ECONOMIC POLICY INSTITUTE

To: National Commission on Fiscal Responsibility

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Subject: Trigger for Fiscal Consolidation

Fiscal Consolidation Should Wait until Economic Recovery is on Track

The economy remains fragile and well below potential. Major deficit reduction should not be implemented until the recovery is firmly on track, that is, until unemployment has dropped significantly and is on a downward trajectory. Main findings include:

- The US economy remains weak: unemployment is projected to remain elevated for several years.
- Experts agree that deficit reduction should wait.
- "6-for-6" trigger: unemployment should reach 6 percent and remain below that rate for 6 consecutive months, before any fiscal contraction should be implemented.
- Near term investment is essential
- Targeted job creation will remain necessary even after the trigger is reached.

Deficit reduction and short-term job creation are not competing priorities. Job creation is needed today to ensure a strong economy and a solid tax base tomorrow: you can't reach reasonable budget targets without a strong and rapid recovery, and you won't get a strong recovery if you pursue austerity too early.

Setting an appropriate trigger for fiscal consolidation would help to ensure that the recovery is not stunted by an inappropriate change in fiscal policy.

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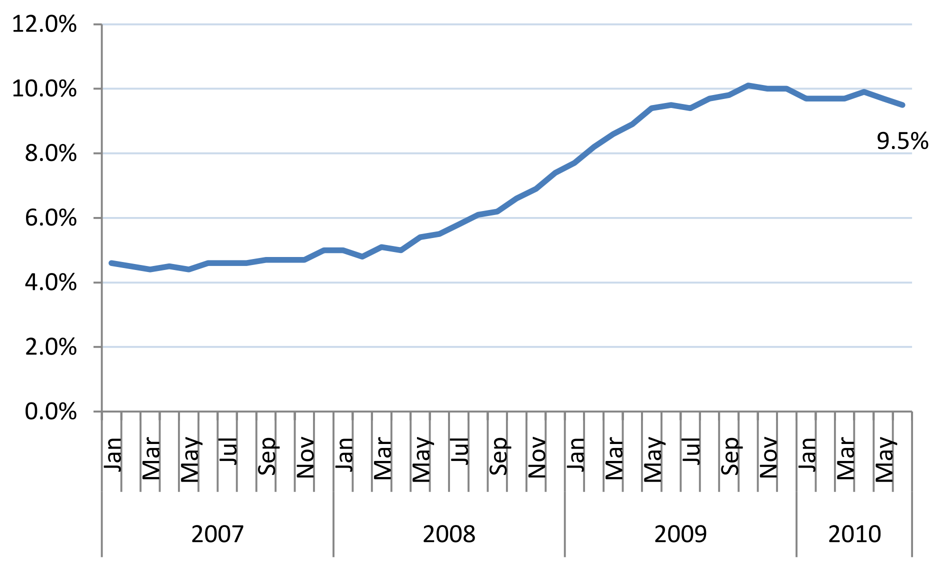
Current conditions

The recession has caused the greatest job loss since the Great Depression. Overall unemployment stands at 9.5% in June after peaking at 10.1% in October of last year. The current rate is at the same level as one year ago. While the rate has stopped rising—in part due to efforts to stimulate the economy through the Recovery Act and other measures—the economy has not been strong enough to generate job growth at a pace to ensure broad improvements in the labor market.

Figure A. Unemployment Rate, 2007-2010



Labor market indicators

Aside from the headline unemployment data, there continue to be indications of a weak labor market.

