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The Economy, the War and Choosing Our Future

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THE WAR, THE ECONOMY
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Lawrence Mishel

Thank you for the opportunity to talk with you today.

I'm going to talk about how the economy is doing, the impact of the war, and what we need to do to strengthen the recovery.

I'm going to offer four conclusions:

First, unless our nation's economic policies change, growth will be slow and unemployment high throughout this year and next year. Working people's wages will continue to decline; working families' incomes will continue to decline; and most Americans will conclude–correctly, in my view–that the economy isn't improving as much or as fast as it should.

Second, the problem with the economy is not the war and the end of the war will not lead to a rapid recovery.

War-related uncertainties may have delayed some consumption and investment. But the idea that the war was weighing down the economy ignores the boost to growth from war-related expenditures last year and this year.

On balance, the war and the reconstruction will have a net positive effect. Those touting the war's dampening effect on the economy may only be trying to distract us from the sad state of the economy.

That leads me to my third conclusion: Attention must be paid to what has been happening to jobs, to wages, and to workers.

There has been a severe deterioration in the labor market – with jobs disappearing and wages decelerating – with severe macroeconomic effects that have been under-appreciated by most analysts.

I will discuss some new analysis showing that wage income has made a remarkably weak contribution to recent growth.

Given the continuing unraveling of wage growth, it is hard to see how current consumption growth can be sustained. It's even harder to see how consumption can be improved enough to spark the job and investment growth that we need.

That leads to my fourth–and final–conclusion: The best way to strengthen the recovery is through tax and spending measures that are one-time, immediate, and temporary. Such measures can stimulate demand this year and create the jobs we need – NOW. The alternative approach of permanent tax cuts, including a new exclusion for dividend income, is not really about creating jobs in 2003.

A LIVING STANDARDS APPROACH

Before I go any further, I want to make clear that – as you've probably already noticed – my analysis of the economy is a "living standards" approach.

That means looking at the economy through the lens of the incomes and living conditions, the problems and prospects, of working families and people without work.

In this approach, a successful economy is one that "works for working people" – that generates a broadly shared prosperity.

At the Economic Policy Institute, we consider growth, productivity, inflation, and unemployment to be important economic indicators, but not the last word. They are important only insofar as they broadly raise living standards.

An emphasis on living standards leads to a focus on two dimensions of the economy.

First and foremost, there's the labor market – in other words, the number and quality of jobs and the growth of wages and benefits. Jobs, wages, and benefits are all-important because for most families, their incomes are their paychecks. These wages are the basis for their spending and consumption.

The second area of concern is distribution – in other words, who gets how much? That means examining job, wage, and income trends for various types of workers and families. How else can we tell what people are experiencing?

This living standards focus is different from the approach favored by brokerage house economists and most economic forecasters. They track overall economic growth and interest rates so as to predict corporate profits, potential sales, and stock market trends. They track aggregate macroeconomic forces much more than labor market trends. When they examine labor market trends, they look at averages rather than subgroups.

As you know, averages can be very misleading. A man with one leg in boiling water and the other in ice water is "on average" very comfortable. That is, an average can be true but not informative – and even irrelevant to the reality experienced by most people. This has been especially true for a labor market riddled with growing inequalities over the last 25 years.

My point is that the usual economic experts may analyze the economy correctly, but they do so from their particular perch and for their purposes. I believe their analyses do not capture economic trends as experienced by most Americans.

SO HOW IS THE ECONOMY DOING?

So how is the economy doing? Not too well when you look at the basic indicators of jobs and paychecks.

First, unemployment has been hovering around 5.8% for over a year. Although unemployment has not reached the levels of other recessions, it is still almost 2% higher than it was in 2000. I believe that returning to a 4% unemployment rate is both possible and desirable.

Second, a better indicator of labor market slack is the severe loss of jobs, especially private sector jobs. When newly revised data are available in June, you will see that private employment has fallen by 2.8 million jobs in this downturn. This is a 2.6% employment decline, far larger than in any other postwar recession (See Figure #1).

