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**Contradictions Coming Home to Roost?
Income Distribution and the Return of the Aggregate Demand Problem**

by
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INTRODUCTION: THE CONTRADICTED ECONOMY

According to official NBER business cycle dating, the U.S. economy has been in expansion mode since April 1991 (ten years), making this expansion the longest in U.S. economic history. Now there are signs that the expansion may be drawing to a close - so much so that some speculate we may even find ourselves "revised" into recession a couple of quarters from now (since recessions are defined as two quarters of back-to-back GDP decline, their onset is only formally identified several months after the fact).

The prospect of a slowing economy has raised questions as to what has caused the slow down, and what we have learned from the "Great Expansion." These are important questions, and how they are answered stands to influence both economic policy and public discourse about the economy. At issue is whether the current slowdown represents a correction of temporary excesses in an otherwise balanced and sustainable economy, or whether it is the product of deeper inconsistencies surrounding the generation of aggregate demand.

The temporary excess point of view identifies the gyrations on Wall Street as the proximate cause of the slow down. It argues that the booming stock market coincided with the long economic upswing, and a sputtering stock market is now coinciding with a stalling economy. The implication is that once the stock market finds its feet, the economy will be poised to rebound and rapid growth can resume.

The aggregate demand generation point of view maintains that the economy is beset by structural problems that have been obscured by the financial boom of the 1990s. Interestingly, both views allow for the existence of financial excess, but they have dramatically different interpretations. The temporary excess view sees the prior financial excess as a readily correctable phenomenon, whereas the aggregate demand generation view sees the reversal of financial excess as exposing structural deficiencies.

Most importantly, the two views have profoundly different policy implications. The temporary excess view sees little need for corrective policy action other than the Fed marginally lowering interest rates. This should help put a bottom to the stock market, and thereafter rising equity prices should play into a generally healthy economic picture. The aggregate demand generation view sees the economy as beset by structural inconsistencies that are likely to prove difficult to remedy. At the base of the problem lies a deteriorated income distribution. A rising stock market has helped offset this problem. However, the stock market has now risen to bubble levels, and this means that covering the shortfall of aggregate demand with further equity price increases enjoins the contradiction of further inflating the existing asset price bubble. Consumer borrowing has also offset the problem of aggregate demand, but consumers are now approaching debt ceilings, and further rapid growth of borrowing risks a consumer debt crisis.

The bottom line is that the boom of the 1990s may have been built on a combination of forces that are unsustainable - an explosive rise in asset prices, and consumer borrowing that has produced record high household debt and record low saving rates. These developments helped cover up the contradictions between deteriorated income distribution and aggregate demand generation, but further staving off these contradictions is only possible at the cost of deepening of existing unstable financial positions.

INCOME DISTRIBUTION: THE DOG THAT HASN'T BARKED -- YET

The deterioration of U.S. income distribution is a phenomenon that has been proceeding steadily for the last twenty years, and it is well documented (see Mishel, Bernstein, and Schmitt, 2000). Between 1979 and 1999 the top fifth of families increased their income share from 41.4% to 47.2%, while the share of income going to the bottom 60% of families fell from 34.5% to 29.8%. The ratio of family income of the top 5% relative to the lowest 20% increased from 11.4 in 1979 to 19.1 in 1999. Over the same period family income of the top fifth grew by 42%, while that of the bottom 60% grew by just 3.3%. This worsening of family income distribution was accompanied by generalized income and wage stagnation. Whereas median family income had grown at an annual rate of 2.75% between 1947 and 1973, it grew at only 0.52% per year between 1973 and 1999 - and this at a time when female labor force participation was increasing and average hours worked grew by over 10%.⁽¹⁾ Real average hourly earnings of production and non-supervisory workers (who constitute roughly 80% of employment) grew at annual rate of 2.25% between 1947 and 1973, but then fell at an annual rate of 0.12% between 1973 and 1999.

These trends in the distribution of family income and average hourly real wage growth have been amplified by shifts in the functional distribution of income which have raised the profit share at the expense of the labor share. Table 1 shows business cycle peak-to-peak profit rates. The pre-tax profit rate rose from 9.2% in 1979 to 12.1% in 1999 - a 31.5% increase, while the post-tax profit rate rose from 4.9% in 1979 to 8.1% in 1999 - a 65% increase. Side-by-side, the profit share also increased, rising from 17.7% in 1979 to 20.5% in 1999 - a 15.8% increase.

Figure 1 places these income distribution trends in a unified framework, and illustrates how working families have been squeezed at two margins. First, the shift toward profit income has reduced the wage share. Second, within the wage share component there has been a shift away from production and non-supervisory workers to managerial workers. These two trends have added up to increased family income inequality. However, whereas the increased profit share has been relatively unproblematic and may even have done good in the form of increased investment spending, the changed composition of the wage share has been unambiguously damaging.

An old adage is that a mass production economy needs mass consumption markets to support it. Behind this claim lies the implicit belief that robust mass consumption markets rest on a healthy distribution of income. Yet, despite the clear worsening of income distribution, the last two business cycles have seen the U.S. economy still generate substantial increases in aggregate demand. This has cast doubt on the core Keynesian proposition that market economies are prone to failure regarding aggregate demand generation, as well as casting doubt on the claim that income distribution matters for aggregate demand.

