108th CONGRESS } SENATE { REPORT
2nd Session 108-416

THE 2004 JOINT ECONOMIC REPORT

R E P O R T

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON THE

2004 ECONOMIC REPORT
OF THE PRESIDENT

Together with

MINORITY VIEWS

November 18, 2004 -- ordered to be printed

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LETTER OF TRANSMITTAL

November 18, 2004

HON. BILL FRIST
Majority Leader, U.S. Senate
Washington, DC

DEAR MR. LEADER:

Pursuant to the requirements of the Employment Act of 1946, as amended, I hereby transmit the 2004 Joint Economic Report. The analyses and conclusions of this Report are to assist the several Committees of the Congress and its Members as they deal with economic issues and legislation pertaining thereto.

Sincerely,

ROBERT F. BENNETT
Chairman

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THE 2004 JOINT ECONOMIC REPORT

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MR. BENNETT, from the Joint Economic Committee,
submitted the following

REPORT

together with

MINORITY VIEWS

Report of the Joint Economic Committee
on the 2004 Economic Report of the President

OVERVIEW OF CURRENT AND RECENT MACROECONOMIC CONDITIONS

The nation will enter 2005 with an economy that is expanding at a robust pace. During much of this year, some argued that the outlook for the U.S. economy was bleak and that a reversal of the policies of the last four years was necessary. The facts show otherwise:

- The U.S economy displayed continued strong growth in 2004. Labor markets improved significantly relative to the past few years.
- Businesses have added 2.0 million new jobs to their payrolls during the first ten months of 2004. More than 2.2 million jobs have been added to payrolls over the past 14 months through October 2004.
- Economic activity in the manufacturing sector improved and activity in the services sector remained vibrant.
- Assisted by continued low mortgage interest rates, housing markets remained especially vibrant over the past year.

- Consumer and business investment spending—which provide large contributions to the size of the gross domestic product (GDP)—remained resilient, spurred by tax relief enacted in earlier years and low interest rates.
- Partly because inflation and inflation expectations remained well contained, interest rates have not changed significantly since last year. Energy prices increased significantly during 2004 because of geopolitical uncertainties and low inventories. Some raw commodity prices also showed some marked increases, partly because of strong demand from China and India. Despite rising energy and commodity prices, inflation in consumer prices remains low by historical standards.

Between the third quarter of last year and the third quarter of 2004, quarterly GDP growth, expressed at an annualized rate, has averaged 3.9%, a very strong pace of growth. Private forecasters continue to expect further job gains and strong, sustainable growth through 2005.

The Federal Reserve, recognizing the sustained and strong growth in the economy, significantly improved labor markets, the resilience of the economy, and its ability to absorb rising energy and commodity prices, began to remove its accommodative policy beginning in June 2004 by raising its target for overnight interest rates.

We are encouraged by the direction the economy is heading in terms of growth and opportunity. This does not mean that the economy does not or will not face challenges in the months and years ahead, but it does mean that recent economic policy decisions are beginning to pay dividends for the nation's citizens.

The Economy Ended 2003 with Strong Momentum

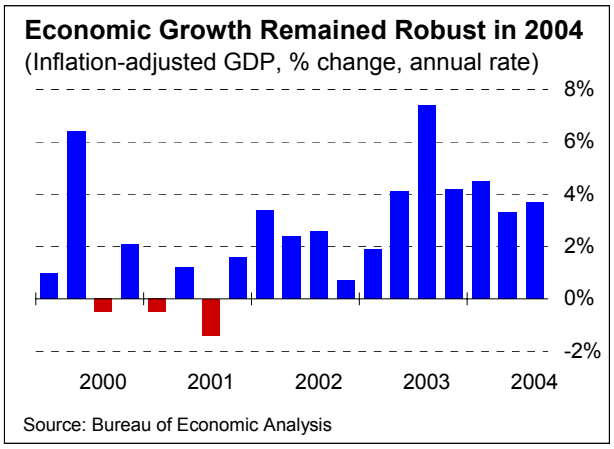
Last year closed with the economy growing in the fourth quarter at a robust 4.2% annual rate and productivity growing at a 3.1% annual rate, well above long-run averages. The unemployment rate in December 2003 was 5.7%, lower than the recent peak of 6.3% in June 2003, and below the average unemployment rates of the 1970s, 1980s, and 1990s. Monthly changes in payroll employment began to turn positive in September 2003 and job gains continued throughout the remainder of the year.

Inflation remained benign at the close of last year. This allowed the Federal Reserve to keep short-term (overnight) interest rates at the 45-year low of 1.0%. Both short-term and long-term interest rates remained very low by historical standards.

The Federal Reserve's policy of accommodating strengthening economic growth combined with tax reduction played key roles in stimulating growth through the end of last year and into 2004. Low interest rates and tax relief helped sustain both consumer and business investment spending and to accelerate economic activity in both the manufacturing and the service sectors of the economy throughout the second half of 2003. Tax relief and low interest rates also kept housing market activity and refinancing at very high levels.

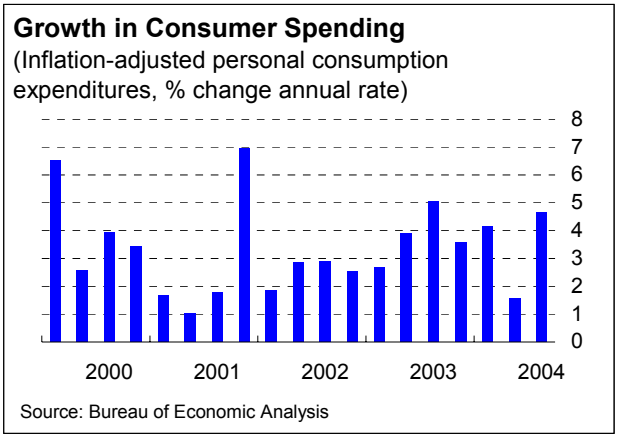
Economic Activity Remained Robust in 2004

Growth in GDP accelerated to 4.5% in the first quarter of 2004, from 4.2% in the previous quarter. Growth continued at more sustainable rates of 3.3% and 3.7% in the second and third quarters, respectively. Many analysts viewed the decline from the 4.5% first-quarter growth to 3.3% growth in the second quarter, along with moderating employment gains and declines in some other economic variables, as a temporary soft patch in an ongoing economic expansion. The expansion regained traction in the third quarter as GDP growth accelerated to 3.7%, the 12th consecutive quarter of growth.

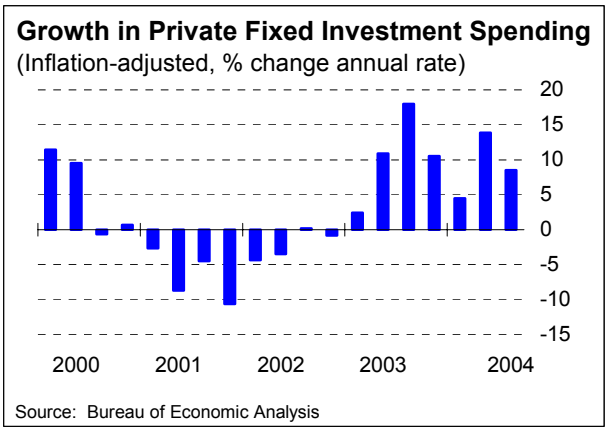


Consumer spending, which accounts for over two-thirds of economic activity, fueled much of the growth through the first three quarters of 2004, driven by gains in wages, salaries, and after-tax income. Growth in inflation-adjusted consumer spending rose 4.1% in the first quarter of 2004, ebbed to 1.6% in the second quarter, and then accelerated sharply to 4.7% in the third quarter. Despite strong consumer spending during the past several years, household debt burdens have not risen markedly. Indeed, household debt burdens

remain below a recent peak that occurred in the fourth quarter of 2002.[1] Moreover, household assets, which are almost 500% of GDP, continue to heavily outweigh home mortgage debt and consumer credit, each of which is well below 100% of GDP.



Following enactment of the 2003 tax reductions, investment growth also contributed substantially to overall GDP growth during 2004. Inflation-adjusted private fixed investment grew by 4.5% in the first quarter, 13.9% in the second quarter, and 8.5% in the third quarter. Investment remained strong, growing by nearly 9.0% during the first three quarters of 2004.

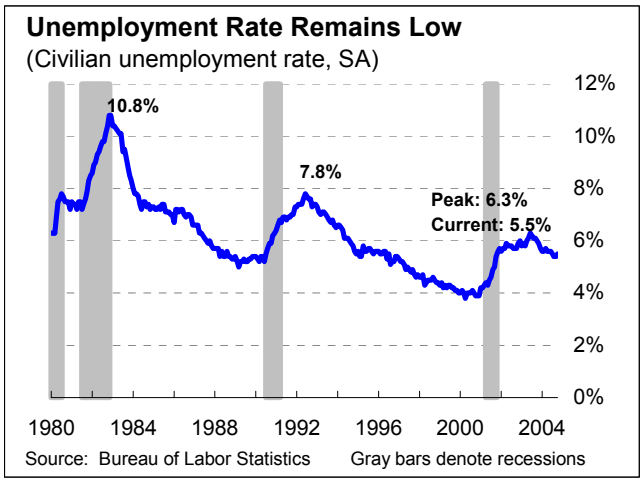


[1] The household debt burden measure is financial obligations as a percentage of disposable income, as measured by the Federal Reserve. Financial obligations include payments on mortgage debt, rent, auto leases, homeowners' insurance, and property taxes.

Labor Markets Strengthened in 2004

Fourteen consecutive months of payroll job gains have added more than 2.2 million jobs to business payrolls. There were gains in payroll employment in each month of 2004 through October. The average monthly gain in payroll jobs through October has been roughly 180,000; above the threshold that many believe must be crossed for job creation to exceed growth in the population.

The unemployment rate in October 2004 was 5.5%, below the 5.7% rate at the end of 2003 and a lower rate than the recent peak of 6.3% in June 2003. The current unemployment rate is below the average unemployment rates of the 1970s, 1980s, and 1990s.



Rapid Productivity Growth Continues

Productivity growth remained high during the first half of 2004. Output per hour in the nonfarm business sector has increased at an annual rate of more than 5.0% since the end of the recession, well above the 2.0% average of the 1990s. Such a rapid pace of productivity growth has not been seen since the 1960s. In the long run, productivity growth boosts business profits, increases wages, and improves living standards.

Business Activity Remained Vibrant in 2004

Economic activity in both the manufacturing and the service sectors of the economy remained strong during 2004, according to surveys by the Institute for Supply Management. As of October 2004, manufacturing activity has increased for 18 consecutive months while activity in the services sector has increased for 19 consecutive months. Capacity utilization in the industrial sector remains low by historical standards, hovering around 76%. Despite remaining below the 82% to 83% levels seen in the late 1990s, utilization trended upward through 2004.

The Housing Market Remained Strong in 2004

New home sales and existing home sales trended up as mortgage interest rates remained relatively low in 2004. Levels of sales remained very strong throughout the year, boosted by mortgage interest rates that are still well below 6.0%. The pace of existing home sales set new record highs in May and June of 2004, while the pace of new home sales remained very strong through the year. The continued blistering pace of home sales in 2004 pushed the nation's homeownership rate to a record high of over 69% during the year.

Energy and Raw Commodity Prices Remain Elevated

Energy and many other commodity prices rose sharply in 2004, but eased somewhat toward the end of the year. Gasoline prices reached new highs during the year; crude oil prices rose above $50 per barrel; and natural gas prices remained high by historic standards. After adjusting for inflation, however, energy prices are still lower than the price spikes of the 1970s and early 1980s. Prices of many raw commodities, such as scrap steel and imported steel coil, rose significantly during 2004, as did overseas shipping rates. Substantial increases in many commodity prices and shipping rates partly reflected the significant demand from China and India for raw materials.

Inflation Has Accelerated Slightly, but Remains Low

Consumer price inflation, measured by the year-over-year percent change in the consumer price index (CPI), remains well contained. CPI inflation was 3.2% in October 2004, very low by historical standards but an increase from CPI inflation of 1.8% at the end of 2003. Inflation in producer prices, measured by the year-over-year percent change in the producer price index (PPI) for finished goods, was 4.4% in October 2004, an increase from around 4.0% PPI inflation at the end of 2003.

