Hitting the sweet spot with PGEPs: Pro-growth, equalizing policies
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Introduction: What's a PGEP?

This brief paper focuses on policies that are both pro-growth and promote greater income equality, hereafter PGEPs (**p**ro-**g**rowth, **e**qualizing **p**olicies). It turns out that such policies abound, providing policy makers' considerable opportunities to simultaneously accomplish two venerable goals.

Of course, in advanced economies across the globe, politics has been a significant barrier to progress in this regard, in part because of an embedded prejudice among economists that policies that promote equality hurt growth and vice versa. Thus, one goal of this work is to push back against that notion by discussing numerous policies designed to promote equalizing growth.

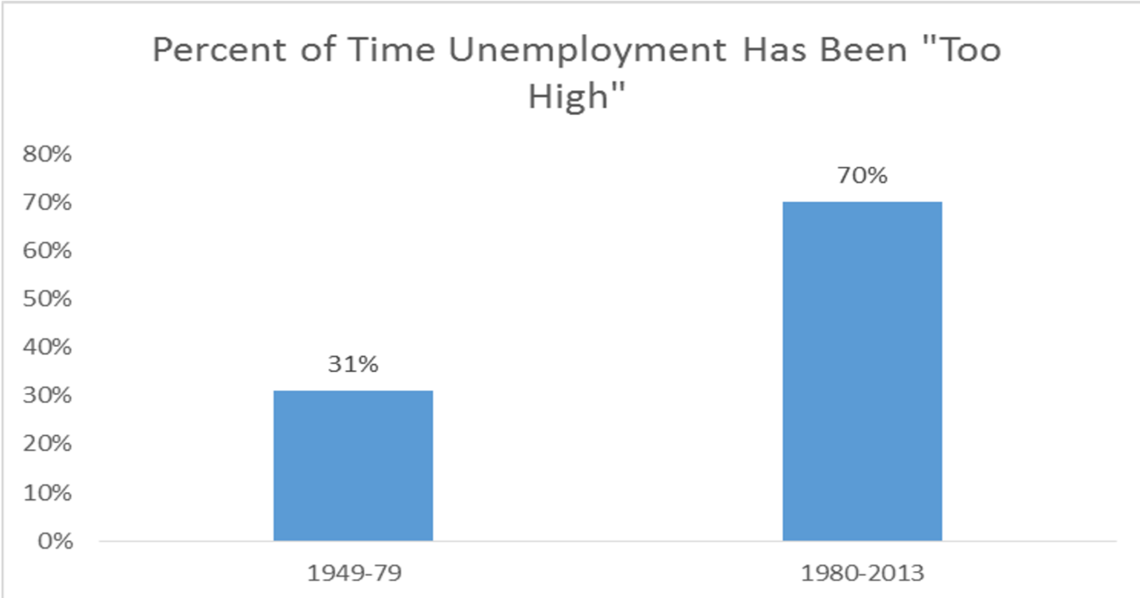
Before getting into details, a word about "growth" in the context of what follows. The ideas below consider three types of growth. First, countercyclical growth in the interest of closing output gaps. However, especially given the persistence of such gaps in recent years in advanced economies, this policy set should not be thought of solely as short-term, temporary stimulus. Instead, they should be viewed as part of a necessary, ongoing policy effort to achieve and remain at full employment, as a key finding of this work is that such efforts are both pro-growth and equalizing.

Second, there's the economy's potential growth rate—its growth rate at full resource utilization. PGEPs in this context, like education, are intended not to close existing output gaps but to increase the economy's speed limit. Finally, in a short section towards the end, I expand the concept of growth in ways consistent with recent work wherein the definition of GDP is broadened to include sustainable growth and growth that gives weight to well-being in ways not currently measured, such as balancing work and family.

Macroeconomic PGEPs

Probably the first PGEP on the minds of most who think about this sort of thing is education policy, especially for those who face access and completion barriers to educational opportunities. This is in fact a critical PGEP, one I reference below. However, too often the conversation stops there. In fact, the spate of PGEPs is much wider than that.

