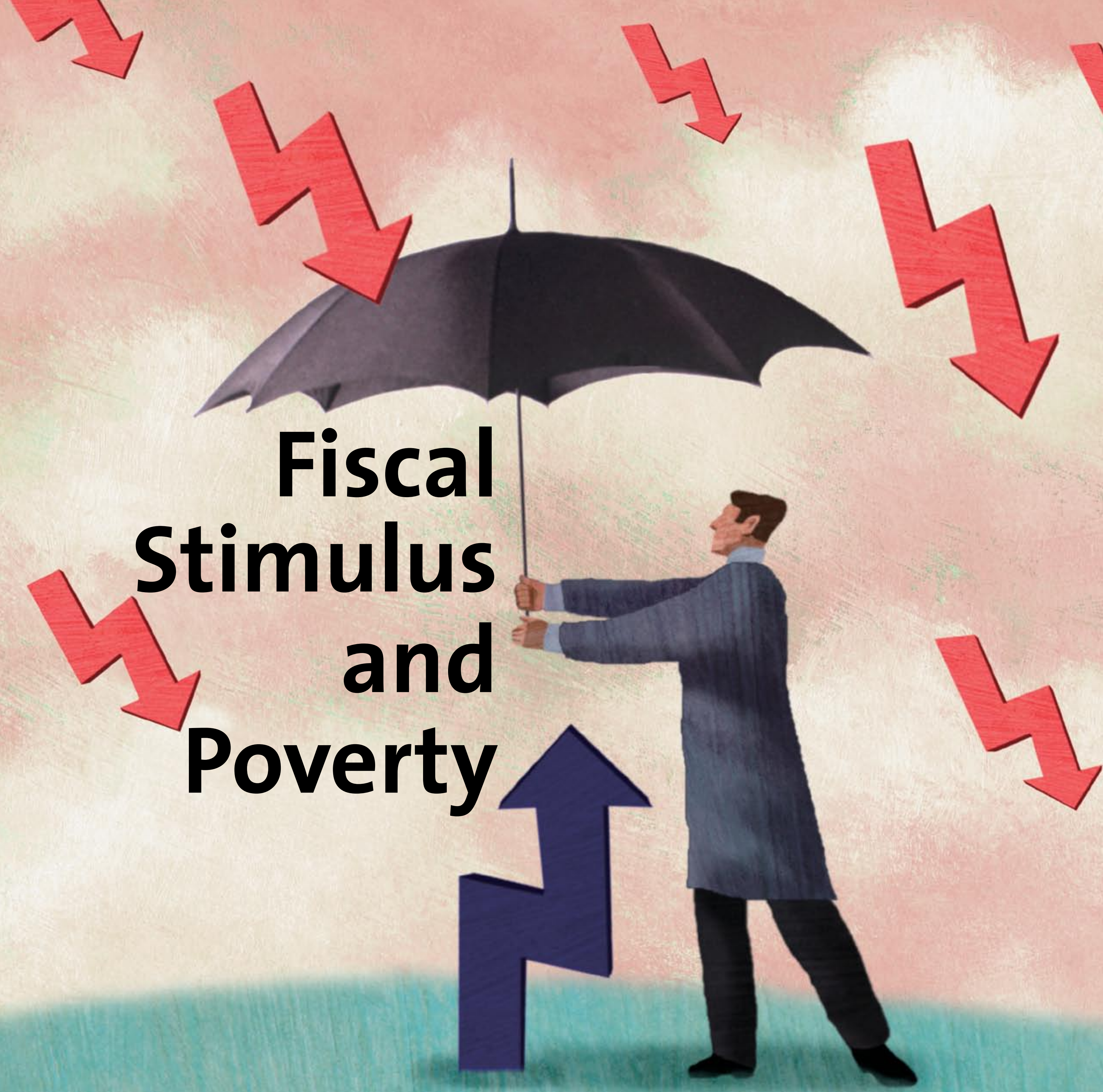
Fiscal Stimulus and Poverty



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Consider the following: An America struggling with rising oil prices and an economic slowdown; a Congress that introduces a fiscal stimulus plan that includes a one-year, temporary tax rebate for individuals together with temporary incentives for business investment; and a radical decision to make these tax rebates refundable, such that even households without income tax liability are eligible to receive them.

