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Report of the Joint Economic Committee on the 2001 Economic Report of the President Vice Chairman's Views and Democratic Staff Reports December 2001

Overview of the Economy in 2001

The longest economic expansion in U.S. history ended in 2001. After growing at an average annual rate of 3.5 percent during the nearly ten years of expansion, the economy grew by only 0.3 percent (at an annual rate) in the second quarter of 2001, and *declined* by 1.1 percent in the third quarter, the sharpest quarterly drop since 1991. Although complete data are not yet available, most analysts believe the economy declined in the final quarter of the year as well.

The downturn comes on the heels of a particularly robust economy. Between 1996 and 2000, economic growth was especially strong. Real GDP grew at an average annual rate of 4.1 percent. That unusually strong growth was fueled by a surge in productivity. Between 1996 and the middle of 2000, nonfarm productivity grew at an average annual rate of 2.7 percent. The unemployment rate declined to 3.9 percent in September 2000, while the core rate of inflation (the change in the Consumer Price Index excluding food and energy) rose only slightly in 2000 after hitting a thirty-three year low in 1999.

The nation's factories have borne the brunt of the current slowdown. Since mid-2000, production and employment declines in the manufacturing sector have been the sharpest in nearly twenty years. Particularly hard hit have been producers of high-technology commodities such as computers, communications equipment and semiconductors. After rising at an average annual rate exceeding 40 percent from 1996 through 2000, business investment in computers and peripherals has *fallen* at an average annual rate of nearly 21 percent so far this year. In November, manufacturers of high-technology equipment were operating at a mere 60 percent of their capacity.

As the weakness in demand spread from the high-technology sector throughout the rest of the economy and to our trading partners overseas, U.S. businesses curtailed production and met waning sales out of inventory stocks. As a result, inventories were drawn down, employment declined, household incomes weakened, and household spending slowed as well.

The economic downturn was already well underway prior to the terrorist attacks on September 11. A September 7 report issued by the Joint Economic Committee Democratic staff warned that, even at that time, there were significant further downside risks to the economy and the federal budget including a possible downturn in consumer spending in the near term, lower than expected productivity growth over the longer term, and the possibility that recent positive “budget surprises” might unwind as the economy slowed down. The attacks only deepened the contraction that had begun in March. Business and consumer confidence plummeted and jobless claims began to soar. At the close of the year, the economy has yet to regain even the weak momentum that many analysts believed it had prior to the attacks.

Since the end of the expansion in March, the U.S. private, non-farm economy has lost 1.5 million jobs. The civilian unemployment rate rose by 1.4 percentage points since March to 5.7 percent in November. In recent months, the number of long-term unemployed also has risen sharply. More than one in four of the 8.2 million people unemployed in November have been jobless for 15 weeks or more. Moreover, in November about 1.2 million people were unemployed for longer than 26 weeks, which is especially troublesome because unemployment benefits for covered workers typically run out after 26 weeks.

As has been the case during previous economic downturns, the most economically disadvantaged are the ones hardest hit by the economic downturn. For example, by November, the unemployment rate for women maintaining households had risen by more than two percentage points since March, to 8.3 percent. Unemployment among minorities was much higher than for the rest of the population. The November unemployment rate was 10.1 percent for blacks and 7.1 percent for Hispanics compared with 5.1 percent for whites.

An unusual amount of uncertainty clouds the economic outlook. The current consensus projection of forecasters is for the economy to grow slowly during the first half of next year, building enough momentum to be on a solid recovery path by the fall of 2002. With the inventory correction mostly done, most analysts expect that the year-long easing of short-term interest rates by the Federal Reserve along with some near-term fiscal stimulus by the federal government will be sufficient to enable U.S. production to grow early in 2002. However, further weakening of the leading foreign economies could slow the U.S. recovery as well.

Even if the economy were to begin its recovery in early 2002, it will likely take longer for the employment situation to improve. The recovery in employment has typically lagged that in the overall economy—indeed, during the most recent business cycle in 1991, the unemployment rate did not begin to decline until more than 15 months after the expansion in overall activity had begun.

The Road to Economic Recovery

The challenge now for policymakers is how to get the economy out of recession quickly and put it back on the path of strong and sustainable growth. The Federal Reserve has done its part, cutting short-term interest rates eleven times since the beginning of the year, lowering the federal funds rate to a forty year low of 1.75 percent. Congress and the Administration also took steps immediately following the September attacks by enacting \$40 billion in emergency spending and \$15 billion in assistance to the airline industry. While there was a compelling case for emergency spending following the attacks, it was less clear that all of the problems in the airline industry were tied to the events of September 11 and the temporary halt to airline travel that followed. The Joint Economic Committee Democratic staff evaluated the arguments behind the airline assistance package in a report published on October 3 (*“Assessing Losses for the Airline Industry and Its Workers in the Aftermath of the Terrorist Attacks”*).

The steps taken so far might be enough to keep the recession short and shallow. Many economists believe however, that the post-September 11 economy is particularly vulnerable to negative shocks and that additional economic stimulus would provide valuable insurance against a serious downturn—as long as such stimulus is quick and effective. A poorly designed policy, in contrast, would waste vital resources, provide little or no help with economic recovery, and could even be counterproductive by driving up long-term interest rates.

