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Briefing Paper

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GENERATING JOBS AND GROWTH

An economic stimulus plan for 2003

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The U.S. economy clearly needs government action to stimulate job creation in what has been, so far, a "jobless recovery." Without action, the modest economic growth projected for next year will be too little to stop unemployment from rising to 6.0% or higher and staying there throughout 2003.[1] The challenge is to devise a stimulus plan that is both effective and avoids undermining the nation's long-term fiscal health. Any stimulus designed to increase productive capacity—the supply side of the economy—will be ineffective because at this time there is already substantial unused capacity. And any stimulus involving *permanent* spending increases or tax cuts will adversely affect the government's future fiscal position. Thus, a stimulus package that is both effective and fiscally prudent must consist of new but temporary spending, coupled with an immediate but temporary tax cut in the form of a wage bonus. Such measures will boost demand for goods and services, generating more customers and leading businesses to invest and increase employment.[2]

The year 2000 showed that U.S. unemployment can be pushed down to 4.0% without causing inflation. The goal now should be to accelerate growth, moving the economy back to a 4.0% unemployment rate and the broad-based prosperity that would follow.

The proposed stimulus package outlined below meets all the key criteria of effectiveness. It would create jobs and income by generating more consumers; it uses temporary tax cuts and spending measures that do not effect the nation's long-term fiscal situation; it will have an immediate effect; and, where possible, it addresses unmet needs and reduces inequality. The plan has two main elements:

- One-time spending of $110 billion on: grants to states to offset financial crises and preserve health, education, law enforcement, and other critical services ($50 billion); school repair and renovation ($25 billion); federal extension of unemployment benefits for the long-term unemployed, along with expanded eligibility for those who are currently ineligible due to having worked only part time or for low wages in the months preceding their unemployment ($25 billion); and other temporary spending measures ($10 billion).

- One-time wage bonus from general revenues ($65 billion) would benefit 149 million workers by providing 3.5% of their first $15,000 in wages. For example, a worker who earned $15,000 in 2002 would receive the maximum rebate of $525, and a family with two such workers would receive $1,050.

This stimulus plan, described in more detail below, would generate growth amounting to an *additional* 2.0% of gross domestic product in 2003, creating 1.5 million jobs and lowering unemployment by an entire percentage point.

The cost of doing nothing

Though the economy has been expanding since the last quarter of 2001, growth has been too slow to increase employment, which still remains 1.4% (1,850,000 jobs) below its pre-recession level. Because of this slow growth and the modest growth projected for 2003,[3] unemployment is forecast to grow to 6.0% or higher and remain there throughout 2003.[4]

High unemployment affects more than simply those who are jobless at any given point in time. When the unemployment rate averages 6.0% over a year, an estimated 12-15% of the workforce will experience unemployment at some time during that year. Just as important, high unemployment reinforces a pervasive sense of economic insecurity among millions who have not (yet) lost their jobs. Moreover, it can cause the income of those who are employed to decline. In 2001, the sluggish economy and rising unemployment caused the bottom 95% of American households to lose income; the median household that year lost $934, or 2.2% of income. Given that these sizeable and widespread income losses occurred as unemployment rose merely from 4.0% to 4.8% over the 2000-01 period, its further rise to 5.7% in 2002 indicates that, when the data are in, it will turn out that household incomes fell rapidly in 2002. Household incomes will fall again in 2003, absent faster growth.[5]

Household incomes have fallen in part because of a slowdown in wage growth. Production/non-supervisory workers—who make up 80% of the workforce—have seen their wages grow over the past 12 months by only 3.1% (before adjusting for inflation), substantially less than the 4.1% growth over the prior 12 months (and the lowest growth since the mid-1990s). Wages are now rising more slowly than inflation for low- and middle-wage men, a stark contrast to the rapid real-wage growth of the 1990s. These figures show slow growth and high unemployment taking a bite out of family paychecks.

Criteria for an effective stimulus plan

Though it is widely agreed that some form of economic stimulus is needed, the meaning of “stimulus” and the characteristics that an effective stimulus package should have are not very clear in current policy discussions. Many policies are purported to stimulate the economy, but it is important to distinguish between those that will have their effect in the next year and those that take effect only much later. Any useful stimulus package should strengthen the recovery immediately and create more jobs in 2003. Some obvious examples of policies that fail this criterion are: expansion in trade through yet-to-be-negotiated agreements, further industry deregulation, or changes in tax policy that only take effect years from now. Whatever their merits, these policies have nothing to do with the job creation needed now.

An effective, appropriate stimulus package should meet the following five criteria.

