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The Perfect Fiscal Storm

Policy Note 2002/05

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Bard

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> **In October 1991, three weather systems collided off the coast of Nova Scotia to create a storm of singular fury, boasting waves over one hundred feet high. Among its victims was the Gloucester, Massachusetts-based swordfishing boat the *Andrea Gail*, which vanished with all six crew members aboard.**
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> **It was the storm of the century, boasting waves over one hundred feet high a tempest created by so rare a combination of factors that meteorologists deemed it "the perfect storm." When it struck in October 1991, there was virtually no warning. "She's comin' on, boys, and she's comin' on strong," radioed Captain Billy Tyne of the *Andrea Gail* off the coast of Nova Scotia, and soon afterward the boat and its crew of six disappeared without a trace.**

This is a story about a fiscal storm that has been brewing since 1973 on three different levels: State, Federal, and International. One might even say it is a perfect fiscal storm, recalling the title of the book by Sebastian Junger, who described how the confluence of natural forces created the perfect storm in October 1991 that doomed the *Andrea Gail* in waves of over 100 feet. In our case, a confluence of what we might call unnatural fiscal forces at the state, federal, and global levels have doomed our poor Goldilocks economy and will hinder recovery. As captain Billy Tyne of the *Andrea Gail* radioed just before disappearing without a trace: "She's comin' on, boys, and she's comin' on strong." We are in for some very rough times ahead, and the fiscal reactions to the economic slowdown are likely to make things very much worse. Double digit unemployment rates, and a multiyear recession are possible. As of mid-summer 2002, a few economists are beginning to recognize the possibility of a "double-dip" recession and "jobless recovery" like that of the early1990s. Unfortunately, the coming recession is likely to exceed even these pessimistic expectations.

The story is complicated. Let me quickly summarize so the reader won't get lost in the details.

I'll begin with the federal budget. Since the Nixon era, Keynesian economic policy has fallen out of favor. Not only were "welfare" programs cut, but federal government also reduced its support for state governments through devolution, it slowed growth of spending—especially on defense, and it increased payroll taxes--all of which reduced the role of government while gradually tightening the fiscal stance. This finally led, over the course of the Goldilocks expansion, to sustained and large fiscal surpluses.

Turning to the state level, states were faced with more responsibility, especially for social programs like welfare and Medicaid. However, all but one state is restricted by statutes or constitutions to running balanced budgets. The problem is that state revenue is strongly pro-cyclical, increasing in a boom and falling in recession. And this is a big problem when the states are increasingly responsible for types of spending that need to rise in recession—like welfare and Medicaid. What States typically do is to cut taxes and increase spending in a boom—which helps to fuel the boom—and then raise taxes and cut spending in a recession—adding to the depressionary forces that generate the recession. States have also come to rely more heavily on regressive taxes—especially taxes on consumption, while like the Federal government they give tax credits and inducements to encourage saving. This depresses spending, especially in recession when the regressive taxes on consumption are increased at exactly the time that households are trying to cut back spending to increase rainy day funds.

In the international sphere, the US pushed privatization, globalization, and free trade as the Washington Consensus reduced protection for workers, consumers, and the environment. But more importantly, the notion that sound fiscal policy means balancing national budgets was spread around the world. International financial institutions like the IMF and World Bank encouraged fiscal austerity as the solution to any financial crises. Euroland adopted the Maastricht criteria, cutting spending and increasing taxes to reduce government deficits. With the adoption of the Euro, the nations of Europe surrendered fiscal sovereignty and essentially became like American states, no longer able to run sustained budget deficits when needed. Many nations, like Argentina, went further and dollarized or adopted currency boards that impose even tighter constraints on fiscal policy.

What all this means is that government budgets became very much tighter at every level—state, national, and international. And they are much less able to deal with recessions when they occur.

But wait a minute—didn't we just enjoy a Goldilocks economy in the 1990s, with high economic growth, low unemployment, and growing budget surpluses? Yes. The economy boomed. Wall Street bubbled with "irrational exuberance". Sure, we took a tumble after 9-11, but hasn't the economy recovered? The federal and state budget problems are surely temporary. Next year will be just fine.

I'll explain why I think that is a pipe dream.

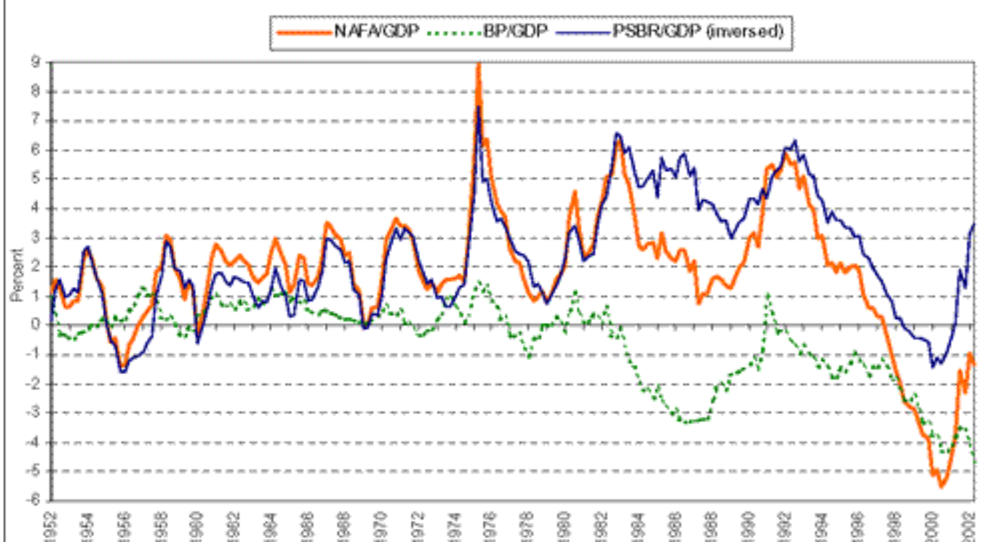
The Goldilocks Expansion

Let's take a quick look at what happened over the past 30 years, but paying most attention to the course of the Goldilocks expansion—which is the first expansion in the postwar period in which the federal government did not play a positive role. Then we'll turn to a brief analysis of the state of the downturn as well as to policies to get the economy going again.