PGEPs that target Output Gaps: First, consider two facts. Many advanced economies, including the US, have been running large output gaps for many years now. According to the Congressional Budget Office's estimates of the natural rate of unemployment, unemployment in the US economy has been "too high"—above their estimate of the lowest rate consistent with stable inflation—70% of the time since 1980. (See Figure 1; from 1949-1979, unemployment was above the natural rate only 30% of the time).

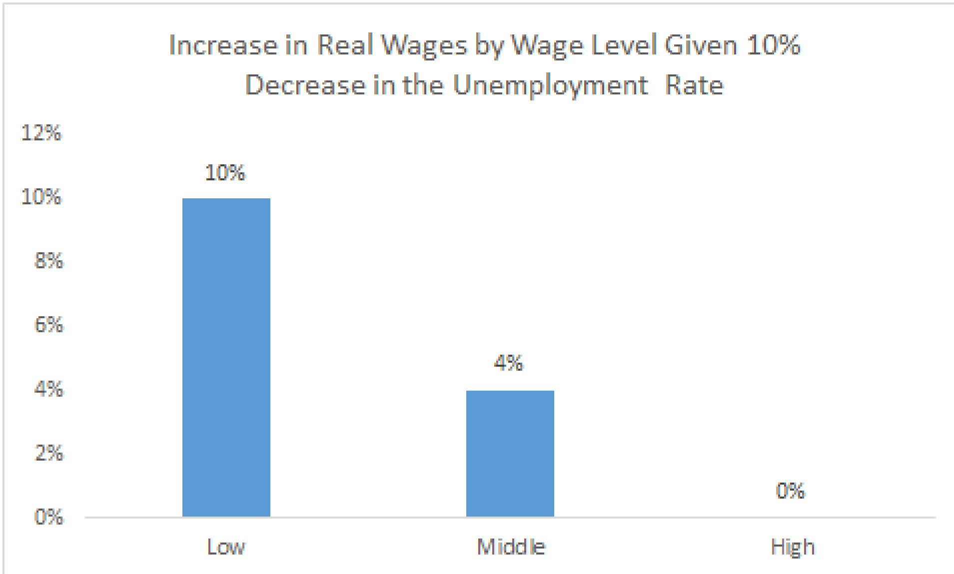


Sources: CBO, BLS

[Figure shows percent of quarters that unemployment minus CBOs natural rate was greater than zero.]

Second, research by Dean Baker and myself, along with similar work of others,[1] finds that high unemployment leads to wage dispersion and vice versa. Using a panel data set of US states from 1979 to 2011, we find that a lasting 10% decline in the unemployment rate (say, from 6% to 5.4%) is associated with a gain of 10% in real terms of low hourly pay, 4% for the earnings of middle-wage workers, and zero for the earnings of high wage workers. Additional analysis from this work finds significant hours-worked effects that also disproportionately help low-income households, implying not just hourly wage gains but family income gains as well.

[1] For similar work in the UK, see http://www.resolutionfoundation.org/wp-content/uploads/2012/09/What-a-drag.pdf and http://ner.sagepub.com/content/228/1/R3.abstract.



Source: Baker and Bernstein: Getting Back to Full Employment. "Low" wage is 20th percentile, "middle" is 50th percentile, and "high" is 90th percentile.

Thus, fiscal and monetary policies that close output gaps and move the economy toward full employment are not only pro-growth. They also have the potential to reduce inequality as the benefits of lower unemployment redound more to lower and middle-wage workers than to high wage workers.[2]

One counterargument to the above is that the Fed's quantitative easing (QE) policy, as it raised asset prices, actually led to higher inequality. While there's obviously some logic to this claim—the wealthy control a disproportionate share of valuable assets—it must be considered against a counterfactual wherein monetary policy fails to improve its macro targets. Moreover, this counterfactual must also weigh the evidence that QE's impact on asset prices and thus inequality was not of a magnitude that could plausibly offset the positive macro impacts on jobs, unemployment and wage growth discussed above.[3]

Based on the equalizing wage and income impacts of lower unemployment, pro-growth fiscal policy is also implicated as an important PGEP in periods of output gaps. Perhaps the best examples of this claim are recent and pervasive weakness in advanced economies across the globe that prematurely pivoted to deficit reduction, failing to close or exacerbating existing output gaps in the process.

