Center for American Progress

State of the Economy

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The economy will likely play a prominent role in this year's State of the Union address. In the weeks and months leading up to the speech, the President and his economic team and staff have sought to create a selective and exaggerated picture of the economy as a means to justify their fiscally reckless economic policies and to support making their tax cuts permanent. Yet, while GDP growth may have been solid over the last couple of years, growth over the full recovery has been mediocre, and job and wage growth have been historically weak. The tide may be rising, but it is has been unusually weak at lifting all boats. Historically low job growth, declining wages, rising poverty and the worst deterioration in our fiscal situation in history is hardly proof that current fiscal policies are working or should be continued.

The Economy Has Failed to Deliver for Typical Workers: In 2003, the White House argued its tax cuts would "help the economy create new jobs today while permanently raising the wages and living standards of American workers now and in the future."[1] Three years later, the tax cuts have hardly passed this test. Just as it is unfair for the White House to claim credit for everything good happening in the economy, it is unfair to blame its economic policies for everything that is bad, but given our historically slow job growth, falling wages, and rising debt levels, it's hard to say the tax cuts have delivered as promised.

Both Average Real Hourly and Weekly Wages Are Falling. Despite White House promises, little of the prosperity supposedly generated by the tax cuts has reached millions of Americans:

- Since the end of the recession in November 2001, real average weekly earnings have fallen 0.4 percent from $552.58 to $550.60 in Dec. 2005. Real hourly wages have been effectively stagnant, dropping one cent from $16.35 from $16.34 in Dec. 2005.[2]

- Since the 2003 tax cuts, real average weekly earnings have fallen 0.8 percent from $554.92 in May 2003 to $550.60 in Dec. 2005. Hourly wages fell even further: *down 1.1 percent* from $16.52 in May 2003 to $16.34 in Dec. 2005.[3]

- In 2005, real weekly earnings fell 0.4 percent from $552.75 in Dec. 2004 to $550.60 in Dec. 2005. Real hourly wages fell 0.4 percent as well from $16.40 in Dec. 2004 to $16.34 in Dec. 2005.[4]

- Even taking into account the growth in benefits, employee compensation has been historically weak in this business cycle. According to statistics the Department of Labor collects on employer costs, in the first 18 quarters of this business cycle total compensation (the non-inflation adjusted costs of wages/salaries, pensions, and health insurance) in major industries rose at a 3.6 percent annual rate through September of 2005—the slowest pace through this period of any post-war

business cycle 18 quarters or longer. Average annual growth in previous cycles was almost twice as strong: 7.0 percent.[5]

- According to the data released annually by the Census Bureau, real median household incomes have fallen each year under President Bush. Since the year before Bush took office and the end of the last business cycle, real median household incomes fell $1,669 in 2004 dollars from $46,058 in 2000 to $44,389 in 2004 (the last year reported). Even since the recession ended in 2001, they have declined $673 from $45,062. [6]

- The poverty rate has risen each year under President Bush, from 11.3 percent in 2000 to 11.7 percent in 2001 and then to 12.7 percent in 2004.[7]

We're in the midst of the weakest job recovery on record. Since the last recession started in March 2001, the economy has added just 34,000 jobs per month, growing at a 0.3 percent annual rate —one-seventh the 2.2 percent average annual rate throughout other post-war cycles.

- Since the end of the recession in November 2001 (the first 49 months of the recovery), employment grew at a 0.7 percent annual rate—the lowest for the first 49 months of any recovery since World War II that lasted this long.[8] *But even using the more flattering measures the White House itself cites, job growth has been weak by historical standards*.

- Job growth during 2005 – about the fourth year of the recovery – was the weakest of any comparable post-war recovery. In 2005 (months 38-49 of the current recovery), total employment grew just 1.5 percent. In months 38 through 49 of post-war recoveries this length, employment growth has never been this slow, averaging more than twice that rate: 3.1 percent. [9]

- Job growth since the 2003 tax cut is also the weakest for this stage of the recovery. Indeed, the 4.6 million jobs the White House boasts about is historically weak job growth for this stage of a recovery**.** If the President sticks to recent White House talking points, we'll hear about the 4.6 million jobs created since the tax cuts on dividends and capital gains in 2003. But spread over the last 31 months this is only 150,000 jobs a month or a 1.4 percent annualized rate—*less than half the average rate in months 19 through 49 in post-war recoveries this long and the slowest on record.* [10]

