THE JOINT ECONOMIC COMMITTEE

DEMOCRATIC STAFF

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THE 2002 JOINT ECONOMIC REPORT: VICE CHAIRMAN'S STATEMENT

I. Introduction

The U.S. economy struggled unsuccessfully this year to mount a strong, sustainable recovery. Sluggish growth in overall demand for goods and services, together with strong growth in productivity (output per hour), has meant that employers have been able to expand output sufficiently to meet demand without adding many new workers to their payrolls. Thus, the unemployment rate remained high, fluctuating in the narrow range of 5.5 to 6.0 percent over the first 10 months of the year. Economic growth showed signs of faltering in the fourth quarter, and in November the Federal Reserve cut interest rates for the first time in nearly a year. Starting in the summer, forecasters became more pessimistic about the economy's growth prospects over the next 6 to 12 months, but most expected the economy to avoid slipping back into recession. Nevertheless, a robust rebound and strong recovery remain elusive.

The federal budget outlook weakened along with the economic outlook. The Federal budget deficit was $159 billion in 2002, compared with a $127 billion surplus in 2001 and a $236 billion surplus in 2000. Some of this shift from surplus to deficit reflected legislative actions, most notably the economic stimulus package enacted in March and the additional spending enacted in response to the September 11, 2001 terrorist attacks. Federal revenues also declined unexpectedly for reasons related to the stock market decline and other factors.

In the short run, these policy changes may have helped keep the economy from weakening even more than it did. However, declining spending and tax increases at the state and local level blunted their impact. More troubling for the economy, however, was the deterioration in the long-term budget outlook. In March, the Congressional Budget Office (CBO) projected a cumulative surplus of $2.4 trillion for 2003-12. In its August update, CBO's projection for cumulative 2003-12 surpluses had shrunk to just $1 trillion. This substantial deterioration of the long-run budget outlook probably had a negative impact on longer-term interest rates.

The average American family did not fare very well in economic terms over the past year. The poverty rate went up while inflation-adjusted median household income fell. State and local governments suffered budget crises, which limited their ability to respond to rising levels of need. The response has also been limited at the Federal level. For example, though long-term unemployment remains high, the extended benefits program enacted last year to provide an extra 13 weeks of unemployment insurance benefits to those who have exhausted their regular benefits is about to expire, and it has not yet been renewed.

Trends in Output and Employment

The economy is still feeling the effects of the recession that began in early 2001. Since the fourth quarter of 2000, real (inflation-adjusted) gross domestic product (GDP) has grown at an average annual rate of just 1.4 percent. With such sluggish growth, it is no surprise that the unemployment rate went from an average of 4.0 percent in 2000 to an average of 5.7 percent this year. Through early November, new claims for unemployment insurance remained relatively high. Moreover, the average length of an unemployment spell remained near 18 weeks, the highest level since early 1996.

It is an open question whether the economy is still technically in a recession, but there is little question that it is still in an economic slump. The acknowledged arbiter of when recessions begin and end is the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), a private organization, and they have not yet made a determination. The NBER defines a recession as "a significant decline in activity spread across the economy, lasting more than a few months,…" Real GDP started growing again in the fourth quarter of 2001, and, if that growth is sustained, the NBER may ultimately decide that the recession ended at that time. But the economy is still in a slump, in the sense that growth has been too slow to make much of a dent in the unemployment rate or the percentage of the nation's productive capacity that is lying idle.

Given recent trends in productivity and labor force growth, the economy has to grow at a little more than 3 percent per year just to keep the unemployment rate from rising. Even stronger growth is necessary to bring down the unemployment rate. In the first three quarters of 2002, growth averaged just 3.1 percent at an annual rate. But that growth was driven by special factors such as inventory adjustments in the first quarter and new car purchasing incentives in the third quarter. Underlying demand as measured by final sales (GDP less inventory change) grew at a more modest 1.8 percent at an annual rate. Moreover, it seems that the economy is losing steam rather than picking up, which prompted the Fed to ease monetary policy by cutting its interest rate target by one-half percentage point in early November.

