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HOW NOT TO STIMULATE THE ECONOMY

Bush proposal fails tests any successful stimulus package should pass

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Eighteen months after the National Bureau of Economic Research officially declared recession, economists and policy makers continue to debate how the federal government should kick-start an economy still stuck in neutral. The economy's condition is far from good: fixed investment has been down for the past seven quarters, GDP grew at an annualized pace of only 1.3% in the second quarter, consumer confidence dropped sharply in September and is now at its lowest level since last November, and unemployment is mired at 5.7%. Most economists agree that some kind of jolt is needed and that only the federal government is in a position to deliver it.

What is not agreed is how much and what kind of stimulus is needed. Some ideas suggested by the Bush Administration have yet to be fleshed out; but it is already clear they will not deliver what the economy needs. They will neither stimulate the economy nor reduce unemployment. Worse yet, some of the measures proposed, such as raising the contribution limits on 401(k)s, would likely trigger a further slowdown.

There are three tests a stimulus package must pass. First, the increase in economic activity that it achieves must occur quickly. Second, a successful package must help stimulate demand for goods and services. Third, the overall package must be large enough to boost growth by one to two percentage points over the next year. That level of growth, given that the size of the U.S. economy is now greater than $10 trillion, will require a stimulus of at least $100 billion, assuming that each dollar of new spending adds about one and a half dollars to GDP (as a result of the "multiplier" effect).[1]

The package proposed by the Bush Administration cannot possibly bring about a recovery because it fails all three tests.

Wrong time, wrong place, wrong size

Instead of a quick infusion of cash to energize the economy, the Bush Administration offers some proposals that would take years to become effective and some that would actually harm overall demand.

The President's most costly "stimulus" proposal is to make last year's tax cuts permanent after 2012. But in order to end the slowdown and prevent another recession, government stimulus is needed immediately, not 10 years from now.

Likewise, a major element of the Bush plan rests on the fast-track "trade promotion authority" that he recently obtained from Congress. But major trade agreements take years to negotiate. Such agreements as the proposed Free Trade Agreement of the Americas, even if eventually achieved, cannot possibly provide the near-term stimulus that the economy needs now.

Moreover, trade deals negotiated in the 1990s, such as the 1994 North American Free Trade Agreement, actually hurt the economy. The trade deficit has exploded since 1994 and shows no signs of abating. As a result, the United States has lost more than 3 million high-paying jobs, mostly in manufacturing industries like aircraft, electronics, steel, and textiles. And the deficit growth has required increasing amounts of capital inflows, turning the United States into the world's largest debtor and putting its economic stability at risk.

As for the increase in contribution limits for 401(k) plans, proposed recently by President Bush at his economic forum in Waco, Texas: even if successful, this measure would not stimulate demand but rather would increase savings and drive down consumption. Consumer spending is the only part of the private economy that has contributed to growth over the past two years. A decline in consumption could push the United States back into recession.

The economy needs another boost

GDP growth has been sluggish so far in 2002, following a decline in output and the onset of recession during the first three quarters of 2001.[2] While the economy has experienced three consecutive quarters of growth, it is important to note that this growth has been below 3% per year, the rate needed to keep unemployment from rising.

Any robust economic recovery to growth rates above 3% will require an additional economic stimulus in the form of more government spending. The only factor that kept the recession from deepening in the past year was the increase in federal government spending and tax rebates. Indeed, government spending is the most viable way to stimulate demand quickly.[3] Without substantial short-run stimulus, the economy is likely to remain fundamentally weak well into 2003.

Recently, much ado has been made about supposedly strong economic fundamentals. But a closer look reveals that fundamentals—such as consumption, investment, and trade—are weak at best and, at worst, are contracting. For example, while consumption is the largest component of GDP and an important contributor to GDP growth, consumption growth slowed from 3.1% in the first quarter to 1.8% in the second.

Another major source of future weakness is the growing share of consumption that has been financed out of debt. Consumer debt has remained at very high levels—more than 14% of disposable personal income—through the first quarter of 2002. Default rates reached record highs in the first quarter of 2002 as they jumped from 3.3% to 4.1% for all consumer loans and from 6.3% to 9.2% for credit cards. The growth in borrowing and default rates will make it harder for consumers to finance continued consumption with credit cards or other kinds of debt.

