Economic Analysis in Support of Economic Recovery & Reinvestment Act

The proposed $550 billion package of well-targeted government spending makes sense today because

- the economy and jobs are sinking fast and need a big boost;
- we have a large backlog of worthwhile infrastructure projects that have been studied and approved;
- states are on the verge of sharply reducing investments in education, health, and public safety;
- investments in technology and skills will pay dividends for many years; and
- as millions of additional families face severe economic hardship, we should take forceful action to support employment and to provide income support for those who lose their jobs and income.

This package should have the effect of staving off the worst prospects of the current economy now in the process of "shutting down" in the words of a recent congressional economic witness. But there remains a significant likelihood that further action will be needed. There is a very real risk that, because of unanticipated economic bad news, this legislation may undershoot its target. Congress must be alert to counter additional economic weakness because the strength of the country and security of American families are at stake.

Lack of Demand Creates Extraordinary Slack

The federal government should step in to increase demand for American goods and services because all other sources of demand are declining.

- Households are spending less because they're losing jobs and their homes and investments are losing value. In the second half of 2008, real consumer spending on goods plunged at the fastest rate in six decades of data.
- Businesses are scaling back investment because they have more and more excess capacity and they lack confidence that demand for their goods and services will recover soon enough to justify adding more capacity.
- State and local governments are retrenching because of falling revenues and balanced budget requirements. The Center on Budget and Policy Priorities estimates that the states' fiscal gap will reach 17 percent of their general budget in the next fiscal year and that they face a combined $350 billion shortfall for the remaining six months of this fiscal year and the next two fiscal years.
- Recessions abroad are shrinking demand for our exports. The consensus of economic forecasters calls for GDP to shrink this year in Europe and Japan by the same 1-1/2 percent as in the United States.

The recession has already created considerable economic slack and forecasters expect that slack to increase. Improving technology and rising population together raise the economy's potential output by at least 3 percent a year. Actual output today is lower than it was five quarters ago. That 3 percent shortfall means that we are already producing about $500 billion below our potential. Although they are factoring in positive

effects from stimulus legislation, economic forecasters expect that shortfall to double over the next year and to remain large for an extended period after that.

We will need a strong fiscal boost to continue even after the economy hits bottom and starts to grow again, possibly later this year or early next year. The usual drivers of strong recoveries – housing and autos – seem unlikely to provide the typical boost this time around. Even after output hits bottom, employers seem likely to hold off hiring, just as they did in the years just after the last two recessions. Unemployment rose another 1.5 million in the 15 months after the 1990-91 recession and by 1.3 million in the 19 months after the 2001 recession. Because of the continued overhang of vacant housing, economic forecasters expect to see subpar growth throughout 2010 and thus unemployment to exceed 8 percent -- higher than at any time in the last quarter century.

Unfortunately, the current trajectory of the economy allows ample capacity to absorb the 3.7 million jobs that the Obama economic team projects will be created or saved by the recovery bill. That's less than the 4.3 million rise in unemployment that has occurred from 6.8 million in mid 2007 to 11.1 million in December 2008. The consensus of economic forecasters expects unemployment to reach 13 million people in 2010, even after they factor in sizable economic stimulus. Forecaster Zandi projects that, without stimulus, we would see unemployment reach 16 million people in 2010.

The rate of deterioration in the job market has been accelerating. The January 9 labor report came in worse than had been expected at the time of the projections made in the last paragraph, not only for December but for prior months. Over the last three months of 2008, both job loss and unemployment increases have been running about 500,000 a month, for an annual rate of 6 million.

The current downturn has also seen an unprecedented level and increase in the number of people who have been involuntarily cut back from full-time to part-time work by their employer. That number has doubled from less than 2.9 million in the summer of 2007 to 5.9 million in December 2008. 4.2% percent of those still employed – one in every 24 – have held on to their job but have only part time hours instead of the full time hours that they had and want. The combination of rapidly falling employment and massive shift from full time to part time work resulted in the steepest decline in hours worked since 1974.

Positive Effects from the Recovery Bill

Two recent economic studies reached similar conclusions with respect to the benefits of an economic stimulus bill along the lines of this one. They both find that such a bill would slow the inexorable economic decline over the next year and bring a stronger recovery sooner. Neither study expects unemployment to decline back to the levels of a few months ago any time soon.

A January 10 analysis done by Christina Romer (President-elect Obama's nominee to chair the Council of Economic Advisers) and Jared Bernstein (economic adviser to Vice President-elect Biden) estimated that, by the end of 2010, the package would:

- lower the unemployment rate by 1.8 percentage points and
- save or create 3.7 million jobs

relative to what would occur without a stimulus package.