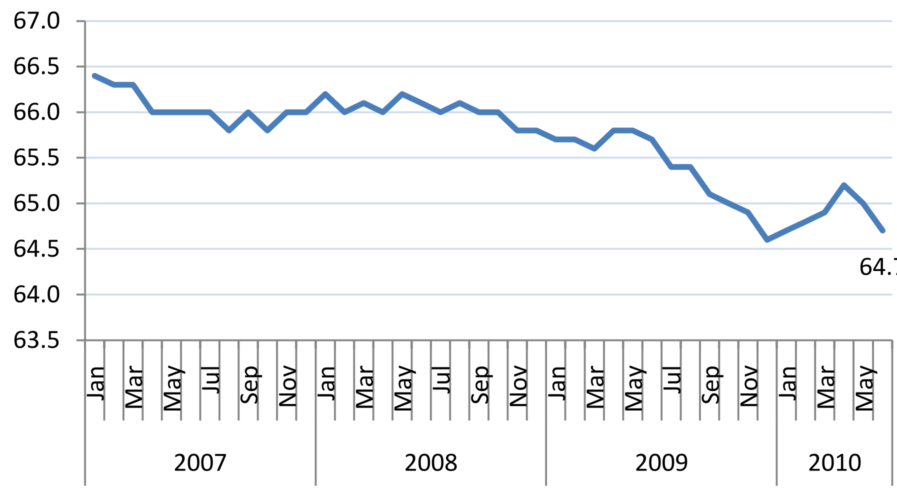
- The average length of unemployment has dramatically increased, and there are currently 6.8 million people who have been unemployed for more than 6 months. These people represent nearly half of the unemployed.[1]

- There are currently 5 unemployed workers for every job opening.

[1] See H. Shierholz, "Job Creation at a Glacial Pace" July 2, 2010, at http://www.epi.org/publications/entry/job_creation_at_a_glacial_pace/

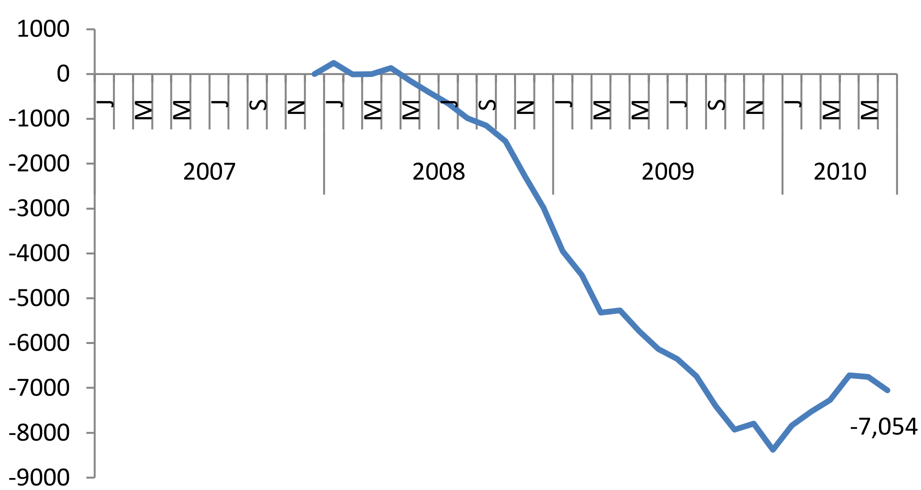
- The employment to population ratio is currently at 64.7%, which is 1.3 percentage points lower than pre-recession levels in 2007, and remains near recession lows (see Figure B).

Figure B. Employment as a percent of population, 2007-2010



- Employment remains well below the peak level that occurred in December 2007. The economy currently has 7 million fewer jobs than at the start of the recession. The economy also needed to add about 3 million jobs in order to keep pace with population growth – leaving a “jobs hole” of about 10 million jobs. (See Figure C.)

