

Testimony submitted to House Ways and Means Committee, hearing on the state of the U.S. economy and policies that can promote job creation and economic growth, at 10am on Tuesday, January 13, 2015. Embargoed until the hearing starts.

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A. Main Points

1. Beginning in 2007 and reaching peak intensity in fall 2008, a global financial crisis had major negative impact in almost all industrial countries. The effects in the United States, Europe, and around the globe included a sharp contraction in asset prices, trade, output, and employment. The provision of credit was severely disrupted. This was the most serious implosion of financial sector firms and markets since the Great Depression.
2. More than 8 million jobs were lost in the U.S. as a result of this sudden and deep recession. Unemployment and long-term unemployment increased dramatically. Millions of families were plunged into poverty; from 2007 to 2010, the poverty rate among children rose from 18 percent to 22 percent.²
3. The pernicious effects of such crises are persistent and the process of economic recovery is always difficult, particularly in countries where the financial sector suffers large losses relative to shareholder equity. Compared with almost all industrial countries, the United States has experienced a sustained and robust recovery. And relative even to emerging markets, the short-term prospects for growth in the U.S. now look strong.
4. Including the latest available data, nonfarm payroll employment in U.S. has increased for 58 consecutive months and total employment rose by 2.95 million in 2014.
5. In contrast, the European recovery has been much more problematic and other major industrial countries are also not doing well. The International Monetary Fund's latest published growth forecast for 2015, on a fourth quarter-on-fourth quarter basis, is 3.0 percent for the United States, 1.6 percent for the euro area, 2.2 percent for the UK, 2.4 percent for Canada, and 0.6 percent for Japan.³

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² Sheldon Danziger, Koji Chavez, and Erin Cumberworth, [Poverty and the Great Recession](#), October 2012.

³ These forecasts are from the [IMF's October World Economic Outlook \(Table 1\)](#) and express the Fund's official expectation for GDP in the fourth quarter of 2015 compared with the fourth quarter of 2014. The IMF's forecasted growth in the United States will almost certainly be revised upwards, on the basis of recent data and also the decline in world oil prices. The outlook for Europe remains relatively gloomy, although lower oil prices should also be helpful. There is growing pressure on the European Central Bank to increase the scope and scale of its quantitative easing policies; at the same time as the Federal Reserve is scaling back on such activities.

6. Best practice for economic policy – including as advocated by the IMF around the world (with the support of both Republican and Democratic administrations) – involves the use of countercyclical macroeconomic policies to offset the effects of adverse shocks. It is the use of those policies that has helped to speed the U.S. recovery and to put it on a more sustainable basis. Other industrial countries have struggled to pursue macro policies that have been anywhere close to the effectiveness of what we have experienced in the U.S.
7. In terms of monetary policy, short-term interest rates were lowered to almost zero and the Federal Reserve engaged in unusual measures to help lower the cost of credit. Inflation has also remained firmly under control, at the same time as we have avoided the risks associated with deflation (i.e., a fall in the level of prices).
8. In terms of fiscal policy, the U.S. economy was helped by “automatic stabilizers” – meaning the fall in tax revenue and rise in spending that occurs, without policy changes, when the economy contracts and unemployment increases. There were also some important discretionary fiscal policy decisions, including measures taken in the American Recovery and Reinvestment Act: cutting taxes, extending the availability of unemployment insurance, fiscal support provided to states, and infrastructure spending.⁴ There was a significant positive impact from ARRA on GDP and employment, relative to what would otherwise have been the case, particularly from the second half of 2009, in 2010, and in 2011.⁵
9. Our economic recovery was made much more difficult by the politics of budget issues, including the lack of consensus regarding the need to support the economy, actual or near government shutdowns, and repeated confrontations over the debt ceiling. In particular, threatening to default on any country’s national debt creates a great deal of uncertainty in that country. Such uncertainty discourages investment and consumption.
10. For example, the debt ceiling impasse in summer 2011 created a degree of uncertainty that was not helpful to private sector job creation. The “fiscal cliff” stand-off at the end of 2012 was another instance of policy induced uncertainty – if the same deal had been reached six months earlier this would have been much better for the economy than what actually transpired.
11. As the economy recovered, some temporary spending declined and revenue increased – this is the automatic stabilizers at work. In fiscal year 2009 the federal government’s budget deficit was 9.8 percent of GDP. Due to the depth of the recession, this deficit was still 8.5 percent of GDP in fiscal year 2011 and 6.8 percent in fiscal year 2012. In fiscal year 2013, the deficit was down to 4.1 percent of GDP, and by fiscal year 2014, that deficit was down to 2.8 percent of GDP.
12. Revenue was about 9 percent higher in fiscal 2014 than in the previous year. In nominal terms, revenues have “increased by 44 percent since 2009.”⁶ As a percent of GDP, federal government revenues were 17.5 percent in 2014; this was the first time since 2007 that

⁴ For details on the American Recovery and Reinvestment Act of February 2009, see <http://www.recovery.gov/arra/Pages/default.aspx>.