The argument that is developed below maintains that both Keynesian claims remain solidly intact - market economies can have a problem generating sufficient aggregate demand, and income distribution matters for aggregate demand. Making this argument involves showing how the process of demand generation over the last two business cycles has served to mask the impact of deteriorating income distribution. Moreover, this existing process is unsustainable. Consequently, the U.S. economy now confronts the risk of systemic demand shortage.

The current slowdown has already contributed to a revival of public awareness of Keynesian-styled concerns with deficient aggregate demand - though it is also the case that this awareness is still often coded as a problem of excess capacity (Business Week, April 9, 2001.)⁽²⁾ However, the linkage between "sustainable" aggregate demand generation and income distribution remains less understood.

THE GENERATION OF AGGREGATE DEMAND: WHAT HAS COVERED FOR WORSENING INCOME DISTRIBUTION?

Whereas much has been written about the causes of worsening income distribution and stagnating wages, little has been written as to why the deterioration of income distribution has failed to impact aggregate demand.⁽³⁾ For Chicago School economists the fact that the income distribution/aggregate demand dog has not barked is of little surprise since they discount the problematic of aggregate demand, and they believe that all households have a common propensity to consume regardless of income level.⁽⁴⁾ However, for Keynesian economists accounting for this silence is important, and explaining the absence of demand effects of deteriorated income distribution is a necessary step in making the claim of a contradicted economy.

At the most abstract level, the reason why the demand effects of deteriorating income distribution have not yet shown up is because modern financialized economies possess many margins of compensation, and these margins can operate for lengthy periods of time before they are exhausted.⁽⁵⁾

These margins of compensation have served to mask and keep at bay the problem of demand shortage.

FEDERAL BUDGET DEFICITS

One of the most important margins of adjustment has been the growth of debt - both public and private. The worsening of U.S. income distribution gathered steam in the 1980s, but this coincided with the enormous Reagan government budget deficits. Between 1980 and 1990 gross federal debt jumped from \$909.1 billion to \$3,206.6 billion, and during this period

the federal government ran budget deficits every year. In absolute terms the deficit (on a fiscal year basis) peaked at \$221.2 billion in 1986, and over the course of the decade it averaged (on a NIPA basis) 3.4% of GDP. The federal deficit, funded by a growing federal debt, therefore served to inject demand into the economy. This contributed to offsetting the negative demand impact of the shift in income distribution from low income/higher propensity to consume households to high income/lower propensity to consume households.

Whereas public sector deficits were an important engine of aggregate demand in the 1980s, this engine began to slow down in the 1990s as the government deficit started falling and the federal budget began its steady climb toward surplus. This change in direction of federal financial policy began with the Deficit Reduction Act of 1993, but it is important to recognize that deficits persisted through 1997. Thus, though the size of the federal stimulus to aggregate

demand was falling during this period, it remained positive. The impact on aggregate demand only turned negative in 1998 with the emergence of the first federal budget surplus in over a generation.⁽⁶⁾

DECLINING PRIVATE SECTOR SAVING

Large federal deficits for most of the last twenty years have been one important factor maintaining aggregate demand in the presence of deteriorating income distribution. A second even more important factor has been changed private sector saving behavior which has made for a steady decline in the private sector's saving rate. Moreover, the decline in the private sector saving rate accelerated in the 1990s just as the federal government began to reverse its financial course, so that the private sector stepped in and more than compensated for the declining size of the federal deficit in generating aggregate demand. The change in private sector saving behavior is illustrated in figure 2 which shows the private sector deficit, the government deficit, and the current account deficits as shares of GDP from 1959 - 1999. In 1992 the private sector had a net financial surplus, defined as the difference between total private sector saving and investment, of 4.2% of GDP. However, by 2000 this surplus had been transformed into a deficit of 6.2% of GDP. Thus, in the space of just eight years the annual private sector saving rate had fallen by an amount equal to 10.4% of GDP.⁽⁷⁾

Godley (2000) has emphasized the current size of the private sector deficit. At 6.2% of GDP, the private sector is now issuing liabilities at a rate that exceeds growth of income, giving rise to a rapidly rising liability-to-income ratio which Godley concludes is likely to prove unsustainable. Godley's analysis is conducted at a highly aggregative level and focuses on the private sector as a whole. However, it is useful to decompose the private sector into component parts as this serves to link with other analyses that have emphasized the significance of household debt in the business cycle (Palley, 1994, 1998a). It also sheds further light on the mechanisms that have helped defer the aggregate demand impact of worsened income distribution, as well as shedding light on why the current configuration is unsustainable.

The private sector balance is defined as

[1] Private sector balance = Private sector saving (S) - private sector investment (I).

here saving and investment are defined as shares of nominal GDP. Figure 3 shows the evolution of private sector saving and investment as shares of GDP. The figure shows a dramatic decline in the private sector saving rate since 1984 and a recovery in the private sector investment share after 1990. The implication is that both saving and investment behavior have contributed to maintaining robust demand. Rising investment spending has directly fueled aggregate demand, while a declining private sector saving rate has fueled consumption spending. However, the private sector saving rate has fallen to historical record lows, while the investment share remains well within the bounds of normal highs. This indicates that changed saving patterns have played the greater role.

