



Understanding Bushonomics

How We Got Into This Mess in the First Place

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August 2008

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Introduction

In 1914, Henry Ford convinced the directors of Ford Motor Company to increase the minimum wage it paid most workers to \$5 a day. In return, Ford, the first company to use the assembly line to produce automobiles, got greater commitment from its employees to help management achieve the potential efficiencies possible with assembly production. In addition, the company gained so much free publicity that it was able to virtually eliminate its advertising budget for years after the announcement. But Henry Ford argued years later that the biggest benefit to the company was the enrichment of its workforce, *“For on that day we first created a lot of customers.”*¹



For a time, Ford's action put upward pressure on wages not only among automobile manufacturers but in other industries as well. In less than a decade, however, Ford's leadership in profit sharing was almost totally ignored by most U.S. businesses. The 1920s were a period of remarkable growth in industrial output. Between 1920 and 1929 worker productivity grew by 63 percent while real wages (after accounting for inflation) fell by 9 percent.² The benefits of this productivity boom accrued entirely to business. Part of it was distributed to stock holders in the form of dividends, helping to push share prices ever higher, while the remainder was invested in new plant and equipment, which further increasing productivity and industrial output.

That cycle continued until October of 1929, when Wall Street suddenly realized that consumers could not begin to purchase all of the goods and products that this capacity was capable of producing. The late Arthur Schlesinger wrote in *The Crisis of the Old Order*:

Management's disposition to maintain prices and inflate profits while holding down wages and raw material prices meant that workers and farmers were denied the benefits of increases in their own productivity. The consequence was the relative decline of mass purchasing power. As goods flowed out of the expanding capital plant in ever greater quantities, there was proportionately less and less cash in the hands of buyers to carry goods off the market. The pattern of income distribution, in short, was incapable of long maintaining prosperity.

The George W. Bush Team Plots Economic Policy

Nearly three quarters of a century after the 1929 crash, George W. Bush began gathering his economic advisors to prepare the policy agenda for his incoming administration. There seemed to be little appreciation of the lessons of either Henry Ford or the Great Depression. The first orders of business were massive tax cuts focused heavily on corporations and the highest income individuals to foster economic growth through assistance to the “supply side” of the economy.

Tax policy

An analysis in 2004 on the effects of the first three Bush administration tax cuts by the Congressional Budget Office showed that the average tax cut received by the top 1 percent of households (families with an average income of \$1.2 million) equaled more than \$83,000 while that of middle-income households (families with an average income of \$51,600) was less than \$1,000—even after excluding the “bonus depreciation” business tax cut and the phase-out of the federal estate tax. The percentage by which the effective tax rate was cut for high-income families was nearly twice the rate cut for those in the middle of the income spectrum.³

Minimum wage

The Bush economic team was also anxious to assist the “supply side” of the economy in ways that extended beyond tax cuts. One involved the cost of labor. The most immediate issue was whether the minimum wage should be adjusted for inflation. At \$5.15, it had been not been adjusted in three-and-a-half years, and had already fallen in real terms by 8 percent. Compared to the \$5 per day or \$0.63 per hour minimum that Henry Ford offered his employees in 1914 the federal minimum wage in 2001 amounted to about \$0.30 an hour in 1914 dollars.⁴

The Bush administration was careful not to directly oppose an adjustment in the minimum wage, but threatened to veto the measure if it were not accompanied by further large business tax cuts. These it was argued were necessary to offset the negative effects on businesses that were forced to pay higher wages.⁵

The result of the administration's position was that the minimum wage was stuck at \$5.15 for a total of 10 years, the longest period without adjustment since it was instituted in 1938. In inflation-adjusted dollars it reached its lowest value in over 50 years, dropping by 29 percent before the new law was adopted in 2007.⁶

Enforcement of federal wage and hour laws

Two recent reports by the Government Accountability Office found that the Wage and Hour Division at the U.S. Department of Labor was flagrantly failing to meet its responsibility to enforce laws intended to prevent worker exploitation, and to oblige employers to pay wages owed to their employees. In 15 wage cases examined by GAO, the office concluded that the Wage and Hour Division had inappropriately rejected complaints because of incorrect information provided by employers; that it had failed to make sufficient efforts to locate employers; and that it did not thoroughly investigate and resolve complaints.⁷

GAO said that it had found more than 100 cases that had been closed because the Department of Labor had failed to locate the employer. In 350 cases the department had failed to assign the complaint to an investigator for more than a year after it had been received⁸

In one case examined by GAO, a pool maintenance technician had filed a complaint saying that he had not received a final paycheck. The investigator was informed by the employer that he had in fact failed to pay the wages due the employee but the investigator still dropped the case.⁹

Another case involved a homeless woman employed as a night attendant at an assisted-living facility. She filed a complaint stating that the facility had not paid her any wages for more than a year. The facility contended that it did not have to pay wages because it provided her with room and board. Despite the fact that the Department of Labor's examination of the case indicated that the employer owed the woman \$4,500, the investigator dropped the case when the facility argued that it was financially unable to make the payment. According to GAO, the facility continued to be in business more than a year later.¹⁰

A CNN commentator concluded that the Labor Department should be relabeled the Department of Cheap Labor. The Chairman of the House Education and Labor Committee, Congressman George Miller (D-CA) stated, "In too many cases investigators from the Wage and Hour Division simply drop the ball in pursuing employers that cheat their employees out of their hard-earned wages."¹¹

Unions

Another important issue was use of the various legal authorities of the federal government that regulate the procedures by which workers can seek to be represented by labor unions. As recently as the Ford administration, Republican office holders had not only

used those authorities to protect worker rights but had also worked to expand those rights. That, however, was not on the agenda of the incoming Bush administration. Earlier this year, Sen. Edward Kennedy, Chairman of the Senate Health, Education, Labor, and Pensions Committee said of Robert Battista, the man Bush had selected to run the National Labor Relations Board for nearly the entire two terms of his presidency, that he had *“led the most anti-worker, anti-labor, anti-union Board in its history.”*¹²

The NLRB affects the outcome of organizing efforts in two ways. First, it administers elections to determine if a particular plant or workplace is to be represented once workers have demonstrated sufficient interest in having representation. Delays in holding elections almost always work to the advantage of an employer that is opposing representation of his workforce. Under the Battista regime the delays were lengthy.¹³

Second, the Board rules on issues that are not clearly defined by law. In a series of rulings the Battista Board determined that large segments of the workforce were not eligible for representation, including so-called “charge” nurses who provide even the lowest level of supervision to other health care workers. The precedent that this ruling sets for other industries creates the potential of eliminating nearly a quarter of the American workforce from the right to be represented by a union. In other cases, the Battista Board denied the right to organize to graduate students, temporary employees, and certain disabled workers.¹⁴

A Center for American Progress report written by this author last November detailed widespread abuse of administrative authorities by the Labor Department’s Office of Labor Management Standards. The report detailed the office’s use of the Taft-Hartley law to harass labor unions with complex and redundant accounting and reporting requirements; to present false and misleading information, grossly exaggerating the level of criminality found among union employees and officers and coordinating activities; and to disseminate misleading information with partisan political operatives and organizations dedicated to undermining and destroying labor organizations.¹⁵