A January 6 analysis by Mark Zandi of Moody's Economy.com (and prominent economic advisor to the presidential campaign of Senator McCain in 2008) found that a $750 billion stimulus package:

- would lower the unemployment rate by 2 percentage points in mid 2010 relative to the rate without the stimulus; and
- lead to 3.8 million more payroll jobs in 2010 and, even more striking, 17 million more job-years over the next four years.

Although the two studies find that the recovery package would have comparable effects, Zandi starts with a much more pessimistic base line. While he finds that the package would lower unemployment from 11 percent to a bit less than 9 percent in late 2010, Romer-Bernstein say it would lower unemployment from a base case of 8.8 percent to 7.0 percent. Both studies could correctly estimate the effects of the proposed recovery package but, if the pessimistic Zandi baseline is correct, the actual path of unemployment could resemble what the Obama team is projecting if nothing is done.

Lessons from the Great Depression

The Great Depression of the 1930s taught some hard lessons. After the financial bubble burst in 1929, both fiscal and monetary policy turned restrictive. Over the next four years, real per capita income dropped by a third and unemployment soared from 3.2 percent to 22.5 percent. The aggressive spending, regulatory and monetary reforms of the New Deal revived the economy: unemployment dropped to 9.1 percent by 1937 and GDP per capita had fully recovered its 1929 level. In 1937 policy makers mistakenly decided that they needed to eliminate the deficit of 2.2 percent of GDP. Slashing New Deal jobs programs and raising taxes did succeed in lowering the deficit to 0.1 percent of GDP, but it also threw the economy into a recession. Unemployment jumped back up to 12.5 percent by 1938 and manufacturing production plunged 24 percent. Both the successes of 1933-37 and the failure of 1937-38 should inform our policy-making in this economic downturn.

Infrastructure and Construction Issues

A large boost to federal infrastructure spending makes sense for several reasons:

1. Infrastructure projects – transportation, scientific facilities, improved energy efficiency – make the economy more productive and reduce oil imports and greenhouse gas emissions while raising the quality of life.
2. State and local governments are scaling back needed infrastructure projects because of budget pressures.

3. Construction workers have by far the highest unemployment rate of any industry.

Construction has been the hardest hit industry and occupation in this recession. In just the last year, construction employment has plummeted by 1.3 million workers, from 9.3 million to 8.0 million while unemployment among construction workers far exceeds that in any other occupation.

The rapid deterioration in construction and manufacturing has caused unemployment to rise much faster among men than among women. In the summer of 2007, men and women had comparable unemployment rates (4.7 percent versus 4.6 percent, respectively). By the end of 2008, however, unemployment among women rose to 6.4 percent as it soared to 7.9 percent among men. The 1.5 percent gap between men's and women's unemployment is the largest margin that men's unemployment has exceeded women's on record. (Unemployment rates for men and women have closely tracked each other for most of the last 30 years, but before that women's unemployment usually exceeded men's, often by large margins.)

According to the previously cited study by Christina Romer and Jared Bernstein for the Obama transition, "women have accounted for roughly 20% of the decline in payroll employment," but "the total number of created jobs likely to go to women is roughly 42% of the jobs created by the package." They found that, while infrastructure spending will favor men who predominate in construction, other parts of the package boost jobs in industries that favor women. For example, fiscal relief to states will support jobs in health and education while reduced income taxes will favor retail jobs.

The recovery bill has been structured to generate spending at a much faster rate over the next two years than typical infrastructure legislation:

1. In many cases, state and local governments are given deadlines to commit to projects. If they do not meet those deadlines, the money will be allocated to other states ready to spend it.
2. The bill's guidelines also favor projects with faster spend-out rates.
3. Because of the fiscal bind of most state and local governments, matching requirements are waived.

Current conditions also favor faster than normal spend-out rates:

1. State and local governments have many ready-to-go infrastructure projects that they have had to put on the shelf under current budget pressures.
2. With so much economic slack – particularly in construction, the necessary labor, equipment, and materials can be staged to move into place more quickly.
3. Some infrastructure projects are ready to go in 2009. Other projects are in the pipeline and, with the incentives created by this bill, will be ready to go in 2010.

There are advantages to the fact that not all infrastructure spending will disburse in the first year. When the Wall Street Journal recently asked various economists for their remedies to address the current downturn, it quoted and paraphrased noted economist Alan Blinder:

> "The downturn is still young, it is going to go on for much longer, and it will be very deep. 'We need to think of having time-release capsules,' he says, that will help boost the economy a year from now. Infrastructure spending, which some economists argue against because it takes awhile to be put in place, does exactly that."