Private sector saving share can in turn be decomposed into personal and business components so that the private sector saving share becomes defined as

[2] Private sector saving = Personal saving + Business saving

Figure 4 shows personal and corporate saving as shares of GDP. This figure sheds important light on process of private sector demand generation. The business sector saving share has been largely unchanged, and all the change in the private sector saving share has therefore been driven by a collapse in the personal saving share. Prior to 1980 personal saving was slightly above 5% of GDP, but since then it has steadily drifted down, and in the last quarter of 2000 and the first quarter of 2001 it actually turned negative. Few countries have experienced negative personal saving rates. Two that have are Norway and Sweden in the second half of the 1980s, and both experienced severe hard landings.⁽⁸⁾

Finally, the share of personal saving can in turn be written as

[3] Personal saving share = $\frac{\text{Personal saving}}{\text{personal disposable income}} \times \frac{\text{personal disposable income}}{\text{GDP}}$

Figure 5 shows the evolution of these two components of the personal saving share. This figure shows how the decline in the personal saving share has been driven by falls in both the rate of saving out of personal disposable income (a behavioral propensity) and the personal disposable income share of GDP. The decline in the personal saving rate began in the early 1980s and has proceeded steadily. The decline in the personal disposable income share began in 1990, and it reflects the twin influences of a shift to government budget surplus and a rising business sector saving rate. From an historical perspective it is again noteworthy that the personal disposable income share is well within the normal range, while the personal saving rate is abnormally low. This raises questions as to whether such a low saving rate is sustainable.

HOUSEHOLD SECTOR DEBT

The decline in the personal saving rate has helped finance household sector consumption spending. Another development is the increase in consumer debt, and household borrowing has financed additional consumption spending. Figure 6 shows the evolution of household debt-to-personal disposable income ratio. This figure shows a cyclical pattern around an upward trend, and the ratio now stands at a record high level.

Figure 6 reveals two important features. The first is the rising trend of the household debt - income ratio. This rising trend reflects the extensive process of financial innovation in the U.S. economy over the last twenty five years. Such innovation has given households increased access to credit, thereby increasing their ability to borrow to finance consumption. The increased use of credit cards, with their extensive credit facilities, is one example of this innovation. A second example is home equity loans which have allowed households to tap wealth that was previously illiquid. These innovations have come on stream steadily and have been gradually and continuously diffused into the economy. This long and steady process has been a critical factor explaining how demand problems have been kept at bay.

The second important feature of figure 6 is that it shows that the debt-to-income ratio has risen rapidly in the 1990s. Borrowing has therefore risen faster than income, and this at a time when national income has been rising rapidly. In 2000 the debt-income ratio was 1.02, which is 22% higher than its previous cyclical peak of 0.834 in 1989. The scale of the increase suggests that households may now be approaching their debt ceiling ratios, and this promises to put a stop to using debt financed consumer spending to compensate for the deteriorated underlying aggregate demand generation process. [\(9\)](#)

Figure 6 provides data on the economy average debt-income ratio. This average ratio may conceal deeper problems. Household sector saving can be decomposed into two parts as follows

(4) Household saving = Saving of creditor households + Saving of debtor households

In effect, there are two types of households - financially affluent households and financially strapped households. The former have positive savings, while the latter have negative saving and borrow from the financially affluent. Financial distress in the strapped group of households may be much more advanced than is suggested by aggregate numbers.

Evidence for this proposition comes from the Federal Reserve's 1998 Survey of Consumer Finances (2000). Table 2 decomposes the results of the survey into households earning less than \$50,000 and households earning more than \$50,000. For households earning less than \$50,000 the debt-to-income ratio was 2.86: for households earning more than \$50,000 it was 1.19. In 1999 the median family income was \$48,950. Putting the pieces together indicates the divided state of household sector finances. The top half of households have debt burdens that are unproblematic, but the bottom half have heavy burdens.

Two important implications follow. First, interest rate cuts may be relatively ineffective in stimulating consumer borrowing because the top half of households are not liquidity constrained and have little demand for new borrowing. Side-by-side, the bottom half of households are constrained, but credit risk is more important than the cost of wholesale financial funds in setting their interest rates. This means that the marginal impact of Federal Reserve interest rate cuts is likely to be small. The second implication is that reducing debt burdens to create the conditions for another expansion of consumer lending could take considerable time, and during this period of transition the economy is vulnerable to a vicious circle of lending contraction - which is the twin of the recent virtuous circle of lending expansion. Thus, a contraction of income causes an increase in the debt-income ratio, which lowers lending and income, thereby further raising the debt-income ratio. This is the model of the debt driven business cycle presented in Palley (1994).

INVESTMENT EXHILARATIONISM

An examination of the household sector shows how reduced saving rates and increased consumer borrowing have been important factors offsetting the negative demand effects of worsened income distribution. A second important factor has been increased investment spending which has risen steadily over the course of the 1990s. Investment spending as a share of GDP bottomed at 13.4% in 1991, but then rose to 18.4% in 2000. Two principal factors can be identified with this rise - one systemic, the other temporary - and both are riven by contradiction. This suggests that any further increase in the investment share is unlikely.

On the temporary side, the rise in investment spending in the second half of the 1990s was helped by the exuberance promoted by "New Economy" chatter. An examination of the record of investment spending shows a dramatic acceleration in 1997 of spending on equipment and software. This acceleration transformed what had previously been a sub-par business cycle expansion into a record expansion. However, the exuberance that drove this spending had the hallmarks of a bubble, and it has now become evident that translating new economy developments into private profit is a difficult task. With the bursting of the bubble's expectations and the stark realization about the difficulties of turning new economy developments into profits, growth of investment spending on equipment and software has fallen dramatically and has actually turned negative. The new conditions suggest that it will be hard to maintain existing levels of investment spending, let alone grow them, and this points to an urgent need for new sources of aggregate demand generation.

