112TH CONGRESS
*1st Session*

SENATE

REPORT
112–101

# THE 2011 JOINT ECONOMIC REPORT

## REPORT

OF THE

## JOINT ECONOMIC COMMITTEE
## CONGRESS OF THE UNITED STATES

ON THE

## 2011 ECONOMIC REPORT
## OF THE PRESIDENT

DECEMBER 16, 2011.—Ordered to be printed

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## LETTER OF TRANSMITTAL

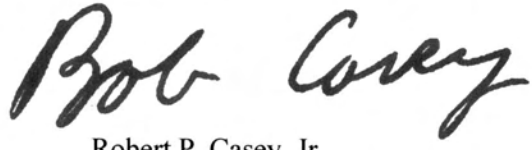
December 16, 2011

HON. HARRY REID
*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 2011 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 P. Casey, Jr.
*Chairman*

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# THE 2011 JOINT ECONOMIC REPORT

DECEMBER 16, 2011– ordered to be printed

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

# REPORT

**Report of the Joint Economic Committee on the 2011 Economic Report of the President**

## CHAIRMAN'S VIEW

Almost two-and-a-half years after the Great Recession officially ended, the economy is growing at only a modest rate and the unemployment rate remains well above pre-recession levels. The deceleration in output in the first half of 2011, combined with lackluster job creation, translated into an output gap—a measure of the economy's productive slack—continuing at near record levels. The following report examines the economic recovery in 2011 and highlights the challenges that remain for the economy and for workers.

Economic growth so far in 2011 has been below what forecasters predicted at the beginning of the year. In the first half of 2011, growth slowed, in part as a result of rising oil prices and supply chain effects following the tsunami in Japan. In 2012, several challenges to the

recovery will remain, including ongoing deleveraging by households and businesses, fallout from financial and economic strains in the eurozone, and high levels of long-term unemployment. Additionally, efforts to reduce the deficit have led to passage of some fiscal austerity measures, with more under consideration, which could significantly reduce government spending in the immediate term and possibly jeopardize the recovery.

Workers are facing the challenges of stagnant wages, for those who have jobs, and high rates of unemployment. Since the recession ended in June 2009, real disposable personal income has only grown at about a one-percent average annual rate. While consumption has generally outpaced income growth, providing a boost to the economy, wages and income will need to increase to bolster consumer spending and sustain the recovery. Ongoing declines in home prices and in equity prices have slowed the rebuilding of household wealth following the recession and added to the pressures facing households.

This year was characterized by only modest progress in the recovery of labor markets. Since the end of 2010, the unemployment rate has dropped by 0.8 percentage point, with some of that decline resulting from discouraged workers dropping out of the labor force rather than obtaining jobs. Long-term unemployment remains one of the defining characteristics of the recovery, with over forty percent of unemployed workers having been jobless for at least six months.

Given the modest GDP growth during the recovery and continued weakness in the labor market, the report notes that fiscal policies—such as reauthorizations of the 2011 payroll tax cut and extended unemployment benefits—and continued easing in monetary policy should be used to boost aggregate demand.

Additional detail is provided on how young adults and older workers have experienced higher rates and longer spells of unemployment, respectively. In particular, African American workers have suffered from both high rates of unemployment and long-term unemployment.

Finally, the report highlights the increased income inequality in the United States during the past three decades and examines how that

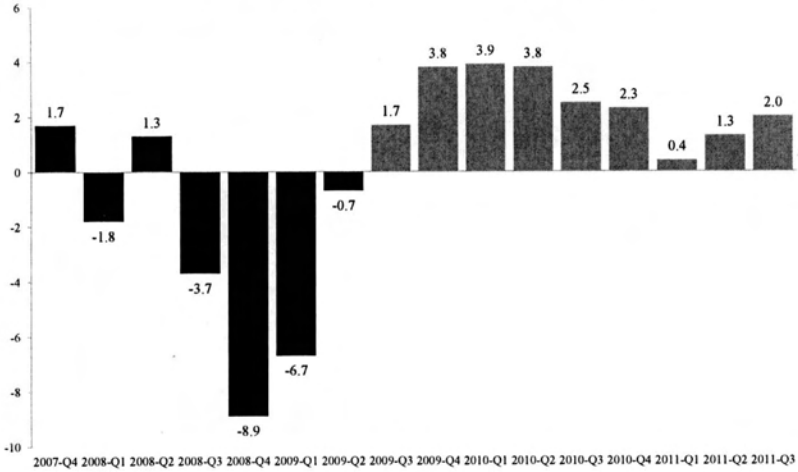
inequality contributed to the Great Recession and may be slowing the pace of the recovery.

## RECENT U.S. MACROECONOMIC PERFORMANCE AND POLICY

### *U.S. Macroeconomic Performance*

So far this year, the U.S. economy has grown at a more subdued pace than forecasters had expected at the start of the year.[1] Coming off an acceleration in economic activity in the second half of 2010, the U.S. economy was initially expected to grow at a pace exceeding 3 percent over the course of this year.[2] But a number of unexpected factors worked to keep the economy from gaining momentum in the first half of the year. Increased political strife in the Middle East and North Africa coupled with accelerating demand from emerging economies boosted world commodity prices, particularly oil—the resulting rise in consumer prices eroded purchasing power and household spending. Apart from the devastating human toll of the March earthquake and tsunami in Japan, those natural disasters created supply chain bottlenecks, particularly for the automobile industry, that took months to work out. Partly reflecting the effects of such factors, real (inflation-adjusted) gross domestic product (GDP) grew at a 0.4 percent annual rate in the first quarter of 2011, picking up to only 1.3 percent in the second quarter and 2.0 percent in the third quarter (see **Figure 1**). As the year nears its close, it now appears virtually certain that the economy will have grown by less than 2 percent over the course of 2011.[3]

**Figure 1. U.S. Economic Growth**
Percent change in real (inflation-adjusted) gross domestic product, annual rates

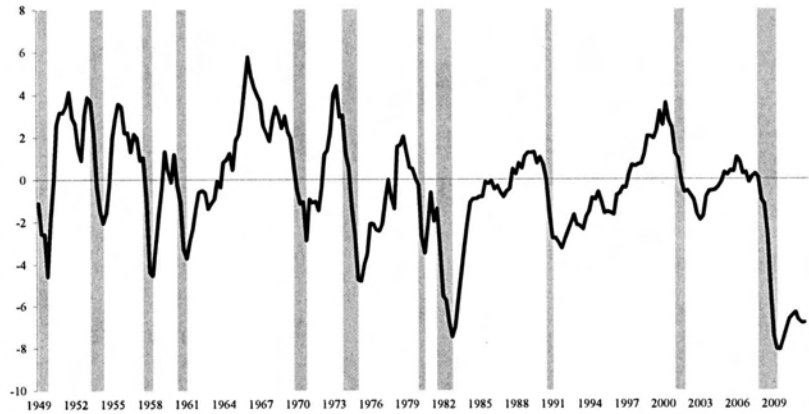



Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Perspectives on the recovery. The disappointing economic performance so far this year served to further slow what already had been a sluggish recovery. In July, historical revisions of the national economic accounts revealed that the recession was even more severe and the recovery even weaker than was previously recognized. The recession was the sharpest and most protracted U.S. decline since the 1930s and by the second quarter of 2009 (when the overall recession is judged by economists to have ended), real GDP had dropped by 5.1 percent from the cyclical peak in 2007-Q4. Given the remarkable depth and duration of the recession, many economists initially expected the recovery to be relatively robust and for the economy to sustain growth at above its trend pace for some time. To be sure, the economy has shown significant improvement since the financial crisis. Even so, over the 9 quarters of recovery since mid-2009, real GDP has grown at an average annual rate of only 2.4 percent; that's just below the average 2.5 percent annual rate of growth between the cyclical peaks in 2001 and 2007 and substantially below the 3.8 percent average annual pace recorded between the cyclical peaks of 1990 and 2001.[4] It has taken 9 quarters for real GDP to recover to its pre-recession peak level—no cyclical recovery in modern U.S. history has been as protracted as the current one.

The output gap. Both the severity of the recession and the weakness of the ensuing recovery are clarified by comparing what the economy did produce (actual GDP) with an estimate of what the economy could have produced if productive resources (i.e., labor and capital) had been fully utilized with overall inflation stable and low. The output gap—the difference between actual and potential real GDP—provides a comprehensive measure of an economy's productive slack. By mid-2009, the U.S. output gap had widened to a post-war record of more than 8 percent of real potential GDP (see **Figure 2**). While the output gap has narrowed somewhat since then as the economy has grown, that narrowing has been more slowly-paced than in previous recoveries from severe downturns (for example, the back-to-back recessions of the early 1980s and the sharp downturn of 1974). Moreover, the sharp deceleration in GDP in the first half of this year meant that actual GDP was growing more slowly than potential and the output gap widened somewhat.[5] The extraordinary size and persistence of the output gap serves as an indication for policymakers that both monetary and fiscal policies should be promoting aggregate U.S. demand, at least over the near term.

**Figure 2. U.S. Output Gap**
Actual minus potential real GDP as percent of potential GDP, quarterly through 2011-Q3

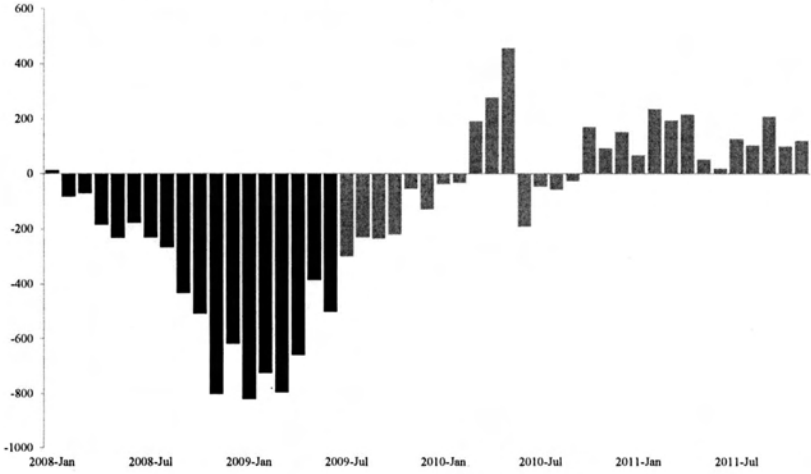



Sources: Chairman's staff of the Joint Economic Committee using data from the Bureau of Economic Analysis, U.S. Department of Commerce and Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011).

Note: Shaded regions mark periods of recession as determined by the National Bureau of Economic Research.

Overview of employment and unemployment. The recovery in U.S. product markets has been weak, the recovery in labor markets has been even weaker. Nonfarm payroll employment began to recover in March 2010 (9 months after the start of the overall recovery) but job growth has been relatively modest: payrolls grew by just over 100,000 jobs per month over the last 10 months of 2010, and by just over 130,000 jobs per month over the first 11 months of 2011 (see **Figure 3**). Private nonfarm businesses have provided all of the payroll growth: private-sector payrolls gained an average of 124,000 jobs per month over the last 10 months of last year and 156,000 jobs per month so far this year. Public payrolls, by contrast, have continued to contract. Job losses have been most acute for fiscally-strained state and local governments: since reaching a peak in August 2008, state and local government payrolls have declined by a cumulative 639,000 jobs (a loss of 3.2 percent).

**Figure 3. Nonfarm Payroll Employment**
Change in thousands, monthly through November 2011

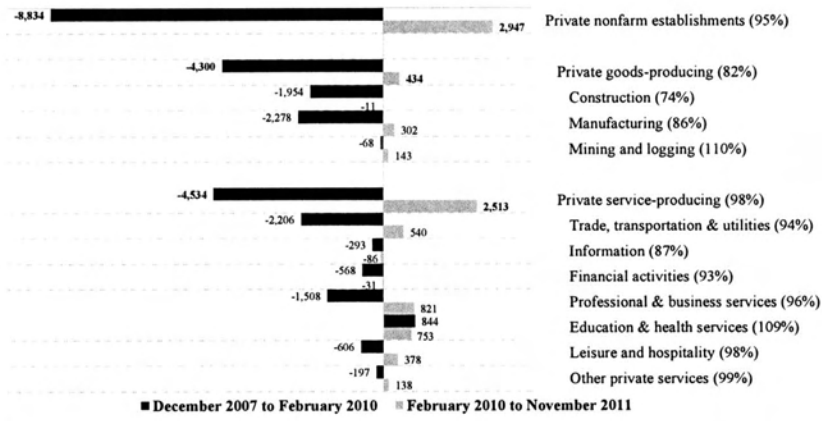



Source: Bureau of Labor Statistics, U.S. Department of Labor.

Payroll employment is still a long way from full recovery and, just as the recession's impacts were unevenly distributed, so too the pace of recovery has been uneven across industries. Since February 2010, private nonfarm payrolls have increased by about 2.9 million jobs, regaining only about one-third of the 8.8 million jobs lost between

December 2007 and February 2010 (see **Figure 4**). A disproportionately high share of the private-sector job loss during the recession was borne by goods-producing industries (especially construction and manufacturing) and the recovery so far has brought only small, if any, employment gains to those sectors. While some service-providing sectors have proven to be remarkably resilient to the downturn (especially health-related services which are significantly influenced by aging demographics), private service-providing industries as a whole have gained only about 55 percent of the jobs lost since the start of the recession. Even if private-sector payrolls were to immediately sustain growth at a pace as high as 250,000 jobs per month, it would still take until late 2013 for private payrolls to recover to the level that prevailed in December 2007.

**Figure 4. Private Nonfarm Payroll Employment by Sector**
Change in thousands of jobs




Source: Chairman's staff of the Joint Economic Committee using data from the Bureau of Labor Statistics, U.S. Department of Labor.

The weak growth in payroll employment is mirrored in the considerable slack still plaguing labor markets: unemployment remains high and underemployment even higher (see **Figure 5**). Starting from 5.0 percent of the civilian labor force at the end of 2007, the official unemployment rate more than doubled over the course of the downturn, reaching a peak at 10.1 percent in October 2009. Since then, the unemployment rate has declined only gradually, dipping below 9 percent in February and March 2011, and again in November when it reached 8.6 percent. Broader measures of labor underutilization remain unusually high as well, reflecting the relatively large number of

workers who are working part-time for economic reasons and workers who have dropped out of the labor force (and are, thus, not counted among the officially unemployed) but are willing and able to work if a job were to become available.

**Figure 5. Measures of Labor Market Slack**
Percent of official or augmented labor force, monthly through November 2011

Source: Chairman's staff of the Joint Economic Committee using data from the Bureau of Labor Statistics, U.S. Department of Labor and the National Bureau of Economic Research.

Underlying the persistently high U.S. unemployment rate are extraordinary changes in the employment-to-population ratio and labor force participation (see **Figure 6**). The employment-to-population ratio (which measures the fraction of the population with a job) declined more precipitously during the recession than it had in previous downturns. Moreover, that ratio has not recovered to any appreciable extent since the overall recovery commenced in mid-2009. On the other hand, the labor force participation rate (which measures the fraction of the population that is either working or unemployed but actively seeking work) has been on a downward trend at least since the start of the downturn, a trend that has tempered the rise in the civilian unemployment rate. The decline in the participation rate reflects secular as well as cyclical influences and, largely because of the aging of the population, most forecasters do not expect labor force participation to return to pre-recession levels. That said, the lack of

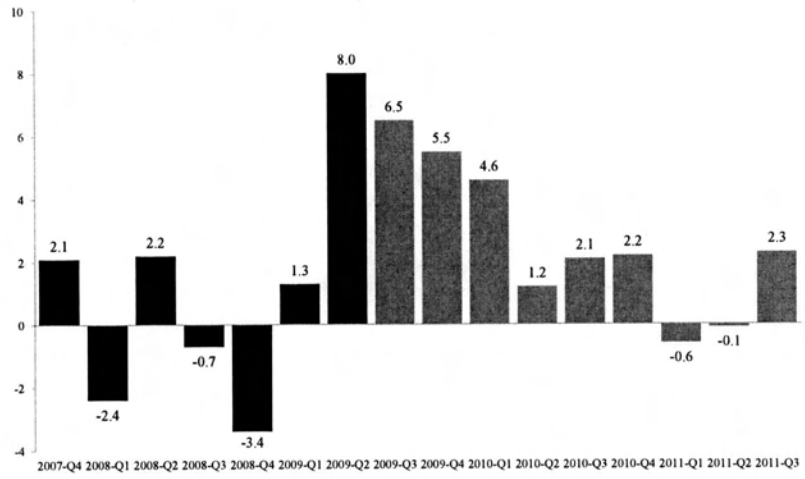
some pronounced cyclical rebound in the employment-to-population ratio thus far into recovery from a severe recession is one of many defining (and disturbing) characteristics of the current recovery. Labor markets are discussed in more detail later in *Labor Market Stresses in the Aftermath of the Great Recession* on page 30.

**Figure 6. Employment and Labor Force Participation Rates**
Percent of civilian noninstitutional population, 16 years and older, monthly through November 2011

Source: Chairman's staff of the Joint Economic Committee using data from the Bureau of Labor Statistics, U.S. Department of Labor and the National Bureau of Economic Research.

Productivity and the distribution of income growth. Returning to growth even before the overall recession had officially run its course, average labor productivity in the nonfarm business sector (that is, output per hours worked) has proven to be relatively strong during the recovery so far (see **Figure** 7). Over the 9 quarters since mid-2009, nonfarm business productivity has grown at an average annual rate of 2.6 percent. Over that same period, real output in the nonfarm business sector grew at a 3.3 percent average annual pace while total hours worked in that sector grew at only a 0.7 percent rate.

**Figure 7. Productivity Growth, Nonfarm Business Sector**
Percent change in output per hour, annual rates



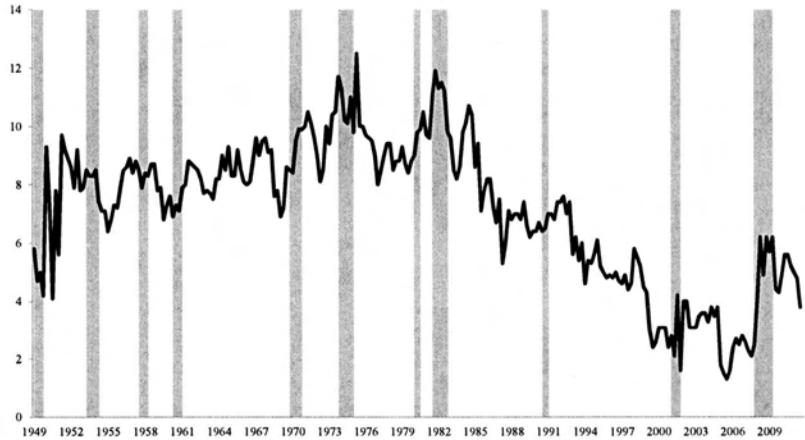

Source: Bureau of Labor Statistics, U.S. Department of Labor.

