Policy Solutions to Reduce Inflation

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KEY POINTS

The United States economy in 2022 faces sustained high inflation and slowing economic growth, largely due to demand-boosting fiscal policy and loose monetary policy.

- The annual inflation rate in September 2022 was 8.3 percent, near a 40-year high, and the economy grew by less than a tenth of a percent over the first three quarters of 2022.
- The American Rescue Plan (ARP) Act and other COVID response programs in 2021 boosted consumers’ incomes above what they otherwise would have been, fueling high U.S. demand in the face of supply constraints and increasing prices.
- The Federal Reserve kept its monetary policy stance accommodative while inflation was picking up throughout 2021, further stoking demand in an environment of demand-driven inflation.

In order to reduce inflation, Congress should implement supply-side policy reforms that complement the Federal Reserve’s attempts to cool demand through monetary tightening.

- Reducing government spending would tamp down on demand-fueled inflation, while at the same time restoring confidence in the ability of the federal government to pay down the debt and thus control inflation expectations.
- Removing barriers to work through occupational licensing reform, increasing work flexibility, and mitigating work disincentives in tax and transfer programs would increase labor force participation, thereby reducing the cost of production for firms.
- Deregulation of energy, housing and other markets would reduce the regulatory burden on businesses, lowering the cost of domestic production and bringing down prices.
- Removing barriers to international supply by reducing tariffs and eliminating regulatory barriers like the Jones Act and Foreign Dredge Act would provide consumers access to cheaper goods and increase the resiliency of supply chains.
INTRODUCTION

The United States economy in 2022 faces an uncertain outlook driven by sustained high inflation and slowing economic growth. The average annual inflation rate in the first half of the year was 8.3 percent, near a 40-year high, contributing to a stagnating U.S. economy during the first three quarters of 2022. In September, the annual inflation rate remained elevated at 8.3 percent.¹

In order to control inflation and ultimately increase economic growth, policymakers require a comprehensive understanding of the causes of high inflation and the policies that can reduce it. This report begins by documenting how sustained high inflation is weakening the economy and slowing growth, and explaining why the United States is facing its current challenges. It then recommends four areas of supply-side reform to reduce inflationary pressures: practicing fiscal discipline, incentivizing work, cutting regulations, and removing barriers to international supply.

SUSTAINED INFLATION HAS WEAKENED THE ECONOMY

Amidst a weakening economy, one bright spot is strong labor demand. Nominal wages increased by 5.3 percent on average in 2022 compared to a year prior, and the economy created an average of over 400,000 jobs each month in 2022.² The unemployment rate in October 2022 was 3.7 percent, close to a half-century low.³ Furthermore, as of September 2022, there were 5.0 million more job openings than unemployed Americans.⁴

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² JEC calculations; Average wage gains are found by averaging year-over-year percent changes in hourly wages across all months of 2022. For comparison, average y-o-y wage gains in 2019 were 3.3 percent.
Yet, other signals suggest economic weaknesses, many of which are caused by persistent inflation. The economy grew by less than 0.1 percent in the first three quarters of 2022, and when focusing only on final sales to private domestic purchasers (a measure of domestic consumption that is less volatile), growth has slowed in each successive quarter of 2022.\(^5\) The slowdown in economic growth is a result of the Federal Reserve increasing interest rates to fight inflation. Inflation-adjusted consumer spending on goods is also starting to soften, as rising goods prices have caused consumers to shift away from goods and toward services.\(^6\) Finally, high inflation drove consumer sentiment down in June to its lowest point since records began in 1952.\(^7\) While falling gas prices have since led consumer sentiment to rebound slightly, consumers' perceptions of current economic conditions in 2022 are still at their lowest level since 2009.\(^8\)

The data make it clear that inflation is a primary driver of our current economic challenges. It is unlikely that the United States will be able to achieve meaningful economic growth until inflation is under control. Unfortunately, inflation remains high.

After a year and a half of persistently elevated month-over-month inflation rates, the topline Consumer Price Index (CPI) remained relatively unchanged in July and August of 2022, signaling a possible slowdown in headline inflation rates. Yet, inflation grew from a 0.1 percent monthly rate in August to a 0.4 percent monthly rate in September.\(^9\) Also, core inflation (a less volatile indicator which excludes

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energy and food) has not softened; it grew from a 0.3 percent monthly rate in July to a 0.6 percent monthly rate in both August and September, leading to the highest annual core inflation rate in September in 40 years.\(^{10}\)

Furthermore, the inflation that has already occurred likely represents a permanent increase in the price level. The latest estimates from the September 2022 Joint Economic Committee (JEC) State Inflation Tracker show that, even if prices were to stop increasing, the average American family will have to pay an additional $8,700 over the next twelve months to afford the same goods and services it purchased in January 2021, before inflation rose above recent historical norms.\(^{11}\)

**Inflation Causes: COVID, the Administration, and Congress**

Inflation rates first began rising in early 2021, driven by rising goods prices. During the 2020 recession, spending on both goods and services plummeted as mass layoffs and general economic uncertainty significantly reduced demand.\(^{12}\) After demand recovered later that year, Americans, still hesitant to engage in in-person interactions, flocked to goods consumption. Increasing demand for goods in turn put upward pressure on goods prices, including globally traded goods. This in turn increased stress on production, freight transportation, and supply chains, driving up transportation costs. At the same time, producers faced increased costs and shortages of intermediate inputs as global production was slow to recover from the COVID-19 shutdowns.

