CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

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PRINCIPLES FOR ECONOMIC STIMULUS

By Andrew Lee

Although the downturn in the economy started in March 2001, the policy debate over how to improve the economy's performance began in earnest after the terrorist attacks in September 2001. Policymakers, academics, and institutions such as the Congressional Budget Office have produced various analyses highlighting what constitutes effective stimulus. Despite the diversity of sources, there is considerable agreement on these concepts. For example, the Chairmen and Ranking Members of the House and Senate Budget Committees issued a joint, bipartisan set of principles for economic stimulus in October 2001. (See box on page 2.) As Congress prepares to consider more proposals for stimulating the economy, it is worth reiterating and clarifying these basic principles.

Short-term economic stimulus addresses a condition in which there is insufficient demand for what the economy is capable of producing. It is important to note that boosting the economy in the short run is different from trying to improve economic growth over the long run. Indeed, these two economic goals can be in conflict. For instance, although policies that encourage savings are appropriate for long-term growth, they are the opposite of what is needed for near-term stimulus, which requires individuals and businesses to spend — not save — more in the short run. Similarly, short-term fiscal stimulus typically increases the budget deficit, while budget policies conducive to long-term growth generally call for lower deficits.

Following are three key principles for short-term economic stimulus found throughout the analyses prepared during the past 15 months:

- **Give money to those most likely to spend it.** — Since the goal of stimulus is to boost demand, the key is putting money into the hands of the entities — whether they be households, businesses, or state governments — that are most likely to spend it and thus pump funds into the economy. Funds should be used to encourage these groups to undertake new spending today or to prevent cutbacks in spending they otherwise would have made.

- **Use policies that take effect quickly.** — The goal is to speed-up the economic recovery that will eventually occur, albeit more slowly, if the economy is left to its own devices. As a result, there is a fairly narrow time frame during which policies can have an impact on the recovery process. Policies that take too long to implement miss this narrow window and take effect when the economy is already growing robustly or has already recovered.

- **Do not worsen the long-term fiscal situation.** — It is essential that policies to boost the economy in the short run do not weaken the economy in the long run or exacerbate future fiscal difficulties. Consequently, stimulus proposals should be temporary, potentially increasing the deficit in the short run but avoiding higher

Bipartisan Principles for Economic Stimulus

In October 2001, the Chairmen and Ranking Members of the House and Senate Budget Committees released a document detailing a set of bipartisan principles for economic stimulus.* They emphasized an overall principle that "an economic stimulus package should be based on the recognition that long-term fiscal discipline is essential to sustained economic growth." Within this context, the document stated that:

- The objectives of an economic stimulus should be to restore confidence, increase employment and investment, and assist those in need during the downturn without creating a structural deficit.
- The stimulus should take effect quickly and all measures should be temporary — sunsetting within one year, to the extent possible.
- The stimulus should not be limited to particularly industries, but should "achieve the greatest possible stimulus effect per dollar spent" by targeting individuals likely to spend additional funds and businesses likely to increase investment and employment.
- The size of the package should equal approximately one percent of GDP.
- The short-term cost of the package should be offset in order to maintain long-term fiscal discipline — "...outyear offsets should make up over time for the cost of near-term economic stimulus."

* "Principles for Economic Stimulus," Kent Conrad, Pete Domenici, Jim Nussle, and John Spratt, October 4, 2001.

deficits in the long-term. Guarding against deterioration in the long-term outlook is also important for the short-term recovery. Since financial markets are forward-looking, projected future deficits can put upward pressure on interest rates now and impede the current recovery.[1]

Taken together, these principles suggest temporary, targeted policies with a high "bang for the buck" — that is, proposals that provide strong stimulative benefits to the economy relative to their total cost. Such policies would boost demand in order to stimulate the economy in the short term, while maintaining long-term fiscal discipline to protect long-run economic growth and avoid worsening the daunting fiscal challenges the government ultimately will face as a result of the baby boomers' retirement and the rising cost of health care.

Boosting Demand in the Short Run

During a short-term economic slowdown, the primary problem is lack of demand. As the Congressional Budget Office has explained, "whereas longer-run tax policies designed to improve economic growth do so by increasing the economy's capacity to produce, the purpose of fiscal stimulus is to generate demand sufficient to engage more of the economy's existing

[1] See William Gale and Peter Orszag, "The Economic Effects of Long-Term Fiscal Discipline," Urban-Brookings Tax Policy Center Discussion Paper, December 17, 2002.

productive capacity."[2] The current problem is not a lack of productive resources (labor and capital) on the *supply* side, but rather a lack of *demand* for products and services.

Spending occurs in three sectors: households, businesses, and public institutions all purchase goods and services in the economy. While consumer demand has held fairly steady, business investment is down and may be the main cause of sluggish recovery. Most argue that this is a reflection of overcapacity from too much investment in the late 1990s rather than a lack of available funds for investment. Public sector spending is up at the federal level but down among states.

Household Spending

One way of increasing demand is to increase household consumption. This is accomplished most efficiently by targeting households that are more likely to spend than to save additional money. Economic research, as well as common sense, suggest that lower-income households are more likely to spend additional funds than higher-income households. For example, a cash-constrained family living from paycheck to paycheck is likely to spend additional funds simply in order to get by, while a wealthier family can more easily use the money to improve its savings. Thus, policies aimed at low- and moderate-income households will be more effective stimulus than policies that increase the after-tax income of high-income households. Likewise, an extension of unemployment insurance benefits would be well-targeted stimulus because unemployed workers need to spend those funds to replace lost wages.