On the systemic side, the rising investment share of GDP has also been driven by the rising profit share and rising profit rates that were documented in table 1. These favorable capital income trends have increased incentives to invest, and they correspond to a regime which Bhaduri and Marglin (1990) term "exhilarationist". In such a regime rising profitability spurs an increase in investment that more than compensates any reduction in consumption attributable to worsened income distribution. However, the critical unknown is whether exhilarationist regimes (high profit rate/high profit share) are permanently sustainable, or whether the initial rise in investment and profit rates eventually peters out. This can occur if the worsening of income distribution - be it the result of a shift to profits or a shift within the wage distribution to upper income groups - results in a situation in which there is insufficient aggregate demand to absorb the additional capacity created through new investment. At this stage excess capacity would begin to emerge, competitive pressures would start to erode profit rates, and investment spending would be scaled back. The extensive presence of excess manufacturing capacity both domestically and internationally suggests that this could be happening. [\(10\)](#)

THE ROLE OF THE STOCK MARKET

The stock market boom of the last twenty years has been another prominent feature of the U.S. economy and it has played an important role in explaining both the declining saving rate and the strength of investment. In January 1980 the Dow Jones index stood at 904, and by January 2000 it had reached 11,281. This tremendous increase in stock market values has provided another mechanism for compensating the negative aggregate demand impacts of deteriorated income distribution. Moreover, the fact that the stock market has risen almost uninterruptedly for twenty years again serves to illustrate the long time period over which these demand compensation mechanisms can operate. However, as with consumer indebtedness, there are now indications that this mechanism may also be exhausted, with the market hitting a valuation contradiction. Even if corporate earnings are sustained, current price-earnings ratios look rich, and the picture only gets worse if earnings start to fall because of deficient demand.

With regard to consumption spending the stock market has operated through three channels - a wealth effect channel, a confidence channel, and an expectations channel. The wealth effect is the most widely recognized channel, and it has rising equity prices contributing to greater household wealth, thereby encouraging households to consume more and save less. [\(11\)](#) The wealth effect has likely grown in size given the extensive shift in the composition of household portfolios which has resulted in more households owning stock. Moreover, this shift has been amplified by the spread of 401(k) saving plans and by the shift in pension arrangements toward defined contribution plans away from defined benefit plans. Both of these arrangements contribute to households directly owning more stock, and they also encourage households to view pension wealth as if it were standard private wealth. However, despite these changes, equity ownership still remains enormously concentrated at the top end of the income distribution, and for this reason it is unlikely that the wealth effect has been the main channel of transmission. [\(12\)](#)

The second channel is the "consumer confidence effect" which has consumers interpreting a rising stock market as an indicator of robust real economic conditions. Whereas the household wealth effect is restricted to operate only on households who own equities, the consumer confidence effect impacts all households. Consequently, its impact can be far more widespread.

The third channel is the "stock market expectations effect." This has households extrapolating current price gains into the future, leading them to believe that their future wealth will be significantly larger. Even households with small current holdings of equity can be significantly influenced by the expectations effect, and this means it can also be widespread. Thus, low wealth households, believing that their small holdings will multiply in value over time, may increase consumption and reduce saving now.

Whereas the wealth effect is a stock market "price level" effect, the confidence and expectations effects are driven by the "rate of change of stock prices" - i.e. they depend on a rising stock market. This is a critical distinction. The latter two effects are probably the most significant because of their application to all households, and not just the wealthiest, but they require a steadily rising stock market. It is this feature that ultimately generates contradiction since stock prices must eventually get pushed to implausibly high valuations. Once equity prices stop rising, the stock market confidence and expectations effects can even kick into reverse. When this happens consumer confidence and spending can taper off very rapidly, revealing the underlying inconsistency between income distribution and consumption spending.

Finally, in addition to impacting consumption spending, the rising stock market may also have influenced aggregate demand

through its effect on the cost of capital. The logic here is that rising stock prices lower the cost of equity capital, thereby encouraging firms to finance increased investment spending with new equity issues. This investment channel may have been particularly important in the information technology sector which was marked by a tidal wave of initial public offerings (IPOs). However, even here it may not have been the cost of equity capital *per se*, but rather the irrationally exuberant expectations about the payoffs to new technology investment.⁽¹³⁾ With these expectations now revealed as unjustified, investment in the new technology sector and stock prices of new technology sector companies have collapsed together.

Lastly, it is important that the above demand compensation role of the stock market not be conflated with the mainstream view that the current slowdown is due to a temporary wobble in the stock market. The fact remains that the recent decline in the stock market remains fairly modest. As of late April 2001 the Dow Jones index is less than 10% below its all time high. It is true that the NASDAQ has fallen some 60%, but at its peak it only represented 20% of total stock market valuation so that the lost wealth is much more modest. Moreover, both the Dow and the NASDAQ remain above the levels of three years ago so that most households still have considerable unrealized stock market gains. As such, the recent wealth give backs on the stock market are simply not large enough to explain the scope of the economic decline now being experienced.

THE TRADE DEFICIT AND THE BUDGET SURPLUS

Whereas reduced household saving rates, increased household indebtedness, and a rising stock market have contributed to maintaining aggregate demand, the worsening of the U.S. trade deficit has contributed to draining aggregate demand out of the economy. However, just as there are doubts about whether the above processes of demand compensation can be maintained, so too there are questions as to whether the trade deficit leak can be plugged in a non-destabilizing fashion.