Enforcement of trade agreements

Another major issue was the enforcement of U.S. trade agreements. Free trade allows nations to compete in selling their products based on natural advantages, including the access to natural resources, workforce skills, and even low wages. But trade agreements also prohibit subsidies that provide an industry within a particular nation further advantage. The Bush Commerce Department provides businesses interested in selling their products in China with the following advice:

Chinese competitors, particularly those from the state-owned sector, often enjoy very low costs of capital. Thus, they can enter markets quickly, and they can expect to receive strong encouragement from the government for their efforts. The Chinese government makes no secret of its support for state-owned enterprises. Foreign companies should not expect a level playing field.¹⁶

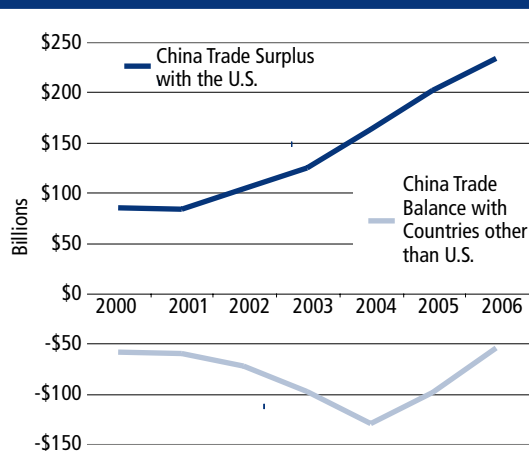
To the extent this description accurately describes the unfair competition in China's domestic markets, it equally describes the Chinese export sector, which now accounts for 41 percent of the nation's Gross Domestic Product.¹⁷ While the Bush administration has acknowledged these facts in complaints to the World Trade Organization, it has refused to take the concrete steps necessary to change China's abusive trade practices. As a result the incentive for U.S. businesses to move production facilities from the United States to China has grown steadily. The advantage of joint ventures with the Chinese include not only much lower wages but in most instances lower cost of capital, cheaper rents, and subsidized energy.

Since 2000, the U.S. bilateral trade deficit with China has more than tripled, from \$83 billion to more than a quarter of a trillion a year in 2007.¹⁸ Not surprisingly, China has run an overall trade surplus in each of those years but that overall surplus has been markedly smaller than the surplus with the United States. In other words, China has run a trade deficit with most of the rest of the world while running huge surpluses with the United States.¹⁹

This has had dramatic effects on manufacturing employment in the United States. Between May 1992 and May 2000 U.S. employment in manufacturing grew by 445,000, or nearly 3 percent. In the subsequent eight years manufacturing jobs fell 3.7 million, or more than 21 percent.²⁰

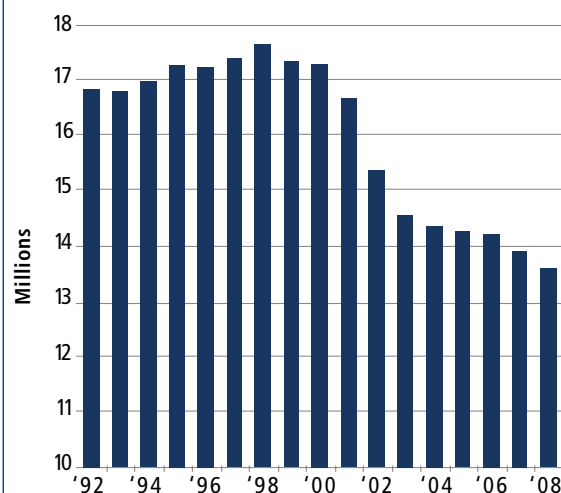
The movement of manufacturing jobs to China affected U.S. household incomes in several respects. First, it reduced the overall number of jobs in the economy and contributed to the nearly 2 percent decline in adult workforce participation that

FIGURE 1. CHINA'S TRADE SURPLUS WITH THE U.S. COMPARED TO ITS DEFICIT WITH THE REST OF THE WORLD



Chinese Statistical Yearbook, Foreign Trade and Economic Cooperation, available at <http://www.stats.gov.cn/tjsj/ndsj/2007/indexeh.htm> and U.S. Census Bureau, U.S. Exports, Imports, and Merchandise Trade Balance by Country: 1990 to 2006, available at <http://www.census.gov/compendia/statab/tables/08s1278.xls>

FIGURE 2. U.S. EMPLOYMENT IN MANUFACTURING



Bureau of Labor Statistics, Current Employment Statistics.

occurred between 2000 and 2008. Second, the jobs available to workers forced from the manufacturing sector were often lower paying than the jobs they had lost. Jobs in retail trade on average pay about 25 percent less than jobs in manufacturing, while jobs in the leisure and hospitality industry pay about 40 percent less.²¹

Finally, the loss of so many jobs in the manufacturing sector clearly had a chilling effect on the wages of those who remained in that sector. As more and more factories were relocated overseas the threat of relocation became more credible to employees that might have otherwise insisted on pay increases. While inflation-adjusted wages in manufacturing grew by about a dollar between 1995 and 2003, they have since fallen below 1995 levels.²²

Immigration

It is not clear that more vigorous and effective enforcement of U.S. immigration and foreign worker laws would have markedly reduced the flow of undocumented workers accepting low paid jobs in the United States in recent years. It is likewise unclear how much the mismanagement and general chaos that characterized the newly created Department of Homeland Security agency for Immigration and Customs Enforcement contributed to the flow of cheap but illegal labor into the United States. It is clear, however, that numerous organizations tightly aligned with the Bush White House represent businesses that benefited greatly from the influx of undocumented workers.

Most prominent among these organizations is the National Restaurant Association. Its website proclaims that association members employ 12 million workers or 9 percent of the total U.S. workforce. As John Gay, the association's director of government affairs, explains, *"We value the work done by our employees, documented **or not.**" During the 2006 elections, the association focused nearly 90 percent of its contributions on candidates and organizations who were allied with the current White House.*²³

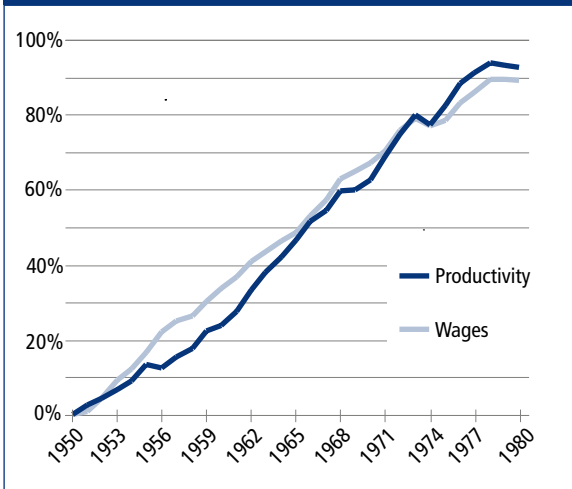
Other major and politically active organizations with a keen interest in illegal worker policy include the National Association of Home Builders, the American Meat Institute, the American Nursery & Landscape Association, and American Hotel & Lodging Association. All of these organizations have targeted the majority of their political contributions on organizations and candidates aligned with the Bush White House.²⁴