⁵ Table 1 in the CBO’s [February 2014 report on the ARRA](#) shows a positive effect of GDP of over 2 percent from Q3 of 2009, rising to over 4 percent of GDP in Q1 through Q3 of 2010 and between 2 and 3 percent of GDP in Q1 through Q3 of 2011. The unemployment rate impact was between 1 and 2 percent points during this same period.

⁶ The deficit, revenue, and spending figures are from the CBO’s Monthly Budget Review: Summary for Fiscal Year 2014, <https://www.cbo.gov/publication/49759>.

revenues had exceeded the 40 year average (17.3 percent of GDP over 1975-2014). This was up from revenues that were 16.7 percent of GDP in 2013 and 15.3 percent in 2012.

13. Net spending by the government was less, in nominal terms, in 2014 than 2009, 2011, and 2012. In 2014, federal government spending was 20.3 percent of GDP, which is slightly less than the 40 year average (20.5 percent).
14. Countercyclical macroeconomic measures taken in response to the financial crisis did not damage our medium-term budget prospects. And major changes in our health care system, from the Affordable Care Act, have actually been associated with a slowdown in the rate of cost inflation in Medicare – a very important component of all longer-run budget forecasts.⁷
15. Responding to higher deficits with fiscal austerity – or with destabilizing debates about the degree of austerity – can have adverse and unintended consequences. In a country like the United States, with an ability to borrow at low interest rates, when faced with a severe adverse shock it is better to use short-term fiscal policy to support the economy – and then, when the recovery is assured, to seek medium-term fiscal sustainability.⁸
16. Medium-term fiscal sustainability must include a sufficiently robust base for government revenue that matches goals and likely outcomes for government spending. Government debt relative to GDP should be put on a trajectory that stabilizes over time.
17. There is now an important potential role for comprehensive tax reform, in terms of boosting medium-term potential output in the United States – including through supporting education, infrastructure, and savings for retirement. However, it is important that such tax reform should not add to the budget deficit, i.e., it should be revenue neutral.
18. The next section proposes a set of complementary measures that should, in the years ahead, help sustain growth and create opportunities for a broad cross-section of society.

B. What Should Be Done?

At the heart of the 2008 crisis was an undercapitalized financial system in which systemic risks materialized suddenly and with devastating impact. The 2010 Dodd-Frank financial reforms were put in place as an attempt to avoid repeating this experience.

One top priority now should be attempting to strengthen the safeguards in the Dodd-Frank financial reform legislation. Repealing or rolling back that legislation poses a major fiscal risk.⁹ The fact that this is not currently scored by the Congressional Budget Office does not reduce this risk or make it any smaller.

In effect, a financial system with dangerously low capital levels – hence prone to major collapses – creates a nontransparent contingent liability for the federal budget in the United States.¹⁰ This

⁷ See Tricia Neuman and Juliette Cubanski, The Mystery of the Missing \$1,200 Per Person: Can Medicare's Spending Slowdown Continue? <http://kff.org/health-costs/perspective/the-mystery-of-the-missing-1000-per-person-can-medicares-spending-slowdown-continue/>

⁸ See Simon Johnson and James Kwak, *White House Burning: The Founding Fathers, Our National Debt, and Why it Matters to You*, Pantheon, 2012.

⁹ See Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*, Pantheon, 2010.

¹⁰ See Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive," Stanford University, March 2011 (revised), <https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf>. See also

can only lead to further instability, deep recessions, and damage to our fiscal balance sheet, in a version of what one senior official at the Bank of England has referred to as a “[doom loop](#)”.

Beyond ensuring that we do not experience another serious financial crisis, there are an important set of issues surrounding medium-term growth – including increasing the potential rate of growth for the U.S. and how best to ensure that more people benefit as overall GDP rises.

