



The Economic Stimulus Package: Will It Work, and for Whom?

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Congress and the White House recently settled on an economic stimulus package with unusual speed, pushing the throttle to pull the economy out of a nosedive. Is this just election-year grandstanding, or does economic stimulus really work? And if it *can* work, what works best?

While some experts argue that priming the economy now is unnecessary, ill-timed or even counter-productive, those who support the concept applaud the design of the recently approved \$168 billion package, centered on rebates of \$600 to \$1,200 for more than 130 million households. "They have moved remarkably quickly, so maybe this time it will, in fact, be well-timed," says [Nicholas S. Souleles](#), finance professor at Wharton. Souleles conducted a study titled, "[Household Expenditure and the Income Tax Rebates of 2001](#)," that found a 2001 stimulus package did indeed help the economy recover from recession.



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That smaller plan included permanent tax cuts that encouraged consumers to increase their spending, while the current package has only temporary features, he says. But this shortcoming may be offset by today's greater emphasis on getting money to low- and moderate-income people who are especially likely to spend it quickly. "If the new rebate is being more directed towards [financially] constrained households, that ... difference would tend to increase the total spending," he notes. More consumer spending will increase companies' sales, reducing any need for workforce cuts and encouraging growth. At least, that's the theory.

The stimulus should work, suggests Wharton finance professor [Jeremy Siegel](#). But that's what worries him: He thinks the economy is likely to recover later in the year anyway, and that the stimulus package could combine with rising commodity prices to spur inflation. "I do think the economy is going to recover," he says. "The Fed may have to start raising interest rates in the third quarter to offset the stimulus from this package... This just makes the job of the central bank a little harder."

Housing Bubble vs. Tech Bubble

Offering yet another view, Wharton finance professor [Richard Marston](#) thinks today's economic problems are quite different from those of 2001, and likely to be more severe and long-lasting -- and resistant to remedies. The key feature of today's downturn is the collapsed housing bubble, which has a broader effect than the burst tech-stock bubble of 2001, he says.

While the rebates will lead to more spending, Marston notes, the lack of a long-term tax cut will make the stimulus package less effective than the one in 2001. At the same time, the Fed's interest-rate cuts will not work as well because today's credit problems are caused by lenders' fear of risk rather than a shortage of money to lend. Reducing rates will not necessarily reduce that fear. "I think the banking part of this is more problematical this time than it was in 2001 because we're in the middle of a fixed-income crisis -- because people just don't trust each other," he says, adding: "It's very scary, very scary.... I don't see a quick recovery."

It is not yet clear that the U.S. economy fits the technical definition of a recession -- generally seen as two consecutive quarters of economic contraction, plus other criteria -- but there's no doubt it is in trouble. The economy grew just 2.2% in 2007, the lowest level since 1.6% in 2002. In the fourth quarter, it grew at an annual rate of 0.6%, down from 4.9% the quarter before.

Bad economic news has continued this year: On February 15, the government reported that import prices had soared in January at the highest rate since 1983, and that manufacturing was declining. The most recent Reuters/University of Michigan survey showed consumer confidence at its lowest since early 1992.

Siegel says a recession appears more likely than it did a few months ago, but that a recession, if it occurs, is not likely to be deep or prolonged because the employment and consumer spending pullbacks have not been severe. "The odds are definitely going up," he says of recession prospects. "But so what? If we get plus-point-one percent [GDP growth] it's *not* a recession; if we get minus point-one percent, it *is* a recession. Nobody can tell the difference."

Others are less optimistic. "I think the economy's contracting," says Mark Zandi, chief economist and co-founder of Moody's Economy.com. "It shrank in December. It shrank in January.... It's likely contracting again for February. We still have another three or six months of decline to go. That is recession."

Zandi points to falling employment figures and pullbacks in retail and vehicle sales. In addition, his weekly survey of businesses finds executives newly focused on the need to cut payrolls and equipment investment.

But several factors could keep the recession mild, according to Zandi. "Corporate balance sheets, outside housing-related businesses, are in good shape," he says. Hence, companies "can weather a very serious financial storm like the one we are experiencing." And the global economy remains strong. "I think, particularly, emerging economies, which account for half of global GDP, will hold up very well."

Finally, U.S. policy makers are handling the downturn well, Zandi adds, citing the Federal Reserve's recent rate cuts and Fed chairman Benjamin Bernanke's signals that more cuts could come quickly. "The fiscal stimulus is significant and unprecedented in the sense that it was put together so quickly." The rebates are "targeted to the right people, who are more likely to spend them quickly. I suspect most people who get this money are going to spend it on groceries, daily living expenses, electric bills.... I think it will be enough to get the economy growing, along with low interest rates."

2001 vs. 2008

The best analogy to the current package was the Economic Growth and Tax Relief Reconciliation Act of 2001, a response to the recession that began that March. About two-thirds of U.S. households received tax rebates of \$300 to \$600 as an advance on the income-tax cuts that also were part of that package.