Stagnating wages and declining household incomes

It is difficult to calculate the individual impact that each of the factors listed above has had on wages over the past seven years, but the cumulative impact of all of those factors is quite clear. In 2000, the average weekly earnings of production and non-supervisory workers (a group that makes up about 80 percent of the workforce) was \$580. After six years it had risen to only \$589, an increase over 7 years of less than 2 percent.²⁵

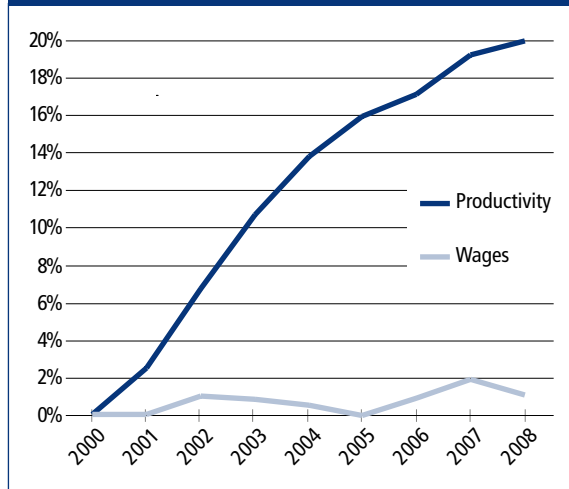
The extremely slow growth of compensation during this period stands in stark contrast to the growth of the overall economy—and in particular to the growth in worker productivity. During the same period the overall economy grew by 18 percent, heavily driven by increases in the hourly productivity of American workers, which grew by more than 19 percent.⁶

FIGURE 3. GROWTH OF HOURLY PRODUCTIVITY & HOURLY WAGES 1950 to 1980



Bureau of Labor Statistics, *Major Sector Productivity and Costs*.

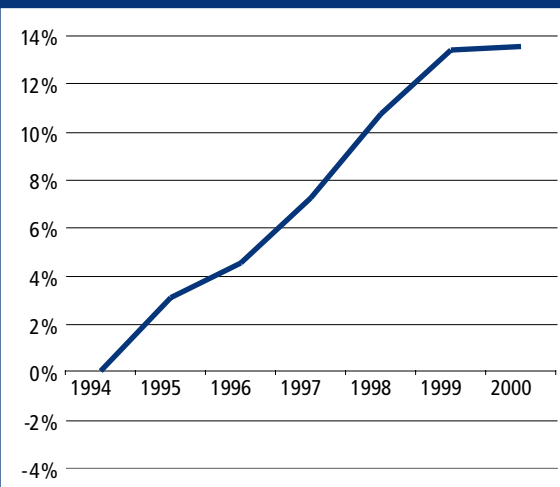
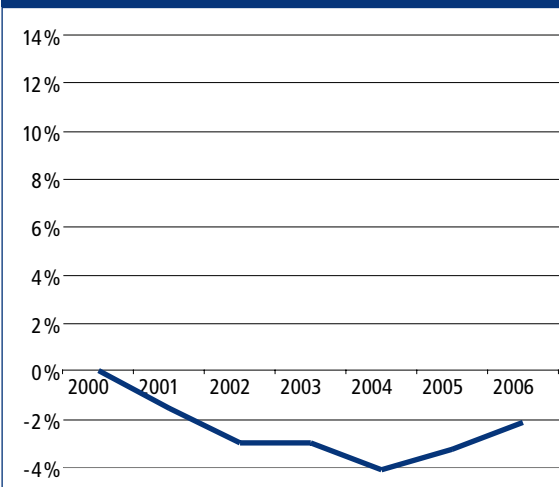
FIGURE 4. GROWTH OF HOURLY PRODUCTIVITY & HOURLY WAGES 2000 to 2008



Bureau of Labor Statistics, *Major Sector Productivity and Costs*.

Such a separation between worker productivity growth and wage growth is highly unusual. For the 30-year period between 1950 and 1980, wages and productivity growth closely paralleled one another every year for a full 30 years. Overall during that period productivity grew by 92 percent while wages grew by 89 percent.

Families have been affected not only by stagnant wages but also by slow job growth. As a result, fewer family members were likely to be working. Between 2000 and 2006, total non-farm payrolls expanded by only 3.3 percent, while the population grew by nearly 6 percent. As a result, the annual inflation-adjusted income of middle-income families²⁷ actually declined despite the small increase in weekly earnings. By 2006, the last year for which data is available, the average income of middle-class households (families between the 40th and 60th percentiles of all families measured by income) was 2 percent lower than the inflation-adjusted income of the same grouping in 2000. During the previous 6-year period, that group enjoyed a 14 percent increase in inflation-adjusted income.²⁸

FIGURE 5. CHANGE IN ANNUAL INCOME OF MIDDLE INCOME HOUSEHOLDS 1994 to 2000Bureau of Labor Statistics, *Current Employment Statistics*.**FIGURE 6. CHANGE IN ANNUAL INCOME OF MIDDLE INCOME HOUSEHOLDS 2000 to 2006**Bureau of Labor Statistics, *Current Employment Statistics*.

Strong economic growth and declining incomes?

Repeatedly over the past seven years the Bush White House has touted “strong economic growth” as proof the president’s policies were working. The economy did in fact grow at a reasonably strong pace through most of the Bush presidency. Between 2000 and 2006 real gross domestic product increased by a little more than \$2 trillion, or about 17 percent. The question is, however, who benefited from that growth?

