among traditionally wealthy households spending as if they are living 'hand-to-mouth,' the traditional stability of household consumption and its calming effect on economic volatility appears to have declined significantly.[9]

Our growing understanding of income inequality, and the macroeconomic risks of the household financial fragility that comes with it, has progressed so much in the last decade that there has been less focus on the policies that drive both of these trends. Inequality is a policy choice, and it is a choice the U.S. has led the world in embracing, with a few respites, for the last four decades. Indeed, the most significant legislation of the Trump administration was an inequality-fueling tax cut, doubling-down on the policy choices that have fueled the rise in both inequality and household fragility. Not only did wealthy families and corporations get the bulk of tax cuts, they got more tax-free savings options, reinforcing the cycle of illiquid savings that amplifies the business cycle.

It's not just decades of tax cuts for the wealthy, and pushing government spending to the state level, where it amplifies business cycles because of balanced budget requirements; there are numerous policies that increase inequality especially, but not exclusively, in the tax code.[10] Pushing responsibilities to state and local governments has made more government spending subject to balanced budget constraints, while giving wealthy individuals, corporations and even sports teams a menu of taxes and tax breaks they can choose from, while undermining the ability of government to reduce inequality through progressive tax. Estate taxes apply to fewer and fewer families, while capital gains taxes are both lower than the effective rates most workers face on their income, and can be paid on a schedule dictated by asset holders.

Perhaps no government policy underscores that inequality is a choice our government makes more than the step-up basis loophole, which lets estates avoid paying any taxes on capital gains earned over a lifetime. Not only does this loophole deliver huge tax benefits to families who can afford to not touch their savings, but by offering an opt-out of capital taxes for the wealthy, it effectively holds down the tax rates governments can apply to all capital income.[11] Inequality is not an inevitable consequence of the modern economy, but a long-term policy goal for the American Right—a fact reaffirmed by the Trump administration and Congressional Republicans, whose number one economic priority was a tax cut for corporations and the wealthy in the face of all the evidence discussed thus far.

TAX-PREFERRED SAVINGS VEHICLES FOR THE WEALTHY AMPLIFY THIS EFFECT

The effect of rising household income inequality on economic demand is amplified by a tax code that has focused on a decades-old quest to maximize domestic savings using decades-old ideas to incentivize savings from the wealthiest households. We have tax breaks to encourage savings, but the downside of earmarking savings for college, retirement, private schools, and Opportunity Zones, is that these incentives reach relatively few Americans and when they do, they reduce household liquidity. The growth of tax breaks for wealthy households has not only served as a ratchet that perpetuates inequality, but has increased the fragility of households with savings by locking away the savings that used to serve as a buffer to consumption in tax-preferred accounts with spending restrictions.

With so many wealthy and near-wealthy households driven by the restrictions on tax-preferred accounts to behave as if they have no savings, a recent paper from Federal Reserve Economists coined the term 'Wealthy hand to mouth' consumers.[12] The goal of tax breaks for savings was to ensure a ready supply of cash to invest, but the end result has been such a large supply of wealth that the U.S. has driven interest rates to near zero, creating a variety of new policymaking concerns.[13] But perversely, very little of this wealth serves the traditional role of middle class savings. We have tax breaks for college savings, retirement savings, private school savings, housing debt, student debt and on and on. But we have no tax break for the rainy day savings that middle class households used to accrue and rely on, and which ensured macroeconomic stability was sustainable.

Today, fewer and fewer households have the ability to build up savings, while the households that can save are discouraged from building these buffers due to low returns from ordinary savings relative to tax-preferred options, or from paying off the large debts incentivized by a system that pushes housing and student debt. Of course, assets in tax-preferred accounts can be withdrawn, but with large penalties that discourage the practice, the end result is that many families who appear to have ample financial cushion behave much more like a household with no savings at all, reducing the stability of consumption and increasing economic volatility.[14]

VOLATILITY HAS INCREASED IN OTHER WAYS

Across the U.S. economy, from consumption to investment to government, volatility and fragility has increased as inequality has grown, and a greater fraction of our economy has run up against borrowing constraints. The Shareholder Value Revolution, along with the rise of stock buybacks, have provided strong incentives for corporations to operate with as little capital buffer, and as much leverage, as possible. This model has continued to make large companies more vulnerable to short-term shocks.

8 Ben S Bernanke. (2005). The Global Saving Glut and the U.S. Current Account Deficit, Sandridge Lecture, Virginia Association of Economists, Richmond, Virginia; Ben S. Bernanke. "Monetary policy in a New Era.. Rethinking Macroeconomic Policy (Conference), Peterson Institute, Washington DC, October 12-13, 2017

9 For an overview of consumption spending in the Great Recession see, e.g. Stephanie Hugie Barello, "Consumer spending and U.S. employment from the 2007–2009 recession through 2022," Monthly Labor Review, U.S. Bureau of Labor Statistics, October 2014, https://doi.org/10.21916/mlr.2014.34. For a detailed analysis of the causes that led to low household spending during the Great Recession and recovery, see Mariacristina De Nardi & Eric French & David Benson, 2012. "Consumption and the Great Recession," Economic Perspectives, Federal Reserve Bank of Chicago, issue Q I, pages 1-16.

