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ANOTHER ROUND OF ECONOMIC STIMULUS?
Hurricane Reconstruction and Relief is the Right Medicine

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"[W]e don't really need any national stimulus package in the form of more tax cuts either, particularly with federal spending at about one percent of GDP on Katrina. ... So any case made for relief should be for relief in the affected region." — Glenn Hubbard, former Chairman of the Council of Economic Advisers under President Bush, Marketplace radio, September 12, 2005

In the aftermath of Hurricane Katrina, some have suggested that Congress enact broad-based federal legislation to stimulate the national economy. Such a course would be ill-advised; Congress should focus instead on immediate reconstruction of the devastated areas and relief for the victims of Katrina. In addition to being necessary for the people and the economy of the affected areas, targeted regional relief and reconstruction will very likely meet any need for stimulating the national economy to offset the effect of Katrina.

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The Congressional Budget Office, the investment houses Goldman Sachs and Merrill Lynch, President Bush's current and former top economic advisers, and other economists and forecasters generally concur that the effect of Katrina on the national economy will be both limited and temporary (in contrast to its effects on the regional economy). They expect only a modest slowing of the economy in the next few months — far from a recession — followed by a substantial economic rebound. In fact, experts expect that following a relatively modest downward effect on national economic growth in the rest of 2005, Katrina is likely to result in faster economic growth in 2006 than would have occurred without the hurricane, because of the significant economic activity that will be created by the extensive rebuilding effort that will ensue. This strongly suggests there is no economic need for a broad-based, national stimulus package, which even if enacted today would not begin to have much effect until 2006.

In its meeting on September 20, the Federal Reserve essentially adopted a similar view. The Federal Reserve said that while Katrina could have short-term economic effects, it does not pose a larger threat to economic growth. By electing to continue increasing interest rates — the opposite of what the Federal Reserve did in the face of a true economic downturn earlier in the decade — the Federal Reserve made clear that even after Katrina, it does not think that a major economic slowdown is a significant threat and regards additional action to stimulate the economy as unnecessary.

Who Has Benefited From The Recovery?

The fruits of the recent recovery have accrued disproportionately to corporate profits and the well-off. In contrast, employment levels, wages for workers, non-residential investment, and wealth and income growth generally, have fared less well than in prior recoveries.[a] This phenomenon is primarily a reflection of problems with the *nature* of the economy, however, and is also a reflection of a multi-decade trend toward rising income inequality. Legislative responses to the unbalanced nature of the economy, if appropriate, should therefore focus more on labor policy than on economic stimulus — particularly not on "stimulus" policies aimed at those who have already benefited the most during the recovery.

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a. See Shapiro, Kogan, and Aron-Dine, "How Does This Recovery Measure Up?," Center on Budget and Policy Priorities, August 9, 2005, at http://www.cbpp.org/8-9-05bud.pdf.

Furthermore, a broader economic stimulus package would be costly. It likely would include expensive measures that could prove difficult to terminate or relatively easy to extend. Costly tax and spending proposals that do *not* represent efficient stimulus tend to proliferate, and to be pushed forcefully by special interests and policymakers, when talk turns to broad economic stimulus packages. There is evidence that lobbyists already are at work pushing pet proposals in the name of stimulus.

A national stimulus package would further swell deficits and debt, especially if supposedly temporary tax breaks and other provisions were extended when they were slated to expire. The national debt already is projected to grow faster than the economy for the foreseeable future, which signifies that existing and projected deficits are not sustainable. A broad-based, national stimulus package thus is inadvisable: not only would it be unnecessary, but it would be risky, adding to existing and future deficits and debt. Excessive deficits tend to weaken the economy over the long term, can push interest rates higher than they would otherwise be, and limit the nation's ability to deal with ongoing needs and future emergencies.

The remainder of this analysis elaborates on these points.

Could Katrina trigger a new recession that needs to be averted? Although the gains of recent economic growth have been unevenly distributed, the U.S. economy was growing at a healthy rate before Katrina. The Congressional Budget Office, Treasury Secretary John Snow, former CEA Chairman Hubbard, current CEA Chairman Bernanke, the investment firms Goldman Sachs and Merrill Lynch, and other economic experts expect that Katrina will have a relatively modest negative effect on national economic growth over the next few months, and that in 2006 the economy will bounce back and economic growth will likely be faster than it would have been without Katrina. Analyzing the economic outlook in the aftermath of Katrina, the Congressional Budget Office wrote on September 6:[1]

1 CBO, "Macroeconomic and Budgetary Effects of Hurricane Katrina," September 6, 2005. Available at http://www.cbo.gov/ftpdocs/66xx/doc6627/09-06-ImpactKatrina.pdf.

