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ASSISTANCE FOR HARD-PRESSED FAMILIES IS ONE OF THE BEST WAYS TO PRESERVE AND CREATE JOBS

Measures Supported By Some Policymakers Would Be Far Less Effective

by Chad Stone

In negotiations over the forthcoming economic recovery package, some policymakers have argued that various measures aimed at low- and moderate-income families would serve a "safety net" function but that the package should focus more heavily on creating jobs. This argument reflects a fundamental misunderstanding of the current economic situation and of how economic stimulus works. Some of the proposals that policymakers apparently think of as job creators would actually preserve or create many *fewer* jobs than other proposals directed at families with low or moderate incomes or unemployed workers.

- The main reason why the economy is shrinking and unemployment is rising is a sharp drop in demand for goods and services.

- The quickest, most efficient way to bolster demand is to put money in the hands of people who will spend it quickly — namely, people who need it to cover basic expenses such as housing, food, and transportation.

- Helping struggling families thus isn't an *alternative* to preserving and creating jobs; it's one of the *most effective ways* to preserve and create jobs and needs to be a prime focus of the forthcoming package.

In contrast, general business tax cuts would be less effective in preserving or creating jobs and blunting the recession because firms would tend to retain a substantial portion of the tax cut until economic conditions improve, rather than spend it now.

- Businesses do not retain or hire workers or make investments just because they have cash; they generally do so only when the additional workers or investments will produce goods and services that they can sell. If there is not demand for more of their products, they will retain their tax-cut dollars.

- Thus, each dollar in tax cuts for low- and moderate-income families — and each dollar in increased benefits provided through such programs as unemployment insurance, food stamps, and Supplemental Security Income — will generate more of an increase in demand during a recession, and hence more jobs, than each dollar in business tax cuts or tax cuts for affluent households.

Funds to relieve the fiscal stress that state governments face would also constitute effective stimulus, because without fiscal relief, states will have to take draconian budget measures that will drain demand from the economy and undermine other fiscal stimulus efforts.

Funds for infrastructure projects that can be undertaken in the next couple of years constitute effective stimulus, as well. Such infrastructure investments are appropriate measures to include in a recovery package. In general, however, those funds will take somewhat longer to spend out than benefits and tax cuts focused on hard-pressed families or fiscal relief to states.

If policymakers shift funds from President-elect Obama's proposals focused on lower- and moderate-income families, unemployed workers, and state fiscal relief to other measures that may be touted as "job creators" but would constitute less effective stimulus, they will make the package less effective in fighting the recession and less effective at creating jobs.

Stimulus Measures Should Be Targeted on People Who Will Spend the Money Quickly

When the economy is weak, generating more demand for goods and services is what creates and preserves jobs. Retailers that face stronger demand for their products are more apt both to hire and retain employees and to maintain or increase orders from their suppliers. The initial boost in spending thus gets multiplied through the economy.

To boost demand for goods and services, fiscal stimulus should be targeted where it is most likely to be spent *immediately*. This suggests targeting on low- and moderate-income individuals and unemployed workers who need a replacement for lost income. People whose income is disrupted in a recession and who lack the savings to tide them over and maintain their normal consumption, and people whose incomes are so low to start with that they have difficultly making ends meet, are the people most likely to spend quickly any added income they receive. Assisting them consequently provides strong stimulus.

More affluent individuals, in contrast, are more inclined to save a substantial share of additional income they receive, because they do not need it to meet their immediate needs.

This distinction is crucial. The Congressional Budget Office (CBO) has stated that "the efficacy of fiscal stimulus depends critically on households' tendency to spend the income placed in their hands." The larger the share of income that a group of households spends, "the more powerful is the ultimate boost to demand" from stimulus measures that increase those households' income.[1] Similarly, in a 2008 analysis, CBO stated that "Lower-income households are . . . more likely to be among those with the highest propensity to spend. Therefore, policies aimed at lower-income households tend to have greater stimulative effects."[2]

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[1] Congressional Budget Office, "Economic Stimulus: Evaluating Proposed Changes in Tax Policy," January 2002, http://www.cbo.gov/ftpdoc.cfm?index=3251&type=0.

[2] Congressional Budget Office, "Options for Responding to Short-Term Economic Weakness," January 2008, http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf.