First, let's look at what happened to private sector finances. Hyman Minsky devised a well-known classification scheme--hedge, speculative, and Ponzi--to describe three types of balance sheet positions. (Papadimitriou and Wray 1998) He argued that over the course of an expansion, economic units would take increasingly fragile positions, especially if the expansion were led by private sector spending. This would be reflected both at the micro level as income and outgo flows became more closely articulated, and at the macro level as the weight shifted from mostly hedge to largely speculative finance. Empirically, we could look at overall debt service ratios, at the ratio of private sector deficit spending to income, and at aggregate debt-to-disposable income ratios to obtain an idea of the fragility of the Goldilocks economy.

It is easy to show that Goldilocks was driven by unusual and unsustainable private sector deficit spending. **Figure 1** (*The Three Financial Balances)* shows the income/spending balances for the three sectors of the economy: the private sector (households and firms), the public sector (aggregating across all levels of government) and the foreign sector. (Note the sign is reversed for the government sector—a deficit is given a positive sign.) By identity, the private sector's balance equals the sum of the government sector's balance and the foreign sector balance. When the consolidated government runs a surplus in the presence of a balance of payments deficit, the private sector must have a deficit.

Figure 1: Financial balance of the US (% of GDP)

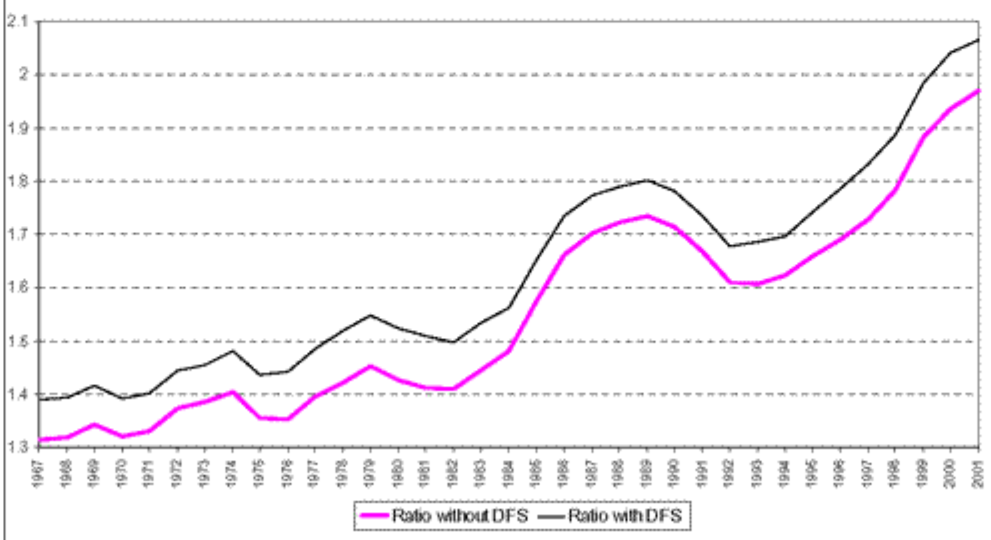


Source: Wynne Godley calculations based on Flow of Funds data. NAFA=private sector net acquisition of financial assets (surplus); BP= balance of payments (surplus); PSBR = public sector borrowing requirement (or, general government deficit).

What really stands out in Figure 1 is the Goldilocks expansion, during which the private sector deficit reached historic levels early in the expansion and then continued to deteriorate to entirely unprecedented levels (to 6% of GDP by the end of 2000). The fall from a private sector surplus of about 6% of GDP at the beginning of the Clinton expansion to a deficit of nearly 6% is much larger than the turn-abouts that occurred as the economy recovered from the recessions in the early 1970s and the early 1980s.

The analogue to the private sector deficits is growth of debt. The outstanding debt stock grows when the private sector deficit-spends. The debt ratio increases when the rate of growth of private sector spending exceeds the rate of growth of its disposable income. In other words, if the private sector's deficit rises as a percent of its income, then the debt to income ratio will grow. Over the course of the Goldilocks expansion, the debt-to-disposable income ratio climbed to the stratosphere—nearly twice disposable income. (See **Figure 2**: *Private Debt Ratios*) While rising private sector debts have been widely recognized, many commentators have dismissed their importance, either because it could be argued that this is merely a continuation of a long-term trend (albeit, one that appears to have accelerated) or because the debt was largely offset by rising equity values (while there is some truth to that, $7 trillion of equity values has subsequently been wiped out even as debt continues to grow). It must be admitted that there is no fine rule governing willingness and ability to deficit spend and to incur rising debt ratios. Prospective income flows, expected capital gains, interest rates and debt service ratios, confidence and euphoria, custom and attitudes toward risk and uncertainty, and expected continued access to credit on reasonable terms are all important determinants.

Figure 2: Ratio of Total Private Sector Debt to Disposable Income, 1967-2001



Sources: Bea, Flow of Funds (http://www.federalreserve.gov/releases/Z1/Current/z1r-2.pdf). DFS: Domestic Financial Sector

The Federal Reserve publishes data on the debt service burden, which includes only payments on consumer debt and home mortgages--but it is a reasonable proxy for the overall private sector burden. (See **Figure 3**: *Debt Service and Fed Funds Rate*.) The debt service burden is determined by three factors: average interest rate paid, the debt stock, and income flows. In the US, a clear pattern emerges: the debt service burden tends to rise over the course of an expansion, peaking at just above 14% before falling in recession. Note also that with only one major exception (the business cycle that included the Bush, senior, recession), monetary policy (as measured by the fed funds rate) has little impact on the debt service burden--swings of the debt service burden are not normally correlated with swings of the fed funds rate. In other words, rising debt service burden is not (primarily) due to rising interest rates but rather can be attributed to growth of debt at a pace faster than income flows grow. The debt service burden in the US reached above 14% by the end of the Goldilocks expansion—as is normal—and while Fed easing has apparently stopped growth of the debt service burden, it has not significantly reduced it. If the past is any guide, the burden will fall only when households stop spending beyond their incomes.