The disparity evident between the product and labor market outcomes has had important implications for the distribution of income growth over the recovery: growth of real labor income has paled beside unusually strong growth of real capital income. Real labor income (defined as labor compensation plus two-thirds of proprietors' income in the national income and product accounts and deflated by the GDP price index) grew at an average 1.2 percent annual rate between 2009-Q3 and 2011-Q3. By contrast, real capital income (defined as national income minus labor income, again deflated by the product price index) grew at an average annual pace of 7.9 percent over that same period. Over the first 9 quarters of the current recovery, labor income has grown substantially less rapidly than was typical in the 9 previous U.S. recoveries at the same stage, while capital income has grown more rapidly than typical in post-war recoveries.

Sources of change in income and demand. The relatively slow growth in labor income during the recovery has limited the growth of household income and spending over the recovery. Real disposable personal income grew at an average annual rate of only 0.7 percent between 2009-Q3 and 2011-Q3. While real personal consumption spending has grown at a higher average pace of 2.2 percent over the

entire period of recovery so far, the pace of spending growth has slowed so far this year: consumption increased at an average annual rate of only 1.7 percent over the first three quarters of 2011. Moreover, consumption growth during the current recovery has been more subdued than it was at the same stage of the cyclical recoveries that began in 1991 and 2001. Consumer spending on durable goods (not including housing) has been especially volatile through the recovery, largely reflecting sharp movements in purchases of motor vehicles. Consumer spending on nondurable goods has grown at an average annual rate of 2.2 percent over the first 9 quarters of recovery, while spending on services (which accounts for about two-thirds of personal consumption spending) has grown at an average rate of 1.3 percent, well below the pace of service spending over the first 9 quarters of recovery from the previous two U.S. recessions. At 3.8 percent of personal disposable income in the third quarter of 2011, the personal saving rate has tended to decline over the course of the recovery though it remains more than a percentage point higher than it was at the start of the recession in late 2007 (see **Figure 8**).

**Figure 8. Personal Saving**
Percent of disposable personal income, quarterly through 2011-Q3



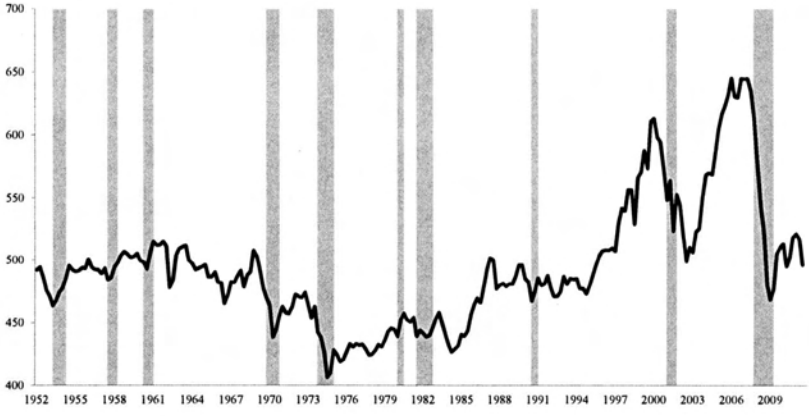

Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Note: Shaded regions mark periods of recession as determined by the National Bureau of Economic Research.

The bursting of the housing bubble caused home prices to plunge, with some national indexes indicating that prices have fallen to about two-

thirds of the peak values reached in 2006. Some regions of the country have experienced even larger declines in home prices. While home prices have stabilized considerably since mid-2009, prices may still be trending down moderately as the stock of homes in foreclosure or delinquency remains at or near historical highs and sales of distressed properties comprise a high proportion of existing-home transactions; the stock of completed but unsold new homes remains elevated as well. Excess supplies of housing are expected to continue to dampen growth prospects for the depressed residential construction sector. The sharp declines in home prices forced a downward revaluation of the net home equity of the household sector, which remains well below its pre-recession levels which, along with sharp declines in the values of equities held by households in the second and third quarters of this year, has limited the growth of net household wealth over the recovery (see **Figure 9**). The ongoing deleveraging of the household sector has been a major factor in the protracted nature of the recovery and is likely to temper growth in household spending over the near term. Moreover, that deleveraging may be inhibited by increased income inequality (as discussed later in *Growing Income Inequality* on page 37).

**Figure 9. Household Wealth**
Net worth of household and nonprofit sector as a percent of disposable personal income, quarterly through 2011-Q3

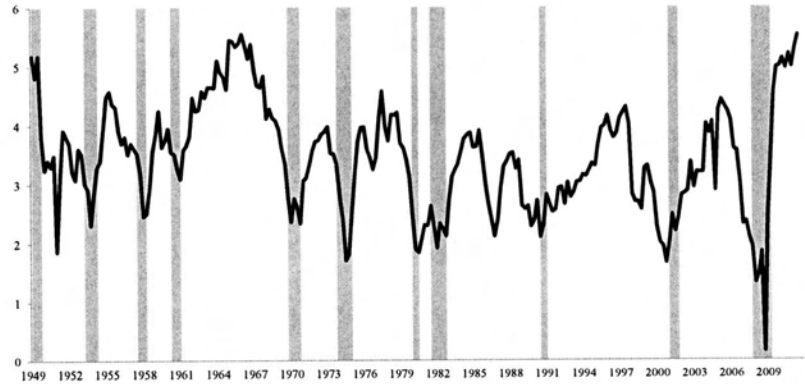



Sources: Board of Governors, Federal Reserve System and Bureau of Economic Analysis, U.S. Department of Commerce.

Note: Shaded regions mark periods of recession as determined by the National Bureau of Economic Research.

In contrast with the subdued rates of growth evident in household income and wealth, business income has been exceptionally strong so far during the recovery. Some of that has translated into increased capital spending by businesses: real nonresidential investment spending has grown at an average annual rate of 6.9 percent over the first 9 quarters of the recovery, led by an increase of 12.7 percent in spending on equipment and software. By contrast, business spending on construction faltered during the early stages of the recovery, reflecting both high vacancy rates for office and industrial buildings and financing strains; though vacancy rates remain high, business construction picked up some in the second and third quarters of 2011. On balance, however, corporate saving has grown to an even greater degree than has spending on fixed business capital over the course of the recovery. After plunging during the most severe stage of the financial crisis, corporate saving has recovered even more spectacularly, reaching a post-war high of 5.5 percent of national income in the third quarter of 2011 (see **Figure 10**).

**Figure 10. Undistributed Operating Profits of Corporations**
Percent of national income, quarterly through 2011-Q3



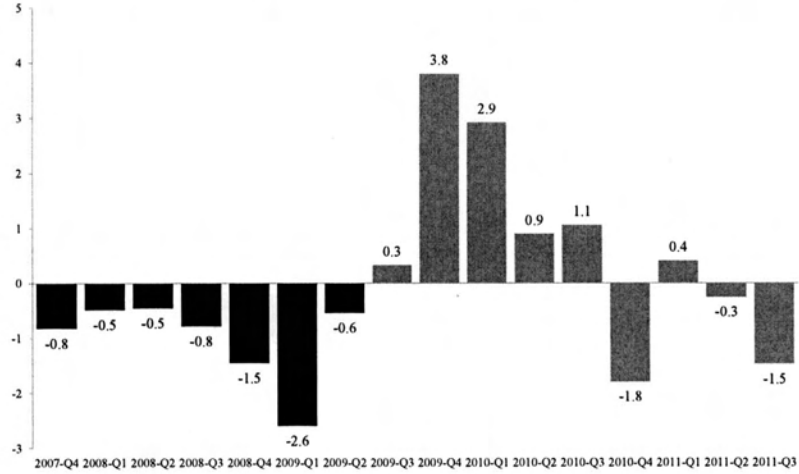

Source: Chairman's staff of the Joint Economic Committee using data from the Bureau of Economic Analysis, U.S. Department of Commerce.

Note: Shaded regions mark periods of recession as determined by the National Bureau of Economic Research. In the national income accounts, the undistributed operating profits of corporations equal the book value of corporate profits with adjustments for inventory valuation and capital consumption minus taxes and dividends paid.

Business investment in inventories has contributed about 1.6 percentage points to the 2.4 percent increase in real GDP since 2009-Q2. When household and business confidence crashed at the flash point of the financial crisis in late 2008, it quickly became clear

that business stocks of inventory were extremely high relative to anticipated sales; the consequent downward adjustment to inventories accounted for a substantial portion of the decline in overall production. That adjustment appeared complete by mid-2009 and businesses began to rebuild inventories until late last year, accounting for most of that component's contribution to real GDP growth over the recovery (see **Figure 11**). Since the final quarter of 2010, changes in business inventories have tended to be a drag on overall growth. If current inventory stocks are now in line with business sales (as some economists believe to be the case), an acceleration in sales would likely translate into increased production and higher overall growth.

**Figure 11. Real Nonfarm Business Inventories**
Percentage point contribution to growth of real gross domestic product, annual rates

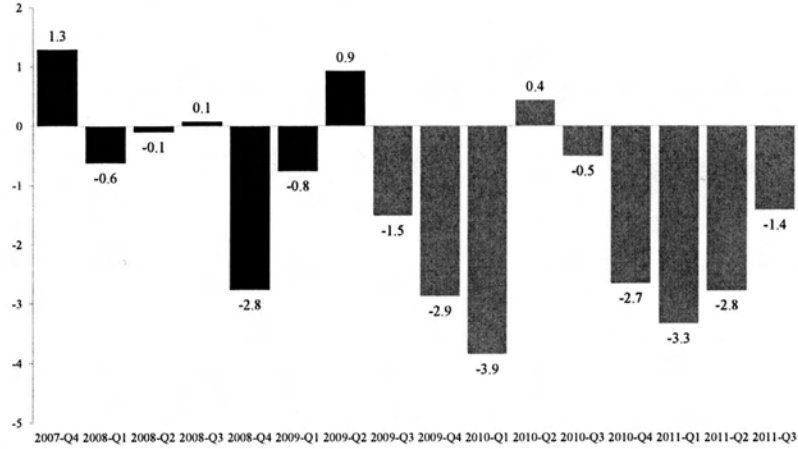



Source: Bureau of Economic Analysis, U.S. Department of Commerce.

While accelerated purchases of goods and services by the federal government provided a significant countercyclical impulse throughout the recession, the contribution of federal purchases to real GDP growth has moderated since mid-2009. By contrast, state and local governments (which largely operate under statutory constraints requiring them to balance their operating budgets) generally cut back on their purchases of goods and services during the downturn, thereby exacerbating the declines in overall production (see **Figure 12**). As federal assistance to state and local governments began to subside during the recovery, those governments cut their purchases even more

sharply. While state and local governments have recently seen some strengthening in revenues, most forecasters do not expect that sector's purchases to pick up appreciably any time soon.

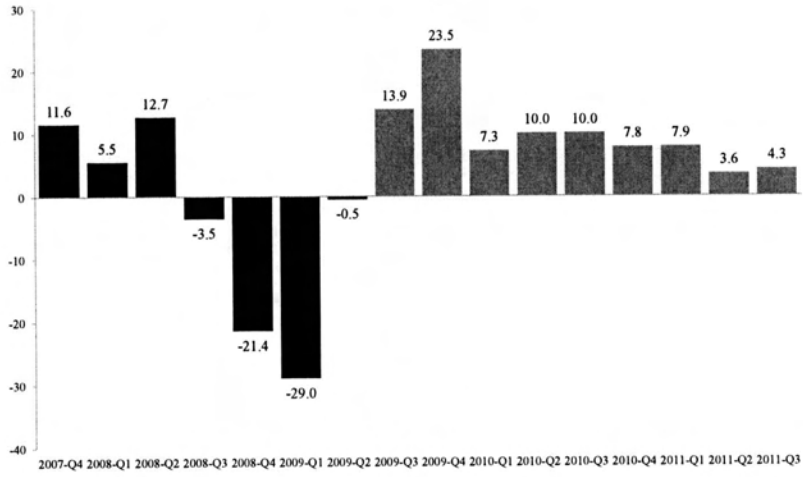
**Figure 12. Real State and Local Government Purchases of Goods and Services**
Percent change, annual rates




Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Along with business spending on capital equipment, U.S. exports of goods and services have been a relatively strong source of overall demand during the recovery (see **Figure 13**). The recoveries experienced by emerging economies were substantially more robust than most forecasters had expected it would be at the end of the downturn and U.S. exports surged into the early part of this year, aided by declines in the real exchange value of the U.S. dollar through mid-year. More recently, European economies appear to be near if not already in recession, production appears to be slowing in major emerging economies, and the dollar has been rising (largely a reaction to deteriorating financial conditions overseas), all of which suggests a more moderate trajectory for U.S. exports over the near term. Over the course of the recovery, growth of real U.S. exports has exceeded growth of U.S. imports, so that the net contribution of U.S. international trade to GDP growth has been positive.

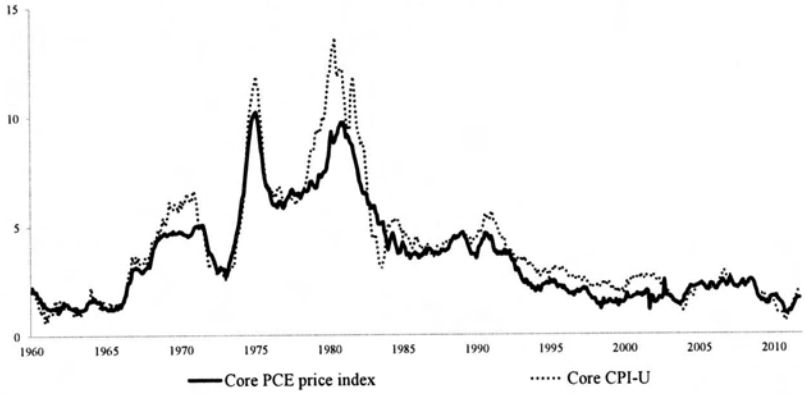
**Figure 13. Real U.S. Exports of Goods and Services**
Percent change, annual rates




Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Inflation. The extraordinary slack in product and labor markets has tended to temper underlying inflationary momentum in the U.S. economy. Notwithstanding a modest pickup in the first half of 2011 that has since receded, "core" inflation in consumer prices (that is, excluding changes in the prices consumers pay for food and energy) has remained remarkably low relative to the historical experience (see **Figure 14**).[6]

**Figure 14. Core Inflation in Consumer Prices**
Twelve-month percent change, monthly through November 2011 (CPI-U)

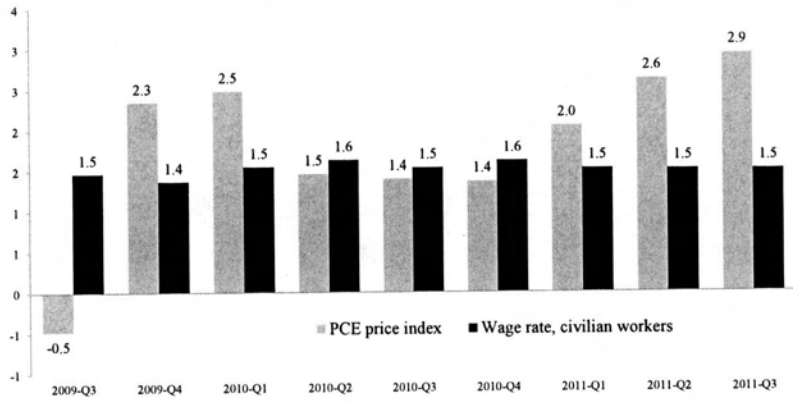



Source: Bureau of Economic Analysis, U.S. Department of Commerce and Bureau of Labor Statistics, U.S. Department of Labor.

Note: Core price indexes of consumer prices exclude the volatile indexes for food and energy prices. The PCE price index is the price index for personal consumption expenditures in the national income and product accounts (available through October 2011). The CPI-U is the consumer price index for all urban consumers.

The ongoing weakness in labor markets has translated into stagnant wage growth during the recovery. In nominal terms, growth of the average wage rate of civilian workers has moved within a narrow band around a 1½ percent annual rate since mid-2009 (see **Figure 15**). At the same time, changes in the overall cost of living have generally outpaced changes in nominal wages, and to an increasing degree so far in 2011.

**Figure 15. Inflation in Consumer Prices and Wage Rates**
Twelve-month percent change available for the final month of each quarter




Source: Chairman's staff of the Joint Economic Committee using data from the Bureau of Economic Analysis, U.S. Department of Commerce and the Bureau of Labor Statistics, U.S. Department of Labor.

Note: The PCE price index is the price index for personal consumption expenditures in the national income and product accounts. The wage rate is for civilian workers as measured in the employment cost index.

Interest rates. Finally, a combination of relatively weak overall demand, relatively low inflation expectations, and, most importantly, aggressive easing by the Federal Reserve has kept yields on U.S. Treasury debt interest rates at or near historical lows across the range of debt maturities (see **Figure 16**). Additionally, increased volatility in equity prices along with elevated concerns over the deterioration of financial conditions in the eurozone have tended to raise the attractiveness of U.S. sovereign debt relative to other assets in the eyes of many investors.

**Figure 16. Yields on U.S. Treasury Debt**
Percent, end of month value through November 2011

Source: Board of Governors, Federal Reserve System.

*Macroeconomic Policy*

An extraordinarily large output gap, persistently high unemployment and low inflation indicate that macroeconomic policy should be expansionary. Following its aggressive and effective response to the financial crisis, the Federal Reserve continues to apply downward pressure to longer-term interest rates, having already lowered short-term rates as much as possible. With the economy still struggling and short-term interest rates at effectively zero, the federal government's fiscal policy should be aimed at boosting aggregate demand. However, despite an aggressive and effective countercyclical fiscal response in early 2009, lawmakers have been more recently focused on cutting the budget and, as a result, fiscal policy could well be a drag on overall U.S. economic growth over the near term.

