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LARGER FISCAL STIMULUS NEEDED TO LIMIT IMPACT OF DOWNTURN, NEW LEVY ECONOMICS INSTITUTE ANALYSIS SAYS

New Study Argues Government Expenditure More Effective Than Tax Rebates

ANNANDALE-ON-HUDSON, N.Y.—With consumer confidence plummeting, unemployment rising, and foreclosures reaching record levels, it's clear that the real estate and credit crises are having a profound effect on the U.S. economy. While growth has remained slightly positive, many economists and policymakers are predicting that the U.S. economy will go into recession. A new study from The Levy Economics Institute of Bard College contends that the current crisis will reduce private borrowing and spending and push the U.S. economy into at least a mild recession in 2008. In their Strategic Analysis, *Fiscal Stimulus: Is More Needed?*, the Levy Institute's Macro Modeling Team—President Dimitri B. Papadimitriou and Research Scholars Greg Hannsgen and Gennaro Zezza—argue that the government's current plan to boost the economy with a one-time $168 billion net transfer, mostly in the form of tax rebates, is inadequate and will do little to bolster the economy.

Using optimistic assumptions regarding housing and financial markets, oil prices, and business and household borrowing, the Levy model projects a further slowdown in U.S. GDP growth, and a mild recession in 2008, similar to what occurred in 2001. The lower growth rate—combined with a weak dollar and the expectation of no further increase in oil prices—will gradually improve the U.S. balance of payments, which the Macro Modeling Team maintains is the key to the sustainability of the rebound of the economy. Still, even with a mild recession, the Levy study indicates that by 2012 output will be permanently reduced by 4.1 percent, translating into a 2 percent increase in unemployment.

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To help mitigate the impact of the current crisis, the Bush Administration and Congress have approved a $168 billion (roughly 1 percent of GDP) fiscal stimulus in the form of net transfers (mostly tax rebates) from the government to the private sector in the third quarter of 2008. Analyzing this plan, Papadimitriou, Hannsgen, and Zezza suggest that the size and form of the stimulus will do little to boost GDP. "The shock to output from recent problems in financial markets will amount to approximately $260 billion *each quarter* in the current year," the authors project. "A fiscal stimulus given in one period only, and taken away in the next, will hardly change the picture," they write. Stressing this point, the scholars allude to the mild recession in 2001, when fiscal spending was increased dramatically, such that the government surplus of 1.3 percent at the end of 2000 went to a deficit of about 2 percent one year later, and reached a peak deficit of 4.9 percent by the end of 2004. "Therefore, the magnitude of a fiscal stimulus to avoid the current dangers of a recession has to be much larger than 1 percent of GDP," the authors write.

If the policy objective is to boost GDP, the Levy Macro Team argues that a $600 billion stimulus in the form of government expenditure over four quarters would be far more effective than the tax rebates. Using a standard analysis of the Keynesian multiplier for fiscal stimulus, the scholars estimate that a $1 transfer from the government to the private sector has an impact of $0.30, whereas an increase of $1 in government expenditure (buying or producing more services) has an impact of $1.30. Papadimitriou, Hannsgen, and Zezza argue that a $600 billion stimulus in the form of government expenditures on such things as public works and education would reduce output loss by at least 1 percent in each of the four quarters during which it was applied. Still, the authors argue that even a stimulus lasting four quarters will have only a temporary effect, and an enduring recovery will depend on a prolonged increase in exports, due to the weak dollar, a moderate increase in imports, and the closing of the current account gap.

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<u>Strategic Analysis: *Fiscal Stimulus: Is More Needed?*</u>

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