You might think this describes 2008, and you would be right. But it also describes 1975, the birth year of the earned income tax credit (EITC), widely seen as one of America's most successful antipoverty initiatives. And so it follows that recessionary times, however painful, can serve as incubators for policies that reduce the incidence of poverty. I lay out below how we can ensure that the present economic slowdown will again serve as just such an incubator.

But first let's recall in more detail how the EITC came about. The economy had just gone into recession in 1973. It was not until March 1975, however, that Congress finally enacted a fiscal stimulus plan—ironically the same month that the recession ended. The stimulus plan included rebate checks that were partially refundable for low-income households and that were phased out for high-income households. Overall, 6 million households received an average benefit of $201, yielding a total of $900 million in refundable credits. That is the equivalent of $700 per household in today's purchasing power. Scaled as a size of the economy, the refundable credits are equivalent to $8 billion today.

The idea of work-related tax credits predated the recession, and such credits were supported by President Richard Nixon and many others. But the stimulus bill provided a convenient pretext for enacting them. These work-related refundable credits were extended annually for several years, ultimately made permanent, then expanded in several rounds of tax legislation over the following decades. It wasn't until 2008 that another fiscal stimulus plan explicitly included a refundable component. (The 2001 tax rebate, by contrast, was limited to households that had taxable income before any credits.) It is this refundable component of the stimulus plan that has much poverty-combating potential.

The 2008 Fiscal Stimulus

The mantra that guided the 2008 package was that stimulus should be timely, temporary, and targeted—principles endorsed by figures as diverse as Ben Bernanke, Nancy Pelosi, Martin Feldstein, and Lawrence Summers. All three principles have important economic rationales. Recessions tend to be short-lived, so it is critical that stimulus be delivered in a timely manner. Moreover, fiscal stimulus can boost consumption almost immediately, helping fill in the time before the Federal Reserve's interest rate reductions can affect the economy, a process that takes about one year.

These same factors motivate the temporary nature of stimulus—we would not want to substantially increase the long-run budget deficit to combat a short-term recession. If we did that, we could be doing more harm than good.

Finally, it is important that fiscal stimulus be targeted by impact as well as need. By impact-targeting, I refer to the objective of generating, for every dollar added to the short-run deficit, the largest possible increase in gross domestic product. In other words, if we want stimulus spending to produce the maximum stimulus, we need to target that spending where it is most likely to be spent by recipients. By need-targeting, I refer to the simple objective of assisting those households that need it most. In all recessions, some people experience large reductions in their income as they lose their jobs or face major pay cuts, while others continue to do fine. And even a small income loss can be very painful for a household living on the edge. A stimulus package is thus need-targeted to the extent that it goes to households experiencing job loss, major pay cuts, or even smaller pay cuts that might nonetheless push them over the edge.

These two senses of targeting are complementary. High-income households can save or borrow to smooth temporary shocks in their income. As a result, a temporary rebate has little impact on that household's consumption, as the rebate is likely to just go into savings. It follows that such poorly targeted rebates will have no expansionary macroeconomic effect. In contrast, as Federal Reserve Chairman Ben Bernanke testified earlier this year, "If you're somebody who lives paycheck to paycheck, you're more likely to spend that extra dollar." This is why the Congressional Budget Office and Moody's Economy.com both gave temporary increases in food stamps the highest rating of any fiscal stimulus policy.

The fiscal stimulus of 2008 did a much better job on the timely, temporary, and targeted dimensions than pretty much any fiscal stimulus that preceded it. It was enacted just as the economy was slipping into recession (if indeed the current episode is ultimately classified as an official recession). The provisions of the stimulus are all slated to expire, and it is my expectation that they actually will. And, finally, the majority of the stimulus was very well targeted, including $40 billion in refundable tax credits—five times larger as a share of the economy than the pioneering 1975 refundable tax credits.

Steps for Future Fiscal Stimulus Bills

This stimulus package might therefore be viewed as a template for future bills. But it was the product of compromise and, as such, it inevitably includes items that should be changed. Although some of these changes should occur this year, others should be borne in mind for stimulus bills in future recessions. There are three changes, in particular, that merit singling out.

Extended unemployment insurance. First, the fiscal stimulus bill should have extended unemployment insurance to cover long-term unemployment—a problem that should be remedied immediately. This is especially pressing because the long-term unemployment rate is not just higher than it was going into either of the last two recessions, but is in fact even higher than it was when President Bush proposed extended unemployment insurance benefits in 2002.

