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THE FOUR PIECES OF EFFECTIVE FISCAL STIMULUS: UNEMPLOYMENT INSURANCE, STATE RELIEF, FOOD STAMPS, AND TAX REFUNDS

Recent evidence that the economy has weakened significantly has sparked discussion of possible fiscal stimulus measures. To be effective, such measures must be timely, targeted, and temporary.

- *Timely* measures are those that, once triggered, stimulate new spending quickly so that businesses do not have to cut back on production or lay off workers due to weak demand.

- *Targeted* measures include those aimed at people who are most likely to experience hardship in a weak economy, since they are most likely to spend quickly the bulk of any new resources they receive. Targeted measures also include those aimed at entities that would quickly spend any relief they receive, such as fiscally strapped state governments. If measures are *not* targeted, any stimulative effect is likely to be relatively ineffective.

- *Temporary* measures are those that expire once the economy improves. Measures that are not temporary will increase long-term deficits, weakening the economy over the long term — and possibly in the short term as well, if the prospect of greater long-term deficits causes interest rates to be higher than they otherwise would be.

Some policymakers appear to assume that tax cuts are inherently stimulative, while spending increases are inherently less desirable as economic stimulus. Such assumptions do not withstand scrutiny. Both spending measures and tax cuts can be effective — or ineffective — as stimulus, depending on their nature and design.

As Nobel laureate Joseph Stiglitz and now-CBO director Peter Orszag wrote in late 2001, "Basic economic analysis indicates that increased government expenditures can indeed be stimulative, and, in fact, are often more effective as stimulus measures than tax cuts." Similarly, two senior Federal Reserve economists found in 2002 that increases in government purchases tend to have a greater stimulative effect than tax cuts that have the same cost, because more of the increase in government spending will translate quickly into an increase in total spending in the economy, while a substantial part of a general tax cut will typically be saved.

Components of an Effective Stimulus Package

An effective stimulus package — one that meets the above criteria — should include four elements:

- **Strengthened unemployment insurance.** Temporary increases in unemployment insurance (UI) benefits are particularly effective as stimulus: the benefits go to workers who have lost their jobs, so the added income is likely to be spent quickly. As CBO director Orszag recently told the House Budget Committee, "research has shown that the unemployment insurance system is among the most effective dollar-for-dollar economic stabilizers that we have in terms of counterbalancing periods of economic weakness."

  Accordingly, a stimulus package should include a temporary measure to provide additional weeks of federally funded UI benefits for workers who exhaust their regular UI benefits before they can find work, as Congress has done in every recent recession. The need will be especially great if a new recession sets in, given the large share of unemployed workers who have remained without a job for longer than 26 weeks (the normal duration of UI benefits).

  In addition, reforms are needed now in the UI program itself, which reaches only 37 percent of unemployed workers because of its outmoded rules. In October the House passed a package of permanent reforms recommended in the mid-1990s by a congressionally chartered, bipartisan advisory commission. The bill would encourage states to modernize their UI systems so more female, low-income, and part-time workers who lose their jobs through no fault of their own can qualify for benefits.

  Unfortunately, there is no assurance that the Senate will move swiftly on a UI modernization bill. Even if it does, it would take some time for states to respond to the bill's incentives. As part of any stimulus package, therefore, Congress should *temporarily* fund UI benefits for part-time workers who have lost their jobs, as well as for laid-off workers who would qualify for UI if their most recent quarters of earnings were counted. (Many states operate under outdated rules established before the computer era that fail to count workers' most recent earnings in determining their UI eligibility.) During the last recession, in 2002, a similar proposal to expand UI eligibility temporarily was a basic part of both the House Democratic and Senate Democratic stimulus packages and secured 57 votes in the Senate.

- **State fiscal relief.** As of late-January, half the states already were reporting that they face budget shortfalls for fiscal year 2009 (which begins for most states on July 1). Nineteen of them have quantified their projected shortfalls, which total at least $32 billion for these states alone. Both the number of shortfalls and the size of the combined shortfalls are expected to rise sharply in coming weeks as more states complete budget reviews and governors unveil their 2009 budgets.

  Because states must balance their budgets each year, the drop in revenues that results from an economic slowdown causes serious problems, forcing states to raise taxes or cut spending in the middle of a recession and thereby further weakening the economy. States typically institute hefty cuts in health care, education, and aid to local governments during economic downturns. Temporary fiscal relief can enable states to minimize these budget cuts and tax increases. In the last recession, Congress provided $20 billion in fiscal relief to the states.

  As in the last recession, the federal government should provide fiscal relief in the form of both general aid and a temporary increase in the federal Medicaid matching rate to help minimize cuts in health coverage. (During the last recession, state cutbacks eliminated public health coverage for more than 1 million Americans; many more would have lost coverage if Congress had not provided federal fiscal relief.) In addition, in light of the growing pressures on local governments from declining property tax revenues, fiscal relief should be designed to encourage states to temporarily increase assistance to local governments. During downturns, states often cut back local aid to help balance their budgets.