Although this recession has been milder than some in terms of lost output, it has been more typical in terms of job losses. Strong productivity growth has allowed output to keep growing even though employment has stagnated. Output per hour in the nonfarm business sector has grown at an average annual rate of 3.1 percent since the end of 2000, suggesting that the productivity boom of the late 1990s may be continuing. For the longer term, strong productivity growth is good news, because it translates into higher wages and a rising standard of living for American workers. In the current slump, however, strong productivity growth has translated into inadequate job creation. In fact, the number of employees on nonfarm payrolls was about the same in October 2002 as it was in January 2000.

The current downturn has also been unusual in other respects. It appears to have been precipitated by a sharp drop in business investment that was cushioned by continued strong demand by consumers for motor vehicles and housing. More typically, consumer spending slows first, which then prompts businesses to cut back on their investment. Recovery is typically accompanied by a revival of household spending on housing and durable goods, which then prompts businesses to step up their investment. The ongoing strength of household spending in the current slump means that there is less scope for the kind of surge that typically sparks a strong rebound. The risk that the slump will be prolonged, or worse, that the economy will dip back into recession, arises from the fact that consumer spending may begin to flag before business investment picks up. That risk is especially relevant if the stock market declines further.

International developments have also contributed to prolonging the slump in economic activity. The lingering effects of a sharp appreciation of the dollar in the late 1990s are reflected in a large trade deficit, with U.S. exports of goods and services substantially less than U.S. imports. Given the attractiveness of the United States to foreign investors in the late 1990s, the rise in the dollar was most likely unavoidable, but a strong dollar makes foreign goods cheaper for U.S. consumers and U.S. goods more expensive for foreign purchasers. The dollar weakened somewhat in 2002, but sluggish growth among our trading partners remained a drag on U.S. export performance.

Inflation continued to be well-contained in 2002. As productivity grew, labor costs per unit of output remained stable. At the same time, the relative weakness in overall demand discouraged many businesses from raising the prices of their products. As a result, the core consumer price index (which excludes the effects of changes in food and energy prices) rose at an average annual rate of just 2.1 percent through September.

Monetary Policy

The Federal Reserve responded quickly to signs of slowing economic activity and eased monetary policy substantially in 2001. The Fed acts directly by cutting its target for the federal funds rate (the interest rate banks charge each other for overnight loans). In general, a cut in the federal funds rate leads to an expansion of money and credit and a reduction in other interest rates as well, including the longer term interest rates that affect business expenditures on plant and equipment and consumer expenditures for housing, cars, and consumer durables such as furniture and appliances. Between January and December of 2001, the Fed cut its federal funds target from 5.5 percent to 1.75 percent. However, notwithstanding the Fed's aggressive easing of monetary policy, longer-term interest rates remained stubbornly high for a while in 2001. Those rates have come down some this year, but there is still a large spread between the short-term interest rates that respond quickly to Fed actions and the longer-term rates that matter for most interest-sensitive spending. In addition, the spread between interest rates on treasury securities and the rates on corporate bonds has widened, indicating that the market sees increased risks to private investment.

The Fed took no further monetary policy actions for most of this year. At the beginning of the year, the conventional wisdom was that the economy was on the road to recovery—though risks remained. The consensus forecast for growth this year and in 2003 became more pessimistic late in the summer, and by early November there were sufficient signs of weakness that the Fed cut interest rates again. The target for the federal funds rate is now 1.25 percent, which seems to leave the Fed limited room for further aggressive easing should the need arise. In testimony to the JEC, however, Federal Reserve Chairman Alan Greenspan indicated that the Fed had sufficient alternative tools – such as purchasing long-term securities – if there was need for additional stimulative policies.

The Near-Term Outlook

For much of the year, forecasters have been downgrading their predictions for near-term growth. The most recent Blue Chip consensus—the average forecast of approximately 50 leading private-sector forecasters—expects a slowing in real GDP growth to 1.6 percent (annual rate) in the current quarter. The consensus forecast for growth is 2.3 percent this year and 2.8 percent next year. Given current trends in labor force growth and productivity, that growth is too slow to bring down the unemployment rate, which the Blue Chip consensus forecast expects to remain near its current level through 2003. The consensus forecast expects inflation to remain moderate at 2 to 2.3 percent through the end of next year.

II. Government Budgets

Deterioration of the Federal Budget Outlook

The Federal budget deficit was $159 billion in 2002. This is in marked contrast to the $127 billion budget surplus last year, and the $236 billion surplus in 2000. Lower receipts accounted for about half of the $286 billion budget swing from last year. While the tax cuts enacted in 2001 and 2002 were partly responsible for the decline, most of the drop off in receipts occurred for reasons other than policy changes.

