Levy Economics Institute of Bard College

# Strategic Analysis

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# BACK TO BUSINESS AS USUAL? OR A FISCAL BOOST?

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## Introduction

Recent trends in employment and conventional measures of unemployment show only modest improvement over the past year (see Figure 1). When one includes people who are marginally attached to the workforce as well as those who are involuntarily working only part time, the percentage of people who needed (more) work stood at 14.5 percent in March 2012, compared to 16.2 percent one year ago (BLS 2012b). Layoffs have slackened somewhat, but businesses are not hiring at a fast enough rate to bring substantial progress in reducing the jobless rate. There is some sense of improvement in the rate at which private industry is hiring new employees, but employment nationwide has still not recovered even to February 2007 levels. Joseph Stiglitz (2012) notes that while job creation occurred at a rate of 225,000 per month in February, that number "is only about 100,000 beyond the number required to provide jobs for the average monthly number of new entrants into the labor force. At that pace, it would take 150 months to reach full employment—13 years, some time around 2025." When hiring is so consistently slow relative to the number of workers unemployed, one can be certain that the government has erred on the low side in applying economic stimulus.

The orange shaded area in Figure 1 highlights the gap between the actual employment rate and the peak it reached prior to the 2001 recession. To fill that gap, the nation needs to find jobs for about 6 percent of the working-age population, or roughly 15 million people. Since the working-age population has been growing on average by 2.4 million people per year, or 205,000 each month, job creation that barely reaches a threshold of that number multiplied by the current employment-population ratio of about .59 (see BLS 2012a) will not narrow the gap.

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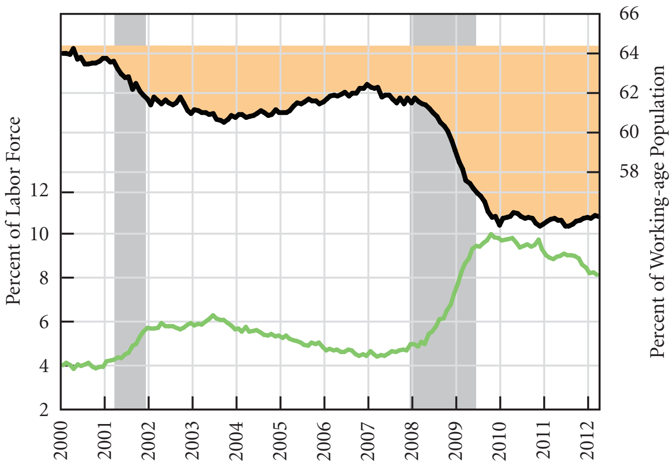
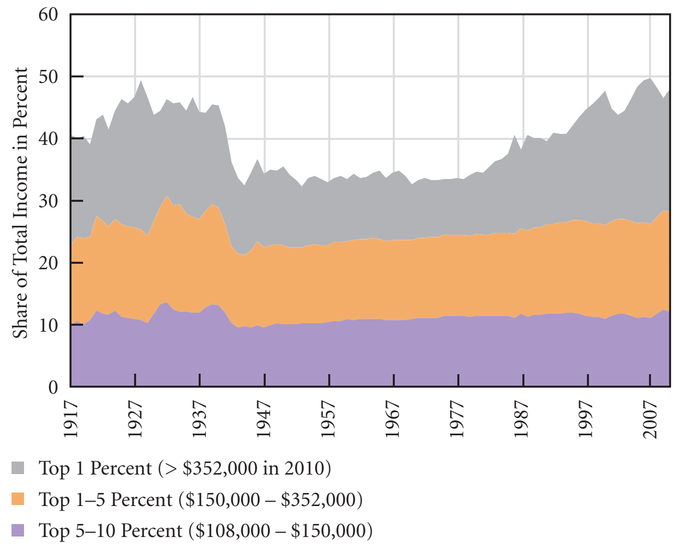
**Figure 1** Employment and Unemployment




*Note:* Shaded areas indicate recession.

