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THE HIGH ROAD TO LOW UNEMPLOYMENT

How short-term deficits can create a high-employment budget

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From 1998 to 2001, the nation's unemployment rate was 4.7% or less for 46 consecutive months. No significant inflation was observed in the economy during this period, even though at one point the unemployment rate fell to 3.9%. Neither the budget proposed by President Bush nor the one put forward by his Democratic opposition will return the U.S. labor market to this sustainable level of unemployment. The result of either budget will be unnecessary joblessness, lower wages, and a higher crime rate (Mishel, Bernstein, and Tiffany 2002).

What can be done to help minimize unemployment? Since the Federal Reserve reduced interest rates 11 times last year, further changes in monetary policy are unlikely to help lower unemployment. The missing link now for accelerating growth and lowering unemployment further must come from better fiscal policy. The Congressional Budget Office (2002a) projects a small deficit of $21 billion for fiscal year 2002. But to achieve the economy's growth potential, an economic stimulus is needed that deliberately increases the deficit by $150 billion for the remainder of the current fiscal year and by another $150 billion in FY2003.

What is stimulus?

Deliberately increasing the projected federal deficit, either by lowering taxes or increasing spending, would stimulate the economy. In either case, the aim would be to increase household spending in the short term. More federal spending would encourage businesses to retain and expand their payrolls to meet expected consumer demand, and the resulting new employment would give families more money to spend. But present indicators show that employment will fall well short of its potential for the remainder of the year (Mishel, Bernstein, and Tiffany 2002; Bernstein 2002). Lowering corporate taxes at this point probably won't help remedy the situation

either — businesses are unlikely to use tax breaks to increase spending because they are already operating below capacity (Weller 2001, 2002).

It may also be helpful to take measures that reduce deficits and increase surpluses in the longer term, after employment has fully recovered. Improvements in the long-term outlook contain the possibility of reducing long-term interest rates, which could have benefits in the short and long run.

The unemployment rate as of March 2002 was 5.7%, but recent history shows that the economy can safely reach a 4.0% unemployment rate. Say that one accepts the Office of Management and Budget's assumption that an increase in real gross domestic product (GDP) of 1.0% is followed by a 0.5% drop in the unemployment rate. If GDP grows an extra 3.0% over two years — roughly $300 billion, not counting inflation — then the unemployment rate could be pushed down to about 4.0%.

To get an extra $300 billion in GDP over the next two years (in other words, an extra 1.5% of growth each year), the federal government could increase spending by $150 billion annually. By contrast, President Bush's budget proposes deficit increases of $97 billion for the remainder of this fiscal year and $121 billion for FY2003. There is plenty of room for these proposed deficits to grow for the sake of reducing unemployment. It would be a mistake, out of a misguided sense of fiscal responsibility, for Congress to move deficits in the wrong direction and sacrifice jobs in the process.

But increasing the federal budget deficit is only part of the answer — the composition of the budget matters, too. Almost two-thirds ($138 billion) of the deficit increases proposed by President Bush for this fiscal year and next consist of tax cuts that would probably have little or no effect on employment. Ideally, President Bush's proposed deficit increases for FY2002 and 2003 of $218 billion would be transformed in two ways: the combined level would be raised by an additional $82 billion to $300 billion, and his proposed tax cuts of $138 billion would be redirected to better stimulate the economy.

In particular, new domestic spending initiatives should have greater short-term effect insofar as they imply faster "spend-out" rates. Capital expenditures, whether for military hardware or public infrastructure, tend to be funded more slowly and involve projects that take longer to be completed. Although civilian public investment helps the economy to grow in the medium and long term, it often does not provide the short-term fix the economy needs right now. Some spending options that would quickly pump funds into the economy include aid to the unemployed, aid to state and local governments, and funds for school repair (Scott and Weller 2001; Sawicky 2001; Sawicky and Harris 2001).

On the tax side, cuts that favor lower-income families, who are more likely to spend any extra funds and therefore boost economic growth, would be better than tax cuts for high-income families (Sawicky and Denk 2001). And such tax cuts need not be temporary — a permanent, progressive tax cut combined with permanent repeal of some portion of Bush's proposed higher-income and corporate tax cuts can add up to a short-term stimulus. The cost of the Bush tax cuts increases rapidly in the years to come. A progressive alternative would not only be cheaper in the long run but could also provide a net tax reduction over the next year or two (Sawicky, Cherry, and Denk 2002).

Far-out budgeting

One year ago a unified budget surplus of $5.6 trillion was projected over the next 10 years. Now the figure has

been revised downward by $4 trillion. Some elementary facts make this change virtually useless as a guide to policy.

Much has been made of factors that bias the new surplus projection upward. One is the implausible presumption that the Bush tax cut expires altogether at the end of 2010, triggering a huge tax increase. Another is the huge difference in projecting for a different time period — FY2003 to FY2012 — rather than FY2002 to 2011. The new period drops a low-surplus year — 2002 — and adds one with a high projected surplus — 2012.

What has received less scrutiny, however, are factors that could make for surplus projections that are too low. In January 2001, the Congressional Budget Office reported the budgetary effects of a "recession scenario." The CBO predicted that a "mild recession" would cause a decrease in projected surpluses of $133 billion for a 10-year period (CBO 2001, 102). But in January 2002, in light of what CBO also described as a "mild recession" (CBO 2002a), the CBO announced adjustments totaling a far greater $1.6 trillion.