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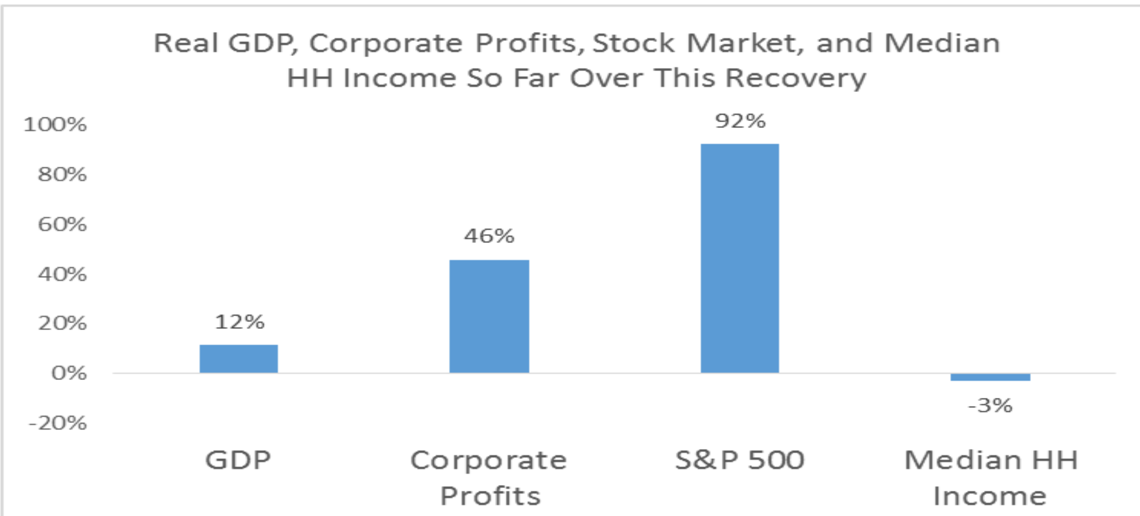
[2] I discuss this issue of the Federal Reserve's impact on inequality and growth in greater detail here: http://www.washingtonpost.com/posteverything/wp/2014/10/20/yes-the-federal-reserve-can-reduce-inequality/

[3] See Baker (http://www.cepr.net/index.php/blogs/beat-the-press/krugman-on-quantitative-easing-and-inequality) and Krugman (http://krugman.blogs.nytimes.com/2014/10/25/notes-on-easy-money-and-inequality/?module=BlogPost-Title&version=Blog%20Main&contentCollection=Opinion&action=Click&pgtype=Blogs&region=Body) on these points.

There is little question that such so called austerity policies have been negatively correlated with growth.[4] But is there evidence that they exacerbated inequality? While more work is needed here, *suggestive* evidence is not hard to come by. Research by analysts at Goldman Sachs has carefully tracked the impact of positive or negative fiscal impulses on real growth in the US, showing, for example, that spending and tax increases lowered GDP growth by 1.5 percentage points in 2013. If, using rule of thumb estimates, that growth loss increased unemployment by three-quarters of a point that year, that would amount to just about a 10% increase in the 2013 unemployment rate, which in turn could trigger dis-equalizing impacts similar (though inverse) to those in the second figure above.

The next figure provides a similar perspective on the US recovery, showing real changes over the first five years of the recovery in some key indicators, including GDP, corporate profits, equity markets, and the median household's income. While overall growth has been steady if not robust, it has clearly not reached the middle class. Corporate profitability, on the other hand, has hit record highs.



Sources: BEA, BLS, Standard and Poors, Sentier Research.

This is all rough, suggestive analysis; it comes nowhere near to proving that the recent negative fiscal impulse, for example, was inequality inducing (that austerity diminished growth is, on the other hand, well established). But the connections between austere fiscal policy, weaker growth, and higher unemployment, as well as the uneven wage growth impact of the latter, all suggest that more careful research might well reach similar conclusions.