*Source:* Bureau of Labor Statistics (BLS)

**Figure 2** Top-decile US Income Shares




*Source:* Saez 2012

Another argument for strong stimulus is that even the slow-paced recovery in payrolls described above represents an awfully lucky outcome, given the weakness of the acceleration in GDP growth since 2009, the last official recession year. The postrecession decrease in unemployment may represent nothing more than a one-time bounce back, a turn of events that owes its strength to the unusual severity of job losses during the recession itself (Bernanke 2012). Hence, achieving a big improvement in the labor market may require far higher growth rates than those of the past few years. Appropriate stimulus, as we will suggest below, could take the form of any one of a number of different types of legislation, depending upon the mood of the country and the makeup of the next Congress.

Given the other factors that affect hiring, economic growth, and medium-term sustainability, a detailed analysis is needed to determine the level of stimulus required. In our last report (Papadimitriou, Hannsgen, and Zezza 2011), we presented some results from four different projections of our model, conditional on different assumptions. This Strategic Analysis reports the results of new simulations based on an updated quarterly dataset from the Federal Reserve, the Bureau of Economic Analysis (BEA), and other public sources. Our simulations show the results of the following three scenarios: (1) a private sector demand increase, which can only come from a private-borrowing scenario, in which we find the appropriate amount of private sector net borrowing/lending to achieve the path of employment growth projected under current law by the Congressional Budget Office, in a report characterized by excessive optimism and a bias toward deficit reduction (CBO 2012); (2) a more plausible scenario, where we assume that most tax cuts are extended, and that household borrowing increases at a more reasonable rate; and (3) a fiscal stimulus scenario, in which we simulate the effects of a new, modest-size dose of public spending.

## Some Slow-moving Forces Driving Economic Change

The global economy continues to be held back by a variety of factors. Here is a partial list of the more slow-moving, but fundamental, forces that figure in our understanding of the current economic situation, especially in the United States:

(1) *Gradually escalating income disparities*: those at the top of the economic pyramid now earn far more relative to the rest of us than they did in the 1950s, ’60s, and ’70s (Figure 2). In 2010, this trend did not reverse itself. Average family income for the top 1 percent grew by 11.6 percent, while the

bottom 99 percent experienced income gains of only one-fifth of 1 percent (Saez 2012).

One of the key forces driving increasing personal income concentration is the falling number of companies competing in most industries. In 1960, the top 500 global corporations with operations in the United States and Canada had revenues equivalent to less than 20 percent of world income. This share stood at about 32 percent in 2008 (Foster, McChesney, and Jonna 2011). With fewer global companies vying to sell their wares, competition is a less effective constraint on the prices of many goods and services.

Along with a weakened level of competition among companies, the past four decades have brought a number of developments that are inimical to broadly shared income growth (Krueger 2012). Some of the other forces behind this trend include weaker unions, lower real minimum wages, and a more regressive tax system.

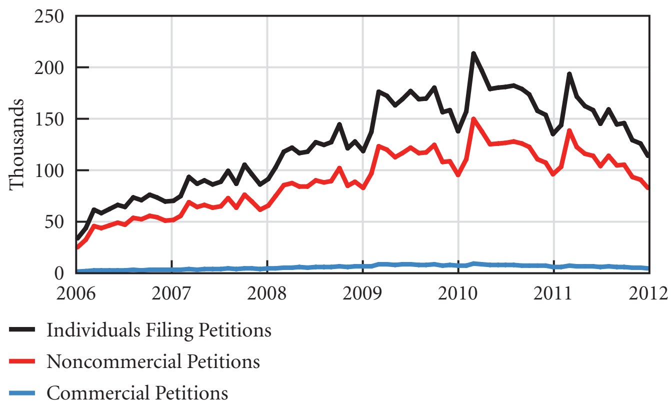
This increasing concentration of income among the very wealthiest tends to slow down economic growth for reasons that vary from the simple to the complex. For starters, lower-income households tend to consume almost all of their income, while the highest-income 1 percent of households puts aside perhaps 50 percent of its lifetime income (Dynan, Skinner, and Zeldes 2004). Therefore, if the government were to raise taxes by, say, $100 billion a year on the richest people, and transfer that money to the poorest tenth or quarter of Americans via tax credits, consumption spending would rise by perhaps $50 billion.