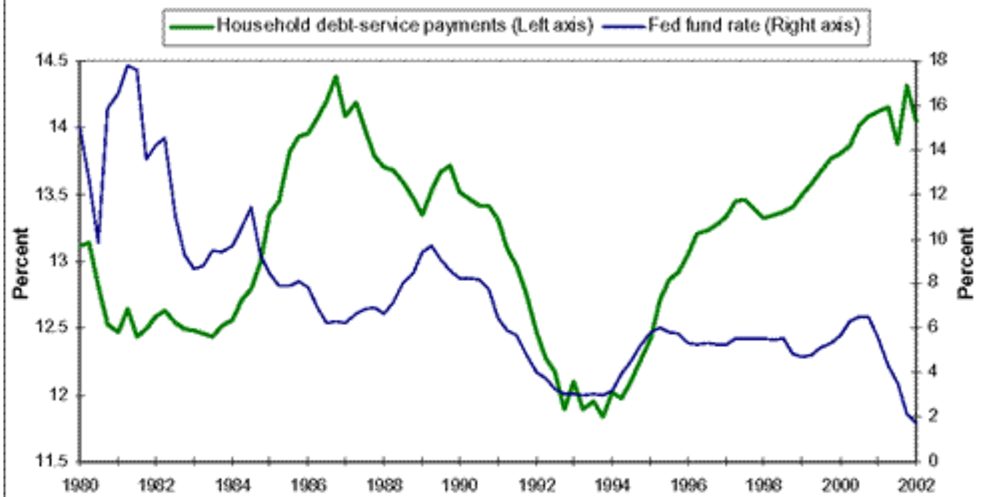


Figure 3: Household debt-service payments and Federal Funds rate

Source: Board of Governors of the Fed. Household debt-service payments are expressed as a percentage of disposable income (seasonally adjusted).
Note that the debt-service burden is underestimated as it does not include car lease payments.

Minsky analyzed each economic unit as a "money-in, money-out" entity. As he wrote in 1963, "each liability emitter attempts to arrange his receipts and spending so as to be able to meet his commitments." (Minsky 1963, p. 412) He emphasized the important role played by margins of safety--that is, by the maintenance of a gap between money inflows and outflows, as well as a gap between assets and liabilities, and a reserve of liquid assets to be called upon should money inflows fall short of committed money outflows. In an expansion fueled by the private sector, these margins of safety would be (intentionally) reduced as an ever-increasing proportion of prospective income flows would be committed to servicing liabilities, and as the ratios of debt to net worth and of debt to liquid assets would increase. However, Minsky contrasted this with a government-spending-led expansion: "During a protracted expansion dominated by household and business deficits the ratio of household and business financial commitments to income rises, whereas in an expansion dominated by government deficits the ratio of private commitments to income decreases." (Minsky 1963, p. 412) Hence, not all expansions are created equal--an expansion that is led by private sector deficits is inherently unstable and unsustainable because "the greater the payment commitments relative to expected receipts the greater the reluctance and the smaller the ability of a private unit to finance its operations by deficits." (Minsky 1963, p. 412) When the prospective gain is outweighed by the reluctance and inability to undertake additional deficits, the private sector-led expansion must come to an end.

The other side of the coin is that the government sector was running surpluses during the Goldilocks expansion. In fact, given that the US runs a trade deficit, the only way the economy could grow given the budget balance was for the private sector to deficit spend on an increasing basis. Hence, Goldilocks growth was an extreme example of Minsky's case of an expansion led by private sector deficits with public sector surpluses—implying rapidly deteriorating private sector balance sheets. Clearly, the expansion was unsustainable, but it could have gone on for an indeterminate period so long as borrowers and lenders allowed it to do so. While the dating of her demise could not be predicted with anything approaching accuracy, it was inevitable. If the expansion had instead been based on expansion of public sector spending relative to its income--that is by public sector deficits--Goldilocks could have been sustained for some time. Of course, Minsky always argued that stability is itself destabilizing--a sustained expansion fueled by public sector deficits would eventually change expectations in such a way as to encourage destabilizing behavior. In other words, Minsky never believed in fine-tuning, however, he emphasized that a growth path requiring ever rising private sector deficits would exhibit greater endogenous fragility than one fueled by public sector deficits that generated private sector surpluses (as in the 1960s).

It is ironic that on June 29, 1999 the Wall Street Journal ran two long articles, one boasting that government surpluses would wipe out the national debt and add to national saving—and the other scratching its head wondering why private saving had gone negative. The caption to a graph showing personal saving and government deficits/surpluses proclaimed "As the government saves, people spend". Almost no one at the time (or since!) recognized the necessary relation between these two that is implied by aggregate balance sheets. Since the economic slowdown that began at the end of 2000, the government balance sheet has reversed toward a deficit that reached 3.5% of GDP last quarter, while the private sector's financial balance improved to a deficit of 1% of GDP. So long as the balance of payments deficit remains in the four-to-five percent of GDP range, a private sector surplus cannot be achieved until the federal budget's deficit rises beyond 5% of GDP (as we'll see in a moment, state and local government will continue to run aggregate surpluses, increasing the size of the necessary federal deficit). As we can see from Figure 1, in recession the private sector normally runs a surplus of at least 3% of GDP; given our trade deficit, this implies the federal budget deficit will rise to 7% or more if a deep recession is in store. At that point, the *Wall Street Journal* will no doubt chastise: "As the people save, the government spends", calling for a tighter fiscal stance to increase national saving!

Turning to the international sphere, it should be noted that US Goldilocks growth was not unique in its character. As **Figure 4** (*International Budget Deficits*) shows, public sector balances in most of the OECD nations tightened considerably in the past decade--at least in part due to attempts to tighten budgets in line with the Washington Consensus (and for Euroland, in line with the dictates of Maastricht criteria). (Japan, of course, stands out as the glaring exception—it ran large budget surpluses at the end of the 1980s before collapsing into a prolonged recession that wiped out government revenue and resulted in a government deficit of nearly 9% of GDP.) Tighter public balances implied deterioration of private sector balances. Except for the case of nations that could run trade surpluses, the tighter fiscal stances around the world necessarily implied more fragile private sector balances. Indeed, Canada, the UK and Australia all achieved private sector deficits at some point near the beginning of the new millennium.