Most of the acceleration in inflation has been due to volatile energy prices. Accelerating inflation in crude materials costs facing producers also partly explains the increase in producer price inflation. The "core" rates of inflation, which exclude food and energy prices, remain relatively low, but have also accelerated during 2004. Inflation in the core CPI was 2.0% in October 2004, up from core CPI inflation of 1.1% at the end of 2003. Core PPI inflation has also accelerated—to 1.7% in October 2004 from 1.0% at the end of 2003. The core personal consumption expenditures deflator, regarded by many as a superior indicator of inflation, remains relatively low.

The Federal Reserve Began to Increase Short-Term Interest Rates in 2004, but Long-Term Interest Rates Remain Low.

In May 2004, the Federal Reserve warned of impending increases in its target short-term interest rate—the federal funds rate, which is the inter-bank overnight lending rate—from the 45-year low of 1.00% that had been in place for nearly a year. With low inflation and signs that the economic expansion was fairly firm, the Federal Reserve believed it could move away from its policy accommodation at a measured pace. Policy accommodation refers to a policy of keeping interest rates very low to accommodate economic growth. The Federal Reserve's

signal that accommodation could be phased out at a measured pace was a signal that short-term interest rates would be pushed up in small incremental steps.

In June, the Federal Reserve increased its target for the federal funds rate by one quarter of one percent, from 1.00% to 1.25%. This was followed by identical increases in July, September, and November. Thus, by November the Federal Reserve had pushed its target federal funds rate up in small incremental steps from 1.00% to 2.00%. Convinced that the economic expansion, despite a spring soft patch, was on solid footing and that inflation remained low, the Federal Reserve has moved gradually.

Despite the increases in short-term interest rates, long-term interest rates have not risen substantially over the year. Part of this is because long-term inflation expectations remain low, so lenders have not increased the premium they demand as compensation for perceptions that inflation will rise in the long term. Long-term interest rates remain low by historical standards, including mortgage interest rates.

Lending Conditions Eased in 2004, but Stock Markets Were Essentially Flat

Interest rates on corporate bonds were somewhat high relative to rates on less risky government securities as 2004 began. After the dissipation of some geopolitical uncertainties and uncertainties about the durability of the economic expansion, lending conditions eased. One sign of dissipation of uncertainty about the durability of the expansion is that senior loan officers reported increased loan demand by businesses toward the end of 2004—a sign of business optimism about the future. Loan officers also reported an easing of lending conditions toward the end of 2004—a sign that lenders were more optimistic about the economy and the geopolitical situation.

After a huge advance in 2003, stock prices have traded in a relatively narrow range during most of 2004. It is difficult to explain stock price movements, but it may be that rapidly rising energy costs are weighing on the profit outlook of investors, even as optimism has increased regarding the general outlook for the economy during the year. Since the beginning of 2004, the Dow Jones Industrial Average is essentially unchanged and the NASDAQ is up by approximately 4.0%.

International Developments

In 2003, the yen appreciated by close to 10% vis-à-vis the dollar. In the first few months of 2004, Japanese authorities intervened heavily in foreign exchange markets in attempts to drive the dollar price of the yen down, which would make Japanese goods less expensive to U.S. consumers. During that period, the yen did indeed depreciate vis-à-vis the dollar. Japanese authorities abandoned that strategy later in the year, and the yen depreciation seen in the early months of 2004 was erased by periods of yen appreciations. On net, the yen appreciated (which is the same as saying that the dollar depreciated) by around 2.0% as of mid-November.

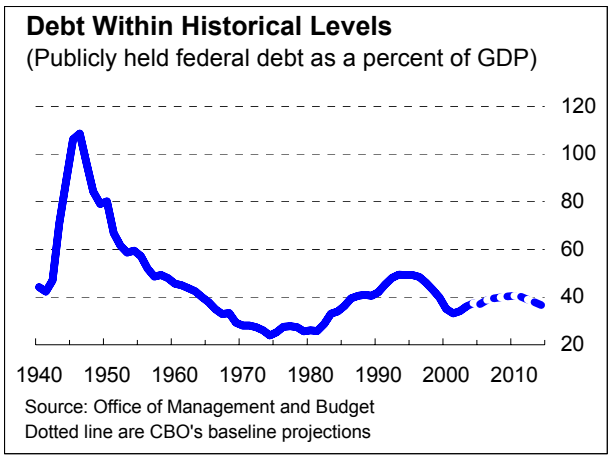
In 2003, the dollar depreciated by almost 17% vis-à-vis the euro. In contrast, the dollar has depreciated vis-à-vis the euro by only around 3.3% between the beginning of 2004 and mid-November. Appreciation of the dollar early in the year was erased by depreciation that began in the autumn of 2004.

Many believe that further depreciation of the dollar will be necessary given that the trade deficit is large and growing relative to GDP. A declining dollar makes imports more costly and less competitive in U.S. markets and makes U.S. exports more competitive in world markets. However, economic weakness abroad has hampered exports, contributing to U.S. trade deficits.

Trade deficits have helped fuel a historically high U.S. current account deficit of slightly over 5.0% of GDP. The current account deficit means that U.S. savings are not sufficient to fund U.S. investment; on the other hand, it also reflects the fact that investors abroad continue to view the U.S. as a particularly attractive place to invest.

The Federal Budget

The federal budget deficit reached $422 billion, or 3.6% of GDP, in fiscal year 2004. While this deficit is the largest ever in dollar terms, it is still lower as a percentage of GDP than those experienced in the 1980s and the early 1990s. The recent swing in the government's fiscal balance has been primarily caused by the economic slowdown and recent spending growth due to increased homeland security measures and two wars. Despite the recent swing, publicly held federal debt remains well within historical levels. The primary force necessary to eliminate existing budget deficits is sustained, strong economic growth.



The Outlook

Recent economic data provide confirmation of the remarkable resilience of the U.S. economy. After weathering a sequence of negative shocks including the tragedy of September 11, 2001, corporate accounting scandals, rapidly rising energy prices, and two wars, the economic expansion that has been in place since November 2001 continues at a robust pace.

Boosted by monetary policy that remains very accommodative toward growth and well-crafted tax relief, economic growth remains robust. Of course, some risks and uncertainties remain. Energy and some commodity prices remain elevated. The economies of Europe, Japan, and other trading partners remain weak, limiting markets for U.S. goods, though there have been positive signs that growth in those economies will pick up. The global risks of terrorism and unrest in the Middle East also remain.

Despite our nation's challenges, we maintain our confidence in the American economy's ability to expand and provide improved job opportunities for all Americans. We must work to insure that fiscal and regulatory burdens do not hinder economic growth and job creation.

SENATOR ROBERT F. BENNETT,
Chairman

REPRESENTATIVE JIM SAXTON,
Vice Chairman

VICE CHAIRMAN STAFF REPORT

MACROECONOMIC PERFORMANCE SINCE 2000

Introduction and Summary

This paper reviews events and highlights debate surrounding U.S. macroeconomic performance since 2000. The booming, "new economy" period of the late 1990s, when stock prices and consequently investment and household net worth increased sharply, is examined and found to be unsustainable. This period is associated with a behavioral response to this stock price inflation. This response took the form of commitments or debt obligations as well as increased risk taking that, during the period of asset price inflation, seemed perfectly appropriate. Unfortunately, however, during this boom period the ground work was laid for future painful, protracted economic adjustments and lengthy subpar economic performance following the decline of asset prices.

When the stock market "bubble burst" early in 2000, conditions deteriorated dramatically. Balance sheet distortions became evident as asset (stock) prices fell but the value of nominal debt remained unchanged, inducing net worth to decline. As a result, a host of economic variables (e.g., investment, industrial production, manufacturing activity, employment, real GDP, consumption, net wealth) began to slow or even decline. Notably, the slowdown of these variables was underway in the Summer of 2000: i.e., before the change in administration. But the adjustment to repair balance sheet deterioration was not rapid. These adjustments can take many months, if not years, to complete. In short, the "seeds were sown" during the booming "New Era" period of the late 1990s for a lengthy, subpar period of growth. The associated lengthy adjustment process was inherited by the new Administration when it took office in January 2001.

<u>After reviewing these relevant events in more detail, the paper discusses important policy questions.</u> In particular, <u>the paper establishes three key points about policy:</u>

(1) The paper shows that assertions associating the subpar economic performance in early 2001 with the policies of the newly inaugurated administration are misleading and inaccurate for a number of reasons. The data clearly show

that an economic slowdown was underway following the stock market bubble burst in early 2000. A number of important economic variables were clearly slowing by mid-year 2000, well before the January 2001 inauguration date. Furthermore, well-known policy lags imply that the impacts of the new administration's economic policies could not have been observed until mid-2001 at the earliest: i.e., the economic effects of these policies could not have occurred until after the commencement of the 2001 recession.[2] The previous administration's own CEA Chairman and Nobel Prize winner Joseph Stiglitz (among others) explicitly recognized that "the economy was slipping into recession even before Bush took office,"[3] that seeds for an economic slowdown were sown during the late Clinton years, and that any new administration (like Bush's) necessarily inherits economic problems spawned previously.

(2) Careful analysis shows the boom years of the late 1990s laid the groundwork for an inevitable, lengthy economic adjustment during the period following the stock market decline. Because of the timing of this stock market decline, these necessary adjustments were pushed into 2001 and 2002: i.e., into the new Bush Administration.

(3) The healthy economic rebound in late 2003 and 2004 provides further evidence that once the administration's economic polices were allowed to take root, they boosted economic performance and were not the cause of earlier economic sluggishness.

The Late 1990s' "New Era" Economy

During the late 1990s, economic activity was robust. The macroeconomy was experiencing the longest economic expansion on record. This record-breaking expansion followed the 1980s' expansion, so that the U.S. economy experienced back-to-back two of the longest economic expansions in U.S. history. Although there was a recession in the 1980s, it was short and mild. Accordingly, optimism about control of the business cycle and a more certain future was

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[2] The 2004 Economic Report of the President analyzed the revised data and concludes that the recession actually began in the fourth quarter of 2000. (See, Report, pp.30-1.)

[3] Joseph Stiglitz, "The Roaring Nineties" Atlantic Monthly, October 2002, p. 2.

prevalent. Because economic downturns had become so infrequent and mild since the early 1980s, and the current robust growth was viewed as sustainable, the term "new era" was increasingly used to describe the period's economy. Additional ingredients of this "new era" economy included rapid stock market increases, significant technological innovations and advances, the fall of communism, increased globalization, and a more market-oriented Congress.[4]

These events of the "new era" were associated with important economic developments such as rapid investment (and capacity) growth, (see Charts 1 and 2), rapid productivity growth, persistently strong consumption and housing advances, net wealth gains, healthy job growth, low unemployment rates, low inflation and interest rates, and a strong dollar.

The Late 1990s: Sowing the Seeds for Future Painful, Protracted Economic Adjustments

These economic trends, while impressive, were unsustainable. In particular, the "New Era" economy was associated with an environment where the behavior of households, business, and government changed. Partly to take advantage of expected sustained increased returns to stock and other asset price gains, and partly because of the perception of improved balance sheets, households, businesses, and government invested and consumed more while taking on commitments as well as debt obligations.

Chart 1

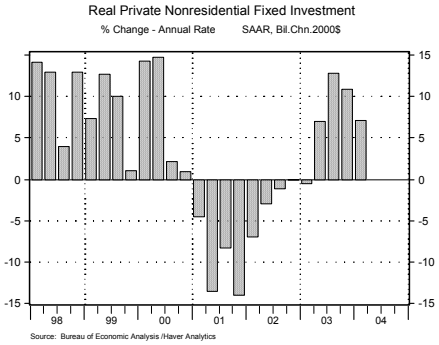
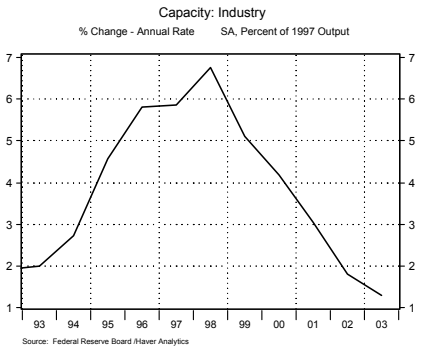


Chart 2

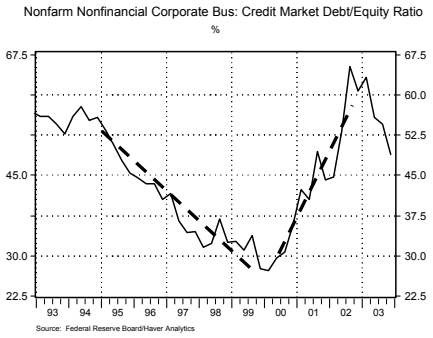


[4] See Robert J. Shiller, Irrational Exuberance, Broadway Books, N.Y. 2001, Chapters 5, 6.