How can we reconcile these developments – severe job loss but without historically high unemployment? The answer is that the labor force, which was expected to grow 1% a year, has grown far more slowly than that. Why? Because about two million people have not come into or have dropped out of the labor force and are not being counted as unemployed. If they were still in the labor force, unemployment would be at least 6.5%

When the economy really starts growing again, this "missing labor force" may show up again – seemingly from nowhere – to search for the emerging job opportunities. This will make it more difficult to reduce the official unemployment rate.

The third important indicator is household income. Labor market weakness forced an across-the-board decline in household incomes in 2001, with the median household losing 2.2%, or $934.

That is a large loss for what seems a relatively small rise in unemployment from 4.0% to 4.8%. When the 2002 data are released in September, you can be sure that they will show an even larger decline between 2001 and 2002. Moreover, there is a further decline occurring now because of employment losses and real wage decline.

Fourth, high unemployment has thrown wage growth into reverse in 2003. Wages have responded slowly, but surely, to higher unemployment. The fast productivity and low unemployment of the late 1990s generated real wage growth that carried forward into 2001, when real weekly wages grew 2.5% at the median. But last year nominal wage growth slowed (by 1 to 1.5%) and, with higher inflation, has led to real wage declines for high, middle, and low-wage workers (Figures #2 and #3). This has macroeconomic implications I will explore later.

Last, consider this: unless employment starts growing, President Bush will be the first president since Hoover to preside over an actual decline in employment. To avoid that dubious honor and keep unemployment where it is, the administration would have to figure out a way to create 140,000 jobs a month. To get unemployment down to 5%, the economy must generate 210,000 jobs per month.

This seems very unlikely to me, especially given the administration's preferences for back-loaded rather than front-loaded tax cuts.

WAR AND THE ECONOMY

Now, I will turn my focus to the impact of the Iraqi war and reconstruction on the near term economy.

I have been sifting the detailed data on consumption, sales, investment, and so on to identify the footprints of the war. It has been a lot of fun. However, I will spare you the details and go straight to my conclusions.

There has been much discussion that war-related anxieties and uncertainties have "weighed down" the economy. I think this view is fundamentally wrong. The bottom line is that the war's impact on recent growth may have been slightly negative, but the consequence is to displace some consumption and investment into the next quarter. There's no reason to believe the war's end will suddenly spark a vigorous recovery.

More important, recent reporting has overlooked the boost to growth from defense spending. For instance, the greater defense spending in 2002 lifted GDP by 0.4% compared to 2000, and accounted for 15% of GDP growth last year.

Spending on the war and reconstruction in 2003 and 2004 will have a further positive effect. Let's assume that, out of the $79 billion supplemental appropriations package, 80% is spent domestically and two-thirds is spent this year. That will boost GDP by 0.4% in 2003.

The remaining expenditures, plus additional appropriations next year, will provide a similar boost for 2004.

Now that we know there will be no oil crisis or sustained conflict, it should be apparent that the war and reconstruction in Iraq has stimulated rather than depressed growth. The administration may choose to highlight the war as a negative factor, but we should view this as "spin" intended to deflect criticism of the sad state of the economy.

SO WHERE DOES THAT LEAVE US?

Given this impact of the war, where does this leave us? Of course, this depends on where we are going and where we want to be.

Where we are going is a period of sub-par growth, too slow to generate enough jobs to lower unemployment. The 4% unemployment we had in 2000 cannot even be seen with binoculars.

The most recent Blue Chip consensus projects GDP to grow 2.4% in 2003 and 3.6% in 2004.

But is that good enough? To set the right growth target, we must first recognize the really positive productivity trends since 1996. Productivity growth has accelerated by almost 1% -- to a 2 to 2.5% growth rather than the 1.5% annual growth we had seen before 1996. This faster growth has continued even during the downturn.

This higher productivity means that we need to demand more of the economy. With 2.5% productivity growth, the economy can grow by 2.5% without adding any employment. Thus, economists recognize that to absorb a growing labor force we need to grow by 3 to 3.5%. However, we will need even faster growth if we want to lower unemployment. So, what used to be considered acceptable growth is now a recipe for a jobless recovery. And that's where we are.

