# THE ABCs OF ECONOMIC RECOVERY

**The employment effects of every dollar increase in the deficit depend on whether it is spent on goods and services (infrastructure) or is the result of tax reduction or increases in government transfer outlays such as unemployment compensation.**

**by Thomas F. Dernburg**

President Obama called his $787 billion recovery program a "stimulus" program designed to "jump start" the economy. It sounded very much as if "stimulus" is a cousin of what used to be called "pump priming." The theory is an optimistic one. The idea is that the Federal government should prime the pump by increasing federal spending and cutting taxes, and the private economy will spring to life and do the rest.

Unfortunately we can't be too confident that spending in the private economy will recover fully in response to the stimulus. In the current severe recession, there is likely to be a persistent deficiency of private spending that will necessitate continuing federal deficit spending for years to come. To get private spending up and keep it up, consumers must overcome their current pessimism. But at present consumers seem more intent on rebuilding their financial assets after severe stock market losses. Investment by business in plants, equipment, and inventory must recover. But with substantial amounts of excess capacity at most stages of production and distribution, private investment spending is not likely to provide a boost very soon. The same is true for residential construction in the face of foreclosures, rising vacancies, and falling home prices. Until the banking freeze thaws, lack of credit will continue to be a huge obstacle to the revival of spending on automobiles and other durable goods.

Most members of Congress are lawyers who seem to lack training in economics, especially macroeconomics. Conservatives seem to believe the way to prosperity is through ideology rather than sound economic analysis. Confusion about the number of jobs that an increase in the federal budget deficit would create has been a prime example of muddled thinking. There has been little recognition that the employment effects of every dollar increase in the deficit will depend on whether it is spent on goods and services such as infrastructure or is the result of tax reduction or increases in government transfer outlays such as unemployment compensation. The first job here is to clarify the difference.

Many congressional conservatives insist that tax reduction for the rich is more effective in creating jobs than government expenditures on goods and services. That trickle-down claim is demonstrably wrong, but that doesn't seem to be well understood. A simple example will nail down an essential difference. Let government spend $1 billion on road-repair projects. Contractors respond by hiring workers and purchasing equipment and materials. Employment increases, and Gross Domestic Product (GDP) rises by $1 billion. But that is only the first round of spending. The $1 billion becomes income to the workers and others who provide input for the projects. Hopefully, they will spend most of the additional income on consumer goods. That second round of spending then becomes income to other people. All the subsequent rounds of income and consumer spending added up yield a "multiplier" effect on GDP. For

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illustrative purposes, assume that the multiplier value is 2.5. GDP increases by $2.5 billion in response to a $1 billion investment in roads.

It is important to note that the spending effects will peter out over time. Therefore, to keep GDP at its new level, there will have to be a continuing stream of new projects. A one-shot expenditure won't do the trick. We should not therefore be surprised if there have to be repetitions of the current recovery program in the near future.

Tax cuts and transfer outlays provide the same $1 billion increase in income. They have the same employment effects as the second round of the road projects. The $1 billion in road projects are, however, by-passed. The multiplier will therefore be 1.5, so GDP will rise by $1.5 billion. That increase could be much lower if pessimistic recipients use their tax cuts as savings with which to rebuild their assets rather than spending the additional income on consumer goods. It also seems obvious that there will be very little spending effect if the tax cuts go to the rich.

Is the $787 billion stimulus legislation sufficient? Many distinguished economists don't seem to think so. There is a yawning gap between the GDP level that would restore full employment and the actual level of GDP. The Congressional Budget Office (CBO) estimated that, over the next three years beginning in 2009, there will be a $2.9 trillion gap between what the economy could produce and what it is actually likely to produce in the absence of a federal recovery program. That estimate was made some time ago, so some supplementary back-of-the-envelope calculations may be helpful.

Here is what such calculations disclose: the growth of current dollar GDP over the period 1999 to 2007, two prosperous years, was at a 5 percent annual rate. If this rate is projected, its hypothetical continuation provides rough estimates of "potential GDP." For the third quarter of 2008, this procedure projects potential GDP at an annual rate as $15.232 trillion. But actual third-quarter GDP was $14.413 trillion. The difference between the two implied a gap of $819 billion, a level consistent with CBO. However, the gap became much larger in the fourth quarter when the economy virtually fell out of bed, with GDP declining 6.2 percent at an annual rate. Our estimated gap increases to $1,908 billion, placing the economy about 13 percent below capacity.

These estimates suggest that the enacted recovery program is well below the level the economy needs for a satisfactory recovery. On the negative side, the outlays contemplated by the program will be spread out over a two-year period. In fact, by mid May only 6 percent of the $787 billion had been spent by the Treasury. Also, a substantial fraction of the total consists of tax cuts and increased transfer outlays, which have a lower multiplier effect than expenditures on goods and services. On the plus side, the president's plan is to begin immediately to reform the healthcare system. That will add a lot of additional spending. It is possible as well that the government funds given to the banking system will unfreeze lending activity, thereby financing increases in consumer and business spending.

State and local governments are suffering severe deficits, due largely to revenue losses caused by the recession. They will certainly benefit from federal grants provided by the stimulus package. The effect on GDP will depend on the fraction of the grants that are used as public investment in roads, bridges, school construction, and the like. They could also be used to hire back laid-off teachers and government workers and prevent others from losing their jobs. It is unfortunate that some conservative governors have been balking at using the federal funds allocated for their unemployment compensation systems. They claim that an expanded system will cost more once the federal money runs out. That may be true. If it is, it calls attention to the inadequacy of their state systems. And in the meantime the governors are denying their unemployed citizens badly needed income support.

Increased spending and tax cuts give rise to concerns over the growth of the federal deficit. We can ease the pain by noting that when GDP rises the deficit declines, thanks to income-tax feedback and automatically reduced transfer outlays. A larger increase in GDP will yield larger feedback. Conservatives won't like the conclusion, but infrastructure outlays will give the economy more of a boost and therefore also produce greater revenue feedback. This means the net increase in the deficit, from both the initial and feedback effects, will be smaller than the effects of equal tax cuts and increases in transfer outlays. ■

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