Fixed investment meanwhile has been in decline for almost two years, due to slow consumption growth and excess capacity. With consumption growth slowing, a recovery in investment in the near future is highly unlikely, especially since there is no real incentive for businesses to invest more when their capacity is already sufficient to handle demand. In July 2002, manufacturing capacity was still underutilized, at a utilization rate of 74.4%, a full 7.6 percentage points below its low-run average of 81% (Pearlstein 2002). In other words, firms can still expand their production for a while before they have to start investing in new plants and equipment.

Some investors have begun to shun manufacturing in recent years. At the same time, in other sectors, surplus capacity has been accumulating rapidly. For example, office vacancy rates have been increasing for 18 months and are now reaching 18% in San Francisco, 24% in Raleigh-Durham, N.C., and 25% in Dallas (Pearlstein 2002). Overcapacity is also taking its toll in service industries, ranging from airlines and hotels to professional organizations, such as law firms, advertising agencies, consulting companies, and architectural firms (Pearlstein 2002). Airlines have already slashed 120,000 jobs and could shed an equal number next year. Many analysts estimate only 5-10% of new telecommunications capacity is being used. This sector has already lost nearly 500,000 jobs since its peak in 2000, and layoffs continue. It could take years for such excess capacity to be eliminated and for investment (other than replacement equipment) to pick up again.

Meanwhile, the growing U.S. trade deficit has been slowing the economy since the early 1990s. Though the deficit declined slightly in 2001 as output fell, it has begun to increase again in 2002 and is likely to keep growing for at least the next 12 to 18 months, further reducing overall growth.[4]

Finally, growth in spending by federal, state, and local governments so far has been the economy's main salvation. However, state and local governments, which collectively spend almost twice as much as the federal government on consumption and investment (excluding transfer payments), are reeling from the budget impact of the recession. Fiscal crises at the state and local level are already exacerbating the recession by leading to spending cuts and raised taxes. These ongoing state and local fiscal crises will further dampen growth in 2003.

The economy needs a new stimulus of at least $100 billion

In the face of such a dim outlook for economic growth, the government must quickly provide a temporary demand stimulus that is large enough to be effective. The best way to do this is to rapidly increase spending on a wide variety of established programs with well-defined distribution networks and significant backlogs of unmet or unfunded needs.[5] At least $100 billion in new federal spending should be put in these existing pipelines immediately. Instead, the Bush Administration's proposals, even if they actually had a stimulus effect, would offer only $23 billion in new money in 2003 (Weismann 2002).

The wrong target

Not only is the Bush plan too small, it targets the wrong people. None of the proposed policies would help those hardest hit by this recession, particularly low-wage workers, recently hired and fired welfare recipients, and the long-term unemployed. In fact, many of the president's proposals, such as increasing the tax exempt contribution levels for 401(k) and IRA accounts, will only help the most affluent Americans, as currently less than 5% of individuals with 401(k)s—mainly high-income individuals—contribute the maximum amount allowed.

Also, many of the president's proposals, such as making the 2001 tax cut permanent in 2012, obviously will not have an immediate impact on the economy. And none of Bush's measures are large enough to spur a robust economic recovery.

In this quintessential supply-side stimulus strategy, President Bush is proposing six massive tax cuts for the wealthiest Americans.[6] First, as noted above, Bush wants the 10-year, $1.35 trillion tax cuts enacted in 2001 to be made permanent. Second, he wants a permanent repeal of estate taxes. Third, he proposes an increase in the deductible amount allowed for investment losses. GOP officials estimate the deduction limit will be increased from $3,000 to at least $9,000. Charles Schwab, chairman and co-CEO of the Charles Schwab Corporation, advocates an even larger deduction limit of $20,000. Fourth, President Bush proposed ending the "double taxation" on stock dividends, either by eliminating investor or corporate dividend taxes. Fifth, Bush indicated to reporters that he is considering increasing limits on tax-free contributions to 401(k) and IRA accounts. Finally, he proposes to eliminate new access taxes on broadband communication technology.

Not only does the President's plan provide massive tax cuts for the wealthiest Americans, but it will not significantly increase spending, since wealthy taxpayers tend to save a larger share of such windfalls. Corporations would also receive some goodies under the President's plan, but with dubious effect on the economy. For example, Bush wants to provide free terrorism insurance to bail out insurance companies that have been hurt by the collapse in the stock market. The administration's claims that the result would be $8 billion worth of commercial construction projects are ludicrous in the face of massive and widespread excess capacity in commercial real estate.