Monetary policy. The Federal Open Market Committee (FOMC), the body within the Federal Reserve that is charged with decision-making authority over monetary policy, operates under a dual mandate to maximize employment and maintain price stability over the long run. In normal times, the FOMC does so by easing monetary conditions (lowering short-term interest rates) when unemployment is high and inflation low and by tightening monetary policy (raising short-term

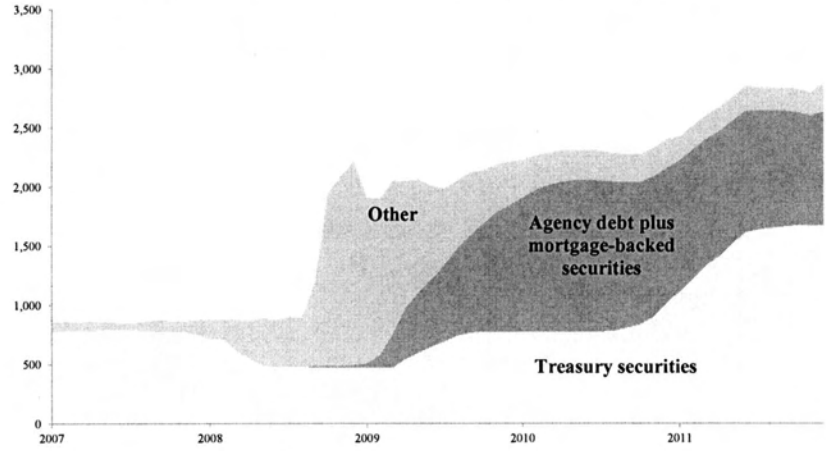
interest rates) when unemployment is low and inflation high. Currently, economic conditions warrant monetary easing: unemployment is well above its trend level and inflation is relatively low. However, since late 2008 the Federal Reserve has done all it can to lower short-term interest rates and is attempting, through unconventional means, to keep longer-term rates as low as possible. Effectively zero, short-term market interest rates are as low as they can be. Long-term market interest rates are also at historically-low levels, the result of Federal Reserve policies and the weakened state of the economy.

Some have criticized the Federal Reserve for holding to its dual mandate and focusing on boosting economic activity, in their view, to the neglect of containing inflation. However, such criticism ignores the fact that an economy with persistently high unemployment and low inflation is susceptible to disinflation (declining rates of overall inflation) and deflation (overall prices declining). In such an environment as the U.S. experiences now, the Federal Reserve's actions to boost economic activity and reduce productive slack also work to counteract persistent disinflationary and ultimately deflationary pressures. In other words, monetary easing under current conditions does serve the objective of stabilizing price inflation as well as boosting employment. Chairman Bernanke made the point clearly in response to a questioner in September: "If inflation falls too low or inflation expectations fall too low, that would be something we have to respond to because we do not want deflation."[7]

In the process of responding to the financial crisis and the weak recovery, the Federal Reserve has more than tripled its balance sheet (see **Figure 17**). Reserve bank credit outstanding (liabilities to the Fed, assets to member banks) increased from an average of about $855 billion over the first seven months of 2007 to $2.9 trillion by mid-December of this year. That swelling of the Fed's balance sheet has prompted concerns over the size of the Federal Reserve's balance sheet, particularly as it must be reduced at some point. However, the majority of the FOMC's current members do not believe the economy is at that point: current indications of high productive slack in the U.S. economy and stable inflation expectations along with the historical experience of other countries with quantitative easing all suggest that it's still too soon for the Federal Reserve to reduce the size of its

balance sheet. The Federal Reserve currently aims to keep its balance sheet roughly constant by reinvesting principal payments from its security holdings. Even so, the Federal Reserve has begun to research and test alternative exit strategies to be implemented once the economy is on a more stable footing.

**Figure 17. Federal Reserve System Assets**
Billions of dollars, last Wednesday of each month through December 14, 2011




Sources: Board of Governors, Federal Reserve System.

In the summer of 2011, with economic activity slowing and market confidence waning, the FOMC took further steps to ease monetary conditions. First, in August, the FOMC announced that it expected to maintain its target funds rate of 0 to ¼ percent through mid-2013.[8] With that decision, the FOMC provided clearer forward guidance to financial markets, assuring the markets that the Federal Reserve would work to keep interest rates as low as possible through the near term.

In September, the FOMC took two additional steps toward easing that would not entail any increase in the size of the Federal Reserve's balance sheet.[9] The FOMC decided to:

- Conduct sterilized purchases of long-term Treasuries. By the end of June 2012, the FOMC would purchase $400 billion of

Treasury securities with remaining maturities of 6 years to 30 years and balance those purchases by selling an equal amount of Treasury securities with remaining maturities of 3 years or less; and,

- Roll over its holdings of agency securities. The FOMC would reinvest principal payments from its holdings of agency debt and agency MBS back into agency MBS. Previously, the expiring agency securities were reinvested in Treasury debt.

The FOMC's sterilized purchases of long-term Treasuries, reminiscent of the so-called "Operation Twist" policies of the early 1960s, are aimed at raising the prices and lowering the yields of longer-dated Treasuries without further expanding the balance sheet (the purchases of longer-dated debt would be offset by sales of shorter-term debt already held by the Federal Reserve). The resulting downward pressure on longer-dated Treasury yields, the FOMC hopes, would indirectly pressure other longer-term interest rates down. The rollover of agency securities is aimed at putting direct downward pressure on mortgage interest rates.

At its November and December meetings, the FOMC announced no changes to its forward guidance on rates or the two programs it had initiated in September.[10]

Even with the aggressive monetary easing already in place, the weak domestic economy and strained conditions in global financial markets continue to present challenges for U.S. monetary policy. For example, although credit availability for U.S. borrowers has generally improved dramatically since the most intense phase of the financial crisis in late 2008, premiums paid by small businesses on short-term loans remain elevated (see **Figure 18**).

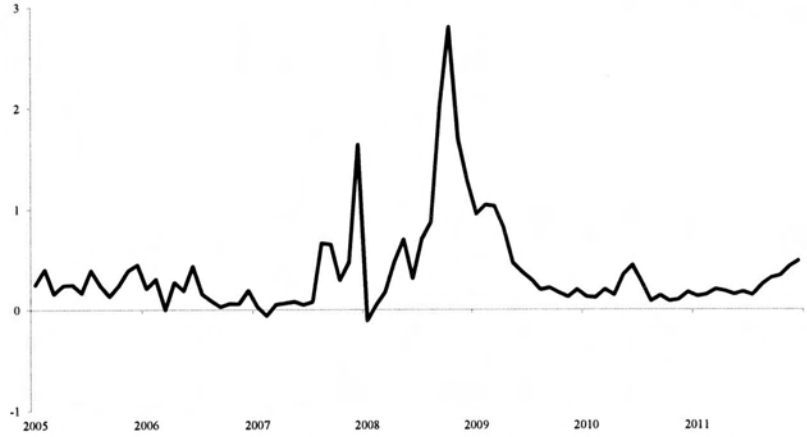
**Figure 18. Short-Term Funding Premium Paid by Small Businesses**
Percentage point difference between the short-term interest rates reported by small business borrowers and the yield on 1-year Treasury bills at constant maturity, monthly through November 2011

Source: Chairman's staff of the Joint Economic Committee using survey data from the National Federation of Independent Business and the Board of Governors, Federal Reserve System.

Note: Shaded regions mark periods of recession as determined by the National Bureau of Economic Research.

More broadly, the festering eurozone debt crisis has emerged once again as a significant downside risk to the economic outlook. European governments and financial institutions have experienced increases in their funding costs, and apparent risk spreads on (normally low-risk) interbank loans have been rising steadily since the middle of the year (see **Figure 19**). Those spreads spiked sharply during the financial crisis, leading short-term funding markets worldwide to seize. The spreads rose again in the spring of 2010, albeit to a lesser degree, when conditions in the eurozone were perceived to have deteriorated. The most recent increases in the interbank spreads are but one indication of the sharp rise in short-term funding costs Europe.

**Figure 19. Offer Rate on Short-Term Interbank Loans**
Percentage point spread between 3-month dollar LIBOR rate and the effective federal funds rate, end of month value through December 14, 2011




Source: Chairman's staff of the Joint Economic Committee using data from the Board of Governors, Federal Reserve System.

Reacting to deteriorating eurozone conditions in late November, the FOMC authorized the extension of existing temporary U.S. dollar swap arrangements with other leading central banks through February 1, 2013.[11] Additionally, the FOMC cut the rate it charges those central banks for dollar swaps by 50 basis points. Those actions increase the capacity of the participating central banks to provide dollar liquidity to financial institutions within their jurisdictions, thereby lessening funding pressures on those institutions and, more generally, improving conditions in global and domestic credit markets. The FOMC had authorized currency swap arrangements during the financial crisis and again in 2010, actions that are viewed as having contributed significantly to reducing pressures in credit markets during the crisis, both here and abroad. While such coordinated swap arrangements alone cannot be expected to resolve the eurozone's political and economic difficulties, they are likely to help relieve pressures that might otherwise build in global funds markets.

Should the economy weaken further, the Federal Reserve still has some options, each with its own benefits and costs, to boost economic activity while keeping inflation within or near the bounds of its comfort zone. For example, the Federal Reserve might lower the

interest it pays member banks on reserves.[12] Alternatively, it could further clarify its policy strategy. One example would be for the Federal Reserve to announce a particular target level for inflation, the price level or even the level of nominal GDP.[13] Another example would be for the Federal Reserve to announce a temporary increase in the range of inflation outcomes it would tolerate.[14] Finally, the FOMC could resume large-scale asset purchases without offsetting those purchases with sales of short-term securities.[15]

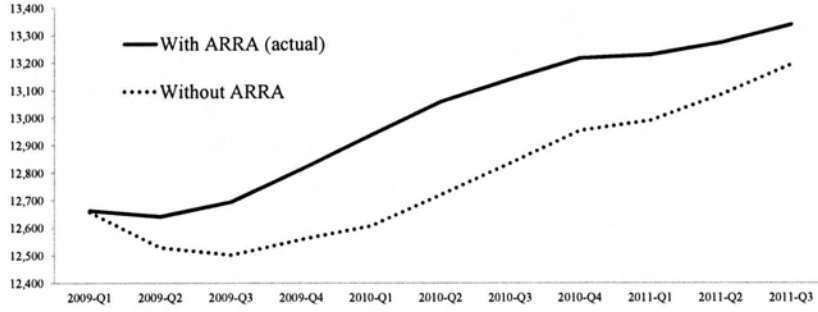
Fiscal policy. As of this writing, Congress has yet to decide whether it will extend key programs to boost economic activity that would otherwise lapse at the end of 2011. As a result, the impacts of fiscal policy on the near-term economic outlook are still uncertain. While provisions of the American Recovery and Reinvestment Act of 2009 (ARRA) continue to boost the level of U.S. economic activity, that federal assistance has been winding down, which is likely to exert some drag on overall U.S. growth in the coming year. Additionally, provisions of the Budget Control Act of 2011 (BCA) are likely to reduce U.S. economic growth in 2012 and even more in 2013. Unless Congress agrees to reauthorize the payroll tax cut and federal unemployment insurance (UI) benefits without large near-term offsets, fiscal policy will very likely be contractionary over the near term, counteracting the Federal Reserve's actions.

On balance, ARRA boosted U.S. economic activity considerably at a time when such assistance was most needed. The legislation raised the level of real GDP relative to what it would have been without ARRA by a magnitude between 0.4 and 1.8 percent in calendar year 2009, and between 0.7 and 4.1 percent in 2010, according to CBO estimates.[16] ARRA worked to lower the unemployment rate by between 0.1 and 0.5 percentage points below what it would have been in 2009 without the legislation and by between 0.4 and 1.8 percentage points in 2010. On average, ARRA increased U.S. economic growth by 1.1 percentage points in 2009 and by 1.3 percentage points in 2010.

By design, the federal assistance built into ARRA was temporary. The salutary impacts of ARRA on economic growth peaked between the second quarter of 2009 and the first quarter of 2010, while the unemployment rate is estimated to have been lowered most in the second and third quarters of 2010. Because of the temporary nature of

the assistance, the flows of income into the economy from ARRA have receded somewhat since mid-2010. While ARRA continues to boost the level of economic activity relative to what it would have been without the temporary assistance, the degree to which the level of economic activity are elevated has been narrowing (see **Figure 20**). As a natural consequence of the withdrawal of temporary assistance, ARRA is expected to have exerted a drag of 1.1 percentage points on U.S. economic growth in calendar year 2011 and to exert an additional drag of 0.8 percentage point in calendar year 2012.

**Figure 20. Estimated Economic Impacts of the American Recovery and Reinvestment Act of 2009 (ARRA)**
Alternative paths for real gross domestic product in billions of 2005 dollars, quarterly through 2011-Q3




Source: Chairman's staff of the Joint Economic Committee using data from the Bureau of Economic Analysis, U.S. Department of Commerce and the Congressional Budget Office.

Note: The counterfactual estimate of real gross domestic without ARRA is calculated as the path consistent with average of the high and low impact estimates reported in Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from July 2011 Through September 2011* (November 2011).

Budget negotiations in 2011 have been marked by tensions over the appropriate design and pace of fiscal consolidation. Both the federal deficit and debt are unusually large: the deficit amounted to just under $1.3 trillion in fiscal year 2011 (8.7 percent of GDP) while the publicly-held federal debt totaled $10.1 trillion in 2011 (67.7 percent of GDP). Just under a quarter of the fiscal 2011 deficit (or about 2 percentage points of GDP) reflected the enduring weakness in the U.S. economy as federal tax revenues are restrained by subdued income growth and some forms of federal countercyclical assistance remain elevated; other things equal, the federal deficit would diminish somewhat over time if economic activity were to accelerate from current levels.[17] To be sure, the deficit and debt are projected to rise

sharply in coming decades if current budget policies are maintained indefinitely, largely reflecting rising health care costs and the aging U.S. population that are expected to propel federal spending at a pace that exceeds what the current tax system collects. There is little disagreement that budget reforms will be needed to achieve a more sustainable federal fiscal balance over the longer-term, but there is also little agreement among lawmakers as to what steps need to be taken now.

Some have supported immediate actions to cut the budget and cling to support from published economic studies that purport to show that fiscal spending cuts can be expansionary and that successful fiscal consolidations tend to be based on spending cuts rather than tax increases.[18] Those studies identify fiscal consolidations over time and across countries by estimating simple fixed relationships between fiscal revenues and outlays in a particular year and the level of the unemployment rate in the prior year; those numerical relationships are then used to adjust the fiscal variables to remove the effects of business cycles. However, many leading economists and budget experts have pointed out the limitations of that simple approach: it is too simple to provide a reliable basis for significant fiscal policy decisions. Several forms of measurement error plague such adjustments. For example, statistical evidence suggests that the relationship between fiscal variables and the unemployment rate can change depending on the phase of the particular business cycle when the fiscal variables are measured and can change across different business cycles.[19] Additionally, large changes in fiscal variables can be associated with cyclical fluctuations that are not fully reflected, if at all, in changes in the unemployment rate, including the degree to which monetary policy is relatively constrained.[20] Finally, the mechanical procedures used to identify fiscal consolidations in those studies cannot detect whether large changes in fiscal revenues and outlays stem from changes in fiscal policy or not.[21]

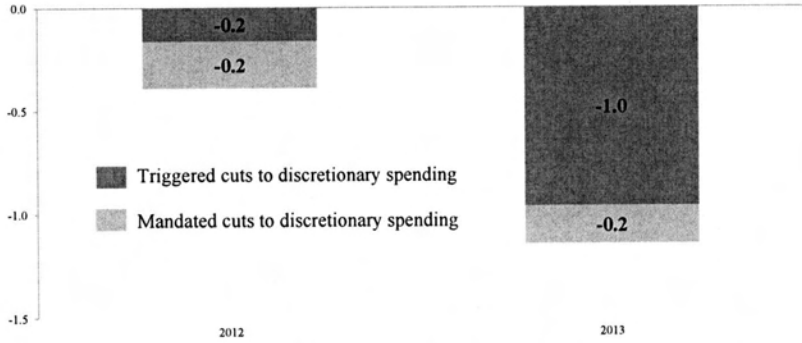
A recent and rigorous cross-country empirical analysis by the International Monetary Fund has dispelled the notion that fiscal austerity is expansionary. That study goes on to point out that "undertaking fiscal consolidation is likely to have more negative effects if—as is currently the case in a number of countries—interest

rates are near zero and central banks are constrained in their ability to provide monetary stimulus."[22]

Budget tensions crested in late July when Congress and the Administration arrived at an impasse with respect to lifting the debt ceiling. That impasse was resolved with the passage on August 2 of the Budget Control Act of 2011 (BCA). The BCA specified procedural mechanisms by which the debt limit could be raised over the near term and requirements that, by year's end, Congress shall have taken steps toward achieving budget balance. Most relevant to the budget projection, the BCA mandated caps on discretionary budget authority through fiscal year 2021 that are expected to reduce discretionary outlays by a cumulative $756 billion over the next 10 years (excluding the associated reductions in debt service).[23] In addition to enacting small net reductions in mandatory spending, the BCA created the Congressional Joint Select Committee on Deficit Reduction and tasked it with recommending additional budget cuts of at least $1.5 trillion over 10 years. In the event that the Joint Select Committee's proposed cuts fell short of the required amount, the BCA outlined a sequester process under which additional cuts of up to $1.2 trillion over 10 years would be automatically applied to discretionary spending. All told, the BCA is expected to reduce the federal deficit by a cumulative $2.1 trillion between 2012 and 2021, including debt service.

The Joint Select Committee on Deficit Reduction was unable to come to an agreement on how to achieve the required budgetary savings, so the nation is now facing the prospect of significant additional cuts to discretionary spending triggered by the sequester, beginning in fiscal year 2013. If realized, the combination of mandated and triggered cuts could exert a significant drag on overall economic growth, especially in 2013. The Chairman's staff of the Joint Economic Committee estimates that the combined impact of the cuts already mandated by the BCA and those triggered by sequester would lower real GDP growth by 0.4 percentage point in calendar year 2012 and by 1.2 percentage points in 2013 (see **Figure 21**).[24]

**Figure 21. Simulated Impacts of the Budget Control Act of 2011 (BCA) on U.S. Economic Growth Over the Near Term**
Percentage point change in growth of real gross domestic product by calendar year




Source: Chairman's staff of the Joint Economic Committee using budgetary costs and economic projections from Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011) and Congressional Budget Office, *Budget and Economic Outlook: Fiscal Years 2011 to 2021* (January 2011).