The 2004 Economic Report of the President (ERP) describes the resulting structural imbalances as stemming from the rapid investment growth in the late 1990s and resulting in rapid capital accumulation and excess capacity. Stock market advances boosted both investment (by lowering the cost of capital) and consumer spending (through increased wealth effects), thereby promoting low savings rates. Research by economist Ray Fair shows that the stock market boom caused (1) increased investment (relative to output), (2) lower budget deficits, and (3) lower savings rates.[5] In this environment, government spending increased as government revenues advanced and constraints on spending eroded. These actions were premised on the expectation of continued sustainable robust gains in asset prices and the perception that balance sheets had improved by some measures (e.g., business debt/equity ratios) during this period. As long as asset prices continued to advance, these decisions appeared to be reasonable. The assumption of more debt obligations produced a financial system more vulnerable to asset price disturbances. A sharp fall in asset prices, for example, would adversely impact or expose balance sheets of households, business, and government, and would force adjustments on these sectors.

From the financial perspective, as stock prices advanced during the 1990s' new era boom, the (marked to market) balance sheets of households improved significantly. Household net worth advanced as liabilities fell relative to assets. Similarly, household debt service burden (as a percentage of GDP) improved. At the same time, business balance sheets improved. Business debt/equity ratios (on a market value basis) fell, signaling improved business financial strength (see Chart 3). Taking advantage of balance sheet improvements, business assumed more debt and extended commitments. Stock market price advances lowered the equity cost of capital and encouraged investment. This is evident as investment grew relative to GDP (see Chart 4.) Further,

Chart 3



[5] See Ray Fair, "Testing for a New Economy in the 1990s," Business Economics, January 2004, pp. 43-53.

as government revenues increased owing to economic and stock market advances, the balance sheet of government improved. As households, businesses, and government recognized persistent, significant improvement of their balance sheets, however, they began to expect these gains to continue. Accordingly, their behavior began to change; they began to take on additional debt and make commitments premised on the belief of a continuation of stock market and asset price gains. The growth of business debt increased materially (see Chart 5). This increased the vulnerability of the financial system to future asset price disturbances.

Chart 4

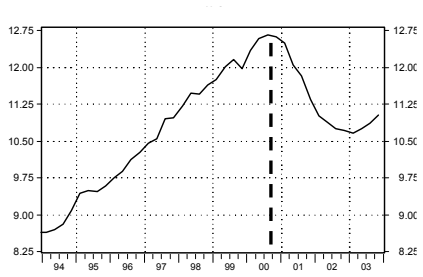
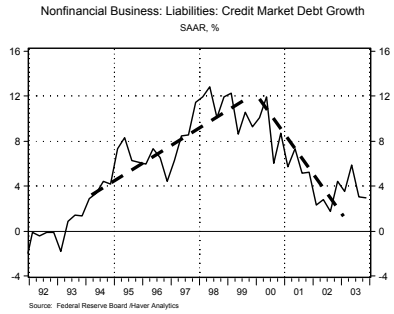


Chart 5



In short, in the late 1990s the "the seeds were planted" for future economic adjustment problems should asset prices deteriorate. That is, the die was cast for painful protracted adjustments, which are often associated with extended subpar economic performance.

The Bubble Bursts

Various measures of the stock market indicate the stock market bubble burst early in 2000[6] (see Chart 6). Most of these stock market measures were falling sharply by spring 2000. Notably, most of the decline of the NASDAQ composite index occurred before January 2001, prior to the inauguration of the new Administration. This sharp market decline impacted the market's capitalization as well as the balance sheets of key sectors of the economy. It reduced, for example, household net worth (wealth) and adversely impacted business balance sheets (see Chart 7.) For purposes of brevity, this paper focuses on the adjustment of the business sector.

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[6] The Dow Jones Industrial index, for example, peaked in January 2000, whereas the NASDAQ composite peaked in March 2000.

Chart 6

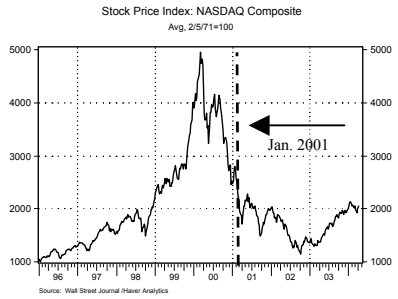
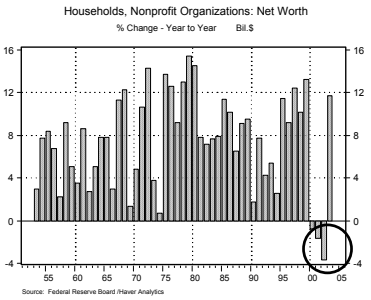


Chart 7



The business sector's debt/equity ratio, for example, had fallen through most of the 1990s when the stock market was advancing sharply (see Chart 3.) This occurred despite a rapid accumulation of debt by the business sector (see Chart 5.) Nonetheless, during the "new era," a falling business sector debt/equity ratio signaled improved financial strength.

As asset prices fell sharply and the stock market "bubble burst" in early 2000, however, the business sector's debt/equity ratio began to increase sharply: i.e., debt increased relative to equity, thereby increasing businesses debt burden. In short, the financial strength of corporate America deteriorated as business balance sheets weakened. This deterioration elicited significant and protracted adjustments on the part of business.

The requisite adjustments following an asset price "bubble-bursting" are multi-dimensioned and complex. They involve adjustments in both the economic and financial realms. These adjustments have been underestimated by economists partly because stock market (and wealth) variables have not been well integrated into many income-expenditure (flow) macro models of the economy. Further, these adjustments occur only infrequently. The recent stock market bubble, for example, was the largest in several generations.

The recent stock market "bubble bursting" episode affected a number of sectors; its impact was widespread and it has not been assessed comprehensively. Fair's research, one of the few empirical studies of this episode, reminds us that recent stock price movements caused changes in the savings rate, in the investment/GDP ratio, and in the budget surplus, among other variables.

After the stock market peaked and began falling sharply in early 2000, widespread slowdowns followed in a number of the economy's key sectors. Significant slowdowns followed, for example, in the growth of investment and to a lesser extent the growth in consumption. Stock price declines, after all, directly translated into increases in the cost of investment capital and into diminished wealth effects adversely impacting consumption. Stock and Watson found that while many traditional leading indicators failed to predict the 2001 recession, stock prices correctly predicted that economic growth would slow. Further, they showed that investment declines lead to falling manufacturing output.[7] Declines also occurred in the growth of real GDP, manufacturing and industrial production. Compared to earlier business cycles, the slowdown was particularly pronounced in investment (and consequently manufacturing) as well as in employment. The employment weakness, however, was concentrated in manufacturing. Requisite adjustments forced on these sectors were lengthy and protracted; they sometimes lasted several years to work themselves out of the system.

The adjustments foisted on the economy also have a financial dimension. The asset price deflation associated with the "bubble bursting," after all, is a financial event that impacts the balance sheet of key sectors of the economy and forces lengthy adjustments on these balance sheets. Deflating asset prices may cause debt burdens to increase and balance sheets to deteriorate. This, in turn, forces downward adjustments in the growth of debt and business spending (investment). Debt-equity ratios increase while debt accumulation slows. Responding to an asset price "bubble bursting" can involve a lengthy adjustment process taking years to complete. When such adjustments occurred after 2000, they often reflected events that occurred earlier, during the previous administration.

Implications for Policy

"Bubble-bursting" events have both economic and financial effects. These effects are associated with lengthy, time-consuming, protracted adjustments of key economic sectors and their balance sheets. In this instance, adjustments – which were necessitated by the excesses of the late 1990s – were foisted on the economy during the period following the stock market decline, during late 2000 and the early years of the Bush Administration. In short, the Bush Administration inherited these

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[7] See James H. Stock and Mark W. Watson, "How Did Leading Indicator Forecasts Perform During the 2001 Recession?", Federal Reserve Bank of Richmond Economic Quarterly Vol. 89, No. 3, Summer 2003, pp. 71-90.

lengthy, delayed adjustments. This does not imply that Clinton Administration officials were responsible for, or acted to undermine the early Bush economy, but rather that this bubble and its delayed adjustment effects were sown earlier, before the Bush Administration took office.

Having reviewed relevant economic circumstances surrounding the events of the recent price "bubble," we turn to a discussion of related policy issues. An understanding of economic and financial events surrounding the bursting of the stock market bubble makes for better policy evaluation.

This paper makes three policy-related points relevant in current economic policy discussion. **First**, a frequent criticism of the Bush administration policies has been repeated by various opponents of those policies. Their contention is that following a "near perfect" economic performance under the previous administration, the sluggish, subpar macroeconomic performance recorded during the early years of the Bush Administration was directly attributable to the adoption of inappropriate Bush economic (tax cut) policies. That is, Bush administration policies caused the subpar economic performance which began in January 2001. A review of the circumstances surrounding the "bubble bursting" episode clearly indicates that this argument is factually incorrect for the following reasons:

- ***Timing Inconsistencies*:** A host of key economic data series shows that the macroeconomy began slowing shortly after the stock market decline (or "bubble-bursting") in early 2000, well before the change in administration in January, 2001. A comprehensive list of economic data supporting this argument is extensive. The list highlighted here is illustrative. Clearly, the stock market (as measured by the Nasdaq composite) fell sharply beginning in March 2000.[8] Indeed, a forty-five percent decline in the Nasdaq composite index took place prior to the change in administration in January, 2001. This reduction translated into losses in household net worth beginning in the fourth quarter, 2000[9] prior to the Bush administration. Indeed, the decline in net worth on a year-over-year percentage change basis occurred in 2000 for the first time since flow of funds data were collected in 1953. This decline was unprecedented

[8] The Dow Jones Industrial index peaked earlier.
[9] These flow of funds net worth data include contributions from homes.

and adversely impacted the growth of real consumption, which slowed significantly from a better-than 5.5 percent annual rate in the year prior to the stock market crash, to about the 3.3 percent range immediately after the stock market declined, but before the change in administration.

The deflation of stock prices, of course, adversely affected investment as well. A decline in stock prices raises the cost of capital, thereby reducing investment. Business investment growth, in fact, fell from double-digit rates in the year prior to the crash to about 1.5 percent in the two quarters immediately prior to the change in administrations. The investment decline was concentrated in the equipment and software component. With the growth slowdown of both investment and consumption, real GDP growth slowed significantly as well. In fact, real GDP growth declined from about a 4.7 percent annualized rate prior to the stock market decline to a 0.8 percent annualized rate in the two quarters immediately preceding the change in administration.

Other key economic variables also follow this pattern; they weakened after the stock market decline as well as prior to the inauguration of January 2001. Industrial production, after advancing for a considerable period, fell in both the third and fourth quarter of 2000, after the stock market decline but prior to January 2001. Manufacturing activity – as measured by the Institute of Supply Management (ISM) index – began contracting in August of 2000 and continued to contract until well after January 2001. The same pattern is evident in changes in payroll employment: i.e., gains in employment fell from robust monthly advances to meager gains in mid-2000. Notably, manufacturing employment had been declining since March 1998.

In sum, most key economic variables began slowing shortly after the stock market decline and well before the change in administrations in January 2001. The economy began weakening, therefore, well before the Bush inauguration. Consequently, a sluggish economy cannot be attributed to Bush economic policies since the sluggishness predated the Bush administration.

- ***Policy Lags*:** It takes time for policy to be implemented and for it to take effect. A number of unavoidable lags

> exist between the inauguration and recognition of the need for new policy, the implementation of new policy, and the economic impacts of that change in policy. Additionally, when a new administration comes into power, understandably, there is an "organization lag."

The combined duration of these various time lags is likely (conservatively estimated) to be 6 months at a minimum. Accordingly, the economic effects of the new administration's economic policies could not have been observed until mid-2001 at the very earliest. In other words, the earliest possible impacts of new Bush policies could not have occurred until **after** the 2001 recession had begun. Therefore, the sluggish, weak economy (and recession) in the early months of the Bush Administration cannot properly be attributed to Bush economic policies.

