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A Recession, an Election, and the Rhetoric of Change

The U.S. economy may seem on the ropes, but don't count it out just yet. It has sustained bigger hits in the past and still continued to grow.

BY WILLIAM A. MCEACHERN

ABC pundit Sam Donaldson says the economy is "in the dumper…in a deep recession." *Newsweek* has a cover story on recession, and the stock market is down sharply on recession jitters. According to polls, more than half of Americans believe we are already in a recession, and they expect overwhelmingly that the economy will get worse.

The verdict seems unanimous: The economy is in a recession. That's a reasonable take on current events. After all, risky mortgages have cost some families their homes, and overzealous lenders have lost more than $100 billion. Add to that plummeting house prices, a country still at war, repeated trade deficits, a weak dollar, and a growing national debt, and presidential challengers have plenty of reasons to talk about change. (Incidentally, the party out of office typically talks down the economy during presidential campaigns; that itself can depress both consumer confidence and the stock market.) What's more, if the economy were not in big trouble, why would the Fed be cutting interest rates so aggressively, and why would Washington be sending most everyone rebate checks?

Although the U.S. economy may seem on the ropes, don't count it out just yet. Home foreclosures can be personal tragedies, and the subprime meltdown is a punch in the gut. But the U.S. economy has sustained bigger hits in the past and still continued to grow. For example, in the mid- to late-1980s, risky real-estate loans contributed to more than 2,000 bank failures, the biggest banking collapse since the Great Depression. Shutting down those banks and bailing out their depositors cost the nation over $400 billion in today's dollars. Yet the U.S. economy continued to grow during those failures, before slipping into a brief recession in 1991, about the time of the first Gulf war.

The recent subprime-loan defaults have hurt big and small banks alike, but how many banks do you suppose have failed so far? Of the nation's 16,000 savings and commercial banks, only three failed in 2007, and so far in 2008, only one has failed. True, many mortgage companies have closed their doors, costing thousands of jobs, but because they get their money from financiers, not depositors, the damage to the larger community is more contained.

During the century prior to World War II, economic expansions, on average, lasted a little longer than recessions (29 months versus 21 months). Since World War II, though, expansions have lasted nearly six times longer than recessions (57 months versus 10 months). The current expansion, which began in late 2001, is now more than 6 years old. And the expansions of the 1980s and the 1990s lasted nearly ten years each.

One reason the U.S. economy can now take a punch better is that the Federal Reserve Board has learned to do a better job. During the Great Depression, the Fed was part of the problem, shrinking bank liquidity just when otherwise sound banks needed to cover depositor withdrawals. Now, at the first sign of trouble, the Fed assures financial institutions that sufficient liquidity will be there if needed. Business media love the breakfast-cereal metaphor of a "credit crunch," but

the world is in fact awash in liquidity. The crunching sound these days is from lenders, once burned, having grown more cautious. That's not a bad thing.

Another source of macroeconomic resilience is the many automatic stabilizers that have been built into the federal budget and, to a lesser extent, into state budgets. Progressive income taxes, unemployment insurance, welfare benefits, and the earned income tax credit were all originally designed to redistribute income, and they do that. But they also reduce troublesome swings in the economy.

Since World War II, real GDP has declined year-over-year only seven times. That's seven years out of the last 60. Consumer spending, which accounts for two-thirds of GDP, has declined only twice year-over-year—by 0.8% in 1974 and by 0.3% in 1980. Without much fanfare and with little public recognition, automatic stabilizers have been quietly doing their job, keeping the economy on a more even keel.

So I'm not ready to concede that the U.S. economy is in a recession or even headed for one this year. The same goes for the Connecticut economy. But for the sake of argument, suppose the economy is heading south. The Fed's interest rate cuts will soften the blow. How about the "fiscal stimulus"? Not so much. People tend to spend less of a one-time increase, such as these rebates, than they would from a permanent increase in income. If they expect harder times, they'll save even more of any windfall. More important than the rebates are the automatic stabilizers, already in place.

If a recession does set in, will its duration depend on who gets elected president in November? Probably not. The average recession since World War II has averaged only 10 months (and the most recent two recessions averaged only eight months each). So any recession now underway would probably be over by the time the next president takes the oath of office on January 20, 2009.

Connecticut's fortunes will depend more on what happens to the Bush tax cuts, which are set to expire in 2010. Arguably, Connecticut's state budget has recently enjoyed surpluses in part because of the Bush tax cuts.

Many argue that the Bush tax cuts were unfair because most of the benefits went to high income households. But *rates* were actually cut proportionately more for lower income taxpayers. The top marginal tax rate fell by nearly one-eighth, from 39.6% to 35%, while the bottom rate dropped by one-third, from 15% to 10%. The Bush cuts took millions of families off the tax rolls altogether.

More important for Connecticut were the reductions in rates for dividends and capital gains. Top rates were cut to 15%. Those in the two lowest income brackets now pay no taxes on dividends and capital gains.

It is commonly thought that "working class families" get whacked by federal income taxes, while the rich pay less than their fair share. The facts show otherwise. For the 2004 tax year, the top 1% of tax filers, by income, paid 37% of all federal income taxes collected; their average tax rate was 24%. The top 10% paid 68% of all federal income taxes collected; their average tax rate was 19%. These two groups pay a higher share now than before Bush took office. In contrast, the bottom half of all filers paid only 3% of all federal income taxes collected, and their tax rate averaged only 3%. This incidence pattern is roughly the same for Connecticut's income tax.

It is tempting for politicians, mid-campaign, to focus on whose total tax cut was bigger, rather than on the total impact of a new tax structure on the economy. Looking beyond the primaries, one might hope for greater recognition of the role lower taxes play in creating new jobs for middle-class folks or those aspiring to be. It would be nice if things changed—but they probably won't.

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