MEMORANDUM

To: U.S. Senate Banking, Housing and Urban Affairs Committee Chairman Mike Crapo and Ranking Member Sherrod Brown
From: Mike Konczal, Katy Milani, Lenore Palladino and Marshall Steinbaum
Date: April 14, 2017

RE: Roosevelt Institute's Proposals to Foster Economic Growth

This memorandum addresses the request from Senate Banking, Housing and Urban Affairs Chairman Mike Crapo and Ranking Member Sherrod Brown for legislative proposals to foster economic growth. We appreciate the opportunity to submit what we believe to be policies that will help consumers, market participants and financial institutions contribute to real economic growth and job creation. The Roosevelt Institute's forthcoming research on monetary policy, market concentration and tax policy explores this issue, and seeks to identify a range of policy levers, including legislative fixes, regulatory rulemaking and enforcement actions, to ensure the rules of our economy incentivize the financial sector to be a productive intermediary in the real economy and promote broad-based growth.

The narrative that financial regulation and financial reform, through the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), have hampered growth and job creation is unfounded. Rather, sluggish growth and job creation is fundamentally the result of weak demand and historically low private investment.[1] This is, in turn, largely due to perverse financial incentives that encourage financial extraction at the expense of real investment — incentives fostered by taxes, financial deregulation and other policy choices. These structural issues came to the surface in the 2007-08 Global Financial Crisis and continue to undermine growth.

The real challenge to economic growth and job creation is the combination of flawed economic policy and anticompetitive and extractive behavior in the financial industry, which can be corrected through:

1. Macroprudential regulations, including preserving and strengthening Dodd-Frank;
2. Monetary policy the supports full employment and growth;
3. Antitrust measures to promote competition in the financial sector; and,
4. Tax policy that disincentivizes excessive speculation and debt accumulation at the expense of real economic investment and growth.

[1] Mason, Josh W. 2015. "Disgorge the Cash: The Disconnect Between Corporate Borrowing and Investment." New York. NY: Roosevelt Institute. http://rooseveltinstitute.org/wp-content/uploads/2015/09/Disgorge-the-Cash.pdf (April 14, 2017).

1. Preserve and Enhance Regulation of Financial Institutions

A well-functioning financial sector plays a critical role in driving productive growth by raising capital and providing needed financing to sustain real economic activities. The U.S. financial industry has increasingly shifted away from its essential function, focusing instead on the pursuit of profits through unproductive or even predatory rent-seeking and speculative activities. As a result of far-reaching changes to the regulatory regime of the financial markets leading up to the Financial Crisis, private rewards for risk-taking have increased, driving up incomes for the top 1 percent. At the same time, productive activity and corporate investment have stagnated and weakened macroeconomic growth.

In Roosevelt's June 2016 report, *Untamed: How to Check Corporate, Financial and Monopoly Power*, we address the growth of the financial sector and propose a range of policy solutions to curb to curb the risks, complexities, and challenges of our modern, global financial system.[2] In this report, we identify key congressional and regulatory actions to strengthen the safety and soundness of the largest institutions and discourage risky activities. We also explore the impact of the financial system on the real and political economy, including the rise of corporate short-termism and the financial struggles of our municipal governments and public investments.

Policy Solutions: In order to ensure that the financial services industry is contributing to economic growth, financial stability and job creation, it is essential to preserve and enhance macroprudential regulatory measures. Our proposal includes:[3]

1. *Preserve Dodd-Frank.* Resist efforts to repeal entire sections of the law.
2. *Regulate the whole balance sheet*. Require higher leverage requirements, higher risk-weighted capital, and more long-term debt.
3. *Continue to push for rigorous testing of banks' living wills.* Ensure a clear liquidation process for when banks do fail to minimize the shock to the financial system and the economy more broadly.
4. *Coordinate regulation of international derivative transactions.* Require banks to deal in backstopped derivatives to reduce the risk of contagion,
5. *Rein in the shadow banking institutions and activities.* Regulate shadow banking entities and short-term debt instruments, such as repurchase agreements, over-the-counter derivatives, and securities lending, to prevent excess leverage and accumulation of systemic risks.
6. *Tackle corporate short-termism*. Limit share repurchases through regulatory action, reform private equity regulation by forbidding new debt to pay dividends to shareholders, and investigate pension obligations to make sure pensions are property funded through the Pension Benefit Guaranty Corporation (PBGC).

