Governments’ role in aligning functional income distribution with full employment

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Abstract
Demand is an incentive for investment. The latter is necessary to create employment. If demand lags behind supply, then unemployment/underemployment rises. Persistent unemployment/underemployment indicates a dysfunctional price mechanism. Then, only governments can stimulate demand. They may equalize ex ante saving and investment by public investment, income redistribution or market regulation.

Key words: Keynesian economics, economic policies, United States
JEL codes: E12; E6; N12

Introduction
According to John Maynard Keynes (1936, 161), human actions are led by “animal spirits”—that is, by spontaneous choices rather than by calculation. This concerns both consumers and investors whose mood and behavior influence each other.

If consumers are pessimistic about their income they, in general, restrict consumption and increase their saving account for precautionary reasons or hoard money because of speculative motives. Successively, entrepreneurs abstain from investment due to an expected lack of demand and a corresponding fear of loss. Instead, they park profits in banks, repay debt, buy back their own stocks, acquire competitors or merge with them. This behavior negatively affects unemployment and underemployment and demotivate consumers even further.1) Governments may combat persistent unemployment and underemployment by equalizing ex ante saving and investment through public investment, market regulation, and redistribution of income.

Keynesian Economics
Keynes’ general theory of employment proclaims a central role for governments in combatting poverty, unemployment and underemployment. It is founded upon five postulates.

First, he claimed that "the utility of the wage when a given volume of labour is employed is [not] equal to the marginal disutility of that amount of employment" and postulated that, in the short-run, money and real wages develop in opposite direction: Marginal productivity determines real wages which diminish with expanding employment, whereas money wages may fall because workers are likely to accept wage cuts when employment falls. Therefore, the traditional postulate that wage bargains determine the real wage is not true (Keynes 1936, 10-11).
Second, monetary authorities may influence investment through the interest rate. Interest rates are the opportunity costs of holding cash. However, because of the liquidity-preference, lower interest rates do not boost investment if demand is slack. They do not equalize ex ante saving and investment. Eventually, it is not the interest rate but the level of income as a whole that determines investment and employment. Investment and income as a whole are related through the investment multiplier, whereas investment and employment are related through the employment multiplier. The size of these multipliers is context dependent. (Keynes 1936, 113-116, 166-172, 202-208, 247; Skidelsky 2015, 365).

Third, what matters is how market participants view the future: The key cause to hoard money is the divergence of the interest rate from what is considered to be a fairly safe level. The decision factor to invest is the foresight of reaping profits in the future. The latter requires the expectation of being able to sell production at a profit (Keynes 1936, 46-47, 201).

Fourth, investment occurs under fundamental uncertainty about its yields in the future. To be precise, economic relations are heterogeneous because of “motives, expectations and psychological uncertainties.” Due to a lack of “scientific basis on which to form any calculable probability whatever,” investors may tend to conform to “the behaviour of the majority or the average.” This herding behavior, which Keynes illustrates with the metaphor of forecasting the winner in a “beauty contest”, may create bubbles which may suddenly bust (Skidelsky 2015, 211, 214, 221, 265, 276, 281).

Fifth, equilibrium between ex post saving and investment does not necessarily occur at full employment. Equilibrium with full employment only exists “by accident or design”. Namely, if income recipients plan to consume a smaller share—that is, to save a bigger share of their income, then entrepreneurs adjust their investment plans if they fear failure. Consequently, less people get employed, incomes drop, poverty rises, and saving falls. This transforms an ex ante disequilibrium between saving and investment into an ex post equilibrium, but under circumstances of unemployment. Therefore, only a third actor whose decisions are independent of short-term expectations may turn the tide. This actor is the government. Governments may stimulate the economy by fiscal expansion, redistribution of income (lower incomes have a higher propensity to consume), or regulating markets, among other things, through import tariffs (Skidelsky 2015 115, 189-193, 250, 344, 352, 386, 528).

This Keynesian theory is extended with analyses concerning the timing and size of government intervention. For example, Paul Samuelson elaborated the interaction of the multiplier and the accelerator. His multiplier model (the Keynesian Cross) showed that equilibrium not necessarily occurs at full employment. Roy Harrod and Evsey Domar’s modelled the warranted rate of growth under full employment. They assumed that investment generates income as well as production capacity. Finally, John Hicks and Alvin Hansen integrated the financial and the real sector in the IS-LM model (Spithoven and Brenner 1996). Joan Robinson called these Keynesians “bastard Keynesians” (Skidelsky 1974, 181).

