

A Perspective on the Perilous State of the Economy

by Raymond Jackson

There is an almost universal assessment that the United States economy is in a perilous state. Unease abounds that the major economic decision makers from elected government officials, industrialists, bankers, labor organizations, and even the Chair of the Federal Reserve (Fed) do not have a real strategy to regain growth and prosperity. Previous post-WWI recessions were largely a product of the business cycle where autonomous fluctuations in investment, consumer spending, technology, interest rates, foreign exchange rates, and demographic trends determined the course of economic activity. An expansionary fiscal policy (the use of government expenditure and revenue collection to influence the economy) plus an accommodating monetary policy (regulation of the money supply) were often very effective in counteracting a negative cyclical factor in a relatively short period of time measured in months.

However, the recent recession followed by slow job growth has its roots in a severe financial crisis rather than the business cycle just as the Great Depression of the 1930s. Today, as in the Great Depression, there also has been a significant reduction in consumer wealth arising from double-digit declines in the value of residential property and in financial assets such as equity retirement funds. Consumer spending is not only a function of income but includes a wealth component that in this case will cause spending during the recovery to be less than anticipated even when employment and incomes rise.

In this environment of financial crisis and declining wealth, it is unlikely that the traditional instruments of fiscal policy or an expansionary monetary policy or a combination of both could be expected to achieve positive results very quickly. Recall that after years of progressive New Deal legislation and the completion of numerous remarkable public works programs, the unemployment that had been 23.6% in 1932 stood at 17.2% in 1939.

Recently compiled statistics convey succinctly the current weak economic situation. The nation became accustomed to years of what might arguably be described as prosperous times. From January 2000 to July 2008 the U.S. unemployment rate varied within a

narrow range of 4.0% to 6.0%, a performance admired both here and abroad. In the last quarter of 2008, as the financial crisis took hold, the unemployment rate started rising and then hit a peak of 10.1% in October 2009. Since its peak the rate declined only modestly to 9.6% in August 2010. Economic growth also has been disappointing. In the last quarter of 2009 growth was an impressive 5.0% but has fallen to a weak 1.6% in the second quarter of 2010. The federal stimulus has not stimulated significant additional spending or employment and the historic low interest rates orchestrated by the Fed, have led to a sharp increase in refinancing but not in real investment. There are two reasons for the lack of positive impact, in addition to the decline in wealth – a climate of uncertainty that has been created and failed economic policies.

A Climate of Uncertainty

The Obama legislative agenda has moved forward successfully on a number of fronts such as health care and financial reform and will soon deal with taxes for 2011 (this was written in September 2010). The merits and deficiencies of this legislation are not debated here but there is little doubt they have created a climate of uncertainty, particularly among businesses both large and small, who at this moment do not

really know the cost of hiring a new employee when health insurance is key part of the compensation package. A business or an individual cannot be sure how a request for a loan will be approved. Everyone at this moment is unable to reliably forecast their future tax liability even one year in advance.

The health care bill added a new set of taxes and sweeping mandates affecting individuals, small businesses and large companies. The new taxes include (1) a Medicare Payroll tax on investment income targeted to upper income taxpayers (2) an excise tax of 40% paid by insurance companies on "Cadillac" insurance plans worth more than \$27,500 (3) a requirement that the value of employer provided health insurance must be added to an employee's W2 form as reported income and (4) a quirky 10% tax on indoor tanning services.

The mandates in health care include (1) employers with more than 50 employees must provide health insurance or pay a fine per employee (2) most small business are required to provide insurance but will receive tax credits (3) individuals without insurance must acquire it or be fined and (4) health insurance companies must allow children to remain on the family plan until the "child" is 26 years old. Much of the health insurance mandated for the uninsured, small businesses, and the self-employed will be bought through yet to be established state-operated insurance exchanges. This may be the best way to move the nation forward on health care but the taxes and mandates add a heavy dose of uncertainty to an economy trying to restore economic growth and directly affect a business contemplating the cost hiring additional workers.