We need 4 to 4.5% growth to get on track to reach 4% unemployment in three years or so. This is a modest and essential goal. We will not see widely shared prosperity again until we reestablish low unemployment.

In this light, the growth rates that are being forecast are disappointing and unacceptable. This is especially true since most of the forecasts assume that growth will be boosted by a stimulus package that is yet to be legislated. How can we speed up growth and job creation?

SLUGGISH WAGES

Here's where I give you some breaking news. Sustained high unemployment has substantially dampened wage growth, causing real median weekly wages to decline for four consecutive quarters (Figure #4). Such a continuous real wage decline has not occurred since 1990! And it will not readily reverse itself until vigorous employment growth resumes. Meanwhile, these wage problems will sap the strength of the recovery.

So far there has been reasonable growth in aggregate disposable income and consumption during this downturn, but there's good reason to believe this will not continue.

Because of the large employment losses and the wage slowdown, recent income growth relied less on wage income than in previous downturns. Here's a startling calculation: total wage and salary income contributed only 16% of the growth in disposable income so far in this downturn; in contrast, wage income contributed almost half of all income growth in prior downturns (Figure #5). All labor income, including the growth in benefits costs, has contributed just 28% rather than the 58% in earlier downturns.

Luckily, faltering wage growth was offset by an unusual decline in tax payments, which accounted for a remarkable 40% of recent disposable income growth. In prior downturns, tax payments did not fall at all and therefore did not boost disposable income growth. Let me assure you that the lower tax payments are not the consequence of income tax rate cuts. In fact, they are due to the natural workings of a progressive income tax system. As realized capital gains and upper incomes fell, this produced a decline in tax payments proportionately far greater than the income decline. According to the Congressional Budget Office, tax payments fell 14% in 2002 and only a fourth of this reduction is due to recent changes in tax laws. Three-fourths was due to a decline in capital gains and income.

So a sharp reduction in tax payments bailed us out in 2002, offsetting a sub-par contribution of wage income to overall growth. The point going forward is this: even if employment stops falling, declining real weekly wages will continue to dampen overall wage and income growth. Consumption will continue to grow, but too slowly for us to achieve the kind of growth we need in order to lower unemployment.

Remember, you heard it here first: wage erosion will constrain the recovery.

THE WAY FORWARD

Going forward, we need policies that immediately boost growth and job creation in 2003. There are many reasons why this is so–here are three. First, growth this year and even next year will be too slow to lower unemployment. We need to get on track to roll unemployment back to 5% and then to 4%.

Second, the real wages of full-time workers are falling for the first time since 1990. This is not only unpleasant in and of itself, it will also undercut income growth even if employment stabilizes or grows.

Third, the projections of slow growth assume fiscal stimulus. Obviously, without stimulus the growth will be even weaker.

For me, whether we're looking at any "jobs and growth" plan, tax cuts, or stimulus proposal, the big question is: Will it provide an immediate economic boost? Unfortunately, most of the reporting gets diverted onto the size of the tax plan in the budget resolution over 10 years – be it 350 billion, 726 billion, or none at all. Much more important is whether the Bush plan or any other plan will actually create jobs and what the impact is this year and next.

There are many reasons why the Bush plan will do little for the economy soon. The biggest one is that it was not designed to do so. The administration has been clear, at moments, that it is concerned with other matters: long-term growth rather than "stimulus," shifting taxes from capital onto labor, and shrinking the size of government. Not surprisingly, therefore, the plan provides little stimulus in FY2003–just $41 billion, or 1.5% of a 10-year total of $2.7 trillion. The total effect on this year and next is only 6.5% of the total increase in costs over 10 years. And, its components are not geared to boosting demand—high-end tax cuts and the dividend exclusion would be on nobody's top list of ways to boost immediate consumption, or investment. Tax cuts in 2005 and beyond have nothing to do with creating jobs in 2003.

It is possible to create jobs in 2003 without creating chronic deficits and spending far less than $726 billion or even $350 billion. In December, I proposed a job stimulus plan costing $175 billion. Given where we are now, I would make the total larger, but would keep the key components. These expenditures and tax reductions would apply to the next eighteen months, thereby leaving our long-term fiscal position unaffected. They include:

(1) One-time tax payments to lower and middle income families
(2) Fiscal relief to the states; and
(3) School renovation and construction.