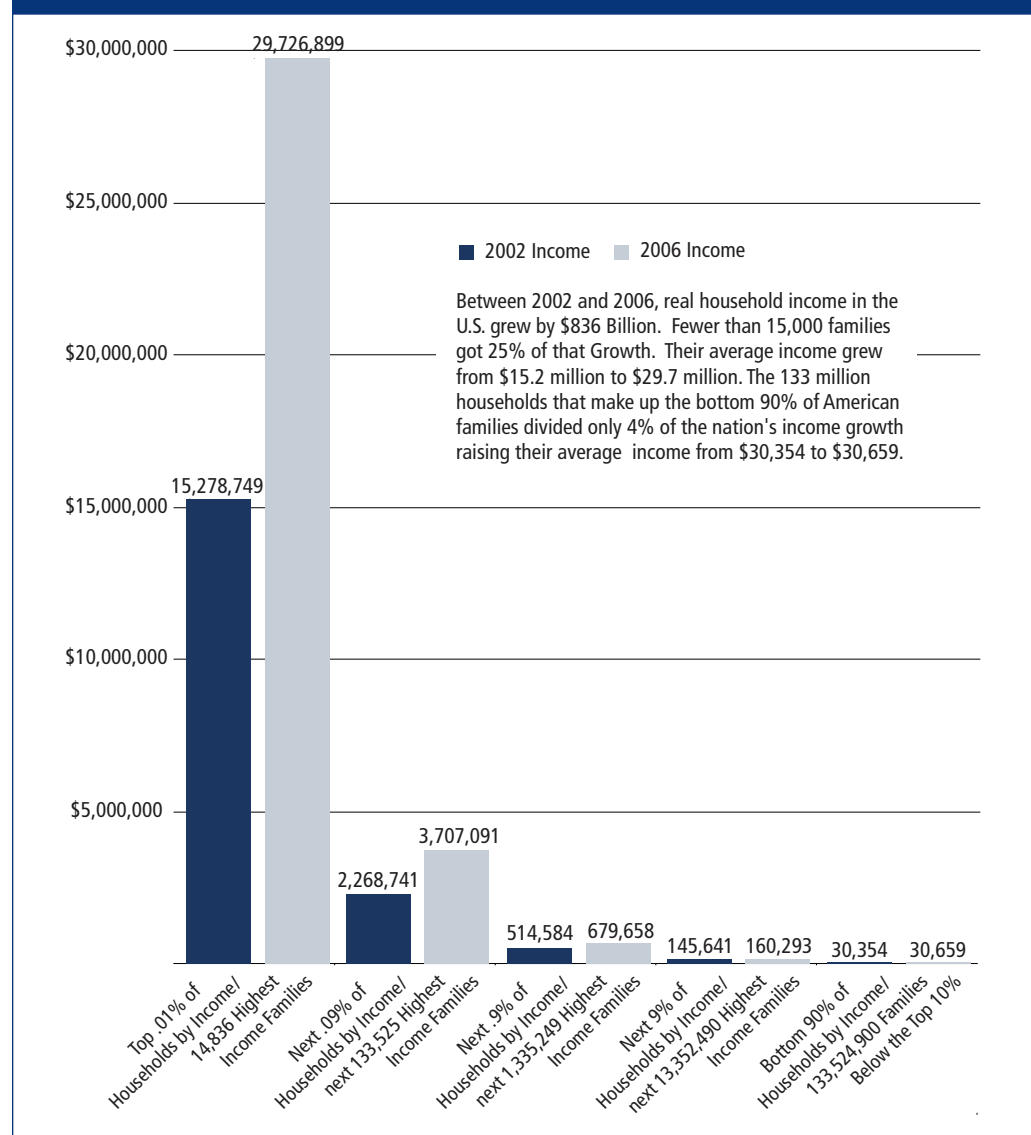
The Commerce Department’s national income and product accounts indicate that between 2000 and 2006, personal income when adjusted for inflation grew by a little more than one trillion dollars, or by about 10 percent.²⁹ But data collected by in the Current Population Survey administered by the same department indicate that not only did middle-income households lose ground but so did the vast majority of other Americans. While the middle fifth of U.S. households were on average 2.5 percent worse off in inflation-adjusted income in 2006 than in 2000, the next lower fifth was 3 percent worse off while the bottom fifth saw their incomes decline by 4.5 percent. More surprisingly the average income of upper-middle-income families also declined in real terms. Households between the 60th and 80th percentiles on average saw their income drop by about \$500, to \$73,329.³⁰

The Current Population Survey is generally presumed to provide reliable data on income trends for the population as a whole, but it is flawed with respect to households at the very high end of the earning scale. That portion of the population is small in number, difficult to reach by normal survey techniques, and often unwilling to be forthcoming about the details of their personal finances.

An alternative method of estimating income growth by this group has been developed by Thomas Piketty of the Paris School of Economics and Emmanuel Saez of the University of California, Berkeley. Using U.S. Internal Revenue Service statistics from federal tax returns they have developed a time series estimating the annual income shares of U.S. households dating back to 1913 when the income tax was instituted.³¹

Their analysis of the tax data indicates that between 2000 and 2006 the income of U.S. households after adjusting for inflation increased from \$7.4 trillion to slightly more than \$8 trillion. Since the number of households increased during that period from 134 million to 148 million, the growth in income was insufficient to prevent the average

FIGURE 7. FEWER THAN 15,000 FAMILIES GET ONE QUARTER OF NATION'S PERSONAL INCOME GROWTH 2002-2006



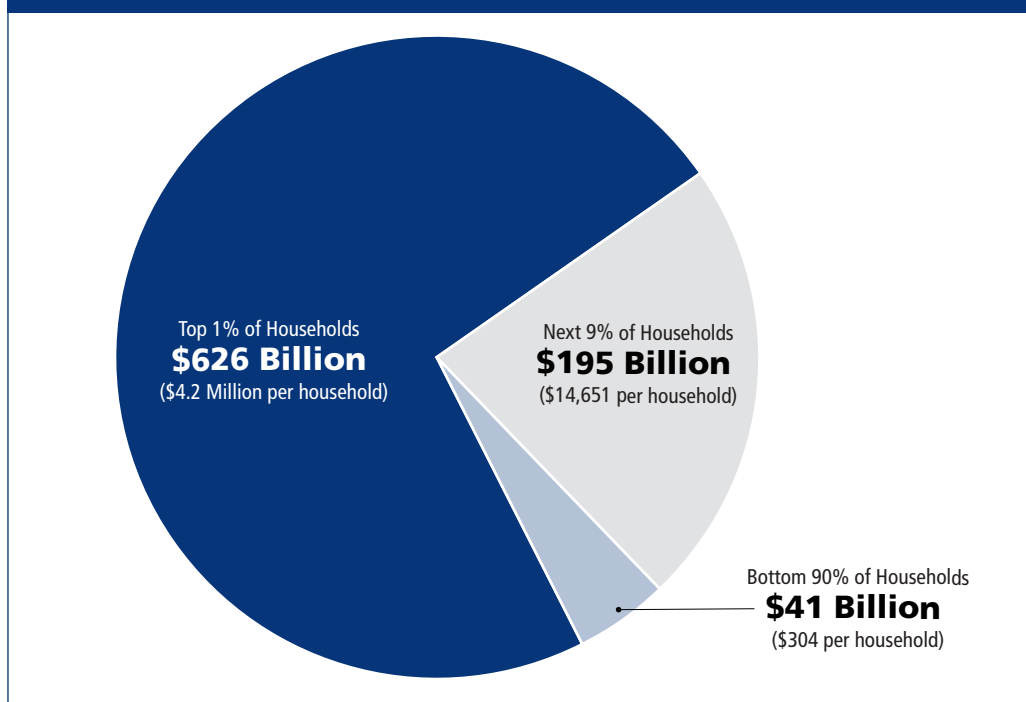
Emmanuel Saez and Thomas Piketty, "Income Inequality in the United States, 1913-1998 UPDATED." *Quarterly Journal of Economics*, 118(1), 2003, 1-39.

income per household from falling. Families fared quite differently, however, depending on where they were on the income spectrum. Those among the top 10 percent of all households on average increased their income by about 2 percent, while those in the bottom 90 percent lost more than 4 percent. These weak figures for income growth are reflective of the impact of the economic downturn that occurred in 2001 and continued into 2002.³²

What is remarkable about the Piketty-Saez data, however, is the distribution of economic growth during the first four years of the so-called “Bush Recovery,” the period between 2002 and 2006 (the last year for which IRS data is available). During this period, average household income grew from \$48,346 to \$54,444, or in aggregate by \$863 billion. But the distribution of that growth was astonishing. The top one-hundredth of 1 percent of households enjoyed a 95 percent increase in their income. On average, the income of these 14,836 families increased from \$15.3 million a year to \$29.7 million. By 2006, their aggregate annual income exceeded \$441 billion, or more than 5 percent of the household income of the entire country. Between 2002 and 2006, these 15,000 families accounted for almost one quarter or all household income growth.