Non-interest spending increased by $184 billion in 2002, while interest payments were $37 billion less than in 2001. Increased defense spending account for 22 percent of the overall increase in non-interest spending—the single largest dollar increase. Outlays for unemployment compensation and Medicaid were also up sharply in 2002.

A temporary return to deficits may be the appropriate policy during an economic slowdown, but the deterioration of the long-term budget outlook is more worrisome for future economic growth. As recently as March of this year the Congressional Budget Office projected a cumulative surplus of $2.4 trillion for 2003-12. In its August update, the CBO lowered its projection of the ten-year budget surplus to just $1 trillion. Most of that decline is due to a worsening outlook for Federal revenues over the next ten years as a result of the stock market collapse.

More telling, however, is how far the budget picture has deteriorated since the projections of record long-run surpluses less than two years ago. In January 2001, the CBO projected a cumulative surplus of $5.6 trillion over the ten years from 2002-2011. As of this past August, CBO's projected surplus for 2002-2011 had shrunk to $336 billion, with 96 percent of that remaining cumulative surplus occurring in 2011 (under the assumption that last year's tax cut expires as scheduled at the end of 2010).

According to CBO, that $5.3 trillion deterioration of the budget surplus is explained by a combination of legislative actions, changes in the economic forecast, and changes resulting from "technical" re-estimates. The largest single factor is the 2001 tax cut, which reduced the ten-year surplus by over $1.6 trillion, accounting for 31 percent of the downward revision. Changes in the economic forecast because of the recession contributed 15 percent, and changes resulting from technical re-estimates (modifications to the budget forecast not directly related to enacted legislation or to revisions in CBO's economic forecast) accounted for 29 percent. The tax cut's 31-percent contribution to the decline in the surplus is twice that of increased spending for defense, homeland security, and international programs (totaling 16 percent), while increases in domestic spending outside of homeland security account for just 4 percent of the decline in the surplus.

Moreover, the current projections assume the entire tax cut expires at the end of 2010. A permanent version of the tax cut would be responsible for a much larger share of the deterioration of the ten-year surplus. For example, in 2010 alone—when the tax cut is fully phased in—the tax cut is responsible for 42 percent of the deterioration in the surplus.

The Social Security Surplus

The Social Security surplus continues to increase—revenues exceed benefit payments, which allows the Trust Funds to add to the stock of accumulated assets, held in the form of Treasury securities. However, the Social Security program is treated as "off budget." As a result CBO projects that the "on-budget" accounts of the Federal government will show a cumulative deficit of $1.5 trillion over the next ten years. In these circumstances, money from the securities held by the trust funds offsets other borrowing that would be necessary to finance the deficit, so that effectively some of those off-budget surpluses are being used to help pay for "on budget" items.

Over the current budget window (the ten year period over which CBO makes budget projections) the Social Security system will continue to collect more in revenue than it pays out in benefits, because the large baby boom cohort will not start to receive retirement benefits until the end of the projection period. Shortly beyond the budget window, however, Social Security benefit payments will start to exceed the system's tax revenues. At this point, interest on trust fund reserves and redemptions of assets will be needed to supplement tax revenues. Social Security surpluses will no longer be available to finance on-budget deficits, and unless there are on-budget surpluses, additional government borrowing will be required. If the large on-budget surpluses projected in early 2001 had materialized, some of those surpluses could have been used to cushion the effects of the shortfall in Social Security, and possibly, to allow a transition to a fully-funded system. But in the absence of surpluses, the shortfall in Social Security will become an even more difficult problem to solve.

Impacts on State Budgets

State budgets have also been hurt by the economic downturn. Reduced revenues cause major problems for many states because their constitutions require them to have balanced budgets. States had to take actions to close budget gaps for fiscal year 2002, and are now putting in place spending cuts and tax increases as part of their fiscal year 2003 budgets.

Fiscal year 2002 budget gaps at the state level totaled at least $37.2 billion, according to the National Conference of State Legislatures (NCSL), and around a dozen states reported budget gaps in excess of 10 percent of their general fund budgets. Initial estimates for fiscal year 2003 are even bleaker, suggesting an aggregate budget gap of $49.1 billion, with California's $15.1 billion gap accounting for nearly 31 percent of the total.