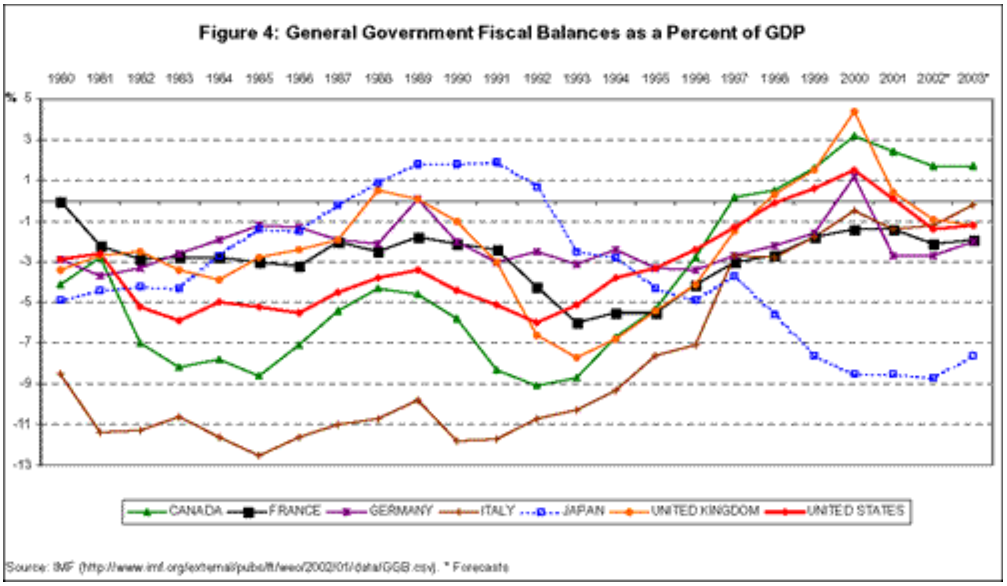
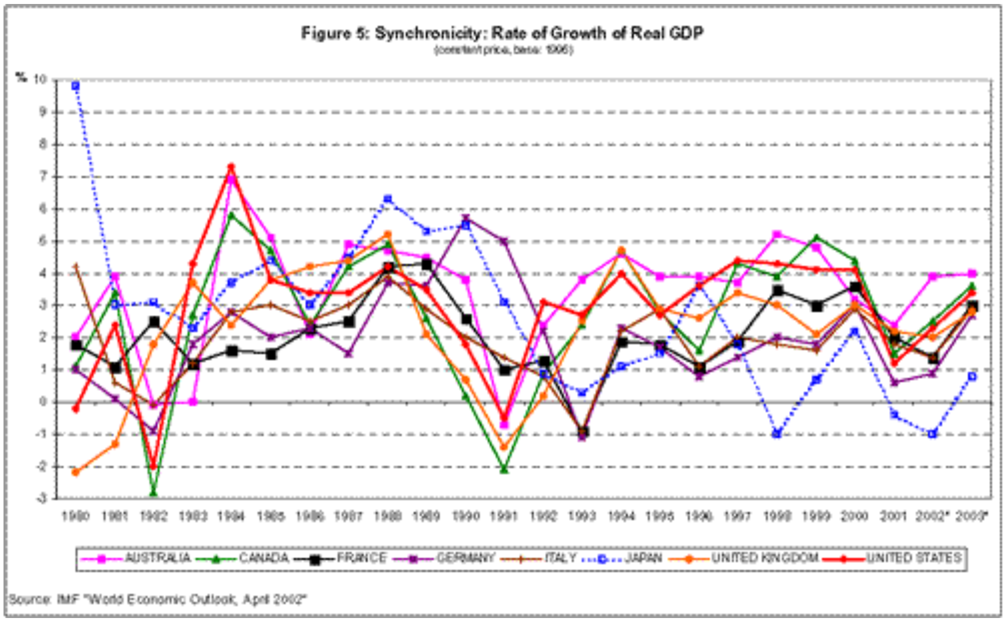


Figure 4: General Government Fiscal Balances as a Percent of GDP

Source: IMF (http://www.imf.org/external/pubs/ft/weo/2002/01/data/GGB.csv). * Forecasts

Figure 5 (*Synchronicity*) demonstrates a remarkable degree of synchronicity of real GDP growth among OECD nations, particularly since the breakdown of Bretton Woods. Two factors have probably contributed toward increased synchronization: first, with the movement to flexible exchange rates each nation fears that GDP growth that diverges greatly from that of other nations will affect exchange rates, hence, economic policy is biased toward keeping growth rates close to those of the other OECD nations. This is probably also enhanced by prevailing fads--the pro-market and anti-government biases of the past decade must have influenced the policy stance. Budgets have been tightened such that even low economic growth causes the government budget to move toward balance or surplus. This means that growth comes mostly from exports or from the private sector. Of course, export-led growth is not possible for everyone simultaneously—for every trade surplus there has to be a trade deficit. And expansion led by the domestic private sector means deteriorating private sector balance sheets, as Minsky emphasized. Add on top of that the trend toward dollarization and currency boards and you have a world economy that is biased toward fiscal austerity and slow growth.