Note: The simulations were performed on the multicountry macroeconometric model developed and published by Professor Ray Fair of Yale University. The staff used a version of Fair's July 2011 baseline version of the model (MCG) and simulated the fiscal policy shocks while keeping in short-term U.S. interest rates near zero through 2013.

As of this writing, Congress has yet to decide whether to extend this year's cut in the payroll tax rate paid by employees and reauthorize extended federal UI benefits, both of which are set to lapse at the end of this year. Assistance to the unemployed and payroll tax cuts are the two most potent of an array of options for the federal government to boost near-term economic activity and employment analyzed by CBO.[25] Failure to extend those programs through the end of 2012 could further cut into expected economic growth in 2012, by as much as one percentage point.[26]

## LABOR MARKET STRESSES IN THE AFTERMATH OF THE GREAT RECESSION

Deep problems persist in the labor market even as the economy has begun to grow again. While the private sector picked up 1.7 million jobs in 2011 (as of November), those gains, combined with the 1.2 million private-sector jobs added during the last 10 months of 2010, make up only a fraction of 8.8 million private-sector jobs lost between December 2007 and February 2010. The unemployment rate remains elevated at 8.6 percent as of November 2011, well above the 5.0 percent unemployment rate in December 2007, at the start of the recession. The Federal Reserve projects that the unemployment rate will remain elevated for the foreseeable future, ranging between 6.8 percent and 7.7 percent by the end of 2014.[27] More troubling, record long-term unemployment has become a defining and enduring characteristic of the recession and recovery.

### *Uneven Labor Market Outcomes*

Although the recession hurt the labor market prospects of workers across the demographic spectrum, the impact was not uniform. In particular, younger workers (ages 16 to 24), especially in the African American community, suffered serious setbacks.

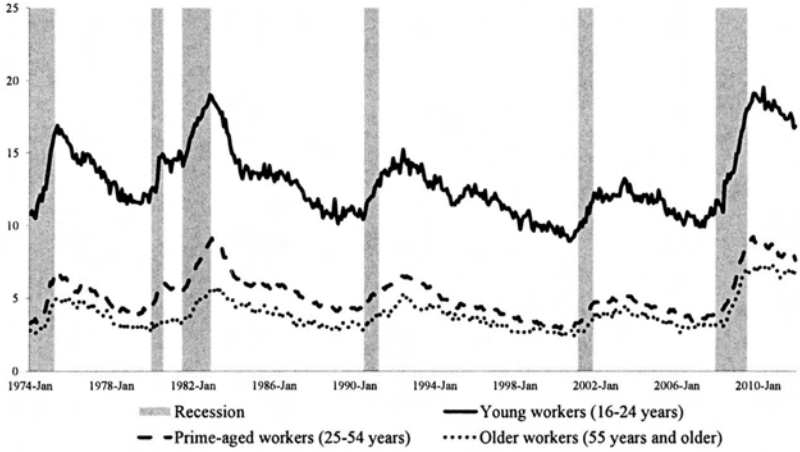
African American workers. African American or black workers are faring worse than the overall labor force along nearly all dimensions. For example, even though African Americans comprise nearly 12 percent of the labor force, as of November 2011, they account for 21 percent of the unemployed and 24 percent of the long-term unemployed.[28]

Within all age groups, African American workers have higher unemployment rates than workers of other racial and ethnic groups.[29] However, the extraordinarily high rate of unemployment among African American teenagers (ages 16 to 19), 39.6 percent in November 2011, is particularly worrisome.[30]

Youth. Young workers (ages 16 to 24) also have encountered difficulty during the recession. The unemployment rate among these workers is

currently 16.8 percent, much higher than the 7.6 percent unemployment rate among prime-age workers (ages 25 to 54) and 6.4 percent unemployment rate among older workers (55 years and older) (see **Figure 22**).

**Figure 22. Unemployment Rate by Age Group**
Percent of official labor force, monthly through November 2011

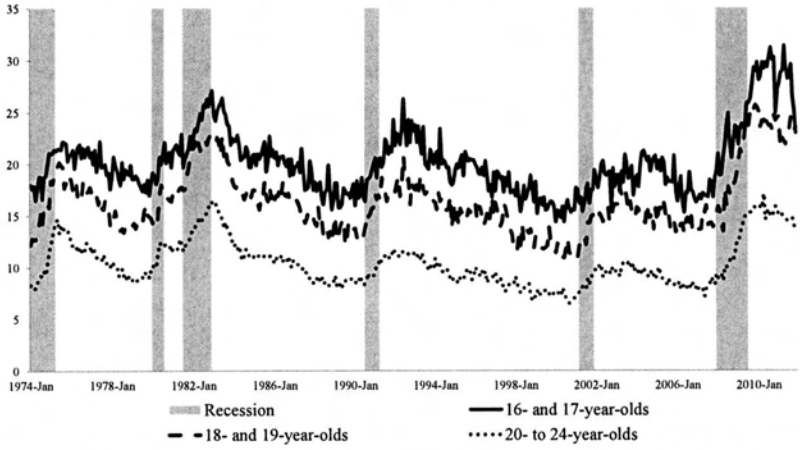



Source: Chairman's staff of the Joint Economic Committee using data from the Bureau of Labor Statistics, U.S. Department of Labor.

Note: Shaded regions mark periods of recession as determined by the National Bureau of Economic Research.

Among 16- to 24-year-olds, younger workers are faring the worst (see **Figure 23**). As of November 2011, the unemployment rate for young teen workers (ages 16 and 17) is 23.0 percent, and the unemployment rate for 18- and 19-year-olds is 23.6 percent. Young adults (ages 20 to 24) continue to have the lowest unemployment rate among workers between the ages of 16 and 24; as of November 2011, their unemployment rate is 14.2 percent.

**Figure 23. Unemployment Rate for Young Workers**
Percent of official labor force, monthly through November 2011




Source: Chairman's staff of the Joint Economic Committee using data from the Bureau of Labor Statistics, U.S. Department of Labor.

Note: Shaded regions mark periods of recession as determined by the National Bureau of Economic Research.

Policymakers should be concerned about high unemployment among young workers because lifetime earnings trajectories depend heavily on a worker's first experience in the labor market, which may be particularly negative given the weak labor market. Research suggests that many of these young workers will suffer significant long-term effects from entering the labor market during a severe recession, even if the labor market improves in the future.[31]

*Health Insurance Coverage among Young Adults*

In addition to the direct impact on lifetime earnings, high unemployment among young adults may also have financial implications for those young adults who get sick or injured. Not having health insurance can mean foregoing important preventative medical services which can reduce future health problems and related costs. It can also mean incurring burdensome medical debt for those who do get sick or injured.[32]

High unemployment rates for young adults during the recession and recovery led to lower rates of employer-sponsored health insurance and

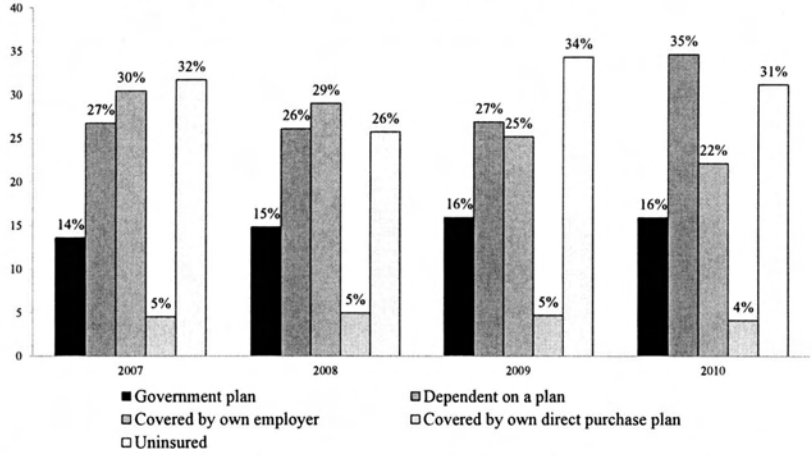
a rise in the percentage of young adults without health insurance coverage in 2008 and 2009. Over one-third of individuals between the ages of 19 and 25 were uninsured in 2008 and 2009.[33]

However, the passage of the Patient Protection and Affordable Care Act (PPACA) in 2010 changed the rules for adult dependent health insurance coverage. The new law fills the gap in coverage faced by many young adults, especially those unable to find a job, allowing them to remain covered as a dependent on a private health insurance plan until their 26th birthday. In practice, this means many young workers are able to stay on their parents' health insurance. Although the statutory implementation date was September 2010, many insurance providers chose to change their dependent coverage policies early.[34]

As a result of the PPACA, overall health coverage among young adults rose in 2010, despite continued high unemployment rates and corresponding declines in employer-sponsored health insurance coverage among young adults. The adult dependent coverage provision of the PPACA has led to a substantial increase in the proportion of young adults who are covered by private health insurance as a dependent, and a decrease in the percentage of young adults who are uninsured (see **Figure 24**). The gains are most dramatic for young adults ages 21 to 25. Although unemployment rates were higher among teens, many insurers already allowed coverage for dependents up to age 19 and up to age 21 if they were full-time students.[35]

In all, the change in the rules for adult dependent coverage allowed up to 2 million more young adults to obtain health insurance coverage as dependents in 2010, with most of those between the ages of 21 and 25.

**Figure 24. Health Insurance Coverage Status of 21- to 25-Year-Olds**
Percent of population by type of health insurance plan, 2007-2010




Source: Chairman's staff of the Joint Economic Committee using data from the Census Bureau, U.S. Department of Commerce 2008 to 2011 Current Population Survey Annual Social and Economic Supplements.

Note: Categories sum to over 100% because individuals may have more than one type of insurance coverage in the year.

*Long-Term Unemployment among Older Workers*

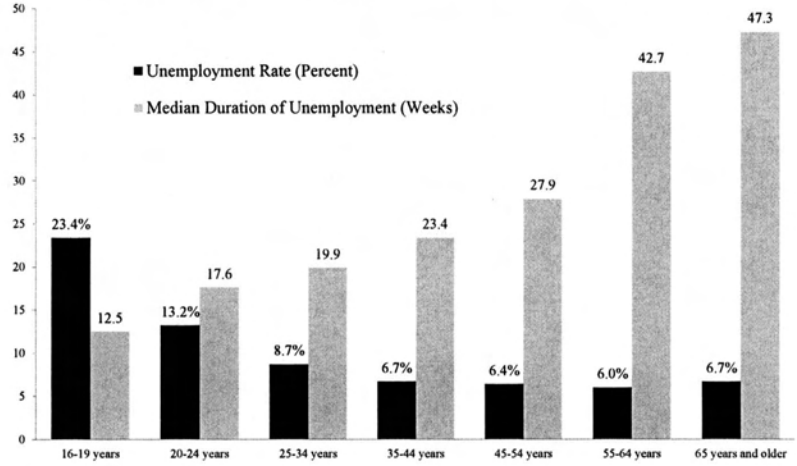
While younger workers have experienced much higher rates of unemployment than older workers, older workers who lose their jobs tend to stay unemployed for much longer. Though only 6 percent of workers aged 55 to 64 are unemployed, the median duration of unemployment for these workers is 42.7 weeks (see **Figure 25**).

The longer a worker has been unemployed, the more difficult it is to find employment. Workers who have been unemployed for less than five weeks are three times as likely to find work as those who have been unemployed for more than six months. Younger workers often leave the labor force to obtain additional training and education, keeping the duration of their unemployment spells relatively short, while older workers remain in the labor force during jobless spells.[36]

Long-term unemployed workers face a variety of problems in the labor market that may make them unattractive to employers. For example, the skills—including technical and interviewing skills—of these workers may have deteriorated, and employers may prefer to hire

workers with shorter gaps in their resumes. Obtaining additional training and education is less attractive to older workers, who would have fewer working years to recoup the investment. Moreover, older workers are more likely than younger workers to have dependents or obligations, such as a mortgage, that make it more difficult to go back to school. The challenge for policymakers is to begin to reduce the duration of unemployment spells, especially for older workers who must contend with a number of unique challenges.

**Figure 25. Unemployment Rate and Median Duration by Age Group**
November 2011, not seasonally adjusted




Source: Chairman's staff of the Joint Economic Committee using data from the Bureau of Labor Statistics, U.S. Department of Labor.

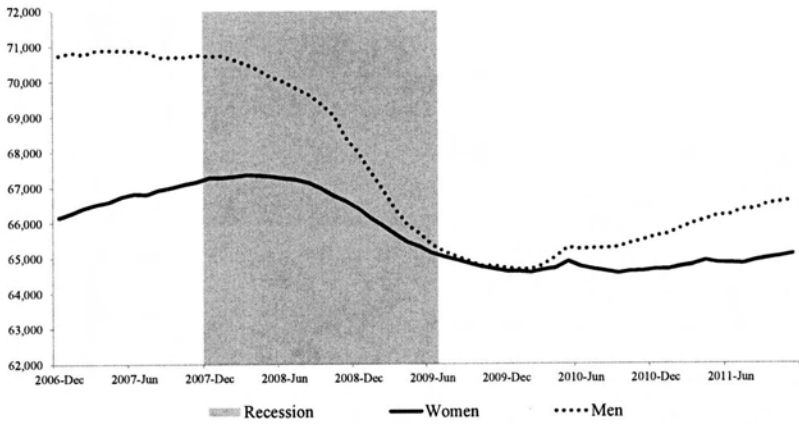
*Gender Differences*

While the vast majority of jobs lost during the Great Recession were lost by men, women lost a substantial number of jobs during the recession and accounted for a larger share of lost jobs than in the two previous recessions. From December 2007 to January 2010, women lost 44 jobs for every 100 jobs lost by men. By contrast, during the 2001 recession, women lost 17 jobs for every 100 lost by men, and women lost less than 2 jobs for every 100 lost by men during the 1990s recession. However, since February 2010, men have gained jobs at a much quicker pace. Since February 2010, women have gained only

26 jobs for every 100 jobs gained by men, for a total of nearly 2 million jobs added by men and just over half a million added by women (see **Figure 26**).

Moreover, there is no evidence of any coming upturn in women's employment. In particular, the government sector, which disproportionately employs women, is likely to continue to lose jobs in the future. State and local governments have shed 639,000 jobs from their peak employment in August 2008. Of those loses, 227,000 were in 2011 (to date) alone.

**Figure 26. Nonfarm Payroll Employment by Gender**
Level of employment, monthly through November 2011




Source: Chairman's staff of the Joint Economic Committee using data from the Bureau of Labor Statistics, U.S. Department of Labor.

Note: Shaded regions mark periods of recession as determined by the National Bureau of Economic Research. Total nonfarm payroll employment includes both public (government) and private sectors.

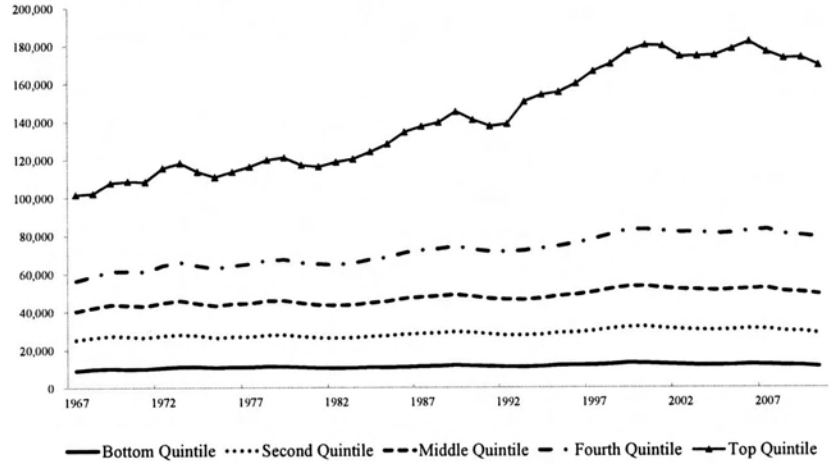
## GROWING INCOME INEQUALITY

Income inequality has increased in the United States over the past 30 years. In addition to eroding living standards for middle-income households, this increased income inequality may hinder future economic growth.[37] Inequality may also stifle intergenerational earnings mobility.[38]

One measure of income inequality, the Gini coefficient, which has values ranging from zero (if all households have the same income) to 1 (if a single household accounts for all of the country's income), has risen in the U.S. from 0.36 in 1980 to 0.47 in 2010.[39] Households at the top end of the income scale have seen their real after-tax incomes grow substantially, while middle- and lower-income households have faced much slower income growth, according to a recent CBO analysis.[40] From 1979 to 2007, the wealthiest 1 percent of households experienced a 275 percent increase in after-tax income, compared to a 65 percent gain for other households in the top 20 percent, a 40 percent increase for the households making up the middle 60 percent and an 18 percent gain for the bottom 20 percent.[41] During this same time period, the share of after-tax income accounted for by the top 20 percent of households grew from 43 percent to 53 percent.[42]

Similarly, an analysis of IRS tax data conducted by Emmanuel Saez found that the top 1 percent of households accounted for more than half of all income gains between 1993 and 2008.[43] Middle-income households have been contending with stagnant wages since the late 1960s, recording income growth of just 22 percent from 1967 to 2010 (see **Figure 27**).

**Figure 27. Average Household Incomes by Quintile**
Constant 2010 dollars, yearly through 2010




Source: Chairman's staff of the Joint Economic Committee using data from the Census Bureau, U.S. Department of Commerce Current Population Survey.

Widening income inequality provides an additional challenge to the economy as the United States slowly recovers from the Great Recession. An increased concentration of wealth at the top can inhibit economic growth by limiting the purchasing power and consumption of middle-income households. Conversely, reducing inequality can lead to longer periods of economic growth. A recent International Monetary Fund study found that reducing income inequality by 10 percent increases the duration of an economic expansion by 50 percent.[44] As the study's authors noted, "Helping raise the smallest boats may help keep the tide rising for all craft, big and small."[45]

*Declining Mobility*

More troubling than the growing gap between those at the top and bottom of the income ladder is the decline in mobility between income groups. Family income mobility declined between 1969 and 2006, with the wealthiest less likely to move down the income ladder and the poorest less likely to move up the income scale.[46] With less mobility, the income of a child's family is an increasingly powerful predictor of that child's income when he or she becomes an adult.