In early October, the Chairs and Ranking Members of the House and Senate Budget Committees laid out a set of principles for effective economic stimulus. They stressed that stimulus policies should have an immediate but temporary impact. Economic stimulus that comes too late or lasts too long threatens to turn any cyclical budget deficit into a long-term structural deficit, hurting future generations and undermining the recovery by driving up long-term interest rates.

The Joint Economic Committee Democratic staff analyzed a broad range of possible stimulus options in an October 17 paper (*“Economic Stimulus, Principles and Options”*). The paper concluded that measures that increase consumer incomes directly are likely to have the greatest impact on short-run consumer spending, and therefore will stimulate the economy most quickly and effectively. Spending proposals have an important place in any stimulus package because they can often be implemented quickly, can be turned off when they are no longer needed, and can be targeted to those most affected by the recession.

In a second paper on economic stimulus published on December 11, (*“Effective Economic Stimulus: How do Congressional Proposals Measure Up?”*) the JEC Democratic staff assessed how well specific congressional recovery plans measure up to the principles outlined by the Budget Committees. The report evaluated the short-term economic impact of various provisions based on results from policy simulation using a large-scale macroeconomic model. The paper concluded that tax or spending provisions targeted to the low-income working population—such as tax rebates or enhanced unemployment insurance assistance—were likely to produce the greatest bang for the buck in the short-term. Provisions to spur business investment—such as additional depreciation allowances—did not produce the same increase in GDP per dollar of federal assistance, in part because those proposals applied to new investment taking place over more than one year. Limiting tax incentives to investment only in the first year would appreciably increase the short-term economic impact.

The Long-Term Budget and Economic Outlook

Even prior to September 11 it is clear that official estimates of the projected federal budget surplus could easily be too high. A September 7 JEC Democratic staff report ("*A Return to Deficits? An Analysis of the Bush Administration's Mid-Session review and the CBO Update to the Economic and Budget Outlook*") concluded that there was a significant chance that the federal budget could return to deficits sometime in the near future and cautioned that it was extremely unwise for policymakers to continue to treat projections of budget surpluses five and ten years out as if they were money in the bank.

Unfortunately, those warnings were more prescient than anyone knew. The director of the Office of Management and Budget recently disclosed that the Administration now expects a deficit in the federal budget as early as next fiscal year and that budget deficits could continue at least until 2005.

What happened to the surplus? In May of this year the Congressional Budget Office projected a unified budget surplus of \$5.6 trillion for the next ten years. By August, the CBO had lowered its projection of the ten-year surplus to \$3.4 trillion. In October, a bi-partisan estimate by the House and Senate Budget Committees projected that the ten-year surplus would fall to \$2.6 trillion. More than half (55 percent) of the decline in the projected budget surplus between May and October was due to the large tax cut enacted in June. Since then, the economic situation has worsened not improved, despite claims that the tax cuts were needed to boost the economy. The declining economy has further worsened the budget outlook.

The tax cut has made it more difficult to proceed with fiscal policies that could produce short-term economic stimulus. In addition, it has detracted from the nation's ability to address important priorities in the areas of health care, education, and defense, let alone the new burdens of carrying out a war against terrorism and strengthening security at home. The country will need to address all these issues while at the same time preparing for the retirement of the baby boom generation, which is now less than ten years away.

It seems evident that a tax cut of the size and scope of the one enacted in June would not have popular support today. In a series of papers published in May and June, the JEC Democratic staff dissected various aspects of the tax cuts including: the true cost of the tax bill over ten years and why many families will get little or no benefit from the costly tax cuts that are scheduled to take effect after 2002 ("*What do Families Really Get From the Tax Cut?*"); some of the misleading arguments behind the push for repeal of the estate and gift tax ("*Myths About the Estate Tax: Rhetoric versus Reality*"); and why there still are strong economic reasons to reduce taxes on lower-income families ("*Who Faces the Highest Marginal Tax Rates?*").

The long-run challenge of future demographic changes means that Congress and the Administration must balance pressing current needs with policies that promote long-term economic growth. Investment is the key to future economic prosperity. Government can undertake that investment directly through spending on education and infrastructure. The most significant way that government policies can contribute to investment and economic growth, however, is through increased public saving—either by decreasing government deficits or increasing government

surpluses. Increased government saving lowers interest rates and frees up more capital for private investment.

A policy of deficit reduction in the latter half of the 1990s helped spur the rapid economic expansion of that era. The Administration's tax cut is an unfortunate reversal of past fiscal discipline. Although certain tax cuts and other government policies can encourage private saving, the effects of these saving incentives are more uncertain and far smaller than the direct effect of public saving. Compared with the Administration's tax cut, other government policies would provide more economic stimulus in the short run, without jeopardizing national saving and economic growth in the long run.

The reports cited in these remarks can be accessed from the Joint Economic Committee Democrats' web site: WWW.SENATE.GOV/~JEC/

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