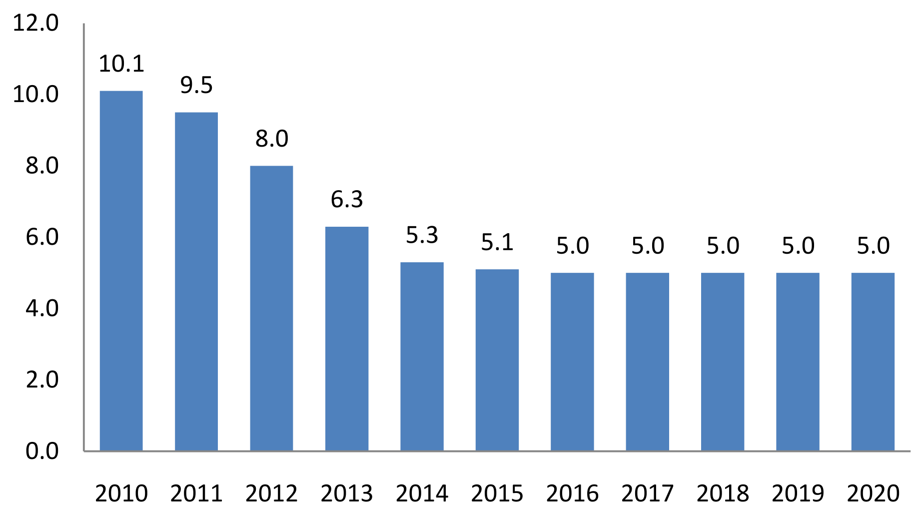
Figure C. Jobs lost since December 2007



Outlook

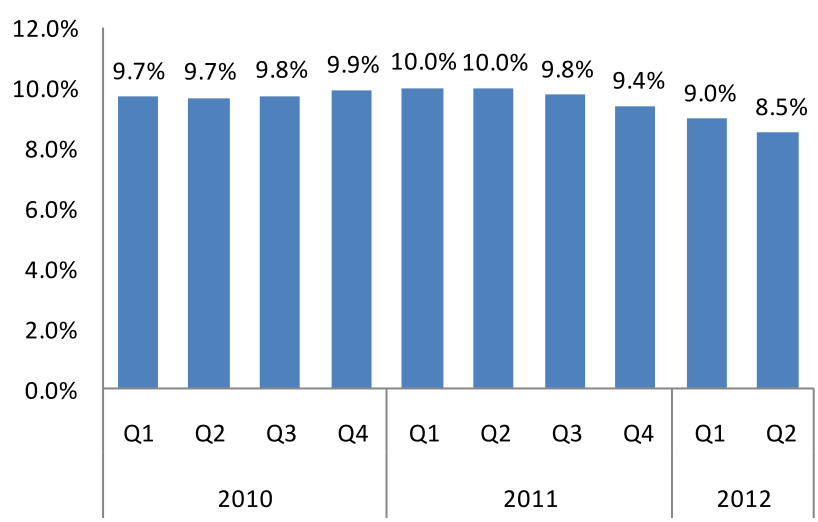
An array of economic forecasts all show unemployment lingering at historically high levels for an extended period of time. For example, Goldman Sachs forecasts unemployment to remain in the 9.5 to 10 percent range through the end of 2011. The Congressional Budget Office's most recent projections show unemployment averaging 8 percent in 2012 (more than four years after the beginning of the recession) and remaining above 6 percent through 2013 (see Figure D). Moody's Economy.com also projects elevated unemployment dropping to just 8.5% by mid 2012 (see Figure E).

Figure D. CBO projected calendar year average unemployment rate 2010-2020



Source: CBO, January 2010

Figure E. Unemployment forecast 2010-2012, Economy.com



Source: Economy.com, July 2010

Fiscal Experts Agree Near-Term Deficits are Appropriate

It is widely accepted among economic and budget experts that stimulus spending (and maintaining other federal outlays) is necessary in the short term. It is also generally accepted that our current near-term deficits are largely inconsequential relative to the long-term fiscal challenges posed by other factors, such as rapidly rising medical costs. A small sample:

- David Walker, President of the Peter G. Peterson Foundation: “I think it’s very important to separate the short term from the structural. It’s understandable to run deficits when you have a recession, a depression, or unprecedented financial services and housing-type of challenges and crises that we’ve had. That’s not what I’m concerned about.”

- Gene Steuerle, Senior Fellow, Urban Institute: “Contrary to much debate, getting the long-term budget in order does not require avoiding stimulus in bad times; it only means reasonable reductions in those levels in good times.”

- Greg Mankiw, Harvard Professor and former Chairman of the Council of Economic Advisors under George W. Bush (in the aftermath of the 2001 recession): “It is a textbook principle of prudent fiscal policy that deficits are an appropriate response in times of war and recession.”

