

# Senate Democratic Policy Committee Hearing

## “Will The Bush Economic Plan Create Jobs?”

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### **Immediate problem: Too little demand**

The economy suffers from two distinct problems, one short-term and one long-term. The immediate problem is too little demand for all the goods and services we can produce. Factories are running at only 73 percent capacity, the lowest in two decades; offices are empty, equipment is idle, unemployment is rising. We've lost almost 2.6 million private-sector jobs in the last two years.

The only solution is to ratchet up demand. How? A tax break to companies won't work. Businesses won't invest in additional factories or equipment until they know there's a market for any additional production. A tax break for the rich is bonkers. The rich already spend everything they want to spend. After all, that's the definition of being rich.

The best way to boost demand is to put more money in more peoples' wallets through a tax cut (a refundable credit or temporary cut in payroll taxes, or both) for working people of modest incomes, totaling more than \$1,500 per family, both this year and next. Add in an emergency \$50 billion bailout of the states. Most are now cutting vital social services and school aid because they're broke.

The “deflation” word is coming up more and more often these days. The Federal Reserve Board recently warned that America faces a risk of it. Japan has been suffering from it for more than a decade. Europe is heading toward it. The entire world economy could succumb to it.

Optimists say deflation is unlikely. I'd join the optimists if the Bush administration were taking steps to avoid it. But so far, there's been no strategy. The tax cut offers little help. And last weekend the White House missed a big opportunity to take move against deflation when the President met with the leaders of the other seven major economic powers.

What is deflation, and should we be worried? Deflation means falling prices. But - you say - prices are rising for health care, college tuition, and home heating. Where's the evidence of deflation? Almost everywhere else. The prices of cars, computers, clothing, airlines, and commodities of all kinds are dropping. The only reason health care and college tuitions are

rising is that these “products” include more and more things, like increasing amounts of research on new drugs or more lavish student centers. And heating prices went up because of the Iraq war. Now that the war is over and oil prices are dropping, heating prices will drop, too.

So what’s bad about falling prices? Nothing if prices are dropping because people and companies are becoming more productive. But if prices are dropping mainly because companies have to cut them in order to make sales, we may be heading for trouble. The immediate result is shrinking profits.

When profits shrink, companies have to lay off more workers and slash the pay of those who remain. Naturally, these people stop buying as much as before. Other consumers hold back because they figure if prices continue to drop, they can get better deals later on. All this means fewer sales. Fewer sales put an even greater squeeze on profits. This results in more layoffs and lower pay. You see how this can turn into a vicious downward cycle.

Deflation also puts the squeeze on debtors. Although other prices drop, debts don’t. Debtors have to pay back their loans in dollars that are harder and harder to earn. Not surprisingly, deflation usually means more defaults on loans. That means banks and other lending institutions have a harder time staying solvent. This adds to the downward cycle.

Here’s the worst part about deflation. Central banks are powerless to cure it. If the United States went into a deflationary cycle, the Federal Reserve Board couldn’t spur the economy by lowering interest rates. With prices dropping and dollars harder to earn, no one would want to borrow even at zero interest.

What’s the risk of deflation any time soon? Optimists point out that corporate profits are moving upward. The new tax cut will put a bit of money in peoples’ pockets. The federal government will spend about \$400 billion more this year than it takes in, which will also spur the economy. Another spur will come from exports, aided by a falling dollar.

But deflation is a bigger risk than the optimists are willing to admit. The basic problem is that the global supply of goods and services is way larger than worldwide demand for them - and the gap is widening. That’s a sure recipe for falling prices here and everywhere else.

The world’s second-largest economy (Japan) is still suffering from deflation. Unemployment there is at record highs. The third-largest economy (Germany) is on the brink of deflation. Unemployment is rising there and across Europe. Meanwhile, China is pumping out more low-cost manufactured goods than ever. And India and other low-wage nations are generating all sorts of cheap services - from call centers to software programming.

America isn’t immune. Although corporate profits are still growing, they grew only an anemic 1 percent between January and March, according to last Wednesday’s Commerce Department report.

Look closely and you'll see where those profits are coming from. Companies continue to lay off their workers, and they're keeping a tight lid on the pay of those who remain. In other words, the way companies are maintaining profits in the face of weak demand is by cutting payrolls.

This could be the first round in a deflationary cycle. With fewer jobs and stagnant wages, Americans won't be able to buy enough to keep the economy going. The Commerce Department reported last week that consumer spending dropped by a tenth of a percent in April. This will put continued downward pressure on profits and on prices.

Consider what's already happened. America has lost more than 2.5 million jobs in the private sector since the spring of 2001. That's understating the problem, because the population of adult Americans has grown since then. Look at the population as a whole and you find that more than 74.5 million American adults are not working - that's up more than 4 million since March 2001.

Washington isn't doing nearly enough to spur demand and avoid deflation. The new tax cut goes mainly to rich people, but they won't spend the extra dollars. Being rich means you're already spending as much as you want to spend. The cut should have gone mostly to average working people, who would have spent the extra cash.

Last weekend, at the G-8 meetings, the Administration failed to push the European and Japanese governments to spend more and cut interest rates further. A falling dollar won't mean much if foreigners are in no mood to buy.

I'm not predicting deflation, at least not yet. But don't put me in the optimist camp for now.

### **Long-term problem: Too little capacity**

The long term challenge is to boost the rate of economic growth in order to pay for the giant boomer generations' retirements, starting less than a decade from now, and for the global responsibilities that come with being the last remaining superpower on Earth.

How? Contrary to Bush's supply siders, cutting taxes on the wealthy won't work because they invest the additional money wherever around the world they can get the best return on it. In other words, their investments are as likely to trickle out as to trickle down.

The only way to boost long-term growth is by investing in assets that will uniquely build American productivity and thereby attract global capital: our people (their education, training, and health), and our infrastructure (transportation, water and sewer, and sustainable energy supplies that won't emit as much carbon dioxide into the atmosphere or depend on foreign supplies).

Instead of trickle-down economics, call this bubble-up economics. It's a supply-side solution to our long-term problem, but it's not based on supply-side capital formation. Its based on supply-

side “human capital” formation.

In today’s global economy, financial capital flows anywhere around the world it can get the highest return. The real determinant of long-term economic growth in any single place on the globe is the capacity of people in that area to utilize global capital and generate high productivity with it.

Most Americans are more concerned about the economy than about terrorism. With Congress in Republican hands, Bush did get enough of a tax cut to claim victory. But his plan won’t revive the economy and it won’t deal with its long-term challenges. Democrats can win back the White House if they focus on what really needs to be done: (1) a short-term stimulus based on putting money into the pockets of people likely to spend it; and (2) instead of supply-side “trickle down” capital formation, a supply-side “bubble up” strategy focused on human capital.