(2) *Deteriorating state and local government finances*: A recent article on the front page of the *New York Times* noted that, "even as there are glimmers of a national economic recovery, cities and counties increasingly find themselves in the middle of a financial crisis" (Hakim 2012). The article cited "a toxic mix of stresses that has been brewing for years, including soaring pension, Medicaid, and retiree health care costs." Around the country, a number of big local governmental entities have declared bankruptcy. Job cuts at the state and local levels have more than offset the effects of federal stimulus programs since 2008. In his March 4 op-ed column in the *Times*, Paul Krugman (2012) observed, "If government employment under Mr. Obama had grown at Reagan-era rates, 1.3 million more Americans would be working as schoolteachers, firefighters, police officers, etc., than are currently employed in such jobs."

(3) *Shaky progress in stabilizing finance*: Because of this tight fiscal situation, the municipal bond market is one of a number of fragile financial markets. Meanwhile, the regulatory framework has yet to be rebuilt following the passage and signing of the Dodd-Frank bill, and many argue that the new rules written to implement this legislation won't be strong enough to prevent deceptive, dishonest, or risky activities from destabilizing numerous markets. For example, Dodd-Frank comes nowhere close to restoring the regulatory barriers that once separated investment banking operations from traditional commercial banking. Hence, some financial sector insiders suggest that even the worst crisis since the 1930s has failed to break the momentum of dangerous financial deregulation (Johnson 2012; Kregel 2010).

(4) *Ongoing household financial stress*: The financial cleanup from that crisis is hardly over. In February, over 134,000 individuals filed bankruptcy petitions, still far in excess of prerecession levels (Figure 3). Falling property values have led to a situation in which one out of three homeowners with a mortgage owes more than the market worth of their home (Reich 2012). And national home-price indexes are still on a downward trend (S&P 2012).

**Figure 3** **Bankruptcy Petitions Filed**




*Source:* Harvard Bankruptcy Project

## The Way to Grow: Private Sector or Public Sector Demand?

The BEA recently announced that the trade deficit for February was $46.0 billion, down from $52.5 billion in January, but higher than the previous February. This imbalance has crept back up during the course of the economic recovery. Martin Wolf (2012) argues that the economy needs to deleverage over the long term with the help of increased exports. But this process cannot easily be spurred by macro policy measures, such as a deliberate devaluation of the dollar. Troubled European economies are now being forced to reduce their real production costs by cutting real wages. Their need to export goods and services in an inexpensive currency will keep world policymakers from encouraging a bidding up of the euro. Moreover, the Chinese currency has been appreciating for several years, but this process cannot be changed into a speedy one, given the policies of the Chinese government. Hence, we cannot count on an increase in US exports over the next five years.

For this reason, attaining reasonable rates of employment growth will require greatly increased demand from the public sector, the private sector, or both. The discussion below of our three scenarios looks in detail at each of the ways the economy might reach higher growth rates of output and employment.

## Scenario 1: GDP Gets Back to Potential under Current Law

As in most of our previous reports, in our first scenario we take the projected path for government receipts and outlays from the latest CBO (2012) forecasts. In their baseline simulation, the CBO is projecting a large drop in the federal budget deficit during the current and next fiscal years. This number is based on (1) an increase in revenues from 15.4 percent of GDP in 2011 to 20 percent in 2014, followed by a slow increase thereafter; and (2) a drop in outlays from 24.1 percent of GDP in 2011 to 22.1 percent in 2014, followed by a period of steady spending levels. As a result, the federal deficit is expected to fall very quickly, from 8.7 percent of GDP in 2011 to 3.7 percent of GDP in 2013 and 2.1 percent in 2014.