For all of 2000 the U.S. ran a current account deficit of \$435 billion or 4.4% of GDP. On the face of things, it would appear easy to plug this leak of demand by simply reducing imports. Here, the goal is to bring about a reduction of imports through expenditure switching (i.e. shifting spending toward domestically produced goods), and to avoid reduction brought about by recession and a generalized reduction of incomes. Lowering the exchange rate to accomplish this would seem the easiest way to accomplish such switching, but it is in fact problematic. First, a lower exchange rate stands to raise imported inflation, and this risks an errant Federal Reserve interest rate response. Second, a lower exchange rate and reduced U.S. imports stand to reduce global demand and trigger recession in the rest of the global economy. Global recession in turn risks feeding back and amplifying the demand shortage in the U.S. economy. This illustrates how the contradictions in the aggregate demand generation process extend beyond U.S. borders and into the global economy.

Just as the trade deficit has become a major source of demand leakage, so too has the federal budget surplus. In 2000 the total federal surplus was \$236 billion or 2.4% of GDP. The surplus now represents a serious drain of demand out of the system. As is discussed below, tax cuts and spending increases represent easy avenues for closing off this drain, but here too there are risks owing to flawed understandings of the economic impact of budget surpluses.

In particular, economists have argued that deficits are bad because they decrease national saving and capital accumulation, while surpluses do the reverse. Such teaching has led policymakers to view surpluses as a goal of policy. Though current political conditions are forcing a reduction in the surplus, the underlying mis-understanding remains intact, and this gives rise to the following danger. In the event of a prolonged economic slowdown the surplus is likely to start automatically and rapidly disappearing owing to falling incomes and tax receipts. At this stage policymakers may try to protect the surplus by cutting spending and raising taxes, and evidence of the likelihood of such a response is provided by discussions about spending triggers. Such a reaction would effectively reduce aggregate demand, and this at a time of demand shortage. Were this to happen, fiscal policy would amplify the downturn.

CONCLUSION: ECONOMIC POLICY AND THE CONTRADICTED ECONOMY

The current slowdown of the U.S. economy is attributable to a slowdown in the rate of aggregate demand growth. The dominant view amongst economists is that this slowdown will prove short-lived and that there is nothing wrong with the economy's underlying demand generating process. However, this paper has argued that the slowdown may prove considerably more intractable. The reason is that there are structural problems with the foundations of aggregate demand, and these problems are directly related to the severe worsening of income distribution that has taken place over the last twenty years.

The aggregate demand effects of the worsening of distribution have been kept at bay over two long business cycles through a number of mechanisms - reduced household saving rates, increased household borrowing, a rising profit share that has stimulated investment spending, and a prolonged stock market boom. The demographics of the "echo" baby boom have also helped. These combined mechanisms have been so powerful that they have even at times been capable of creating conditions verging on excess demand. However, the ending of the "Great Expansion" suggests that these mechanisms are exhausted, and the dangers posed by this exhaustion are compounded by the deflationary stance of fiscal policy and the intractable nature of the U.S. trade deficit. Together, these considerations suggest that the slowdown risks being serious and prolonged.

The under-lying policy problematic concerns how to restore a solid basis to the aggregate demand generation process. Tackling this problem involves the huge task of confronting the misguided intellectual understandings that now guide policy.

(1) The easiest part of the problem is monetary policy where the Fed must be enjoined to implement a regime of low real interest rates. But low interest rates are unlikely to be sufficient, as has been proved by Japan's experience over the last half decade. Moreover, there is the danger that the Fed, despite its recent willingness to provide rate relief, remains wedded to the theory of the natural rate of unemployment. Consequently, there is an ever-present risk of the Fed raising interest rates before the economy has been able to transition to a sustainable aggregate demand generation process.

(2) The problem of the federal on-budget surplus can be readily solved by a combination of tax cuts and spending increases. But here political conflicts intervene. The best policy would be a combination of immediate tax cuts aimed squarely at middle and low income households, and sustained spending on needed national programs such as Medicare. Middle and low income households have a higher propensity to consume and they are also the most debt burdened. Giving them tax relief would therefore yield the biggest bang per buck. However, current political conditions augur for a phased-in tax cut aimed squarely at the rich. This promises to delay and diminish the impact of fiscal policy.

(3) The problem of the off-budget social security surplus is deeply intractable with policy makers of all stripes committed to pre-funding Social Security. Pre-funding, whether it be through private saving accounts or the publicly owned Social Security Trust Fund, exerts a deflationary drag.⁽¹⁴⁾ The existing payroll based Social Security funding system compounds the problem by imposing a job tax that amplifies corporate incentives to shift jobs offshore. What is needed is a pay-as-you-go-system funded out of general revenues. This would allow decisions about the management of the time path of the national debt to be made jointly with decisions about the needed fiscal policy stance.

(4) Just as it is important to remedy the drag imposed by the budget surplus, so too there is a need to remedy the drag imposed by the trade deficit. The contradictions inherent in a trade strategy exclusively focused on import reduction suggest that the solution is to increase world demand growth, and thereby raise demand for U.S. exports. However, expanding global demand and trade must not be taken as meaning more NAFTA-style trade agreements. Instead, it means new development policies that pay attention to income distribution, and a new international financial architecture that provides stable flows of development capital. Such measures can allow developing countries to consume an increasing share of the goods they produce, while still retaining access to financial resources to fund their growth and development.