- ***Concessions by Opponents*:** A number of these views were explicitly endorsed by certain economic spokesmen of the previous administration. President Clinton's own CEA Chairman and Nobel Prize winner Joseph Stiglitz explicitly recognized that "…The economy was slipping into recession even before Bush took office…."[10] Stiglitz also noted that the seeds for future economic retrenchment and slowdown were sown during the Clinton years.[11] Stiglitz stated, for example, that "…in the very boom were planted some of the seeds of destruction, seeds which would not yield their noxious fruits for several years…"[12] Further, Stiglitz recognized that any new administration, like Bush's, inevitably inherits economic problems it had nothing to do with. Such new administrations have to "play with the hand they are dealt."[13] The finishing touch to this argument was added by the previous administration's CEA member, Jeffrey Frankel:

> As convenient as it would be for the Democrats to be able to claim that Bush fiscal policies caused the weak economy of the last

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[10] Joseph Stiglitz, "The Roaring Nineties," The Atlantic Monthly, October 2002, p. 2 of 10. See also Joseph Stiglitz, The Roaring Nineties, Norton, NY, 2003, p. 322.
[11] Ibid., pp. 9, 219, 3.
[12] Ibid., p. 9, underline added.
[13] Ibid., pp. 33, 322.

> three years, good economic logic does not support that contention.[14]

> ***Furthermore, it is relevant to note that newly released transcripts of the (detailed) FOMC minutes, indicate that the Federal Reserve Board Chairman, several Federal Reserve Bank Presidents, and some senior Board staff all recognized recessionary indicators (especially in manufacturing) as early as 1998.*** [15]

In sum, the argument that Bush administration economic policies caused and are responsible for the sluggish, weak economy in the early years of that administration is factually incorrect because of time inconsistencies and the lags of economic policy. Further, key officials of the previous administration conceded that this was the case. And those concessions were (implicitly) corroborated by observations of Federal Reserve officials.

A **second** important point related to assessments of the economy in recent years is mentioned above: namely, that the Bush administration inherited a number of economic problems from earlier periods. That is, "seeds of destruction" were sown during the stock market boom of the late 1990s. These "seeds of retrenchment" would yield their "noxious fruit" only over an extended period of time (perhaps for several years.)[16]

The bursting of the stock market bubble, for example, left distorted portfolios in most sectors of the economy, investment imbalances, and household net worth losses requiring large, protracted (multi-year) financial adjustments to regain normal equilibrium. These required protracted adjustments, in turn, adversely impacted several years of economic growth in 2001-2003. In short, the effects of the various imbalances associated with the late 1990s brought about adjustments causing consumption, investment, and hence, economic activity to be weaker than otherwise. These adjustments help to explain weaker-than-normal economic activity in 2001-2003.

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[14] Jeffrey Frankel, "It's a Tough Job to Create Jobs," Washington Post, Saturday April 11, 2004, p. B30. (Frankel was a member of President Bill Clinton's Council of Economic Advisers from 1997 to 1999.)

[15] See Federal Open Market Committee transcripts released in late April 2004 (after a five year embargo). See also, for example, Greg Kaza, "Clear Signs of Deterioration," National Review Online, May 4, 2004.

[16] See Stiglitz, op. cit., p. 9.

A **third** observation relating to the policy debate about macroeconomic performance pertains to the recent improvements in economic growth. In particular, the economy has expanded at a robust 4.9 percent annualized growth rate over the last four quarters (an improvement over more modest growth during the first seven quarters of recovery.) Further, consensus forecasts of the economy project better-than 4 percent growth for the near-term future. This improved performance provides further evidence that once the administration's economic policy finally took root, it worked as anticipated. This vigorous economic expansion indicates that the prescribed economic and tax cut policies proved potent. These successful policies boosted the economy and therefore were obviously not the cause of the earlier economic sluggishness.

Summary and Conclusions

After reviewing economic and financial events influencing U.S. macroeconomic performance since 2000, this paper establishes three points related to economic policy. First, Bush administration policies did not cause the subpar economic performance experienced immediately after January 2001. Timing considerations and evidence, recognized policy lags, and concessions by opposition economic spokesmen support this contention. Second, the Bush administration inherited a number of economic problems associated with the stock market bubble and its various remnants. These problems were created in earlier periods and left adjustments unfinished for later periods. Third, the recent improvement in economic growth provides further support for Bush economic policies. This recent economic performance suggests that once Bush economic policies took root, they proved to be potent and were not the cause of earlier sluggishness.

Prepared by Dr. Robert Keleher

RANKING MINORITY MEMBER'S VIEWS AND LINKS TO MINORITY REPORTS

RANKING MINORITY MEMBER'S VIEWS

I. Overview

For the fourth straight year of the Bush presidency, the economy has underperformed expectations, leaving a large jobs deficit. In October 2004, there were 1.3 million fewer private sector jobs than there were when President Bush took office. There were 7 million fewer jobs than the Bush Administration predicted there would be in its first post-9/11 economic forecast in early 2002. This year, job creation has been only slightly more than enough to keep pace with population growth and has been only about half of what the Administration predicted it would be as recently as February.

The consequences for ordinary Americans of this economic failure are serious. After adjusting for inflation, median household income has dropped over $1,500 during President Bush's term, 2.1 million more Americans are unemployed, 4.3 million more Americans are living in poverty, and 5.2 million more Americans are without health insurance.

The President and his Republican supporters in the Congress have had one policy and one policy only to deal with this record of poor economic performance—tax cuts. But those tax cuts have not worked. They were ineffective at stimulating job creation in the short run; they were unfair, going disproportionately to very high-income taxpayers; and they were fiscally irresponsible, contributing significantly to squandering the hard-won budget surpluses the President inherited. As a result, we are left ill-prepared to deal with the imminent retirement of the baby boom generation.

Meanwhile, other important national priorities have been neglected or mishandled. For example, health care expenditures have been increasing, and health insurance premiums, including Medicare premiums, have been rising explosively. In 2005, some 2.1 million seniors will have their entire Social Security COLA taken away by a record increase in Medicare premiums. Seniors will have to wait until 2006 for prescription drug coverage under the Medicare law passed last year, but the healthy and wealthy non-elderly benefit immediately from the tax-advantaged health savings accounts (HSAs) created in the same legislation. The President's preferred policy of tax deductions and tax

credits for health insurance carries a high budget cost, offers little to the uninsured, and could undermine existing coverage.

The President's misguided proposals for Social Security would weaken the financial condition of the program dramatically. The private accounts he favors would cost $2 trillion or more to implement. That would entail cutting benefits or raising taxes—or letting the budget deficit grow even larger.

Unlike past presidents—including his father—President Bush allowed the federal extended unemployment insurance benefits program to expire at the end of 2003 when the number of long-term unemployed and people exhausting their regular state benefits was still high. In 2004, as long-term unemployment has remained high, there is no longer help for those workers.

Nor has there been help for people struggling to escape poverty. Welfare caseloads continued to decline, even as the number of poor households experiencing the kind of economic hardship traditionally addressed by welfare went up. But instead of recognizing that serving fewer people at the same time that poverty is going up and unemployment is high is a sign of failure, the Bush Administration has perversely trumpeted welfare reform as a success.

With the economy still struggling to climb out of the most protracted jobs slump since the 1930s, President Bush has the worst jobs record of any president since Herbert Hoover. The President's policies have not addressed the major problems facing American families today and they have undermined our long-term fiscal health, making it harder to confront tomorrow's challenges.

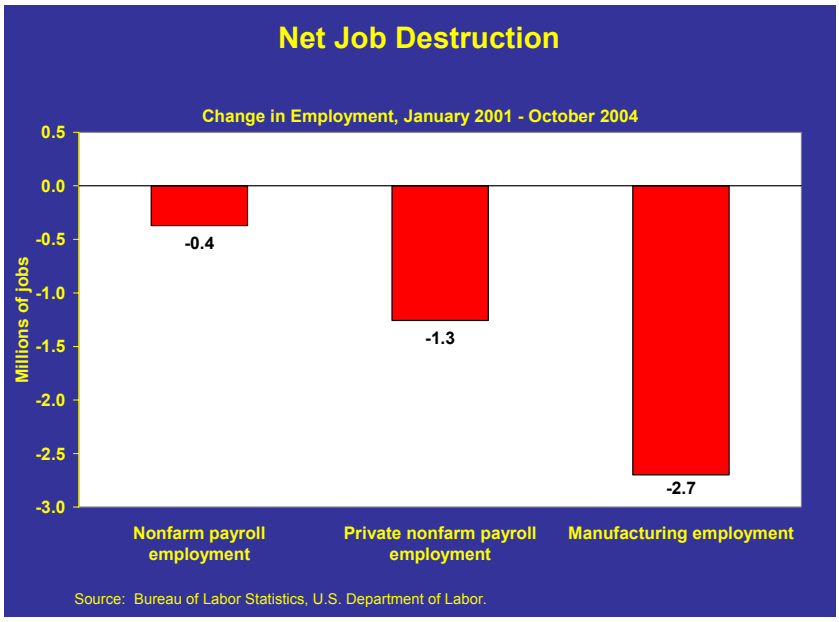
II. The Bush Economic Record

A Protracted Jobs Slump

Net job destruction. The economy finally stopped hemorrhaging jobs a year ago, but job growth since then has been weak. As a result, through October 2004 there is still a substantial jobs deficit on President Bush's watch. Driven by massive losses in manufacturing, private sector payrolls have shrunk by 1.3 million jobs under President Bush (**Chart 1**). There has been some net job creation in the

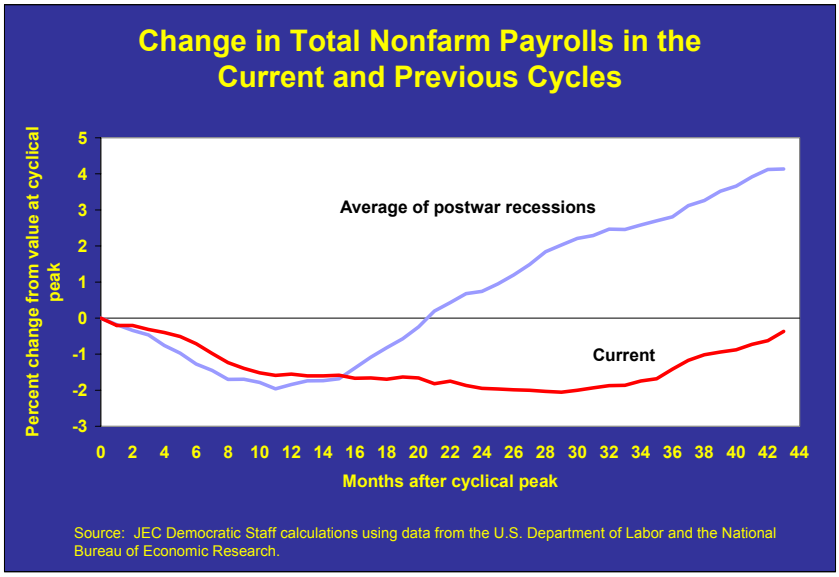
government sector, but the overall deficit in total nonfarm payrolls is still nearly 400,000 jobs.

Chart 1



The recession that precipitated those job losses began in March 2001 and ended in November 2001. But payroll employment continued to decline until August 2003. Both the ongoing loss of jobs following the end of the recession and the fact that there is still a substantial jobs deficit so long after the start of the recession are unprecedented in business cycles going back to the 1930s. Focusing on the post-World War II episodes for which we have consistent data, the pattern of job loss and partial recovery in this latest business cycle is very different from that of the average of all other post-World War II cycles (**Chart 2**).