President Obama observed, "...over the last few decades, the rungs on the ladder of opportunity have grown farther and farther apart, and the middle class has shrunk. You know, a few years after World War II, a child who was born into poverty had a slightly better than 50-50 chance of become middle class as an adult. By 1980, that chance had fallen to around 40 percent. And if the trend of rising inequality over the last few decades continues, it's estimated that a child born today will only have a one-in-three chance of making it to the middle class—33 percent."[47]

*Link Between Inequality and Financial Crises*

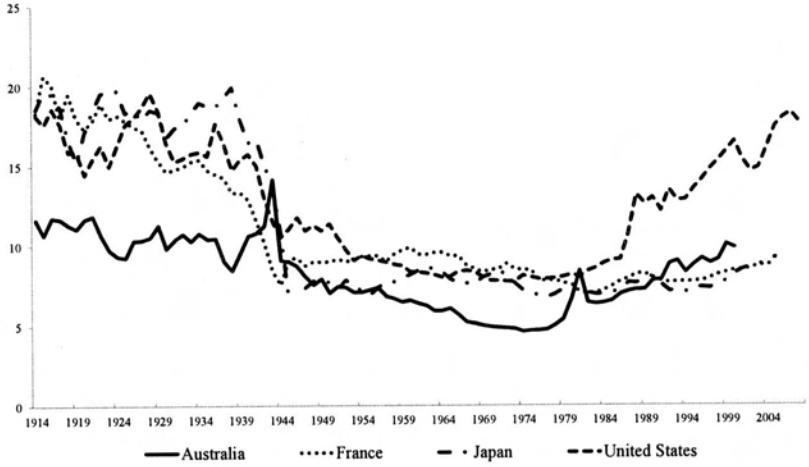
Income inequality peaked just before the two most severe financial crises in U.S. history—the Great Depression and the Great Recession—and may have been a major contributor to those crises. In both 1928 and in 2007, the share of income going to the top 10 percent of households reached record levels—exceeding 49 percent. On the eve of the Great Recession, the wealthy invested increased sums of money in new, largely unregulated financial products, destabilizing the economy. Middle-income households, facing stagnant incomes and holding a smaller share of overall wealth, had fewer resources for consumption, which increased their demand for credit, helping to fuel the credit bubble and trigger the Great Recession.[48] The increased inequality may also be one of the causes of the weak recovery. Deleveraging may take place more slowly when the majority of households struggle to make ends meet compared to an economy in which income is more evenly distributed.

*U.S. Experience Different from Other Advanced Economies*

The United States' growing inequality in the post-World War II period is unlike the experience of most developed countries (see **Figure 28**). After World War II, income inequality declined in most advanced countries and has remained stable since the 1980s. While the United States also experienced a decline in inequality following World War II, income inequality spiked in the 1980s and has been on an upward trend for the past three decades. Among all 34 OECD countries, only Chile,

Mexico and Turkey have greater income inequality than the United States.[49]

**Figure 28. Top One Percent Income Shares by Country**
Percent of income earned by the top one percent, yearly through 2008




Source: Chairman's staff of the Joint Economic Committee using data from the World Top Incomes Database. Estimates for the United States and Japan exclude capital gains.

## CONCLUSION

The Great Recession was the sharpest and most protracted U.S. decline since the 1930s, and, despite the significant improvement in the economy since the financial crisis, real GDP recovered to its pre-recession peak only recently. While the Great Recession officially ended almost two-and-a- half years ago, American workers continue to feel its effects: wages are stagnant, unemployment and long-term unemployment are high, the distribution of joblessness across classes of workers has been uneven, and economic growth remains modest.

Payroll employment is still a long way from full recovery and, even if private-sector payrolls were to immediately sustain growth at about double this year's pace, it would still take until late 2013 to recover to the level that prevailed in December 2007.

A comparison of what the economy actually produces with an estimate of what it could have produced without the excess slack in labor and

capital markets shows an extraordinarily large and persistent output gap. That large output gap serves as a strong indication that both monetary and fiscal policies should be promoting aggregate demand, at least over the near term.

While budget reforms will be needed to achieve a more sustainable federal fiscal balance over the longer-term, near-term cuts to federal spending will exert some drag on U.S. economic growth and could risk undermining the fragile recovery. In particular, failure to reauthorize programs such as the payroll tax cut and extended unemployment insurance benefits for the coming year could cut off about one percentage point from overall growth in 2012. Ensuring that the economy grows at a more robust pace than it has is critical to sustained deficit reduction.

Policymakers will need to pursue two objectives at the same time: incentivizing and strengthening economic growth in the short-term and putting in place policies that will get the nation's fiscal house in order in the medium- and long-term.

The growing income inequality in the United States evidenced in recent decades could also hinder future U.S. economic growth. Therefore, it is crucial to ensure that approaches to deficit reduction over the longer term do not exacerbate income inequality. Indeed, fiscal policy should be designed to reduce that inequality as well as to promote income mobility.

## ENDNOTES

[1] This report reflects developments in economic data available through mid-December 2011. In particular, the national income and product accounts were available only through the Commerce Department's second estimate for the third quarter.

[2] In January 2011, leading private-sector forecasters expected the U.S. economy to grow at a 3.3 percent rate, on average, between the fourth quarter of 2010 and the fourth quarter of 2011 (Apen Publishers, *Blue Chip Economic Indicators*, January 2011). In late January 2011, the Federal Reserve's Board of Governors and Reserve Bank presidents upgraded their economic outlook

for 2011, tending to expect U.S. growth of between 3.4 percent and 3.9 percent over the four quarters of 2011. Federal Reserve, *Minutes of the Federal Open Market Committee*, January 25-26, 2011 (http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20110126.pdf).

[3] Assuming that economic activity is accelerating in the fourth quarter, an average of leading private-sector forecasts indicates that real GDP will have grown 1.6 percent over the four quarters of this year (Aspen Publishers, *Blue Chip Economic Indicators*, December 2011). By early November 2011, the Federal Reserve's Board of Governors and Reserve Bank presidents had downgraded their "central tendency" projection for economic growth in 2011 to a range from 1.6 percent to 1.7 percent. Federal Reserve, *Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents*, November 2011 (http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20111102.pdf).

[4] Real GDP grew at an average annual rate of 3.4 percent between the cyclical peaks of 1948 and 2007.

[5] The estimates of potential real GDP used here are taken from Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2011 (http://www.cbo.gov/ftpdocs/123xx/doc12316/08-24-BudgetEconUpdate.pdf). CBO bases its estimate of potential GDP on a gross up of net service flows from productive labor and capital. CBO's approach to measuring potential output is sensitive to secular trends as well as pronounced cyclical movements in the labor force and the net capital stock; indeed, CBO's measure of potential output growth slowed somewhat during the recession. By contrast, other, more purely statistical, approaches to measuring underlying trends in output growth might be less sensitive to cyclical fluctuations in factor inputs and, as a result, might yield even larger estimates of the output gap than those implied by CBO's methods.

[6] Leading forecasters regard the recent upward trends in the twelve-month changes in overall and core consumer prices as temporary. For example, see Jan Hatzius, "US Daily: Signs of Disinflation," *Goldman Sachs Global Economics, Commodities and Strategy Research*, November 16, 2011; and Hui Shan and Andrew Tilton, "US Daily: Rent Inflation Likely to Stabilize," *Goldman Sachs Global Economics, Commodities and Strategy Research*, December 6, 2011.

[7] Reuters, "Bernanke says Fed would act if inflation falls," September 20, 2011 (http://www.reuters.com/article/2011/09/29/us-usa-fed-bernanke-idUSTRE78R5QK20110929).

[8] Federal Reserve, *Press Release*, August 9, 2011 (http://www.federalreserve.gov/newsevents/press/monetary/20110809a.htm).

[9] Federal Reserve, *Press Release*, September 21, 2011 (http://www.federalreserve.gov/newsevents/press/monetary/20110921a.htm).

[10] Federal Reserve, *Press Release*, November 2, 2011 (http://www.federalreserve.gov/newsevents/press/monetary/20111102a.htm) and Federal Reserve, *Press* Release, December 13, 2011 (http://www.federalreserve.gov/newsevents/press/monetary/20111213a.htm).

[11] Federal Reserve, *Press Release*, November 30, 2011 (http://www.federalreserve.gov/newsevents/press/monetary/20111130a.htm). A dollar swap arrangement is essentially a short-term dollar-denominated credit line from the Federal Reserve to a foreign central bank. When a foreign central bank draws on its swap line, it agrees to sell a specified amount of its currency to the Federal Reserve in exchange for a corresponding quantity of U.S. dollars valued at the prevailing market exchange rate for the two currencies. Under the terms of the swap agreement, the foreign central bank agrees to sell back its currency at a future date at that same exchange rate, ensuring that the Federal Reserve incurs no exchange rate risk by agreeing to the swap. For its part, the foreign central bank can lend the dollars it's borrowed from the Federal Reserve to institutions in its own jurisdiction, on terms that are determined in that jurisdiction and that do not involve the Federal Reserve. Because the foreign central bank is obligated to return the dollars to the U.S. central bank under the terms of the separate dollar swap arrangement, it is the foreign central bank and not the Federal Reserve that incurs any credit risk for the loans it has made using the swap. Finally, under the terms of the swap arrangement, the foreign central bank agrees to pay the Federal Reserve a fee equal to a fixed premium plus the U.S. dollar overnight index swap rate (a rate that is linked to the federal funds rate).

[12] Since 2008, the FOMC has paid member banks a ¼ percentage point of interest on the required and excess reserves they hold with the Fed. Reducing that rate would give member banks an incentive to reduce their excess reserves and, perhaps, increase their lending. This option has the advantages of operational simplicity and it would not increase the Fed's balance sheet; by

the same token, however, the effects on bank lending and the economy would probably be limited.

[13] Currently, the FOMC does not publicize a formal target for inflation or the price level; instead, it provides a projected range of inflation rates over the long term that are taken to be generally consistent with its objective of maintaining long-term price stability at maximum employment. One version of this option would have the FOMC set an explicit numerical inflation target. That would have the advantage of anchoring long-term inflation expectations (currently, market-based measures of inflation expectations fluctuate, sometimes in volatile ways); however, on its own, an explicit inflation target would be controversial given the FOMC's dual mandate and it might require consultations with Congress which would likely erode the FOMC's ability to respond quickly and flexibly to changes in economy activity. An alternative version of this option would have the FOMC target a level or range of levels of nominal GDP; that indicator is influenced by both inflation and real growth, and targeting monetary policy to nominal GDP would make policy more explicitly sensitive to both changes in inflation and unemployment. Almost certainly, that option would signal a longer period of monetary accommodation; however, it could make it more difficult for markets to deduce from the nominal income target a particular path for inflation and market-based inflation expectations could become unsettled as a result.

[14] That option would keep the FOMC from having to be overly precise in communicating its inflation target but it would communicate to markets that the FOMC is willing to ease monetary policy further and most likely for a longer period. The main drawback to this option is that it could undermine somewhat the longer-term credibility of the FOMC and, with that, the efficacy of monetary policy once the economy is on a stronger recovery path.

[15] That option has the advantage of providing more stimulus than the sterilized purchases of longer-dated Treasury securities but the possible disadvantage that it would further increase the size of the Federal Reserve's balance sheet.

[16] Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from July 2011 Through September 2011*, November 2011 (http://www.cbo.gov/ftpdocs/125xx/doc12564/11-22-ARRA.pdf). Other studies by leading economists of ARRA's economic impacts support the significant positive findings of the nonpartisan CBO. See, for example, Alan S. Blinder and Mark Zandi, *How the Great Recession Was Brought to an End*,

July 2010 (http://www.economy.com/mark-zandi/documents/End-of-Great-Recession.pdf).

[17] Congressional Budget Office, *The Effects of Automatic Stabilizers on the Federal Budget*, April 2011 (http://cbo.gov/ftpdocs/121xx/doc12129/04_21_AutomaticStabilizers.pdf).

[18] A widely cited recent study of this genre is Alberto F. Alesina and Silvia Aradagna, "Large Changes in Fiscal Policy: Taxes Versus Spending," *Tax Policy and the Economy*, ed. Jeffrey R. Brown, vol. 24 (Chicago: University of Chicago Press, 2010), pp. 35-68 (available in preliminary manuscript form at http://www.nber.org/papers/w15438.pdf). The bibliography to that paper cites earlier studies in the same vein.

[19] Jane G. Gravelle and Thomas L. Hungerford, "Can Contractionary Fiscal Policy Be Expansionary?" *Congressional Research Service*, number 7-5700, June 6, 2011 (http://www.fas.org/sgp/crs/misc/R41849.pdf).

[20] International Monetary Fund, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," Chapter 3 of *World Economic Outlook* (Washington: International Monetary Fund, February 2010), pp. 93-124 (http://www.imf.org/external/pubs/ft/weo/2010/02/pdf/c3.pdf).

[21] International Monetary Fund, *ibid.* See also Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," *American Economic Review*, vol. 100, no. 3, June 2010, pp. 763-801 (http://elsa.berkeley.edu/~dromer/papers/RomerandRomerAERJune2010.pdf).

[22] International Monetary Fund, *ibid*, p. 113.

[23] Estimates of the budgetary impacts of the BCA are taken from: Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2011, pp. 6-7 (http://www.cbo.gov/ftpdocs/123xx/doc12316/08-24-BudgetEconUpdate.pdf).

[24] The Chairman's staff of the Joint Economic Committee estimated those impacts by simulating the static budgetary impacts of the BCA using a large-scale macroeconometric model. The model used is the multi-country (MCG) model developed and maintained by Professor Ray Fair of Yale University; the model and extensive documentation are available online at

http://fairmodel.econ.yale.edu/main3.htm . The version of the model used for the staff simulations was dated July 2011 and the baseline was adjusted to make U.S. short-term interest rate exogenous and effectively zero through 2013, consistent with the most recent forward rate guidance from the Federal Reserve. CBO's static budgetary impacts were normalized to an estimate of pre-policy nominal GDP. The policy shocks were distributed across federal purchases of goods and services (80 percent of the shock) and federal transfers to households (20 percent of the shock).

[25] See, most recently, Douglas W. Elmendorf, *Presentation to the Forecasters Club: The Economic Outlook and Options for Fiscal Policy*, October 27, 2010 (http://www.cbo.gov/ftpdocs/119xx/doc11948/10-27-2010-ForecastersClub.pdf).

[26] See, for example, Mark Zandi, *Global Policy Prescriptions: How Another Recession Can Be Avoided*, Moody's Analytics Special Report, August 26, 2011 (http://www.economy.com/mark-zandi/documents/Policy-Prescriptions-20110826.pdf ).

[27] Board of Governors of the Federal Reserve System. "Economic Projections of the Federal Reserve Board Members and Federal Reserve Bank Presidents, November 2011," Table 1 of the Summary of Economic Projections released with the FOMC minutes, November 1-2, 2011.

[28] Bureau of Labor Statistics, Current Population Survey.

[29] *Ibid.*

[30] *Ibid.*

[31] Dr. Till von Wachter (2010b). Testimony before the Joint Economic Committee hearing on "Avoiding a Lost Generation: How to Minimize the Impact of the Great Recession on Young Workers." May 26, 2010.

[32] Centers for Medicare and Medicaid Services, The Center for Consumer Information and Insurance Oversight, *Young Adults and the Affordable Care Act: Protecting Young Adults and Eliminating Burdens on Families and Businesses* (http://cciio.cms.gov/resources/files/adult_child_fact_sheet.html).

[33] JEC staff calculations using data from the Current Population Survey's 2003-2011 Annual Social and Economic Supplements (ASEC).

[34] Centers for Medicare and Medicaid Services, The Center for Consumer Information and Insurance Oversight, *Young Adults and the Affordable Care Act: Protecting Young Adults and Eliminating Burdens on Families and Businesses* (http://cciio.cms.gov/resources/files/adult_child_fact_sheet.html).

[35] HealthCare.gov, *Young Adult Coverage*, December 14, 2011 (http://www.healthcare.gov/law/features/choices/young-adult-coverage/index.html). Some states had already required private insurers to extend dependent coverage to individuals beyond their 19th birthday. As of May 2010, 25 states had laws extending the age, with many extending coverage up to age 25. In addition, state laws did not cover self-funded insurance plans. The adult dependent coverage provision of the PPACA applies to self-funded plans. The Henry J. Kaiser Family Foundation, Focus on Health Reform, *Explaining Health Care Reform: Questions About the Extension of Dependent Coverage to Age 26*, May 2010 (http://www.kff.org/healthreform/upload/8065.pdf).

[36] For more information about the long-term unemployed, see Joint Economic Committee, "Addressing Long-Term Unemployment After The Great Recession: The Crucial Role of Workforce Training," A Report by the Joint Economic Committee Chairman's Staff, August 2011.

[37] International Monetary Fund, "Equality and Efficiency," Finance and Development, September 2011, Vol. 48, No. 3, Andrew G. Berg and Jonathan D. Ostry. Emmanuel Saez calculations using Internal Revenue Service data. (See http://elsa.berkeley.edu/~saez/). See also Piketty, Thomas and Emmanuel Saez. 2007. "Income Inequality in the United States, 1913-2002." Rajan, Raghuram G. 2010. Fault Lines: How Hidden Fractures Still Threaten the World Economy. Princeton: Princeton University Press.

[38] OECD Directorate for Employment, Labour and Social Affairs, *Divided We Stand: Why Inequality Keeps Rising*, December 2011 (http://www.oecd.org/document/51/0,3746,en_2649_33933_49147827_1_1_1_1,00.html).

[39] U.S. Census Bureau, Table A-3, Selected Measures of Household Income Dispersion: 1967 to 2010.

[40] Congressional Budget Office, "Trends in the Distribution of Household Income Between 1979 and 2007," October, 2011, Summary.

[41] *Ibid.*

[42] *Ibid.*, p. XIII.

[43] Cited in David J. Lynch, "Growing Income Gap May Leave U.S. More Vulnerable to Crisis," *Bloomberg Businessweek*, October 13, 2011(http://www.businessweek.com/news/2011-10-13/growing-income-gap-may-leave-u-s-more-vulnerable-to-crisis.html).

[44] International Monetary Fund, "Equality and Efficiency," Finance and Development, September 2011, Vol. 48, No. 3, Andrew G. Berg and Jonathan D. Ostry.

