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University of Massachusetts Amherst

10th floor Thompson Hall, University of Massachusetts, Amherst, MA 01003
(413) 545-6355, peri@econs.umass.edu, http://www.umass.edu/peri

Recession, Deficit Spending, and U.S. Economic Prospects

Robert Pollin*
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Even before assuming office, George Bush eagerly pounced on signs of a recession at the end of 2000 because he wanted to sell his program of tax cuts for the rich as the cure for recession. But tax cuts for the rich have never been an effective anti-recession measure—not to speak of whether they would be fair by any minimum standard of equity. Bush's specific proposal in particular couldn't possibly have worked at fighting the recession, since almost all of the tax cuts were to have been phased in starting in 2002, and the major impact of most of them would not have been felt until 2004. Meanwhile, the recession was happening in 2001. In addition, the illusion of Alan Greenspan as economic *maestro* had finally evaporated. Greenspan clearly had no answer to the stock market collapse. The only effective force fighting recession in 2001 was the expansion of government spending, especially at the state and local level. But state and local government budgets were then also tapped out by 2002 and falling into crisis. The federal government now remains as the only entity in the economy capable of picking up the slack. But the federal government means George W. Bush and company. As such, without some dramatic change in the political environment, our foreseeable economic prospects offer little room for optimism.

Digging out of Recession

The collapse of private investment was the primary force pulling down overall growth in 2001, as we can see from the upper panel of Table 1 (next page), which shows the sources of GDP growth in 2001. The U.S. position in world trade—i.e., our sale of exports minus our purchases of imports—also made a negative contribution to overall growth. If it weren't for two positive contributors to growth—overall household and government spending—the downturn would have been much more severe.

Ever-increasing levels of household debt were important in preventing a deeper recession over 2001, even while also producing highly fragile financial conditions for a large share of

* Robert Pollin is Co-Director of the Political Economy Research Institute and Professor of Economics, University of Massachusetts, Amherst.

households. But it is unlikely that further increases in debt-financed household spending will be sustainable, unless job opportunities and household incomes also start growing more rapidly.

Table 1. Government Spending and GDP Growth in 2001 Recession

Negative Contributors to Growth	
Private investment spending	-1.90
Exports less imports	-0.18
Positive Contributors to Growth	
Household consumption spending	+1.67
Government spending	+0.65
Other	+0.12
TOTAL GDP GROWTH	**+0.36**

Breakdown of Government Contributions to Overall U.S. GDP Growth in 2001

	Share of Government Growth Contribution
Federal Government Spending	+45 percent
Military Spending	+30 percent
Non-Military spending	+15 percent
State and Local Government Spending	+55 percent

Source: National Income and Product Accounts Table 8.2

And what about jobs and income themselves? The central point here is that the household sector of the economy, unlike private businesses and the government, does not, for the most part, hire people into jobs. It is rather where people come home from work after having been on the job, either with a private business or the government. With private businesses having cut back on their investment spending in 2001, this meant that the government sector was the most stable source of jobs as well. Thus, between the fourth quarters of 2000 and 2001, the private sector lost 1.3 million jobs, while the government sector gained 463,000. The government sector's positive contributions to the job market, in turn, provided firmer footing for consumers to increase their borrowing and spending. Thus, along with the increases of household debt itself, it is not an exaggeration to say that the growth of government spending was the major counterweight to the recession in 2001, preventing an even sharper downturn.

Government Spending and Growth

How did the government sector make its contribution to the economy's overall growth? Of course, the major new spending sources were all related to the September 11 terrorist attacks and war in Afghanistan. But direct spending by the military, though important, was not the primary factor. As we can see from the lower panel of Table 1, increased military spending did account for most of the contribution to overall growth by the *federal* government, with the military contribution to growth being 35 percent of the federal government's 45 percent total contribution. But a full 55 percent of the government's contribution to growth came rather from state and local governments.