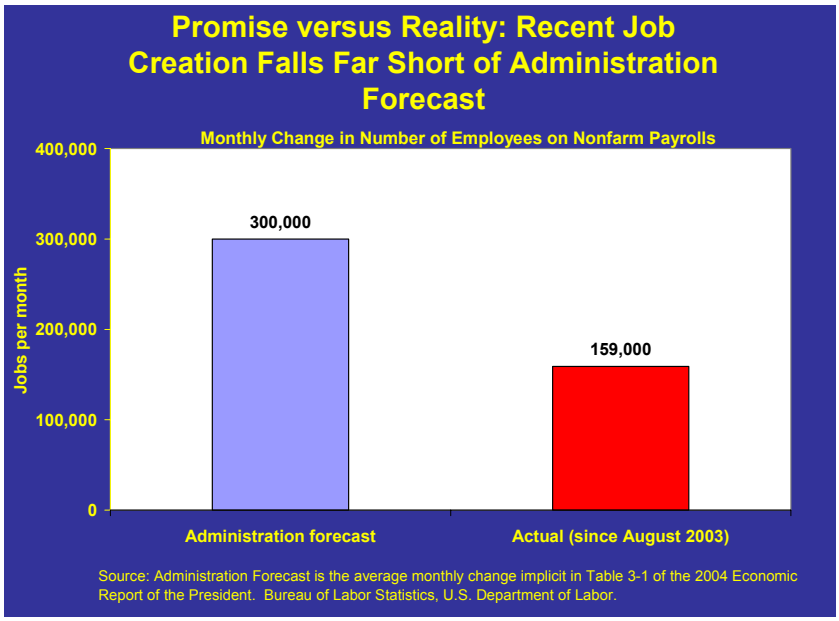
Chart 2



Typically, job losses in a recession end after 12-15 months and the jobs deficit is completely erased within two years. Prior to the current episode, the longest it took to get back the jobs lost in a recession was 31 months for total nonfarm employment and 33 months for private sector employment. That was in the 1990-91 recession and the ensuing "jobless recovery." As of October 2004, it has been 43 months since the start of the recession, and the jobs slump persists.

Weak job growth in the past year. In each of its economic forecasts going back to February 2002, the Bush Administration has been projecting an imminent economic recovery with employment gains on the order of 300,000 jobs per month. We are still waiting to see sustained job growth anything like that. Much as the President wants to tout the 2.2 million jobs created since August 2003, that figure translates into just 159,000 jobs per month—about half of what the Administration has been forecasting (**Chart 3**).

Chart 3



In fact, a rate of 159,000 jobs per month is not much more than enough to keep pace with the trend-rate of growth in the labor force for an economy that is already at full employment. It is nowhere near enough to restore the jobs lost in the recession and to employ people who finally begin looking for work again after having stayed out of the labor force when job prospects were poor. Those considerations are reflected in the Administration's forecast of 300,000 jobs per month. However, reality has fallen far short of that promise. Nonfarm payroll employment in October 2004 was 7 million jobs short of the Administration's first post-9/11 forecast in February 2002.

Apologists for the Administration's poor jobs record sometimes argue that the payroll employment data understate job creation under President Bush. They point to larger job gains in a different official survey, the survey of households. They also point to expected revisions in the payroll numbers. Upon closer inspection, however, those arguments are weak (**Box 1**). Most experts believe that trends in the payroll employment data are the best indicator of job creation, and the revisions are likely to be modest. Moreover, the growth in employment reflected in the household survey is also much weaker in the current business cycle than it has been in past recoveries.

Box 1

Are Job Losses Overstated?

The Bureau of Labor Statistics (BLS) has two different measures of employment. One is based on a survey of nonfarm establishments and asks employers how many jobs they have on their payrolls. The other is based on a survey of households and asks people whether or not they have a job. While nonfarm payroll employment has declined since early 2001, employment based on the household survey has increased.

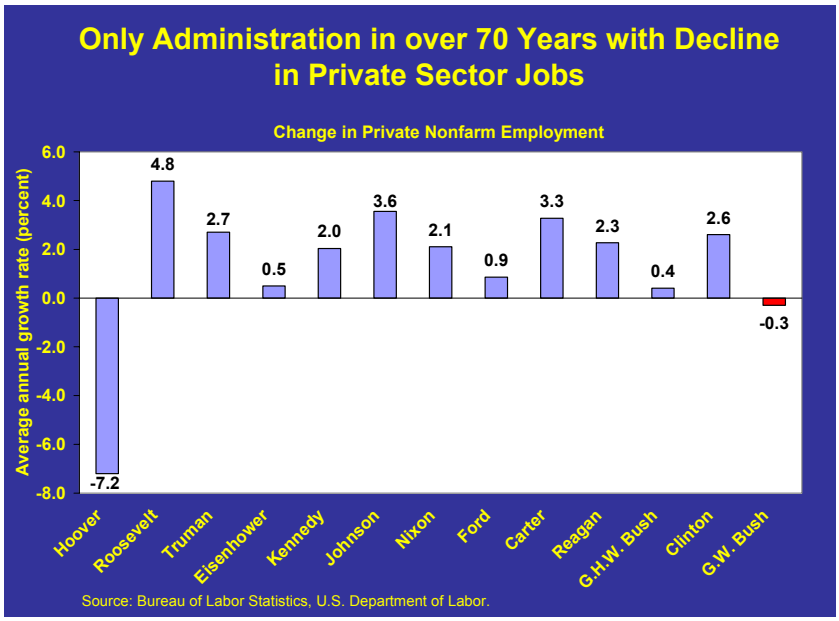
In theory, the household survey might be picking up sources of job creation that are not captured by the payroll survey, but that does not appear to be the case. Nor is the payroll employment data seriously underestimating job creation in new businesses that are not included in the establishment survey.

The payroll and household data differ in scope and coverage. For example, the payroll data do not include those who say they are self-employed, while the payroll data count each job of a person holding more than one job. No one has fully reconciled the differences between the two, but most experts, including the BLS, the non-partisan Congressional Budget Office, and Federal Reserve Chairman Alan Greenspan, believe that trends in the payroll employment data are the best indicator of job creation.

If the payroll employment data were seriously underestimating job creation in new businesses, that would show up and be corrected early next year when the BLS releases its annual "benchmark" revisions of the payroll data, which are based on information from virtually all establishments. However, preliminary evidence released by the BLS in October suggests that the next revisions are likely to be modest and would not materially affect the picture we have of a long jobs slump and only a modest jobs recovery.

In summary, there is overwhelming evidence that President Bush has presided over the most protracted jobs slump since the 1930s. As a result, he has the worst jobs record of any President since Herbert Hoover, and he has been the first President in over 70 years to preside over a net loss of private sector jobs (**Chart 4**).

Chart 4

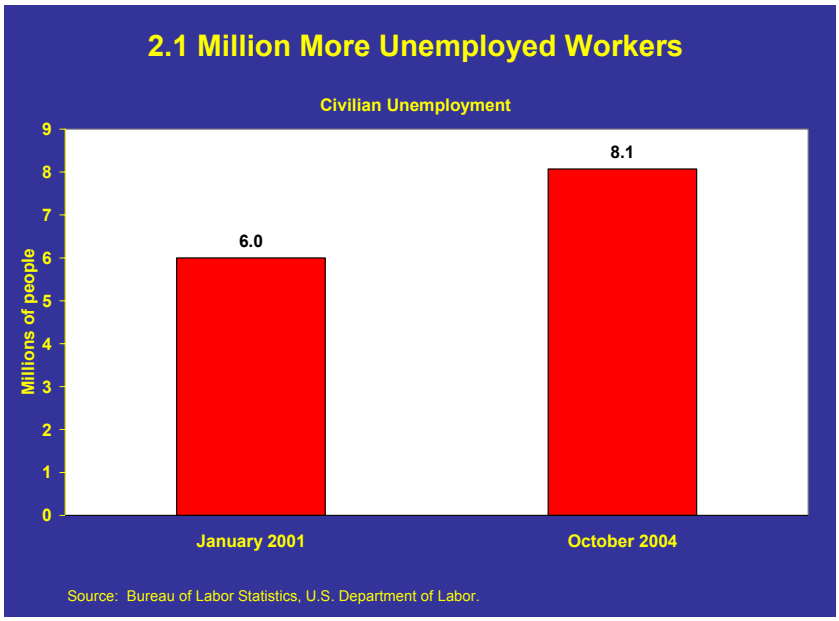


Higher Unemployment and Reduced Labor Force Participation

The payroll employment data paint the clearest picture of the protracted labor market weakness in the U.S. economy since early 2001. But other data paint a similar picture of labor market weakness.

Unemployment remains high. The unemployment rate in October 2004 was 5.5 percent. Those who would like to argue that the economy is strong often suggest that this is satisfactory, based on the average rate of unemployment over the past 30 years. But that argument misses the point that such an unemployment rate is very disappointing compared with the period immediately before President Bush took office. October's 5.5 percent unemployment rate is 1.3 percentage points higher than it was when President Bush took office and higher than it ever was during the entire four years of President Clinton's second term. At 8.1 million, the number of people out of work has increased by 2.1 million since President Bush took office (**Chart 5**).

Chart 5



Labor force participation remains low. Labor market conditions are actually weaker than the unemployment rate suggests, because the unemployment rate fails to reflect the large decline in labor force participation since early 2001. At that time, more than 67 percent of the population aged 16 or over was working or looking for work. That proportion declined as the economy shed jobs, but it has stayed low even as payroll employment has started to grow again. At 65.9 percent, the labor force participation rate in October 2004 is the same as it was in February 2004 and as low as it has been at any previous time back to 1988.

People can leave the labor force for all kinds of reasons, including going back to school or pursuing other activities outside the labor market, but discouragement over job prospects appears to be a major reason for the latest decline. That can be seen, for example, in the BLS's alternative measures of labor underutilization. In particular, the broadest measure, which includes people who want to work but have given up looking and workers who have had to settle for part-time work, was 9.7 percent in October 2004, 2.4 percentage points higher than it was when President Bush took office.

The fraction of the working-age population with a job is down sharply. Reflecting the combined effects of the rise in the unemployment rate and the decline in labor force participation, the proportion of the working age population with a job fell from 64.4 percent when President Bush took office in January 2001 to 62.3 percent in October 2004. That translates into about 4.7 million fewer people working than would be working if the employment-population ratio had stayed the same as it was when President Bush took office.

Long-term unemployment remains high. One final measure of unemployment distress is the proportion of those currently unemployed who have been out of work for more than 26 weeks—the amount of time a worker can collect regular unemployment benefits. That figure has been above 20 percent for more than two years, the longest such stretch since the late 1940s, when the Labor Department started keeping track of such data.

A Squeeze on Paychecks

While workers have endured the most protracted jobs slump since the 1930s, the rest of the economy has fared better. For example, real (inflation-adjusted) gross domestic product (GDP)—the broadest measure of economic output—has been growing since the end of 2001. The disparity between the output market and the labor market is explained by extraordinary growth in labor productivity (output per hour). Thus far in the recovery, employers have been able to squeeze more and more output from their workers without substantially expanding their hiring. In particular, since the start of 2001, output in the nonfarm business sector grew at a 3.2 percent average annual rate, even though hours worked declined at a 1.0 percent average annual rate.

Productivity gains are not reflected in real wages. Only a fraction of the resulting strong productivity growth has translated into higher real earnings for workers. Although productivity has risen at a 4.2 percent annual rate since the start of 2001, real compensation per hour (which includes not only wages and salaries but also benefits) has risen at just a 1.4 percent annual rate. Moreover, benefits, including employer contributions to health insurance, have been rising faster than wages and salaries. When benefits are excluded, workers' take-home pay has barely kept up with inflation. For example, the usual weekly earnings of full-time workers grew just 0.2 percent per year faster than

inflation between the end of 2000 and the end of 2003. That compares with a growth of 1.7 percent per year from the end of 1996 to the end of 2000.

The President may think the economy has turned the corner in 2004, but workers are still waiting to see that reflected in their paychecks. In the first nine months of this year, real average hourly earnings are down 0.6 percent and real average weekly earnings are flat.

Wages and salaries have reached a record low as a share of national income. The combination of lost jobs and sluggish earnings growth for those still working has caused the share of national income going to compensation of employees (wages plus benefits) to fall by over 2 percentage points since President Bush took office. That translates into a current shortfall of roughly $215 billion. In other words, if labor's share of national income had not fallen, workers would be receiving $215 billion more in aggregate wages and benefits. Focusing just on wages and salaries, workers' share of national income is the lowest it has ever been in the more than five decades for which we have data.

The flip side of the declining share of labor compensation in national income in recent years has been a rising share going to business profits. While the aggregate wages and benefits of workers have increased just 13 percent (before taking inflation into account) since President Bush took office, business profits have increased almost 50 percent.