Lastly, new corporate governance legislation passed by Congress, originally opposed by the Bush Administration but now embraced, is suddenly supposed to restore investor confidence. A recovery in consumer spending and business investment, however, would do much more for the economy; confidence alone will not lead to rising wages and profits.

A different stimulus is needed

The U.S. economy's slump could last for many more months, or even years, unless quick action is taken by Congress and the administration. At best, the economy will continue to grow at rates well below 3% for the rest of this year and into 2003 without more stimulus. This is not enough growth to reduce unemployment or stimulate investment.

While President Bush has acknowledged the need for some form of economic stimulus, his proposals primarily would benefit wealthy taxpayers with tax cuts that will have their biggest effect five to 10 years from now, long after the current downturn has ended. Indeed, he proposes a classic supply-side economic plan designed to increase economic capacity in an economy drowning in excess buildings, plants, and equipment, and to give benefits (many years from now) to an already well-off few.

Supply-side economics failed in the 1980s and it will fail again today. What the economy needs is a quick burst of new spending to minimize the chances of a double-dip recession like the one the U.S. experienced in the early 1980s. Among other things, this jump-start could be accomplished with state revenue sharing, with increases in unemployment insurance, with funding for school repairs, and with prescription drug benefits for the elderly.

These existing programs could easily be used to inject $100 billion or more into the economy in 2003. The states, most of which are constitutionally required to maintain balanced budgets each year, face a shortfall of at least $45 billion next year (National Governors Association 2002). With long-term unemployment growing, the states could easily channel another $8 to $10 billion to unemployed workers by extending benefits for an additional 13 weeks in 2003. And there is a massive backlog of at least $20 to $30 billion in new, desperately needed school repairs across the nation. In fact, the federal programs are already in place that can direct these resources to the most needy schools and districts for items such as rodent control, emergency plumbing repairs, leaking roofs and walls, and repair of damaged and dangerous electrical systems.

There is also a tremendous need for prescription drug insurance for the elderly, a new program that could be administered through the existing Medicare system (although this would not be a short-run program). This system could easily absorb $30 to $50 billion per year in spending for new benefits, and it could start immediately with small changes in the legislation that is now awaiting final passage in the Senate. There is no better time than a downturn to put a costly new program like prescription drug insurance in place, when new spending is desperately needed to stimulate the economy and reduce state fiscal shortages as well.

Together, these four programs could easily absorb $100 billion or more in fiscal year 2003, providing the immediate boost of spending needed to restart the economy, end the recession, and begin to reduce unemployment to pre-recession levels.

Endnotes

1. Popper (2002) also calls for a new stimulus of at least $100 billion.

2. The National Bureau of Economic Research, which is responsible for dating recessions, determined that a recession began in March 2001 (www.nber.org). The rate of growth was 5.0% in the first quarter of 2002, but more than half of this growth (2.6 percentage points) was due to a slowdown in the rate of inventory shrinkage, and growth in the second quarter was 1.1% (U.S. Department of Commerce 2002).

3. We assume that productivity will grow at its long-run trend growth rate of 2% per year, and that the labor force will expand at least 1% per year. Hence, the economy must grow at least 3% to keep unemployment from rising. To reduce unemployment, Okun's law (Bernstein et al. 2002) states that output must increase by two percentage points per year above the long-run rate of growth in potential output for one year in order to reduce unemployment by one one percentage point. Thus, to eliminate the two percentage point increase in unemployment in the past two years, the economy will need to grow 5% per year for two years.

4. An increase in the trade deficit reduces the demand for domestic goods and services. Some of the domestic demand for goods is leaking to goods and services produced abroad when the deficit is growing.

5. Tax cuts, even if they are targeted toward lower-income households, are less effective than spending increases since there will always be some leakage in the form of increased savings, instead of more consumption.

6. An alternative demand-side tax cut is a tax rebate, such as the one that was enacted in 2001. Low and moderate-income households, who are more likely to spend than to save the money, benefited substantially from this tax cut. Also, it was a temporary measure that was enacted quickly and thus helped to boost the economy.

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