Business Investment

Another way of increasing demand is to encourage businesses to increase investment spending or hire more workers. To do so efficiently, policies should focus on incentives for new investment or hiring rather than provide windfall gains for old investment. While such windfall gains can improve the financial positions of companies, they are unlikely to provide near-term stimulus to the economy, since many companies would likely retain these windfall gains rather than use them to increase purchases now or hire more workers. It makes sense for firms to increase purchases or hire more workers only when that would lead to the firms' producing more goods and services they can actually sell.

Trying to stimulate the economy in the short term through business incentives is inherently difficult to do because businesses mostly base production, investment, and hiring decisions on expected consumer demand, not on tax incentives. Thus, Business Roundtable Chair John T. Dillon recently advocated a stimulus plan focused on putting cash into consumers' pockets.[3] Adding to the difficulty of stimulating economy through business incentives is the fact that it is hard to prevent a share of any tax incentive provided for business investment from turning into tax breaks for investments that businesses would have made anyway. This reduces the efficiency of such policies.

[2] "Economic Stimulus: Evaluating Proposed Changes in Tax Policy," Congressional Budget Office, January 2002.

[3] "Business Leaders Advance $300 Billion Tax Stimulus Plan," *Tax Notes*, November 21, 2002.

State Fiscal Relief

Increasing demand for goods and services can also be achieved by providing fiscal relief to the states, which place a drag on the national economy when they enact spending cuts and tax increases. State governments have already acted to close budget deficits of approximately $50 billion for state fiscal year 2003 (which runs through June 30, 2003 in most states) and face additional deficits they must close of about $17.5 billion in 2003. In addition, states face further budget deficits of $60 billion to $85 billion for state fiscal year 2004.[4] These represent the largest state budget gaps in half a century. Due to these large shortfalls, many states are cutting expenditures substantially — including expenditures for education and health insurance — to meet balanced budget requirements. A growing number of states also are considering tax increases. Such budget cuts and tax increases *reduce* demand and thereby retard economic recovery. Providing fiscal relief to states constitutes effective stimulus, as it helps the economy by reducing the need for expenditure reductions and tax increases that states otherwise would institute.

Targeting Proposals for Short-term Effectiveness

To address the current economic slowdown, stimulus proposals must take effect quickly. Policies that fail to take effect quickly will not provide stimulus in time to help speed the recovery. For example, it is often difficult to provide quick stimulus through creating new government spending programs because of the time required to set up the programs. (This is another reason why state fiscal relief would be effective stimulus. Rather than creating new programs, states would quickly use relief funds to prevent cuts in already-existing programs.) Similarly, federal tax cuts that would not put much cash into taxpayers' pockets until taxpayers file their 2003 tax returns in early 2004, and tax cuts that induce taxpayers to save rather than spend more (such as increased tax breaks for retirement savings), would do little to stimulate the economy.

Policies also should be temporary, ending as the economy picks up steam. Policies that remain in effect after that, such as permanent tax cuts or permanent entitlement increases, provide poor "bang for the buck" as stimulus because they entail ongoing government costs or revenue losses beyond the relevant time frame for stimulus. Furthermore, investment credits or depreciation tax breaks are more effective as stimulus when established as temporary, short-term measures rather than as multi-year or permanent measures. A short-term provision can encourage firms to accelerate investment to take advantage of a tax break while it is available. A tax cut for business investment that extends beyond the immediate future, however, is less effective as stimulus, because it provides little incentive for firms to accelerate their investment plans into the period when the economy needs the boost.

Last year, the chairmen and ranking members of the House and Senate Budget Committees supported the importance of quick-acting and temporary provisions in their

[4] Iris J. Lav, "Many Federal 'Stimulus' Tax Cuts Under Consideration Would Be Highly Costly for States," Center on Budget and Policy Priorities, December 23, 2002.

"Principles for Economic Stimulus" by arguing that the stimulus package should have rapid impact and sunset within one year.[5]

Do Not Worsen the Long-term Fiscal Situation

Maintaining long-term fiscal discipline is important for several reasons. First, future deficits can undermine the immediate goal of stimulating the economy by putting upward pressure on current interest rates. Financial markets are forward-looking and tend to react to expected future budget deficits. In a recent study, Brookings Institution economists William Gale and Peter Orszag find that among econometric studies that take into account expected future deficits, most show significant connections between deficits and long-term interest rates.[6] Higher long-term interest rates discourage business and consumer spending. Due to this impact on interest rates, future deficits can hinder short-term economic recovery.

Furthermore, larger future deficits will reduce national savings over the long term. This translates into reduced national investment and lower future national income. As Gale and Orszag explain, "... long-term budget deficits reduce national saving and impose substantial long-run costs on the economy, regardless of whether interest rates are affected….the expanded budget deficit will manifest itself in some combination of reduced domestic investment and an expanded current account deficit. Either way, and regardless of the effect of deficits on interest rates, increased budget deficits reduce future income."[7]

Finally, the nation already faces tremendous long-term fiscal challenges. The retirement of the baby boomers, rising health care costs, and the costs of the tax cut enacted in 2001 (if made permanent) will exert tremendous pressure on the budget. Stimulus proposals that worsen the long-term fiscal situation will make these challenges even more excruciating to deal with and ultimately lead to larger tax increases and cuts in programs, or to larger budget deficits.

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[5] "Principles for Economic Stimulus," Kent Conrad, Pete Domenici, Jim Nussle, and John Spratt, October 4, 2001.

[6] Gale and Orszag, *op. cit*.

[7] Gale and Orszag, *op. cit*.