The remaining 134,000 households in the top one-tenth of 1 percent also did well. On average their incomes rose by 63 percent from \$2.3 million a year to \$3.7 million. This group accounted for another 22 percent of the nation’s total income growth.

FIGURE 8. HOW THE \$863 BILLION IN HOUSEHOLD INCOME GROWTH DURING THE FIRST FOUR YEARS OF THE BUSH RECOVERY (2002-2006) WAS DIVIDED BY INCOME GROUP



Emmanuel Saez and Thomas Piketty, “Income Inequality in the United States, 1913-1998 UPDATED.” *Quarterly Journal of Economics*, 118(1), 2003, 1-39.

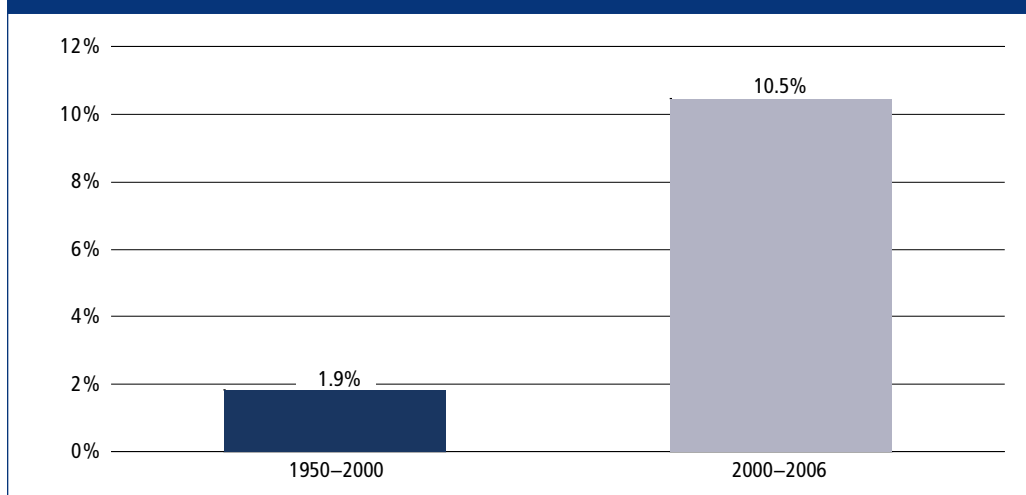
Besides the two groups mentioned above, there are another 1.3 million households that make up the top 1 percent. These families certainly did well, but not nearly as well as those at the top of their percentile. On average, their incomes grew from \$515,000 to \$680,000, or by 32 percent. They accounted for another 25 percent of the nation's total growth in household income.

In 2002, households between the 90th and the 99th percentile had incomes ranging from \$100,000 and \$309,000 a year. On average their income was \$146,000. They did markedly less well than the top 1 percent of households, but still held their own, with their average income rising to \$160,000 after adjusting for inflation, or by about 10 percent. Most of these gains, however, were among the higher-income families, with those at the top end gaining about 22 percent and those at the bottom gaining only 4 percent. As a group, these 13 million plus families accounted for a little more than 22 percent of the nation's income growth.

In total, the top 10 percent of families accounted for 95.3 percent of the nation's income growth between 2002 and 2006, leaving the other 133 million families in America to divide up the remaining 4.7 percent of the nation's income growth. The average real income for families in the bottom 90 percent of households increased by about \$300 to a little less than \$30,700. Other data suggests, however, that all of that increase went to families in the 80th to 90th percentiles, and that the vast majority of households experienced declining incomes during the Bush expansion.

According to calculations by Piketty and Saez, the top 10 percent of U.S. households accounted for 49.32 percent of all household income in 2006—the highest level of any year in the data series, including 1928, when it was 49.28 percent. They have increased their share from 43 percent 10 years ago and from 33 percent 30 years ago.

FIGURE 9. AVERAGE ANNUAL RATE OF GROWTH IN REAL CORPORATE PROFITS
(PreTax Profits Adjusted for Inventories and Inflation)



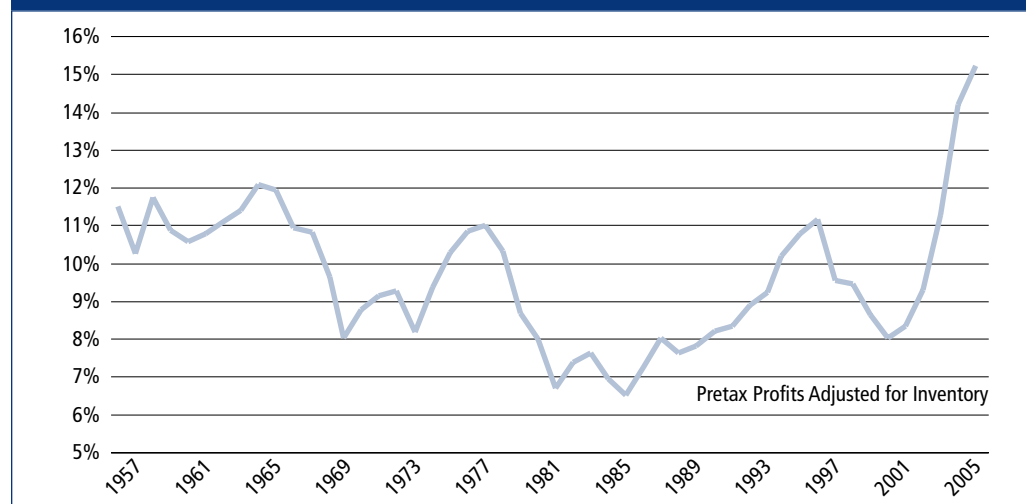
Bureau of Economic Analysis, *National Income and Product Accounts*.

Corporate profits

But the biggest beneficiaries of U.S. economic growth that occurred between 2000 and 2006 were U.S. corporations. One would expect corporate profits to grow in relationship to the growth of the overall economy. During the second half of the 20th century, corporate profits grew at a little less than two-thirds the growth rate of the gross domestic product when both were adjusted for inflation. GDP increased by 368 percent during that period while corporate profits grew by 218 percent. But between 2000 and 2006 corporate profits grew nearly four times as fast as GDP. While GDP increased by 17 percent, profits grew from \$985 billion to \$1.632 trillion or by 66 percent. In the 50 years prior to 2000 the average annual growth rate of real corporate profits was 1.9 percent. Between 2000 and 2006 it was 10.5 percent.³³

As a result the share of the nation's income accounted for by corporate profits grew dramatically during the Bush presidency while the share going to individuals declined. Between 2001 and 2006 corporate profits jumped from 8 percent of national income to more than 15 percent—significantly higher than at any point in the past half century.

