A Second Quick Boost From Government Could Spark Recovery

[Editor's note: These comments by Mark Zandi, chief economist of Moody's Economy.com, are edited excerpts of testimony he gave before the U.S. House Committee on Small Business on July 24, 2008.]

I strongly support efforts for a second fiscal stimulus plan designed to help the economy by early 2009. Like the first stimulus plan, it should be temporary and not raise the long-term budget deficit. The plan should also be targeted to help lower- and middle-income households and smaller businesses that will use the help quickly and aggressively to stimulate the economy.

There are three principal reasons for my support. First, the economy continues to struggle. Most significantly, employment is falling and unemployment is rising. More than 400,000 payroll jobs have been lost since the beginning of the year, and the unemployment rate has risen by more than 1 percentage point since its low in the spring of 2007.

The job losses have been broad-based across industries and regions of the country. Construction, manufacturing, retailing, transportation, financial services, information services and professional services are all losing jobs. Only health care, educational services and government continue to add to payrolls on a consistent basis.

Nineteen states are now suffering very weak job markets, characterized by generally falling employment and rising employment: Alabama, Arizona, Delaware, California, Idaho, Indiana, Florida, Kentucky, Maine, Michigan, Mississippi, Missouri, Nevada, Ohio, Rhode Island, South Carolina, Tennessee, Wisconsin, and Virginia. Very few states, mostly those with economies based on energy and agricultural production, are adding significantly to employment.

More job losses are likely in coming months. The housing downturn continues unabated, high energy and food prices are undermining consumer purchasing power, and the financial system remains under significant stress, which is restricting the availability of credit to households and businesses. These economic headwinds are unlikely to abate quickly.

Second, although the economic benefits of the first stimulus package passed early this year have been substantial, they will fade by year's end. The tax rebate checks mailed from May to early July have substantially lifted retail sales this summer and have been instrumental in offsetting the ill-effects of record gasoline prices. Indeed, the $100 billion in rebate checks will largely pay for the approximately $100 billion more consumers will have to pay for gasoline this year. Unfortunately, because of the higher cost of gasoline and food, the tax rebates will not be the catalyst for a self-sustaining economic expansion as policymakers had hoped. In fact, retailing is likely to weaken sharply in coming months as the rebate money is spent and the weak job market continues to weigh heavily on consumer purchasing power.

The first stimulus bill also provided business tax incentives to stimulate increased investment. This will provide a small boost to investment spending this year, but the incentives expire at the end of the year and investment will decline in early 2009.

Third, the need for more fiscal stimulus is compounded by already very low interest rates. The Federal Reserve has aggressively lowered interest rates over the past year, and with the federal funds rate target now at 2%, the central bank will be constrained from lowering rates further. Moreover, monetary policy may be less effective in stimulating growth in the current environment. The most immediate conduit between monetary policy and the economy runs through the housing market. Housing is the most interest-rate sensitive sector of the economy, and historically it would receive a quick boost from monetary easing. This boost is much more muted today considering the problems in the private mortgage securities market and at the government-sponsored enterprises Fannie Mae and Freddie Mac. Low interest rates are not increasing the availability of mortgage credit.

A second fiscal stimulus plan should include temporary tax and spending items costing $50 billion to $100 billion. The $50 billion to $100 billion in proposed stimulus can also be thought of as making up some of the difference between consensus expectations for growth in 2009 and the economy’s potential growth. According to the Blue Chip survey, the consensus is for real GDP to advance by less than 2% in 2009. Most economists have not assumed that a fiscal stimulus plan will be passed, and most put potential growth below 3%. If economists are correct about growth next year, then a $50 billion to $100 billion stimulus plan would simply put the economy back closer to its trend. If economists are wrong, it's likely they will have erred on the side of optimism and that the economy is already in recession. In that case, a fiscal stimulus plan would be especially helpful.

An effective stimulus package could include a gas tax holiday, expansion of the food stamp program, a payroll tax holiday, aid to state governments, extension of the investment tax incentives, and increased infrastructure spending. The biggest lift from this stimulus would go to lower-income households struggling to pay soaring gasoline and food prices and to small businesses getting hit hardest in the current downturn.

Extending food stamps is the most effective way to prime the economy's pump. A $1 increase in food stamp payments boosts GDP by $1.73. People who receive these benefits are very hard-pressed and will spend any financial aid they receive within a few weeks. Because these programs are already operating, increased benefits can be quickly delivered to recipients.

Fiscal Bang for the Buck

One-year $ change in real GDP per $ reduction in federal tax revenue or increase in spending

Tax Cuts	
Nonrefundable Lump-Sum Tax Rebate	1.02
Refundable Lump-Sum Tax Rebate	1.26
Temporary Tax Cuts	
Payroll Tax Holiday	1.29
Across the Board Tax Cut	1.03
Accelerated Depreciation	0.27
Permanent Tax Cuts	
Extend Alternative Minimum Tax Patch	0.48
Make Bush Income Tax Cuts Permanent	0.29
Make Dividend and Capital Gains Tax Cuts Permanent	0.37
Cut Corporate Tax Rate	0.30
Spending Increases	
Extend Unemployment Insurance Benefits	1.64
Temporarily Increase Food Stamps	1.73
Issue General Aid to State Governments	1.36
Increase Infrastructure Spending	1.59

Source: Moody's Economy.com

Another economically potent stimulus method is aid to financially pressed state governments. This could take the form of general aid or a temporary increase in the Medicaid matching rate to help ease health coverage costs. Such help appears unlikely in the proposed plan, but this could quickly change if the economy’s problems grow more severe and widespread in coming weeks as the legislation is being fashioned.

Fiscal problems have already developed in half the nation’s states. Tax revenue growth has slowed sharply along with flagging retail sales and corporate profits. Income tax receipts are also sure to suffer as the job market weakens. California and Florida are under the most financial pressure, but states as far-flung as Arizona, Minnesota and Maryland are also struggling.

Since most state constitutions prohibit budget deficits, most states are already drawing up plans to cut funding for programs ranging from healthcare to education and are cutting grants to local governments, which are having their own financial problems. Most rely on property tax revenues, which are slumping with house prices. Cuts in state and local government outlays are sure to become a substantial drag on the economy later this year and into 2009.

On the face of it, increased infrastructure spending appears to be a particularly efficacious way to stimulate the economy. The boost to GDP from each $1 spent on building bridges and schools is estimated to be a large $1.59, and who could argue with the need for such infrastructure? The overriding limitation of such spending as a part of a stimulus plan, however, is that it generally takes a substantial amount of time for funds to flow to builders and contractors and into the broader economy. (It should be noted that Table 1 estimates the change in GDP one year after the spending occurs and says nothing about how long it may take to cut a check to a builder for a new school.) Many infrastructure projects can take years from planning to completion. Even if the funds are used to finance only those projects that are well along in their planning, it is difficult to know just when the projects will get under way and when the money will be spent. Another complication arising from infrastructure spending is the politics of apportioning these funds across the country in a logical and efficient way. Despite these caveats, if projects that could be started quickly can be identified, they could prove to be an efficacious stimulus.

The economy will continue to struggle in coming months, but a temporary, targeted, and well-timed second-round fiscal stimulus program would go a long way toward lessening the severity of the difficulties and perhaps even jump-start a self-sustaining expansion.