U.S. policy decisions in 2021 exacerbated inflationary pressures from COVID-related economic slowdowns, driving U.S. inflation higher than in comparable countries around the world. In March 2021, Congress passed the American Rescue Plan (ARP) Act, a $2 trillion overcorrection


\(^{12}\) U.S. Bureau of Economic Analysis, Real Personal Consumption Expenditures: Goods [DGDSRXI], retrieved from the Federal Reserve Bank of St. Louis, [https://fred.stlouisfed.org/series/DGDSRXI]; U.S. Bureau of Economic Analysis, Real Personal Consumption Expenditures: Services [PCESC96], retrieved from the Federal Reserve Bank of St. Louis, [https://fred.stlouisfed.org/series/PCESC96].
made 11 months after the COVID recession officially ended. The ARP’s stimulus was delivered three months after consumer spending had surpassed pre-COVID levels, and its size equaled almost 300 percent of the estimated output gap over the following three years—the gap between the economy’s actual output and the maximum output it can sustain without overheating and causing inflation.\textsuperscript{13} Other COVID response programs enacted by Congress and the Biden Administration produced similar effects, including the expanded Child Tax Credit, which provided unconditional cash transfers to parents, and the pause on student loan interest accumulation and payments, which increased disposable income for 27 million borrowers.\textsuperscript{14}

These COVID-era programs boosted consumers’ incomes above what they otherwise would have been, fueling high U.S. demand in the face of supply constraints. Compounding the problem, the programs also weakened work incentives and reduced labor supply, contributing to a labor force participation rate that as of October 2022 is 1.2 percentage points below its pre-COVID level.\textsuperscript{15} Researchers including from the Federal Reserve Bank of San Francisco estimate that the ARP added 2.5 to 3.0 percentage points to U.S. inflation in 2021, implying that the 7.0 percent U.S. inflation rate experienced at the end of 2021 would have been closer to 4.0 percent had Congress not passed the ARP.\textsuperscript{16}

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\item \textsuperscript{15} U.S. Bureau of Labor Statistics, Labor Force Participation Rate [CIVPART], retrieved from the Federal Reserve Bank of St. Louis, \url{https://fred.stlouisfed.org/series/CIVPART}.
\end{itemize}
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Figure 1 shows how the ARP worsened inflation in the United States relative to other nations. Core prices in 2021 rose nearly three times as fast in the United States as in euro-using nations, even as climbing U.S. inflation was likely spilling over to euro inflation through international trade.  

Figure 1: Annual Percent Change in the Harmonized Index of Consumer Prices, Monthly, January 2003 to July 2022

This trend has continued into 2022. While rising energy prices in Europe have narrowed the headline inflation gap between the United States and euro-using nations, U.S. core inflation in 2022 is still approximately twice as high on average as euro inflation.  

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17 Francois de Soyres, Ana Santacreu, and Henry Young, “Demand-Supply Imbalance During the Covid-19 Pandemic: The Role of Fiscal Policy.”

18 JEC Calculations; U.S. data are retrieved from the Bureau of Labor Statistics via Haver Analytics; Euro Area data are retrieved from the OECD via Federal Reserve Bank of St. Louis. Organization for Economic Co-operation and Development, Consumer Price Index: Harmonized Prices: Total All Items Less Food, Energy, Tobacco, and Alcohol for the Euro Area [CPHPLA01EZM661N], retrieved from the Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/CPHPLA01EZM661N.
The euro area are both experiencing the same global supply shocks, so this disparity in core inflation is likely driven by U.S.-specific policies that boosted demand more in the United States than euro-area policies boosted demand in euro-using countries.

What’s Ahead: The Federal Reserve and Interest Rates

Elevated core inflation and strong labor demand forced the Federal Reserve onto a path of restrictive monetary policy to cool demand in the economy. The Federal Open Market Committee (FOMC) raised the federal funds rate during six of their seven meetings in 2022—their main tool to bring down inflation by making borrowing and investment more expensive and saving more attractive. So far, the FOMC has raised the federal funds rate from a target range of 0.0 to 0.25 percent in January to a range of 3.75 to 4.00 percent in November. At the annual economic symposium held in Jackson Hole, Chairman Jerome Powell emphasized the FOMC’s continued commitment to raising interest rates, stating, “We are taking forceful and rapid steps to moderate demand so that it comes into better alignment with supply, and to keep inflation expectations anchored. We will keep at it until we are confident the job is done.”

Yet prior to this year, while Congress was stoking consumer demand with fiscal stimulus, the Federal Reserve was slow to recognize rising inflation as a demand-driven macroeconomic development worthy of a monetary policy response. The FOMC kept its monetary policy stance accommodative while inflation was picking up throughout 2021, which consisted of purchasing treasury bonds and other assets like mortgage-backed securities to keep interest rates low. This policy stance further stokes demand by decreasing the cost of borrowing to finance current investment and consumption.

During 2021, the Federal Reserve’s preferred measure of inflation—the core personal consumption expenditures price index (PCEPI)—tripled

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from January (1.6 percent) to November (4.8 percent).\textsuperscript{21} In December, after core PCEPI inflation reached 5.0 percent, the FOMC decided to scale back its asset purchases\textsuperscript{22}—but it did not raise the federal funds rate until the second meeting of 2022.\textsuperscript{23}

The Federal Reserve’s view that inflation was mainly supply-driven and transitory in 2021 was ultimately mistaken, according to researchers from the Federal Reserve Bank of San Francisco. They found that demand-driven factors had a larger impact than supply-driven factors on inflation in 2021.\textsuperscript{24} Therefore, accommodative monetary policy in 2021 boosted demand even further in an environment of demand-driven inflation.