The overall spending increases by state and local governments resulted from increased funding for domestic security measures while also maintaining or even increasing funds within the main additional budgetary areas of health, education and infrastructure. A large share of the overall increases resulted from spending programs that go up automatically in a recession when people's incomes go down, Medicaid being the major case in point here.

The problem is that the state and local governments cannot continue to increase their spending until they get more revenues, either from a growing economy or through receiving more funds from the federal government. This is because, unlike the federal government, almost all state and local governments are prohibited by law from running budget deficits. Many states were able to increase their spending over 2001 because they had built up "rainy day funds" during the 1990s boom years. But 2001 *was* the rainy day for these governments.

By 2002, most states were forced to impose major cutbacks in their budgets, including across-the-board program cuts, layoffs, early retirements, and reorganizations. Cutbacks were particularly severe among programs targeted at the poor. As of January 2002, Kevin Carey and Iris J. Lav of the Center on Budget and Policy Priorities reported that "More than two-thirds of the states have already taken steps to cut spending on programs that serve low-income residents." Public programs that serve low-income people are generally easier to cut since, of course, the direct beneficiaries of such measures tend to have little political power. The fact that the poor lack political power then translates into governments maintaining greater flexibility in the ways they fund these programs than is the case with other budgetary items.

But the post-recession fiscal crisis has also hit more rigidly administered budgetary areas, like education. The Detroit school district, for example, announced more than 650 layoffs in January 2002. The district also cut funding for summer school programs, significantly reduced the purchase of services and equipment, and cut maintenance costs by 10 percent. Buffalo, Miami, and Houston are among other cities making significant cuts in their school budgets this year.

On top of this, as of mid-2002, the Bush administration was planning to impose sharp reductions in the so-called "revenue sharing" funds that are channeled from the federal budget to state and local governments. In 2001, the federal government contributed $274 billion to state and local governments, which amounted to 21 percent of their total spending. The squeeze from the state and local governments' own revenue sources would suggest that these federal contributions should be increased. The cuts in revenue sharing proposed by Bush will instead create a still more critical situation.

The Bush cuts will come through two basic channels. First, the federal government will make major reductions in its support for programs other than those mandated by law. Including all non-mandated or "discretionary" programs, the Bush administration is proposing cuts of four percent for the 2003 fiscal year (assuming no inflation at all for 2002-03, and thus no additional cuts in spending levels due to inflation). Some of the major areas Bush proposes to cut are Community Development (-37 percent), Low Income Energy Assistance (-18 percent), and Drug-Free Schools and Communities (-17 percent). But in addition, the federal government tax cuts enacted in 2001 will themselves reduce the revenues received by state and local governments. This will occur because state and local governments depend on the federal government to establish what constitutes taxable income. If the federal government narrows the tax base through enacting new deductions, revenues to state and local governments would also fall.

Max Sawicky of the Economic Policy Institute estimates that overall spending cuts in state and local budgets for the fiscal year 2003 will amount to roughly $100 billion. Cuts of this magnitude would drag down overall economic growth by nearly one percent, i.e. substantially more than the state and local governments' positive contribution to growth in 2001. In other words, in addition to the damages inflicted on vital social programs and services, it is clear that, from an overall economic standpoint, state and local governments cannot continue as a leading engine of growth over the coming years as they were in 2001. They are rather poised to become a drag on the economy, probably to a substantial extent.

The Return of Federal Deficit Spending

Moving the country out of recession and a slow-growth trend will therefore depend heavily on the ways in which the federal government intervenes in the economy. For one thing, the federal government is the only source of funds for the short-term—i.e. 2003 and 2004—that can reverse the ongoing sharp contraction in state and local government spending. But more generally we are confronted with the issue of deficit spending by the federal government. This, of course, was the topic that, as recently as the 2001 budget forecasts of both the federal Office of Management and Budget and the Congressional Budget Office, to say nothing of the 2000 Presidential campaigns of both George Bush and Al Gore, had been dismissed as a passé relic of earlier economic times.