A good way to assess a proposal's stimulative effect is through its fiscal "bang for the buck" — how much immediate spending boost it would deliver (and hence how much additional job creation it would generate) for each dollar it costs. In testimony this summer, Mark Zandi, chief economist for Moody's Economy.com and a former advisor to presidential candidate John McCain, evaluated various stimulus options in terms of their effect on the economy in the first year after enactment. Zandi's rankings (see Table 1, next page) provide a useful assessment of the relative value of various measures in generating economic stimulus.

TABLE 1: RELATIVE "BANG FOR THE BUCK" OF VARIOUS STIMULUS PROPOSALS

	Demand generated per dollar of cost
High "Bang for the Buck"	
Temporarily increase food stamps	$1.73
Extend unemployment benefits	$1.64
Provide general aid to state governments	$1.36
Provide refundable lump-sum tax rebate	$1.26
Lower "Bang for the Buck"	
Extend Alternative Minimum Tax patch	$0.48
Make dividend and capital gains tax cuts permanent	$0.37
Cut corporate tax rate	$0.30
Make Bush income tax cuts permanent	$0.29

Source: Mark M. Zandi, Testimony before the House Committee on Small Business hearing on Economic Stimulus for Small Business, July 24, 2008, p. 5.

The two most cost-effective stimulus measures Zandi evaluated were temporarily increasing food stamp benefits and extending unemployment benefits. Similarly, in 2007, Peter Orszag, then the director of the Congressional Budget Office and now President-elect Obama's nominee to head the Office of Management and Budget, stated, "research has shown that the unemployment insurance system is among the most effective dollar-for-dollar economic stabilizers that we have in terms of counterbalancing periods of economic weakness."[3]

This should not be surprising. Jobless benefits are targeted on workers who are involuntarily unemployed and whose income has fallen below their normal level of spending, a group that tends to be concentrated in the areas and industries most affected by a slowdown. Supporting spending by unemployed workers in hard-pressed communities helps prevent the spread of layoffs and loss of jobs in those communities.

Measures such as expanding the Child Tax Credit for low-income working families and President-elect Obama's proposal to offset the worker's share of Social Security payroll taxes for the first $8,100 in earnings would also constitute effective stimulus because they would be aimed in whole or in significant part at low- and moderate-income people who would spend the money quickly.

In contrast, some of the *least* cost-effective stimulus proposals Zandi examined were tax cuts aimed at businesses and upper-income families, such as cutting the corporate tax rate or extending cuts in capital gains and dividend taxes. CBO's 2008 analysis similarly placed such corporate tax cuts in the lowest category for cost-effectiveness.[4]

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[3] "State of the U.S. Economy and Implications for the Federal Budget," Hearing before the House Budget Committee, House of Representatives, December 5, 2007.

[4] Congressional Budget Office, "Options for Responding to Short-Term Economic Weakness," January 2008, http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf.

Business Tax Cuts Generally Provide Poor Stimulus

The reason why business tax cuts that merely increase firms' after-tax income do not provide meaningful economic stimulus is that the primary problem employers face in a recession is a shortage of *demand* for their products, not a shortage of cash.[5] In a recession, most firms would likely keep much or all of any tax windfall they receive — or pass it on to shareholders and business owners, two groups that tend to have higher incomes and thus spend relatively little of any additional income they receive in the short term.

Goldman Sachs made this point in a 2007 analysis, noting that "companies don't spend money just because it's there to spend. To justify outlays for new projects, the expected returns have to exceed the costs, and that usually requires growth in demand strong enough to put pressure on existing resources."[6]

For these same reasons, firms will not hire (or retain) more workers than it takes them to produce the goods and services they can sell. Simply giving them a general tax break is unlikely to affect their hiring in most cases. While it might be tempting to consider giving firms tax credits targeted specifically on new job creation, the practical difficulties of designing such a measure are so daunting that it is likely to be inefficient. How would one identify which jobs in expanding firms were created due to the credit and which would have been created anyway? How would one identify jobs in contracting firms that would have been lost without the credit? The temptation for firms to game the system would be huge.

Consequently, the most promising strategy for boosting business production, investment, and hiring during an economic downturn is to *boost demand* so that people buy more of the products that firms produce. Simply providing firms with more cash generally will not help much.