1. A stimulus package should generate growth and jobs.

The point of stimulus is to increase economic growth and thereby generate more jobs. We already have the capacity to produce much more than we do, since capacity utilization is only at about 75%[6] and there are many unemployed workers ready and willing to work. *What is missing are customers.* As the Business Roundtable Chairman, John T. Dillon of International Paper, has said, we need to "stimulate demand and ignite the economy." With wages growing more slowly and household debts high, we cannot rely on consumption maintaining its current growth.

The two feasible ways to boost demand are to increase consumer spending or increase government spending (at the federal, state, or local level). Any stimulus aimed at spurring more business investment will be ineffective at this point, because business investment will remain sluggish until consumer and government demand picks up. Indeed, businesses already have sufficient cash resources[7] to make investment possible, and the current low level of interest rates would already be encouraging greater investment, if only businesses were expecting higher consumer demand. Without a rise in consumer demand, corporate tax relief and other business investment incentives will not be effective in stimulating growth.

Government spending is more effective than tax cuts in stimulating domestic demand. This is because part of any tax cut is saved and because consumers are more likely than government to spend on imports. Also, tax cuts directed at the wealthy (such as those remaining to be implemented from the original Bush tax package) or at shareholders (73% of publicly traded stock is owned by households with incomes over $100,000) will not be as effective as tax cuts directed at low- and middle-income households, which will spend a larger share of any extra income.

2. A stimulus package should be fiscally responsible.

The purpose of any good stimulus package is only to get the economy rolling again so that the private sector can play its role in restoring economic growth. For this one-time, short-run objective, permanent, ongoing measures are inappropriate. A "permanent" stimulus package is unnecessary and could adversely affect the fiscal position of the federal government five or 10 years from now. Therefore, any stimulus proposal involving tax cuts and pump-priming spending should design these components as one-time, temporary measures.

3. A stimulus package should take effect quickly.
An effective stimulus should have its impact within the next year. Ideally, it would have some components that have immediate effect, while others might reasonably have impact in six months to a year. By any estimate, unemployment will still be substantially higher than 4.0% at that point and there will still be no danger of over-stimulating the economy.

4. A stimulus package should have fair effects.
The distributions of wages, income, and wealth in the United States have become vastly more unequal over the last 30 years.[8] In fact, this country has a more unequal distribution of income than any other advanced country. Therefore, one criterion for favoring one stimulus plan over an equally effective one should be that the favored plan avoids exacerbating income inequality and, wherever possible, acts to lessen current inequalities.[9] A temporary increase in federal revenue-sharing with the states, for example, would fulfill this criterion well by helping preserve public school spending, Medicaid for low-income families and low-income elderly in nursing homes, and other state programs now in jeopardy due to the fiscal crises facing most states. A one-time wage bonus from general revenues targeted to the first $15,000 of wages would also help assure an equitable stimulus package.

5. A stimulus package should target unmet needs.
Another goal of any good stimulus plan should be to meet, where possible, unmet social needs. For instance, it is widely acknowledged that there is a huge backlog of necessary school repairs and school construction. A temporary spending increase for school repairs would not only fulfill the other criteria for an effective stimulus but also meet an acknowledged, unmet need. Other examples could include funding superfund cleanup programs, or addressing the backlog of needed sewage-treatment plant construction.

An effective stimulus plan

The following stimulus package meets the criteria of efficacy in creating jobs, fiscal responsibility, fairness, targeting of unmet needs, and timing. The total cost is $175 billion, of which $110 billion goes to temporary spending and $65 billion to a temporary tax cut in the form of a wage bonus. More goes to spending than to tax cuts because spending has greater stimulus effect: some funds freed by tax cuts do not go into domestic spending but rather into savings and buying imports. Tax cuts are included, however, because government spending, in some cases, does not stimulate growth as quickly as tax cuts can.

Temporary spending

To offset states' fiscal crises. Distributing $50 billion worth of fiscal relief to the states would have an immediate impact and would be administratively easy to do, requiring no more than a staff of 25. The shortfall in state budgets during this recession has been substantially larger than in earlier recessions,[10] causing states to draw down their reserves, cut spending, and raise taxes in order to balance their budgets. Unfortunately, when states raise taxes and reduce services they reduce overall demand, thereby exacerbating the recession. The layoffs and spending reductions also curtail the health care, education, and law enforcement services that citizens need and desire. Thus, fiscal relief grants to the states can be a particularly effective way to restore demand in the economy.[11] They also can have virtually immediate impact, since current plans to cut programs, raise taxes, or execute layoffs can be suspended or scaled back right away.