The extensions do not address international trade. International trade limits the possibilities of governments to interfere in the economy. First, austerity measures to foster international competition may negatively affect employment in wage-led countries such as the United States of America (hereafter abbreviated as U.S.) (Spithoven 2013). Second, international trade negatively affects the multiplier. This might be partly compensated by a redistribution of the gains of trade towards the losers.

Another ignored problem in the extended Keynesian approaches concerns animal spirits and fundamental uncertainty, as is acknowledged by Hicks (1980, 140, 145-146, 152). Although uncertainty might become manageable through empirical examinations by economists and econometricians but it may not become eliminated (Keynes 1936, 148, 247, 249). Additionally,
governments may provide relief by creating an environment for businesses where they experience less uncertainty. However, regulatory uncertainty continues to exist because democratic elections may enforce institutional adaptations and because of “inconsistencies in government decisions” such as the bailout of Bear Stearns in March 2008 and letting Lehman Brothers in August 2008 to file bankruptcy.

**Economic Policies in 1970-2008**

Until the early 1970s, the extensions of Keynes’ general theory of employment enabled governments to avoid “socialized investment” and convinced economists that the Keynesian approach provided a solid base to control the market economy by monetary and fiscal instruments. This conviction was seriously challenged by the oil crises in 1973 and 1979. In the early 1980s, the coincidence of abiding mass unemployment and inflation became “construed as a refutation of the Keynesian ideas. Once again the focus of attention shifted to the supply side of the economic system” (Spithoven 1996, 39).

In the 1980s, President Ronald Reagan blamed the government for the high inflation rates and practically resurrected Say’s law—that is, supply creates its own demand—to justify his policies, among which, the tax cuts and the deregulation of financial markets (Spithoven 1996, 47). An example of the latter concerns the Garn-St. Germain Depository Institutions Act which allowed riskier investment in the housing market and constituted the run up to the Saving and Loan crisis at the end 1980s and begin 1990s. Unemployment fell, but not below five percent. The latter was achieved no sooner than Bill Clinton became President. The relative low unemployment rate in 1998-2002 (See Table 1), with its lowest level of four percent in 2000, may be ascribed to the “Third Way” policies of Clinton.1)

On the one hand, Clinton’s Third Way policies comprised stringent fiscal policies, privatization, deregulation, and globalization policies. They were embedded in tight monetary policies, which aimed at two to three percent inflation and maintaining low interest rates:3)
- Clinton’s fiscal policies aimed at eliminating the budget deficit. They eventually resulted in a government budget surplus in 1998-2001.
- His privatization policies affected prisons and resulted in the Federal Activities Inventory Reform Act.
- His deregulation policies are exemplified by, among other things, the Gramm-Leach-Bliley Act that repealed the Glass-Steagall Act; the Commodity Futures Modernization Act that exempted credit-default swaps from regulation, and; the Community Reinvestment Act that reduced red-lining—that is, banks were encouraged to lend more to citizens in low-income neighborhoods.
- Finally, his globalization policies concerned several free trade agreements. He signed the North American Free Trade Agreement (Mexico and Canada) in 1993. The trade agreements with Canada and Mexico contributed to the deterioration of the trade balance. In addition, it must be acknowledged that the trade balance with China and Germany also worsened. The deficits speeded up since the joining of China and Germany to the World Trade Organization in respectively December 2001 and January 2005. These developments lay behind the transformation of the U.S. economy into a more open economy: GDP, export and import rose respectively with 7.1, 9.4, and 10.6 percent per year (compound growth rates) in the period 1970-2008.
On the other hand, Clinton’s Third Way policies comprised social policies through higher minimum wage, and tax cuts for workers the Temporary Assistance for Needy Families (Wray and Pigeon 2000, 835; The White House [2001]). The latter imposed mandatory work requirements for welfare recipients. It provided that specific work participation rates should be achieved for states to claim federal funding. In line with these policies, he corrected the widening income differentials by fiscal measures such as an expansion of the Earned Income Tax Credit and the provision of a middle-class tax relief. Lastly, he stimulated the housing market through the pressure on Fannie Mae to expand “mortgage loans among low and moderate income people”, and through public securitization of loans to low income borrowers since 1997 (Holmes 1999). In combination with the deregulation policies, this boosted the housing market and employment in the housing industry.