FIGURE 10. CORPORATE PROFITS AS A PERCENTAGE OF NATIONAL INCOME
50 Years from 1957 to 2006



Bureau of Economic Analysis, *National Income and Product Accounts*.

Stagnant wages, falling incomes, and consumer demand

Rising productivity means that the nation is producing more per worker. If 100 workers are producing 100 widgets per day and the level of productivity rises to 101 widgets per day, then buyers must be found for the additional widgets or one worker will have to be laid off. Productivity increases inevitably raise the question, who will pay for the increased output?

That is precisely the problem that rising output and stagnant wages were creating for the U.S. economy in the early years of the Bush administration. Corporations were retaining a very large share on income growth and nearly all of the portion that was going to individuals was going to extremely high-income individuals who were not likely to spend very much of it.

Corporations can create a great deal of demand through investments in plant and equipment. But despite the fact that corporate profits grew by 66 percent between 2000 and 2006, annual national investment in nonresidential structures (largely commercial structures such as factories and office buildings) fell by \$130 billion or more than 30 percent. While investment in equipment and software increased it did not increase nearly as fast as profits and did little more than offset the decline taking place in nonresidential structures. Overall investment in buildings, equipment, and software grew by less than 6 percent during a period in which corporate profits had increased by two-thirds.³⁴

Corporations recognizing the precarious condition of the U.S. consumer were prudent stewards of their shareholders money. They retained profits, bought back their own stock and increased dividends rather than expand capacity.

High-income individuals can also spend a good deal of their rising income and generate demand to absorb rising output. There has been ample evidence in recent years of high levels of consumption by well-to-do individuals, including booming markets in yachts, luxury automobiles, mansions, original art, and expensive jewelry.³⁵ Even so, the Piketty and Saez data seems to indicate that much of this increased income went to savings rather than consumption. It is hard to imagine that most of the 15,000 households that saw their incomes rise between from a little over \$15 million a year to almost \$30 million a year between 2002 and 2006 did not save a substantial portion of that increased income. The same would probably be true for many of those 133,000 families who on average saw their incomes rise from \$2.2 million to \$3.7 million during that period and those two groups combined.³⁶

Trade

The problem of the deteriorating finances of ordinary consumers and the unwillingness of businesses to reinvest their profits was further exacerbated by the fact that over this period the United States maintained a large and growing trade deficit. Our trading relationships have resulted in more products from overseas being added to the domestic market place each year without a commensurate increase in domestic product being shipped abroad. As a result, imports have absorbed an increasing share of domestic demand.

Fixing the demand problem (temporarily)

While much was written during the first six years of the Bush administration about the surprising resilience of the American consumer, that resilience is far less impressive when viewed in the context of the highly stimulative economic policies implemented during that period. The combined impacts of the Bush tax cuts and the Iraq war erased the \$236 billion budget surplus the country had enjoyed in fiscal year 2000, creating a \$413 billion dollar deficit by 2004—a \$650 billion turnaround.³⁷

Such deficits may be bad for the long term fiscal well-being of the country, but they are highly positive for the short-term demand of goods and services. In FY2002 alone the deficit increased by \$286 billion, or by 2.8 percent of GDP—the largest dose of fiscal stimulus in more than a quarter of a century. The following year it grew by \$220 billion, or nearly 2 percent of GDP, the second-largest stimulus in a quarter century.³⁸

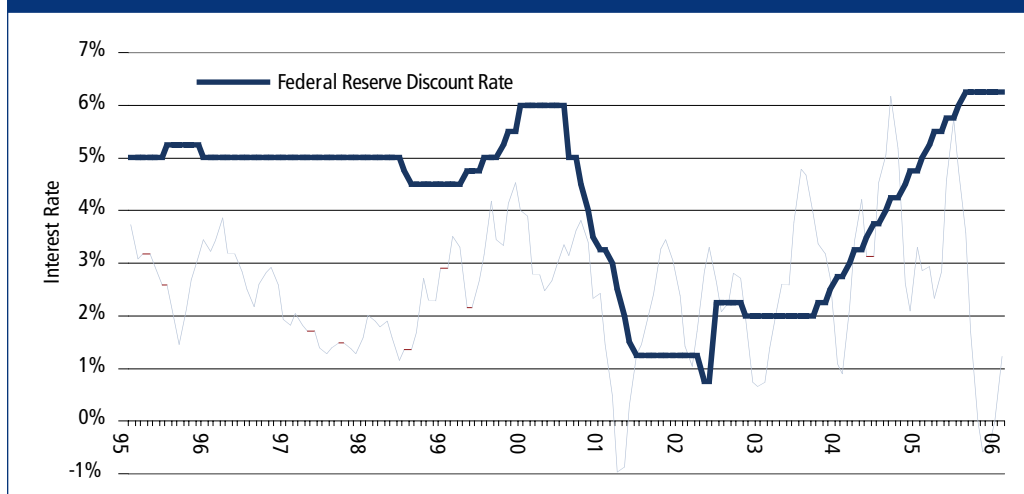


President Bush awards Federal Reserve Chairman Alan Greenspan with the Medal of Freedom

But the economy clearly needed a boost beyond what the growing deficits could provide. That job was left to the Federal Reserve. In January 2001, the Fed Reserve Discount Rate (the interest rate charged by the Federal Reserve to member institutions for short-term lending) was 6.0 percent.³⁹ Less than two years later it had dropped to 0.75 percent even though inflation was averaging close to 3.0 percent during that period.⁴⁰

FIGURE 11. LENDING MONEY BELOW THE RATE OF INFLATION

Federal Reserve Discount Rate Compared to Consumer Price Index (1995 to 2006)



Federal Reserve Bank of New York, *Historical Changes of the Target Federal Funds and Discount Rates*, available at <http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html>. and Bureau of Labor Statistics, Consumer Price Index, 7 month rolling average.

It is an extraordinary act to loan money at interest rates that are below the rate of inflation. Money that is invested in a wide variety of items (even canned goods from the grocery store) is likely to appreciate faster than the cost of borrowing. The Fed's dramatic reduction in the cost of money to member banks began a frenzy of economic activity. Mailings offering new credit cards, car loans, home equity loans, and other lines of credit flooded mail boxes from coast to coast. But the biggest immediate effect was in home mortgage refinancing.

In normal times Americans spend more in a year on purchasing and renovating houses than the amount they borrow in new mortgages. That is because most home sales involve some amount of down payment by the purchaser. Some purchasers—particularly those trading up from an existing home—may put down a majority share of the purchase price. During the 1950s mortgages covered about 50 percent of home purchases and improvements. By the 1970s that portion had risen to above 80 percent.⁴¹ But by 2001 mortgages were becoming much more than a way to finance home purchases. In 2000, the growth in mortgage debt roughly equaled the value of home purchases and improvements, but by 2002 mortgage debt was growing at a rate 65 percent faster than the amount being spent on home purchases and improvements. By 2003 it exceeded those expenditures by 75 percent.

