

Economic Consequences of Stimulus Legislation

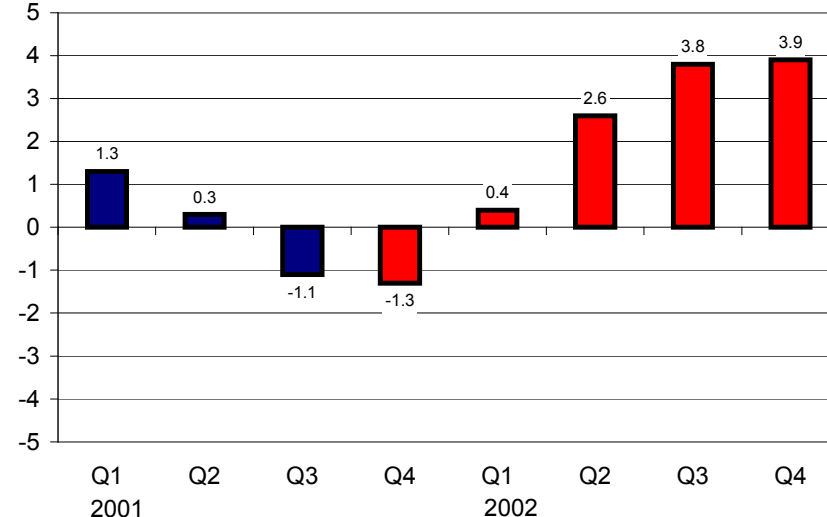
The National Bureau of Economic Research (NBER) recently made the official declaration that the United States is in recession. This call served as confirmation of the well-known fact that economic growth in the United States began to decelerate in the middle of 2000 and has been substantially below its potential. A key factor in this slowdown has been a downturn in business investment.

In making its determination, the NBER also pointed to the events of September 11 as a key factor. The economic effects of the terrorist attack—the disruption of financial markets and the air transport system, and the resulting layoffs—temporarily restricted the economy’s ability to supply goods and services in the short run. These impacts substantially reduced the growth rate of GDP during the third and fourth quarters of 2001. The more persistent economic aftermath includes shocks to household and business confidence, and increased uncertainty regarding the overall economic environment.

Private forecasters – the Blue Chip Consensus forecast, in particular – anticipate that the economy will begin to recover in early 2002 (see below).

Blue Chip Consensus Outlook

Percentage change in GDP from previous quarter, annual rate



The baseline outlook, however, is subject to three important risks. First, while consumer confidence has stabilized there remains the possibility that there could be a more substantial and prolonged decline. Households are particularly worried about the outlook for jobs. Second, businesses remain uncertain about the overall economic climate. To the extent that this uncertainty leads managers to defer or cut back investment spending, the rebound will be slower and less robust. Finally, there is the risk that Congress may fail to pass an economically meaningful stimulus bill.

The three risks are not unrelated. The tax proposals suggested by the President focus on offsetting investment uncertainty, and aiding private sector job creation, thus bolstering

confidence. Accelerating the reduction in the 27 percent tax rate to 25 percent to 2002 will result in approximately \$15.8 billion of tax relief in 2002 for over 33 million taxpayers, or one-third of all income taxpayers. Because business owners and entrepreneurs account for 10 million (30 percent) of those benefiting from the rate reduction, the lower marginal tax rates and extra cash in the hands of these business owners will provide incentives for hiring and business expansion. Small businesses are an important source of job creation.

Allowing businesses to deduct immediately 30 percent of the cost of qualifying new business investments, 2001 and providing an immediate deduction for up to \$35,000 of qualifying new business investments for small businesses will reduce the cost of undertaking new business investment. Reducing the cost for a three-year period provides incentives and funds for business expansion and cost-saving investments that would otherwise be deferred due to uncertainty. The three-year period provides lead-time to undertake major investments in new plant and equipment that could not be completed during a shorter period. By addressing the fundamental source of economic weakness over the past year, this tax change will further bolster employment growth.

Extending unemployment benefits for an additional 13 weeks, introducing a refundable tax credit to help displaced workers retain their health insurance – or even get health insurance for the first time – and making targeted, emergency funds available to states will address quickly the needs of those unfortunate enough to have lost their jobs. The Administration’s proposals are “state-friendly.” Extended unemployment would be picked up by the Federal government and augmented by an accelerated return of excess Federal unemployment taxes to the states.

The baseline impact of failure to enact the President’s stimulus package is to lower economic growth by roughly 0.5 percentage point between the fourth quarter of 2001 and the fourth quarter of 2002, largely due to the loss of investment incentives and accelerating the marginal tax rate. Slower GDP growth would diminish private sector job creation, costing about 300,000 jobs.

Failing to enact stimulus legislation would slow and weaken the recovery (see below). In addition, it would raise the uncertainty facing households and businesses who have expected stimulus bill and factored it into their plans.

Blue Chip Consensus Without Stimulus

Percentage change in GDP from previous quarter, annual rate