10 The Great Recession created long-lasting fiscal effects, with state & local government driving a decline in government employment President Obama's 8-year term. Federal Reserve Economic Data (FRED): "All Employees: Government" (retrieved April 2019)

11 For a discussion of revenue maximizing capital gains rates and the role of step-up basis exemptions, see Congressional Research Service (2019) "Capital Gains Tax Options: Behavioral Responses and Revenues" (Washington, April 30 2019) https://crsreports.congress.gov/product/pdf/R/R41364. For a broader discussion of interactions in capital tax policies, see, e.g. David Kamin (2016) "Taxing capital: Paths to a fairer and broader U.S. tax system, Washington Center for Equitable Growth (August 2016) https://equitablegrowth.org/wp-content/uploads/2016/08/081016-kamin-taxing-capital.pdf

12 Greg Kaplan & Giovanni L. Violante & Justin Weidner, 2014. "The Wealthy Hand-to-Mouth," Brookings Papers on Economic Activity, vol 2014(1), pages 77-138. Yuliya Demyanyk, Dmytro Hryshko, Daniel Kolliner, María Luengo-Prado, and Bent Sørensen (2015)." Why Has Consumption Been So Volatile in the New Millennium?", Cleveland Federal Reserve, ECONOMIC COMMENTARY Number 2015-09

13 "Review of Monetary Policy Strategy, Tools, and Communications" Washington: Federal Reserve Board of Governors, 2019

14 The Federal Reserve's Survey of Household Economics and Decisionmaking, arguably the most recent and most official study to explore this topic, found 40% of adults could not meet a $400 expense, echoing similar findings in a host of household surveys since the Great Recession.

The last two recessions have resulted in government bailouts of whole sectors of the economy. It makes sense that the financial sector was in dire shape in the Great Recession, but virtually the entire airline industry was bailed out in the previous recession. The Great Recession was an immense shock, which sunk big names in the financial sector, but also nearly wiped out the U.S. auto industry -- a function of excessively risky debt.

And this story continues today, with the role of leverage and private equity bankrupting some of our best-known retail brands growing increasingly apparent. From Toys-R-Us to Sears to more specialty brands like Remington firearms and David's Bridal, the business model of private equity—high leverage and higher risk for individual companies—has a significant impact on the U.S. economy beyond a simple investment portfolio.

Meanwhile, fiscal federalism has reduced the federal share of total government spending, with states—bound by balanced budget rules and subject to local shocks—providing a larger, more volatile level of government spending. Inequality among households has driven consumption to become more procyclical, while more profit-focused management and the increased role of state and local government have led investment and government to become more volatile components of GDP.

GOVERNMENT SPENDING SHOULD PROVIDE STABILITY, BUT IT HAS BECOME INCREASINGLY VOLATILE AND CONSTRAINED

As tax policy has made inequality worse, conservatives have also made government less of a partner in fighting recessions. By shrinking federal programs and pushing more responsibility to state governments, conservatives have grown the share of the U.S. economy subject to balanced budget rules. The idea that a government should balance its budget annually is a bad enough idea to appear early in economics textbooks that seek to explain why economists are wary of good-sounding policies with negative effects. A national balanced budget rule is consistently opposed by virtually all economists who study the concept. The logic is simple—government spending is largely of the form of insurance, and a balanced budget rule is equivalent to ensuring an insurer will be insolvent when called upon. Yet, balanced budget rules hold at the state level, where government was once quite limited.

Today, these rules result in governments that shrink when their services are most essential and make it harder for workers to find work or assistance in the face of a downturn. The effects of the Great Recession were long-lasting, with fewer government employees when President Trump took office than when President Obama took office, almost completely driven by the long overhang of the Great Recession, coupled with tax and service cuts enacted by conservative state governments in the wake of the 2010 elections.

Fiscal contraction at the state and local level is likely to be a major headwind in future economic recoveries, and one which is difficult to resolve due to the diffuse nature of the problem. It takes a lot of work to overturn bad laws in 50 legislative chambers, especially when good policy is a partisan position.

WE SHOULD BE INVESTING NOW IN OUR ECONOMIC FUTURE, BUT POLICYMAKERS ARE FAILING

Beyond the challenges of procyclical fiscal policy, government spending, or lack thereof, has become a pervasive challenge to economic growth even in normal times. Indeed, much of the consensus around the importance of infrastructure is based on the simplicity of observing that we have not been making the investments in public goods needed to support economic growth for a generation.

Starved of revenue, our policymakers have failed to make important investments in public goods that promote economic opportunity, growth, and security. In urban areas this takes the form of unaffordable housing, or long, congested commutes where a lack of infrastructure investment saps precious hours from workers stuck in traffic, while they drive past housing they cannot afford. Those who live in our nation's most disadvantaged communities also face lead pipes and paint, and contaminated soil, creating lasting challenges for the children we should be investing the most in. Meanwhile, rural areas face the economic drag associated with driving long distances to download 'public' information.

Across America, we're healthier than we were before the last recession, but less healthy than we should be. Millions of families still lack health insurance, and medical bills remain a major source of financial instability. And a lack of public investment is leading to unaffordable childcare and higher education, lowering our ability to grow the economy and create the resilient families of the future.

These shortfalls are even harder to fathom when we consider that the main beneficiaries of the last $1 trillion of tax cuts were corporations, who were supposed to invest in this windfall to create jobs. The windfall came, but the investment has been, by almost all accounts, disappointing. Indeed, across the board, the most common response to the tax cut from companies was to declare a lack of useful investments and send money back to shareholders.

CONCLUSION

The last decade of conservative fueled obstruction to appropriate fiscal and monetary policy during the Great Recession, and the subsequent policy choices of the Trump administration, have left our economy far more vulnerable to the next recession. We could have moved to a progressive direction of shoring up households and government programs that serve to short-circuit economic downturns. Instead we've doubled down on trickle-down economics, even as the evidence shows that these policies help turn moderate economic shocks into larger economic recessions. The bad news is there is more recession-proofing work to do a decade into this recovery than when it began. The good news is the path to insuring our economy and society against the worst economic challenges has not been so clear in decades. Digging out of a hole is hard work, but knowing which direction to go couldn't be easier.