- The unemployment rate would be 7.0 percent if the same share of the population was employed today as at the beginning of the business cycle. The unemployment rate can drop for two reasons: because job growth is strong or because fewer people are looking for work. Unfortunately, the reason the unemployment rate has dropped to 4.9 percent is that Americans have been falling out of the labor market, not because a greater share of the population has a job. In March 2001, 64.3 percent of Americans 16 or older were employed. Had that number not dropped to 62.8 percent by December 2005, an additional there would have been an additional *3.5 million jobs and the unemployment rate would be 7.0 percent.* [11]

Rising Debt, Falling Savings, and Dwindling Pensions Hit Families Hard. Though families' real incomes have fallen, American consumers continue to propel the economy by taking on more and more debt. This doesn't bode well for our economic fundamentals:

- The personal savings rate has plummeted to its lowest level since the Great Depression. After initially recovering from a slight slide in 2001, the personal savings rate (Americans' total personal savings as a share of their total disposable income) has dropped from 2.4 percent in 2002 to *negative 1.8 percent in the third quarter of 2005. 2005 will likely mark the first year since 1933 that the savings rate was negative*.[12]

- Household debt has soared since the last recession. In 2004, as real hourly and weekly wages declined, household debt increased at its fastest pace since 1986 (up 11.1 percent), a trend that continued in 2005 as Americans' total credit grew to a record 121.2 percent of their disposable income by the third quarter (the last months data are available).[13] In the third quarter 2005, the average household spent 13.8 percent of its disposable income servicing that debt (paying interest and principal)—the highest mark on record.[14]

- Pension coverage has slid below 50 percent since 2000. After rising steadily in the late 1990s, the share of workers aged 25 to 64 with an employer-provided retirement plan declined from a peak of 50.3 percent in 2000 to 48.7 percent in 2001 and to 46.3 percent in 2004.[15]

Bush Fiscal Policy is the Single Largest Factor in the Worst Fiscal Deterioration in History— Eventually Worsening Our Fiscal Position by $400 Billion-$500 Billion a Year: The President will likely make two false claims about the deficit in the State of the Union. One, the deficit is temporary and headed down. Two, the costs of war or the failure to control spending on progressive domestic initiatives is to blame for whatever deficits we have. Neither is true. In reality, the fiscal path this administration has put us on undermines our economic foundations and sends mounting interest payments to foreign creditors. Over the long term these deficits threaten our economic strength by damaging our investment climate and diverting billions in debt service payments from other priorities, like dealing with the baby boom retirement or investing in our children. As Fed Chairman Greenspan argued last April, "Under existing tax rates and reasonable assumptions about other spending… the federal budget is on an unsustainable path, in which large deficits result in rising interest rates and ever-growing interest payments that augment deficits in future years…Unless that trend is reversed, at some point these deficits would cause the economy to stagnate or worse."[16]

Independent Analysts Predict the Deficit will Average $500 Billion or More a Year over the Next Decade. When President Clinton left office in 2001, the Congressional Budget Office projected trillions of dollars in surpluses for Bush's term.[17] Just five years later:

- Goldman Sachs predicts $5 trillion in deficits over the next 10 years including reasonable assumptions about the costs of war in Iraq and Afghanistan, AMT relief, and the extension of the President's tax cuts. [18]

- The non-partisan Concord Coalition projects a higher 10-year deficit—$5.7 trillion including its own predictions about costs in Iraq and Afghanistan, AMT relief, and tax cut extensions.[19]

Even Outgoing CBO Director and Former Bush Economic Official Douglas Holtz-Eakin Argues Last Year's Revenue Gains Were Temporary and The Deficit Will Expand Moving Forward. Conservatives point to last year's "improvement" in the deficit to $319 billion as proof that the tax cuts are boosting revenue. Despite the hype, this was no tax cut miracle.