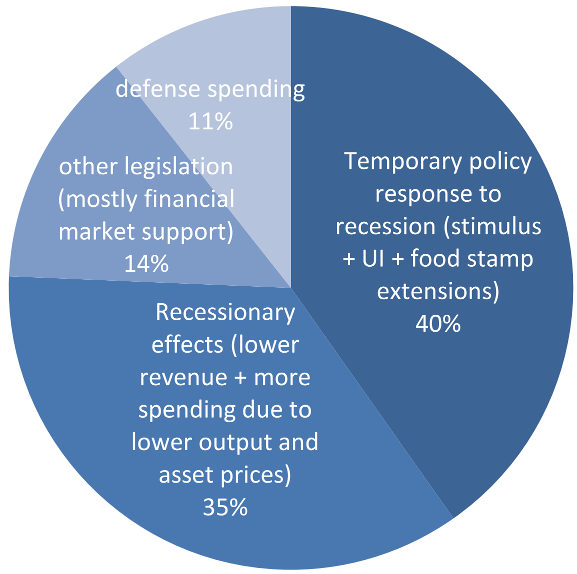
- Mark Zandi of Moody’s Economy.com: “Given the considerable risks remaining and prospects that unemployment will remain high for years, it is appropriate for policymakers to remain focused on further steps to support the job market… Additional financial aid to hard-pressed state governments facing large budget shortfalls would also mitigate some of the job cuts that have already begun to occur.”

- Isabell Sawhill, Senior Fellow, Brookings: “It is important to stimulate the economy now and not worry about the deficits needed to do this, but we should simultaneously be enacting legislation that will gradually phase in spending cuts and revenue increases over the next decade.”

- Concord Coalition: “It may be appropriate for government to spend more than it taxes during downturns in the business cycle. The Concord Coalition has always recognized the importance of fiscal stimulus, so long as the stimulus is timely, targeted, and temporary.”

Most of the present deficit has been driven by short-term economic factors and the enactment of critical emergency measures such as the American Recovery and Reinvestment Act and the Troubled Asset Relief Program (see Figure F).

Figure F. Share of increase in projected 2010 baseline deficits since 2007



- Federal tax receipts as a proportion of GDP will rebound from 60-year lows as profits and incomes recover and counter-cyclical budgetary pressures will subside if the economy is put on a sustainable track for recovery.

Impact of near-term fiscal consolidation

The economic recovery remains fragile and an immediate decrease in federal outlays could jeopardize the budding economic upturn. Aside from the labor market weaknesses, economic risks remain:

- Falling state and local government expenditure and investment have taken an increasing toll on the recovery over the last three quarters, most recently shaving half a percentage point off of real GDP growth in the first quarter. State fiscal woes are expected to continue.
- Consumer spending ticked up in the first quarter, but the increase in spending was financed by a depletion of personal savings while real disposable incomes stagnated.
- With the euro near four-year lows against the dollar, U.S. export competiveness will suffer and a widening trade gap would slow economic growth.
- Standard monetary policy continues to remain maxed-out with short-term interest rates near zero.

Objective observers agree that the Recovery Act has worked to stimulate growth and create jobs. CBO recently estimated that the Recovery Act added between 1.7 and 4.2 percentage points to real GDP by the end of the first quarter, and increased full-time equivalent employment by between 1.8 and 4.1 million jobs. Without the Recovery Act, the economy would have remained mired in recession or reentered a period of contraction. Other estimates, from Goldman Sachs and Moody's Economy.com among others, have also shown that the Recovery Act has had a significant impact. Fiscal contractions would have the opposite impact: lower growth and fewer jobs.

As this federal fiscal support fades (and the outlook for state and local budgets continues to deteriorate), the economy will lose some of the support that helped turn the tide. In an immediate worst case scenario, a severe double-dip recession induced by premature fiscal tightening would counterproductively worsen the medium and long-term fiscal outlook.

"6-for-6" Unemployment Trigger

As noted above, the economy remains fragile and is performing well below its potential. Major deficit reduction should not be implemented until the recovery is firmly on track, that is, until unemployment has dropped significantly and is on a downward trajectory.