Of course, we are not completely out of the recessionary woods. Labor force participation remains low compared to historical levels and unemployment in some parts of the country and for some demographic groups remains unacceptably high. Not everyone has benefited from our return to growth.

In particular, the federal structure of our government means that services provided by local and state governments often contract excessively when revenues fall. The decline in the number of K-12 teachers is a striking recent example that should be of great concern, particularly given the pressing need to build our human capital as a nation.¹¹

More broadly, education and all forms of human capital should take a more central role in our national policy consideration. Many of the most important economic challenges for the US are long-standing (pre-dating 2008), shared across all industrial countries, and very much about human capital. These include:

- A process of technological change which, at least since the 1980s, has tended to displace middle skill and middle income workers.¹²
- Globalization, in the form of increasing trade and various forms of “outsourcing” jobs, has also tended to displace middle income jobs, particularly in manufacturing.¹³
- The ageing of the population, due to improvements in living standards and healthcare, alongside declining fertility rates.
- Rising health care costs, due to ageing, and also due to the cost of new technology.
- The need to manage immigration in ways that are fair for existing residents, while also creating opportunity for people who are newly arrived and who want to participate legally in the economy.

Since the 1980s, a major theme of public policy in the United States has been to cut taxes for high income groups, with the motivation that this will lead to job creation and other benefits that

Anat Admati and Martin Hellwig, [*The Banker's New Clothes: What's Wrong with Banking and What to Do about it*](#), Princeton University Press, 2013.

¹¹ About 250,000 jobs were lost in public education during and after the financial crisis in the U.S. Teachers in the pre-school and K-12 sectors have not experienced significant economic recovery, as a result of budget cuts at the state and local level.

¹² For an important review of the issues and policy implications, see David H. Autor, “[Polanyi's Paradox and the Shape of Employment Growth](#),” paper prepared for the Federal Reserve's Jackson Hole Conference, August 2014. There will be jobs – reports of the death of employment growth have been greatly exaggerated. But there will be relatively few middle-skill and middle-income jobs, compared to experience in the United States after World War II. Increasing job polarization – driven mostly by the nature of technological change – implies increasing income polarization, unless public policies intervene.

¹³ See Daron Acemoglu, David Autor, David Dorn, Gordon Hanson, and Brendan Price, [Import Competition and the Great U.S. Employment Sag of the 2000s](#), Journal of Labor Economics, forthcoming. Technological change likely accounts for more of the pressure on middle skill jobs than does globalization.

will “trickle down” to lift the living standards of all Americans. These policies have not achieved their stated goals – income inequality has widened, with most of the gains in income going to people with at the top of the income distribution.¹⁴ The increase in median wages, measured in real terms, has been slight and people in the bottom 90 percent of the income distribution have not done well.

The pressures from technological change and globalization are present in all industrial countries. But countries differ substantially in the extent to which they have chosen to push back against the implications in terms of the distribution of income.

To the extent that long-term interest rates for US government debt remain low and stable, this creates “fiscal space” for policy to address these issues in the coming years.

Low interest rates are partly due to actions by the Fed through various forms of “quantitative easing”, but U.S. government securities are also seen as a safe haven for international investors. However, this safe haven status will be jeopardized if markets perceive a significant probability that we will not pay our debts as contracted – or if create the perception that our economy will be thrown into repeated turmoil through regular showdowns over the debt ceiling.

Over the CBO’s 10-year forecast window, with the partial expiration of the Bush-era tax cuts, there is no insurmountable budget problem.¹⁵ Our most important budget problems come *after* the ten-year horizon, because Medicare spending accelerates due to an aging population and increasing health care costs. The real issue here is containing healthcare costs – i.e., cutting Medicare in such a way as to shift healthcare costs onto families is not an appealing solution, particularly as this would likely raise healthcare spending as a percent of GDP.¹⁶

We should aim to find a way to control healthcare costs as soon as possible – every year of high healthcare cost inflation makes the problem worse. Our competitors are controlling healthcare costs much more effectively than we are; with the set of advanced countries, the US stands out as having the worst (highest) prospects for rising healthcare costs through 2030 or 2050.¹⁷

The United States is in the midst of a significant demographic transition, with the population ageing. We need to invest in education and ensure access to affordable healthcare to everyone if we are to increase productivity as the population ages.¹⁸ Ultimately, this is the only way to

¹⁴ See Thomas Piketty and Emmanuel Saez, [Income Inequality in the United States, 1913-1998](#), Quarterly Journal of Economics, February 2003, Vol. CXVIII, Issue 1.