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[2] Abernathy, Nell, Mike Konczal and Kathryn Milani. 2016. "Untamed: How to Check Corporate, Financial and Monopoly Power." New York, NY: http://rooseveltinstitute.org/wp-content/uploads/2016/06/Untamed-Final-Single-Pages.pdf (April 14, 2017).
[3] A more detailed explanation of the following policy solutions outlined below can be found in the report.

2. Monetary Policy that Supports Job Creation and Growth

The Federal Reserve Board's (the Board) recent rate hike reignited debate about the extent of the economic recovery. The Board justified the hike by pointing to progress toward full employment (current unemployment rate is 4.5 percent) and price stability (current inflation rate is 1.9 percent)[4], along with concerns that waiting may require the central bank to raise rates drastically, which would risk disrupting financial markets. Federal Reserve Bank of Minneapolis President Neel Kashkari dissented and argued that, among other reasons, the rate hike is too soon given inflation is still below the central bank's 2 percent target.[5]

J.W. Mason and Mike Konczal's forthcoming research finds that the recovery is largely an illusion. Unemployment appears to have stabilized, but the overall recovery has been anemic compared to the economic growth trends projected before the Financial Crisis. Contrary to the picture painted by select indicators like unemployment rates, the U.S. continues to be in an extended recession because of the following:

1. *Below-trend growth:* Real per-capita GDP is over 10 percent below pre-recession forecasts based on the long-term trend. There is no precedent for a gap of this size or duration since the 1930s. The apparent fall in the "output gap" is due to downward revisions in estimates of potential GDP — there has been no recovery of the ground lost in the recession.
2. *Decreased employment and labor productivity:* The shortfall in GDP relative to the trend is due in equal measures to slower growth in employment and in labor productivity. Normally, these two variables counteract each other – a decline in both at once has historically been experienced only in recessions.
3. *A fall in employment that cannot be explained by demographics.* While it is often suggested that the fall in labor force participation is explained by the aging of the population, this accounts for less than half the decline. The majority of the decline reflects lower labor force participation within each age group.
4. *Low inflation, wages and interest rates.* Standard macroeconomic theory says that a fall in the economy's productive potential should be associated with higher inflation, forcing the central bank to raise interest rates. A reduced labor supply should also be associated with higher wages, as employers bid up the price of scarce labor. The fact that inflation, interest rates and wage growth are historically low strongly implies that the problem is with demand, not supply.

Policy Solutions: To promote growth and jobs creation, the Board should keep rates low, in line with the view of Board dissenters like Kashkari. With economic research showing that we are

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[4] Robb, Greg. 2017. "Fed raises interest rates by a quarter-point, sees two more hikes this year." *MarketWatch*. http://www.marketwatch.com/story/fed-raises-interest-rates-by-a-quarter-point-sees-two-move-moves-this-year-2017-03-15 (April 14, 2017).

[5] Kashkari, Neel. 2016. "Why I Dissented." *Medium*. https://medium.com/@neelkashkari/why-i-dissented-5f0fdc48440a#.xkcx0yzcp (March 17, 2017).

not operating at full economic capacity, policymakers in Congress should voice their support of this position. Congress must also pass legislation that brings about a beneficial fiscal stimulus, alongside corporate governance and tax reform to promote innovation and investment. Furthermore, if the economy is suffering from weak demand, this implies that supply-side solutions like deregulation are fundamentally misguided. In a demand-constrained environment, lowering costs for business only pushes the economy toward deflation, unless steps are simultaneously taken to increase private and/or public spending.