The budget shortfalls result from both greater spending and declining revenues, but the revenue losses have been the more significant factor. State revenues have dropped dramatically: nationwide, revenues for the second quarter were over 10 percent lower than a year ago, and several states suffered from 20- to 25-percent declines. In general, states relying on high-tech and financial industries for their corporate revenues, and states with more progressive personal income tax structures, have seen the greatest revenue losses.

States were unable to adjust quickly to fiscal year 2002 revenue shortfalls while in the middle of the fiscal year. But in enacting their fiscal year 2003 budgets, many states passed tax or fee increases. Most states will also be cutting spending. This will hurt programs such as Medicaid, where need usually rises during a recession. Some states may be required to limit coverage or reimbursements to providers under Medicaid to meet their budgets. State budget constraints are also likely to limit the amount of aid that can be given to needy families, whose numbers typically increase as jobs become harder to find. Since the Temporary Assistance to Needy Families (TANF) program became a block grant in 1996, all of the risks associated with rising levels of need are now borne by the states.

III. Tax Cuts and the Economy

The 2002 Economic Stimulus Package

In March 2002, the economic stimulus package became law. The stimulus package provided tax relief for businesses through enhanced depreciation deductions for new investment and more liberal rules for allowing currently unprofitable firms to receive refunds of past taxes. The stimulus package also extended unemployment benefits for the long-term unemployed whose regular benefits had run out.

Specific investment incentives can promote investment and foster longer-term economic growth, but they must be carefully designed if they are to provide stimulus rather than simply shifting expenditures from one accounting period to another. The stimulus package included more generous first-year depreciation deductions, which cost about $16 billion over the ten-year budget window. But companies can take advantage of this greater first-year depreciation allowance until September 2004—and that 3-year window of opportunity means that companies may well hold off on new investments until after the recovery is well underway. As a result, there has been little effect on business investment so far; investment growth is still significantly below the very high rates seen in the late 1990s. Tax incentives can only do so much to stimulate investment in any case, because businesses are unlikely to invest unless they see opportunities for reasonable rates of return. A business with no profits has no need of tax breaks. As a result, such tax breaks probably do little to motivate investment that wouldn't have occurred otherwise. For most businesses, tax considerations are now outweighed by current economic and geopolitical uncertainties.

The 2001 Tax Cut

Beyond the economic stimulus package, no substantial new tax cuts were enacted in 2002. The 2001 tax cuts continue to phase in, however. Only a portion of the tax cut enacted in 2001 has actually taken effect. The tax cuts in place are quite different from the tax cuts scheduled to take effect in later years. In contrast to the first round of income tax cuts, which were broadly distributed across income-tax-paying families, the benefits of the future scheduled tax cuts are heavily skewed toward the highest-income households. Two-thirds of the future income tax cuts go to the top 20 percent of taxpayers, and 60 percent go to the top one percent. Including the effects of repealing the estate tax skews the benefits still further. More than 70 percent of all the future income and estate tax cuts goes to the top 10 percent of taxpayers.

The provisions of the 2001 tax cut that are not yet in place will cost about $600 billion over the 2003-2012 period, assuming that the tax cut is not allowed to expire in 2010. The entire 2001 tax cut will cost $1.7 trillion over the same period. Thus, provisions of the 2001 tax cut that have yet to take effect account for over one-third of the 10-year cost of the entire tax cut. (For further details see the attached studies, "Rethinking the 2001 Tax Act One Year Later" and "A Tale of Two Tax Cuts.")

Tax Cuts as Economic Stimulus

The 2001 tax cuts have had some beneficial effect on the economy in the short term. The initial installment of the tax cut, which went into effect in 2001, was the $40 billion in tax rebates and reduced withholding that began in July 2001, only four months after the official start of the recession. Although the rebates did not go to all U.S. households, they went broadly to households who pay income taxes, and middle-income households received rebates similar in size to the highest-income households ($600 per married household and $300 per single filer).

Tax cuts that go broadly to all income taxpayers stimulate the economy more than tax cuts that are tilted towards high-income households, because high-income households are less likely to spend any tax savings immediately. Lower- and middle-income families are more likely to spend any additional dollar of income, which produces greater immediate economic stimulus. (See “Rethinking the 2001 Tax Act One Year Later,” attached.)

