

## **Mitchell's Musings 5-16-11: What's the Program? What Should It Be?**

The Joint Committee on Taxation issued a report last December on federal "tax expenditures." Given the complexity of the tax code, the document runs over 60 pages. And it comes with the usual caveat. When some activity is given encouragement by the tax code, it presumably changes behavior, that is, it encourages the activity (which is precisely the point of the favorable treatment). Thus, the calculation – which assumes the activity is independent of the tax code – will tend to exaggerate the revenue that would be obtained if the favorable tax treatment were eliminated.<sup>1</sup> (On the other hand, because state and local income taxes tend to mirror the federal tax code, the total public encouragement of tax-favored activities is understated.)

As is well known, Congress has historically loved the idea of home ownership. Thus, in federal fiscal year 2011, the tax expenditure on the combination of the mortgage interest deduction, deductibility of local property taxes, and exclusion of capital gains on sale of residences, came to over \$133 billion in tax expenditure terms. And, there are many other smaller tax-based encouragements to home ownership buried in the tax code, e.g., favored treatment for rehab of older structures. Given the level of tax expenditure, we would surely have to consider home ownership as a major federal program.

Home ownership is ultimately something individuals decide to do or not do. There is little employer involvement. But Congress has long believed that there are things you should do in connection with employment. If your employer provides you with a dollar in wages, it is taxable. But if your employer provides you with a dollar's worth of health insurance, it is not. So there is a strong incentive to obtain health insurance via your employment (or as a dependent of someone in your family with a job). The federal tax expenditure on employer-provided health care is listed in the Joint Committee's report at over \$117 billion in fiscal 2011.

What about saving for retirement? On-the-job defined benefit pensions have a tax expenditure of \$51.9 billion; defined contribution plans have \$38.2 billion. That's a total of over \$90 billion. So we have tax expenditures of over \$200 billion just for the health and retirement income forms of encouraging employees to receive or undertake activity through the employment relationship. (Some other benefits through the employment relationship also receive tax-favored treatment, e.g., life insurance.) Even if your employer does not offer a retirement plan, you can have your own IRA-type plan – but the contributions place in it must generally be work-related.

Of course, to do things through your employer, or through working, you need to have a job, or at least be self-employed. To some extent, providing benefits through the employment relationship does encourage work. There is a market for private purchase of health insurance, for example. But individual policies are expensive and you might not be able to buy it at all because of pre-existing conditions (although that is changing as the new federal health law takes effect). Apart from these indirect incentives, the tax code also provides direct encouragement of working – at least for lower-wage

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<sup>1</sup> The document can be downloaded at <http://issuu.com/danieljbmitchell/docs/taxexpenditures>.

individuals – through the Earned Income Tax Credit (EITC) which had a tax expenditure of over \$52 billion attached to it in fiscal 2011.

Which brings us to the aftermath of the Great Recession and to the legacy it left of joblessness. It appears that further economic stimulus is not going to come from federal fiscal policy. State and local government are much more limited in their ability to stimulate. Indeed, many of them are in layoff and retrenchment mode. So that leaves monetary policy as our sole anti-unemployment program. Or does it?