(5) Each of the above measures can contribute to alleviating the underlying demand problem. Yet, at the end of the day there is a need to repair the damage to U.S. income distribution. The traditional focus has been on the functional distribution of income (profits v. wages). This is misguided. A healthy profit rate is good for investment and growth, and there is little evidence that U.S. profit rates are steeply out of line, either historically or internationally. The real problem in the U.S concerns the distribution of the wage share which has seen a huge shift to upper income managers and professionals at the expense of non-supervisory and production workers. Remedying this problem calls for re-building the institutions that gird the labor market. These include the minimum wage and union density, but these traditional domestic institutions must now be accompanied by core labor standards that can gird the new global economy.

The above set of policy prescriptions is summarized in figure 7 which describes policy makers as facing choices regarding macroeconomic and microeconomic policy variables. The U.S. economy is currently positioned in box B - unsustainable growth. The European economy is positioned in box C - stagnation. Policy stands at a critical juncture. Failure to repair the damage done to income distribution risks setting in train a process of aggregate demand contraction that could force the economy into prolonged and deep recession. The needed policy mix is that described in box A (expansionary macroeconomic policy, level playing field labor markets) which produces sustainable growth. The challenge is how to get there in face of an economics profession and public understandings that lean to prescribing box D.

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Table 1 Profit rates and shares at business cycle peaks, 1959 - 99.

Corporate Sector	1959	1969	1973	1979	1989	1999
Profit rates						
Pre-tax	12.0%	12.5%	10.9%	9.2%	10.0%	12.1%
After-tax	6.4%	6.8%	6.0%	4.9%	5.7%	8.1%
Income Shares						
Profit share	21.9%	19.7%	18.2%	17.7%	18.2%	20.53%
Labor share	78.1	80.3	81.8	82.3	81.8	79.5
REVISED Source: Mishel, Bernstein, & Schmitt, 2000, p.91.						

Table 2 Household debt distribution by income.

Household type	Average Income (\$)	Average Debt (\$)	Average Mortgage (\$)	Average Other Debt (\$)	Debt Share (%)	Mortgage Share (%)	Other Share (%)	Debt/Income	Mortgage/Income	Other/Income
Less than \$50,000	23,090	68,918	36,305	32,614	46	45	48	2.98	1.57	1.41
More than \$50,00	112,232	157,681	87,417	70,264	54	55	52	1.40	0.78	0.63
					100	100	100			
Source: Author's calculations based on Federal Reserve 1998 Survey of Consumer Finances										

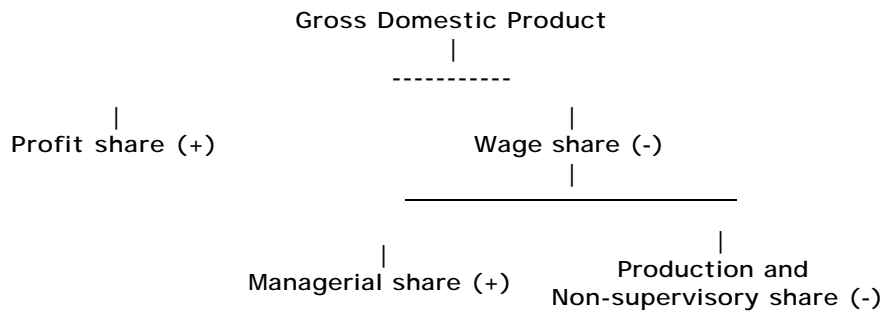


Figure 1 The division of gross domestic product. Signs in parentheses represent direction of change in shares 1979 - 1999.

Figure 2 The private sector, government, and current account deficits as shares of GDP, 1959 - 2000.

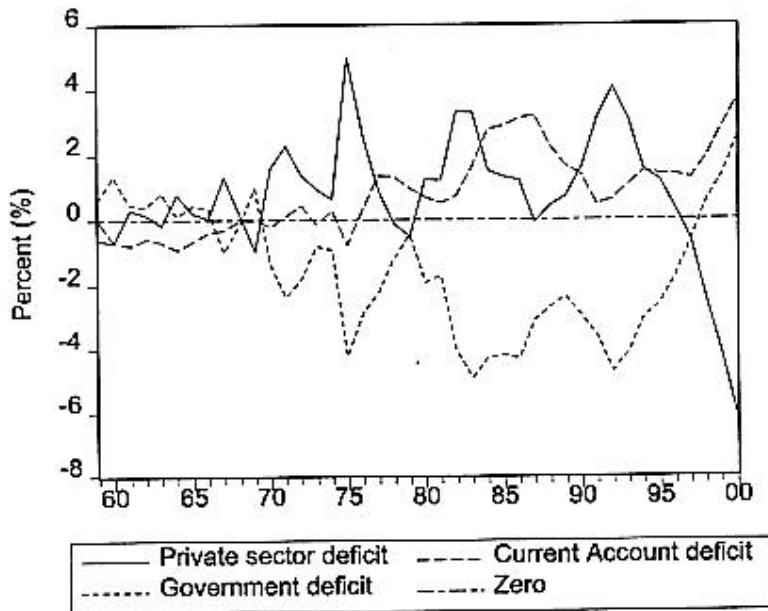


Figure 3 Private sector saving and investment as shares of GDP, 1959 - 2000.