Tax Cuts and Entrepreneurial Activity

There is also very little evidence that marginal rate reductions of the size enacted in the 2001 tax act will stimulate new economic activity. The rate reductions in the upper tax brackets will make higher-income households better off. But when people are better off economically, they can actually reduce the amount of work they do while enjoying the same standard of living. Furthermore, research shows that risk taking may actually be discouraged when personal tax rates are reduced, because deductions for business losses are not worth as much.

Some argue that small business owners in particular will be encouraged to invest and produce more as a result of the reductions in the top personal income tax rates. But these potential effects on entrepreneurial activity are greatly exaggerated. Tax return data from the late 1990s indicate that only a very small fraction of small business owners faced the top marginal income tax rates and thus stand to benefit the most from the rate cuts.

Repeal of the Estate Tax

One part of the Administration’s tax cut agenda that has not yet been completed is the permanent repeal of the estate tax. Proponents of the repeal argue that it would promote capital formation and create more long-run investment and growth, and that the tax imposes crippling and unfair burdens on family businesses and farms. In fact there is little evidence to support these claims.

Theoretically, repeal of the estate tax could cause saving either to rise or to fall. Being able to leave tax-free estates might cause people to save more, if tax avoidance is a major concern, but it might cause them to save less, if their goal is to provide an estate of a specific size. For heirs, the tax repeal would just mean an increased inheritance, which would almost certainly result in some increase in spending. The actual numbers suggest the estate tax does not have a big effect on saving and investment. As of 2002 the estate tax already has an exemption level of $2 million per couple—meaning that only those estates valued over $2 million after various deductions will owe any estate tax, and only on the taxable portions above that high threshold. Estates passing between spouses are not subject to tax. Moreover, even under the lower threshold of $600,000 in 1999, only about 2.2 percent of adult deaths produced taxable estates.

Claims that the estate tax imposes large burdens on family farms and family-owned businesses are grossly exaggerated as well. Most farms and small businesses are worth less than $2 million, and often several family members own shares, reducing the amount that would be taxed as part of any one estate. Further, farms and family-owned businesses already have higher allowances under the estate tax. Most taxable estates are not farms or family-owned businesses. In 1999, for example, farm assets were a majority of the gross estate of only 642 taxable estates—1.4 percent of the 47,482 taxable estates; small business assets were a majority of the gross estate for only 1.1 percent.

The estate tax is very small relative to household net worth. In 1999 the gross value of taxable estates represented less than 3/10ths of one percent of household net worth, and the estate tax itself less than 6/100ths of one percent. Logically, therefore, the estate tax simply cannot affect capital accumulation significantly, because it affects very few people and has an extremely small effect on the economy's overall cost of capital. The repeal of the tax would provide a very large windfall for the very rich, and would cost the Federal government an estimated $740 billion in 2013-2022. This large revenue loss during a time of budget deficits will potentially increase the burden on other taxpayers, who will be called upon to make up these revenues. (For more discussion, see "Repealing the Estate Tax Will Not Promote Economic Growth," attached.)

Permanently Extending the 2001 Tax Cuts

Permanent extension of the fully-phased-in tax cut would have little beneficial effect on the economy over the short run, and would likely have adverse effects over the longer run. Compared with the tax cuts already in place, the parts of the 2001 tax cut that have not yet taken effect would be less effective at providing short-term economic stimulus, because the benefits of the remaining tax cut are heavily tilted toward higher-income households. These future cuts involve dramatically growing revenue losses as the tax cut phases in, while the economic activity that will be induced by these tax cuts is unlikely to be large—in other words, a small bang for big bucks. Moreover, the adverse consequences for the longer-term budget outlook may put immediate upward pressure on longer-term interest rates, threatening current economic activity. (For further discussion see the attached studies, "A Tale of Two Tax Cuts" and "Rethinking the 2001 Tax Act One Year Later.")

The future scheduled rate cuts and the phasing out of the estate tax disproportionately benefit the highest-income households. The loss of tax revenue will reduce public saving, just at a time when the retirement of the baby boomers will begin to place severe demands on the budget. The private-sector saving response to the rate cuts and estate tax repeal is highly unlikely to make up for the reduced government saving. The pool of national saving available to finance new investment will fall, hurting future economic growth.