Also innovations influenced the economy. Examples of these innovations are the opening of the World Wide Web for everyone in 1993 by the European Organization for Nuclear Research, and the credit default swaps in 1994. Together with the (financial) deregulation of markets, these innovations contributed to boosting the stock exchange.

The rising prices of houses and stocks constituted a “wealth effect that triggered consumption and entrepreneurial animal spirits. The latter is indicated by the remarkable rise in investment and may explain the significant fall in unemployment in 1993-2000. The “wealth effects” compensated the negatively influenced private demand through the stringent fiscal policies.

In line with the fall in unemployment rates, poverty rates fell from 15.1 in 1993 to 11.3 in 2000—the lowest level since the mid-1970s. However, it was not all roses. International trade, computerization, and the Internet contributed to a polarization of the U.S. labor market (Autor, Katz and Kearney 2006). Globalization resulted in the loss of medium paid jobs in industrial manufacturing, whereas the Internet resulted in the growth of high paid Internet jobs. After the Clinton administration, the U.S. economy and society had to cope with three crises: the dot.com crisis in 2000-2001; the attack on the World Trade Center in 2001, and; the great financial recession.

The dot.com crisis and the 2001-attack negatively influenced animal spirits of consumers and investors but the continued speculation on the housing market gave some solace. On balance, the period 2001-2008 is characterized by a fall in the growth rates of GDP, consumption and investment. The unemployment rate marginally increased.

The great financial recession of 2007-2009 is associated with highly leveraged bets on assets tied to subprime mortgages by hedge funds and banks such as Bear Stearns and Lehman Brothers. At hindsight, this speculation is mainly rooted in: Reagan’s and Clinton’s deregulation policies, and the ability of the financial sector to innovate and to circumvent regulations. This ability was materialized in the issuance of subprime mortgages, the hedging of subprime mortgages, and the shift to speculative and Ponzi lending (Minsky 1994, 157).

Addressing the Great Financial Recession and its Aftermath
Rising mortgage default rates resulted in August 2007 into the BNP Paribas decision to cease activity in three mortgage hedge funds. This marked the beginning of the housing crisis. Eventually, the bankruptcy of Lehman Brothers in August 2008 revealed that the mortgage assets were worthless. Banks did not trust each other anymore and a systemic risk was lurking.

The great financial recession was limited in its effects due to the deposit insurance, guaranteed bank debt issuance, and aggressive monetary and fiscal instruments. Examples of the monetary instruments are: setting the federal funds rate to zero percent; financial stress tests, and; quantitative easing through purchasing huge numbers of treasury securities, agency
mortgage-backed-securities, and agency debt (Fannie Mae and Freddie Mac). Examples of the fiscal instruments are: the Troubled Asset Relief Program (TARP) through which, among other things, capital was injected into banks, and through which General Motors and Chrysler were saved; the Economic Stimulus Act of 2008, and; the American Recovery and Reinvestment Act of 2009 (Blinder and Zandi 2010).

The unprecedented aggressive monetary policies together with the TARP resulted in saving the banking system from a meltdown. Simultaneously, interest rates fell significantly, the growth of household savings marginally fell, and the Dow Jones Index eventually revived again. The latter is more than thirty percent higher in 2015 than in 2007.

The fiscal stimuli in 2009-2011 resulted in a huge rise of the government debt. However, because this debt was soon almost completely counterbalanced by successive fiscal austerity measures (Krugman 2015). Government debt was 9.8 percent of GDP in 2009 and 2.5 percent in 2015.

In 2008 and 2009, macro-economic indicators significantly worsened but they recovered in the period 2010-2015: GDP rose, investment recovered, several jobs were created, and unemployment rates improved. Nevertheless, quite a few socio-economic indicators left behind: Notwithstanding a fall in unemployment rates—especially through a significant fall of the labor participation rate, which was partly due to the aging of population, and because of the creation of jobs—unemployment rates were still higher in 32 states in September 2016 than in September 2007. The unemployment in the Rustbelt and among black men and women seems to be structural. The purchasing power of those who lost their jobs decreased dramatically and the low interest rates hammered pensions. In line with this, the poverty rate in 2015 was higher than in 2007. Additionally, several workers struggle to keep their head up (because of low paid jobs and underinsurance for health care) or are working below their capacities. These issues do not require lower taxes for big companies but fiscal expansion and measurements such as higher minimum wages, adequate health insurance and social security. Economic researchers have shown that the multiplier effect for the U.S. is substantial during recessions (Batini et al. 2014, 4, 8; Krugman 2015).