CBO growth forecasts reflect this projected tightening of fiscal policy: the agency expects real GDP to grow by 2.2 percent in 2012 and by only 1 percent in 2013, and to accelerate once most of the fiscal adjustment has taken place, with growth reaching 3.6 percent in 2014 and 4.9 percent in 2015 (2012, 128). The unemployment rate is expected to rise to 9.1 percent with the slowdown in economic activity, and to fall rapidly from 2014 onward, once the economy recovers.

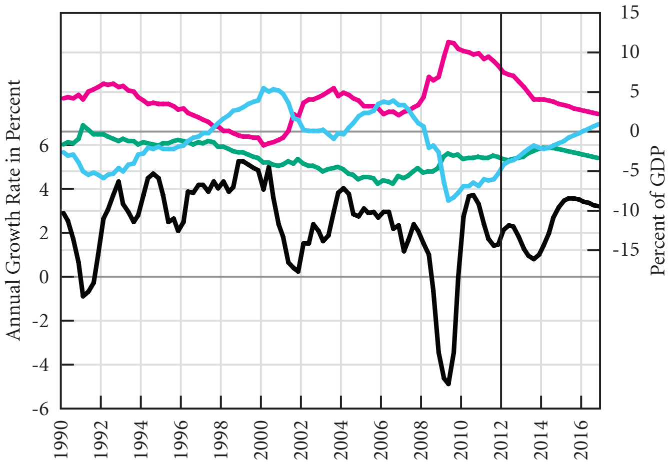
In our first exercise, we assume the CBO path for fiscal policy. We adopt GDP projections for US trading partners from the latest International Monetary Fund Economic Outlook Database. We assume moderate increases in oil and stock prices, stable and low interest rates, and slowly rising house prices. Also, we assume that confidence returns very slowly to financial markets, that household borrowing grows slowly, and that nonfinancial-business borrowing remains at recent levels.

We use a horizon of 2016 for the projections reported in this Strategic Analysis. Simulating the Levy Institute model under the assumptions just described, we obtain a much more pessimistic projection than that of the CBO (not shown in our figures), with a drop in real GDP of about 0.6 percent in 2013, slow growth from 2013 to 2016, and a larger increase in unemployment. Under what circumstances would the CBO's more optimistic projections seem more reasonable? Given net exports and fiscal policy, if the economy has to reach the growth rates projected by the CBO, the gap in demand can only be filled by an increase in domestic investment and consumption fuelled by borrowing. Therefore, in our first scenario, we adjust our assumptions about household and business borrowing to align our projections for GDP growth with the CBO's.

The results of our simulation are reported in Figure 4. The government deficit falls rapidly, but if we want to achieve the CBO's projected growth path, the private sector has to start borrowing again, switching to a deficit position. Under this scenario, we would return to a situation not so different from the one we had before the 2007–09 recession.

In Figure 5 we report the path of household and nonfinancial business debt, relative to GDP. Both of these sectors must become more indebted, given our scenario 1 assumptions. If this is the path the US economy takes, it will not be long before another crisis hits, if only because of heavy private sector indebtedness.