IV. How Families Are Faring

Household Incomes

Many households have seen their income remain stagnant or even decline in real terms in this recession. Estimates of income and poverty rates from the Census Bureau show that the majority of Americans were worse off in 2001 than they had been the year before. The proportion of people in poverty rose to 11.7 percent, reversing the trend of falling poverty rates since 1992. Median household income (adjusted for inflation) also declined significantly for the first time in a decade, by 2.2 percent. The real median household income of African-American families declined 3.4 percent in 2001.

Households in the lowest three-fifths of the income distribution experienced the largest decreases in average incomes. The share of total income going to the bottom three-fifths of all households declined, while that going to the top fifth rose. The top one-fifth of households in the distribution of income now receive more than half of all income, and the top 5 percent alone get more than 22 percent. In contrast, the bottom three-fifths of households together receive less than 27 percent of total household income**.** Their share declined by about 2 percent over the past year.

Poverty rates also rose in 2001 for the first time since 1992**.** This increase in poverty affected Americans of all ages and types. The poverty rate for the population as a whole rose from 11.3 percent in 2000 to 11.7 percent this past year**.** There were almost 33 million people in poverty (under the official Census Bureau definition) in 2001, an increase of about 1.3 million since 2000. (Under the Census definition, the poverty line for a family of three, for example, was just over $14,000 in 2001.)

Almost one out of every six American children is poor. The poverty rate for children under 18 years old was 16.3 percent in 2001, up slightly from the previous year. Black and Hispanic Americans also continue to have very high poverty rates. The poverty rate for African Americans was 22.7 percent in 2001; the rate for Hispanic Americans was 21.4 percent. (See "Poverty Rates Rise While Incomes Fall For Low- and Middle-Income Families," attached.)

Aid to Needy Families

Temporary Assistance to Needy Families (TANF) is the major program providing cash assistance to families based on financial need. TANF was established in the 1996 welfare reform act and is up for reauthorization this year. It has not yet been reauthorized, but the deadline for reauthorization has been extended to December 31, 2002.

Since 1996, the number of families receiving welfare through TANF has fallen by fifty percent. While there are many success stories of families who have moved off welfare and into the workforce, this reduction in TANF rolls does not automatically mean that all of these families are better off financially. Welfare-leavers who are working tend to be in low-skill, low-paying jobs. Research on people who have left welfare shows that most of those who are employed are in service or clerical jobs with average hourly wages between $5.50 and $8.80. By one estimate, more than three-quarters of those welfare leavers did not get health insurance through their employers, either because it was not offered or because they could not afford it. So while many families may have higher incomes than they did when they were on TANF, they may still be at or close to the poverty line. These workers are at high risk for losing their jobs in a weak job market.

About one-third of former TANF recipients are not working. Non-workers generally face one or more barriers to employment: lack of skills, poor health for themselves or a child, lack of affordable child care, or transportation problems. The Administration has proposed requiring TANF recipients to work an additional ten hours per week, even if they have preschool age children, without providing sufficient funding to allow former welfare recipients to overcome their barriers to work. These changes only exacerbate the challenges faced by some families in making the transition to employment.

In an economic slump, more people are likely to need TANF assistance. States are already facing fiscal difficulties, but Federal funding for TANF would be essentially frozen at current levels under the Administration plan. States may have to cut back their current programs in areas such as child care and training to deal with this budget crunch. Quality, affordable child care is an essential element in the economic well-being of working families, and without it parents may not be able to enter or stay in the labor force. While many working families feel the burden of child care costs, low-income families spend a significantly higher share of their income on child care. Families below the Federal poverty line ($17,960 for a family of four in 2001) pay about 23 percent of their income for child care, even with existing subsidies. In contrast, high-income families pay about 6 percent of their income on average for child care.

Unemployment Compensation

The current economic slowdown has been especially hard on the long-term unemployed. Of the 8.2 million people who were unemployed in October, nearly 3 million had been jobless for at least 15 weeks, and nearly 1.7 million had been without work for at least 27 weeks. Many of the unemployed are now exhausting their additional benefits under the temporary extensions that went into effect in March. Without further extensions of unemployment insurance, many of the jobless will have to either take less productive jobs than is appropriate for their skills or leave the labor force entirely.