At any rate, the broad punchline in the context of this overview is that most monetary and fiscal policies that help to close output gaps are PGEPs. Why "most" and not all? Because tax cuts, depending on how they are targeted, may be less effective in this regard. Specifically, tax cuts targeted toward the upper end of the pay scale may help growth to a limited extent but could exacerbate after-tax income inequality.[5]

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[4] See my chapter (#7) in this volume: http://www.boeckler.de/pdf/p_restoring_shared_prosperity.pdf
[5] See Chuck Marr's work on this point: http://www.cbpp.org/cms/?fa=view&id=3241

Another PGEP in this output-gap space may seem less obvious than monetary or fiscal policy but is equally important: reducing our persistent trade deficits. While globalization has surely had positive growth affects by increasing the supply of goods and lowering prices, it is also implicated in the growth of inequality. That said, it may not be intuitive where there's a PGEP here, given that "less globalization" might reduce inequality but would not be pro-growth.

The resolution of the riddle is not a call for less trade but for more balanced trade. Over the period when the US economy was at full employment 70% of the time (see Figure 1), the trade balance was about 0.5% of GDP. Over the period when we were at full employment 30% of the time, the trade balance averaged –2.6% of GDP. The kicker in the PGEP context is this: persistent trade deficits of this magnitude hurt both inequality and growth.

The former claim—trade can exacerbate inequality—is not in dispute and in fact grows neatly out of Stolper-Samuelson models wherein trade with lower-wage countries puts production workers from higher wage countries at a relative disadvantage. The basis for the latter claim—trade deficits hurt growth—is simple: the trade deficit is by definition a negative in GDP accounting. Of course, here again, counterfactuals are important, and both costs and benefits must be considered. But it is decidedly odd that until relatively recently, many economists put very little weight on the negative growth engendered by trade deficits.

So, how can we achieve more balanced trade? Or in the vernacular of this paper, where is the PGEP here? I and others have written extensively on the drag from current account deficits in the US and other countries, including some in the Eurozone periphery. A key part of this story, as told compellingly by Ben Bernanke back in 2005, is that countries that suppress consumption generate excess savings and thus, by identity, current account surpluses. As they export those excess savings, their current account surpluses must be absorbed by deficit countries.[6]

As Gagnon, Bergsten, and many others point out, dollar/exchange rate policy can help rebalance current accounts.[7] Details are beyond my scope, but the idea is actually one more consistent with "free trade" than "protectionism" in the sense of policies that strive for currency values to be set in markets, not by surplus countries that accumulate reserves (of which dollars are most common) in order to make their exports to us cheaper than our exports to them.

Not to lose the thread, the insight here is that such exchange rate policies are PGEPs: growth enhancing by reducing the trade deficit's drag on GDP growth, and inequality reducing by support the creation of potentially millions of good jobs for production workers in exporting sectors.[8]

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[6] Bernanke: http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/; Bernstein (http://www.nytimes.com/2014/08/28/opinion/dethrone-king-dollar.html) and Austin (http://econpapers.repec.org/article/mespostke/v_3a36_3ay_3a2014_3ai_3a4_3ap_3a607-634.htm have also written about this topic.

[7] http://www.iie.com/publications/interstitial.cfm?ResearchID=2302

[8] See Dean Baker's estimate that bringing trade into balance would create 4-6 million jobs: http://www.pathtofullemployment.org/wp-content/uploads/2014/04/BAKER.pdf

A final PGEP in this macro space—lowering output gaps—is financial market regulation, though the idea here is not to close output gaps but to prevent such large, persistent, and disequalizing gaps from forming so frequently in the first place. Though these ideas can be traced back to Adam (Smith, of course) and Keynes, a more recent literature associated with Minsky explains the tendency of financial markets to become increasingly leveraged and volatile as the business cycle progresses.[9] Bubbles inflate, as risk is systematically underpriced.

The problem from the inequality/growth nexus is that when the bubble bursts, the loss of wealth (and the demand that the wealth effect was helping to generate) fall disproportionately on middle-class and low-income households. Thus, while capital losses may initially hurt the wealthy and lower inequality, the wealthy's ability to sustain and recover from these losses is much greater than that of the less well off (especially when they also benefit from government bailouts with few strings attached).

Thus, "macroprudential" oversight by the Fed and Dodd/Frank-style reforms should also be viewed as PGEPs.