¹⁵ See James Kwak, “The Weirdness of 10-Year Deficit Reduction,” <http://baselinescenario.com/2011/07/21/the-weirdness-of-10-year-deficit-reduction/>.

¹⁶ For more detail, see the CBO assessment of the budget proposal put forward by Congressman Paul Ryan in 2011: http://cbo.gov/sites/default/files/cbofiles/ftpdocs/121xx/doc12128/04-05-ryan_letter.pdf.

¹⁷ See the IMF’s [Fiscal Monitor \(October 2012\)](#), Statistical Table 12a, columns 3 and 4. Most of our main economic competitors have some form of universal health care system with a dominant or single payer (i.e., the government). Our fragmented system has not proved able to control costs in the past, in part because of constraints placed on the ability of the federal government, for example to negotiate lower prescription drug prices and to control reimbursement rates across all programs.

¹⁸ The Affordable Care Act helped increase access to health care and to improve the living standards of lower wage workers. It also reduced some payment rates and changed incentives. [The rate of Medicare cost inflation and healthcare inflation more generally has slowed](#) since the ACA was passed, although it remains to be seen how much of that slowdown in cost increase is structural and how much will prove to be cyclical.

ensure that older, retired workers can receive a sustainable level of reasonable benefits (including pensions and healthcare).

Comprehensive immigration reform could also be helpful to both boost medium-term economic growth and to sure our fiscal accounts remain sustainable. In particular, to the extent that immigration helps to keep the age structure relatively young, this has significant positive impact.

In this context and over the coming decades, the United States needs to make a longer-term fiscal adjustment. Part of that should include additional tax revenues.¹⁹ The Bush-era tax cuts reduced revenue to an excessive degree, given the ageing of society. We are still struggling to recover from that flawed way of thinking about our public finances.²⁰

It is striking the extent to which income inequality has increased dramatically since the last tax reform in 1986.²¹ From 1986 to 2006, there was little change in average income for the bottom 90 percent of wage earners while the top 1 percent experienced a gain of around 50 percent. The gains for the top one-tenth of one percent were even higher.²²

The returns to higher education have greatly increased over this time period and there are not good income prospects for anyone with only a high school education (or less). If anything, the tax system should lean towards becoming more progressive – and investing the proceeds in public goods that are not sufficiently provided by the private sector, like early childhood education and the kind of preventive healthcare that helps prevent disruption to education (e.g., due to asthma).

We should also consider shifting the emphasis of our public education system from K-12 to K-14, i.e., adding an additional two years of vocational training. Such efforts should focus on measures that will, in aggregate, increase the supply of such training opportunities – and linking them more closely to actual jobs and career development.²³

A number of other policies also merit active consideration, including:

- Raising the minimum wage.
- Expanding the earned income tax credit, to include people without children.²⁴

¹⁹ For more details on the viable options, see [White House Burning](#), Pantheon, 2012, by Simon Johnson and James Kwak.

²⁰ In addition, Medicare Part D was not paid for, in the sense of being supported by additional revenues. This is not a model to follow in the future – and efforts to cut back on the revenues raised by the Affordable Care Act should be resisted.

²¹ For more details and discussion of what accounts for the increase in inequality, see David Autor and Daron Acemoglu, “Skills, Tasks and Technologies: Implications for Employment and Earnings,” <http://econ-www.mit.edu/files/5571>.

²² Similarly, according to data available on the economist Emmanuel Saez’s invaluable Web site, from 1993 to 2011, average real income for the bottom 99% of the population (by income) rose by 5.8%, while the top 1% experienced real income growth of 57.5%. The top 1% captured 62% of all income growth over this period, partly owing to a sharp rise in returns to higher education in recent decades. (On average, those with only a high school education or less have few good income prospects.)

²³ As a result of the financial crisis, almost all states cut the funding provided to colleges. Some of the cuts have been dramatic. It is hard to say that this sector is currently headed in the right direction.

²⁴ See Chuck Marr and Chye-Ching Huang, “[Strengthening the EITC for Childless Workers Would Promote Work and Reduce Poverty](#),” Center on Budget and Policy Priorities, July 30, 2014.

In this context it makes sense to examine ways to improve the environment for business, including start-ups in the United States. However, we should also keep in mind that according to the best available comparative indicators, the US already ranks very highly both compared to other countries and in absolute terms.