To be concrete, unemployment should reach 6 percent and remain below that rate for at least 6 consecutive months, before any fiscal contraction should be implemented.

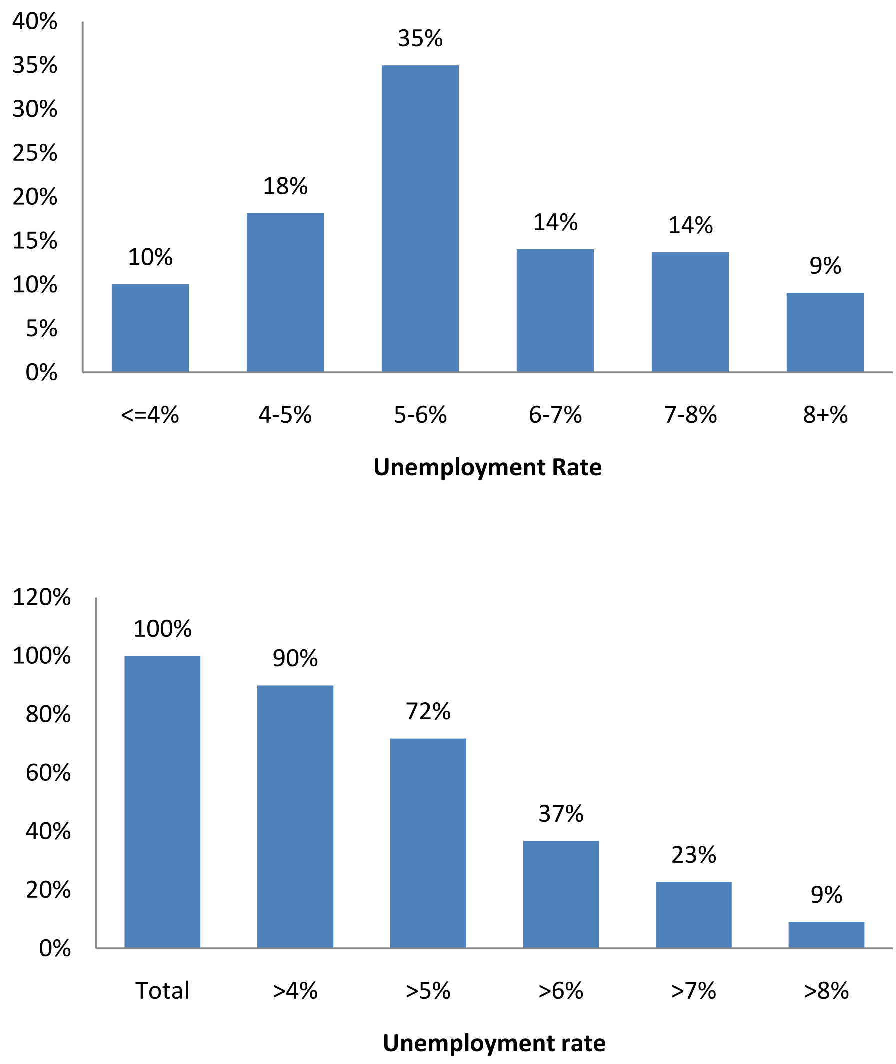
- Tax and spending policy can be changed before the target is reached, however, the overall stance of fiscal policy should be expansionary or neutral before the target is reached—that is, as a whole, fiscal policy must either add to or keep unchanged current projections of GDP growth under current policy.
- Under CBO projections, the trigger would not be reached until 2014. However, given the uncertainties around the pace of the recovery, the exact timing of the trigger is highly uncertain. A trigger would be preferable to a simple delay because of this uncertainty.
- Six percent unemployment should not be considered a final stopping point for the economy.[2]
    - The U.S. economy was able to achieve unemployment rates at or below 4.6% for over 3 years between 1998 and 2001.
    - The unemployment rate was 5% or lower for a 2½ year period from 2005 through 2007.