PGEPs that target potential growth rates: As noted, the most commonly-cited PGEP is education policy. A deep dive into this policy space is far beyond my scope, so I will just tick off some of the ideas that I think are most relevant for hitting the PGEP "sweet spot."

The OECD leaned into this point in their useful review of this question of PGEPs.[10] They maintain that "…making educational outcomes less dependent on personal and social circumstances should boost GDP per capita by enhancing entrepreneurship, the overall quality and allocation of human capital and, ultimately, productivity. At the same time, a more equitable distribution of educational opportunities has been shown to result in a more equitable distribution of labour income."

Specific PGEPs include access to quality pre-school for less advantaged children,[11] less dependence on local funding for primary and secondary school, improved teacher evaluation and support, wraparound services for less advantaged students,[12] improved access and help with completion[13] to post-secondary education, and increased opportunities to "earn and learn" through apprenticeships.[14]

A recent spate of research puts some empirical meat on these bones through an interesting channel: equalizing opportunity leading to positive growth outcomes. Work by Chetty et al as well as Bradbury and Triest show that higher parental inequality dampens their children's upward mobility as they age into adulthood. In regressions of growth outcomes on children's absolute mobility in "commuting zones" across the country, Bradbury and Triest find positive and significant correlations between upward mobility and economic growth, which

[9] http://www.newyorker.com/magazine/2008/02/04/the-minsky-moment
[10] http://www.oecd.org/eco/growth/49421421.pdf
[11] http://www.nea.org/home/18163.htm
[12] http://www.massbudget.org/report_window.php?loc=Uplifting_the_Whole_Child.html
[13] http://www.onegoalgraduation.org/about-us/
[14] http://www.pathtofullemployment.org/wp-content/uploads/2014/04/holzerlerman.pdf

in their words, indicates "…a negative and significant effect of inequality of opportunity on growth."[15]

In their model, blocked opportunities create [my bold] "…inefficiency as barriers prevent the most productive use of human and other resources. It has long been recognized that at a microeconomic level policies that relax barriers to opportunity will also enhance economic efficiency. The interesting result that appears to be emerging from the nascent research literature on inequality of opportunity and economic growth is that the strength of the efficiency effect is strong enough to be picked up at an aggregate level. **The finding that inequality of opportunity has a negative effect on growth suggests that relaxing barriers to opportunity may be a viable strategy for promoting economic growth."**

Since education is a fundamental way in which more equal opportunity unlocks the potential efficiencies stressed by Bradbury and Triest, their recent work underscores its function as a PGEP. That said, this empirical work is new and should be viewed as uncovering correlations less than causal channels. Also, some research fails to find these correlations.[16]

Another PGEP that could lift the economy's potential growth rate is some form of welcoming immigration reform targeted at boosting the size of the labor force. Balanced against this effect, however, is the concern that increased labor supply absent greater demand would put downward pressure on some workers' wages. Such downward pressure could exacerbate inequality, depending on the human capital composition embedded in the immigrant flows.

Without delving too deep into the extensive research on this question, the dominant finding is that those domestic workers at risk from new immigrant competition are those who are substitutes to new immigrants as opposed to their complements. Thus, when it comes to low-skill immigrants, research finds that minority high school dropouts, for example, may suffer from immigrant competition, thus worsening inequality.

At the other end of the pay scale, however, increasing immigration among high-skilled workers, like lawyers and doctors, could put downward pressure on their pay and thus reduce wage differentials between high and lower wage workers. In that regard, a PGEP targeted at reducing occupational protectionism that prevents high-skill workers from immigrating here would be useful.

Microeconomic PGEPs

Next, consider safety net programs, like food stamps or the Earned Income Tax Credit, a substantial wage subsidy for low-income workers with children that redistributes over $60 billion per year through the tax code.

These policies are thus clearly inequality reducing, but are they also pro-growth? To the extent that they redistribute income for non-liquidity constrained households with relatively

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[15] http://www.bostonfed.org/inequality2014/papers/bradbury-triest.pdf

[16] See, for example, Bloome, Deirdre. 2014. "Income Inequality and Intergenerational Income Mobility in the United States." Harvard University Department of Sociology and Harvard Kennedy School.

low marginal consumption propensities (MPCs) to constrained households with higher MPCs, safety net programs too could be pro-growth. While I am not aware of any research that empirically substantiates this argument, the theory that this consumer spending channel boosts growth is certainly plausible. To the extent that minimum wage increases are also redistributive from profits to wages, they could have a similar effect.