An alternative to fiscal policies is privatization of semi-public goods, for example, by offering the private sector the possibility to invest in the infrastructure in exchange for allowing them to reap profits in the form of tollage. Privatization of semi-public goods not only changes the character of the good or service involved but might also be more expensive than when it is provided by the government. Due to the historic low interest rates, fiscal expansion is not likely to result in a real threat for regular government spending, whereas the costs of the provision of the privatized goods and services are likely to be higher due to high costs to collect tollage, the relative high interest rates that the private sector has to pay in comparison to governments, and profits on the exploitation of the investment.

Protectionist measures in order to combat persistent unemployment is likely to be marginal. The World Trade Organization safeguard, subsidy and anti-dumping rules limit protectionist measures. An alternative policy might be the acceptance of international trade and to redistribute income from beneficiaries to losers through expanding tax credits for lower incomes, providing social security, and reemployment assistance. For the U.S. this implies a redistribution of income from capital, especially the big firms, to labor. Those who benefit continue to benefit but less than before.

Conclusion and Discussion Notes
The upbeat to the great financial recession can be found in the deregulation of financial markets beginning with President Reagan. Also the Clinton administration contributed to its
development through deregulation of the financial markets in combination with stimulating home-ownership in low-income neighborhoods. The possible positive psychological impact of Clinton’s policies upon investors, the booming Internet and housing industry, and, in line with this, the growing number of jobs, might be reasons that the budding of the great financial recession escaped notice by economists.

The great financial recession was addressed with aggressive monetary and fiscal policies. They saved the banks for a meltdown, boosted the value of stocks, and contributed to a recovery of main macro-economic data. However (regional) unemployment, underemployment and poverty seem to be rather persistent. The government may address these problems by fiscal expansion, redistribution of income, or regulating markets. This might require an expansion of the tax credits for lower incomes, expansion of the social security system, higher minimum wages, and reemployment assistance. It implies abandoning the principle of limited government and requires a revival of a meaningful democracy. The latter depends on citizens and governments who are aware that they are not helpless victims of mysterious economic laws or of the vested interests’ influence over the social climate and economic zeal.
Endnotes:

1) Unemployment is a statistical artifact and underemployment concerns employment below one’s capacities (Skidelsky 1974, 184).

2) My empirical statements are based on statistical data that I derived from: https://bea.gov/ (consumption, inflation, investment, saving); http://www.bls.gov/ (productivity, unemployment (for states) and prices); https://www.census.gov/ (completed new houses; discouraged workers; U.S. foreign trade per country; poverty); https://www.huduser.gov/ (housing); https://www.quandl.com/ (Dow Jones Index); https://stats.oecd.org/ (consumer confidence, consumption, employment, Gini, investment, saving, trade, unemployment); https://www.whitehouse.gov/ (debt).

3) According to Larry Summers, the optimal inflation rate would be between two and three percent (Mankiw 2001, 10, 14, 34, 51). Actually, this level is realized during the Clinton Presidency. That the FED targeted this inflation of two to three percent may be deduced from the fact that Alan Greenspan (2008, 160, 162) and Summers weekly met each other.

References:


Table 1: Economic policy indicators of the U.S.