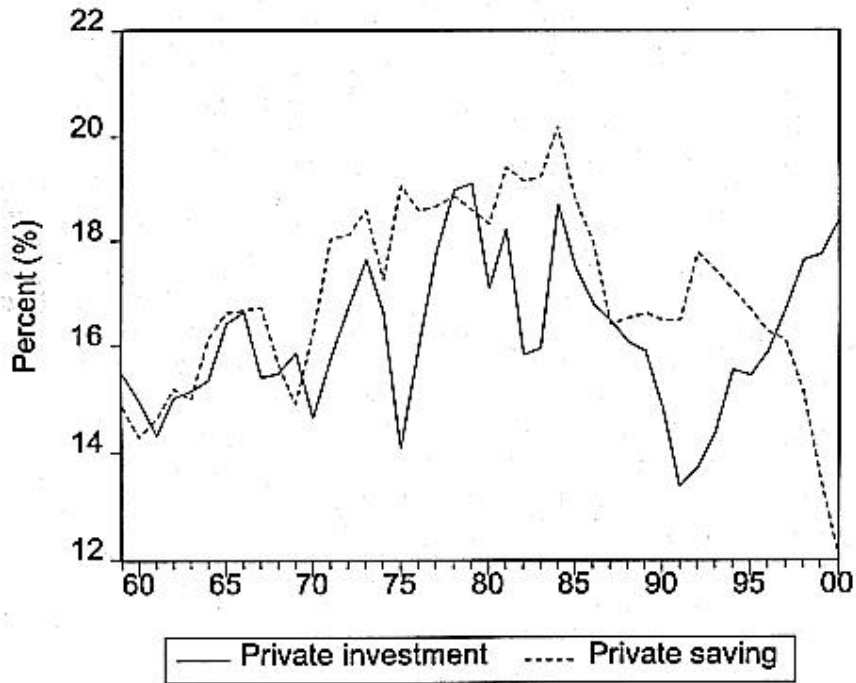


Figure 4 Personal and business sector saving as a share of GDP, 1959 - 2000.

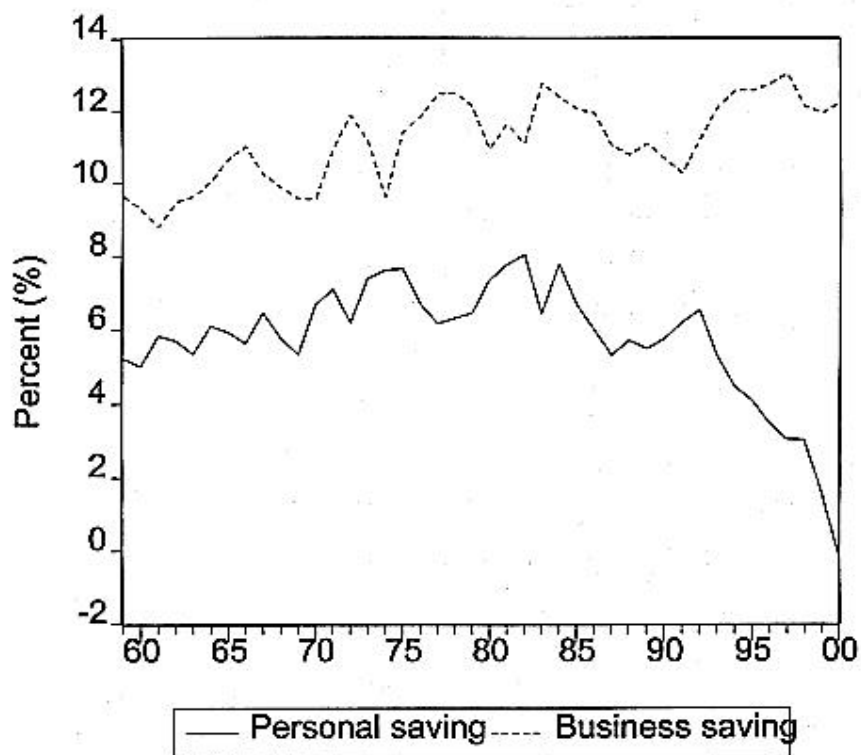


Figure 5 Personal disposable income as a share of GDP and Personal saving as a share of personal disposable income, 1959 - 2000