- Holtz-Eakin has argued that despite improvement in 2005, the outlook for the deficit over the next 10 years remains "largely unchanged" [20] and that we should be "taking this with a grain of salt," as the boost came from temporary factors. The CBO director recognized that the improvement in revenues in 2005 was due to the end of a one-time business tax cut and a one-time tax holiday allowing companies to bring home foreign earnings at a cut rate. In response to conservative claims that this one-year result puts us back on the right fiscal track he has said, "I do hope people are taking this with a grain of salt and not thinking this is 1998 all over again."[21]

- Even the White House admits this year's deficit will head back towards $400 billion, a number they floated to the press before they release official estimates with their budget next month. While they will blame this reversal on Katrina, this ignores the bleak budget outlook even within the 10-year budget window. If extended, costs of the tax cuts will explode in the next decade, fueling deficits well after hurricane reconstruction should be complete.[22]

Bush Decision to Propose and Sign New Tax Cut and Entitlement Initiatives without Off-Setting Savings Is the Largest Reason for the Deficit Explosion. Because the President completely dropped the principle of "pay-as-you-go" – in which new tax and entitlement initiatives are passed with savings to ensure they have no negative effect on the deficit – his new initiatives will have a permanent negative impact on the deficit long after more temporary costs such as hurricane relief or the wars in Iraq and Afghanistan have passed. Ironically, domestic discretionary spending, which the President will probably propose slashing by 5 percent, has played the *least* role in this deterioration:

- Deficits from the tax cuts and the prescription drug benefit will cost over $400 billion by 2011 and over $500 billion when added interest costs are included. Since the White House made no plan to pay for the Medicare prescription drug benefit or take reasonable measures to constrain its cost (allowing the government to negotiate better prices for drugs would have been a good start), it will add *$850 billion to the deficit during its first 10 years in effect*—more than twice the administration's initial "ten-year" estimate.[23] *In 2011, when all the tax cuts since 2001 would be in full effect if extended, the combined one-year cost of the tax cuts and prescription drug benefit will* ***top $400 billion***.[24]

- Hurricane relief costs are temporary and relatively modest. Congress appropriated $62.3 billion in relief for the Gulf Coast, of which an estimated $30 billion will be spent in 2006. In addition, $6 billion in hurricane-related tax relief for 2006 and 2007 has been enacted by Congress.[25] While the current deficit means we will have to borrow to cover these costs, they *do little to change our long-term fiscal outlook* even if the costs eventually run over $100 billion.

- Even though conservatives would like to blame the deficit on non-security domestic discretionary funding, it has held flat since its levels in the surplus years of 1999 and 2000. According to analysis by the Center on Budget and Policy Priorities and Center for American Progress, excluding the costs of homeland security and other domestic security spending, domestic discretionary spending as a share of the economy in 2006 will be 3.1 percent of GDP--almost identical to its level 3.2 percent level from 1999-2000.[26]

- CBO projections show that historically low revenue collections drive deficits. In 2004, revenue was smaller as a share of the economy than in any year since 1959. Even though revenues picked up

in 2005, CBO projects they will slide as a percent of GDP from 17.5 percent in 2005 to an average of 17.1 percent over the next 10 years—the lowest 10-year period in nearly half a century.[27]

Deficits Aren't Worth the Price—Bush Tax Cuts Deliver Bad Bang for the Buck. Given the increased economic risks we face by running large deficits, it is fair to ask what we are getting from the President's tax cuts.

- Studies by the Joint Committee on Taxation (JTC), OECD, and CBO all confirm that deficits negate or reverse any economic benefits of the cuts. In its analysis of the 2003 tax cuts, JTC found that any economic benefits of the tax cuts were *"eventually likely to be outweighed by the reduction in national savings due to increasing Federal government deficits."*[28] Four of the five models it used showed a negative effect on real GDP by the next decade, while the fifth showed no impact at all. *CBO and OECD studies confirmed the tax cuts would raise deficits and hurt growth*.[29] While tax cut proponents argue that the deficit effects could be mitigated through the magic of supply-side economics, a more recent CBO study of the effects of eliminating taxes on capital income reaffirmed what most economists already believed: even if reducing taxes stimulated investment and raised *some* new revenue, "evidence indicates that such an offset would represent only a fraction of the forgone revenue."[30]