> [T]he overall economy was growing steadily at the time of the disaster. (CBO's summer forecast called for 3.7 percent real growth in 2005 and 3.4 percent in 2006.) The devastation in the Gulf Coast region is unlikely to knock the economy far from that course…[e]vidence to date suggests that the overall economic effects will be significant but not overwhelming. Because they are concentrated in this year, there is potential to reduce growth by between one-half and one percentage point at an annual rate in the second half of 2005. (On a year-to-year basis, the impact may be as small as a few tenths of a percent of GDP.) … While Katrina devastated ordinary business, it will also likely lead to a boom in clearing and reconstruction activities. … Economic growth and employment are likely to rebound during the first half of 2006 as rebuilding accelerates. …."

It is CBO's view that before Katrina, the overall level and growth rate of the economy had almost fully recovered from the recession, that Katrina will initially slow the overall growth rate slightly but not nearly enough to push the economy into recession, and that as reconstruction accelerates, the economy will regain the ground it temporarily lost as a result of Katrina.

Glenn Hubbard, former Chairman of the Council of Economic Advisers under President Bush, concurs. On September 18, he wrote,

> While Katrina's damage will inflict a short-term blow to US production and employment, its effect on the national economy over a year is likely to be modest. This is not because the damage is inconsequential but because gross domestic product and incomes rise as additional production, construction and employment follow from the rebuilding after a disaster. [2]

A broad-based, national stimulus package is inadvisable: it would be unnecessary and add to deficits and debt.

Ben Bernanke, current Chairman of the President's Council of Economic Advisors, offers a similar view. "Prior to Katrina," Bernanke said on September 15, "the near-term forecasts of both CEA and private-sector economists had called for continued solid growth. Katrina's effects may reduce growth somewhat in the short run, but the longer-term growth trajectory remains in place."[3]

The investment firm Merrill Lynch has reached a similar conclusion.[4]

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[2] Glenn Hubbard, *A Post-Hurricane Action Plan Should Focus on People*, op-ed, Financial Times, September 18, 2005, page 19, available at http://news.ft.com/cms/s/da961ae8-2869-11da-97c7-00000e2511c8.html.

[3] Ben Bernanke, *The Outlook for the Economy and For Policy*, speech to the National Bureau of Economic Research Conference, September 15, 2005.

[4] Merrill Lynch special report, *Reactions to Hurricane Katrina*, September 2005, available at http://www.ml.com/media/49255.pdf.

At this point, our best guess is that the hurricane will subtract between 0.5% and 1% from real gross domestic product (GDP) growth in the third quarter. For the fourth quarter, and possibly the first quarter on 2006, reconstruction efforts could add up to 0.5% to GDP growth.

A stimulus package almost certainly would begin to affect the economy too late and last too long.

Treasury Secretary Snow similarly has observed that the economy should not only rebound after Katrina but may come out larger than it would otherwise have been: "The normal pattern is that after the negative consequences, we get into a rebuilding mode, and that rebuilding mode takes you to higher GDP levels."[5]

The investment firm Goldman Sachs also subscribes to the view that both economic growth and the total size of the economy likely will be greater in 2006 than they would have been without the hurricane. In an analysis issued September 9, Goldman Sachs analysts wrote:[6]

With the full impact of Hurricane Katrina still unclear, the trickle of pre-hurricane data this week confirmed solid momentum in the economy just before Katrina struck. … Following Hurricane Katrina, we have made our growth forecast more backloaded. We now expect real GDP to grow at annualized rates of 3% in the second half of 2005 and 3¾% in the four quarters of 2006, versus 4¼% and 3% previously. … The model underlying our forecast changes is very simple — slower growth in 2005 as Katrina disrupts economic activity and raises energy prices, followed by faster growth in 2006 as normal activity resumes, the energy shock fades, the rebuilding effort begins, and the lagged effects of somewhat lower interest rates in 2005 boost spending. … Katrina has reinforced our confidence that interest rates will rise further than the market currently expects. … [T]he likely net impact of the disaster is to boost the level of GDP in 2006, as discussed above. If so, the unemployment rate would fall and the level of resource utilization would rise further than previously anticipated, increasing the risk of inflation yet more.

Why could both the growth rate and the size of the economy be greater in 2006 as a result of Katrina? The very large amounts of federal funding being discussed for reconstruction and relief would equal roughly 0.8 percent to 1.2 percent of GDP, with the bulk of these amounts likely to be spent in fiscal year 2006, which starts October 1. Contrast this with CBO's estimate that "on a year-to-year basis, the impact [of Katrina] may be as small as a few tenths of a percent of GDP." The fact that the amount of expenditure is likely to be *greater* than the economic loss from Katrina helps to explain why, after an initial dip, GDP may end up larger in 2006 than it would have been without Katrina. In addition, some businesses and individuals in the affected areas will convert some of their personal savings into consumer spending — on repairs, for example — which will provide some additional macroeconomic stimulus.[7]

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[5] John W. Snow, quoted in David Leonhardt and Edmund Andrews, "Tumult in Gulf Region but Little Early Effect Across the Nation," New York Times, September 4, 2005.

[6] Goldman Sachs, US Economic Analyst, Issue # 05/36, September 9, 2005.