In the latest [Doing Business indicators](#), the US is ranked #7 (out of 189 countries), with an overall score that is close to almost all the countries above it (other than Singapore). There are some apparent weaknesses, including the ease of obtaining construction permits and electricity, but these are hardly federal government issues.²⁵ Still, it could make sense for the US to benchmark itself more carefully against other countries – and to look at what drives differences in starting a business within the US. It would make particular sense to consider what will help support the manufacturing sector and its relatively high productivity and high paying jobs.

In addition to these more general issues, in 2015 there will almost certainly be further discussion of the potential for increasing trade through signing trade agreements. The next section takes up some specific points that need to be addressed if such agreements are really to lead to job growth.

C. Preventing Currency Manipulation

Seeking ways to stimulate economic growth and create jobs, the Obama administration is seeking to push forward in 2015 with a free trade deal known as the [Trans-Pacific Partnership \(TPP\)](#). The idea is to create a form of free-trade area across the Pacific. The initial goal was relatively modest, involving the US and a range of trading partners (Australia, Brunei Darussalam, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam). But Japan [is now on board](#), South Korea is watching closely, and there is the very real potential of engaging with China through this or a similar framework in the foreseeable future.

The typical thinking when wanting to finalize an agreement aimed at reducing barriers to trade – while attempting to protect labor and environmental standards – is to compromise by asking for less, rather than more, from the people on the other side of the table. But the TPP at this stage is different – the odds of success would be much greater if the U.S. now attached the additional requirement that participating countries not participate in currency manipulation.

One of the major issues with our global trading system in recent decades is that there is no effective constraint on countries that intervene heavily in order to keep their currencies undervalued. A significantly undervalued currency implies a potentially big surplus of exports over imports.

Ordinarily, such a surplus puts pressure on the currency of the exporting country to appreciate -- making their exports less competitive and making it easier to sell goods and services to that country. But if a country intervenes to buy up foreign currency, this can prevent appreciation for a prolonged period of time.

²⁵ The World Bank, which constructs these indicators, looks at local conditions; for the US this is Los Angeles and New York, both of which have expensive real estate and a great deal of regulation for construction.

Such intervention results in the build-up of what are known as foreign exchange reserves – much of which is held in the form of US government debt. In one way, this is helpful to the US; it helps keep interest rates lower than they would be otherwise.

But currency manipulation in this way is also an unfair way to gain a trading advantage, with excessive negative effects on trading partners. The International Monetary Fund was founded, in part, to prevent this kind of economic strategy, which resulted in “competitive devaluations” during the 1930s. Unfortunately, the IMF in recent years has proved unable or unwilling to prevent precisely this kind of manipulation.

Similarly, according to law, the US Treasury is supposed to determine if a country is intervening to an unfair and unreasonable extent. In practice, the Treasury reports on this topic are generally toothless with no real consequences.

Fred Bergsten and Joseph Gagnon, my colleagues at the Peterson Institute, [have proposed](#) to include a currency clause in any TPP deal. In essence, this would amount to the signatories agreeing not to manipulate their currencies.

Such a clause could come with stronger or weaker teeth. The important thing is to shift norms and expectations.

Some US officials are supportive of this approach to TPP, but others are resistant. The latter group should think harder about what will be the dynamics on Capitol Hill when TPP comes up for a vote.

Even people who are very much in favor of freer trade and even specifically some version of the TPP – like Messrs. Bergsten and Gagnon – feel that some Asian countries have overstepped the boundaries of reasonable behavior.

At this precise moment, the level of intervention by major countries is limited (China) or even non-existent (Japan). This is a perfect moment for including a currency clause in the TPP, as most countries are less likely to become defensive. Participating countries could allow their currencies to float, or they could operate a fixed exchange rate – but if they do the latter, they must commit not to run large current account surpluses and run up big amounts of excess foreign exchange reserves.

Any blatant and repeated breaking of this commitment would – and should – result in the loss of the special privileges granted under the TPP. This would be a reasonable and commensurate response.

There is strong support on Capitol Hill, from both Democrats and Republicans, for finding some way to limit currency manipulation.

Both parties are generally interested in supporting trade, along responsible lines – and recognizing legitimate concerns. Currency manipulation has become a little too ugly in recent years, including with associated significant negative impacts on some sectors and some communities in the United States.

Hopefully, the other countries involved in TPP will also come to understand that this agreement is more likely to pass Congress and to prove sustainable – in economic and political terms – if it strongly discourages currency manipulation.