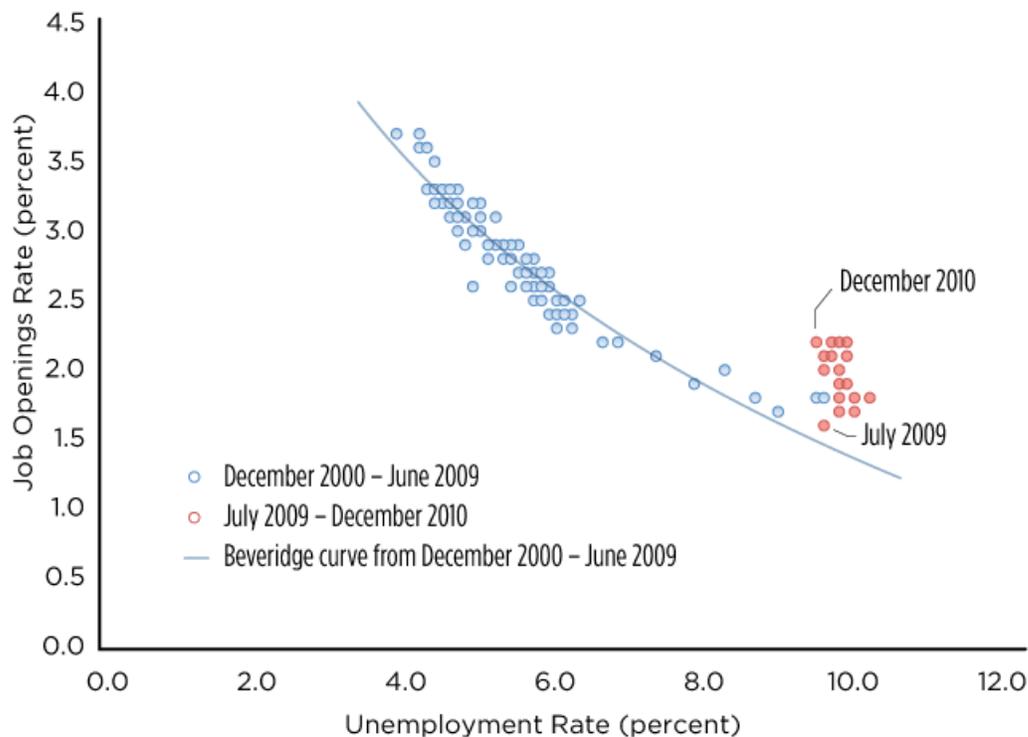
There are voices in the Federal Reserve anxious to promote the idea that a) there is little the Fed can do because the unemployment problem has become structural, and b) the goal of monetary policy should be exclusively on holding down inflation and that single-minded approach will (eventually) allow unemployment to fall. An example of this approach can be found in the 2010 Annual Report of the St. Louis Federal Reserve Bank, available at

[http://www.stlouisfed.org/publications/ar/2010/pages/ar10\\_2a.cfm](http://www.stlouisfed.org/publications/ar/2010/pages/ar10_2a.cfm)

The structural argument appears in that Report in the context of a “Beveridge” curve from the report reproduced below:

### U.S. Beveridge Curve

December 2000 - December 2010



SOURCE: Job Opening and Labor Turnover Survey, Bureau of Labor Statistics/Haver Analytics.

The curve traces an empirical relation between the vacancy rate (job openings) and the employment rate from the end of 2000 until the end of the Great Recession (officially in July 2009). Thereafter, through December 2010, the vacancy rate rises but unemployment does not fall as expected from the estimated curve. The conclusion drawn is that the new unemployed don't match what employers are seeking and therefore there is little the Fed can do about the mismatch. Readers familiar with U.S. economic history will recognize that similar sentiments were common in the early 1960s when the incoming Keynesians of the Kennedy administration were confronted with structuralist objections.

The Beveridge curve is not really a theoretically-derived relationship. It simply embodies the common sense idea that if vacancies are high, there should be less unemployment. We don't have a long history of vacancy data to know what the relationship "should" be after a major shock such as the Great Recession.<sup>2</sup> The earlier recession in 2001 which the data on the chart encompass was very mild.

To be considered a vacancy, the employer offering the position must engage in "active recruiting" for individuals to fill it. According to the Bureau of Labor Statistics, "Active recruiting means the establishment is taking steps to fill a position. It may include advertising in newspapers, on television, or on radio; posting Internet notices; posting 'help wanted' signs; networking with colleagues or making 'word of mouth' announcements; accepting applications; interviewing candidates; contacting employment agencies; or soliciting employees at job fairs, state or local employment offices, or similar sources."<sup>3</sup> There is considerable variation in the intensity of such recruitment methods. Whether employers have altered their intensity of candidate search as a result of the economic shock of the Great Recession is unknown. Similarly, how the unemployed may have recently adapted to the so-called "new normal" (sustained high unemployment rates) is also unknown.

In short, it is rather early to make definitive judgments as to whether a mismatch in vacancies and job candidates has mysteriously opened up in the past two years. Official projections from the Fed suggest that the long-run normal rate of unemployment is thought to be in the 5-6% range, which does not seem to indicate that a structural shift toward a job mismatch is believed to have occurred.<sup>4</sup> If it is not expected to be present in the long run, it is not clear why it should be assumed to exist now. And, of course, there is a considerable gap between current unemployment of around 9% and a norm of 5-6%. So there is room for improvement, even if you believe some kind of structural shift has developed.

Is there a danger of inflation? At some level, there is a danger of virtually anything. However, data on the spread between inflation-adjusted Treasury securities and conventional (non-inflation-adjusted) Treasuries suggest that no big acceleration in inflation is expected by financial markets. Financial

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<sup>2</sup> The U.S. Bureau of Labor Statistics, in a data correction, lowered the vacancy rate data slightly for 2010. See <http://www.bls.gov/jlt/2010revisionjo.txt>. It appears that those corrections were not included in the chart although the effect would be minor.