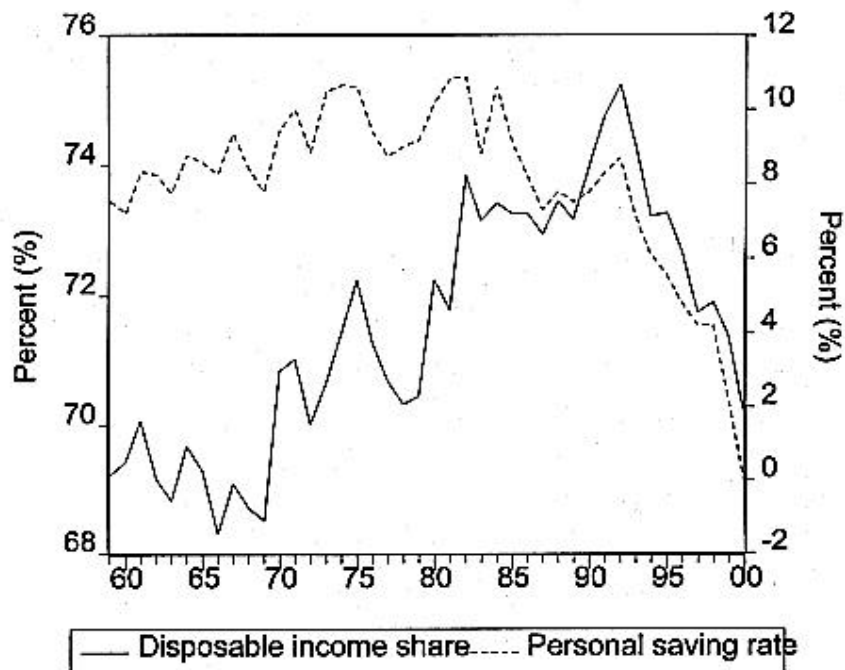
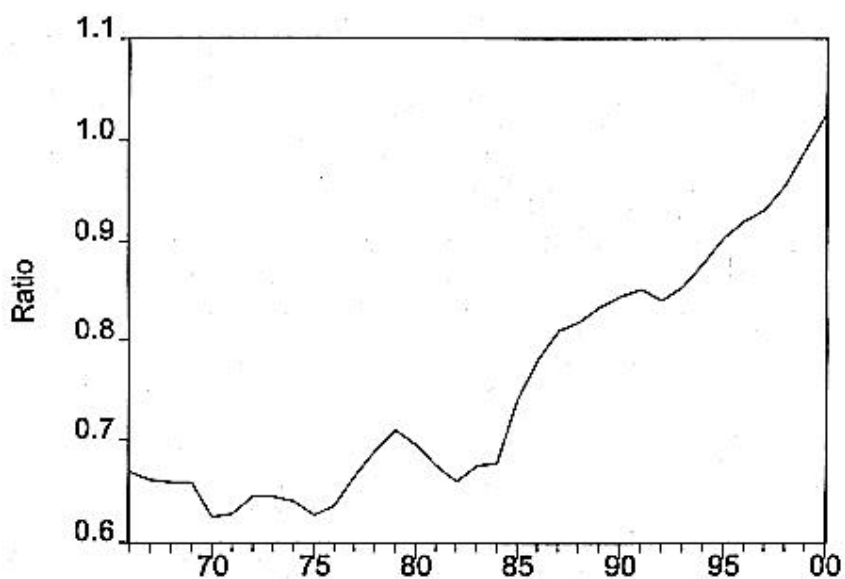


Figure 6 Ratio of total household sector debt to personal disposable income, 1966 - 2000



	Level playing field labor markets	Business dominated labor markets
Expansionary macro policy	A. Sustainable Growth	B. Unsustainable Growth (U.S.)
Contractionary macro policy	C. Stagnation (Europe)	D. Deep recession

Figure 7 The macroeconomic - microeconomic policy matrix. Source: Palley, 1998c.

1. All of the above numbers are either taken directly from Mishel, Bernstein and Schmitt (2000), or are based on calculations using their numbers.

2. The one place where the problem of aggregate demand shortage is openly expressed is in connection with the global economy. For the last several years, the U.S. has acted as global buyer of last resort, providing demand in an otherwise demand-short global marketplace. Now there are fears that a U.S. slowdown could cut global demand, thereby triggering recession in east Asia and Latin America (for example see *The Economist*, March 31, 2001).

3. The reasons for the deterioration of income distribution and the stagnation of average hourly wages is deeply contested. The mainstream of the economics profession maintains that it is the result of a shift in the composition of labor demand away from unskilled to skilled workers (Katz and Murphy, 1992; Bound and Johnson, 1992). An alternative view is that it is due to changed labor market bargaining conditions resulting from reduced union density, weakening of labor market institutions that underpin the wage floor, globalization, and less robust macroeconomic conditions (Palley, 1998a).

4. This belief is based on Friedman's (1956) permanent income theory of consumption.

5. For historians, with their longer time horizons, such a process of gradual deepening of contradictions is readily plausible. However, economists, with their emphasis on fast adjusting competitive markets and "Chicago School" styled rational expectations, find such descriptions profoundly problematic. Instead, they maintain that rational agents will extrapolate forward and see how the current economic configuration implies future trouble - albeit twenty years away. These same agents will then unravel the implications of future trouble through a process of backward recursion, thereby bringing it into the present and forcing markets to confront the problem today. Such reasoning explains why the economists are resistant to casting policy arguments in an historical - structural frame of reference.

6. Prior to 1998, the last time the federal government ran a surplus was in 1969.

7. From the national income account identities the private sector deficit is defined as

Private sector deficit ($S -$) = government balance ($G - T$) + current account balance ($X - M$).

8. A number of other countries (Canada, Australia, New Zealand, Sweden) also have unusually low personal saving rates today. If the low saving rate augurs trouble - for reasons discussed below - these economies may also find themselves hit by hard landings.

9. The exact level of this ceiling is impossible to predict as the ceiling has risen with every cycle owing to the gradual diffusion of financial innovations within retail financial markets which has more and more households taking advantage of them. It is this type of change that makes forecasting business cycles so difficult.

10. As of March 2000 total U.S. industry capacity utilization 82.25, and U.S. manufacturing capacity utilization was 81.6%.

11. Saving less also includes borrowing more since borrowing constitutes a form of negative saving.

12. In 1998 the top 10% of households owned 86.1% of all common stock including pensions (Mishel, Bernstein, and Schmitt, 2000, p.265).

13. To the extent that investors had wildly optimistic expectations about future profitability in the new technology sector, the cost of equity capital (measured in terms of expected future profits given away) may even have been quite high.

14. Both private and public pre-funded systems exert a deflationary drag, but public systems have a range of other advantages associated with collective insurance and inter-generational income insurance (Palley, 1998b).