[45] *Ibid.*

[46] Federal Reserve Bank of Boston, Working Paper No 11-10, "Trends in U.S. Family Income Mobility, 1969-2006, Katharine Bradbury, October 20, 2011, p. 1 and Figure 2.

[47] President Obama, Remarks by the President on the Economy in Osawatomie, Kansas," Osawatomie High School, December 06, 2011.

[48] IMF Working Paper, WP/10/268, "Inequality, Leverage and Crises," Michael Kumhof and Romain Rancière, November, 2010.

[49] OECD, *Income Distribution and Poverty: Data, Figures, Methods and Concepts* (http://stats.oecd.org/Index.aspx?QueryId=26067).

## VIEWS OF VICE CHAIRMAN KEVIN BRADY, SENATOR JIM DEMINT, AND REPRESENTATIVE MICK MULVANEY

We submit these views without the benefit of reviewing the contribution of the Chairman and other Democratic members of the committee:

### OVERVIEW

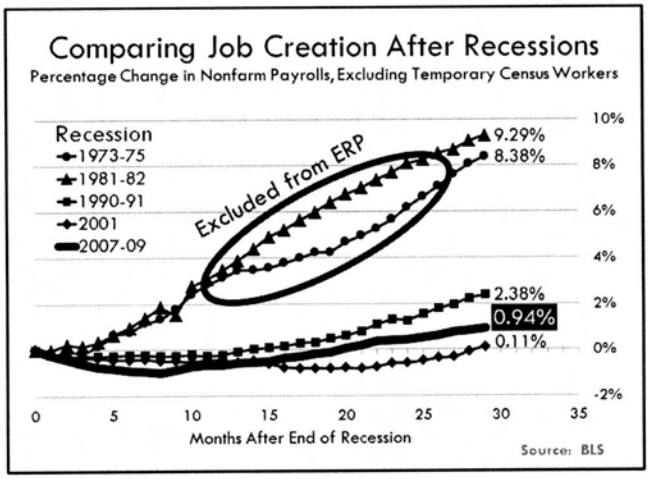
Nine months have passed since the White House released the *Economic Report of the President together with the Annual Report of the Council of Economic Advisers* on February 23, 2011 (ERP 2011). The Administration used the ERP 2011 for two primary purposes: (1) to exaggerate the positive effects of government intervention into the economy, casting the economy's lackluster post-crisis performance in the best possible light; and (2) to reassert the Administration's misguided faith in government control of the economy. Reviewing these claims today, it is again clear that the Administration has it wrong.

The private investment that hardworking Americans pour into our nation's economy drives long-term economic growth and job creation. Americans create their own prosperity, not the government. The Administration must recognize this key economic principle; it should encourage Americans to work harder, save more, and invest more by fostering a favorable and stable economic environment. Instead, the Administration has contributed to the gloomy post-crisis economic outlook by pursuing temporary and scattershot command-and-control policies. It has saddled the American economy with an ever-increasing web of regulation, and contributed to deficits and debt as far as the eye can see by doubling down on ineffective government spending.

The Administration's policies have sapped American confidence by producing momentous market uncertainties.

The ERP 2011 greatly exaggerated any contribution to the recovery from the Administration's economic policy. For example, the ERP 2011 touted a relatively quick turn to "modest" monthly payroll job growth after the trough of the severe recession of December 2007–June 2009, in comparison with the longer turns after the troughs of the very mild recessions of July 1990–March 1991 and March 2001–November

2001.[1] However, as the following chart shows, when comparing this recovery with recoveries after the similarly severe recessions of November 1973–March 1975 and July 1981–November 1982, or indeed after all post-World War II recessions, payroll job creation now is failing to keep pace with the job creation in most other recoveries, despite unprecedented federal intervention and massive federal spending.




In fact, in the first 29 months following the end of the deep 1981-82 recession, the economy generated over 8.2 million jobs, aided by the policy tailwinds of the Reagan Administration. In contrast, fewer than one quarter as many jobs – 1.2 million – have been generated since the last recession ended in June 2009, and these gains have been in the face of policy headwinds created by the Obama Administration. Nevertheless, the ERP 2011 indicated the Administration has no intention of changing course.

While the ERP 2011 began with a hopeful discussion of the importance of private fixed nonresidential investment and exports in generating sustainable economic and job growth, it appears that such statements constituted mere lip service. The ERP 2011 discussed the outsized role that personal consumption expenditures and residential investment played in the growth of the 2000s. The ERP 2011 expressed the need to adopt policies that encouraged exports and private business investment. Yet when reviewing the Administration's policy prescriptions, one was left perplexed and wondering if the writers of the policy chapters had even read the report's introductory chapters.

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[1] ERP 2011, 46.

Throughout the policy chapters the ERP 2011 consistently exuded an unshakeable and misguided faith in the importance of government intervention to foster desirable economic growth. Of the 40 times that the ERP 2011 discussed investment, fewer than 10 references were made to purely private investment and most of those are references made to historical data or the 2010 extension of tax cuts.

Especially troubling was the ERP 2011's failure to give serious consideration to the negative effects that unprecedented deficit spending and burgeoning federal debts have on the economy. Our precarious fiscal position is heightening uncertainty about future tax rates, deterring private business investment, and slowing economic growth and job creation. The adverse consequences from the Administration's fiscal irresponsibility will only grow over time. To accelerate growth and job creation, there must be a meaningful reduction in federal spending relative to the size of the economy, including a realistic solution to unsustainable entitlement programs.

Unfortunately, the Administration used the ERP 2011 to reassert its faith in government control of the economy rather than to acknowledge that Americans, through the power of the free market, create our country's economic growth, opportunity, and prosperity.

In February 2012, the Administration will have another opportunity to admit that its economic policies have not created vigorous economic growth and job creation over the past two-and-a-half years. Next year's *Economic Report of the President together with the Annual Report of the Council of Economic Advisers* (ERP 2012) should acknowledge that the Administration's Keynesian economic policies have failed. The ERP 2012 should clearly state that private nonresidential investment in buildings, equipment, and software by business firms drives private sector job creation. Then, the ERP 2012 should acknowledge that the Administration's economic policies have reduced the expected return on new private business investment by both increasing costs now and the uncertainty over what additional costs may be imposed in the future. Thus, after conceding that the consequences of the Administration's economic policies have been sluggish real GDP growth and a stubbornly high unemployment rate since the recovery began in July 2009, the ERP 2012 should announce that President Obama is making an economic policy U-turn.

Therefore, the ERP 2012 should (1) outline a comprehensive tax reform designed to raise the after-tax return on new private business investment to accelerate the recovery and create millions of new jobs;

(2) support budget process reform designed to redress the bias toward ever higher federal spending and the accumulation of federal debt, including (a) constitutional amendments to (i) limit federal spending on discretionary and mandatory programs to a fixed percentage of potential GDP, (ii) require a balanced federal budget, and (iii) require a supermajority vote to raise federal taxes, and (b) laws to require the President to prioritize federal spending on discretionary and mandatory programs; (3) propose a comprehensive reform of Social Security, Medicare, Medicaid, and other medical entitlement programs to make them sustainable over the long term; (4) announce a suspension of all new regulatory initiatives and reform existing regulations to reduce burdensome costs; and (5) advocate amending the *Federal Reserve Act* to (a) give the Federal Reserve a single mandate of price stability and (b) increase the transparency of monetary policy.

## COMMENTARY ON ADMINISTRATION POLICIES DISCUSSED IN THE 2011 ECONOMIC REPORT OF THE PRESIDENT

*ENERGY*

The ERP 2011 portrayed clean energy as a virtual panacea to America's economic woes. The ERP 2011 found little virtue in conventional energy sources and no faults in new energy sources. This starkly one-sided account of the possibilities of clean energy investment left the reader with many doubts. Questionable numbers were frequently used to justify the benefits of current and proposed Administration policies,[2] but there was inadequate citation or discussion of how the numbers were derived. Many of the ERP 2011's assertions were difficult, if not impossible to measure, but they were used as though they were widely accepted.

The ERP 2011 failed to discuss the contributions that coal, natural gas, or nuclear energy can make to energy supplies in the future; and the ERP 2011 failed to acknowledge any problems with ethanol, biofuels, or the presumed causes of global warming. The Administration took pride in the various programs that it has enacted and proposed. However, the ERP 2011 did not explain how choices ultimately are made among divergent technologies that require separate infrastructure, or how coherent systems of energy generation and transportation evolve out of scatter-shot subsidies and mandates.

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[2] ERP 2011, c.f. 126-127.

Ultimately, the Administration did not clearly explain its decision-making process, but the Administration did communicate its fundamental belief that the government, not the private sector, can spur innovation and pick winners and losers: "the Administration is deploying resources to create fundamental breakthroughs at the beginning of the innovation pipeline."[3]

The case of solar panel maker Solyndra has become a glaring example of how the Administration's energy policy has failed. Solyndra, a startup focused on new solar panel designs, was the Administration's "poster-child" for effective stimulus spending on clean energy. The Department of Energy extended $535 million in federal government loan guarantees to Solyndra using funds allocated under the *American Recovery and Reinvestment Act of 2009*. Despite warnings that the firm would face a cash-flow shortage because the market could not support its pricing, the Administration pushed forward with the loans and even restructured them in February 2011 to make the federal government a subordinated creditor.

Shortly thereafter in late August 2011, Solyndra filed for bankruptcy. Secretary of Energy Steven Chu has conceded that likely all of the government-backed loans will be unrecoverable. The Solyndra story refutes the contention that the federal government can create markets where they do not exist. The fundamental economics of Solyndra's technology meant that it would not succeed, despite the Administration's best attempts to make it so.

*ENVIRONMENT*

The ERP 2011 focused on the Administration's use of environmental policy to incentivize the transition to a "clean energy future." In particular, the ERP 2011 addressed the benefits, costs, externalities (third party effects), and means (e.g., regulations, tax subsidies, cap-and-trade) of its environmental policies. Emphasis was given to various theories, by which economic benefit would allegedly be realized from shifting away from carbon-based energy. These theories involved energy security, technology development, increased international competitiveness, the decline in world energy prices due to decreased U.S. demand, and decreased government storage costs for the Strategic Petroleum Reserve.

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[3] ERP 2011, 60.

However, the ERP 2011's assessments fell short. It used the term, "Social Cost of Carbon," which was not adequately defined, and which was criticized after it was introduced in a draft August 2010 Environmental Protection Agency study.[4] The Administration failed to recognize the detrimental effects of its environmental policies on economic efficiency.

*GLOBAL ECONOMY AND INTERNATIONAL TRADE*

The ERP 2011 provided a ray of hope to readers as the Administration expressed a commitment to growing markets and recognized that "growth abroad is good for the United States – the global economy is not a zero sum game."[5] However, the question remains whether President Obama will follow through with meaningful action.

On a positive note, the Administration allowed the free trade agreements with Colombia, Panama, and South Korea to become law after delaying their enactment for over two-and-a-half years. These "Sell American" agreements will contribute to the creation of nearly 250,000 jobs and $13 billion in new sales opportunities for American manufacturers, farmers, and service companies.

Unfortunately, the ERP 2011 ignored other global economic issues, including a major cause of persistent global imbalances—massive foreign exchange interventions by the People's Republic of China and certain other Asian countries to support their export-led growth strategies. By buying U.S. dollars, China and certain other Asian countries with trade surpluses have minimized the appreciation of the foreign exchange value of their currencies relative to the U.S. dollar that would have otherwise occurred. Absent such massive and sustained interventions, the resulting increase in the foreign exchange value of the Chinese renminbi and the currencies of certain other Asian countries would have slowed their export growth (as their exports become more expensive), would have boosted their imports (as imports become relatively cheaper to their domestic firms and households), and would have redirected some of their domestic production away from

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[4] USEPA Office of Air and Radiation, August 2010. "The Benefits and Costs of the Clean Air Act: 1990 to 2020 - Revised Draft Report," Washington, D.C. See also, Interagency Working Group on Social Cost of Carbon, 2010. "Technical Support Document: Social Cost of Carbon for Regulatory Impact Analysis under Executive Order 12866," February 2010. Found at (www.epa.gov/oms/climate/regulations/scc-tsd.pdf).

[5] ERP 2011, 102.

exports and toward their now wealthier domestic consumers. Thus, current account surpluses in China and certain other Asian countries would have declined as a percentage of GDP. Simultaneously, the opposite process would have occurred in the United States, reducing our current account deficit as a percentage of GDP.

China and certain other Asian countries invested most of the U.S. dollars that they accumulated through their massive interventions in foreign exchange markets in U.S. debt securities, especially Treasuries. This action reinforced the Federal Reserve's overly loose monetary policy from 2002 through early 2006, helping to inflate an unsustainable housing bubble in the United States.

*HEALTHCARE*

The ERP 2011 incorrectly claimed that the recent enactment of the *Patient Protection and Affordable Care Act* (PPACA) would bring about significant improvements in our nation's health care system. Specifically, the Administration claimed that the PPACA would expand and improve health insurance coverage, increase the quality of care, and reduce costs through delivery system reforms and competitive insurance markets.[6]

However, such claims were based on unrealistic assumptions and flawed economics. The PPACA is merely the latest addition to our nation's unsustainable system of medical entitlements. The PPACA not only expands Medicare and Medicaid coverage but also creates refundable tax credits to subsidize the purchase of health insurance.

The PPACA will be financed through a combination of tax increases and Medicare cuts. But the available budget estimates do not consider the negative effects of higher taxes on economic growth and job creation. The new 3.8% surtax on interest, dividends, and capital gains for those earning over $200,000 (single) and $250,000 (married) will substantially reduce businesses investment and employment.[7]

Also, available budget estimates fail to include the effects of increased demand on the price of health care. The PPACA will increase coverage for the insured and expand coverage to many of the uninsured, resulting in greater demand for health care services. But

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[6] ERP 2011, 111.

[7] PPACA as amended by the *Health Care and Education Reconciliation Act of 2010* (P.L. 111-152).

various supply constraints—such as certificates of need for new facilities, physician education and training, testing and patents for drugs and devices—restrict the availability of health care services. As a result of these constraints, much of the increased demand will generate higher prices, not more services. The Medicare Office of the Actuary has noted that higher prices due to increased demand would likely increase the costs of the PPACA to federal taxpayers or decrease patient access to medical services relative to its initial budget estimate. On October 14, 2011, Secretary of Health and Human Services (HSS) Kathleen Sebelius announced that HHS would cease implementing the *Community Living Assistance Services and Support Act* (CLASS Act), a long-term care entitlement program created under PPACA, because it was financially unsustainable.[8]

The CLASS Act is one prime example of the flawed economics of the Administration's health care "reform." It was included in PPACA despite the warnings of several analysts, including the actuary for Medicare and Medicaid, that the CLASS Act was fundamentally flawed. As a voluntary, unsubsidized, and non-underwritten entitlement program, the CLASS Act suffered from a classic economics problem known as adverse selection. Essentially, higher risk individuals would be more likely to participate in the program than lower risks individuals. As a result, the average premium level required to fully fund the program would rise over time as the pool of participants became riskier on average. This would cause even fewer healthy individuals to participate due to the premium increases, thereby leading to even further premium increases. Some have termed this problem an "insurance death spiral." This phenomenon is what eventually led Secretary Sebelius to scrap the program.

The failure of the CLASS Act further underscores the shaky economic foundation of the PPACA. Without the CLASS Act, the $83 billion excess of CLASS premiums over CLASS outlays in the ten-year budget window, which represent nearly all of the illusory budget savings the Administration promised that the PPACA would bring, are gone.

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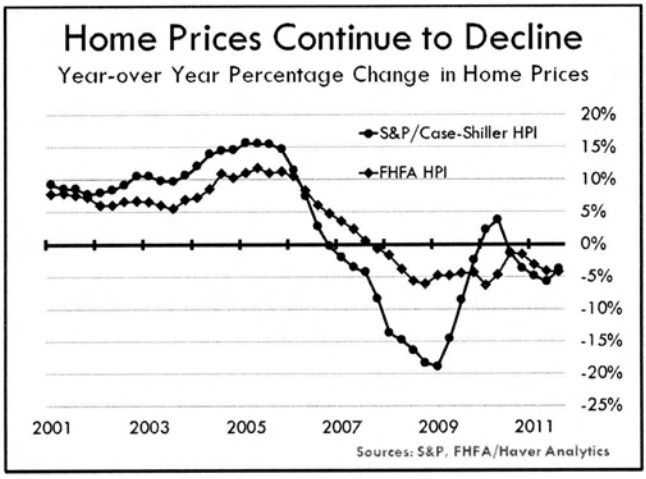
[8] See Repeal CLASS Working Group, "CLASS' Untold Story: Taxpayers, Employers, and States on the Hook for Flawed Entitlement Program," September 2011. Found at: http://thune.senate.gov/public/index.cfm?a=Files.Serve&File_id=f03d8200-bfa4-4891-8a4c-aa78a54e2de0.

*HOUSING*

While acknowledging some volatility in home prices over the past year, the ERP 2011 claimed that home prices have generally stabilized since March 2009.[9] However, the ERP 2011 ignored more woeful signs—such as the S&P/Case-Shiller 20-City Home Price Index, which posted six straight months of declines (from July 2010 to December 2010) before the ERP 2011 was published and had virtually no upward movement since the recession ended in June 2009. The ERP 2011 also ignored the possibility that home prices may continue to fall because of expired tax credits, distressed sales, and the substantial inventory of unsold homes, all of which create headwinds to price appreciation.




The ERP 2011 touted the "Administration's housing programs, including the Home Affordable Refinance Program (HARP), the Housing Affordable Modification Program (HAMP), and funds allocated to … the hardest-hit areas, have helped many borrowers achieve more affordable mortgages."[10] However, the consensus among economists is that these mortgage modification programs have faced implementation problems and been generally ineffective. For example, the Administration estimated that it would achieve 3-4 million permanent loan modifications using the $75 billion initially allocated to the HAMP program; however, according to the Special Inspector General of TARP, there were fewer than 522,000 ongoing permanent modifications and nearly 792,000 cancelled modifications as of

[9] ERP 2011, 34.
[10] ERP 2011, 36.