In March of this year, the Congress extended unemployment benefits for workers whose regular benefits have run out before they have found a job. Under that legislation workers in all states may receive an additional 13 weeks of unemployment benefits after they have exhausted their first 26 weeks of benefits. In addition, a further 13 weeks are available in states with exceptionally high unemployment rates. This extension expires on December 31, 2002, and it has not yet been renewed. About 2.2 million workers are expected to exhaust their benefits by the end of this year.

Unemployment insurance benefits are important in helping families that experience a temporary job loss, but not all unemployed workers qualify for benefits. Low-income workers including former TANF recipients are particularly likely to lack coverage. In order to qualify for benefits, workers must have a minimum amount of earnings over the course of one year. In thirty-eight states and the District of Columbia, the most recent quarter of work is not included in determining eligibility for benefits, effectively requiring a longer period of work to qualify for benefits. Thirty states do not cover part-time workers. Therefore, people who have just recently entered the workforce or who work part-time because of child care responsibilities, for example, may not qualify for benefits. By one estimate, less than half of those who are currently unemployed qualify for unemployment insurance benefits.

Unemployment compensation is an excellent example of a counter-cyclical program—its outlays rise during recessions and fall during expansions, automatically acting to stabilize household incomes and spending. Expanding unemployment benefits to cover more of the work force and providing extended benefits during economic slowdowns would provide additional targeted short-term stimulus without contributing to expanding deficits when the economy is strong.

Health Care

Fewer Americans had access to affordable, quality health care this year than in recent years. After declining in each of the past few years, the number of people without health care insurance increased in 2002. Both employees and employers face the prospect of steadily rising health insurance premiums. Congress failed to reach a consensus on any important health care legislation, which means that many families will continue to lack health insurance coverage and that seniors will go another year without a prescription drug benefit as out-of-pocket health care costs continue to rise.

The recession has reduced the availability of health care coverage for working American families. The Census Bureau's report on health insurance in the United States found that, reversing a two-year decline, 1.4 million additional Americans were uninsured last year (41.2 million overall). More than 30 percent of poor people were without health insurance in 2001. (See "More Americans Went Without Health Insurance in 2001, as Working Families Feel the Burden of the Recession," attached.)

Americans with health insurance were also hurt by the recession and by rising health care costs. In 2002, employer health insurance premiums rose 12.7 percent, following an 11 percent increase in 2001. A survey by the Kaiser Family Foundation and the Health Research and Educational Trust found that 17 percent of covered workers were subject to health benefit cuts in 2002.

Although more than two million additional Americans were enrolled in Medicaid and other public programs in 2001, state budget cuts could threaten future increases. Medicaid and the State Children's Health Insurance Program (SCHIP) have been successful safety net programs deserving of Federal government protections. Many states are facing large projected shortfalls in their Medicaid programs as other sources of health care coverage become less available, however. Some states have already cut back on eligibility and reimbursements to health care providers, and more may be forced to do so if the recession continues. A number of proposals have been made to help states. These include: increasing the Federal match rate in the Medicaid program (FMAP) to temporarily assist states; allowing states additional time to spend unused SCHIP monies and eliminating the "CHIP dip" funding shortfall expected over the next few fiscal years; and encouraging states to improve the non-group private insurance market, where premiums are currently very high and insurers maintain the right to refuse coverage.

Seniors also continue to experience increasing out-of-pocket medical care costs. Rising drug costs are a major factor. Consumer spending on prescription drugs, and drug costs in general, have risen dramatically over the last decade. A recent study of Medicare beneficiaries in eight states found that, in 2001, almost one in four seniors spent at least $100 a month on prescription drugs. While several proposals to pay for at least some prescription drugs through Medicare were discussed this year, no agreement was reached. The House plan, preferred by the Administration, would provide only a meager benefit for most seniors and would do little to reduce out-of-pocket costs. Medicare recipients would be required to pay an undetermined yearly premium, a $250 deductible, and 20 percent of the costs between $250 and $1000 for their prescription drugs. Since the average out-of-pocket drug costs for all Medicare beneficiaries was less than $500 in 2000 (according to AARP estimates), those with modest drug costs would likely pay even higher out-of-pocket costs under the House plan than they currently do.