As the Federal Reserve now attempts to cool demand with monetary tightening (i.e., by raising interest rates), the most interest rate sensitive sectors of the economy are likely to experience slowdowns in activity. The housing and real estate sector has been arguably the most affected by the Federal Reserve’s recent actions. After skyrocketing throughout 2021, consumer demand for housing weakened in 2022 once the Federal Reserve started reducing its holdings of mortgage-backed securities, causing the average 30-year fixed mortgage rate to more than double from 3.1 percent in December 2021 to 7.0 percent as of early November 2022.\textsuperscript{25} Because of rising mortgage rates, new and existing home sales have each trended downward since the beginning of the year,\textsuperscript{26} residential construction spending has fallen for four

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\textsuperscript{21} U.S. Bureau of Economic Analysis, Personal Consumption Expenditures (PCE) Excluding Food and Energy (chain-type price index) [PCEPILFE], retrieved from the Federal Reserve Bank of St. Louis, \url{https://fred.stlouisfed.org/series/PCEPILFE}.


\textsuperscript{25} Freddie Mac, 30-Year Fixed Mortgage Average in the United States [MORTGAGE30US], retrieved from the Federal Reserve Bank of St. Louis, accessed on November 8, 2022, \url{https://fred.stlouisfed.org/series/MORTGAGE30US}.

\textsuperscript{26} U.S. Census Bureau and U.S. Department of Housing and Urban Development, New One Family Houses Sold: United States [HSN1F], retrieved from the Federal Reserve Bank of St. Louis, \url{https://fred.stlouisfed.org/series/HSN1F}; National Association of Realtors, “Summary of August 2022
consecutive months,\textsuperscript{27} and the National Association of Homebuilders/Wells Fargo Housing Market Index—an indicator of homebuilders’ sentiment in the single-family housing market—is down 54 percent since January.\textsuperscript{28} Similarly, rising borrowing costs triggered declines in both residential domestic investment and nonresidential domestic investment in buildings in each of the first three quarters of 2022, contributing to stagnating real Gross Domestic Product (GDP).\textsuperscript{29}

As the Federal Reserve continues its path of monetary tightening, it is likely that rising interest rates will spur additional slowdowns in investment and propagate through other parts of the economy in the coming months.

**POLICY REFORMS TO REDUCE INFLATION**

Achieving price stability is one part of the Federal Reserve’s dual mandate, which also includes promoting maximum sustainable employment. While fighting inflation—primarily by increasing the federal funds rate—is typically considered the job of the Federal Reserve, Congress also plays an important role. This is especially the case in today’s inflationary environment. Congress pursued extraordinary spending in 2021 that increased inflation to its highest level in decades and continues to pursue additional spending while inflation remains high. Congress’s actions forced the Federal Reserve onto a path of monetary tightening which has weakened the economy, but if Congress continues its recent pattern of extraordinary spending, it is unlikely that monetary tightening will be effective at reducing inflation.

Furthermore, changes to the federal funds rate are primarily intended to influence demand. In the current supply-constrained environment, it is vital for Congress to implement supply-side policy reforms and work in step with the Federal Reserve to pursue the common goal of

\textsuperscript{27} U.S. Census Bureau, Total Construction Spending: Residential in the United States [TKRESCONS], retrieved from the Federal Reserve Bank of St. Louis, \textit{https://fred.stlouisfed.org/series/TLRESCONS/}.

\textsuperscript{28} National Association of Homebuilders, NAHB/Wells Fargo Housing Market Index (HMI), October 2022, \textit{https://www.nahb.org/news-and-economics/housing-economics/indices/housing-market-index}.


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inflation reduction, giving the Federal Reserve its best chance to reduce inflation without causing a recession. Appropriate policy reforms that Congress could enact fall under four broad categories: practicing fiscal discipline, removing current disincentives to work, lowering the cost of domestic production through deregulation, and removing barriers to international supply.

Practice Fiscal Discipline

As documented by numerous researchers, fiscal expansion played a major role in the United States’ recent inflation experience. Fiscal policy exacerbated inflation by fueling high consumer demand in the face of limited supply. In addition, it may have further weakened the public’s confidence in Congress’s ability to pay for its spending, which in turn weakens confidence in the Federal Reserve’s capabilities to counteract fiscal-driven inflation. Once confidence is lost, inflation expectations become much harder to manage and inflation becomes much harder to control. Thus, practicing fiscal discipline is necessary to 1) avoid artificially fueling demand any further, and 2) restore fiscal credibility.

Congressional spending in 2021 fueled significant increases in consumer demand and personal spending, resulting in demand-driven inflation. Consumers were able to maintain these high spending levels into late 2021 and early 2022 even as inflation started to surge largely because of the $2.5 trillion of excess savings they accumulated from COVID-era government transfer programs.