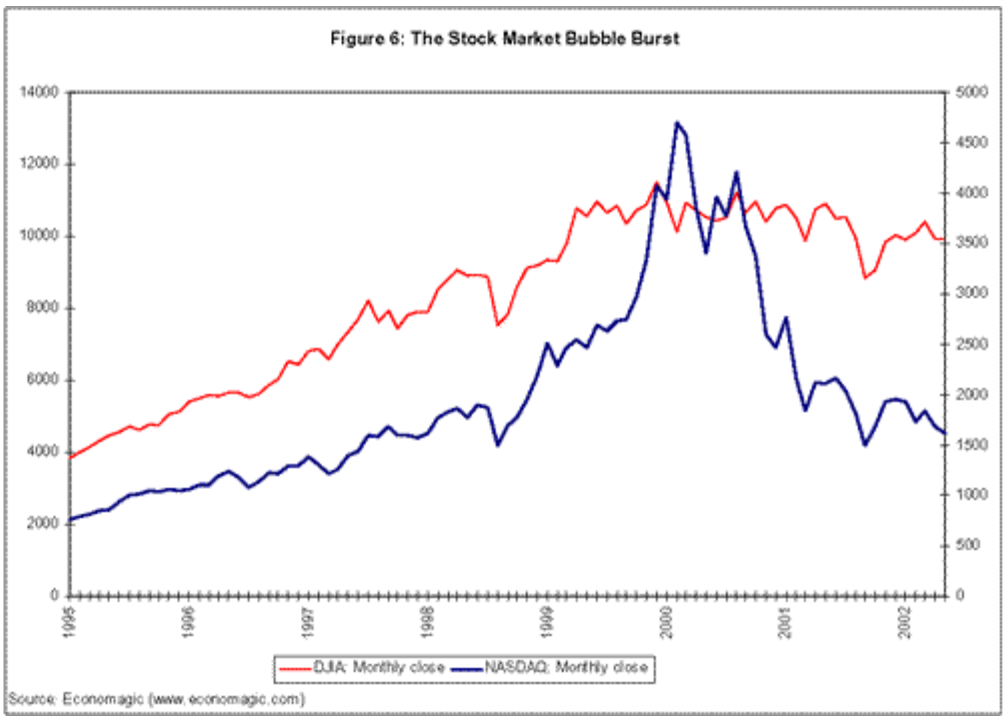


Second, increased economic linkages following from "globalization" have probably increased the degree of integration. Particularly when a large net importer--like the US--grows slowly, this is likely to depress growth of other nations. In any case, if recent history is any guide, a sharp and deep downturn in the US will almost certainly spread around the world. The slowdown of growth in the US has already spread to other countries. For example, Mexico has had negative growth for more than a year, while South Korea has slowed considerably in recent quarters.

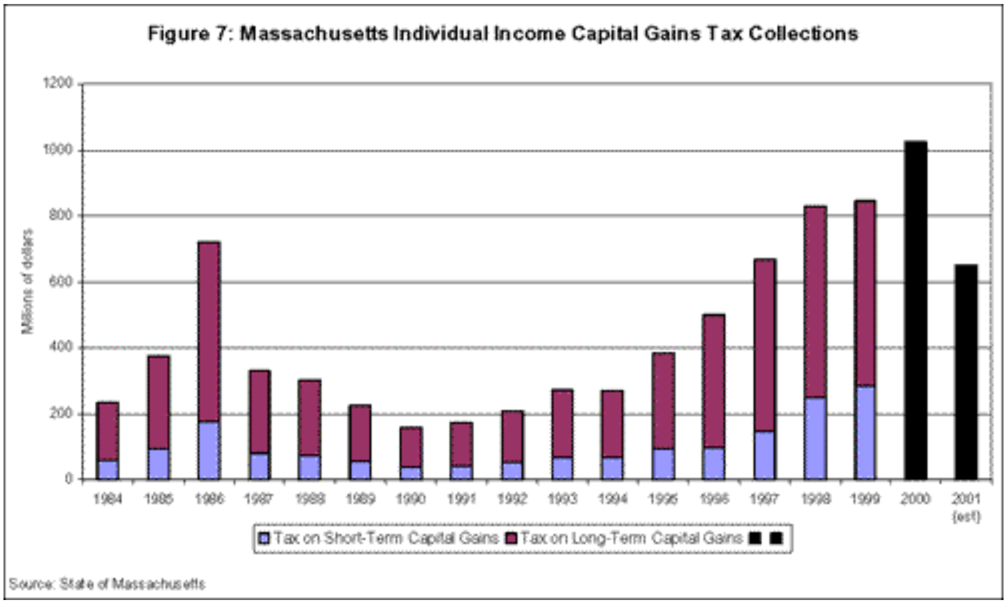
Let me turn to the final unnatural forces generating the perfect fiscal storm, which are state government finances. As already mentioned, since the early 1970s we've been on a devolution trend, putting more responsibilities on state and local government. When I quiz my students, I usually find that they do not know that all of the growth of government relative to GDP since 1960 has been at the state and local government level; the federal government is actually smaller today than in 1960—with federal spending falling from a post-war norm of about 20% of GDP to the pre-9-11 17% of GDP. In 1960, state and local government spending totaled about 40% of federal spending; that is now well over 60%. State and local governments taken as a whole almost always run surpluses. Only in the recession years of 1982, 1991, and 1992 did they run deficits, which isn't surprising, as most states are prohibited from running deficits by their statutes or constitutions and by financial markets that downgrade their debt when they run current account deficits. As a result, during a slowdown, they must raise taxes and/or slash discretionary spending. Historically, they have mostly raised taxes because there isn't much spending that is discretionary.

For example, over the Bush, senior, recession years, from 1990-92 federal receipts rose by 6%, while state and local government receipts rose by 15%. While state and local government spending rose slightly more than 15%, they were able to keep total deficits to less than $10 billion per year. In contrast the federal budget deficit rose from $173 billion to almost $300 billion annually as spending growth outpaced revenue growth. Because state and local governments raise taxes as much as they increase spending in recession, and because state and local governments have regressive tax systems, they do not help to maintain demand in a countercyclical manner. In fact, they do the opposite. In expansion, they run up surpluses--$50 billion a year by 1999—which makes it even harder to achieve and maintain full employment because private sector deficits (and/or federal budget deficits) have to be that much greater. And then even in recession state and local governments try to maintain surpluses, or at least balanced budgets. In other words, because of the different financing situation faced by state and local government, to prevent large deficits from rising, they must raise taxes and/or cut spending precisely when fiscal stimulus is required.

The Goldilocks expansion was the most extreme example. During the Bush, Senior, recession of the early 1990s, states were hit hard. They cut some spending and raised taxes trying to balance budgets. That helped to contribute to the double dip recession. Then the economy and NASDAQ began to boom. (See **Figure 6**: *Stock Market Bubble.*)



The stock market bubble helped fuel Goldilocks in two ways. The first is well known. Households received capital gains that they borrowed against to finance a consumption boom. Greenspan recently claimed that the so-called wealth effect now accounts for one-fifth of all consumption spending. I think this is largely overstated, but there is no doubt it did add to the boom. The second way it helped was through state government finances. State taxes of capital gains exploded. For example, Massachusetts expected to reap over one billion dollars of capital gains tax revenue in 2000. (See **Figure 7**: *Massachussettes Capital Gains Taxes.*) As another example, in California, the total income from stock options and capital gains in 1994 was only $25 billion. By 2000, state residents got $200 billion from stock options and capital gains—that increased state tax revenue by about $17 billion.