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<tbody>
<tr>
<td>Gross Domestic Product (GDP), (constant prices)(^{(1)})</td>
<td>2.7</td>
<td>2.9</td>
<td>3.5</td>
<td>3.9</td>
<td>2.1</td>
<td>0.2</td>
<td>2.0</td>
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<tr>
<td>Investment (constant prices)(^{(1)})</td>
<td>0.6</td>
<td>4.3</td>
<td>3.8</td>
<td>7.1</td>
<td>0.6</td>
<td>-4.6</td>
<td>4.3</td>
</tr>
<tr>
<td>Consumption (constant prices)(^{(1)})</td>
<td>2.7</td>
<td>2.8</td>
<td>3.3</td>
<td>7.0</td>
<td>2.5</td>
<td>0.5</td>
<td>1.6</td>
</tr>
<tr>
<td>Consumer confidence composite indicator (month average)</td>
<td>11.5</td>
<td>3.4</td>
<td>3.3</td>
<td>5.3</td>
<td>5.0(^{(2)})</td>
<td>-7.2(^{(3)})</td>
<td>7.0</td>
</tr>
<tr>
<td>Consumer prices(^{(1)})</td>
<td>6.7</td>
<td>8</td>
<td>3.9</td>
<td>2.6</td>
<td>2.8</td>
<td>0.6</td>
<td>1.7</td>
</tr>
<tr>
<td>Household savings rate (year average)</td>
<td>12.9</td>
<td>10.5</td>
<td>9.2</td>
<td>5.8</td>
<td>3.9(^{(4)})</td>
<td>5.8</td>
<td>5.7</td>
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<tr>
<td>Federal funds rate (quarter average)</td>
<td>6.6</td>
<td>9.6</td>
<td>7.0</td>
<td>4.9</td>
<td>2.8</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Monetary base (month average)(^{(1)})</td>
<td>7.0</td>
<td>6.8</td>
<td>7.2</td>
<td>7.0</td>
<td>4.8(^{(2)})</td>
<td>45.7(^{(3)})</td>
<td>14.6</td>
</tr>
<tr>
<td>Dow Jones Index(^{(1)})</td>
<td>0.3</td>
<td>5.0</td>
<td>11.3</td>
<td>16.0</td>
<td>3.0(^{(4)})</td>
<td>-33.8(^{(5)})</td>
<td>8.5</td>
</tr>
<tr>
<td>Government debt (fiscal year average)</td>
<td>-1.8</td>
<td>-3.2</td>
<td>-4.0</td>
<td>-0.8</td>
<td>-1.9</td>
<td>-8.5(^{(6)})</td>
<td>-3.2(^{(7)})</td>
</tr>
<tr>
<td>Multifactor productivity(^{(1)})</td>
<td>1.1</td>
<td>0.4</td>
<td>1.0</td>
<td>0.9</td>
<td>1.0</td>
<td>1.3</td>
<td>0.4</td>
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<tr>
<td>Civilian employment growth(^{(1)})</td>
<td>1.8</td>
<td>2</td>
<td>1.8</td>
<td>1.8</td>
<td>0.8</td>
<td>-2.2</td>
<td>1.4</td>
</tr>
<tr>
<td>Participation rate men (average)</td>
<td>86.4</td>
<td>85.6</td>
<td>85.4</td>
<td>84.3</td>
<td>82.2</td>
<td>80.0</td>
<td>78.7</td>
</tr>
<tr>
<td>Participation rate women (average)</td>
<td>51.3</td>
<td>59.0</td>
<td>66.3</td>
<td>70.1</td>
<td>69.5</td>
<td>68.7</td>
<td>67.3</td>
</tr>
<tr>
<td>Participation rate total (average)</td>
<td>68.2</td>
<td>71.9</td>
<td>75.6</td>
<td>77.1</td>
<td>75.8</td>
<td>74.3</td>
<td>72.9</td>
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<tr>
<td>Poverty rate (year average)</td>
<td>11.8</td>
<td>13.0</td>
<td>13.7</td>
<td>13.3</td>
<td>12.5</td>
<td>14.7</td>
<td>14.6</td>
</tr>
<tr>
<td>Unemployment rate (average)</td>
<td>6.1</td>
<td>7.6</td>
<td>6.5</td>
<td>5.2</td>
<td>5.3</td>
<td>9.5</td>
<td>7.6</td>
</tr>
<tr>
<td>Gini coefficient (disposable income)</td>
<td>0.316(^{(8)})</td>
<td>0.336</td>
<td>0.352</td>
<td>0.357</td>
<td>0.379</td>
<td>0.38</td>
<td>0.401(^{(9)})</td>
</tr>
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</table>

**Sources**: See endnote 2.

**Legend**: \(^{(1)}\)=compound growth rates; \(^{(2)}\)=2001-Aug 2008; \(^{(3)}\)=Sept 2008-2010; \(^{(4)}\)=2001-2007; \(^{(5)}\)=2008; \(^{(6)}\)=2009-2011; \(^{(7)}\)=2013-2015; \(^{(8)}\)=1974; \(^{(9)}\)=2013