This effort would stimulate demand, generate customers for business, and jobs—roughly 1.5 million of them—over the next 18 months.

I will leave you with a suggestion that you follow two things closely. Watch what's happening to the wages of the typical worker. And pay attention to how the various budget proposals will perform in creating jobs in this calendar year.

Figure 1. The change in private sector employment, 2 years after the recession began

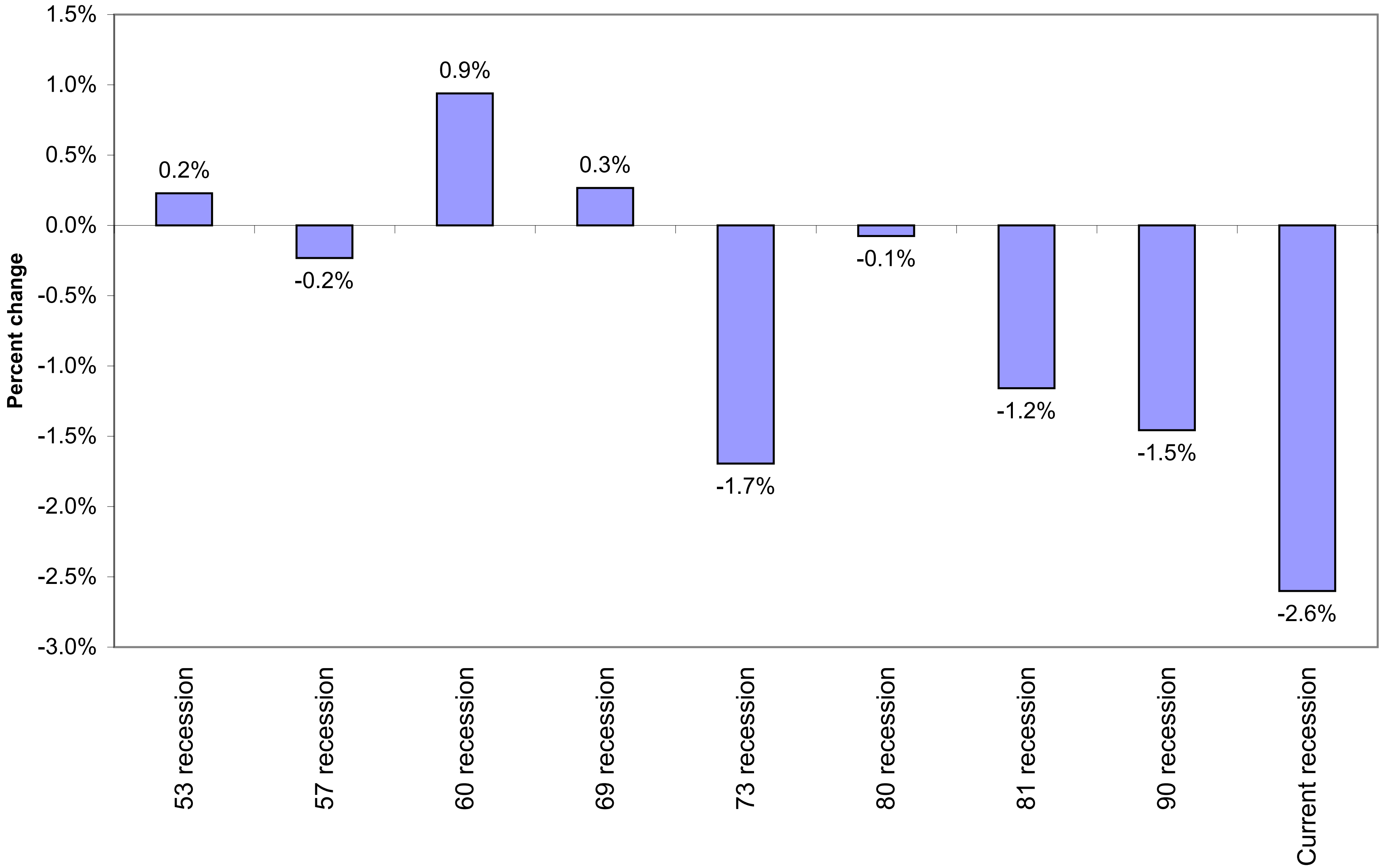

Figure 2: Growth in nominal median weekly earnings and inflation, 1999q1-2003q1

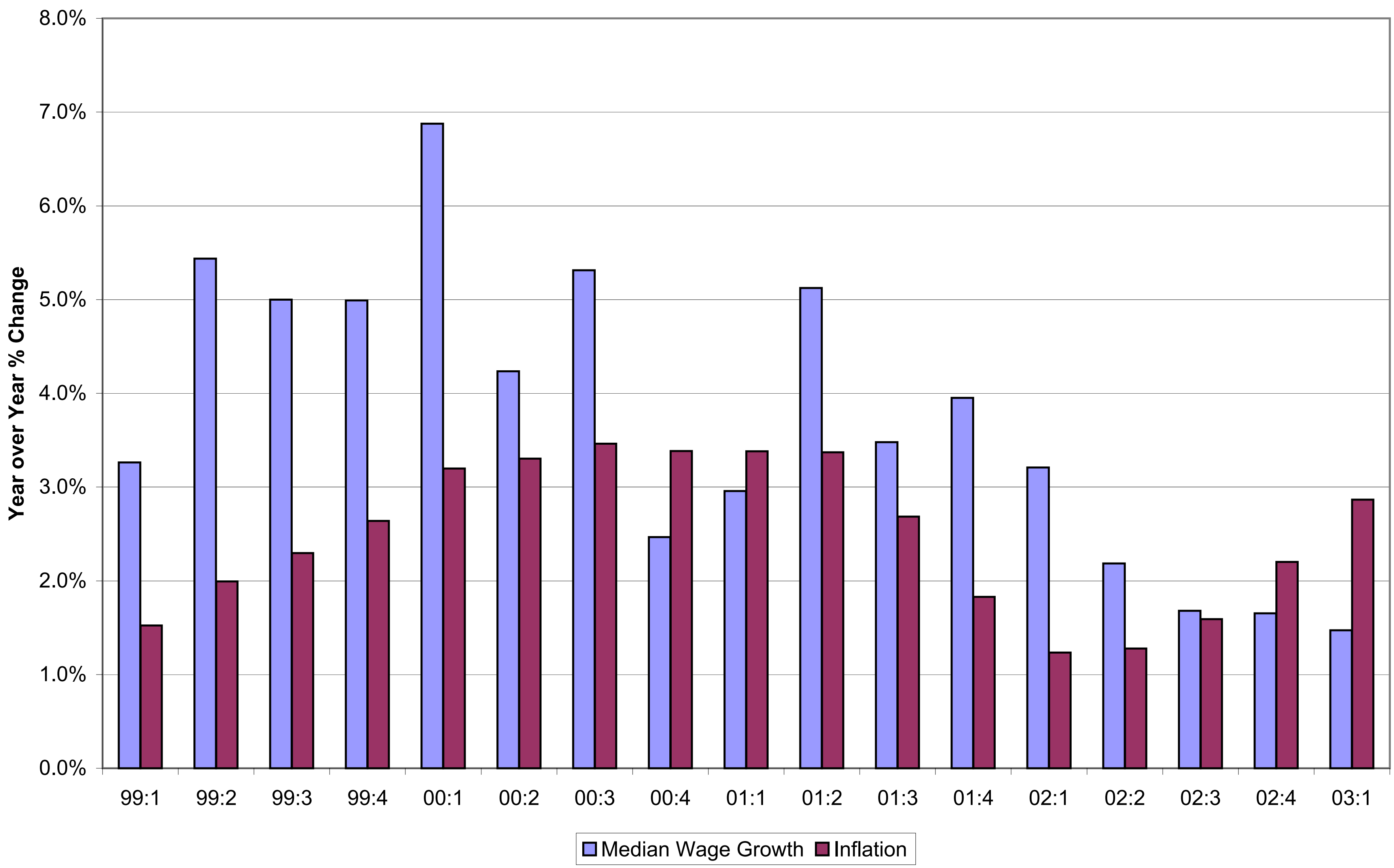

Figure 3. Changes in real weekly earnings by percentile, 2001-2003