Boosting Demand for Goods and Services Critical to the Success of the Recovery Package

The economy is in bad shape right now because there is not enough demand for the goods and services that businesses already have the capacity to produce. To stop the destruction of jobs and begin to put people back to work, it is critical to stimulate the demand for goods and services. As this analysis has shown, one of the most effective ways to do that is to assist low- and moderate-income families, who often have difficulty paying ongoing household costs and thus are likely to spend quickly any additional income they receive. That spending preserves and ultimately creates jobs.

Given the serious condition of the economy, the forthcoming recovery package should be multi-pronged. State fiscal relief and well-designed infrastructure spending also have an important role to play in stimulating the demand that will preserve and create jobs. (See the box on state fiscal relief

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[5] To be sure, the current lack of liquidity in credit markets could make an infusion of cash more valuable to some companies that would, in past recessions, have been able to borrow to meet payrolls and make needed investments to maintain their capital stock. But it is unclear how to focus a tax cut on businesses that would actually spend an infusion of cash. Without an effective targeting mechanism, too much of the expenditure on a business tax cut would be retained rather than spent and hence not have a robust stimulative effect.

[6] GS Weekly, September 21, 2007.

Fiscal Relief for States Is Another Cost-Effective Form of Stimulus

As Table 1 shows, aid to state governments is a highly-rated stimulus measure in terms of "bang for the buck." CBO explains how, in the absence of fiscal relief, states would have to take actions that would aggravate an economic downturn:

> During downturns, state and local governments experience a reduction in revenues resulting from the effect of lower economic activity on sales, income, and other tax bases. Unlike the federal government, which . . . faces no requirement to balance its budget, these entities have to reduce spending and increase taxes . . . to address the resulting fiscal problem. Consequently, the behavior of state and local governments often serves to reduce aggregate demand further.[a]

Fiscal relief helps prop up aggregate demand by lessening the magnitude of program cuts and tax increases that states must impose.

Fiscal relief is especially important now, given the seriousness of states' budget problems. Though states entered the current recession with their largest reserves in history, those reserves have largely been exhausted. Thirty states already have cut services to vulnerable residents in areas such as health care, services to the elderly and disabled, K-12 education, and higher education, and more than a dozen states have raised revenues. Despite these measures, state deficits are likely to total $350 billion to $370 billion over the next 2½ years. Without fiscal relief to close part of that gap, states will have to enact exceedingly deep budget cuts and tax and fee increases that will undercut the stimulus the federal government is trying to provide.

The measures states take to address their budget shortfalls have a direct impact on state jobs. When states cut back on funding to local governments, those entities shed jobs as well. Furthermore, cutbacks in state program expenditures affect jobs among those who supply goods and services to the states, and the loss of demand from state cutbacks has ripple effects on jobs through the economy. Fiscal relief to states attenuates the loss of demand from state budget cuts and tax increases, which are a job-killer during a recession.

In a report issued January 6[b], Mark Zandi notes: "Cuts in state and local government outlays are sure to be a substantial drag on the economy in 2009 and 2010. Additional federal aid to state governments will fund existing payrolls and programs, providing a relatively quick economic boost. States that receive checks from the federal government will quickly pass the money on to workers, vendors and program beneficiaries. Arguments that state governments should be forced to cut spending because they have grown bloated and irresponsible are strained, at best. State government spending and employment are no larger today as a share of total economic activity and employment than they were three decades ago."

[a] Congressional Budget Office, "Options for Responding to Short-Term Economic Weakness," January 2008,.
[b] Mark Zandi, "The Economic Impact of a $750 Billion Fiscal Stimulus Package," January 6, 2009.

on the next page.) Some policymakers seem to think that business tax cuts or cuts in capital gains or dividends would be more effective at creating jobs, but that belief is mistaken. Those measures are largely ineffective at generating demand in a weak economy and would consequently be ineffective at generating jobs.

If policymakers scale back measures to assist low- and moderate-income families in order to create more room in the recovery package for government programs that spend-out slowly and/or tax cuts that will largely be saved (or retained) rather than spent, the resulting package will be much less effective in protecting jobs and strengthening the weak economy.