Consumers in 2022 have started to change their spending habits, causing the growth in inflation-adjusted personal consumption

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expenditures to slow.\textsuperscript{32} However, spending is still elevated; much of the increase in spending in 2021 was on goods, and monthly economy-wide real goods spending is still more than $20 billion above its pre-pandemic trend.\textsuperscript{33}

Moreover, nominal spending growth continues to outpace nominal income growth, which has driven the personal saving rate to its lowest level since 2008.\textsuperscript{34} Figure 2 shows that annualized personal outlays in September were $1.4 trillion above trend. In contrast, annualized disposable personal income in September was only $0.29 trillion above its trend.\textsuperscript{35} A large stock of accumulated savings from the COVID-era programs has allowed consumers to maintain high levels of spending each month relative to their flow of income, thus keeping their saving rate low. This elevated level of demand will continue to pose an inflationary risk as long as consumers continue to use their accumulated savings to spend at above-normal rates.

Outside of the demand-boosting effects of expansionary fiscal policy, which results in too many dollars chasing too few goods, fiscal expansion can also produce inflation if it reduces investors’ confidence in Congress’ willingness or ability to pay for its spending. In this case, the public’s inflation expectations would rise regardless of any monetary policy actions taken by the Federal Reserve, weakening the Federal Reserve’s ability to successfully meet its inflation target.

\textsuperscript{32} U.S. Bureau of Economic Analysis, Real Personal Consumption Expenditures [PCEC96], retrieved from the Federal Reserve Bank of St. Louis, \url{https://fred.stlouisfed.org/series/PCEC96}.
\textsuperscript{33} JEC Calculations; U.S. Bureau of Economic Analysis, Real Personal Consumption Expenditures: Goods [DGDSRX1], retrieved from the Federal Reserve Bank of St. Louis, \url{https://fred.stlouisfed.org/series/DGDSRX1}. The pre-pandemic trend in real goods spending is estimated by finding the difference between actual annualized real goods spending in July 2022 and a linear forecast of annualized real goods spending in July 2022, divided by 12 to convert annualized spending to monthly spending. The linear forecast was created based on monthly real goods spending from January 2015 to February 2020.
\textsuperscript{34} U.S. Bureau of Economic Analysis, Personal Saving Rate [PSAVERT], retrieved from the Federal Reserve Bank of St. Louis, \url{https://fred.stlouisfed.org/series/PSAVERT}.
\textsuperscript{35} JEC Calculations; U.S. Bureau of Economic Analysis, Personal outlays [A068RC1], retrieved from the Federal Reserve Bank of St. Louis, \url{https://fred.stlouisfed.org/series/A068RC1}; U.S. Bureau of Economic Analysis, Disposable Personal Income (DSPI), retrieved from the Federal Reserve Bank of St. Louis, \url{https://fred.stlouisfed.org/series/DSPI}. The pre-pandemic trend in personal outlays is estimated by finding the difference between actual annualized personal outlays and a linear forecast of annualized personal outlays for each month from March 2020 to July 2022, divided by 12 to convert annualized outlays to monthly outlays. The linear forecast was created based on monthly annualized personal outlays from January 2015 to February 2020.
Francesco Bianchi and Leonardo Melosi recently explored the relationship between fiscal credibility and inflation in a 2022 Jackson Hole Economic Symposium paper. They find that “when the fiscal authority is not perceived as fully responsible for covering the existing fiscal imbalances, the private sector expects that inflation will rise to ensure sustainability of national debt. As a result, a large fiscal
imbalance combined with a weakening fiscal credibility may lead trend inflation to drift away from the long-run target chosen by the monetary authority.”36 They estimate that the Great Inflation in the 1970s can be explained by a succession of new spending programs combined with a weakening fiscal backing, and that the end of the Great Inflation came once President Reagan and Congress proved they were credibly committed to stabilizing debt levels and the Federal Reserve gained full independence to pursue price stability. They conclude that half of the increase in inflation in 2021 (3.5 percentage points) can be explained by changing beliefs about the debt level and a lack of confidence in how historic amounts of new government spending would be financed.37

The paper also provides evidence about the importance of a unified inflation-reduction goal between the parts of government that conduct fiscal and monetary policy. The authors model a scenario in which a monetary authority pursues monetary tightening to reduce inflation, but the fiscal authority moves in the opposite direction, pursuing fiscal expansion. In this case, the Federal Reserve’s interest rate hikes to counteract fiscal-induced inflation triggers a recession and simultaneously increases the cost of financing debt. The worsening fiscal imbalance resulting from rising debt servicing costs, in turn, generates even higher inflation and further worsens the economic outlook. Ultimately, the combination of slow growth triggered by monetary tightening and inflation triggered by rising debt expectations results in stagflation.

This may be the scenario playing out today. After authorizing $2 trillion in new spending as a part of the American Rescue Plan Act in 2021, Congress and the Biden Administration have each continued on the path of fiscal expansion. For example, in 2022 Congress authorized over

$250 billion in subsidies to domestic manufacturers.\textsuperscript{38} Congress has also passed other pieces of legislation—like the \textit{Infrastructure Investment and Jobs Act} and the \textit{Inflation Reduction Act}—that will increase spending and may fuel additional inflation at different times over the next ten years depending on the rollout of their provisions.\textsuperscript{39} At the same time, the President recently granted student loan forgiveness to most borrowers. The Congressional Budget Office estimates that this policy will cost $430 billion while other estimates suggest it could cost up to $650 billion.\textsuperscript{40}

Absent any new fiscal policies, the debt is already projected to reach 185 percent of GDP by 2052; adding the fiscal proposals included in the Biden Administration’s 2022 budget would push the debt level past 250 percent and cause interest payments on the debt to make up the largest federal expenditure by 2052.\textsuperscript{41} As interest rates continue to rise, financing the debt will become more expensive and fiscal credibility could be affected if beliefs change about the government’s ability to pay off its debt.