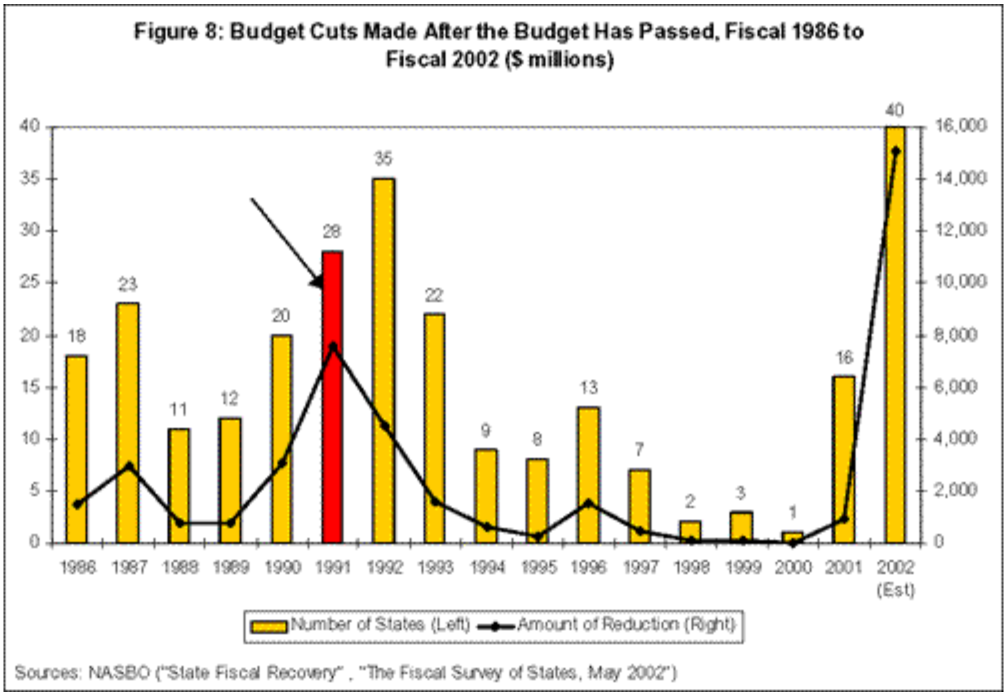


The capital gains added to state revenues that were growing due to the robust economy. For example, during the Clinton boom, Missouri state revenue jumped by 10% in some years. In Missouri, the Hancock Amendment restrains growth of state spending to the inflation rate. Because tax revenue grew much faster, state residents got refunds of $1 billion and taxcuts of $1 billion between 1995-9—a nice pro-cyclical tax cut that helped to fuel private consumption. Across the nation, the windfall gains allowed states to increase spending, put funds away in rainy day funds, and cut taxes. States cut personal income taxes by $28 billion, and other taxes by another $7 billion. In the Bush, senior, recession states had raised regressive taxes. In the Clinton boom, they mostly cut progressive income taxes—making the tax systems less progressive. The average state has a regressive overall tax system, and that has been getting worse.

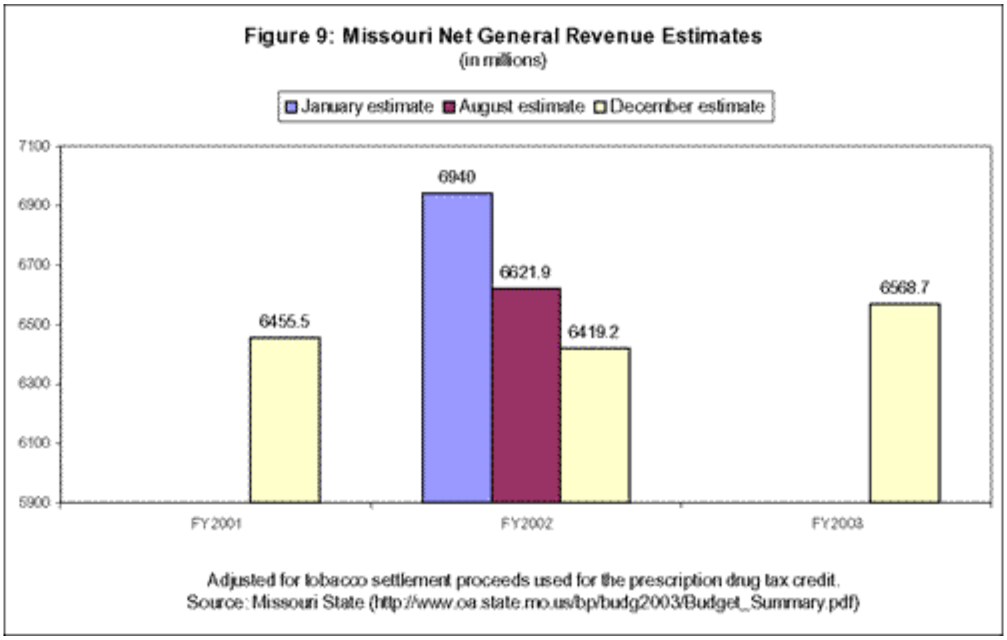
States also increased some kinds of spending. For example, Missouri made major changes to Medicaid, greatly expanding the number of people covered—growing from a bit over half a million eligible in 1993 to 840,000 eligible today. States also could afford to spend more on TANF—the welfare program that replaced AFDC. They are already spending about $19 billion per year, which is $2B more than the federal government provides. Pressures on that will rise if a prolonged recession increases the number of needy exactly when state revenue disappears. In any case, the tax cuts and spending increases that were largely made possible by the irrational exuberance of Wall Street helped to fuel the Goldilocks boom. States also socked away money in rainy day funds—which did not help the boom, in fact that should operate in a countercyclical manner if states then spend the funds when recession hits. As we're finding out, that is a big IF, because many governors won't spend them. While Missouri has a lot of rainy day funds, the constitution requires that if they are used, the state has to replace them within three years--so the state won't spend them.

Suddenly in 2001, the windfall all but disappeared. In California the revenue driven by capital gains fell by up to $15 billion in just one year. Taxable capital gains at the national level fell from about $700 billion in 2000 (14% of the federal tax base) to

$350 billion by 2001. According to an August 11 report by Louis Uchitelle (NYT), only about half the $150 billion in tax payments expected last April was received, suggesting “that the stock market sell-off wiped out capital gains and the tax revenue they generate. Canceled or shrunken bonuses and worthless stock options might also be factors…whatever the explanation, the tax payment shortfall indicates a loss in personal income of $200 billion or more, most of it among wealthy Americans.” Already, tax revenue in 43 states is coming in well below expectations, and 40 states are already making emergency cuts of $27B. (See **Figure 8**: *State spending Cuts*.)