[7] The idea that the economy as a whole may come out slightly ahead may seem paradoxical, but it is standard economics. The size or growth of the economy, as measured by the annual Gross Domestic Product, represents the gross amount of goods or services produced by workers in the United States in a given year. GDP therefore does not shrink when

This suggests that economic stimulus lasting more than a few months could be self-defeating. Financial markets might become concerned about the possibility of economic overheating, and the Federal Reserve might respond by raising interest rates higher than it otherwise would. The fact that the Federal Reserve chose to continue to raise short-term interest rates in the September 20, 2005, meeting of its Federal Open Market Committee strongly suggests that the Fed sees the risk of economic overheating as being greater than the risk of Katrina's causing a significant slowdown or new recession.

Reconstruction Is Excellent Stimulus. The need to reconstruct devastated areas of Louisiana, Mississippi, Alabama, and Florida, to get local communities, businesses, and governments back up and running, and to provide relief to the victims of Katrina is clear. It also should be understood that federal spending on recovery and reconstruction efforts *constitutes high-quality economic stimulus*, because the money will be spent rather than saved and will be injected into the economy relatively quickly.

Investment tax cuts for corporations tend to be inefficient as immediate economic stimulus – much of their cost goes to subsidize investments that would have been made anyway.

Federal reconstruction and relief is high-quality stimulus because it has a very high "bang-for-the buck" — it produces significant economic activity for each dollar spent. The dollars spent on relief are put into the hands of consumers who will spend those dollars quickly on food, clothing, rent, school supplies, and the like. These *relief* expenditures help to offset losses in consumer spending that otherwise would occur as a result of the hurricane.[8] The *reconstruction* efforts differ in that they generally will result in a *net addition* to economic activity, since they will involve construction and new purchases of capital items and consumer durables that, in many cases, would not otherwise have been made.[9]

Conclusion: National "Stimulus" Legislation Has Many Drawbacks. A new national stimulus package, which could include items such as depreciation tax cuts and other investment tax breaks for businesses and corporations in parts of the country not affected by the hurricane, is not needed and would be risky and ill-advised.

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physical infrastructure is destroyed (even though the nation loses *wealth*), but does rise when physical infrastructure is built or rebuilt. Measuring annual GDP is not intended to be the same as measuring the annual increase in national wealth. GDP is a useful measure precisely because it shows how much America's workers are producing during a specified period; an increase in GDP means more jobs, higher wages, more profits, or all three during that period. GDP is thus the relevant measure in considering the need for overall economic stimulus. (The fact that GDP may be higher in 2006 with Katrina than without does not mean that the nation is economically better off because of Katrina, of course, because of the destruction of wealth Katrina caused. And the personal, non-economic damage caused by the massive disruptions to people's families and lives are not measured by any economic statistic.)

[8] Federal assistance that replaces the lost income of Katrina victims in part or in whole is not stimulus relative to a world in which Katrina did not happen. It does not result in additional economic activity over and above what have occurred without the hurricane. Given that the hurricane did occur, however, relief to hurricane victims does constitute efficient stimulus relative to the level of economic activity that would occur if relief were *not* provided. This is a relevant consideration here, given that the policy question we are examining is the extent to which there has been harm to the national economy as a result of the hurricane and whether national stimulus legislation is needed to mitigate or erase that harm.

[9] For recommendations on temporary, targeted changes to existing benefit programs, see *Meeting the Basic Needs of Hurricane Katrina Victims*, Center on Budget and Policy Priorities, September 9, 2005, available at http://www.cbpp.org/9-9-05pov.pdf.

- Economic growth is expected, if anything, to be stronger in 2006 than it would have been without the hurricane because of the massive reconstruction activity that will be underway. Further economic stimulation does not appear to be necessary or warranted.

- In any event, a stimulus package almost certainly would begin to affect the economy too late and last too long, lasting after Hurricane Katrina's temporary adverse effects on the national economy were behind us. Such a package would be mis-timed.

- Moreover, such a package would likely become a magnet for "tax and spending pork" — for special-interest legislation only tangentially related to immediate economic stimulus.

- Some of the stimulus provisions — and costs — might never expire, as a result of powerful special-interest pressures to extend them. For example, although various tax-cut provisions might officially be temporary, they could ultimately end up becoming additions to the lengthy list of special tax breaks known as "extenders," which Congress routinely extends whenever their scheduled expiration dates approach.

- A stimulus package thus is likely to be expensive, and it would add to deficits and debt. The budget deficits already projected for coming years and decades are at levels that are not sustainable. Those deficits ultimately will have adverse effects on long-term growth and limit the nation's ability to pay for ongoing needs and to respond to future emergencies.

- Finally, investment tax cuts for corporations and other businesses tend to be inefficient as immediate economic stimulus, since much of their cost goes to subsidize tax breaks for investments that would have been made anyway, without the new tax incentives.

In short, a national stimulus package would take too long to have an impact on the economy, remain in effect too long, attract pork, and create new tax cuts and spending projects that could remain embedded in the budget for years to come. It would exacerbate the nation's deficit and debt problems. Moreover, the indications are that such package is not needed and that the large-scale reconstruction efforts that will be undertaken will provide any stimulus the economy needs.