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Sizing Up a Covid-19 Stimulus Bill

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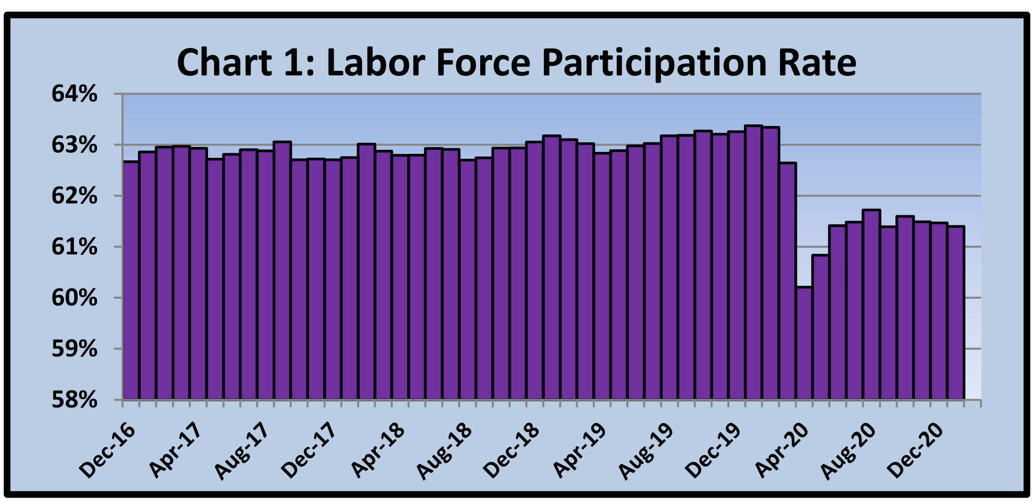
Now that the impeachment trial is over, Congress has finally turned its attention to the economic challenges facing the 330 million Americans not named Donald Trump. The White House and Congress once again must attempt to enact a stimulus bill that may well determine the course of the country's economy for the next few years.

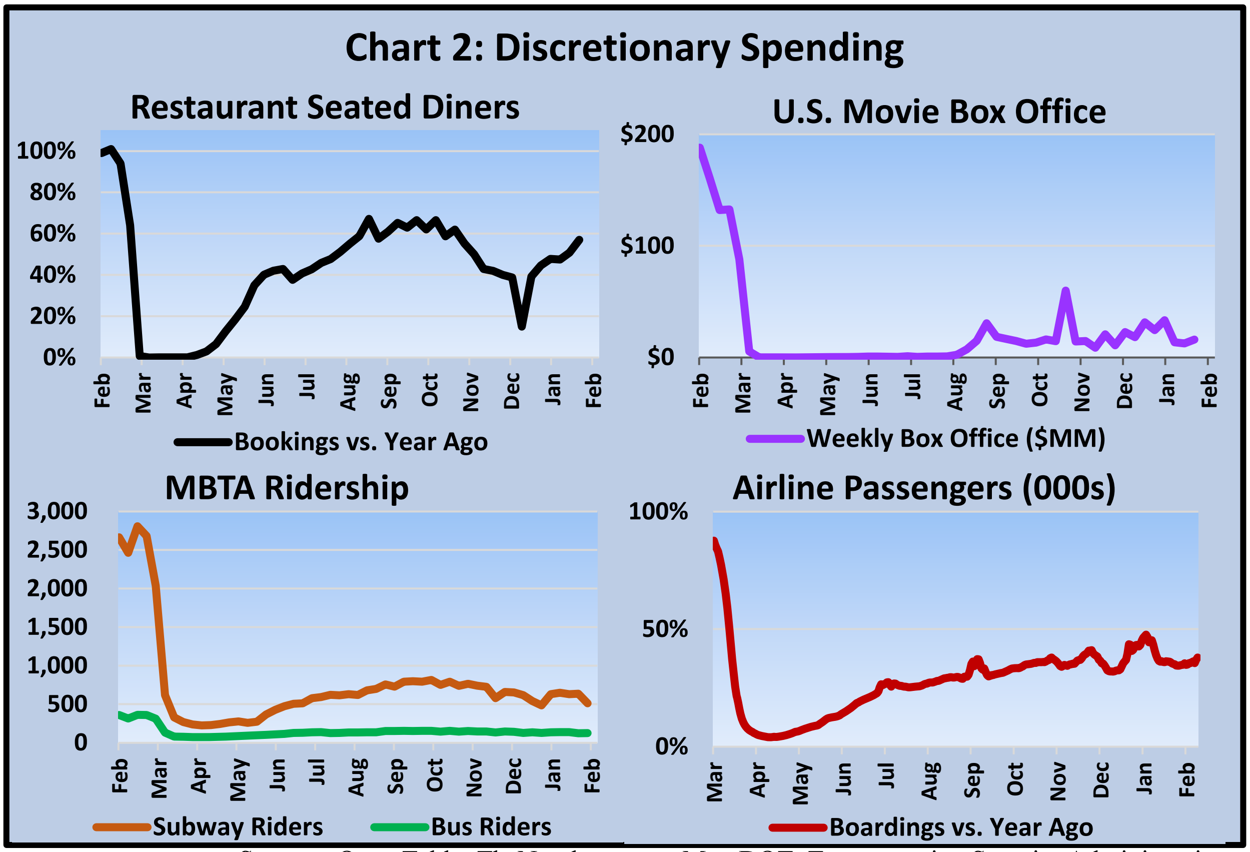
President Biden's dilemma in negotiating with Congress centers on these questions: How much stimulus, who should get it, and how should it be delivered? Go too big, and the only way to pass legislation would be through the reconciliation process with no Republican votes. That path poses substantial political risks with the Democrats defending very slim majorities in both chambers next year. Going too big also raises the possibility of overheating the economy, stoking inflation, and overextending the U.S. Treasury. Go too small, on the other hand, and it may not be enough to help Americans weather the Covid-19 crisis; we may suffer a double-dip recession. The dilemma is therefore both political and economic.