December 31, 2010.[11] Even in recent months, the "TARP-funded housing support programs continue to struggle to reach homeowners, with only $2.5 billion (5.4%) of the $45.6 billion in earmarked TARP funds having been spent."[12]

*LABOR*

The ERP 2011 provided a relatively accurate analysis of the current labor situation, but its claim that job growth was occurring relatively quickly after the recent recession, compared to the two previous recessions, is quite weak. While the Administration recognized that payroll employment remained well below its pre-recession peak, the emphasis of the ERP 2011 was on the brief number of months between the end of the recession and the month in which positive payroll job growth resumed. As of January 2011, the unemployment rate was 9.0%—less than one percentage point below its 9.9% level in December 2009. In November 2011, the unemployment rate was little changed at 8.6%. Even so, a large part of this decline was due to a falling labor force participation rate from 65.7% in June 2009 to 64.0% in November 2011. Since June 2009, 871,000 workers have dropped out of the labor force.

*MONETARY POLICY*

The ERP 2011 was largely silent on monetary policy and the prospects for higher price inflation. During the financial crisis in the fall of 2008, the Federal Reserve acted in its proper capacity as the lender of last resort by injecting a tremendous amount of liquidity into the economy.[13] As a result, the Federal Reserve's balance sheet more than doubled from $985 billion on September 17, 2008 to $2.29 trillion on December 10, 2008.[14] Banks kept most of these additional reserves on

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[11] SIGTARP, Quarterly Report to Congress, January 26, 2011, 11.
[12] SIGTARP, Quarterly Report to Congress, October 27, 2011, 8.
[13] During the financial crisis, the Federal Reserve utilized several new programs—including the Term Auction Facility (TAF), the Primary Dealer Credit Facility (PDCF), the Term Securities Lending Facility (TSLF), the Money Market Investor Funding Facility, the Commercial Paper Funding Facility (CPFF), the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), and the Term Asset-Backed Securities Loan Facility (TALF)—to provide short-term liquidity to banks and other depository institutions and other financial institutions (TAF, PDCF, TSLF) and to provide liquidity directly to borrowers and investors in key credit markets (CPFF, AMLF, MMIFF, TALF).
[14] Monetary data are the average for the week ending on a specified date.

deposit with the Federal Reserve rather than lend them out. Reserves, which were $2 billion prior to the crisis, swelled to $798 billion by year-end.

As the credit shock receded, financial institutions reduced their use of these temporary credit programs and the size of the Federal Reserve's balance sheet began to decrease in early 2009. Rather than allow its balance sheet to contract further, the Federal Reserve initiated large purchases of longer-term Treasuries, government-sponsored enterprise (GSE) debt securities, and GSE mortgage-backed securities in what was dubbed quantitative easing one (QE1).[15] As a result, the Federal Reserve maintained its balance sheet at between $2.05 and $2.28 trillion for the remainder of 2009. However, banks remained reluctant to lend. Thus, excess reserves climbed to $1.19 trillion by February 3, 2010.

In the summer of 2010, real GDP growth decelerated, the unemployment rate remained stubbornly elevated, and the housing market continued to struggle. On November 3, 2011, the Federal Reserve initiated a second round of purchases of up to $600 billion of longer-term Treasuries through the second quarter of 2011, in what was dubbed QE2. Reserves grew again from $969 billion on November 3, 2010 to $1.22 trillion on February 23, 2011.

Since the ERP 2011 was first released, the Federal Reserve has taken two additional unconventional actions to ease its monetary policy stance. First, the Federal Open Market Committee (FOMC) announced in its August 2011 statement that economic conditions warranted "exceptionally low levels for the federal funds rate at least through mid-2013."[16] Federal Reserve policymakers hope this so-called "communications channel" will spur economic activity where large-scale asset purchases have fallen flat because it effectively commits the central bank to a highly accommodative monetary policy in the medium-term.

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[15] QE1 consisted of the purchase of $300 billion in longer-term Treasuries, approximately $200 billion in government-sponsored enterprise (GSE) debt securities, and $1.25 trillion in GSE residential mortgage-backed securities (RMBS).

[16] Press Release, Federal Open Market Committee Statement (August 9, 2011).

Second, the Federal Reserve announced on September 21, 2011, that it would implement a program known as "operation twist."[17] Operation twist extends the average duration of the Federal Reserve's securities holdings through selling $400 billion of shorter-term U.S. Treasuries and purchasing $400 billion in longer-term U.S. Treasuries. The program seeks to stimulate borrowing by lowering long-term interest rates, although a similar program instituted during the 1960s was considered a failure by most economists.

Contemporaneous to the announcement of operation twist, the Federal Reserve announced that it would keep constant the size of its portfolio of federal agency debt securities (issued by Fannie Mae and Freddie Mac) and federal agency residential mortgage-backed securities (RMBS) by reinvesting the principal payments made on its existing portfolio into additional new purchases. Thus, the Federal Reserve will continue to allocate credit selectively toward politically favored borrowers.

Many economists are concerned that the Federal Reserve's unconventional monetary policy actions risk the possibility of sparking a high rate of general price inflation in the near future without appreciably improving the current economic environment.

*BUDGET POLICY*

It is also worth responding to the Administration's comments and proposals in relation to the growth of federal spending and fiscal discipline as they relate to economic growth and job creation. The ERP 2011 failed to give any serious consideration to the negative effects that the Administration's unprecedented deficit spending and burgeoning federal debt will have over time on the U.S. economy. While the Administration feigned fiscal responsibility by proposing a "five-year freeze on non-security discretionary spending, a two-year freeze on federal employee wages, a slowdown in the growth of defense spending, and eliminating earmarks from the appropriations process,"[18] most economists recognized that such modest proposals are wholly insufficient to reduce federal budget deficits as a percentage of GDP or stabilize federal debt as a percentage of GDP.

Put another away, the Administration's deficit and debt restraint proposals contained in the ERP 2011 were limited to discretionary

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[17] Press, Release, Federal Open Market Committee Statement (September 21, 2011).

[18] ERP 2011, 42-43.

spending only, and thereby amount, at most, to practicing fiscal restraint on less than one-third of the federal budget while imposing zero restraint on the other two-thirds of the budget.

However, the Administration's proposal was actually much worse than that. Consider that the President's Budget for Fiscal Year 2012 (released one week prior to the ERP 2011) projected $14.1 trillion in discretionary outlays, $27 trillion in mandatory outlays, $6 trillion in interest outlays, and $47.3 trillion in total outlays over fiscal years 2012-2021.[19] A five-year freeze on non-security discretionary spending would save $406 billion according to the President's Budget,[20] and this is the only quantifiable proposal specified in the ERP 2011. Of the other proposals, the two-year freeze on Federal wages would be baked-into the $14.1 trillion overall discretionary outlay number, possibly reallocating but not necessarily further reducing spending; likewise eliminating earmarks, though arguably a good policy, does not reduce spending; and finally, it is difficult to see where the Administration's proposed slowdown in the growth of defense spending is a new fiscal restraint proposal in light of the Administration's previously expressed desire to follow such a course on ideological rather than fiscal grounds.[21]

Fortunately, House Republicans fought against these fiscal sleights-of-hand. Through the *Budget Control Act*, the Continuing Resolution for FY2011, and other legislation, spending reductions of $997 billion over ten fiscal years—double the Administration's ERP 2011 proposal—were achieved during the first nine months that Republicans controlled the House of Representatives.[22] Had the Democrat-controlled Senate adopted the House-passed Budget Resolution, rather than failing to even consider a budget in committee or on the Senate floor, the resulting spending reductions could have been much greater and put all Americans on a more stable path to prosperity.

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[19] Fiscal Year 2012 Budget of the U.S. Government, Summary Tables, Table S-3. Adjusted Baseline by Category, 174.

[20] Ibid., Table S-2, Effect of Budget Proposals on Projected Deficits, 172.

[21] Reuters, "U.S. Defense Chief Warns of 'Crisis' over Budget," January 27, 2011, http://www.reuters.com/assets/print?aid=USN2722053920110127; and National Journal, "Obama: Cut Defense Spending As Opposed to Food Stamps," July 22, 2011, http://www.nationaljournal.com/whitehouse/obama-cut-defense-spending-before-food-stamps-20110721?print=true.

[22] Fiscal Year 2012 Mid-Session Review, Budget of the U.S. Government, Table 6, Change in Outlays, 22. (8/25/2011).

Nevertheless, though the federal government has much further to go to ensure that the United States avoids the fate of a country like Greece in 2011, it is closer to practicing real fiscal discipline with Republicans controlling at least one of the Houses of Congress than it would be otherwise.

As America moves forward, while an economic crisis erupts in Europe, the Administration would do well to shore up our nation's precarious fiscal position by taking steps to ensure that future tax rates will not rise. So doing would help to spur business investment, leading to economic growth and real job creation. Further, a meaningful reduction in federal spending relative to the economy—including realistic reforms to entitlement programs that ensure that no current or soon-to-be beneficiaries are harmed—could also help to accelerate growth and job creation.

*SMALL BUSINESS*

The ERP 2011 claimed that the Administration is on the side of small businesses by touting a laundry list of initiatives. However, the Administration has taken positions that are, in fact, extremely hostile to small business. The Administration has consistently pushed for higher taxes, healthcare mandates, and increased regulation, all issues that the ERP 2011 ironically documents as the top policy concerns of small business owners.

*TRANSPORTATION AND INFRASTRUCTURE*

The ERP 2011 affirmed that the Administration does not just want to repair and improve the existing government-provided infrastructure but wants to strike out aggressively in new directions by providing high speed rail service to 80% of the population as well as expanding federal government-funded broadband service. While investment in infrastructure can generate economic benefits, it does not mean the federal government has to fund them, or that whatever the federal government decides to invest in will have a payoff.

1. Federal investment, however beneficial, adds to federal debt, which is a growing burden on our economy.

2. Private firms are now providing much of the transportation infrastructure in other countries that government agencies have traditionally provided in the United States (e.g., airports, port

facilities, expressways). The United States lags behind other countries in infrastructure privatization.

3. Decisions about federal investments are inherently political. The Administration's proposals for "high speed" passenger rail outside of the Boston-to-Washington corridor is an example of the political allocation of capital in which federal funds can be misdirected toward projects that are extremely costly but provide relatively few benefits.

4. Governments often mismanage otherwise beneficial projects, resulting in large cost overruns.

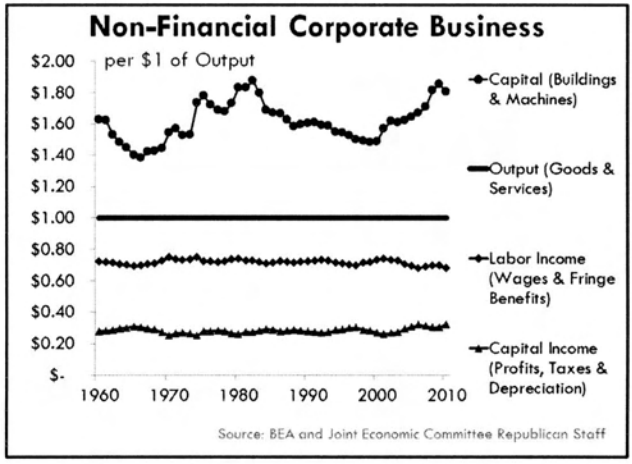
## COMMENTARY ON THE FORTHCOMING 2012 ECONOMIC REPORT OF THE PRESIDENT

Sometime in February 2012, President Obama will submit to Congress the next *Economic Report of the President together with the Annual Report of the Council of Economic Advisers*. In the ERP 2012, unlike the ERP 2011, President Obama should display courage and wisdom by acknowledging the failure of his current economic policies, moving beyond stale political rhetoric, and proposing real solutions to the major economic challenges that confront our country.

### *HOW OUR ECONOMY GROWS*

The ERP 2012 should recognize that our country's economic well-being depends on the quality and quantity of our workers and resources. Labor in the form of knowledge and skills and capital in the form of land, buildings, and machines are combined to produce goods and services. Greater input results in greater output. Greater output means more income for those who work and invest and a higher standard of living for everyone.

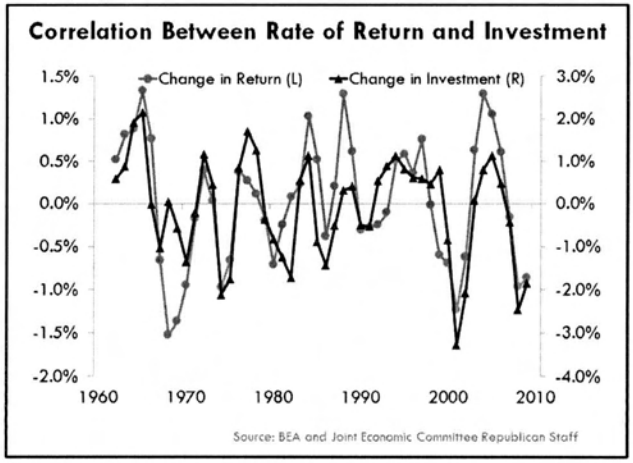
The historical relationship between input and output can be seen in the chart on the following page. Although the amount of capital has varied considerably relative to output, the shares of income attributed to labor and capital have been virtually constant throughout the post-World War II period.



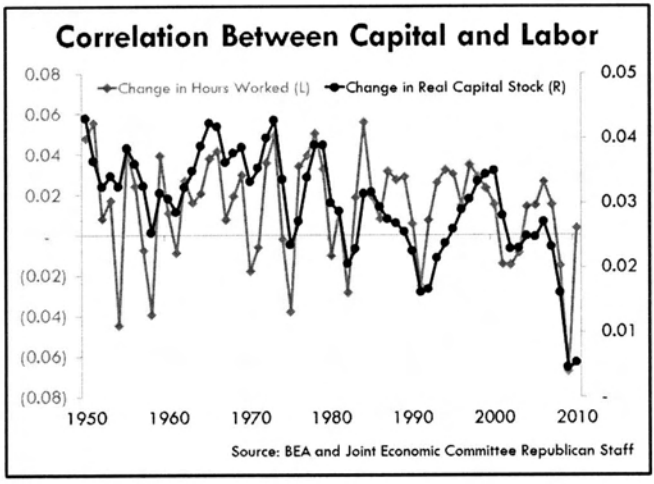

Further analysis of the data reveals another significant relationship. The after-tax rate of return on capital tends to be constant. This is true because investment responds to changes in the rate of return.

When the rate of return goes up, investment rises as previously unprofitable activities become profitable; and when the rate of return goes down, investment declines as previously profitable activities become unprofitable.

Whenever the rate of return deviates from the average, the level of investment adjusts accordingly, thereby increasing or decreasing the capital stock. An increase in the capital stock causes the rate of return to decline, while a decrease in the capital stock causes the rate of return to go up. The historical relationship between changes in the rate of return and changes in investment can be seen in the following chart.



An increase in investment results in a larger capital stock. More capital makes workers more productive. Higher productivity means higher wages. The supply of labor increases in response to an increase in after-tax wages. That means more jobs. The reverse is also true as shown in the following chart.




These empirical findings have important implications for economic policy. Higher marginal tax rates result in lower expected rates of return to capital and labor, and thus reduce investment, employment, and output; whereas lower marginal tax rates result in higher expected rates of return to capital and labor, and thus increase investment, employment, and output. Taxes not only affect how much revenue the government will collect, they also affect how much the economy will grow.

This market-oriented analysis differs from Keynesian analysis. A market-oriented approach assumes economic growth is the result of investment, employment, and output – in that order. Goods and services must first be produced in order to earn the income needed to purchase them. The decision to invest more and work more is based on the expected after-tax return to capital and labor. Thus, a decrease in marginal tax rates will increase the size of the economy by increasing the supply of labor and capital. An increase in marginal tax rates will have the opposite effect.

On the other hand, Keynesian analysis assumes the economy is driven by aggregate demand. Such models assume economic growth is the result of increased spending. From this perspective, tax cuts are simply one way the government has to increase spending. But Keynesian

analysis overlooks the fact that every dollar the government spends must first come from someone else, either in the form of taxes or borrowing. When the government spends more, someone else spends less. This is a zero sum game.

Proponents claim government spending does not always crowd out other spending. During a recession, when everyone is spending less, they claim the government can borrow and spend these "unused" dollars and put the unemployed back to work, without any adverse offsetting effects.

During a recession, there are fewer workers producing fewer goods and services. Because the level of output is lower, the level of spending is lower as well. But the money no longer being spent reflects the goods and services no longer being produced. When the government borrows and spends this money, it increases the supply of money relative to the supply of goods and services.

Increasing the money supply – either directly through monetary policy or indirectly through fiscal policy – faster than output growth is inflationary. History clearly shows more inflation results in less economic growth. Moreover, inflating the money supply does not really avoid the crowding out problem. When the government borrows money, freshly printed or otherwise, what the government is really borrowing are the resources it acquires when it spends the money.

When Keynesian economists talk about stimulating aggregate demand, they give the impression that we can grow our economy by spending money, and it does not matter what we buy. But such talk obscures the fact that at any given point in time our economy is comprised of a specific set of goods and services, each with their own unique factors of supply and demand.

When market conditions change – either because of fickle consumers, foreign competition, rising oil prices, a stock market bubble, or a housing bubble – the mix of goods and services that existed before the change is no longer suitable to meet the market conditions that exist after the change. For example, if consumers decide they want more milk and fewer eggs, no amount of consumer demand is going to magically turn eggs into milk. Farmers are going to have to raise fewer chickens and more cows, and that takes time and investment.

The production of goods and services involves a series of steps in which raw materials are transformed into intermediate goods which are

transformed into finished products. This process takes time. For example, to make bread, we need to grow wheat. To grow wheat we need to plow land. To plow land we need tractors. To build tractors we need glass, plastic, rubber, steel, and so on. Nearly every step of this process relies on experienced workers with unique skills and knowledge who utilize specialized tools and material designed to meet their specific needs.

Given the complex structure of production, an increase in the demand for bread cannot readily bring about an increase in the supply of all the things needed to produce more bread. Likewise, a reduction in the demand for bread cannot readily convert all of the people, places, and things previously used to produce bread into some other productive alternative.