Medicaid protection. Second, the fiscal stimulus should aim to protect poor people not just from direct financial hardship but also from the other consequences of recessions, particularly from state cutbacks in critical safety net programs like Medicaid. This protection could be fostered by temporarily increasing the federal match for Medicaid, a step that was taken in 2003.

This will help ensure that much or all of the additional money is used for this purpose, both because the increase would require states to maintain a specified level of financial effort, and because the increase would effectively lower the price of state provision of Medicaid services.

More low-income targeting. Finally, although it is too late to reopen this year, future fiscal stimulus bills should do more for low-income households. The $40 billion in refundable tax credits was an impressive negotiating accomplishment for House Democrats, but it should not be the template for future fiscal stimulus bills. The final legislation limited low-income households to receiving as little as half as much money as middle-income households. The governing principle in future bills should be a flat, refundable tax credit—phased out for high-income households. In addition, other mechanisms like temporary expansions in food stamps, SSI, or Social Security benefits are an administratively simple way to quickly get money into the hands of the households that are most likely to spend it.

Beyond an Ad Hoc Approach

Passing timely, targeted, and temporary fiscal stimulus bills every time there is a recession would be a major policy accomplishment. But one would not want to rely on such an ad hoc approach. One reason the stimulus passed so quickly this year was the accident of election-year timing. Can we ensure that poverty-reducing stimulus is applied even when the business cycle happens to play out in a less timely way? I review below four structural reforms that would assist in meeting that objective.

Automatic stabilizers. We should improve the "automatic stabilizers" that supply fiscal stimulus as it is needed. For example, when the economy turns down, an automatic stabilizer boosts unemployment insurance benefits and reduces tax revenues, both of which act as automatic fiscal stimulus. As a general principle, the more progressive the tax and transfer system, the more potent are the automatic stabilizers. Unfortunately, policy has been moving in the opposite direction, and the current automatic stabilizers are less effective than they were in the 1960s and less effective than those found in most European countries. The automatic stabilizers would be strengthened if people automatically got more money when their incomes fall and paid more money when their incomes rise. For example, increasing the EITC, expanding eligibility for food stamps, or shifting to a more progressive tax system are all steps that would help make the economy more recession-proof by automatically injecting money to the households most likely to spend it when their incomes fall.

Better indexing. Recessions often coincide with commodity price increases, yet relief is not indexed to those increases. The food stamps program, for example, is not indexed for food price inflation. Thus, when families most need money and when the economy most needs stimulus, food prices and the value of food stamps move in the opposite direction. Indexing food stamps in this manner could help protect the poor against the worst of macroeconomic maladies: stagflation.

Rainy day funds. Recessions often lead states to cut back on essential services. To avoid this, states should refrain from extensive spending and tax relief in good years, instead setting aside revenues in "rainy day funds." The federal government could also help more given its superior ability to borrow in a downturn and pool risks across states. One helpful reform would be to index the federal government's Medicaid matching rates to a national or state indicator of economic activity.

Modernizing unemployment insurance. Unemployment insurance is desperately in need of modernization. The system has been essentially unchanged since its creation in the 1930s. It does not cope well with intermittent workers, temporary workers, the self-employed, or multiple job holders—many of whom are poor. Also, the triggers in place to automatically extend unemployment insurance benefits are badly designed and almost never employed, even in a severe downturn. A number of steps could help remedy these problems, including federal standards for state eligibility rules that make it easier for part-time and low-income workers to qualify for benefits, voluntary accounts to help workers smooth their income during spells of unemployment, and updated rules to trigger extended unemployment benefits based on the actual unemployment rate in states.

Minimizing a Recession

Advocates of antipoverty policies generally stress complementarities with other policy objectives, often rightfully so. In the case of economic stimulus this complementarity has been verified by a substantial body of research and is broadly accepted. Putting money in the hands of the poor can help reduce the severity of a recession. And reducing the severity of the recession is the most important step we can take to mitigate any increase in poverty.

Although the current stimulus package is in many ways a template for the future, there is no guarantee that future downturns will again occur at precisely that time in the election cycle when legislative action becomes viable. I have thus outlined how we might build in automatic stimulus and poverty-reduction via stabilizers and indexing. While we should take as many steps as we can, both on an ad hoc basis in terms of better fiscal stimulus policies and on a permanent basis by improving antipoverty programs and the automatic stabilizers, ultimately we should recognize that we can no more legislate the business cycle out of existence than we can eliminate the link between economic activity and poverty. The poverty-inducing effects of the business cycle can in this sense be dampened but not eliminated.

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