Education

At the outset of 2002, Congress passed the bipartisan No Child Left Behind Act (NCLB) to improve the quality and accountability of our nation's elementary and secondary schools. Despite these efforts to improve the quality of public schools, the President's budget does not provide adequate funds to implement proposed improvements in K-12 public education.

The Administration and Republican leaders have introduced several proposals to allow families to claim a tax credit or deduction for the cost of sending their child to private school. Most of the proposed tax credits range in value from $1,000 to $2,500 per student for educational expenses – broadly defined as tuition, fees, books, transportation, Internet access and other costs associated with education. The President's budget proposed a credit of up to 50 percent of the first $5,000 of qualified education expenses for students currently enrolled in a public school that has failed to make adequate yearly progress, as defined by NCLB. Other proposals would expand existing tax deductions and credits for higher education, such as the HOPE credit and the higher education deduction, to include tuition and fees for K-12 students.

But tax credits and deductions to help families pay for tuition at private schools will not improve the quality of education for several reasons. Students in private schools are not subject to the same accountability standards as those in public schools—some tax credits will go to schools whose standards and facilities are inadequate. Tax credits are likely to cream the most motivated students—or at least, those with the most motivated parents–from public schools. Public schools will be even less able to compete with private schools because they will have lower-achieving students.

Even with the funds from a tax credit, the cost of private school would still be out of reach for many low-income families. The most recent data available suggest that in today's dollars the average tuition for a non-religious elementary school is about $4,700 per year and more than $13,000 per year for secondary school. This does not include the cost of other expenses such as books and transportation. Even with a tax credit, a family earning $25,000 a year, with one student in elementary school and one in high school, would still have to pay about half of their annual income on tuition. (See "A Risky Investment Strategy: Recent Trends in Federal Financial Aid Policy Do Not Meet the Needs of Low-Income Students" for more detail.)

Low- and middle-income families also face the problem that college costs continue to rise faster than prices in general. According to the College Board, the average tuition and fees at a four-year public university rose 9.6 percent in 2002 over the previous year. This is the largest annual average increase since 1981 – 1982, also during a recession. States facing tough economic times are more likely to cut spending on higher education than elementary or secondary education because they can make up the difference in increased tuition and fees. Private universities have also experienced declining endowments as a result of the decline in the stock market. At the same time, student enrollment tends to increase during periods of economic downturn. The ability of families to save for college has been hampered by declining returns in the stock market and low interest rates. Most states with qualified tuition savings plans (also known as 529 plans) have had negative returns on assets in those plans in the past year. All of this suggests that the demand for financial aid will increase.

The value of a college education continues to grow. More and more jobs in the economy require specialized training. According to the Bureau of Labor Statistics, almost one-third of the growth in employment in this decade is expected to occur in jobs that require at least a bachelor's degree – particularly in fields such as health care and computer science. In 2000, the average income of a male college graduate was almost double that of a high school graduate.

Despite this pressing need to expand access to post-secondary education, low-income students are in danger of being left behind by recent trends in financial aid policy that favor tax incentives. The 2001 tax act further expanded the use of tax credits, deductions and other tax incentives to deliver financial assistance to college students. Families with incomes too low to incur income tax liability or who do not have disposable income to invest in college savings accounts cannot get access to these tax incentives. Only 14 percent of the students who claimed an education tax credit in 1999 came from families with an AGI of less than $20,000. In addition, tax credits and deductions do not meet the cash flow constraints of low-income students. Students get the benefit of the credit or deduction when they file their return in April – several months after their tuition bill was due. Credits and deductions do not cover living expenses, which in some cases can be as much or more than the cost of tuition.

Funding for Federal need-based Pell Grants had a significant increase this year – the maximum award was raised to $4,000. But given the large rise in tuition, this increase is still not enough to make college affordable for the most needy undergraduates. In 1975, the maximum Pell Grant covered about 84 percent of the cost of average tuition, room and board at a public four-year university. In the 2001 – 2002 school year, the maximum Pell Grant covered only about 42 percent of those costs. Grants are an efficient method for targeting aid to low-income students who have fewer financial resources and may be more risk-adverse than their more affluent peers. This is an especially important role for the Federal government as states continue to devote an increasing share of financial aid dollars to merit-based programs, and as state budgets become more constrained. (See "Slamming Shut the Doors to College" for further discussion.)