For 2001 the surplus contracted $127 billion relative to the 2000 surplus of $236 billion. The initial forecast of the Office of Management and Budget for 2002 was a deficit of $106 billion. But by June the OMB estimate of the deficit had risen to $150 billion. As OMB Director Mitchell Daniels Jr. acknowledged at the time, the reason he had to revise his deficit estimate upward by 50 percent by the middle of 2002 was that his initial forecast was based on the obviously precarious assumption that the stock market would be returning in 2002 to something approximating its dizzying growth pace of the 1990s. This, in turn, was to have generated an upsurge in capital gains tax revenues as well. We can now decide where to pile the OMB model amid the trash heap of forecasting failures. But a much more important issue is at stake: whether the shrinking of the federal surplus in 2001 and the subsequent return to deficits is good or bad for the economy. To answer this question, we need to look at how deficits are likely to affect the economy during both recessions and growth periods, as well as at the tax and spending priorities of the Bush administration.

Deficits in the Short Run: Stimulus or Not?

If we are considering the impact of government spending on economic growth during and immediately after the 2001 recession, the answer is straightforward: if the federal government had maintained a surplus at its 2000 rather than its 2001 level, this would have eliminated the government's positive contribution to economic growth in 2001. The recession would have been far more severe.

Deficit hawks take an opposing view, claiming that deficit spending may be having a dampening effect on economic growth. But their analysis does not stand up to closer scrutiny They argue that eliminating the surplus prevented long-term interest rates from falling more sharply in response to Alan Greenspan's aggressive cuts in the short-term Federal Funds rate. For example, the Baa corporate bond rate fell only from 8.9 to 8.0 percent over the 18 month period in which Greenspan cut the Federal Funds rate from 6.4 to 1.75 percent. The immediate reason was that lenders in financial markets feared that the evaporation of the surplus and return to deficits would bring higher inflation rates. Of course, such presumptions of higher inflation are, yet again, based on forecasts whose credibility by this point should be nonexistent. Regardless, lenders managed to protect themselves against potential future inflation by maintaining high long-term interest rates. As a result, the deficit hawks argue, allowing the surplus to evaporate has been a self-defeating proposition. Though it produced a stimulus to the economy through increased government spending, it simultaneously generated the depressant of higher interest rates for business borrowers.

The debate, in other words, boils down to whether or not the stimulus of increased government spending has a stronger effect on the economy in the short term than the depressant of higher interest rates. Fortunately, there is a straightforward way of sorting out the merits of the alternative perspectives as they apply to the current situation. The basic point is this: the increased government spending in 2001 and 2002, funded by drawing down the surplus and moving into deficits, injected a *direct, certain, and significant increase of spending into the economy*.

If, alternatively, government policy was committed to maintaining a large surplus even in recession, the mechanism for fighting the recession would be far more tenuous. The effectiveness of the strategy would depend entirely on 1) the private financial markets—still, as always, in the grip of their forecasting newsletters—deciding that long-term interest rates might indeed be ready to fall significantly; and 2) corporations deciding to borrow at these lowered rates to finance increases in their investment spending. However, corporations were already carrying too much debt as well as too much productive capacity relative to the demand for their products. Even at low interest rates, why would corporations choose to increase their productive capacity when they weren't making full use of the equipment they already had? Moreover, since the strategy of lowering interest rates also meant imposing cuts in government spending, that would bring even weaker overall demand for the products that the corporations produce and, therefore, still less use by the corporations of their existing productive capacity. In short, the effects of the federal budget on long-term interest rates, and, in turn, of interest rates on investment, are all fraught with uncertainty.

Deficits in the Long-Run: Spending for What?

The necessity of running federal deficits to move the economy out of the 2001 recession and ongoing slow growth path does not mean that Bush, or his successors, should be granted a Reagan-style carte blanche on deficits. Deficits will need to be closed at the time when the economy reaches a new upswing of growth, with the exception of borrowings to finance long-term capital projects as opposed to year-to-year current account budget items. If the government were still running deficits on its current account budget at that point, it would almost definitely be the result of the tax bonanzas Bush showered on the rich. Under these circumstances, moreover, the continuation of deficits would then create new pressures for cuts in social spending, just as occurred during the Clinton years of eliminating "big government."