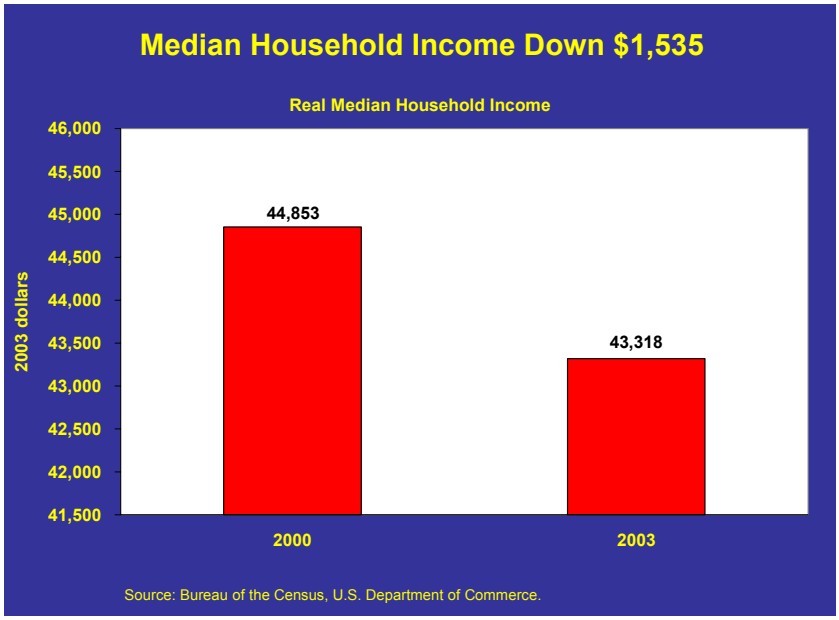
Falling Household Incomes, Rising Poverty, and Declining Health Insurance Coverage

The consequences of a persistent weak job market for middle and lower-income Americans have been serious. Two reports by the Joint Economic Committee Democrats provide the details ("**Poverty Has Increased and Real Income Has Fallen since 2000**", and "**The Number of Americans without Health Insurance Rose for the Third Straight Year in 2003**").

After adjusting for inflation, median household income fell slightly to $43,318 in 2003. The median is the income of the household at the exact middle of the distribution. Half of all households have

higher income and half have lower income. During the Bush years, real median household income has fallen by over $1,500 (**Chart 6**). With a continued weak labor market and stagnant real (inflation-adjusted) wages, real median income is unlikely to bounce back much if at all in 2004.

Chart 6



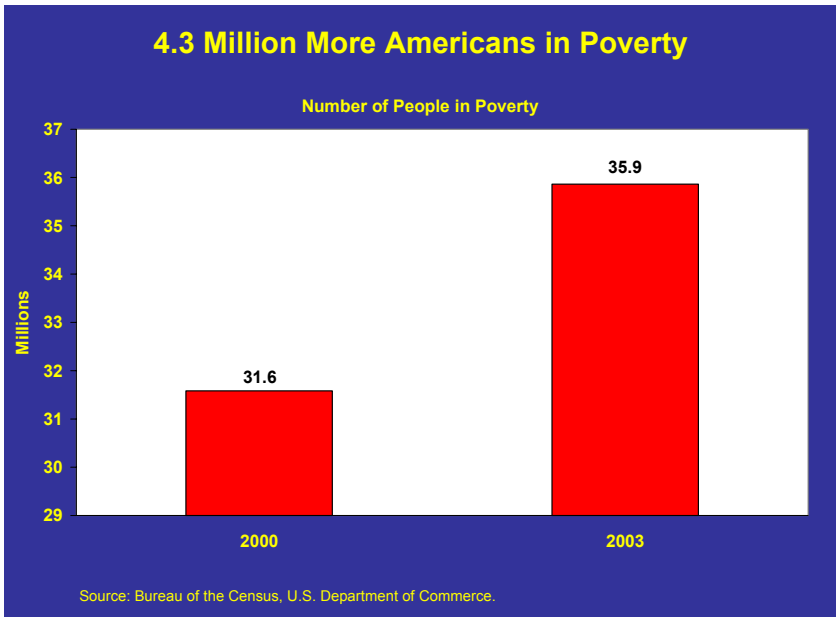
Overall, real median income has decreased by 3.4 percent since the start of the Bush Administration. But that decline has not been uniform across major racial and ethnic groups: median household income declined by 2.0 percent among non-Hispanic whites, by 6.3 percent among blacks, and by 6.9 percent among Hispanics.

Declines in household income have occurred across the income distribution. The poorest fifth of all households experienced the greatest proportional decline in average real income (7.9 percent). The average real income of the richest fifth of all households fell by only 3.2 percent.

The number of Americans living in poverty increased by 1.3 million to 35.9 million in 2003, when the official poverty threshold for a family of four was $18,810. Since the start of the Bush

Administration, the number of Americans living in poverty has increased by 4.3 million (**Chart 7**).

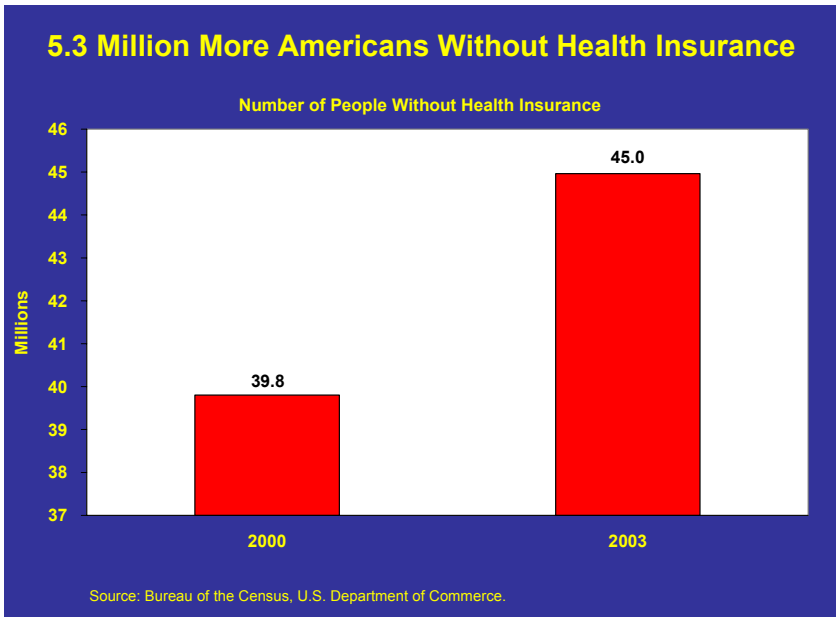
Chart 7



The poverty rate increased from 12.1 percent in 2002 to 12.5 percent in 2003. That made the total increase during the Bush Administration 1.2 percentage points. In 2003, the poverty rate for children under 18 years of age rose 0.9 percent to 17.6 percent, so that more than one in six American children are now living in poverty. Among major racial and ethnic groups, the poverty rate was 24.4 percent for blacks in 2003 and 22.5 percent for Hispanics.

Finally, the number of Americans without health insurance rose for the third straight year to 45 million, 15.6 percent of the population. Millions more spent part of the year uninsured. Since 2000, the number of uninsured has risen by 5.2 million (**Chart 8**). More Americans are now without health insurance than in any year with reported data, which go back to 1987.

Chart 8



The percentage of Americans with employer-sponsored health insurance dropped to 60.4 percent in 2003, the third straight year employer coverage has declined. The total number of people with employer sponsored coverage has fallen by 3.8 million since 2000.

III. Misguided Republican Policies

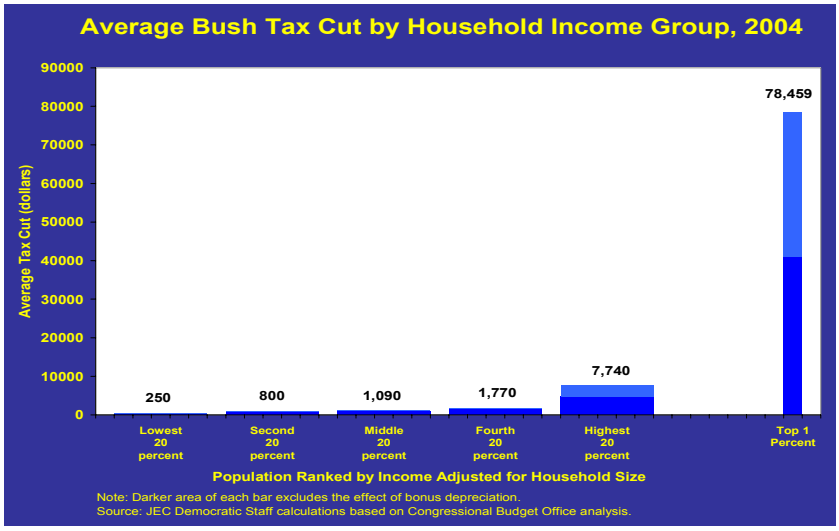
When critics of his policies point to the persistent jobs slump and adverse trends in household income, poverty, and health insurance coverage, President Bush argues that the economy has turned the corner and his policies are working. But that claim does not stand up to analysis. The President's policies, which have disproportionately benefited those who are already well-off, have not produced a strong jobs recovery in the short run. They have not addressed the needs of those most likely to be disadvantaged by a weak labor market. They have not increased health insurance coverage. And they have not strengthened the country's ability to deal with the challenges that will be raised by the retirement of the baby-boom generation.

Unfair, Ineffective, and Fiscally Irresponsible Tax Cuts

The President has pushed for and achieved a major tax cut in each year of his term. Critics have argued that those tax cuts have disproportionately benefited the richest American households. New estimates by the Congressional Budget Office (CBO) of the distributional impacts of the first three major Bush tax cuts confirm that those tax cuts have been skewed toward the rich. That tilt toward the rich also helps explain why the tax cuts have been remarkably ineffective at stimulating job creation in the short run: effective jobs stimulus requires generating new spending, while tax cuts for upper-income taxpayers are more likely to generate saving. Finally, if the President is successful in his efforts to make these tax cuts permanent, they will put a large hole in the federal budget for years to come.

The Bush tax cuts are skewed toward the rich. An analysis by the JEC Democrats, "**New CBO Analysis Confirms That the Bush Tax Cuts Are Skewed Toward the Rich"**, finds that in 2004 the average tax cut for the 1 percent of households with the highest incomes is more than 70 times larger than the tax cut for middle-income households (**Chart 9**). That calculation includes the tax cuts from temporary investment incentives that expire at the end of 2004. But even when those provisions are excluded, the tax cut for the top 1 percent of households is still 40 times as large as the cut for the middle class.

Chart 9



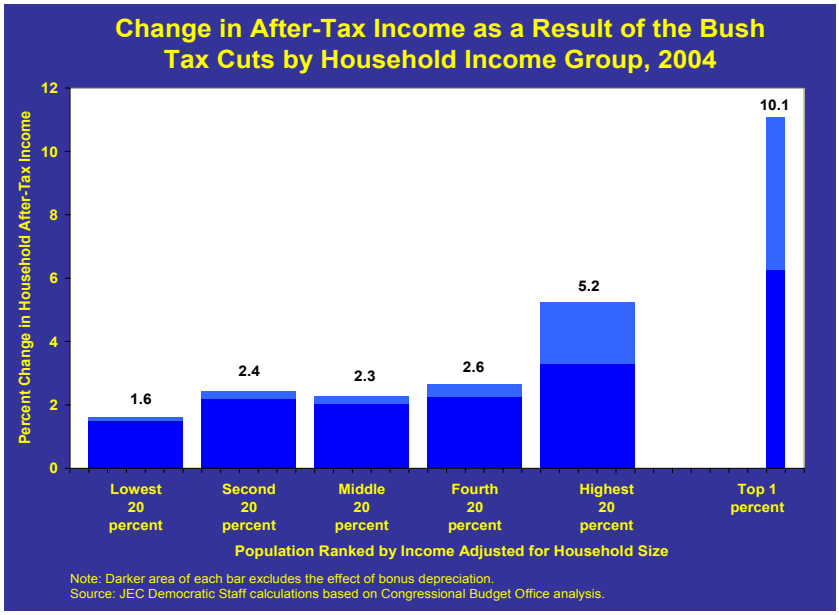
The president has repeatedly justified tax cuts for the highest-income taxpayers as necessary to promote small businesses. But the facts do not support this justification. According to IRS data, less than 3.5 percent of the 18.6 million small business tax returns for 2002 reported income of $200,000 or more, well below the income required to reach the top two income tax brackets. In contrast, the Treasury department claims that over 75 percent of tax returns in the top-income tax bracket are from small business owners. But this claim is highly misleading.