Extremely low interest rates and a growing industry in mortgage origination and lending had made it possible for hard-pressed consumers to maintain and even improve their living standards by taking equity out of their homes.⁴² The loose credit policy was justified on the basis that the country needed economic stimulus, but no one in the White House, the Treasury Department, or the Federal Reserve seemed to comprehend that loaning huge amounts of money to families with stagnant incomes would simply delay and ultimately worsen the day of reckoning.

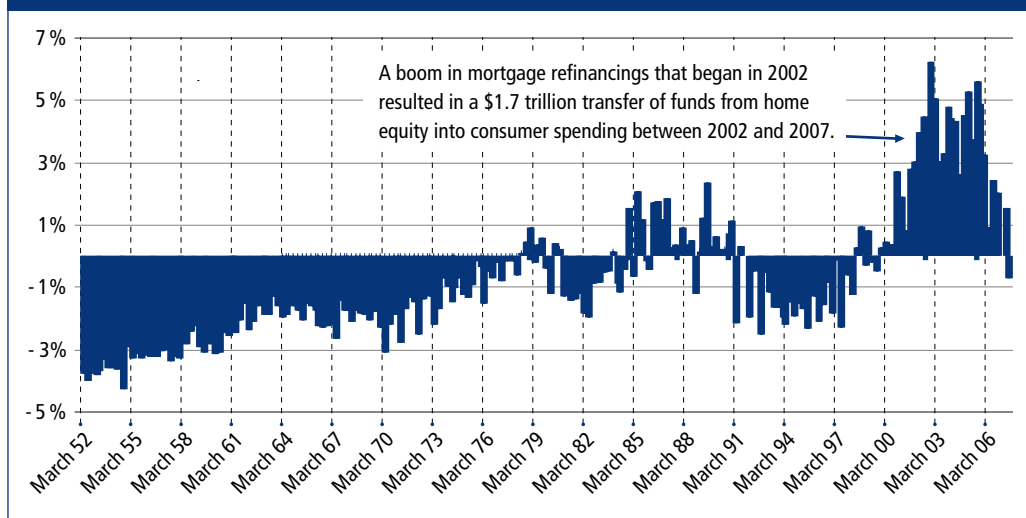
Between 2002 and 2007, home mortgage debt of \$1.7 trillion was more than the amount spent on home purchases and improvements. “Cash outs” of home equity added 3.6 percent to consumer purchasing power in 2002, 4.5 percent in 2003, 4.2 percent in 2004, 4.1 percent in 2005, and 3.7 percent in 2006.⁴³

But by 2007 the refinancing frenzy had run its course. Cash out from home equity provided only 1.5 percent to disposable income. Now, in addition to all of the other problems facing the economy, the tail wind that refinancing added to consumer demand was beginning to reverse, soon to become a head wind. In the first quarter of 2008, mortgages financed only 81 percent of home purchases and improvements, and home purchase/mortgage activity was taking about 1 percent out of disposable income rather than adding to it.⁴⁴

Of further concern is the tremendous growth in mortgage debt. As recently as 1996, mortgage debt was roughly equal to the national debt (held by the public), with both standing at about \$3.7 trillion. While the national debt has risen in nominal (non-inflation adjusted terms) by about \$1.1 trillion, mortgage debt has risen by \$6.7 trillion, or

more than six times as fast. If adjusted for inflation, mortgage debt is rising more than 100 times as fast. That means that for many years home owners will be using substantially more of their disposable income to make mortgage payments.⁴⁵

FIGURE 12. TURNING HOMES INTO ATM MACHINES
Value of New Mortgages Less Value of Home Purchases & Renovations
 (Quarterly Data from January 1952 to March 2008)



The Federal Reserve, Flow of Funds Accounts of the United States, available at <http://www.federalreserve.gov/releases/z1/Current/>.

Housing bubble

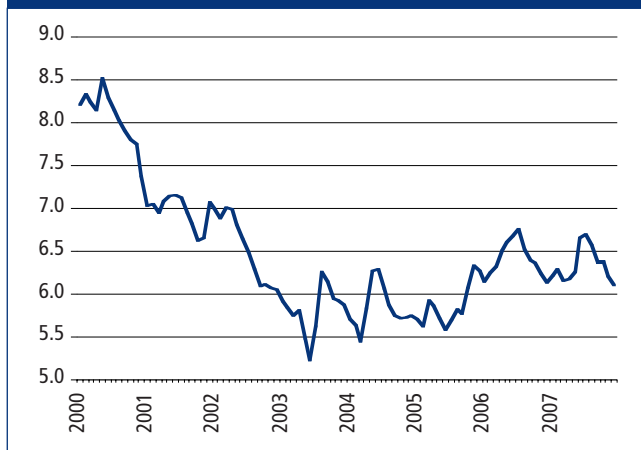
In addition to the massive amounts of cash that falling mortgage rates permitted home owners to convert from home equity—and the short-term impact that had on consumer demand for a wide array of products and services—there was another major consequence of the highly accommodative monetary policy followed by the Federal Reserve during the George W. Bush presidency. Declining interest rates allowed home buyers to pay more for housing, which induced dramatic increases in residential real estate prices. In 2000, the average interest rate on a 30-year, fixed-rate mortgage was slightly above 8 percent. The median price paid for existing homes that year was \$140,000. By June of 2003, 30-year fixed-rate mortgages were available for 5.25 percent.⁴⁶

Unfortunately, the low interest rates did not make houses in most parts of the country more affordable. By 2003 the median price for an existing home had jumped to \$175,000, and the monthly principal and interest payment needed to buy a median priced house was approximately the same as it had been in 2000. But the feeding frenzy in real estate continued even as interest rates stabilized. Lenders looked for new ways to maintain volume, including lending to individuals who would have not previously quali-

fied as borrowers. As long-term interest rates pushed above 6.5 percent in 2006, the median price of existing homes leveled off at \$229,000—65 percent above the level it had been six years earlier.⁴⁷

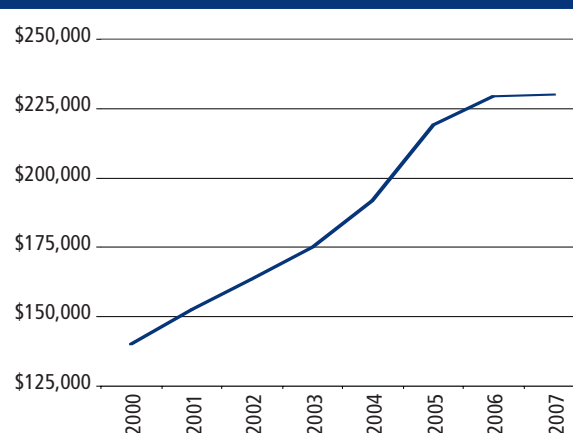
The unraveling of the real estate market that began in the summer of 2007 will in all probability continue for years. It has destabilized the financial system, required billions in bailouts, and continues to haunt national and worldwide equity markets. At the heart of the problem is the fact that even with a 15 percent to 20 percent decline in residential real estate values in many parts of the country, prices are too high to be affordable for most potential buyers.⁴⁸

FIGURE 13. AVERAGE 30 YEAR FIXED RATE MORTGAGE RATES FROM 2000 TO 2007



Freddie Mac, "Economic and Housing Research," available at <http://www.freddiemac.com/news/finance/>.