These longer-term considerations become clearer through examining Bush's spending projections for the next several years. Of course, these projections are based on economic forecasts; the administration projects average GDP growth after inflation of around 3.5 percent between 2003 and 2007, along with a 2.3 percent average inflation rate. These forecasts, as with all the others we have discussed, are no doubt riddled with errors. Still, the administration's budget estimates are useful in providing a sense of Bush's longer-term budgetary priorities.

The Bush administration projects total federal spending in 2007 at 18.1 percent of GDP. This is exactly where government spending was in 2000, the least year under Clinton. So clearly, under Bush-2, there is no going back to the "big government" days of his father, when federal spending was around 22 percent of GDP. For 2001, this difference between a federal budget at 18.1 versus 22 percent of GDP would mean nearly $400 billion of government spending, or about $1,400 for every U.S. resident. But Bush-2 also does not anticipate any further cuts in the overall size of government beyond those that Clinton had already achieved.

What priorities do the administration's spending plans reflect? The biggest jump is projected for military spending. Bush would like military spending to rise from $295 billion in 2000 to $442 billion in 2007. This means it would absorb 17.9 percent of the projected 2007 budget, as opposed to 16.5 percent in 2000. The fact that the September 11 terrorist attacks were carried out by men armed with box cutters has clearly not prevented the Bush administration from concluding that the war on terrorism requires more, and more expensive, weapons systems.

The other large increase would be for health expenditures. The Bush administration plans for this to rise from $154 billion in 2000 to $318 billion by 2007. This would mean a jump in the share of the federal budget devoted to health from 8.6 to 12.9 percent. Expenditures on Medicaid, which is separate from the overall health budget, and on education are also projected to increase substantially by 2007.

How then are these spending increases to be financed, especially given the major tax cuts that Bush has already pushed through and his plans for additional cuts? The administration is counting on a return to large fiscal surpluses, such that by 2007, interest payments on the government debt will fall by five full percentage points, from 12.5 to 7.5 percent, relative to the 2000 budget figure.

In other words, the Bush spending projections are based on yet another forecasting charade. The stated Bush agenda is as follows: to dramatically expand the military, to substantially increase health and education spending as well, to deliver continued tax cuts for the rich, while making no major cuts in any other government spending programs, yet still returning the budget to surplus such that interest payments on the government debt fall dramatically. Obviously, not all of these things will happen.

What will rather most likely happen as long as Bush is President is that he will fight hard for his real priorities, which are the tax cuts and military increases. Increased spending on health and education will then either be jettisoned or persistent deficits will return. Such deficits—to finance the military and more take-home pay for the rich—are hardly to be celebrated in the spirit of John Maynard Keynes. They will rather represent a return to Reaganomics. But there will be one major departure even from the Reagan period. We have already mentioned how the federal government's share of the economy shrank significantly under Clinton. To therefore push a Reagan-style agenda onto a government sector that has already experienced 'the end of the big government era' under Clinton will mean that any further contractions in social spending will cut even deeper to the bone.

Overall then, Bush needs deficit spending, revenue sharing for state and local governments and, more generally, a return to big government—that is, a growing share of total spending in the economy—to retrieve the U.S. economy from the quicksand of the stock market collapse. Big government is the economy's only viable growth engine for the foreseeable future. But a big government solution to the growth dilemma cannot be made legitimate under Bush, given his obvious commitment to use government policy as fundamentally a means of handing out favors to the already rich and privileged. Still, Bush possesses one prospective escape hatch, courtesy of Osama bin Laden and more recently Saddam Hussein. This is the possibility that he can transform the "war on terrorism," the "pre-emptive" war on Iraq, or some combination of the two, into a new government-led growth engine. The central debates under Bush around government spending, the deficit, and economic growth itself will therefore hinge almost entirely on a set of highly contentious political issues—namely, the questions of war and income distribution.

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