- **Temporary increase in food stamp payments.** Dollar-for-dollar, this is one of the most effective forms of stimulus available. Virtually all of an increase in food stamp benefits would be spent, since food stamp households — about 90 percent of whom live below the poverty line — generally spend all their resources to meet their daily needs. Martin Feldstein, chairman of President Reagan's Council of Economic Advisers, recently joined those calling for a temporary food stamp increase, noting that it would be stimulative because it would provide resources to people with a high propensity to consume.

  Moreover, increased food stamp benefits would be injected into the economy much more quickly, and could be implemented much more easily, than almost all other forms of stimulus. Increased food stamp benefits can be issued within 60 days after enactment, and about 80 percent of all food stamp benefits are redeemed within *two weeks* of issuance. Some 97 percent are redeemed by the end of the month. Moreover, the administrative costs of a temporary benefit increase would be negligible. In contrast, temporary expansions of most other programs except unemployment insurance would take additional months to actually show up in the economy and, in many cases, would entail increased administrative costs.

  It should also be noted that many low-income consumers do not receive UI and are not tax filers and thus would receive no help from extended UI benefits or a tax rebate (see below). A food stamp increase would reach a significant portion of this group.

- **Uniform tax refunds.** A tax rebate of a uniform amount for all filers would put money into people's hands quickly and direct a large proportion of the total to people likely to spend it. The rebate could go to all taxpayers who filed a federal income tax return the previous year, or to everyone who worked and paid FICA taxes (whether or not they filed an income tax return). The amount, presumably several hundred dollars, would be the same for all taxpayers and would not be tied to how much tax they paid.

  An even more targeted rebate would focus on people in the middle and bottom of the income range, the ones most likely to spend a very high fraction of the rebate.

A Number of Other Stimulus Candidates Would Be Ineffective — Or Worse

Unfortunately, a number of items being proposed for a stimulus package would have little if any short-term stimulative effects. Some could even slow the economy further in the short run or worsen the nation's budget problems over the long run.

- **Permanent cuts in personal tax rates.** Steps like making permanent the tax cuts enacted in 2001 or 2003 are very poor fiscal stimulus. Most of the benefits would go to higher-income individuals, who are likely to save rather than spend much of any tax cut they receive. (Tax cuts on capital gains or dividends likewise score poorly as stimulus because they would go even more disproportionately to those high up on the income scale.)

  Moreover, extending the tax cuts *after 2010* would do little to boost consumer spending in *2008.* Indeed, permanent tax cuts whose costs are not offset would harm the economy over the long term by increasing deficits. In the short term, they could even be contractionary to the extent that they keep long-term interest rates higher than they otherwise would be.

- **General reductions in business taxes.** Steps like cutting corporate income tax rates are largely ineffective as stimulus. Businesses base their hiring and firing decisions (and their decisions on purchasing raw materials) primarily on expectations about customer demand, rather than on how much cash they have on hand. As a recent Goldman Sachs analysis stated, "companies don't spend money just because it's there to spend. To justify outlays for new projects, the expected returns have to exceed the costs, and that usually requires growth in demand strong enough to put pressure on existing resources."

  In fact, a temporary corporate rate cut might *discourage* new investment and production by reducing the value of the tax deductions companies claim when they invest, pay wages, or make other purchases. Businesses would have some incentive to delay investment, hiring, and other purchases that result in deductions until the corporate rate returned to its previous, higher level.

- **Business investment incentives.** Tax incentives that induce businesses to accelerate their investments, such as "bonus depreciation" or investment tax credits, have usually been regarded as the best candidates for stimulus on the business side. However, even they are likely to have only modest stimulative effects because a substantial fraction of the investment benefiting from tax incentives would likely have been made anyway. A Federal Reserve study found that the bonus depreciation incentives enacted in 2002 and expanded in 2003 had "only a very limited impact" on investment, at best.

  Also, bonus depreciation incentives would have the side effect of weakening *state* revenues in the many states that base their business taxes on the federal corporate tax. That would require states to raise other taxes or cut basic programs more deeply to keep their budgets in balance.

- **New infrastructure projects.** Although increased investment in infrastructure has strong merit, new infrastructure projects (as distinguished from maintenance of projects already underway and possible acceleration of some planned repair projects that require little lead-time) do not rate well as stimulus, because infrastructure projects typically take many months to get off the ground.

Respected analysts such as former Treasury Secretary Lawrence Summers and participants at a recent Hamilton Project forum have suggested a stimulus package in the $50 billion to $100 billion range. Such a package, in combination with the stimulus provided both by the Federal Reserve's easing of monetary policy and by the "automatic stabilizers" (the reductions in tax payments and increases in government expenditures for programs like unemployment insurance that take place automatically when the economy slows), could significantly bolster the economy in coming months.

However, those same analysts have emphasized that such a package must satisfy the "three T's" of good stimulus: timely, targeted, and temporary. As Summers has argued, "Poorly provided fiscal stimulus can have worse side effects than the disease that is to be cured." Because of the political risks of enacting a poorly timed or poorly designed package, Martin Feldstein's proposal to use a decline in employment over a three-month period as a "trigger" for putting a stimulus package into effect merits consideration.

Finally, Congress will face the question of whether stimulus measures should be subject to PAYGO provisions and be offset by deficit reduction measures that would take effect in subsequent years, after the economy has recovered. PAYGO is desirable but not essential as long as the stimulus measures are truly temporary. It *is* essential, however, that these measures be temporary.