Souleles, along with David S. Johnson of the Bureau of Labor Statistics, and Princeton economist Jonathan A. Parker, added questions to the Bureau's regular Consumer Expenditure Survey to find out how people used the rebates

For logistical reasons, the government spread the \$38 billion in rebate checks over 10 weeks from late July to late September. Because each week's recipients were selected at random, the survey, taken as a whole, automatically negated the effects of other temporary influences on spending, such as changes in the stock market or car makers' cheap-financing deals.

The study found that the average household spent 20% to 40% of its rebate on non-durable goods during the three-month period the money was received. After six months, about two-thirds of the rebate had been spent.

The rebates increased consumer spending on non-durable items by about 2.9% in the third quarter of 2001 and 2.1% in the fourth quarter, a significant boost that coincided with the economy's recovery, the authors said. "Our findings imply that the rebates provided a substantial stimulus to the national economy, helping to end the recession of 2001."

Souleles and his colleagues also found that in the three months during which the rebates were received, low-income households spent 63% more of the money on non-durable goods than high-income households did, buying things like food, clothing and health-related items. "In sum, we find that households with low income or low liquid wealth consumed more of their rebates than typical

[households did]..." the authors wrote.

The 2008 rebate should stimulate the economy much as the earlier one did, Souleles says, though its features are somewhat different. The current plan is richer: It is expected to cost \$152 billion in 2008 and \$16 billion in 2009, compared to \$38 billion in 2001. In the new plan, rebates will average \$600 for individuals and \$1,200 for couples filing joint returns, plus \$300 for a dependent child. That's twice the 2001 level.

In the earlier package, rebates were paid to all taxpayers regardless of income. The current one has phase-outs to provide the bulk of the money to households of low and moderate income. The payout will be reduced by 5% for every \$1,000 an individual makes in excess of \$75,000, or that a couple makes above \$150,000.

Even people with little or no tax liability can qualify for a minimum of \$300 per individual or \$600 per couple in the current program, so long as they file a tax return reflecting at least \$3,000 in income. Taxpayers will qualify based on their 2007 tax returns, due by April 15, and checks will be mailed beginning in May. Another chief difference: The 2001 program was part of a 10-year reduction in income-tax rates for all taxpayers, while the 2008 payment is one-time-only.

People were especially likely to spend their 2001 rebates because they knew further tax savings would follow, Souleles says. While the current program does not have that spending incentive, this may be offset by its greater emphasis on people of low and moderate incomes. "You can judge these policies by their goal, and it's very much a goal of short-term stimulus," Souleles says. "It would follow that you would want to disproportionately target these things to the households that are likely to spend them... the constrained households."

Zandi agrees. "I think it's a good tax rebate as far as rebates go...." he says. "It is targeted to the right people, who are more likely to spend it quickly.... I think it will be enough to get the economy growing, along with low interest rates."

The Check Is in the Mail

But the stimulus package may not have the same effect everywhere, notes Wharton finance professor [Nikola Nikolai Roussanov](#). Two households with the same income may experience an economic downturn very differently depending on where they live, he says. The family in a high-cost region like California will feel the downturn more severely and respond by spending the rebate on necessities like food. The family in a low-cost region such as the South may not be hurting as badly, and will be more inclined to spend the rebate on luxuries, or to save it. Therefore, says Roussanov, it is very hard to predict how well the stimulus package will work. "The same dollar of income buys different consumption bundles for people in different parts of the country."

A boost in consumer spending will not come for some time. Checks will start flowing in May, but it could be summer or fall before consumers have their rebates and decide what to do with them.

According to [Kent Smetters](#), Wharton professor of insurance and risk management, such delays make fiscal stimulus a clumsier way to deal with short-term economic problems than monetary policy -- Fed rate cuts. "I tend to lean more toward using monetary policy for short-term things, and using fiscal policy to get the long-term things right," he says, adding, "We typically think monetary policy is a little quicker.... By the time these [rebate] checks come out, who knows where the economy will be?"

A January 2008 study by the Congressional Budget Office, *Options for Responding to Short-term Economic Weakness*, notes that timing is indeed critical. A "recognition lag" caused by the masking effects of high inflation led the government to adopt a stimulus plan well after the 1974 recession had begun, the report says. The tax rebates did not take effect until March 1975, making the stimulus, at best, an unnecessary expense and, at worst, a counter-productive spur to inflation.

But the CBO found that economic weakness was spotted much more quickly during the two most recent recessions, in 1990 and 2001, when inflation was not so high -- a condition similar to today's. "The experience of the past two recessions suggests that recognition lags need not always impede effective stimulus," the CBO states.

Clearly, each economic downturn has unique characteristics, making it impossible to predict for certain how well the government's response will work. But although economists have varying opinions about the wisdom of the latest stimulus package, they tend to agree on one thing: No economic boom is in the near-term forecast.

"I do worry that the recovery in late '08 and '09 could be very disappointing," Zandi says. "That will depend on what happens in the financial system. If conditions don't improve soon, then I think the economy's going to struggle. It's going to grow -- it won't be a recession. But it's going to feel uncomfortable."

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