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From recent news reports, one might think that the US economy was in great shape. The estimated rate of growth in GDP in the 3rd quarter was a very strong 8.2% and the Dow Jones climbed back above 10,000 last week. The economic recovery now seems genuine. Furthermore, forecasts are for growth to continue strong, in the vicinity of 4%, into the coming year. This is very significant politically, of course. Past history suggests that the outcome of presidential elections is heavily influenced by the rate of change in the economy during the year preceding the election, rather than either by economic performance over the entire preceding four years, or by longer term prospects. Voters have short memories, and tend to react to what they read in the most recent newspapers. The truth, however, is that virtually nothing about the economy looks as good from a longer term perspective.

Democrats emphasize that the economy has lost well over 2 million jobs since President Bush took office, more than under any president since Herbert Hoover. The loss in employment is even worse if one excludes government hiring, or focuses on the manufacturing sector. Democratic presidential candidates may be hoping that continued high unemployment will deprive the second George Bush of a second term in 2004 as it did to the first George Bush in 1992.

In response to the jobs situation, Bush supporters take one of two (very different) tacks. The first is to emphasize that employment has finally begun to rise over the last five months. The White House argues that it is just that the hiring has come with a lag after firms began to increase output two years ago. As in the recovery from the 1990-91 recession, firms have waited to hire until they are sure that the expansion is well-established, as it now is. The second response is to argue that the divergent paths of output and employment represent an economically beneficial acceleration of long-run productivity growth. The merit in each of these arguments is, however, limited.

Contrary to the way it might appear in some news reports, the recent expansion of employment has been anemic. Even measured relative to the lowest point in June, the increase in jobs has averaged a mere 54 thousand per month. To be sure, this is an improvement over the steep loss of jobs that preceded it. But by any other benchmark, it is a poor performance. During the eight years of the Clinton Administration, the growth in employment averaged 240 thousand per month. Treasury Secretary Snow himself, in October, set a modest benchmark of two million jobs to be created by the election, or 167 thousand jobs per month. The recent numbers are not enough to keep pace with the rate of growth of the population, let alone to make up for the previous decline.

Some say that the standard payroll employment numbers, which come from the establishment survey of the Bureau of Labor Statistics, substantially understate job growth. They say that we should instead look at the household survey – the one that the BLS uses to compute the percentage unemployment rate – which shows a faster rate of growth in employment. Their argument is that the government statisticians are behind the times, failing to recognize the importance of new start-up firms, which are missed in the survey of business establishments. Unfortunately, this argument is wrong. The job numbers from the establishment survey probably remain the more reliable of the two sets of statistics, because it is based on a larger sample. The BLS has made progress in recent years in adjusting the numbers for the effects of new start-up firms. (Furthermore, the household survey numbers in 2003 may bias estimated job growth upward, because the result of the 2000 Census was to locate in the post-2000 years an upward revision in population that really belongs spread over the 1990s.)[i] It is the critics who are out of date. Thus the first response is not persuasive. The "joblessness" of the recovery to date is genuine.

The other line of defense of the jobless expansion is that it represents an acceleration of long-run productivity growth, which is good for the national economy in the aggregate, even if in the short run it is hard on those who are laid off. Perhaps the full benefits of the Information Technology revolution of the 1990s are only coming on-stream in the current decade.

It is true, as a matter of definition, that if GDP grows more rapidly than employment – outputs are increasing more rapidly than inputs -- then productivity is growing. It is also true, in the long run, that productivity growth is the means whereby countries are able to raise their standard of living from one generation to the next. But an alternative interpretation of recent productivity numbers is possible. In the 1990s, corporate executives and stock market analysts were extravagant in their reporting of contemporaneous corporate profits and overly optimistic in their forecasts of future profit growth. Ever since the corporate accounting scandals began in 2001, executives have been under pressure each quarter to perform more closely to those promises, by delivering profit growth that is strong in reality. Under this alternative explanation of the employment numbers, firm managers have been desperately cutting labor costs in any way that they can, a squeeze that is not sustainable in the long run.