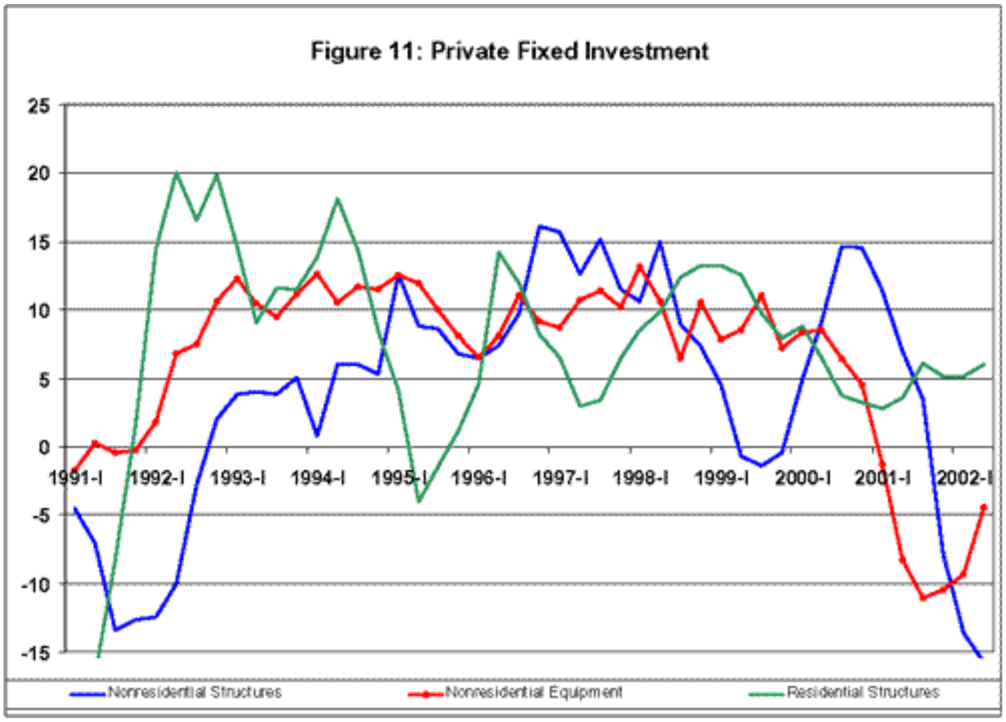
For example, 3 years ago, Indiana had a $2B surplus; now it has a deficit of $1B. New Jersey projects a deficit equal to 12% of its budget. California’s deficit could be $25B, or nearly one-third of its state general fund. Twenty nine states are cutting higher education; 25 are cutting prison spending; 22 are cutting Medicare; and 10 are laying off workers. The state of Tennessee had to temporarily shut down. Missouri actually had to stop paying tax refunds because it was broke. Obviously that hurts private sector spending in the state because 416,000 people had been counting on those refunds. Missouri has made huge cuts to university budgets—but I won’t go into that. We still face a shortfall of $250 million (FY 2002), and that is after the governor had to take $324 million in actions last August and another $212 million in December. (With every new estimate, revenues are reduced. See **Figure 9**: *General Revenue Estimates, Missouri*.)

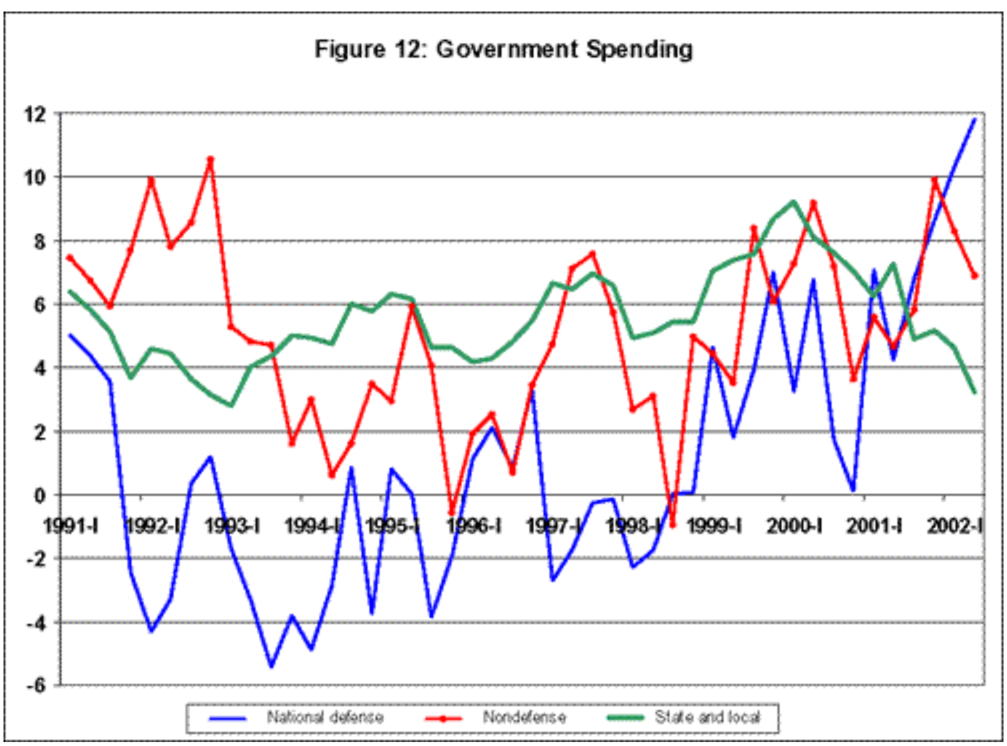


The Current State of the Economy and Policy Prescriptions

As late as June, the FOMC was confident that "the prospects for accelerating aggregate demand remained positive. Some members even suggested that Fed policy was too accommodative, worrying that inflation might accelerate. The Fed expected consumption and investment to pick up, as the economy returned to a growth path of 3 to 3.5%. By the end of summer, many doubted that rosy scenario and even the Fed moved toward an accommodative bias. As **Figure 10** shows (*Consumer Expenditures*), consumer expenditures were down sharply since 2001, with the exception of a sharp spike to durable goods consumption.