3. Increase Competition in Finance

The financial services industry has become more concentrated since the Financial Crisis. The "Generalized Herfindahl-Hirschman Index"—a measure of industry concentration that includes both common ownership by shareholders and cross-ownership by other banks—doubled between 2002 and 2013.[6]

Industry mergers and regulatory policy play an important role in the increased level of concentration and anticompetitive behavior in the industry. For example, the Federal Reserve made it easier for larger lenders to merge by increasing the threshold of total assets of the combined bank requiring extensive regulatory review from $25 billion to $100 billion.[7]

Recent academic research on market concentration in finance contributes several interesting findings related to the use of competition policy to promote economic growth:

1. *Bank Ownership Structure:* Azar, Raina and Schmalz find that prices for financial products vary substantially by region. This can be explained by bank ownership: banks that are commonly owned by the same shareholders compete less and thus charge higher prices and more onerous credit terms.[8] Thus, regulators should review and regulate ownership structures to increase competition.
2. *Antitrust for Institutional Investors:* Posner, Scott Morton, and Weyl argue the Department of Justice and Federal Trade Commission should adopt a "public enforcement" policy of the Clayton Act, which would limit institutions to a 1 percent stake in more than a single firm in oligopolistic markets.[9]

Indeed, the "puzzle" of high profit margins in the financial sector alongside increasing cost to financial services can be reconciled by anticompetitive restraints preventing new entrants (or incumbents) and smaller financial institutions (mid- to small-sized community banks) from

[6] Azar, Jose, Shail Raina and Martin Schmaltz. 2016. "Ultimate Ownership and Bank Competition" https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710252.
[7] Oran, Olivia. 2016. "Fed Eases Bank Merger Rules By Lifting Size Threshold for Review." *Reuters*. http://mobile.reuters.com/article/idUSL2N1GT1YE (March 16, 2017).
[8] Azar, Raina and Schmaltz (2016)
[9] Posner, Eric, Fiona Scott Morton and E.Glen Weyl. 2017. "A Proposal to Limit the Anti-Competitive Power of Institutional Investors." https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2872754.

bidding down prices and profits through greater competition. Greater competition in the financial sector should result in cheaper access to credit, thereby enabling small business and entrepreneurs, who are the largest contributors to job growth, to expand and create jobs. The Roosevelt Institute is conducting further research on the relationship between market concentration in finance and small business growth; however, there is enough evidence to identify policies that regulators can employ to create a financial sector that supports productive growth.

Policy Solutions: Policymakers should encourage regulators to review and regulate ownership structures to increase competition, and enforce the Clayton Act against institutional investors that remain under-regulated in the shadow banking system.

4. Restructure Financial Sector Incentives through Tax Policy

To create a well-functioning financial sector, we need better incentives. Roosevelt Fellow Lenore Palladino's forthcoming paper outlines how tax policy can play an important role in changing the behavior of the financial sector in order to achieve growth in the real economy, specifically to curb speculative behavior and reduce excess leverage. Specific tax policies, such as a Financial Transaction Tax (FTT) and taxing bank leverage, could be effective policy levers to incentivize the financial services sector to serve the real economy, instead of extracting wealth in the form of constantly-rising rents.[10]

Over 30 countries have put in place a FTT to reduce short-term speculative behavior, and numerous studies suggest a FTT could help produce a more efficient and productive economy.[11] Elected officials in Congress have introduced legislative proposals to institute a FTT, including a 2011 proposal from former Sen. Tom Harkin and Rep. Peter DeFazio that would tax stocks, bonds, debt obligations and derivatives at 3 basis points and another from Sen. Sanders and Rep. Keith Ellison which would tax stocks at 50 basis points, bonds at 10 basis points and derivatives at 0.5 basis points. There are many configurations the FTT could take, but the FTT is an effective policy proposal to foster growth and job creation.