**Figure 4** Scenario 1: US Main Sector Balances and Real GDP Growth




- Government Deficit (right scale)
- External Balance (right scale)
- Private Sector Investment minus Saving (right scale)
- Real GDP Growth (left scale)

*Sources:* BEA; authors' calculations

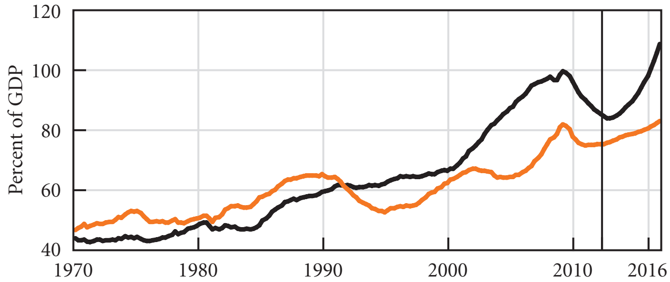
## Scenario 2: A More Plausible Outcome

It must be said that in its January report, the CBO stresses the fact that much of the fiscal adjustment counted on in their baseline relies on temporary tax breaks not being renewed, which is somewhat unlikely. Moreover, there is no sign so far of an increase in private sector borrowing as sharp as the one we had to assume in scenario 1 in order to obtain the growth rates projected by the CBO.

We have therefore modified our assumptions, now assuming that tax rates remain at their current level, and that the deficit is reduced through spending cuts only. We also modify our assumptions on borrowing. Specifically, we assume that household borrowing increases very moderately during 2012, then stabilizes at a sustainable rate through the end of our simulation period.

The results of this exercise are summarized in Figure 6. The government deficit declines only moderately. As a consequence, GDP grows by 2.7 percent in 2012, and manages to grow 1.9 percent in 2013, as compared to 1 percent in scenario 1. With household borrowing so low, however, growth remains at only about 2 percent per year, which is not fast enough to reduce the unemployment rate. In this scenario, household debt continues to fall relative to GDP, but at a slower pace than that achieved over the past four years. By the end of the simulation period, the ratio of household debt to GDP reaches 80 percent, down from 86 percent of GDP in the fourth quarter of 2011.

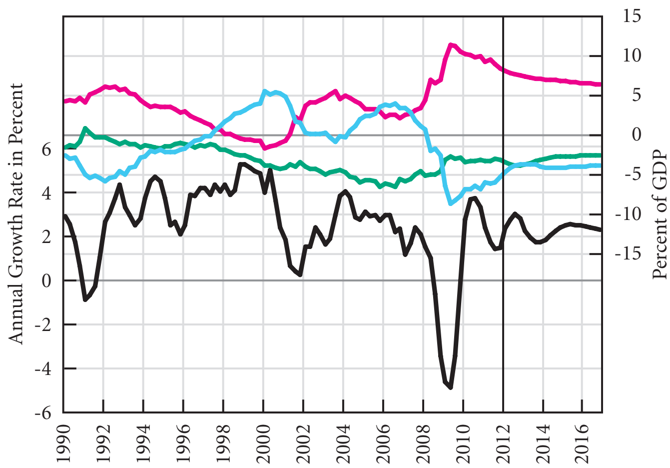
**Figure 5** Scenario 1: US Private Sector Debt




- Nonfinancial Business
- Households

*Sources:* BEA; Federal Reserve; authors' calculations

**Figure 6** Scenario 2: US Main Sector Balances and Real GDP Growth




- Government Deficit (right scale)
- External Balance (right scale)
- Private Sector Investment minus Saving (right scale)
- Real GDP Growth (left scale)

*Sources:* BEA; authors' calculations

## Fundamental Problems with the CBO Model

The two scenarios discussed above involve either insufficient rates of economic growth or an excessive buildup of private sector debt, or both. Having shown in these scenarios that the situation will not improve as easily or as quickly as suggested by the CBO, we would like to mention some respects in which the CBO macro model is flawed.

The January CBO report referred to above contains some signs of faulty thinking. On the one hand, they state that "[from 2018] through 2022, CBO's economic projection is based on the assumption that real GDP will grow at its potential rate because the agency does not attempt to predict the timing or magnitude of fluctuations in the business cycle so far into the future" (CBO 2012, 25) They go on to state, "The projected impact on GDP in later years reflects two opposing forces. The lower marginal tax rates under those alternative assumptions would increase people's incentives to work and save, but the larger budget deficits would reduce (or "crowd out") private investment in productive capital" (29).