Manufacturing slowed sharply in July, to a growth rate of only 0.1%, however, all the growth was due to automobile and truck production (factory output would have fallen 0.3% in July without cars, trucks and parts). And as **Figure 11** shows (*Fixed Investment*), nothing in the fixed investment figures gives reason for optimism. Only government spending (**Figure 12**: *Government Spending*) shows robust growth. State and local government spending growth is down sharply—from 9% at the end of the boom to only 3% at the end of the second quarter of 2002. However, Federal government spending on defense is growing at a 12% pace; nondefense spending accelerated to a 10% pace at the end of 2001(presumably fueled by disaster relief), and is now growing at a 6% pace. It is clear from the numbers that what growth remains in the economy is due to ramped-up federal spending as well as zero interest loans on durable consumption goods.





What about policy recommendations? States really cannot deal with the budget problems on their own. Real needs will rise—for unemployment compensation, for medical care, and for welfare. Trying to cut other spending—like college funding—or trying to raise taxes simply hurts the economy and lowers tax revenue. The old Laffer Curve will come back to haunt the states. What they really need is a federal government bailout. There are two reasons why we want to shift more of the funding responsibility back to the federal government. First, state taxes tend to be regressive; for many they are highly regressive. Second, and more important, states cannot deficit spend. States really do have to use tax revenues to finance spending. The federal government does not, and in fact cannot use tax revenue to finance its spending. Any sovereign nation spends by crediting bank accounts and taxes by debiting them. Only nations that surrender sovereignty (to the Euro, as in the case of Euroland, or to the dollar, as in the case of the Argentinas around the world) have to tax before they can spend. This is the fundamental difference between state finances and federal government finances.

While the problems of the international economy are too complex to be dealt with here, a first step is for individual nations to reassert fiscal sovereignty by abandoning foreign currencies. Exactly how the international financial architecture might be restructured, or how policy of multinational financial institutions might be changed is beyond the scope of this article. However, pegged exchange rates or currency boards or monetary unions (without fiscal unions) stand in the way of progress on that front. There is little doubt that increased integration of economies requires an international approach to reduce the bias toward fiscal austerity. But meantime, individual nations can remove self-imposed constraints that result from pegged currencies.

Turning more specifically to the current situation in the US, few observers recognize the nature of the challenges ahead. It is useful to identify three challenges--only the first has entered public debate. Most immediately, government must cushion the economic downturn. If the private sector tries to adjust its spending sufficiently to return to a much more normal surplus of 3-5 percent (which is what it usually does in a recession), and if the trade deficit remains at about 4% of GDP, then the cyclical budget deficit needs to be somewhere above 7% of GDP. Note two things. First, that is about the size of Japan's budget deficit. Second, we are talking about a short term fiscal adjustment of almost three-quarters of a trillion dollars. Yes, even for the USA that is a big number. Also note that the general government budget balance has already adjusted by some 4.5% of GDP—partly due to falling growth of tax revenues and rising social spending as the economy slows, and partly due to the defense build-up post-9-11.

The second challenge, only dimly recognized, lies in the very real needs neglected by the federal government since the days of President Nixon: public infrastructure investment, public health services, pre-collegiate education, training and apprenticeships programs for those who will not attend college, jobs programs for those not needed in the private sector, and fiscal relief for state and local governments. Jamie Galbraith has advocated increasing temporary federal grants to states to allow them to cut regressive taxes. I'd supplement that with a longer-term federal government program to fund more needed infrastructure spending at the local level—in the range of $300 billion annually, with half of that as a short-run (two or three year) stimulus and another $150 billion annually for the foreseeable future.

Finally, the third challenge lies in the long-term prospects for renewing robust economic growth. The federal budget has become structurally imbalanced, perhaps to a degree last seen in the 1920s (by no coincidence, the last time the federal government ran significant surpluses on a sustained basis). In other words, what is needed is not a short-term fiscal stimulus, but rather a "permanent" relaxation of the fiscal stance. Ideally, we would want to build-in automatic stabilizers, too, so that the budget will swing around the long run stance that is appropriate for full employment growth. An appropriate "permanent" fiscal adjustment would move the structural or full employment budget by 6% of GDP to a sustained deficit of 3% of GDP. A larger deficit than this will be needed over the short run to stem the slide into recession.

To achieve the necessary long-term fiscal adjustment requires a combination of tax cuts and spending increases to total at least $600 billion annually, in today's dollars. The White House tax cut and stimulus package plus the war against evil-doers might total only a third of that over the next few years, and perhaps only a quarter of that for the long term. We need to look for an additional long-term adjustment equal to as much as $450 billion annually. Very roughly, we could accomplish a third of that through reduction of the payroll tax by $150 billion per year. This would increase take-home pay, reduce labor costs, and increase competitiveness of American labor—all of which would help to reduce the incentive to lay-off workers. (It would also eliminate Social Security's annual budget surplus—which I see as a good thing because the surplus fuels all the privatization scams, but we can leave that debate for another day.) Another $150 billion could be provided to state and local governments as tax relief and support of infrastructure and social spending, as discussed above. That is about a 65% increase of federal grant money flowing to them.

The final $150 billion could be used in active labor market programs. We could double the EITC to increase the reward to work. We could strengthen training and education programs. And we could fund a Public Service Employment program as a form of employer of last resort or job guarantee program. That not only would help move the long term budget toward the proper stance, but would add up to about $100 billion of short term countercyclical budget swings to fight recession (based on an estimate of $25,000 annual spending per worker in the program and cyclical swings of employment in the program of approximately 4 million workers between trough and peak). The labor market programs can be devolved to the state and local government levels, with the federal government provide the funding, but state and local governments as well as qualifying nonprofits doing all the hiring, training, and supervision. They know where the jobs are needed and what work needs to be performed but cannot spend in a countercyclical manner.

Without a significant restructuring of the federal budget plus a real federal government stimulus package and a bail-out of state governments, I'm afraid we aren't going to weather this perfect fiscal storm very well. Hopefully we won't sink like the Andrea Gail.

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