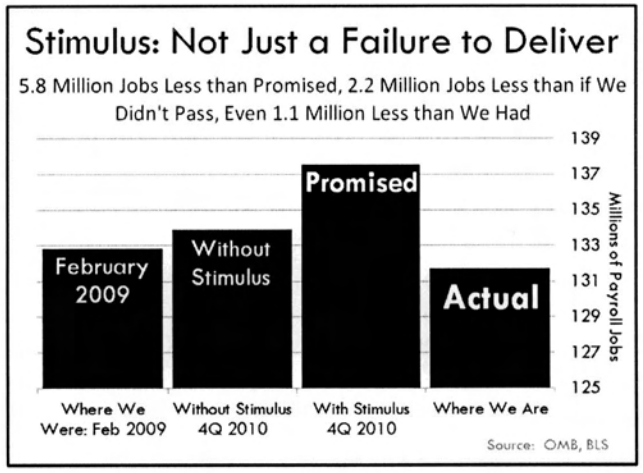
Government efforts to stimulate aggregate demand can neither force people to buy things they do not want, nor transform unwanted items into things people do want. Realigning our economy in a manner consistent with changing market conditions takes time and investment. Efforts to stimulate more consumption can only come at the expense of the investment needed to bring about the necessary economic realignment.

Every dollar the government spends has a cost, regardless of whether the dollar comes from taxes, borrowing, or the printing press. When the government spends money, it diverts workers and resources from alternative uses. Unemployed workers who obtain government-funded jobs delay their search for other employment. Employed workers who are diverted from their current jobs into government-funded jobs reduce the output of other goods and services.
Government-funded jobs fail to reflect consumer preferences and divert workers and resource from other activities, thereby increasing demand while reducing supply. The result is more inflation and less growth.

The only way the government can increase economic growth is by spending other people's money more efficiently than they would. Given the fact that government spending is driven by politics, instead of economics, there is no reason to believe government-funded jobs for non-core government functions provide any net benefit to the economy.

*WEAK RECOVERY AND SLUGGISH EMPLOYMENT GROWTH*

The ERP 2012 should recognize that the Keynesian stimulus authorized by the *American Recovery and Reinvestment Act of 2009* failed to produce the number of payroll jobs or reduce unemployment to the rate that senior Administration economists had promised. This failure did not occur, as the Administration contends, simply because the recession was deeper than senior Administration economists had forecast in January 2009. Instead, the failure reflected a deep misunderstanding of how our economy actually works, what caused the recession, and what policies would produce a vigorous recovery.




The December 2007-June 2009 recession was triggered by a global financial crisis that followed the bursting of an unsustainable housing bubble. Both macroeconomic and microeconomic factors contributed to the inflation of this housing bubble during the last decade.

At the macroeconomic level, the Federal Reserve's monetary policy was overly accommodative between the beginning of 2002 and early 2006. Consequently, interest rates were too low for too long. Intense international price competition in tradable goods and services ensured that monetary ease flowed disproportionately into asset prices.

At the microeconomic level, the Administrations of both President Bill Clinton and George W. Bush pursued regulatory policies under the *Community Reinvestment Act of 1977* to increase the homeownership rate among low- and moderate-income households by pressing banks and other financial institutions to relax the credit standards for residential mortgage loans and to expand the number of residential

mortgage loans extended to low- to moderate-income households. At the same time, the Clinton and Bush Administrations ratcheted up the regulatory requirements under the *Federal Housing Enterprises Financial Safety and Soundness Act of 1992* for Fannie Mae and Freddie Mac to purchase residential mortgage loans extended to low- to moderate-income households or RMBS containing such loans.

Banks and other financial institutions extended residential mortgage loans to increasingly higher risk low- to moderate-income households knowing that these risky loans could be sold to Fannie Mae and Freddie Mac for inclusion in agency RMBS or to investment banks for inclusion in private RMBS that could, in turn, be sold to Fannie Mae and Freddie Mac. The status of Fannie Mae and Freddie Mac as government-sponsored enterprises gave their debt securities an implicit federal guarantee. Fannie Mae and Freddie Mac gained a competitive advantage that allowed them to borrow at very low interest rates, ballooning the size of their balance sheets.

Moreover, the Basel capital standards for banks gave residential mortgage loans and RMBS a lower risk-weighting than most other private loans or debt securities. Thus, the Basel capital standards encouraged banks both in the United States and other developed countries to increase their exposure to residential mortgage loans and RMBS on their balance sheets.

Collectively, these microeconomic distortions ensured that excessive monetary ease artificially boosted housing prices, encouraged many households, especially those with low- to moderate incomes, to borrow more than they could afford to buy houses, and caused overinvestment and sometimes malinvestment in the housing sector, and promoted an excessive concentration in housing-related debt at banks and other financial institutions.

According to the seasonally adjusted S&P/Case-Shiller 20-City Home Price Index, housing prices fell by 31.3% from their peak in July 2006 to October 2011.[23] Because of this price decline, owner's equity in residences by U.S. households fell by 46.2% from a peak of $13.5 trillion in the first quarter of 2006 to $6.2 trillion in the third quarter of 2011.[24]

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[23] S&P, Fiserv, and MacroMarkets LLC/Haver Analytics.

[24] Flow of Funds, B.100 Balance Sheet of Households and Nonprofit Organizations (household real estate less home mortgage loans), Federal Reserve/Haver Analytics.

When President Obama took office on January 20, 2009, he failed to recognize that the fundamental problem plaguing the U.S. economy was a policy-induced misallocation of resources in housing and housing finance. Economists Carmen Reinhart and Kenneth Rogoff have found the negative economic consequence of the collapse of a debt-financed asset bubble can persist for years.

A vigorous recovery after a bubble collapses requires a far different set of policies that the Obama Administration has pursued. President Obama should finally advocate pro-growth economic policies.

*COMPREHENSIVE TAX REFORM*

In the current environment, the most important objective of economic policy should be to stimulate nonresidential fixed investment in new buildings, equipment, and software because business investment drives private sector job creation. To achieve this objective, the ERP 2012 should endorse a comprehensive reform of the federal tax system to increase the expected after-tax return on new business investment.

The United States has the second highest combined federal and average state corporate income tax rate in the world. In most cases, the present value of the tax depreciation and other allowances for business investment is less than the cost of such investment. At the same time, special-interest tax provisions in the tax code bias economic decision-making and reduce the efficiency of the U.S. economy by misallocating resources. And the United States is globally notorious for the complexity of its tax code.

The ERP 2012 should endorse a comprehensive tax reform that (1) lowers the corporate income tax rate; (2) moves from worldwide to territorial taxation of business income; (3) allows for the expensing of new business investment in equipment and shortens the tax depreciation schedule for buildings; (4) ends the double taxation of corporate income; and (5) eliminates the economic distortions created by special interest provisions in the tax code. Such a reform would provide a powerful boost to economic growth and job creation in the United States.

*BUDGET PROCESS REFORM*

The ERP 2012 should announce that President Obama now favors a series of constitutional and statutory reforms to reduce the present bias

toward ever higher levels of federal spending, federal budget deficits, and federal debt as a percentage of GDP. The ERP 2012 should endorse constitutional amendments that would (1) limit federal spending on discretionary and mandatory programs to a fixed percentage of potential GDP; (2) require a balanced federal budget; and (3) require a supermajority vote of each House of Congress to raise federal taxes. Furthermore, the ERP 2012 should endorse a law that would require the President to prioritize all federal spending on discretionary and mandatory programs in the annual Budget.

*ENTITLEMENT REFORM*

The projected growth in outlays for Social Security, Medicare, Medicaid, and other medical entitlement programs over the next 25 years is unsustainable.

In the *2011 Long-Term Budget Outlook*, the Congressional Budget Office estimated that under its alternative baseline scenario, which largely represents a continuation of current policies, outlays for Medicare, Medicaid, and other medical entitlement programs would balloon from 5.6% of GDP in fiscal year 2011 to 10.4% of GDP in fiscal year 2035, while outlays for Social Security would increase from 4.8% of GDP in fiscal year 2011 to 6.1% of GDP in fiscal year 2035.

Because of the explosive growth of these programs, federal budget deficits would expand from 9.3% of GDP in fiscal year 2011 to 15.5% of GDP in 2035, while federal debt held by the public would swell from 69% of GDP at the end of fiscal year 2011 to an incredible 187% of GDP at the end of fiscal year 2035.[25]

Unless Social Security, Medicare, Medicaid, and other medical entitlement programs are reformed, the United States will sooner or later face a debt crisis similar to the one that has overwhelmed Greece.

In the ERP 2012, President Obama should detail specific reforms to Social Security, Medicare, Medicaid, and other medical entitlement programs that would stabilize the outlays for these programs as a percentage of GDP. The ERP 2012 should be honest with the American people. While the federal government will be able to meet all of its existing entitlement commitments to today's senior citizens,

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[25] Congressional Budget Office, *2011 Long-Term Budget Outlook* (June 21, 2011), 8. Found at: http://www.cbo.gov/ftpdocs/122xx/doc12212/06-21-Long-Term_Budget_Outlook.pdf.

the federal government cannot meet all of its existing entitlement commitments to future generations. It is economically and morally wrong to promise future entitlement benefits to younger workers that the federal government will not be able pay.

The ERP 2012 should propose benefit changes to ensure that Social Security, Medicare, Medicaid, and other entitlement programs are sustainable for generations to come. Moreover, ERP 2012 should propose changes to the tax code to encourage younger workers to increase their retirement savings.

*REGULATORY REFORM*

The cost increases associated with new regulations and the uncertainty over higher costs from future regulations have served as a brake on business investment and job creation during the current recovery. The ERP 2012 should announce a freeze on issuing new regulations and a comprehensive review of all existing laws and regulations to identify costly, burdensome, ineffective, or unnecessary provisions. When possible, the Administration should eliminate these provisions by executive orders. When this is not possible, the Administration should propose a comprehensive regulatory relief bill so that Congress can make the necessary changes in the underlying statutes. The ERP 2012 should announce that President Obama now favors a mandatory review by Congress of all proposed regulations that would impose $100 million or more in new costs on the U.S. economy.

The ERP 2012 should announce that President Obama would propose a gradual liquidation of Fannie Mae and Freddie Mac, which have been operating under federal receiverships since September 6, 2008. The ERP 2012 should state that President Obama will ask Congress to repeal the low- to moderate-income housing finance provisions of the *Community Reinvestment Act of 1977* and the *Federal Housing Enterprises Financial Safety and Soundness Act of 1992* that distorted the housing finance market and helped to inflate the housing bubble during the last decade. The ERP 2012 should announce that the Administration would remove any regulatory barriers that are discouraging private housing finance based on sound underwriting standards. The ERP should also indicate that the Administration will work with other major countries through the Basel Committee on Banking Supervision to revise the Basel capital standards to eliminate the bias that encourages banks to invest in certain assets such as residential mortgage loans, RMBS, and government debt securities.

*MONETARY POLICY REFORM*

Currently, the *Federal Reserve Act* establishes a dual mandate for monetary policy. Thus, the Federal Reserve must give equal weight to maintaining price stability and promoting full employment when formulating and implementing monetary policy.

In practice, most central banks have focused their efforts on achieving long-term price stability because a consensus exists among economists that monetary policy only affects employment levels in the short term, whereas fundamental market factors (e.g., productivity growth and innovation, which are largely driven by tax and regulatory policies) affect employment levels in the long term.

Since an environment of price stability is conducive to long-run economic growth, achieving long-term price stability necessarily maximizes the sustainable positive effect monetary policy can exert on employment over the long term.

A recent study by the vice president of the Federal Reserve Bank of St. Louis, Daniel Thornton, echoes this analysis and provides an additional perspective through a historical analysis of the FOMC's statement of policy objectives.[26] Interestingly, the Federal Reserve had never mentioned the maximum employment prong of the dual mandate in its statement of policy objectives (which is found within the policy directive the FOMC votes on every six weeks) until December 2008, almost 30 years after the dual mandate was created. This first mention occurred just before the Federal Reserve began its first large-scale asset purchase program (QE1). Again, in November of 2010, as the second program (QE2) program was initiated, "[r]eference to the objective of maximum employment was more prominent."[27] Although it is unclear whether these references indicate a substantive change in Federal Reserve policy, they do suggest that Federal Reserve governors might be using the maximum employment prong of the dual mandate as a "cover" for engaging in unconventional and discretionary policies.

The best way to achieve maximum employment is to pursue price stability. Given the Federal Reserve's possible use of the dual mandate as a basis for engaging in disruptive, discretionary policies, the ERP

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[26] Thornton, Daniel, "What Does the Change in the FOMC Statement of Objectives Mean?" *Federal Reserve Bank of St. Louis Economic Synopses No. 1* (2011).

[27] Ibid.

2012 should advocate replacing the current dual mandate with a single mandate for price stability.[28]

Moreover, many central banks, including the Bank of England, the European Central Bank, and the Reserve Bank of New Zealand, have successfully executed monetary policy by using an explicit target for the price inflation rate as measured by a broad-based index of goods and services prices.[29] The benefits of these targets are three-fold: (1) they increase accountability for monetary policy at the central bank; (2) they increase transparency of central bank monetary policy formation; and (3) they increase the independence of the central bank relative to elected policymakers. These targets vary in their construction; some are a specific inflation rate (e.g., 2% or 2.5%) and others are inflation rate bands (e.g., 1% to 3% or 1.5% to 2.5%). The majority of the existing targets define price stability as an inflation rate somewhere between 1% and 3%.

The Federal Reserve is now widely-considered as having an "implicit" inflation target; that is, although the Federal Reserve has not explicitly stated an inflation target, historical evidence suggests that the Federal Reserve does target a level of inflation close to 2%. Taking the additional step of requiring the Federal Reserve to "go on record" with their target, and stick to it, will help prevent episodes of discretionary policy in the future.

In measuring inflation, the Federal Reserve should consider the effects of monetary policy on asset prices and the potential misallocation of capital. While an easy monetary policy usually flows evenly into the prices of goods and services, an easy monetary policy sometimes flows disproportionately into the prices of different assets. In such cases, broad-based goods and services price indices (e.g., the consumer price index (CPI), the personal consumption expenditure (PCE) deflator) will not fully capture the price inflation occurring in the economy. As a result, the disproportionate impact of monetary ease on asset prices may cause unsustainable price bubbles in certain assets without broad-based goods and services price indices registering significant price inflation.

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[28] Thornton, Daniel, "The Case for 'Inflation First' Monetary Policy," *Federal Reserve of St. Louis Economic Synopses No. 47* (2009).

[29] Cobham, David (editor), *Twenty Years of Inflation Targeting: Lessons Learned and Future Prospects*, Cambridge University Press (2010).

## CONCLUSION

The ERP 2011 was a disappointing official document for the American people. The ERP 2011 exaggerated the positive effects of government intervention into the economy. The ERP 2011 reasserted the Administration's misguided faith in government control of the economy, while minimizing the importance of entrepreneurs and private businesses in economic growth and job creation.

The ERP 2011 was largely silent about the negative economic effects from the Administration's unprecedented deficit spending and accumulation of federal debt. The ERP 2011 ignored the higher regulatory costs burden imposed by the Administration's energy, environmental, and labor policies on private businesses and households. Moreover, the ERP 2011 disregarded how uncertainty over future tax increases and higher regulatory costs discourages business investment and job creation.

### *THE SIZE OF GOVERNMENT MATTERS*

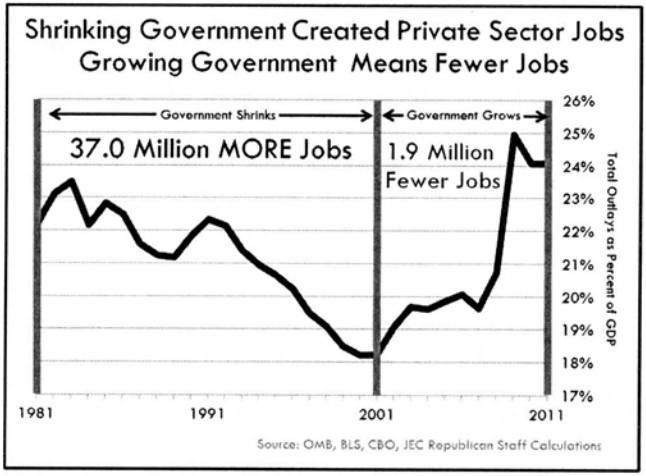
We are not sanguine about the prospects of this Administration recognizing the drag that government imposes on our economy and the threat that big and growing government poses for economic growth and job creation.

From 1981 to 2001, the size of the federal government relative to the size of the nation's economy declined significantly from 22.2% of GDP to 18.2% of GDP.

Since 2001, the size of the federal government has exploded. In each of the last three fiscal years, federal government spending has eclipsed 24% of GDP, even reaching a post-World War II high of 25% in fiscal year 2009.

As the chart on the following page shows, in the period when federal government spending as a share of GDP declined by 4 percentage points, the nation's economy created 37 million private sector jobs – an increase of 50%.

Since 2001, the story is very different. Private sector employment is actually lower by 1.9 million jobs than it was in January 2001.




As we mentioned earlier in this report, private investment, not government spending, is the key driver of job creation in our economy. This Administration needs to recognize the failure of government-controlled economic policies. Unfortunately, rather than switch course, this Administration seems intent on ending America's free market economy in favor of government control. If it is successful in continuing to expand the pervasive influence and control of the federal government, Americans can look forward to an economic future with fewer opportunities and a declining standard of living.

*RECOMMENDATIONS*

The Administration's economic policies have failed. The time for change has come. The ERP 2012 will provide President Obama with an opportunity to make an economic policy U-term. For the sake of our economy, we urge him to change his economic policies.

We urge the President use the ERP 2012 to (1) outline a comprehensive tax reform designed to raise the after-tax return on new private business investment to accelerate the recovery and create millions of new jobs; (2) support budget process reform designed to redress the bias toward ever higher federal spending and the accumulation of federal debt, including (a) constitutional amendments to (i) limit federal spending on discretionary and mandatory programs to a fixed percentage of potential GDP, (ii) require a balanced federal budget, and (iii) require a supermajority vote to raise federal taxes, and (b) laws to require the President to prioritize federal spending on discretionary and mandatory programs; (3) propose a comprehensive reform of Social Security, Medicare, Medicaid, and other medical

entitlement programs to make them sustainable over the long term; (4) announce a suspension of all new regulatory initiatives and reform existing regulations to reduce burdensome costs; and (5) advocate amending the *Federal Reserve Act* to (a) give the Federal Reserve a single mandate of price stability and (b) increase the transparency of monetary policy.

*Representative Kevin Brady*
*Vice Chairman*

*Senator Jim DeMint*
*Senior Republican Senator*

*Representative Mick Mulvaney*