- Study by Federal Reserve economists shows the dividend tax cut has not even had a positive impact on the stock market: Even if a policy increases the value of certain stocks or the market as a whole, that does not mean it is a sound idea. Giving a $1,000 rebate and free key chain to every investor buying stock would probably help the market, but it would hardly improve our overall economic well-being or our economic fundamentals. Yet, according to a recent study by economists at the Federal Reserve, even if boosting stock prices could have an indirect positive effect on the economy, the 2003 tax cuts would have provided no help. In comparing growth in U.S. stocks in key periods in 2003 to the performance of investments which should have been unaffected by the tax cuts that year (i.e. European stocks and real estate investment trusts), the study *"fail[ed] to find much, if any, imprint of the dividend tax cut news on the value of the aggregate stock market,"* as other factors, like the resolution of anxiety regarding the Iraq war, rather than tax cuts, boosted investor confidence from its 2003 lows.[31]

- Rising debt and a historic surge in housing values – not tax cuts – have been most responsible for the solid consumer spending in the face of stagnant wages. In assessing the administration's case for extending the tax cuts, it's important to remember that Americans' willingness to spend money borrowed against their homes has boosted the economy enormously. Though GDP growth has been strong recently, home equity cash-outs alone have added more than $1 trillion to the economy since 2001,[32] while the overall housing stimulus has added a full percentage point to growth over the last three years.[33]

Our Growing Indebtedness Sends Billions in Debt Service Payments to Our Foreign Competitors. Typically, budget deficits put upward pressures on interest rates. However, a primary reason why interest rates have stayed relatively low in this business cycle has been foreign investors' unprecedented willingness to lend us money. However, this borrowing has:

- Put record debt in the hands of foreign lenders. Foreign investors bought 81 percent of new Treasury debt from the start of the business cycle in March 2001 through September 2005.[34] Thanks to this binge, these creditors held 48 percent of our public debt in September 2005, up 32 percent

from March 2001. Japan held $687 billion in government debt, more than any other nation, while China ranked second with $300 billion, and the UK third with $183 billion[35]

- Sent billions in debt payments abroad. Because so much debt is held abroad, interest and dividend payments to foreigners have grown. By September 2005, *net financial payments abroad exceeded 1 percent of gross domestic product (GDP) for the first time since the 1960s*.[36] The federal government paid $30 billion in interest to foreign investors in the third quarter of 2005 alone, up from $21 billion in the first quarter of 2001 and $20 billion in the fourth quarter of 2001.[37]