The financial reform bill does indeed reform but with similar unpredictable outcomes. The main thrust is improving institutional safety and consumer protection through regulation and oversight. The real cost may be high though in terms of a limiting a financial institution's willingness to assume

reasonable risks lending to small businesses and fledgling entrepreneurs. Consumer protections may drive subprime lenders from the marketplace and provide a disincentive for banks to provide financial services to those with less than exemplary credit scores.

The new agencies created include the Bureau of Consumer Financial Protection and the Financial Stability and Oversight Council to monitor the systematic risk across the system and dismantle failing firms that threaten stability. For added safety, capital reserves for banks will be increased and additional regulations will be imposed on investments in hedge funds and the use of derivatives. It is unclear how these agencies will function or whether they have the expertise to carry out their mandates. Banks with higher reserve requirements may be safer but earn less and take fewer risks. Hedge funds under the watchful eye of regulators may be hesitant to take the risky positions that have made them a successful, albeit controversial, player in the financial marketplace.

While financial institutions are absorbing the implications of U.S. reforms, a new set of rules, similar in nature is being crafted by the twenty-seven country Basel Committee on Banking Supervision. The resulting international agreement worked out in Basel will have to be adopted by each of the participating countries including the U.S. As with health care, financial reform as written in Congress and in Basel may be necessary but does add to the unease that is likely to keep banks treading water and watchful rather than taking the lead in extending credit and promoting economic growth.

This nervous economy is also uneasy about the vagaries surrounding taxes for 2011 and beyond. Tax rates on dividends and capital gains may or may not increase. Allowed exemptions and deductions may or may not be phased out as taxable income rises. The new tax bill may try to ensnare more or fewer

taxpayers with the Alternative Minimum Tax (AMT). What is definitely known is the aforementioned requirement that the value of employer provided health care be reported on an employee's W2 form as income and, therefore, subject to taxation.

Failed Policies

The financial crisis has spawned a record number of foreclosures that has created downward pressure on housing prices and threatened the stability of neighborhoods as "For Sale" signs sprout. Under the Federal government's anti-foreclosure program homeowners can either have their mortgage payments reduced to 31% of monthly income by extending the term of the mortgage or by having the interest rate set at 2%.

The program could have been beneficial but has been a failure. The Administration claimed that upwards of 4 million people would be helped by the proposed mortgage modifications. Data released at the end of July 2010 show that only 1.3 million modifications were made and of this number 530,000 had to be cancelled primarily due to non-payment and incomplete documentation. Almost half of homeowners who cancelled negotiated a better mortgage arrangement without government intervention.

A portion of the \$787 billion stimulus package was designated for the Cash for Clunkers Program and a Cash for Appliances Program. Both were expensive but both had minimal success in generating job growth. Over two months the government paid about \$4,000 each to buy back 360,000 clunkers. A recently

released study suggests that auto sales were down by 360,000 in the following seven months making the program a wash. The shifting of auto sales from the near future to the present may have been a benefit to some auto dealers, but it came with a price tag of \$1.44 billion not including administrative costs.

The still running state-run federally funded Cash for Appliances Program has a \$300 million budget. Consumers would receive rebates for a purchase of an energy efficient appliance. Only \$108 of the \$300 million has been paid out. In some states the qualifying rules are too complex while in others the rebates are limited to at most \$50. There is no evidence that this program contributed anything in the way of stimulus.

Prediction and Suggestion

The economy cannot be expected to resume robust growth until the implications of the healthcare initiative, financial reform, and the future tax bill are more fully known and understood. In this climate of uncertainty the wished for prosperity accompanied by job creation is not likely to occur in the near future. The failures of the anti-foreclosure program, Cash for Clunkers, and Cash for Appliances is another sobering reminder that it is best to be skeptical about Washington's ability to get it right. The government should also spend more time rethinking priorities. At this moment, preventing foreclosures should be a top priority while hundreds of millions of dollars to buy old cars and encouraging the purchase of newer washing machines are not.