Currently, nearly 60 percent of the national debt has a maturity of four years or less and 25 percent has a maturity of less than one year.\textsuperscript{42} By the time the debt matures, the government will either need to pay it off or, more likely, refinance it by taking out additional loans at the

\textsuperscript{38} Congressional Budget Office, “Table 1. Summary: Estimated Budgetary Effects of H.R. 4346, as Amended by the Senate and as Posted by the Senate Committee on Commerce, Science, and Transportation on July 20, 2022,” July 21, 2022, \url{https://www.cbo.gov/system/files/2022-07/hr4346_chip.pdf}.


\textsuperscript{42} Veronique de Rugy and Jack Salmon, “Inflation in Times of High Debt,” the Mercatus Center, March 2022, \url{https://www.mercatus.org/publications/inflation/inflation-times-high-debt}.
prevailing interest rate. In the short term, interest rates are rising as the Federal Reserve attempts to combat inflation, and in the longer term, interest rates may remain above the ultra-low levels to which the United States and other nations have grown accustomed, especially if dramatic fiscal expansion continues.

Brian Reidl estimates that interest rates of five percent could push the national debt to 300 percent of GDP in 30 years’ time (compared to current projections of 185 percent), with every one percentage point increase in the average interest rate increasing government interest costs by $30 trillion over 30 years.43 For context, the interest rate on a 10-year treasury bond—a close proxy for the average interest rate paid on government debt—was 3.1 percent in the third quarter of 2022, and CBO projects that the average interest rate on federal debt will reach 4.2 percent in 2052.44

Congress’ continued emphasis on fiscal expansion and the resulting increase in the debt level makes it more difficult for the Federal Reserve to control inflation through monetary policy. To give the Federal Reserve its best chance at lowering sustained high inflation, Congress should do its part by practicing fiscal discipline.

Remove Disincentives to Work

From the perspective of workers, the labor market is the relative bright spot of the economy, measured by job openings and job creation. Labor force participation, however, has struggled to recover since the COVID-19 recession. The resulting challenge for employers is one in which high consumer demand has fueled opportunities for businesses to grow, but there is an insufficient supply of willing and available workers to meet that demand.

Weak labor supply is driving employers to raise wages to attract workers, with the pace of nominal wage growth much higher in 2022 (5 percent) than in the year before the pandemic (3 percent). However, these wage increases have failed to keep up with inflation rates above 8 percent, causing real wages to fall. Even so, accelerated nominal wage growth presents an inflationary risk if employers pass on their higher input costs to consumers through higher prices. If, in turn, workers demand even higher wages to afford rising prices, the risk becomes that of a wage-price spiral: growing wages and prices will continue to feed into one another, creating sustained price and wage inflation.

Before the COVID-19 pandemic, labor force participation was rising, driven by participation increases among the prime age working population (Americans aged 25 to 54). Overall labor force participation increased by 0.3 percentage point in 2018 and again in 2019 after either falling or remaining stagnant each year from 2007 to 2017. Similarly to the labor force participation rate, the employment to population ratio rose among every age group in 2018 and 2019.

As of October 2022, neither the labor force participation rate nor the employment to population ratio has recovered to its pre-COVID level. Much of the remaining gap is driven by an increase in retirements; nearly 4 million Americans left the workforce to retire from February 2020 to August 2022, compared to roughly 900,000 who entered retirement in the same timeframe after the onset of the Great Recession.

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Figure 3 provides insight into who these missing workers are by breaking down the change in employment since February 2020 by age group. Predictably, one of the largest drops has occurred among the population aged 55 and older, whose employment to population ratio decreased 1.4 percentage points since February 2020. However, an even larger drop occurred among Americans aged 20 to 24, whose employment to population ratio has decreased by 2.5 percentage points compared to pre-COVID levels. Among all ages, Americans aged 16 to 19 are the only group that has increased its employment to population ratio above pre-COVID levels, which is a new development as of October 2022. However, the other groups that comprise the prime age workforce—Americans aged 25 to 34, 35 to 44, and 45 to 54—have each experienced relative declines in their employment to population ratios. The fact that younger workers have exited employment along with older workers suggests that the decline in work may be reversible with work-promoting policy reforms.

Figure 3: Percentage Point Difference in Employment to Population Ratio by Age Group, February 2020 to September 2020


Notes: Data are seasonally adjusted.

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The most effective way for Congress and state governments to increase labor force participation is to remove current government-imposed barriers to work and work disincentives written into law. One way to remove barriers to work is through occupational licensing reform. In 2021, roughly 22 percent of the workforce held occupational licenses. While occupational licenses are common in high-skilled occupations like healthcare practitioners (73 percent hold a license) and legal occupations (62 percent), they are also prevalent in lower-wage jobs including healthcare support occupations (37 percent), community and social services (37 percent), and personal care and service occupations (32 percent).\(^{52}\)

Licensing requirements impose significant monetary and nonmonetary costs on lower-income individuals seeking employment. On average, occupational licenses in the United States require $267 in fees and nearly a year of education and experience, with some of the largest barriers disproportionately affecting lower-wage workers. The Institute for Justice finds that the most difficult occupations to enter because of licensing and training requirements are in the cosmetology trades, truck and bus drivers, and pest control applicators.\(^{53}\) Furthermore, occupational licensing requirements reduce geographic mobility for workers who may otherwise choose to move to a different state in search of a healthier job market. Research finds that workers with state-specific licenses exhibit 36 percent lower inter-state migration rates relative to workers with nationally recognized licenses.\(^{54}\)