In other words, the CBO model is still based on theoretical assumptions that have been proven wrong by the spectacular failure of mainstream models to predict the last recession: (1) that output is driven by supply-side forces, such as incentives in the tax code to supply labor; and (2) that a government deficit only crowds out private investment, as long as the economy is growing fast enough to attain so-called "potential" levels of output, at which point the economy falls far short of full employment.

These flaws help explain why the CBO model yields optimistic forecasts for private sector recovery in the absence of increased levels of economic stimulus. Moreover, in general, policies based on a model such as the CBO's tend to undershoot sought-after growth rates, as shown by the results of our first two scenarios.

In addition, CBO optimism is based, at least in part, on the projection of a very low inflation rate of 1 percent and rising real wages. It is hard to believe that these projections will be plausible, unless the dynamics of the price of oil change dramatically.

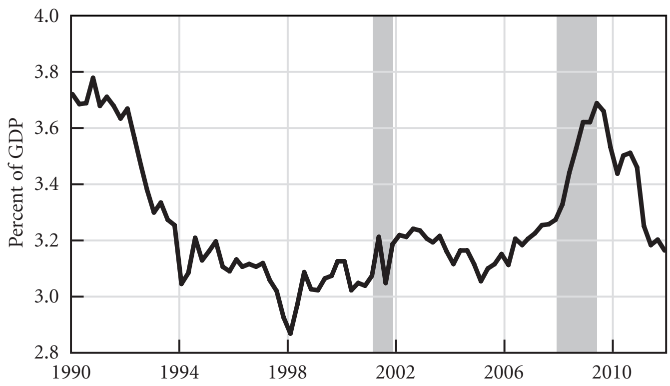
## Scenario 3: The Effects of a Small Fiscal Stimulus

We now turn to a realistic public-spending plan and its likely effects on the results reported above. Much research in recent years suggests that fiscal stimulus has worked in the past and that a given amount of stimulus is likely to have larger effects than the naysayers believe, especially when key short-term interest rates have reached approximately zero percent (Stehn 2012).

In Figure 7, we notice that government investment—especially defense procurement—increased during the 2007–09 recession but is now back to its prerecession level as a share of GDP. Therefore, an increase of about 1 percent of GDP seems reasonably small, yet capable of lowering unemployment. We perform the experiment by raising levels of gross investment during the period spanning the second quarter of this year through the first quarter of 2013. The assumed path exceeds scenario 2 levels by about $150 billion, or roughly 1 percent of GDP, at the endpoint of that timespan. Also, we assume that the government raises tax rates enough to compensate for the additional government expenditure, ensuring that the three financial balances follow roughly the same path as in the previous scenario.

The results of this simulation are encouraging. Not surprisingly, given the research mentioned at the beginning of this section, our assumed policy intervention would be strong enough to reduce the unemployment rate by almost 0.5 percent. A stronger stimulus, or a deficit-financed stimulus, would, of course, have stronger effects.

**Figure 7** **General Government Gross Investment**




*Note:* Shaded areas indicate recession.

*Sources:* BEA; authors' calculations

## Some Macroeconomic Policy Items on the Agenda for the Next Year

In a slowly growing world economy, aggressive efforts to expand exports amount to a "beggar thy neighbor" approach to restoring growth that seems counterproductive from the standpoint of the world as a whole (Robinson 1980, 29; Rodrik 2012). Hence, for our concluding list of policy proposals we look mostly to public sector stimulus, though we also have some proposals in the way of stimuli to private sector job creation and investment. Also, we venture into some related policy areas that, in our view, offer hope for employment and output growth.