The Financial Crisis clearly demonstrated the risk associated with debt accumulation in the financial sector. Tax policy is one mechanism to disincentivize debt accumulation (or over-leveraging). This tax would incentivize financial institutions to hold more equity, instead of financing operations with debt. Taxing excessive leveraging by banks would also complement other regulatory policy that we support, such as robust capital requirements, to reduce systemic risk in the banking sector while progressively raising revenue. This policy was introduced by President Obama in several budgets and by Secretary Hillary Clinton in her presidential campaign. The Minneapolis Federal Reserve's "Minneapolis Plan to End Too Big to Fail" extends the policy to the shadow banking sector and proposes a two-pronged policy to tackle

[10] Palladino, Lenore. 2017. Forthcoming paper.
[11] Sitglitz 1989, Burman 2016 and Baker 2016.

systemic risk, including requiring higher equity in the banking system with a tax on systemically important shadow banking leverage of 2.2 percent and non systemically risky shadow banks of 1.2 percent over $50 billion. This plan would address the formal banking and shadow banking sector to avoid pushing banking activities to the unregulated sector, while also incentivizing productive market participation to foster economic growth.

Policy Solutions: Policymakers should introduce a financial transaction tax, and a bank leverage tax for institutions with over $50 billion in assets, on covered liabilities.

Summary of Policy Recommendations

Below is a summary of the policy solutions we propose to ensure economic growth and job creation:

1. Financial Regulatory Proposals: It is essential to preserve and enhance macroprudential regulatory measures by:
   - *Preserve Dodd-Frank.* Resist efforts to repeal entire sections of the law.
   - *Regulate the whole balance sheet*. Require higher leverage requirements, higher risk-weighted capital, and more long-term debt.
   - *Continue to push for rigorous testing of banks' living wills.* Ensure a clear liquidation process for when banks do fail to minimize the shock to the financial system and the economy more broadly.
   - *Coordinate regulation of international derivative transactions.* Require banks to deal in backstopped derivatives to reduce the risk of contagion,
   - *Rein in the shadow banking institutions and activities.* Regulate shadow banking entities and short-term debt instruments, such as repurchase agreements, over-the-counter derivatives, and securities lending, to prevent excess leverage and accumulation of systemic risks.
   - *Tackle corporate short-termism*. Limit share repurchases through regulatory action, reform private equity regulation by forbidding new debt to pay dividends to shareholders, and investigate pension obligations to make sure pensions are property funded through the Pension Benefit Guaranty Corporation (PBGC).
2. Monetary Policy Proposals: To promote growth and jobs creation, the Board should keep rates low, in line with the view of Board dissenters like Kashkari. With economic research showing that we are not operating at full economic capacity, policymakers in Congress should voice their support of this position. Congress must also pass legislation that brings about a beneficial fiscal stimulus, alongside corporate governance and tax reform to promote innovation and investment. Furthermore, if the economy is suffering from weak demand, this implies that supply-side solutions like deregulation are fundamentally misguided. In a demand-constrained environment, lowering costs for business only pushes the economy toward deflation, unless steps are simultaneously taken to increase private and/or public spending.

3. Competition in the banking sector Proposals: Policymakers should encourage regulators to review and regulate ownership structures to increase competition, and enforce the Clayton Act against institutional investors that remain under-regulated in the shadow banking system.
4. Tax Policy Proposals: Policymakers should introduce a financial transaction tax, and a bank leverage tax for institutions with over $50 billion in assets, on covered liabilities.

About the Roosevelt Institute

Inspired by the legacy of Franklin and Eleanor, the Roosevelt Institute reimagines America as it should be: a place where hard work is rewarded, everyone participates, and everyone enjoys a fair share of our collective prosperity. We believe that when the rules work against this vision, it's our responsibility to recreate them. We bring together thousands of thinkers and doers—from a new generation of leaders in every state to Nobel laureate economists—working to redefine the rules that guide our social and economic realities. We rethink and reshape everything from local policy to federal legislation, orienting toward a new economic and political system: one built by many for the good of all.

The Roosevelt Institute is the nonprofit partner to the Franklin D. Roosevelt Presidential Library and Museum in Hyde Park, NY—America's first presidential library and the only one used by a sitting president.