The Treasury includes in its definition of "small business owners" wealthy investors in small companies who may have little to do with everyday operations. President Bush and Vice President Cheney both report income that would classify them as small business owners according to the Treasury department definition. The Treasury definition also includes CEOs and other top executives of major corporations who report trivial amounts of income from speaking fees and other outside activities.

Using the Treasury definition but limiting it to taxpayers who derive at least half of their income from business activities, the percentage of small business owners among taxpayers in the top tax bracket falls to 25 percent. Limiting the definition only to those who derive more than half their income from owning their own business and not from partnerships or small corporations, the percentage of small business owners in the top tax bracket falls to about 5 percent.

The President and his supporters also argue that the rich deserve larger tax cuts because they pay a larger fraction of the income tax. While it is true that the income tax is progressive, the benefit to the rich from the 2001-2003 tax cuts has been disproportionate. In particular, in 2004 the percentage increase in after-tax income resulting from the tax cut is four times larger for the top 1 percent of households than it is for the middle 20 percent of households (**Chart 10**). Even excluding the effect of the temporary investment incentives, the percentage increase in after-tax income is still 2½ times larger for the top 1 percent of households.

Chart 10



The Bush tax cuts have been ineffective at creating jobs. Quite apart from the unfairness of this distribution, the fact that the Bush tax cuts have been skewed toward the rich has blunted their effectiveness in stimulating job creation. The sheer magnitude of the Bush tax cuts has provided some fiscal stimulus in the short run. However, with their emphasis on cuts in marginal tax rates affecting upper-income taxpayers, dividend tax relief, and repeal of the estate tax, the Bush tax cuts have had a low jobs-stimulus "bang" for their fiscal cost "buck."

For example, the private forecasting firm Economy.com estimates that three-fifths of the cost of the Bush tax cuts was in proposals that generated 60 cents or less of additional spending per dollar of revenue loss. That compares with alternative stimulus policies more favored by Democrats such as extending unemployment benefits ($1.73 of additional spending per dollar of revenue loss) or aid to fiscally strapped state and local governments ($1.24).

The Bush tax cuts will have harmful long-run consequences for interest rates and the trade deficit. Effective job-creating stimulus should be fast-acting and concentrated at the time when the economy has idle industrial capacity and unemployed workers who can be put back to work. The tax cuts of the last few years, in contrast, have

much of their impact in the future. Once the economy is in a sustainable economic recovery and producing close to its capacity, fiscal stimulus from tax cuts is counterproductive. When the economy is already producing all it can, the extra demand stimulated by the tax cuts must be offset by reduced demand elsewhere. Typically, this means some combination of the following: a tighter monetary policy, which forces up interest rates and discourages productive investment; increased purchases from abroad, which increase the trade deficit; and increased foreign borrowing, which inflates the value of the dollar and discourages U.S. exports.

For most of the past few years, large federal budget deficits have not had an appreciable effect on interest rates, because private investment demand has been weak. However, the Federal Reserve has begun to raise interest rates, and interest rates may well have to be pushed higher than they would be if the budget deficit were under control. Meanwhile, we have seen a continuing deterioration of the trade deficit, which has been very disruptive to manufacturing and other trade-sensitive industries. The current account deficit, which is a measure of how much we are borrowing from abroad is now over 5 percent of GDP.

Individuals will feel the effect of higher interest rates directly in their mortgages, car payments, and student loans. Future standards of living will be held down because we have not made investments that raise productivity and wages. Ongoing interest obligations and the need to pay off our foreign borrowing will come at the expense of future national income.

The Bush tax cuts have been fiscally irresponsible. The long run economic harm from the Bush tax cuts arises from their impact on the budget deficit and the national debt. The President's abandonment of fiscal responsibility has created a legacy of deficits and debt that is vastly different from the situation he inherited. On President Bush's watch, large projected surpluses have turned into large deficits (**Chart 11**). What in 2001 was projected to be a $397 billion surplus in fiscal year 2004 has turned out to be a $413 billion deficit. In January 2001, the Bush Administration forecast that the federal debt would be paid down to just $1.2 billion in 2008; in their latest projection the 2008 debt is now expected to rise to $5.5 trillion (**Chart 12**).

Chart 11

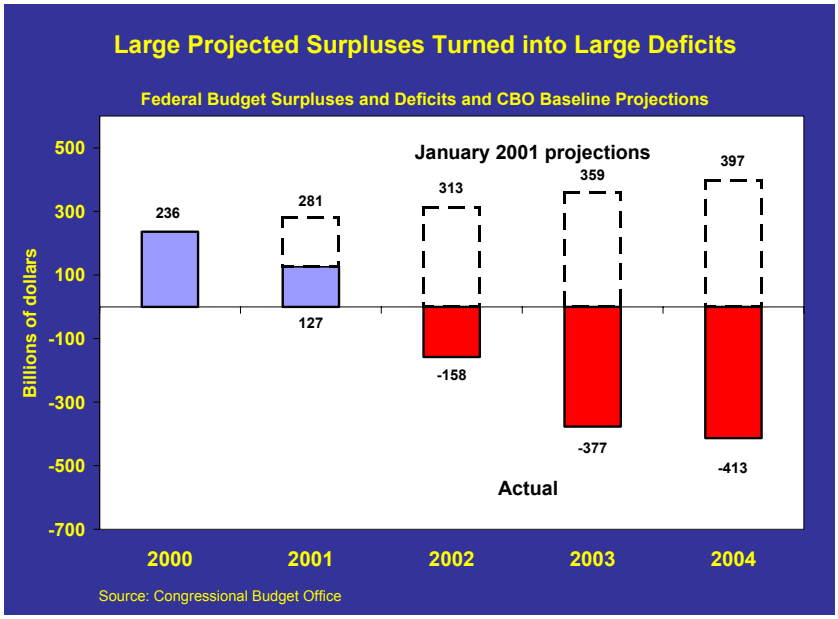
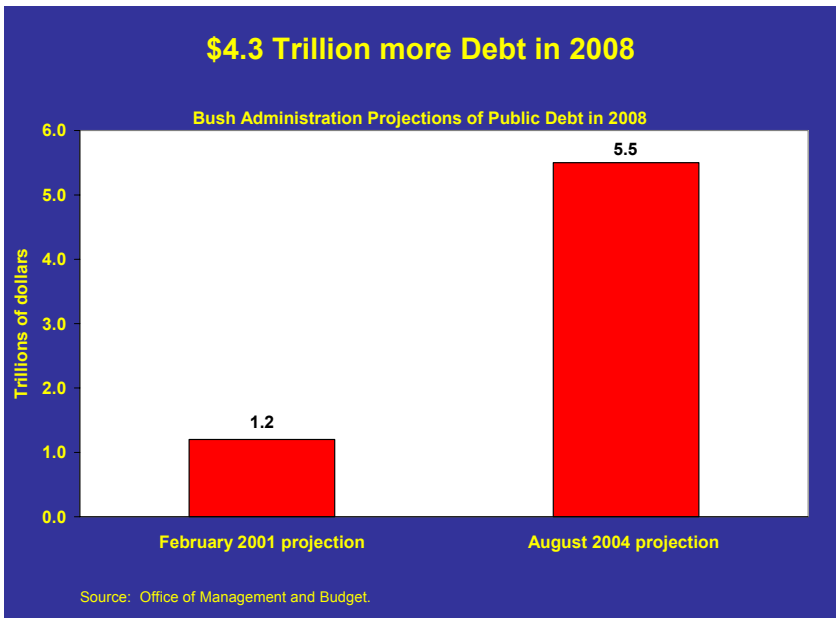


Chart 12



No Compassionate Conservatism for the Unemployed or the Poor

In times of economic weakness, the social safety net is supposed to cushion the economic blows to workers who lose their jobs through no fault of their own and to the economically disadvantaged who struggle to find work to support their families. But neither extended unemployment benefits nor welfare functioned as well as they should have in the long jobs slump of the past four years.

Failure to continue federal extended unemployment benefits. In the past, the federal government has enacted extended unemployment benefits for those who have exhausted their 26 weeks of regular state unemployment insurance (UI). Those extended benefits were kept in place until labor market conditions improved substantially. As usual, federal extended unemployment benefits were enacted in the current job slump, but they were less generous than in the past and were terminated prematurely, as shown in the JEC Democrats' report, "**Job Loss in the 2001 Recession Was Greater Than it Was in the Previous Recession but Federal Unemployment Insurance Was Less Generous"**.

The President and the Republican Congress failed to renew the federal extended benefits program at the end of last year. They did so even though the economy was still 2.5 million jobs in the hole and the rate at which workers were exhausting their regular UI benefits was still twice as high as it was when the program enacted in the 1990-91 jobs slump ended. As noted earlier, October 2004 was the 25th month in a row that the long-term unemployed were 20 percent or more of the total number of unemployed.

Failure to address the contradiction between declining welfare caseloads and increased need. The Bush Adminstration and the Republican Congress have shown a similar lack of compassionate conservatism in their treatment of Temporary Assistance for Needy Families (TANF), the main income support program created by welfare reform in 1996. As shown in the JEC Democrats' report, "**TANF Caseload Declines, Despite Rise in Poverty"**, the need for such income assistance grew in the 2001 recession and subsequent jobs slump. Poverty increased, especially among TANF's target population of children and their families, and unemployment increased for women who maintain families, leaving them with fewer opportunities to

support themselves. While other parts of the safety net expanded to meet the increased need, cash welfare assistance did not.

The only response from the Bush Administration has been continually to repeat the rhetoric that welfare reform is working. The Administration refuses to acknowledge that decreased welfare receipt during a period of increased need is a problem. Welfare reform was supposed to increase economic self-sufficiency, not poverty—though many former welfare recipients still live in poverty. Many policymakers had cautioned that the success of welfare reform could not be judged solely by what happened in the strong economy of the late 1990s, and that the real test would come in a recession. But instead of addressing the problems that have been revealed by the recession when it was time to reauthorize the program, the Republican House of Representatives proposed an even more draconian approach that would make the problems worse. Fortunately, that approach did not become law.

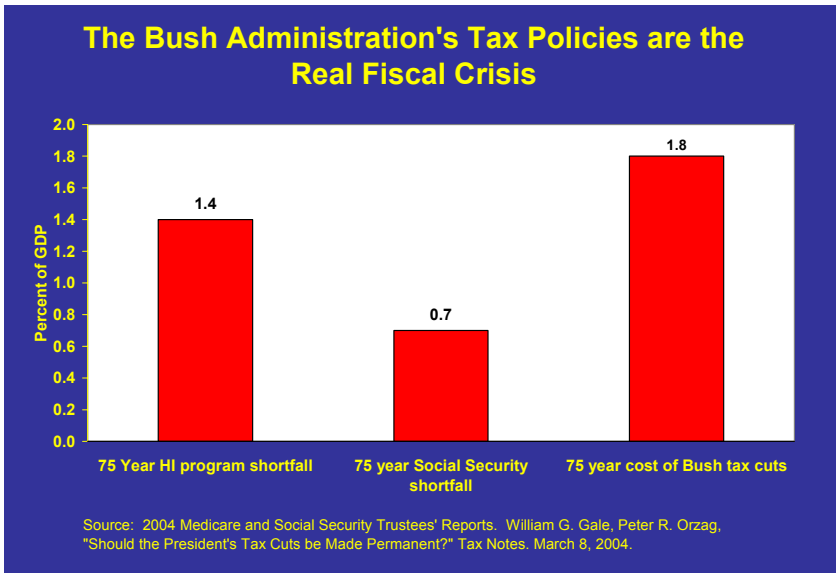
No Compassionate Conservatism for the Elderly and Uninsured

The President's tax-cut dominated approach to policy has left the country with an enormous fiscal deficit for years to come. Meanwhile, we face the imminent retirement of the baby boom generation, which will put enormous pressure on Social Security and Medicare. In addition, the health care crisis is worsening, and the number of Americans without health insurance is growing. As a series of reports by the JEC Democrats have made clear, however, the Republican approach to health and retirement issues fails to adequately address any of these issues.