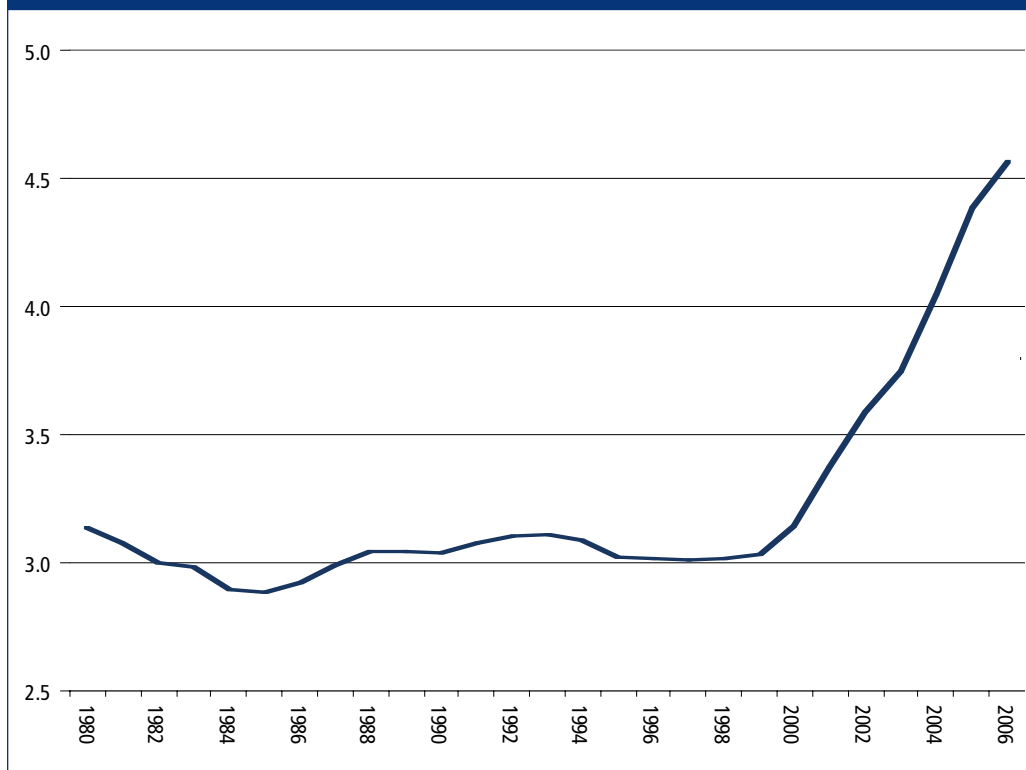
FIGURE 14. MEDIAN PRICE OF EXISTING HOMES JUNE DATA FROM 2000 TO 2007



National Association of Realtors, "Housing Statistics," available at <http://www.realtor.org/research/research/ehspage>.

The housing affordability index produced by the Harvard Joint Center for Housing Studies provides a disturbing picture of what will be required to return to normalcy. The index divides the median sale price of houses in specific metropolitan areas by the median income in those areas. Nationally the index remained remarkably steady from the date it was instituted in 1980. For 20 years it averaged 3.0 points, never rising above 3.1 or falling below 2.9. But it rose from 3.1 in 2000 to 3.4 in 2001, 3.6 in 2002 and finally to 4.6 by 2006. As median income is not rising in real terms, the downward price adjustments that have taken place so far are not nearly enough to reach the affordability levels that dictated the market prior to 2000.⁴⁹

FIGURE 15. NATIONAL HOME AFFORDABILITY INDEX
(Ratio of Median Income to Median Home Price)



Joint Center for Housing Studies of Harvard University, "The State of the Nation's Housing 2008," available at <http://www.jchs.harvard.edu/publications/markets/son2008/son2008.pdf>

Conclusion

This is not a complete review of all of the things that have happened to the American economy over the past seven-and-a-half years. Much could be said about the agglomeration of behemoth financial institutions and the growing lack of transparency in the financial products produced by those institutions. Failure by government regulators to recognize the challenges such changes posed to free and open markets contributed directly to the financial crises that continue to rile world equity markets.

Failure to pursue sensible energy policies has also taken a serious toll on our economy. While we must do a number of things if we are to relieve consumers of high energy prices, two at the top of the list are more rapid development of alternative fuels, and more efficient use of existing energy supplies. Yet the Bush administration has from the outset repeatedly attempted to reduce government efforts in both areas. In his first year in office Bush proposed a 27 percent cut in renewable energy programs, including a 54 percent cut in solar energy. He proposed to cut energy-efficiency programs by 26 percent.⁵⁰

One might also note that while fiscal policy may too frequently be confused with overall economic well-being, that this too has been an area of dramatic decline during the Bush era, and that the nation's capacity to make needed investments and restore economic growth in the future has been weakened by this decline. In his first budget message to Congress, President Bush projected that surpluses would eliminate the national debt within a decade. Instead, the federal debt (held by the public) according to current projections will have grown by more than \$2 trillion dollars or 60 percent during the course of this administration.⁵¹

The crises in banking, housing, energy, and fiscal policy simply add to the already heavy weight on the economy, which was already severely constrained by the falling income of consumers, a problem that was greatly compounded by an explosion of household debt.

This paper does not attempt to provide specific policy proposals to address the various ailments that now afflict the U.S. economy. Rather, it has tried to examine the policies that got us to where we are in the hopes that such an examination will offer a baseline by which to measure other proposals for building the foundations of sustainable growth.

The most striking characteristics of the policies of the current administration would appear to be a lack of balance and sustainability. The size and distribution of the tax cuts were excessive. The unwillingness to raise any revenue to pay for the heavy cost of the Iraq war pushed the nation to uncomfortably high levels of borrowing. The dramatic expansion of credit created excessive debt and distorted the price of housing. It also weakened the dollar, pushing up oil prices.

But all of these stimulative policies were necessary because of the extraordinary transfer of wealth that took place between ordinary households and the extremely well-to-do, and the effort by this administration to address the consequences of that problem without addressing the root cause. That transfer drained the American consumer of the resources needed to keep the economy humming, and we have been able to sustain it only by borrowing from future prosperity and weakening our long-term capacity for growth. Ultimately we will have to relearn the lesson of Henry Ford: lasting prosperity is shared prosperity.

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Center for American Progress
1333 H Street, NW, 10th Floor
Washington, DC 20005
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