How can one tell which explanation of the jobless recovery – short-term cost-cutting or long-run productivity growth -- is the right one? If we were seeing an acceleration of the IT-led productivity boom that began in the 1990s, we would see workers sharing in the benefits, in the form of higher wages, as they did in the late 1990s. Instead, real wages have been almost flat over the last few years. That is, the increases in dollar wages – 2.1 percent over the last year -- have been no more than sufficient to make up for increases in the consumer price index or other measures of inflation. The failure of firms to share productivity gains with workers supports the hypothesis of desperate short-term cost-cutting, and not the hypothesis of an improved long-term productivity trend. So the second excuse for low employment numbers may be equally fallacious.

Employment is bound to recover substantially before long, given how far it fell in 2001-03. Furthermore, even if the recent apparent acceleration of productivity proves transient, there is no reason to doubt that IT continues to propel productivity growth above the low rates suffered during the two decades 1973-1993. Thus if one is looking for the adverse implications of Bush economic policies, it is better to look five or ten years out, than to look at the coming year.

In fact, good economic logic does not support the idea that Bush fiscal policies caused the weak economy of the last three years. Good economic logic supports, rather, a causal link between Bush fiscal policies and the *next* recession. The future downturn is likely to be far worse than the recent one.

The problem is the remarkably ill-conceived composition of the Bush tax changes. A fervent belief in low taxes is not enough; one has to know *which* taxes to cut. It is almost as if some aspects of the tax cuts were composed to *minimize bang for the buck*. Such measures as the decision to abolish estate taxes in the year 2010 and the reduction in dividend taxes, without offsetting future revenue gains, flunk most tests for an intelligent tax cut. The tax changes legislated in 2001 and 2003 were not designed to have most of their effect in the present, when we needed the stimulus. Moreover, they were designed to redistribute from poor to rich and from consumption to saving; thus they have provided only a limited stimulus to consumption. They also created long-range uncertainty that makes planning difficult (nobody from either party expects the relevant tax law to remain as it is currently written) and have provided a very limited boost to investment. Worse, the dividend and estate tax measures were designed to produce large revenue losses later in the decade. Thus they minimize expansionary bang and maximize the long-run buck.

A sensible response to the 2001 recession would have included some tax cuts, but would have had a mix much better targeted to stimulate the economy today, without sacrificing long-term fiscal discipline. It would have allowed low-income workers to share in the break from all federal taxes, and given some revenue to the hard-pressed states to spend on education and health. Such a policy would have had favorable effects on both demand and supply, and would have been more likely to produce a recovery strong enough to reduce unemployment. Perhaps most importantly, a well-designed plan would have avoided setting the future economy on a long-term path of rapidly rising national debt. As it is, interest rates are likely to rise for the remainder of this decade, crowding out private spending, and slowing growth.

It is impossible to say when the next recession will come. But when it does, it is likely to be worse than the 2001 recession. Why? Precisely because we will enter it at a time when the budget deficit, national debt, and international borrowing are already alarmingly high. Even the official White House projections no longer repeat their overly optimistic claim that the deficits will soon go away. Realistic forecasts call for deficits that are still worse than the official forecasts. Thus when the next recession hits, we will not have the luxury of being able to cut taxes and increase spending as George II has done. If anything, we are more likely to be in the midst of raising taxes, as George I had to do in 1990. This will exacerbate the downturn, but -- like Argentina or Brazil in recent years -- we will have no choice. The resulting pain will make the economic travails of George II's first term pale in comparison.

[i] Thomas Nardone, et al, "Examining the Discrepancy in Employment Growth between the CPS and the CES," Bureau of Labor Statistics, October 17, 2003, http://www.bls.gov/bls/feacp2101703.pdf; esp. pages 28-29. And Lisa Lynch, "Comments on Nardone, Bowler and Kropf," Federal Economic Statistics Advisory Committee meeting; revised, December 5, 2003.