The Administration's tax and spending policies—not Social Security and Medicare—have created the real fiscal crisis. The latest annual reports from the Social Security and Medicare trustees estimate that the 75-year actuarial shortfall in Social Security is equal to 0.7 percent of GDP and the 75-year actuarial shortfall in Medicare is equal to 1.4 percent of GDP. Those are projections that should compel policymakers to address the needs of two vital programs for our nation's seniors. However, the Bush Administration has instead pursued policies that erode rather than improve, solvency, as detailed in the JEC Democrats' report, "**Keeping the Social Security and Medicare Trustees' Reports in Perspective: The Administration's Tax and Spending Policies Are the Real Fiscal Crisis"**.

In the near term, the Congressional Budget Office estimates that every dollar of Social Security and Medicare surpluses over the next 10 years will be used to meet other general fund budget expenditures rather than reducing debt and strengthening our ability to meet the demographic challenge posed by the retirement of the baby boom generation. In the longer run, if Congress permanently extends all of the Bush tax cuts and enacts politically necessary reforms to the alternative minimum tax, the cumulative revenue loss will equal 1.8 percent of GDP over a 75-year period, an amount roughly the same size as the combined Medicare and Social Security shortfalls (**Chart 13**). Tax cuts for the wealthy are clearly a higher priority for the Bush Administration than preserving Social Security and Medicare.

Chart 13



The need to protect the Social Security COLA. Unlike most private pensions and other forms of retirement annuity income, Social Security benefits include an annual cost-of-living adjustment (COLA) that is designed to compensate for increased costs of rent, gas, food, and other living expenses. Unfortunately, rising health care costs and last year's Medicare law threaten this valuable cost-of-living protection by driving up Medicare premiums, which are deducted from most beneficiaries' Social Security check.

In early October, the Bush Administration announced the largest premium increase in Medicare history: 17.4 percent, or $11.60 a month. Shortly thereafter they announced that the annual Social Security COLA for 2005 would be 2.7 percent. For the average retiree with a monthly Social Security check of $914, nearly half of the $25 per month COLA would be needed to cover the increase in the Medicare premium.

The JEC Democrats' report, "**Medicare Premiums are Undermining the Social Security COLA—New Data shows Impact by State and Congressional District"**, highlights Congressional Budget Office estimates showing that next year, some 2.1 million beneficiaries nationwide will have their entire COLA taken away by the Medicare premium increase leaving nothing for price increases in other goods and services. Almost 13 million beneficiaries will have over 50 percent of their COLA absorbed by the Medicare premium increase. The report finds that beneficiaries in all states and congressional districts would benefit from legislation proposed by Democrats to limit the increase in beneficiaries' Medicare premiums to 25 percent of their Social Security COLA.

Another JEC Democrats' report, "**Rising Medicare Premiums Undermine the Social Security COLA: New Medicare Law Could Cut Benefits for Some"**, shows that this year's experience is not an aberration. Ongoing increases in health care costs and soaring premiums under the new Medicare Prescription Drug Act will continue to erode the COLA in years to come.

Failure to address the growing health care crisis. Health care costs have risen sharply under President Bush and 5.2 million more Americans are without health insurance. The Bush approach to health care policy promises little relief, since it does not address the underlying problems.

People lack health insurance because coverage is unaffordable and often unavailable. Over 40 percent of the people without insurance have household incomes under $25,000, and about three-fourths have incomes under $50,000. About three-fourths of the uninsured between the ages of 18 and 65 are working full- or part-time, but don't have access to or cannot afford coverage through their employer. The President's approach to addressing these problems is a variety of tax deductions and credits that carry a high budget cost, fail to make health

insurance more affordable or accessible to the uninsured, and could undermine existing coverage.

The first step in implementing the President's approach was the creation of health savings accounts (HSAs), which allow people with qualified high-deductible health insurance to open a tax-advantaged account for health care spending. HSAs were a last minute addition to the Medicare Prescription Drug legislation passed last year—though seniors are not even eligible to open an account.

HSAs are a costly tax subsidy to the healthy and wealthy. The real losers from HSAs are those with lower incomes or chronic and costly health conditions. Combined with the high-deductible insurance coverage required to establish an account, HSAs have the potential to jeopardize traditional employer-provided coverage, drive up insurance deductibles, and raise out-of-pocket costs for working families.

The President's next step for moving people into high deductible health insurance was a $25 billion proposal in his fiscal year 2005 budget that would add a tax deduction for high-deductible health insurance premiums for taxpayers with health savings accounts. That proposal failed to get enacted in this Congress, but Republicans are unlikely to abandon their efforts to add this deduction.

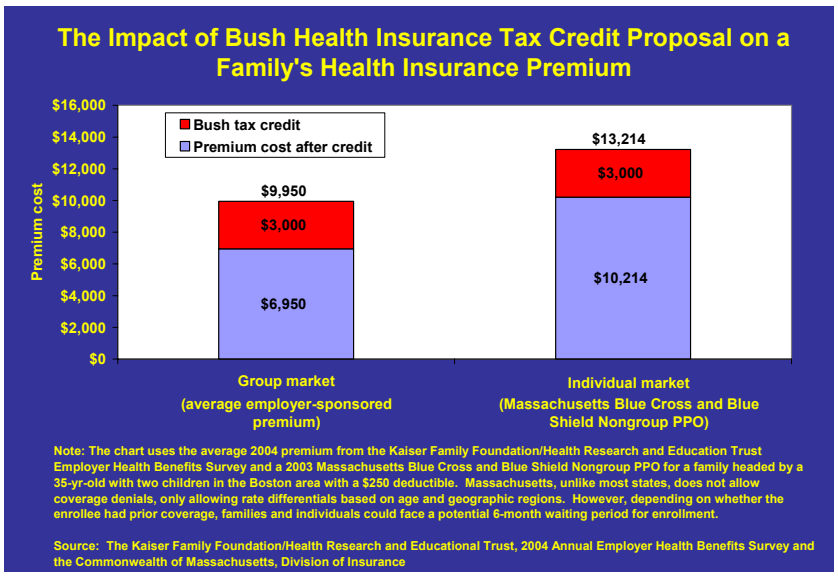
A JEC Democrats' report, "**The President's Costly Tax Deduction for High-Deductible Health Insurance Offers Little to the Uninsured and Could Undermine Existing Coverage"**, shows that the vast majority of uninsured families would get little or nothing from such a new tax deduction. High-income healthy families with HSAs could shelter more each year, but the new tax deduction for health insurance premiums would be worthless to low-income families.

In the name of addressing the uninsured, the Administration has also proposed health insurance tax credits to subsidize health insurance coverage. However, the JEC Democrats' report, "**Administration's Health Insurance Tax Credit Proposal Fails to Provide a Real Solution to the Uninsured**", finds that the amount of the credit would not put coverage within reach for low-income families. In addition, it would encourage enrollment in a market that is notoriously difficult to access and that offers coverage that is not only inadequate but also expensive.

A tax credit works to expand health insurance coverage only if several criteria are met. First, quality health insurance must be available. That means health insurance reform is a necessary ingredient, yet the Bush proposal lacks any market reforms. Second, the tax credit must be refundable. Otherwise, most of the uninsured will not be able to benefit because their incomes are too low. Third, people must be able to get the credit at the time they purchase the insurance. Finally, the credit must be large enough to make health insurance affordable.

The President's plan fails to meet these requirements. With average employer-sponsored premiums at nearly $10,000 for a family, his health tax credit would cover only a small fraction of the cost of health insurance policies for most uninsured families (**Chart 14**). It would do nothing to address the lack of access in the loosely regulated non-group market, where premiums are even higher.

Chart 14



Privatization is not the answer for Social Security. Social Security is one of the country's most popular and successful programs. Currently 90 percent of people aged 65 or older receive some payment from Social Security. About two-thirds of aged Social Security beneficiaries receive at least half of their income from Social Security. For about 20 percent, Social Security is the only source of income. In

2002, Social Security kept 13.1 million elderly people from poverty. Without Social Security the poverty rate among the elderly would have been nearly 50 percent.

The Administration advocates replacing part of Social Security with a system of personal saving accounts. Yet, as the final report from the President's Commission to Strengthen Social Security demonstrates, it is not possible to replace part of Social Security with personal accounts and maintain the solvency of the program without large transfers from general revenues or large cuts in Social Security benefits.

Privatization would worsen Social Security's financial position. Currently all projected Social Security revenues are needed to finance benefits promised to current and future retirees. Under the main plan developed by the President's Commission, Social Security would divert a portion of payroll tax revenues to individual accounts while continuing to pay benefits to current retirees. This would drain $1.8 trillion from the Social Security trust funds in just the next ten years, and speed-up by two decades (from 2042 to 2021) the year in which the trust funds are exhausted.

Privatization would reduce benefits for future retirees. Compared with the benefits promised under current law, the Congressional Budget Office estimates that the Commission's main plan would cut the annual benefit of an average earner retiring in 2065 from $26,400 to $14,600—a benefit cut of 45 percent. This estimate includes the individual account payout under privatization. Because disability benefits and benefits for young survivors are based on retirement benefits, deep cuts in retirement benefits would also cut promised disability benefits and young survivor benefits by 48 percent by 2075. These cuts would not be offset by payouts from individual accounts because disabled workers and young survivors would not have had enough time to accumulate contributions.

Privatization would also increase economic risks. The Social Security program now provides retirees with a predictable benefit that keeps pace with inflation, and is payable as long as the person or his or her spouse is alive. In contrast, the returns from personal accounts are uncertain, depend upon the ups and downs of the stock market, and are not guaranteed to last for a lifetime.

IV. Conclusion

In 2004, the economy is still struggling to climb out of the most protracted jobs slump since the 1930s. Four years of tax cuts have failed to generate a strong and sustained jobs recovery, but they have contributed to squandering the fruits of the strong economy and fiscal discipline of the 1990s. The country faces the imminent retirement of the baby boom generation with a legacy of large budget deficits from the policies of the past few years. All President Bush and his Congressional allies have to offer is more tax cuts and health and retirement policies that will dig the deficit deeper without providing meaningful solutions to the country's most serious problems.

LINKS TO MINORITY REPORTS

Poverty Has Increased and Real Income Has Fallen since 2000
August 2004 (revised September 2004)
http://jec.senate.gov/democrats/Documents/Reports/povertyfactsheet26aug2004.pdf

The Number of Americans without Health Insurance Rose for the Third Straight Year in 2003
August 2004 (revised September 2004)
http://jec.senate.gov/democrats/Documents/Reports/healthinsurance26aug2004.pdf

New CBO Analysis Confirms That the Bush Tax Cuts Are Skewed Toward the Rich
August 2004
http://jec.senate.gov/democrats/Documents/Reports/CBOtaxcuts13aug2004.pdf

Job Loss in the 2001 Recession Was Greater Than it Was in the Previous Recession but Federal Unemployment Insurance Was Less Generous
September 2004
http://jec.senate.gov/democrats/Documents/Reports/uisept2004.pdf

TANF Caseload Declines, Despite Rise in Poverty
October 2004
http://jec.senate.gov/democrats/Documents/Reports/tanfcaseloadoct2004.pdf

Keeping the Social Security and Medicare Trustees' Reports in Perspective: The Administration's Tax and Spending Policies Are the Real Fiscal Crisis
March 2004
http://jec.senate.gov/democrats/Documents/Reports/trustees25march2004.pdf

Medicare Premiums are Undermining the Social Security COLA—New Data shows Impact by State and Congressional District
October 2004 (revised October 16th)
http://jec.senate.gov/democrats/Documents/Reports/colaprotectionbycd19october2004.pdf

Rising Medicare Premiums Undermine the Social Security COLA: New Medicare Law Could Cut Benefits for Some
July 2004
http://jec.senate.gov/democrats/Documents/Reports/colaprotection21july2004.pdf

The President's Costly Tax Deduction for High-Deductible Health Insurance Offers Little to the Uninsured and Could Undermine Existing Coverage
February 2004
http://jec.senate.gov/democrats/Documents/Reports/hsas24feb2004.pdf

Administration's Health Insurance Tax Credit Proposal Fails to Provide a Real Solution to the Uninsured
February 2004
http://jec.senate.gov/democrats/Documents/Reports/hcrc5feb2004.pdf