Net Addition to Federal Debt Much Less than Budgeted Cost

At the end of the day, the net fiscal cost of this bill will be substantially less than its budgeted cost. Compared to what would happen if we failed to act, the bill will:

1. create jobs for people who would otherwise be unemployed;
2. generate sales at companies that would otherwise not occur; and thus
3. increase tax revenues and lower income support payments.

Mark Zandi projects that a $750 billion recovery package along the lines being proposed would raise GDP by $2.9 trillion over the next four years – about four times as much as the initial cost. He projects that GDP will be about $1 trillion higher in both 2011 and 2012. For every dollar of increased GDP, federal revenues tend to go up by more than $0.20. If Zandi's estimate of the effect on GDP is anywhere close to correct, the true net fiscal cost of the bill would be very modest and the deficit will be substantially lower in 2011 and 2012 than without the recovery package. It is worth noting that fiscal stimulus could have such a substantial effect on GDP and therefore revenues over such a long period only because the base case is so dire – 11 percent unemployment in 2010 and GDP not recovering its 2008 level until 2012. In less dire economic times, such a modest net budget cost of spending and lower future deficits would not be possible.

High Bang for the Buck

Unlike the stimulus bill of early 2008 that provided only tax cuts, this recovery package emphasizes the spending side because it provides more "bang for the buck" under current conditions. The tax rebates last spring showed that Americans have become so concerned about their debt and saving that they will not spend a large fraction of any tax cut. Over the last two decades, Americans' saving rate went from 8 percent of income to near zero. Many were running up debts as they tried to make ends meet with stagnant or declining real income. Others felt confident in spending all their income and becoming highly leveraged as they enjoyed rising wealth from homes and stocks without having to save. All that has changed. Credit to financially stressed families has dried up. Falling home and stock prices are causing the net worth of middle and higher income households to shrivel up. While the first group can be counted on to spend their tax cuts, that is not the case of families more concerned with their shrinking net worth. As we saw in the spring, a sizable fraction of any tax cut to them will be used to pay down debts and not be spent. The same logic applies to tax cuts for corporations who have become more obsessed with reducing their excessive leverage than in hiring or investing.

The proposed increases in federal spending, on the other hand, will have nearly complete pass through to additional demand for goods and services.

1. Because infrastructure projects are ready to go or soon will be, they will lead to direct spending in the next two years.
2. Federal relief for state and local operating budgets will prevent them from making cuts in spending or increases in taxes of an almost equal amount in the next two years.
3. Economically stressed families will increase spending by as much as their unemployment insurance, food stamp, and other financial help goes up.

Studies done by the Congressional Budget Office and by Mark Zandi have found that providing income to lower income people – through unemployment insurance, food stamps, or tax cuts – have the highest "bang for the buck" in terms of deficit cost (as well as meet humanitarian goals).

Fear Shifting from Inflation to Deflation

Although inflation worries were widespread as recently as last summer, a growing number of economists have become quite concerned about the opposite, falling prices or deflation. For example, the recently released minutes of the monetary policy committee of the Federal Reserve reveal a growing concern about deflation. The U.S. has not experienced deflation since the Great Depression. Deflation reinforces a downward economic spiral for several reasons. It gives people an incentive to postpone purchases to get a lower price later. It also discourages businesses from investing because they fear that they will not be able to make a return on their investment, especially if they must take on debt to finance investment.

Since the credit crunch hit with full force in September, prices of crude and intermediate goods have been falling sharply – not only for energy but for non-energy categories. We also observe rapidly declining prices in major inputs to infrastructure projects. For example, prices for steel rebar plunged 36 percent from August to December. Prices of asphalt have dropped even more in most parts of the country. Falling demand and rising capacity is also putting downward pressure on cement. With so much excess capacity from falling private demand, we should expect a major push on infrastructure to help stabilize prices but not to raise them in general. Nevertheless, out of concern that some capacity bottlenecks could develop, the Committee has been somewhat more restrained in infrastructure investments than some have urged.

Conclusion

Standing alone, this recovery package is not sufficient to deal with the depth of the current economic crisis. Combined with other needed actions, however, it should make an important contribution to alleviating the current crisis by

- helping to end the recession sooner and to create a faster recovery;
- producing assets in the form of infrastructure, technology, and skills that will strengthen our economy for the future;

- reducing the amount by which state and local governments raise taxes and reduce education, health, and public safety programs;
- increasing jobs by almost four million next year and by millions more after that;
- creating a substantial increase in national output and income over the next few years such that its net fiscal cost will be modest overall and bring about lower deficits in future years; and
- providing important assistance to low income families laid low by the current downturn.