While supporters argue that occupational licenses protect consumers from harm, little evidence exists that license requirements improve public safety or the quality of services offered to consumers.\(^{55}\) Instead, research suggests that occupational license requirements increase


prices for consumers, reduce employment in licensed occupations, depress business creation when licenses are required, and reduce wages for unlicensed workers relative to their licensed counterparts.56

Policy reforms to grow the labor force should also focus on removing barriers to nontraditional work for workers seeking flexibility. Several states have imposed labor regulations changing the classification of independent contractors to traditional employees, subjecting them to traditional labor law affecting hours, wages, and benefits. Forcing every worker to join a traditional employer-employee relationship significantly increases the cost of hiring workers, making it harder for businesses to create jobs. It also reduces employment opportunities for Americans purposely seeking flexible work. In a 2017 survey, nearly 80 percent of independent contractors indicated that they prefer their nontraditional employment arrangement because of the flexibility it allows.57 Unsurprisingly, state-level efforts to expand who falls under the definition of “employee” have been met with pushback by independent workers, including independent truck drivers in California who are integral to functioning supply chains.58

Worker reclassification is also occurring at the federal level. In October 2022, the Department of Labor published a proposed rule that would broaden the definition of an employee, making it more difficult for individuals to work as independent contractors nationwide.59 Given that an estimated 36 percent of workers participate in nontraditional employment arrangements, a national-level employee reclassification could threaten the employment of up to 50 million U.S. workers.60

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Congress should protect independent contractors' abilities to choose their own work arrangements.

To boost labor force participation, policymakers should also reduce work disincentives that are integrated into government transfer programs. Means-tested welfare programs often make non-work more attractive than work by providing cash, food, housing, and medical care without requiring employment or work preparation for non-disabled, working-age Americans. These work disincentives likely contribute to a rising number of prime-age men deciding to remain out of the labor force for reasons other than disability, retirement, education, or homemaking, 41 percent of whom receive government assistance.61

One important means-tested program that discourages work is the Supplemental Nutrition Assistance Program (SNAP). This program is the largest non-medical, in-kind transfer program in the United States, providing nutrition assistance to roughly 42 million people in 2021.62 SNAP is available to all individuals regardless of age or disability status, and because benefits phase out with income, it discourages work. Research finds that the staggered introduction of the food stamp program from 1964 to 1975 lowered rates of employment and hours worked among recipients. Research covering post-welfare reform in the late 1990s and early 2000s similarly finds that SNAP eligibility reduced employment among single female immigrants.63 While non-disabled adults between the ages of 16 and 59 who do not have dependents are required to work 80 hours per month, this requirement is often waived for entire geographic areas based on lax conditions. For example, even in the last quarter of 2019 when the U.S. unemployment

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rate was 3.6 percent, 36 states and territories had a waiver of the work requirement for either part or all of the state.\footnote{“Supplemental Nutrition Assistance Program (SNAP): Status of State Able-Bodies Adult without Dependents (ABAWD) Time Limit Waivers – Fiscal Year 2019 – 4th Quarter,” United States Department of Agriculture, August 12, 2019, \url{https://fns-prod.azureedge.us/sites/default/files/media/file/FY19-Quarter4-ABAWD-Waiver-Status.pdf}.}

The Social Security Disability Insurance (SSDI) program provides social insurance to workers who become disabled after working and paying into the system. Though it provides a vital safety net to workers, SSDI can inadvertently discourage work among recipients who may be capable of returning to work. Earning a sufficient level of income disqualifies recipients from receiving benefits in the future. So even as technology and remote work options have made jobs more accessible to people with disabilities, many choose not to return to work lest they lose their SSDI benefits. Indeed, most recipients remain enrolled in SSDI until death or retirement.\footnote{Scott Winship, “How to Fix Disability Insurance,” \textit{National Affairs} (Spring 2015): \url{https://www.nationalaffairs.com/publications/detail/how-to-fix-disability-insurance}.} Reforms to SSDI that make it less risky for recipients to return to work if able could increase their well-being and labor force participation.

Outside of government transfer programs, the tax code also disincentivizes earning additional income. The median American household faces a tax rate of 43 percent for each additional dollar earned from their labor, with the highest marginal tax rates affecting the lowest and highest earners. One in four households in the bottom 20 percent of the income distribution faces marginal tax rates on working of above 65 percent.\footnote{David Altig, Alan J. Auerbach, Laurence J. Kotlikoff, Elias Ilin, and Víctor Ye, “Marginal Net Taxation of Americans’ Labor Supply,” National Bureau of Economic Research, May 2020, \url{https://www.nber.org/system/files/working_papers/w27164/w27164.pdf}.}

If history is any indication, mitigating work disincentives would increase labor force participation and produce other long-term benefits. The experience following welfare reform in the 1990s that reformed taxes and transfers targeted at low-income Americans to require and reward work demonstrated the success of this approach. Welfare reform increased employment and decreased welfare dependency. The positive effects of welfare reform were strongest for single mothers, who were more likely to work and less likely to live in poverty, and these

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benefits persisted for their children, resulting in increases in food security for generations.  