[1] Office of Management and Budget and Executive Office of the President, "Statement of Administration Policy: H.R.—Growth and Jobs Tax Act of 2003," May 9, 2003.
[2] Authors' calculations based on Bureau of Labor Statistics (BLS), Employment, Hours, and Earnings from Current Employment Statistics (CES), 2006. (www.bls.gov). CPI-W adjusted to December 2005 dollars.
[3] Authors' calculations based on BLS, CES, 2006. CPI-W adjusted to December 2005 dollars.
[4] Authors' calculations based on BLS, CES, 2006. CPI-W adjusted to December 2005 dollars.
Note: because of differences in inflation adjustments, the reported BLS real hourly wage data (adjusted to 1982 dollars) shows a slightly larger 0.5 percent drop from December 2004 to December 2005.
[5] Authors' calculations based on BLS, Major Sector Productivity and Costs, Non-Farm Business Compensation, 2006.
[6] U.S. Census Bureau, 2005, Income, Poverty, and Health Insurance Coverage in the United States: 2004, Washington, D.C.: Census.
[7] Census Bureau, 2005.
[8] Authors' calculations based on BLS, CES, 2006.
[9] Authors' calculations based on BLS, CES, 2006.
[10] Authors' calculations based on BLS, CES, 2006.
[11] Authors' calculations based on BLS, Current Population Survey (CPS), 2006.
[12] Bureau of Economic Analysis, 2006, National Income and Product Accounts, Table 2.1 Personal Income and its Disposition, Washington, D.C. BEA (www.bea.gov).
[13] C. Weller, 2005, "Credit or Cash?," CAP Economic Policy Report, Washington, D.C.: Center for American Progress.
[14] The Federal Reserve started collecting these data in 1980. Board of Governors of the Federal Reserve System, 2005, Household Debt Service and Financial Obligation Ratios, Washington, D.C.: Board of Governors.
[15] Pat Purcell, 2005, Pension Sponsorship and Participation: Summary of Recent Trends, CRS Report RL30122, Washington, D.C.: Congressional Research Service.
[16] Alan Greenspan, Testimony Before the Senate Budget Committee April 21, 2005.
[17] Congressional Budget Office, "The Budget and Economic Outlook, Fiscal Years 2002-2011," January 2001.
[18] Ed McKelvey, "Tax Reform: A Lot to Like, but Can We Afford It ," Goldman Sachs, November 11, 2005.
[19] Concord Coalition, "New Budget Outlook: A Little Good News and a Lot of Red Ink," August 31, 2005.
[20] Market News International, "US CBO Holtz-Eakin: 10-yr Def Outlk 'Largely Unchanged," August 16, 2005.
[21] Jonathan Weisman, "Economic Growth, Tax Receipts Combine to Reduce Deficit," *The Washington Post*, July 2, 2005
[22] Ed Andrews, "Deficit Will Climb in 2006, White House Says," *New York Times*, January 13, 2006.
[23] CBO, "Updated estimates of spending for the Medicare Prescription Drug Program." March 2005. Note: The administration originally estimated that the prescription drug benefit would cost $400 billion in its first 10 years provide. Not only was the methodology of this estimate later proven flawed, but it also included 2004 and 2005 when the drug benefit was yet to go into effect.
[24] Authors' calculations based on CBO and Joint Committee on Taxation cost estimates.
[25] Letter from Douglas Holtz-Eakin, Director, Congressional Budget Office, to Hon. Jim Nussle, Chairman, Committee on the Budget, U.S. House of Representatives, September 29, 2005, Washington, D.C.: CBO (http://www.cbo.gov/ftpdocs/66xx/doc6669/09-29-EffectsOfHurricanes.pdf)
[26] Richard Kogan "Budget Cuts Mark Appropriations for 2006: Domestic Funding is Below 2005 Levels and Constitutes a Smaller Share of the Economy than in 2001," Center on Budget and Policy Priorities, January 25, 2006. Gene Sperling and Brian Deese, "It's Not Spending, Stupid," Center for American Progress, January 2004.
[27] Rirchard Kogan, Isaac Shapiro, and Aviva Aron-Dine, "Drop in Deficit in 2005 Does Note Mean Tax Cuts Are Spurring Economic and Revenue Growth," Center on Budget and Policy Priorities, January 6, 2006.
[28] Joint Committee on Taxation, "Macroeconomic Analysis of H.R. 2, The 'Jobs and Growth Reconciliation Tax Act of 2003,'" Congressional Record, May 8, 2003.
[29] CBO, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004," March 2003. Organization for Economic Cooperation and Development, "Economic Surveys: United States," April 2004.
[30] CBO, "Taxing Capital Income: Effective Rates and Approaches to Reform," October 2005.
[31] See Karen Richardson, "Did the Dividend-Tax Cut Work?," *Wall Street Journal*, December 6, 2005.

[32] Authors' calculations based on Board of Governors of the Federal Reserve System, 2006, Release Z.1 Flow of Fund Accounts of the United States, Table F. 100: Households and Nonprofit Organizations, Washington, D.C.: Board of Governors. (www.federalreserve.gov).
[33] Goldman Sachs, 2005, US Economics Analyst, New York, NY: Goldman Sachs, December 30, estimates that between 2003 and 2005 the housing boom added 1 percentage point to economic growth.
[34] Authors' calculations based on Board of Governors of the Federal Reserve System, 2005, Release Z.1 Flow of Funds Accounts of the United States, Table F.209 Treasury Securities, Washington, D.C.: Board of Governors.
[35] Authors' calculations based on Board of Governors of the Federal Reserve System, as of September 2005, Release Z.1 Flow of Funds Accounts of the United States, Table L.209 Treasury Securities, Washington, D.C.: Board of Governors.
[36] Authors' calculations based on Bureau of Economic Analysis, 2006, Balance of Payments, Table 1: U.S. International Transactions, Washington, D.C.: BEA and Bureau of Economic Analysis, 2006, National Income and Product Accounts, Table 1.1.5 Gross Domestic Product, Washington, D.C.: BEA.
[37] Data are nominal, seasonally adjusted, quarterly figures, taken from Bureau of Economic Analysis, 2006, Balance of Payments, Table 1: U.S. International Transactions, Washington, D.C.: BEA.