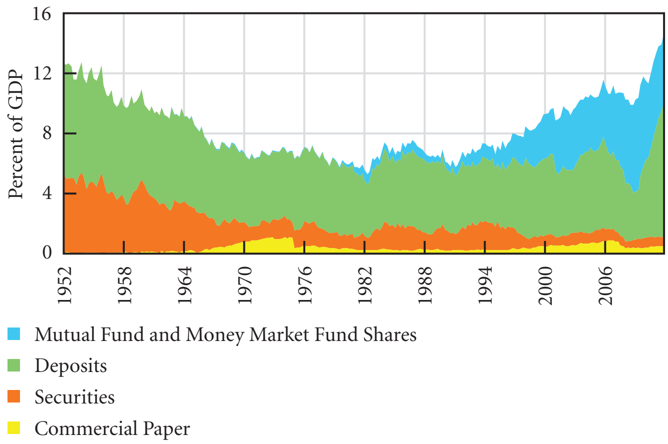
Of course, an obvious implication of the arguments and results above is that we still need a large increase in federal stimulus spending. The elements of a good stimulus agenda would include help for state and local governments, a renewal of the 2011 payroll tax cut, incentives for private sector job creation, and an extension of unemployment benefits. Moreover, with numerous highly skilled people out of work and with capital cheap, now is also the time to invest in long-run initiatives such as infrastructure improvement.

During the current presidential campaign, attention in the economic debate has focused on reforming the federal tax code or cutting taxes as a way of spurring private sector growth. As usual, supply-side economics has been cited in recent weeks in support of the need to encourage business investment by reducing and/or reforming corporate taxes. All of the key reform proposals, including President Obama's framework, begin with a substantial cut in the statutory tax rate for corporations.

The supply-siders have made many exaggerated and/or dubious claims to the effect that almost everything hinges on tax incentives for businesses. It is important to evaluate the claim that efforts to cut corporate taxes in particular are needed at this point, especially since pressure is high to reduce the deficit either by raising taxes or by cutting spending—changes that would carry rather large economic and social costs in many cases.

One point to be made in this regard is that cash is now rather notoriously abundant on corporate balance sheets, leading to concerns that these funds are not being deployed for new business investment or to retain employees (Schwartz 2011). Instead, liquid resources have been used during the recent years of weak economic activity to buy back stock and fund corporate acquisitions.

**Figure 8** **Quarterly Nonfarm, Nonfinancial Corporate Assets**




*Sources:* St. Louis Federal Reserve, FRED database; authors' calculations

Figure 8 depicts time series data on the financial assets held by the nonfarm, nonfinancial corporate sector. The various items included in the figure—bank deposits, municipal securities, and so on—added up to more than 14.5 percent of GDP at the end of last year, all of it held in the coffers of American businesses.

Presumably, low market rates and strong balance sheets indicate that there are relatively few barriers to an expansion of investment. However, returning to corporations per se, profits are likely to deteriorate this year due to slow growth. Such a turn of events would of course reduce the availability of cash to finance new investment; profits are usually the main source of funds for business investment, though inventory investment is often financed with short-term loans or cash on hand.

This situation brings us to current concerns about efficiency and incentives in the corporate tax system. Commentators who are sympathetic with efforts to reduce corporate tax burdens have pointed out repeatedly that the nominal US corporate rate of 35 percent is among the highest in the industrialized world. The problem with this argument is that the effective rate is relatively low, owing to the large number of loopholes in the tax code that can be used by firms to avoid paying the full 35 percent rate. In fact, during the period 2000–05, the US effective corporate rate was only 13.4 percent, which put it at only 15th-highest among a list of developed countries (CBPP 2012, 4)

Corporate tax loopholes bring up fairness and efficiency issues that are also crucial to the national debate. The need to make the income distribution more fair has already been mentioned as a key impediment to continuing growth. Congressional leaders and presidential candidates speak of closing loopholes and eliminating "preferences" in the tax code that lower rates for certain industries and kinds of income. This would lead to a trade of lower overall rates for fewer loopholes and a greater uniformity of rates across tax returns. Potentially, a major overhaul of this type could result in a tax code that was more equitable and provided more incentives for business investment.