To repair and renovate schools. Given wide agreement that the country's school infrastructure needs improvement and expansion,[12] $25 billion could be allocated for this work. The U.S. General Accounting Office estimated in 1995 that school repairs needed at that time would cost $112 billion dollars. Since then, the problem has only gotten worse. But there are existing programs that can be used to expand school repair activity quickly. One mechanism is to expand the repair fund program of the Individuals with Disabilities Education Act (IDEA). Given that many school districts are currently curtailing planned repairs, any new funding for this purpose could be disbursed fast. Another mechanism would be to expand federal funding of the Qualified Zone Academy Bond (QZAB) program, which provides tax credits toward the interest on school construction bonds.

To extend unemployment insurance. An allocation of $25 billion toward unemployment insurance could assist the long-term unemployed with extended benefits, while also allowing eligibility to be expanded: many unemployed workers are currently ineligible due to having worked only part time or having earned too little in the months preceding their unemployment. Such measures would help those hurt by the recession and also increase the purchasing power of consumers.[13] Unemployment insurance automatically injects money into the economy as unemployment rises and, conversely, the payout of benefits naturally declines as unemployment declines. In this way, spending is injected into the economy when the economy is weak, and spending is reduced when the economy is strong. Without the infusion into the economy of $40 billion by the unemployment insurance system from January through September 2002, economic growth would have been even weaker than it was.

Continuation of the extended unemployment insurance program is needed urgently, so that the long-term unemployed can continue receiving benefits even if they have been searching for work for more than six months.

A reform also needs to revise the outdated formula that determines which states automatically receive additional weeks of unemployment insurance benefits. Because the formula was established in an era when 6.0% unemployment was considered acceptable, workers in only three states currently qualify for additional weeks of benefits.

Other spending. Another $10 billion in temporary spending measures should be adopted as part of a stimulus package in 2003. This funding could be earmarked for hiring more school teachers or giving current teachers more professional training and development. It could also go, as suggested above, toward cleaning up more superfund sites or accelerating investments in sewage-treatment plants.

Temporary tax cut: A wage bonus

A wage bonus from general revenues of $65 billion in early 2003 could quickly increase demand and boost production and employment. As mentioned above, tax cuts may have less effect than spending measures, because some of the money provided goes into savings, or goes toward buying imports as opposed to domestically produced goods and services. However, a wage bonus is included in this stimulus plan because government spending, in some cases, may take longer than tax cuts to take effect. Experience with the tax rebate in 2001 showed that rebates can be readily handled administratively. The 2001 rebate, however, would have had greater stimulus effect if it had been targeted more heavily toward lower- and middle-income households: they tend to spend more of a tax rebate, rather than putting much of it away in savings, as higher-income households tend to do.

A wage bonus tied to payroll tax payments in 2002 would reach a broader population and therefore be a more effective stimulus. However, the rebate should come from general revenues, so that payroll taxes earmarked for Social Security are not diverted. Thus, a wage bonus of 3.5% of earned wages, up to a maximum of $15,000, would benefit 149 million workers and provide $65 billion worth of stimulus without reducing the funds needed to keep Social Security solvent. This rebate would provide $525 to every worker earning $15,000 or more, and households with two such workers would receive $1050. A worker earning $10,000 (who did not receive the last rebate) would receive $350.

These wage bonuses could be received in early 2003 and therefore provide a quicker boost to spending than changes to the tax code, such as changes to marginal income taxes or payroll tax rates (whose effect is throughout the year).

Impact on the federal deficit

The tax and spending proposals outlined here will no doubt increase the federal deficit in the short term, but, by expanding the nation's growth rate, they will actually improve fiscal stewardship in the long run. As we learned during the late 1990s, faster growth is the surest road to deficit reduction. By using temporary measures to prime the pump of the economy now when we need to do so, we can lessen unemployment and achieve greater prosperity while at the same time promoting fiscal integrity.

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Endnotes

1. Bernstein (2002).

2. Note that, without such short-run stimulus of consumption, the current level of unused capacity in the economy means that further interest rate cuts by the Federal Reserve will have limited efficacy.

3. Growth of 3.3% is projected for 2003 in the latest *Blue Chip Economic Indicators*, a widely watched monthly survey of leading economists.

4. Bernstein (2002).

5. Describing the income loss due to high unemployment in another way: an unemployment rate of 6.0% rather than 4.0% costs the average household $4,175—a high cost for being in a slack economy.

6. Capacity utilization measure according to the Federal Reserve Board.

7. Weller (2002).

8. Mishel, et al. (2002).

9. The impact of an effective stimulus plan will disproportionately benefit low- and middle-income families and minority families, as they are the families most adversely affected by unemployment and a sluggish economy.

10. As reported by the National Governors Association.

11. Sawicky (2001).

12. Harris and Sawicky (2001).

13. Boushey and Wenger (2001).

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