It is hard to imagine how one mild recession could be so much worse than another. It can't be the economy that has changed so dramatically, so it must be the CBO. More specifically, the CBO's huge adjustment in the surplus estimate must stem from factors unrelated to ordinary swings in the business cycle.

Under this year's view of the world, last year's surplus projection would not have been $5.6 trillion. Not counting the impending tax cuts, last year's projections would have been closer to $4 trillion. Even now, the CBO is at pains to quantify the extent of its uncertainty. Take its $166 billion surplus projection for FY2007, for instance. Because the CBO is not particularly certain of this outcome, it qualifies its projection by stating that there is more than a 30% chance that the FY2007 budget will actually be in deficit that year; the CBO states that there is also a 30% chance that the surplus could be double what it predicts for 2007 (CBO 2002b).

In light of such uncertainty, it is hard to argue that these projections should be used to shape any fiscal policy. It can even be argued that last year's tax law was deliberately written to generate misleading, low-ball surplus projections. The economic modeling process contains gross margins of error. A focus on 10-year projections encourages pointless debate over policies that are purported to have implausible long-term effects. From this standpoint, the use of last year's huge surplus projection to justify a large, permanent tax cut was inappropriate.

The right window for realistic planning is more like three years — FY2002-04. The best way to build confidence in the long-term fiscal picture is first to maximize employment now. Any growth in GDP now improves the outlook for every succeeding year. Congress should forego initiatives that imply unsustainable long-term deficits. For this reason, an honest embrace of a shorter time frame would include repeal of last year's tax cut.

Freezing income tax rates after 2004, as proposed by Senator Edward Kennedy, would be the most obvious way to help the economy's long-term outlook. It will be easy to reconsider tax cuts if the economic picture improves, and it would be politically difficult to reverse tax cuts with poor stimulus effects, even if the economy stagnated indefinitely. Congress should instead consider a different sort of tax cut, one that benefited the average family. Such a tax cut could provide a greater boost to spending and be helpful in creating the political momentum for reversing the much more costly tax cuts now in place (Sawicky and Denk 2001).

Such a tax cut could also be front-loaded to deal with unemployment but be designed to grow slowly enough over time to be much less expensive, in the long run, than the tax cuts passed last year (Sawicky, Cherry, and Denk 2002).

A high-employment budget, by the numbers

Table 1 shows the basic outlines of a high-employment budget. The first line shows projected "baseline" deficits (i.e., spending or taxes if current law remains unchanged), according to the CBO. The baseline deficit for FY2002 is projected at $21 billion. The second row shows the total net spending increases over baseline spending levels proposed by President Bush, including those for defense and homeland security, but not including his newest round of proposed tax cuts. The third row shows the additional stimulus required, on top of Bush's spending increases, to hit the stimulus targets that would be needed for the economy to regain full employment.
In order to push unemployment back down to 4%, the proposed stimulus targets are $150 billion in increased spending for this year and for FY2003. In other words, the projected deficits of $21 billion and $14 billion should be increased to $171 and $164 billion for FY2002 and FY2003, respectively.

To get to these levels, on top of the proposed spending increases in the Bush budget, stimulus packages of $118 billion in FY2002 and $102 billion for FY2003 are required. In other words, significant stimulus is still needed even after granting the entirety of Bush's proposed spending increases and discarding his proposed tax cuts. The table also shows the deficits implied by this proposal in terms of dollars and as a percent of GDP. The bottom row provides information on the proceeds available if part of the tax cut passed last year is rescinded. Redirecting those resources from high-income tax cuts to new spending and progressive tax cuts could add to the stimulus effect of the budget without raising deficits further.

In keeping with a reasonable notion of fiscal responsibility, the decision to expand or contract the size of government on a permanent basis should be done in a deficit-neutral manner. Otherwise the right stimulus targets would not be attained. A pay-as-you-go rule for tax or spending changes can shore up confidence in long-term budget solvency. In other words, permanent changes in taxes and spending should be balanced in a way that precludes increases in projected deficits in the long run.

In summary, a high-employment budget buys confidence in the long-term outlook in two senses: political and economic. The popularity of stimulus measures provides some counter-weight to the political difficulty of pulling back a scheduled tax cut. As noted above, high employment in the short run improves the long-run budget outlook. For example, under the more optimistic scenarios of the Social Security actuaries, projected shortfalls in the trust fund vanish altogether.

The obsession with phantom 10-year surplus projections has not led to effective policy — it has resulted in policies that have failed at sustaining high employment and has done nothing to alleviate apprehensions about long-term budget problems. Ten-year budgets instead distract policy makers from the most pressing and current needs of America's working families.

TABLE 1
How to get a high-employment budget
(Billions, current dollars)

	2002	2003
Baseline deficit	$21	$14
Proposed net Increase in outlays, Bush budget (includes defense and homeland security)	$32	$48
Additional stimulus required for high-employment budget	$118	$102
Deficits required for high-employment budget	$171	$164
As percent of GDP	1.7%	1.5%
Potential additional resources:		
Savings from partial clawback of Bush tax cut	$23	$31
Individual income tax rate reductions	$21	$21
Estate and gift tax		$7
AMT relief	$2	$3

Sources: Congressional Budget Office, Office of Management and Budget, author's analysis.

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