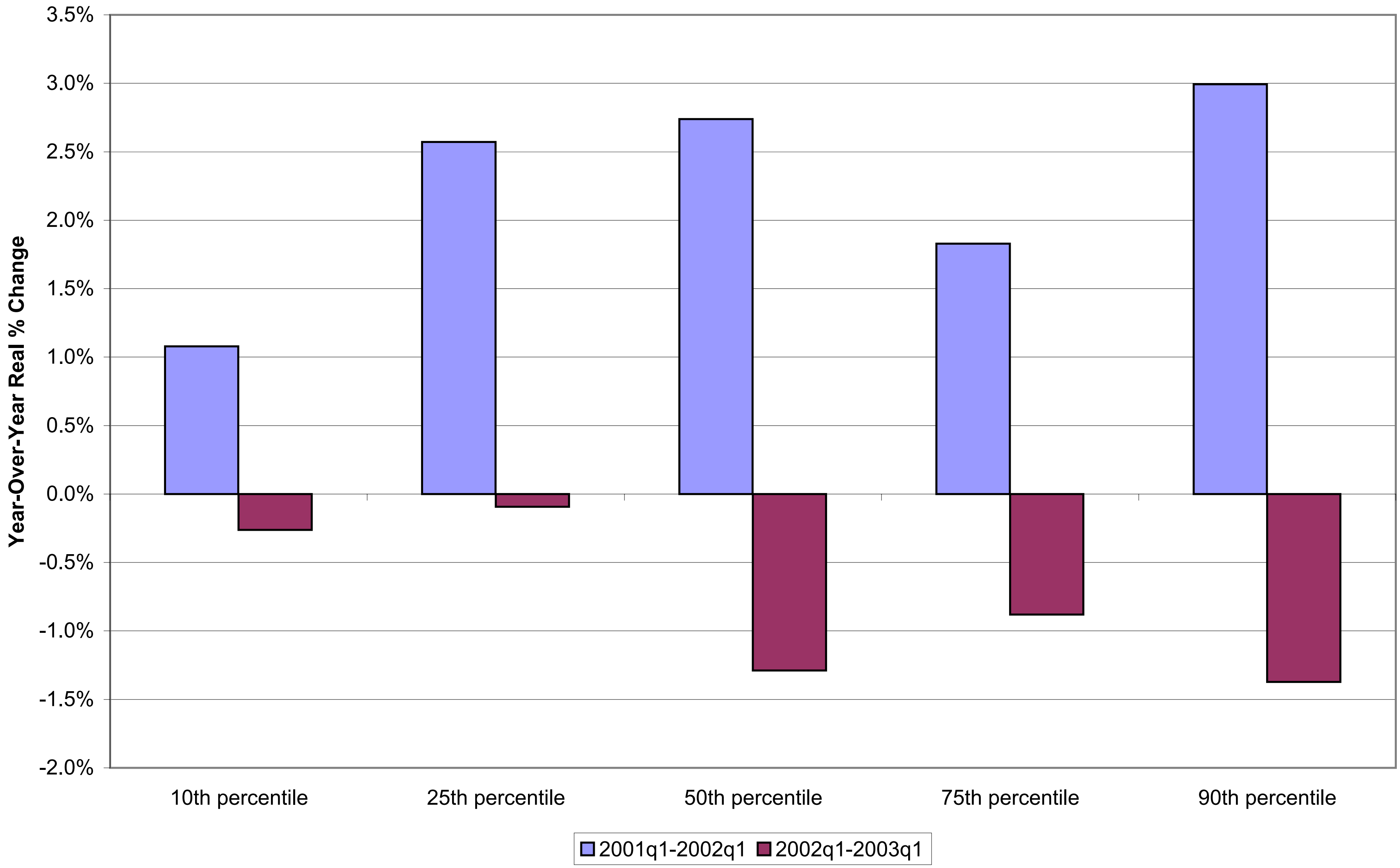

Figure 4: Real median earnings, 1999q1-2003q1

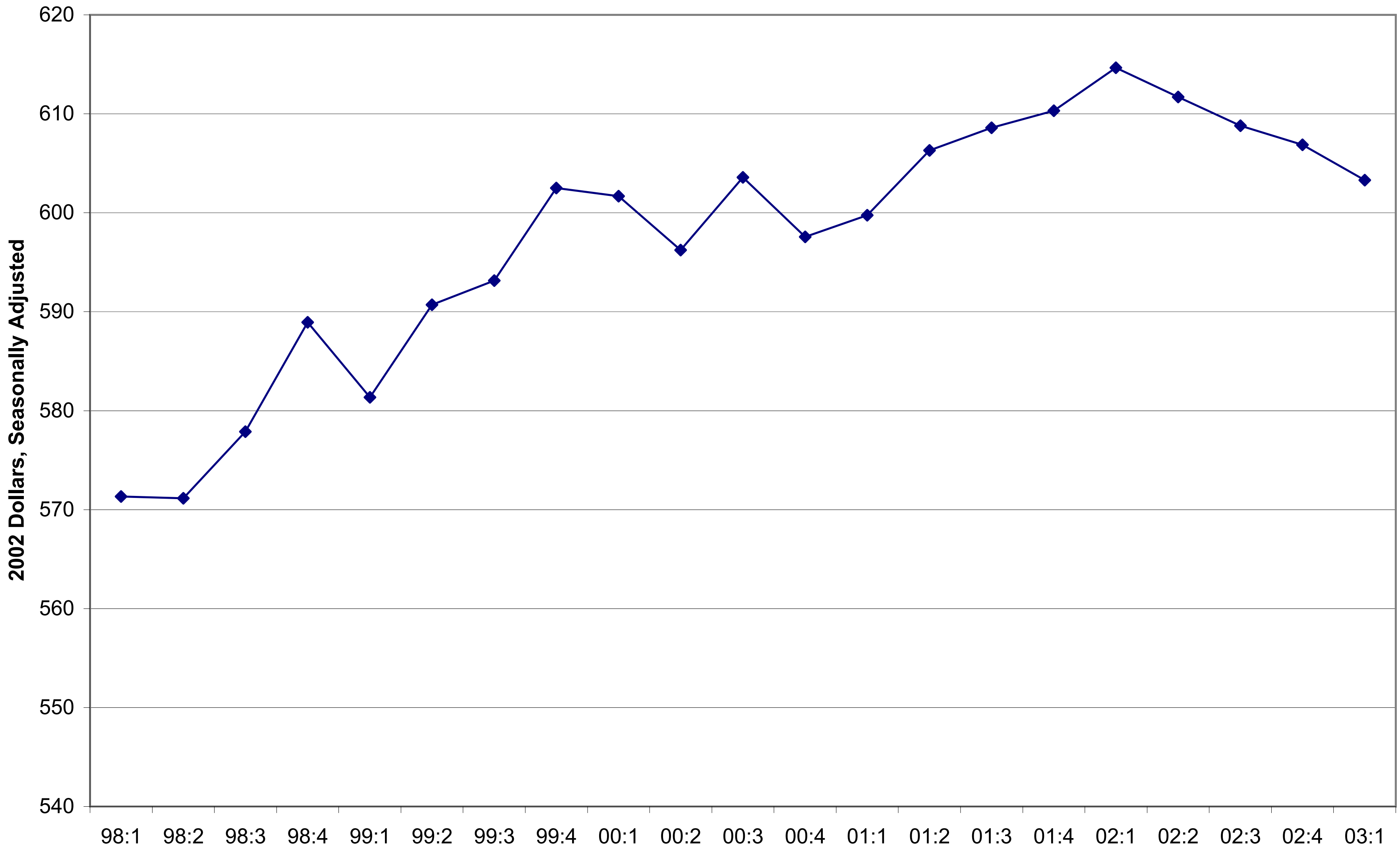

Figure 5. Contributions to disposable personal income growth, This downturn vs. the average of the previous four recessions