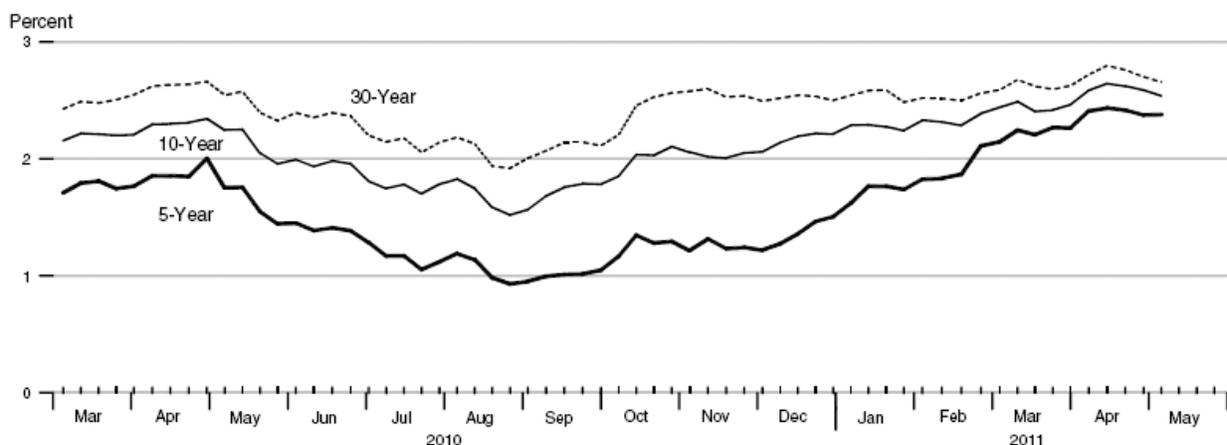
<sup>3</sup> <http://www.bls.gov/jlt/jltdef.htm#2>

<sup>4</sup> See [http://www.federalreserve.gov/monetarypolicy/mpr\\_20110301\\_part4.htm](http://www.federalreserve.gov/monetarypolicy/mpr_20110301_part4.htm)

markets seem to vary their inflation expectations for periods of as long as 30 years in response to short term developments. So perhaps we should not put strong weight on such expectations. Nonetheless, the chart on the below (from the St. Louis Fed!) does not indicate any great fear of imminent inflation. Indeed, the inflation spread (expected inflation rate) over the short term is below the spread of over the longer term.<sup>5</sup>

### Inflation-Indexed Treasury Yield Spreads

Averages of Daily Figures



What about labor costs? Are wages rising to a point that inflation is threatened? If there are rising vacancy rates but job candidates for those vacancies are unsuitable, we should be seeing a notable wage acceleration. Employers should be bidding for the scarce capable candidates. The table on the next page shows the trend in the hourly Employment Cost Index over the past two years. Benefit costs have been the most notable element in compensation increase over that period and it is likely that the culprit in benefits is health care. Overall compensation (wages + benefits) is in the range of 2% per annum, hardly an indication of some incipient wage-push, to use an old phrase.

In summary, federal tax policy remains tilted toward encouraging people to obtain retirement and health care benefits through the work relationship. But unemployment remains high. The conclusion that nothing can be done about this contradiction because unemployment has become structural is at best premature. Harping on a risk of some imminent inflation explosion is also counterproductive. To the extent that there is pressure on labor compensation, it likely is arising from rising health care costs, not from a shortage of capable workers. Getting the unemployment rate down remains – or should remain – the principle goal.

<sup>5</sup> One could ask how financial markets know that the inflation rate from 2016-2021 will be higher than the inflation rate from 2011-2016 (which is implicit in the chart). One could ask how they know that the inflation rate from 2021 to 2041 will be higher than that from 2011-2021. But perhaps such questions would be impolite. The chart is from <http://research.stlouisfed.org/publications/usfd/20110512/usfd.pdf>.

## Percent Change in the Employment Cost Index

Twelve Months Ending:

March 2010      March 2011

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**State & Local Workers**

Total Compensation	2.0%	1.8%
Wages & Salaries	1.6	1.2
Benefits	2.5	3.3

**Private - Union Sector**

Total Compensation	3.4	2.5
Wages & Salaries	2.5	1.9
Benefits	4.8	3.7

**Private - Nonunion Sector**

Total Compensation	1.4	1.9
Wages & Salaries	1.3	1.6
Benefits	1.5	2.8

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Source: <http://www.bls.gov/news.release/pdf/eci.pdf>