David Walker of the Peter G. Peterson Foundation has said 7 percent is an appropriate trigger level. However, an economy at 7 percent unemployment would still be higher than the peak unemployment rate in the 2001 recession and only 0.8 percentage points below the peak in the early 1990s recession. Further, in early 2008, when unemployment was about 5% and there were fears of getting to 6.5% or more, Congress felt the need was urgent enough to pass a bi-partisan stimulus bill.

[2] A 6% target should not be interpreted as the equivalent of a NAIRU or "natural" rate of unemployment.

Figure G shows the distribution of unemployment rates over the last 50 years. The US experienced unemployment greater than 7% only 23% of the time since 1960; and unemployment was more than 6% about 37% of the time. Consequently, in 63% of the time since 1960 the US had an unemployment rate of less than 6%. Thus an unemployment rate under 6% represents an economy on a road to recovery, versus higher levels which are more consistent with abnormal recessionary outcomes.

Figure G. Distribution of unemployment rates, 1960-2010.
(Percent of months with unemployment in specified range)



Pre-Trigger Policy: Public investment is essential

Recessions have long-term consequences,[3] thus even "short-term" recovery spending can have enormous long-term benefits. Public investment will boost growth in the short-run, and lead to greater economic capacity down the road. With unemployment hovering in the 9 to 10 percent range, and with projections putting unemployment at elevated levels for at least the next couple of years, further job creation is indeed necessary in the short run.

Traditional economic analysis suggests that a well-designed stimulus can have more than a 1-1 impact on GDP, and also that some of the costs will be recouped initially through higher tax receipts. In the future, since GDP levels and growth rates are persistent over time, this will mean lower deficits in future years. (Debt levels might be higher or lower depending on how long-lasting is the impulse to GDP.) *Thus deficit reduction in 2015 can be assisted by growth-inducing public investments today*.[4]

Over the long term, we must ensure that the US economy rests on a solid foundation. The foundation must support strong overall growth and rapidly rising incomes for all Americans – not just those at the top. Public investments in infrastructure (including transportation, information, and water systems), investments in education from early childhood through higher education, investments in innovation, investments in health systems, and many other areas are key to providing this foundation. These investments cannot be sacrificed in the name of deficit reduction, for this would put the US economy in a weaker position to address the long-term imbalances that will grow in the coming decades.

Post-Trigger Policy: Targeted job creation will remain necessary

Even after the 6-for-6 target is reached, there will be communities that will have substantially higher rates of unemployment. This will be true for certain racial and ethnic populations as well as certain geographic locations that have been hit hard by the recession or that have seen traditionally higher levels of unemployment. Any fiscal consolidation must not further harm low-income families.

- Given different pace of recovery across the nation and across communities, a one-size-fits-all approach to federal spending is inappropriate. Some targeted programs to address disparities in the labor market should in fact be expanded.
- The formulation of deficit-reduction plans should consider the full distributional impact of both spending changes as well as tax changes. Estimates of the impact should be provided to the commission by CBO before any final decision is made.

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[3] See J. Irons, "Economic scarring: The long-term impacts of the recession" Economic Policy Institute, Briefing Paper #243, September 2009, at http://www.epi.org/publications/entry/bp243/.

[4] See J. Irons, Testimony before the National Commission on Fiscal Responsibility and Reform, June 30, 2010.
http://www.epi.org/analysis_and_opinion/entry/deficit_reduction_should_take_a_back_seat_to_job_creation/

Conclusion

While the commission does have a 2015 target as well as a longer-term mandate, any plan must account for the possibility that the recovery may be slower than currently anticipated – and any action that would harm the recovery should be explicitly delayed, perhaps through one or more trigger mechanisms.

One such trigger – under 6% unemployment for at least 6 consecutive months—would ensure that the economy is on track and better able to accommodate the start of fiscal consolidation.

Further, while it is traditional to phase-in changes over a number of years, any growth-reducing adjustments for 2015 should *not* begin to be phased in immediately, but wait several years until a strong recovery is more certain. The near-term policy priority should be fostering an economic expansion rather than enacting austerity measures to reduce the deficit.