In addition, new research based on following children into adulthood is yielding exciting results in this PGEP space. This work finds that the receipt of benefits like food stamps and the EITC in childhood is connected with more employment and higher earnings in adulthood, and thus more growth relative to a counterfactual where these elasticities remain untapped. These results might lead us to think of safety net provisions that were heretofore considered "consumption" as more like investment, with growth paybacks much later in life.

Poverty scholars at the Center on Budget and Policy Priorities have reviewed some of this research, finding, for example, positive long-term impacts from income supports like the EITC and child tax credit on earnings, education, and health.[17] Similarly, I recently reviewed research showing that when low-income women and their young children had access to food stamps, those children had better health and economic outcomes as adults—less obesity and heart disease, higher educational achievement and more economic self-sufficiency—than did children born at the same time but in neighboring counties that did not yet offer such nutritional support.[18]

While we have good metrics on the extent to which these measures reduce poverty, and some measures of how much they reduce inequality, no one knows the magnitude of these impacts on growth.[19] My intuition is that they may be small relative to that of the macro-interventions discussed above. But regardless of magnitudes, if they do in fact push towards both faster growth and more equal growth, they deserve a seat at the PGEP table.

A final example of a PGEP in this space is one wherein "G" takes on a broader meaning: policies designed to help balance work and family life. Such policies may or may not increase growth as conventionally measured—though to the extent that they boost worker productivity, they could have such effects—but they are very likely to increase a growth rate that factored in family well-being, including spending quality time together.

PGEPs in this space include paid sick leave, robust maternal and paternal leave policies, worker-centered scheduling, ensuring parents have ample time and resources to care for children and elderly parents (prevent discrimination against caregivers), and affordable, high quality child care.

In a similar vein, I would strongly urge that policies which promote environmentally sustainable growth, even if they do not generate faster growth, be considered PGEPs. Of course, in the presence of output gaps, job creation in the service of sustainable production

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17 See http://www.cbpp.org/cms/index.cfm?fa=view&id=3793

18 http://economix.blogs.nytimes.com/2014/03/10/how-aid-to-the-poor-is-also-an-investment/?_r=0

19 On the EITC's poverty reduction impact see http://www.cbpp.org/cms/index.cfm?fa=view&id=2505 CBO income data show that taxes and transfers reduced the market-income Gini by about 25% in recent years: https://www.cbo.gov/publication/49440

provides a triple bonus: such investments are pro-growth, equalizing in the macro sense discussed above, and sustainable. But even if a policy is growth neutral as conventionally measured, it should be considered a PGEP if it produces environmental benefits.

But why should sustainable policies be thought of pushing back on inequality? For the simple reason that lower income people are more likely to be negatively affected by pollution and less likely to have the resources to escape this harm. In that sense, viewing sustainability initiatives as a PGEP requires expanding our metrics not just of "G," but of "E" as well.

Conclusion

The goal of this discussion has been to go wide, not deep. Towards that end, I've introduced a broad palette of policies that are both pro-growth and equalizing. While education policies have long been viewed through this lens, they are but one promising area. Especially given that significant output gaps exist—and not just in recessions, but in underperforming recoveries as well—PGEPs are actually not that hard to come by.

There is much that could build upon this work. Quantifying the magnitude of both aspects of the specific policies—their impacts on both growth and inequality—is a natural next step. For example, considering infrastructure investment or some of the anti-poverty policies cited above: what would be their quantitative impact on both the "G" and "E" of PGEP?

An ambitious but (I think) doable initiative would be to build a macro/micro simulation model that could accomplish such calibrations, i.e., a macro model that was built out to incorporate inequality parameters. For example, such a model could—as all macro models do today—simulate the impact of a more competitive dollar on the trade deficit. But the model I'm proposing would then run that impact through the labor market in terms of jobs, wage, and income effects and calibrate the resulting change in inequality.

Of course, as is said, "all models are wrong, but some are useful." I believe this one would be highly useful to advancing our understanding of PGEPs.