In the long run, it will also be important to reverse declining birth rates that lead to a smaller future workforce. Birth rates in the United States have been on a downward trend since 1971 and have consistently been below replacement level since 2007, paving the way for a shrinking population and labor force. Addressing these demographic challenges will require policy reforms that encourage marriage and family formation, as well as reforms that would make it more affordable to raise a family.

Finally, when American workers are not available, legal employment-based immigration is a valuable tool for increasing employers’ access to workers and boosting the United States’ productive capacity and economic growth.

Lower the Cost of Domestic Production through Deregulation

Another way to reduce inflationary pressures is to lower the cost of domestic production, which would lead to increased output. The most direct way policymakers can reduce production costs is by removing unnecessary regulations.

The weight of regulatory burdens has dramatically expanded in recent history. As of 2021, there were more than one million regulatory restrictions constraining the activity of U.S. producers, workers, and other economic actors, three times greater than the regulation level in 1970. The rising number of regulations has weighed down producers’ capacity to provide goods and services when instead they must devote their resources to compliance. The number of Americans working as compliance officers, whose jobs are to conform to laws and regulations

67 Christina King, Scott Winship, Adam N. Michel, “Reconnecting Americans to the Benefits of Work.”
governing licenses and permits, doubled from 165,000 in 1997 to 335,000 in 2021—more than five times the growth rate of total nonfarm employment during that timeframe.71 According to JEC estimates, the annual paperwork burden imposed on businesses requires $360 billion in wages spent on unproductive economic activity each year.72

As a result, growing regulatory compliance costs have increased barriers to business creation and reduced the value of output produced in the U.S. economy. One study estimates that if the number of regulations remained constant at 1980 levels, the U.S. economy in 2012 would have been 25 percent larger, implying that regulatory growth reduced 2012 GDP by $4 trillion.73 Similarly, research suggests that regulatory growth from 1999 to 2014 was associated with a four to 20 percent decline in both business creation and employment growth, and additional research confirms that increased regulation and taxation is responsible for a decline in new startup rates and dynamism within industries.74 Unsurprisingly, small businesses with fewer resources and less influence over government officials are disproportionately harmed by new regulation, and it is well documented that regulatory accumulation decreases the number of small businesses relative to large ones.75

As deregulation expands supply by removing barriers to production, it provides benefits to consumers in the form of lower prices.

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Deregulation in the 1970s targeted at the airline, trucking, and railroad industries spurred industry-wide efficiency gains and boosted output enough to trigger price decreases between 33 percent and 75 percent.\(^7\) Cost savings for consumers would be especially valuable today while Americans shoulder the burden of sustained inflation.

Two sectors where deregulation would be most impactful are energy and housing. Rising gas prices have been one of the most burdensome developments of the last year, caused by a combination of global supply shocks, low domestic supply, and high demand.\(^7\) While recent slowing global demand (especially in China) has pushed gas prices down, U.S. oil production was still seven percent below its pre-COVID level as of June 2022.\(^7\) U.S. refinery capacity has also steadily declined since the pandemic and has yet to increase from its low point, indicating widespread hesitation to invest in new refinery capacity even as domestic demand for gasoline increases.\(^7\) Investor hesitancy is likely in part a product of regulatory uncertainty from the Biden Administration, whose environmental policy priorities impose high costs on the oil and gas industry.\(^8\) Policymakers should remove barriers to energy production, such as lengthy environmental review requirements and complex permitting processes, to restore investor confidence and lower the cost of energy production.

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\(^7\) JEC calculations; U.S. Energy Information Administration, Refinery Utilization and Capacity Data, Operable Capacity (Calendar Day), accessed on October 11, 2022, [https://www.eia.gov/dnav/pet/pet_pnp_unc_dcu_nus_m.htm](https://www.eia.gov/dnav/pet/pet_pnp_unc_dcu_nus_m.htm).


Similarly, rising home prices and rents (known as shelter inflation) is a primary reason why the Federal Reserve is continuing to pursue monetary tightening. Although rising mortgage rates are starting to slow housing demand, shelter prices are still increasing at above-normal rates; in the United States overall, shelter prices were 9.6 percent higher in September 2022 than in January 2021, and they were 16.3 percent higher in the Mountain West. The housing affordability problem is ultimately a result of a lack of housing supply in areas with strong demand. JEC estimates that the United States faces a housing shortage of 20 million homes. Removing barriers to new housing supply would fill this shortage and put downward pressure on housing prices.

Research shows that local land-use and zoning regulations—such as single-family zoning requirements, minimum lot size requirements, and building height restrictions—reduce applications for new residential construction, ultimately reduce housing supply, and increase home prices. Housing supply in the West is especially limited given that 50 percent of the land is unbuildable because it is owned by the federal government. Giving states the opportunity to purchase non-defense and non-conservation land back from the federal government could spur the construction of an additional 2.7 million homes, completely filling the housing shortages in Arizona, Nevada, and Wyoming and significantly reducing home prices in 12 states. This policy would complement broader reforms by states and localities to cut overly stringent regulations on building housing.