On the other hand, as the debate over a new reform effort takes shape, some people are hoping that any final bill will be revenue neutral or revenue increasing overall. We, too, are concerned about the equity issues raised by reform advocates, but we worry that arguments over the reform agenda will divert Congress's attention from the need for more realistic and timely tax-incentive legislation that could spur job creation over the relatively short time horizon used in the scenarios above. One example would be a cut in the employer portion of the payroll tax.

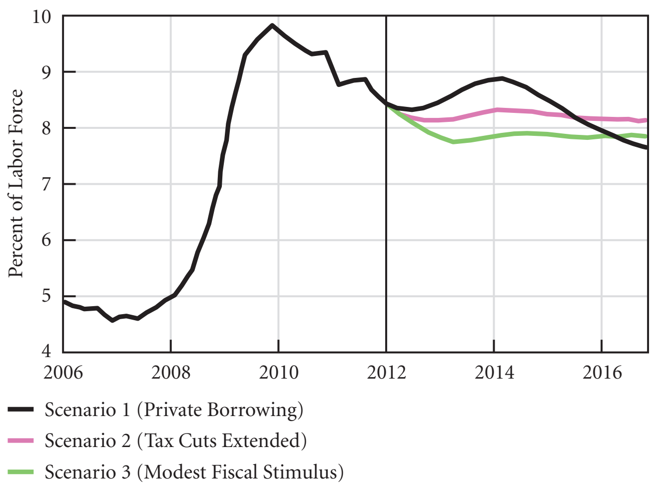
But part of the solution to the problem of encouraging investment will lie, as always, in the public sector, which has greater freedom than the corporate sector to address basic issues in science and technology research. The National Science Foundation recently released a report showing that research and development (R & D) spending in the United States fell in 2009, the most recent year for which data have been compiled (Boroush 2012). Another stimulus to job creation in the short, medium, and long runs could be provided by a significant jump in federally sponsored basic research, which would help speed along this more applied R & D work. The latter is crucial for dealing with the need to adapt to exigencies such as global warming and energy dependency, and will hopefully make US products more competitive.

As for the weakness of efforts to stabilize the financial system, also on our list of slow-moving economic threats, tougher, more thoroughgoing approaches do exist: for example, Amar Bhidé's (2012) proposal for a commercial banking system made up of "boring banks"—safe banks with no shadow banking system of risk-taking ventures and institutions—and the new regulatory paradigm outlined by Jan Kregel (2010) in a recent Levy Institute brief. These ideas are broad proposals rather than à la carte items. Hence, they could form appealing and coherent visions for those who worry about weaknesses in a multifaceted reform effort.

## Conclusion

Our three scenarios show that no matter how these policy issues are resolved in the next congressional session, the nation is still likely to be producing at far below its potential output levels when that session begins next January. Moreover, it is very unlikely that unemployment and underemployment will have reached even moderately elevated levels—say, an official unemployment rate of 6 percent. In fact, scenarios 1 and 2 above indicate that the CBO's meager projections of a mild surge in job growth starting two years from now are unrealistic, unless private sector borrowing takes off again. But a macro policy based on a new run-up in private sector debt levels would heighten the risk of a financial crisis, especially in light of the financial threats already facing households, state and local governments, and corporations. Once again, keeping in mind political realities, we urge at least a modest application of fiscal stimulus. Scenario 3 illustrates that a small, tax-financed increase in government investment could lower the unemployment rate significantly—by approximately one-half

**Figure 9** US Unemployment Rate in Three Scenarios




*Sources:* BLS; authors' calculations

of 1 percent. Figure 9 depicts the paths of unemployment achieved under each of the three scenarios. Based on our results, we surmise that it would take a much more substantial increase in fiscal stimulus to reduce unemployment to a level that most policymakers would regard as acceptable.

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