Remove Barriers to International Supply

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In today’s supply constrained environment, removing barriers to foreign-made goods would help to increase supply and reduce inflationary pressures. The pandemic spurred a dramatic increase in Americans’ demand for imports. By the beginning of 2021, inflation-adjusted goods imports were nearly eight percent higher than pre-pandemic levels, the largest post-recession jump on record.\textsuperscript{85} By the beginning of 2022, the increase in real imports reached 20 percent over pre-pandemic levels.\textsuperscript{86}

In 2018, the United States reversed the course of consistently low barriers to trade over the last several decades by increasing restrictions on foreign supply. It did so by imposing new tariffs on China, the European Union, Japan, and other nations that increase the cost of foreign-made goods. Normally, tariffs rates are negotiated when the United States enters new trade agreements, and additional tariffs can only be applied on top of the negotiated rate for specific, limited purposes. For example, anti-dumping and countervailing duties are applied to foreign goods sold at below-fair market value, often to compensate for subsidies or other preferential treatment by foreign governments. The tariffs levied from 2018 to 2020 were unique in recent history, applying to a much wider swath of goods at constant rates, largely based on agency judgement.

Starting in 2018, tariffs were imposed on foreign-made steel and aluminum and on Chinese goods more broadly, eventually affecting roughly two-thirds of U.S. imports from China.\textsuperscript{87} Instead of solely targeting foreign-made consumer goods with direct competitors in the United States, these tariffs were largely levied on inputs to production, increasing the cost of domestic manufacturing and making the United States less globally competitive.\textsuperscript{88} The tariffs imposed on Chinese goods

\textsuperscript{85} JEC calculations, “post-recession jump” is measured as five quarters after the prior business cycle peak. U.S. Bureau of Economic Analysis, Real imports of goods [A255RXIQ020SBEA], retrieved from the Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/A255RXIQ020SBEA.

\textsuperscript{86} JEC calculations; U.S. Bureau of Economic Analysis, Real imports of goods [A255RXIQ020SBEA], retrieved from the Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/A255RXIQ020SBEA.


\textsuperscript{88} Jackie Varas, “Government Intervention is the Wrong Way to Boost U.S. Competitiveness with China,” U.S. Joint Economic Committee Republicans, July 29, 2021,
quadrupled the trade-weighted average tariff rate paid by Americans and doubled the trade-weighted average tariff rate overall. According to 2019 estimates, 100 percent of these tariff costs were paid by U.S. importers via higher import prices and more recent estimates show that those higher import prices are increasingly passed on to consumers.

These 2018-2020 era tariffs are currently in effect on $280 billion of U.S. imports, imposing a $50 billion annual cost burden on U.S. producers and consumers that use imported goods. Estimates suggest that removing recently imposed tariffs on imports from China, steel and aluminum imports, and Canadian lumber imports could deliver a one-time inflation reduction of 1.3 percentage point. Removing these tariffs would yield greater benefits in the most at-risk sector of the economy, housing, where the average tariff on homebuilding products has increased nine-fold in the last four years.

Tariffs are not the only barrier to international supply in need of reform. Two pieces of legislation in particular can be reformed to increase the functionality of U.S. supply chains. The first, the Foreign Dredge Act, prevents any foreign built, owned, or operated boat from dredging in the United States, the process by which ports are built and expanded.

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This law discourages port expansion by making dredging more costly, and the high cost of dredging is a primary reason why the ports of Los Angeles and Long Beach are the only ports currently large enough to fit many of the vessels that transport goods into the United States.\textsuperscript{94} The inability of container ships to offload at other ports was a key contributor to the container ship backlogs, delays, and supply chain-driven inflation experienced throughout 2021 and into 2022, and continues to act as a barrier to efficient supply chains today.\textsuperscript{95}

The second piece of legislation, the \textit{Jones Act}, works in a similar way by preventing any foreign built, owned, operated, or crewed vessel from sailing between U.S. ports. As such, the \textit{Jones Act} restricts shipping options within the United States by making sea-based shipping needlessly expensive. There are less than 100 \textit{Jones Act} compliant vessels capable of transporting cargo and daily operating costs for U.S. owned vessels are 2.7 times greater than for foreign-owned vessels.\textsuperscript{96} During the supply chain crisis, the lack of sea-based shipping options increased stress on trucks and trains—which were already overloaded—to deliver imports from the ports of Los Angeles and Long Beach to their final destination. Increased transportation costs ultimately translated into higher prices for consumers. Removing the regulations imposed by the \textit{Foreign Dredge Act} and the \textit{Jones Act} would help to decrease inflationary pressures.

Some have argued that the supply chain problems that occurred following the COVID-19 pandemic highlight the potential risks of globalization, suggesting that removing barriers to international supply decrease U.S. resiliency. However, supply shocks can occur at home or


abroad, and openness to international supply is a key strategy to hedge against the risk of domestic supply shocks. A recent example occurred just this year when an Abbott baby formula production facility in Michigan shut down due to concerns about adulterated product. Because of regulatory requirements imposed on foreign-made baby formula and other government-imposed barriers to entry on domestic baby formula producers, the shutdown of this one production facility caused a months-long shortage of baby formula. The Administration relaxed regulatory restrictions on foreign-made baby formula and increased imports, turning to international supply to supplement domestic shortages. Congress also temporarily relaxed tariffs on imported baby formula, opening U.S. markets to foreign supply during the crisis.

**CONCLUSION**

The United States economy faces an uncertain near-term future. Persistent inflation poses a significant challenge and stagnating growth puts our economic health at risk. Many of the nation's current economic challenges—including slow growth, decreased investment, softening goods spending, and low consumer confidence—can be explained by high and persistent inflation rates, and it is imperative for policymakers to prioritize inflation reduction moving forward. As the Federal Reserve continues on the path of monetary tightening to reduce demand, Congress should do its part by practicing fiscal discipline and pursuing policy reforms to expand supply.

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**Jackie Benson**  
**Joint Economic Committee**

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