That the economy is suffering is not in doubt; slack productive capacity is all around. Although the unemployment rate has been cut in half to 6.3%, that figure does not include workers who have become discouraged from seeking new jobs, and it likewise excludes people who have left the workforce entirely. A better view of the current employment picture comes from labor force participation, which measures the number of workers (employed or unemployed but seeking work) against the entire population. As Chart 1 shows, the participation rate fell sharply in the initial stages of the pandemic and has not yet recovered; indeed, the U.S. still has nine million fewer jobs than it did a year ago.



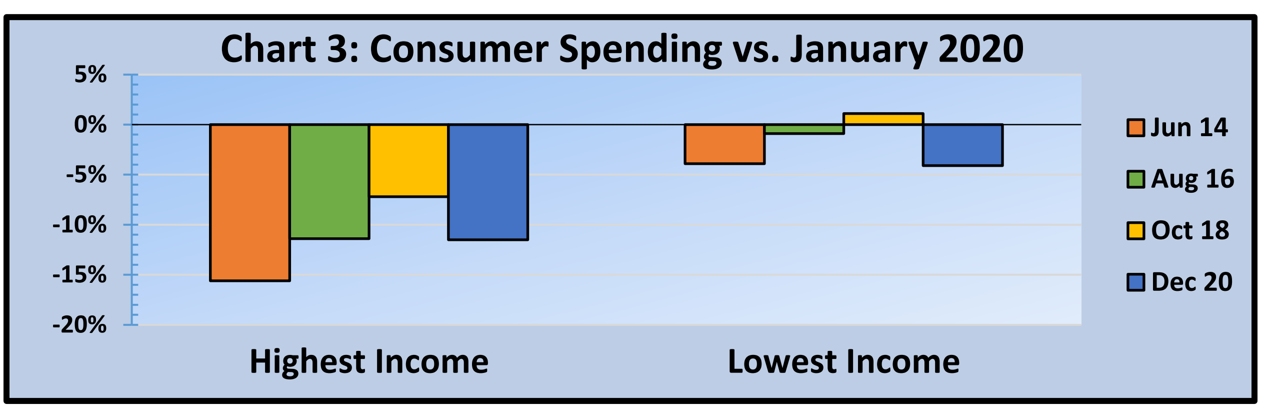
Source: Bureau of Labor Statistics

Plenty of slack capacity is evident in other sectors of the economy, too. Whether from government-imposed restrictions or from a lack of confidence in their future economic stability, Americans are still not spending money. Perhaps surprisingly, it is not the poorest Americans who have cut back, but the wealthiest. The upper-income cohort isn't buying discretionary goods and services, nor are they traveling across town or across the country (Chart 2).



Sources: Open Table; TheNumbers.com; MassDOT; Transportation Security Administration

Conversely, consumer spending by those with the lowest incomes has recovered to pre-pandemic levels thanks to the CARES Act and later legislation (Chart 3); this spending has been concentrated on basics and staples, not the sorts of discretionary items shown in Chart 2.



Source: Chetty et al., www.tracktherecovery.org

This quick review of the economy suggests the priorities that a new stimulus bill should target. Most importantly, new legislation needs to protect those people whose financial stability has been most severely rocked by the pandemic, namely the unemployed and the workers with the lowest family incomes. This support comes in at least three forms: Extended unemployment benefits, direct payments ("stimulus checks"), and eviction protection.

Second, the biggest potential boost to the economy will come in the form of widespread vaccinations against Covid-19. Only then will high-earning Americans regain confidence that they can travel, eat out, go to the theater, or rejoin spin classes at the gym. Each of these high-touch personal service industries normally employs millions of currently sidelined workers, so a resumption of spending on these activities would spur growth across the entire economy. Hence, the stimulus bill needs to include significant funding for vaccine production and distribution.

Third, the bill should include some support for state and municipal governments whose tax revenues have shriveled while their expense burdens have risen during the pandemic. Property tax collections have been steady, but sales tax and income tax revenue have dropped over the past year. Concurrently, these governments have been forced to increase spending sharply on pandemic-related needs in health care and education. Further, their balance sheets have deteriorated because low interest rates have pushed up their pension liabilities.

Beyond these essentials, most of the other provisions in President Biden's $1.9 trillion package are unnecessary but may be politically expedient to include. While a major infrastructure bill has bipartisan support, for example, it can also stand on its own. Some of President Biden's tax proposals may also have merit, but they too should be considered as separate legislation.

Other mooted provisions would actually be counterproductive. Congress and President Biden would be wise to drop at least these two items from consideration:

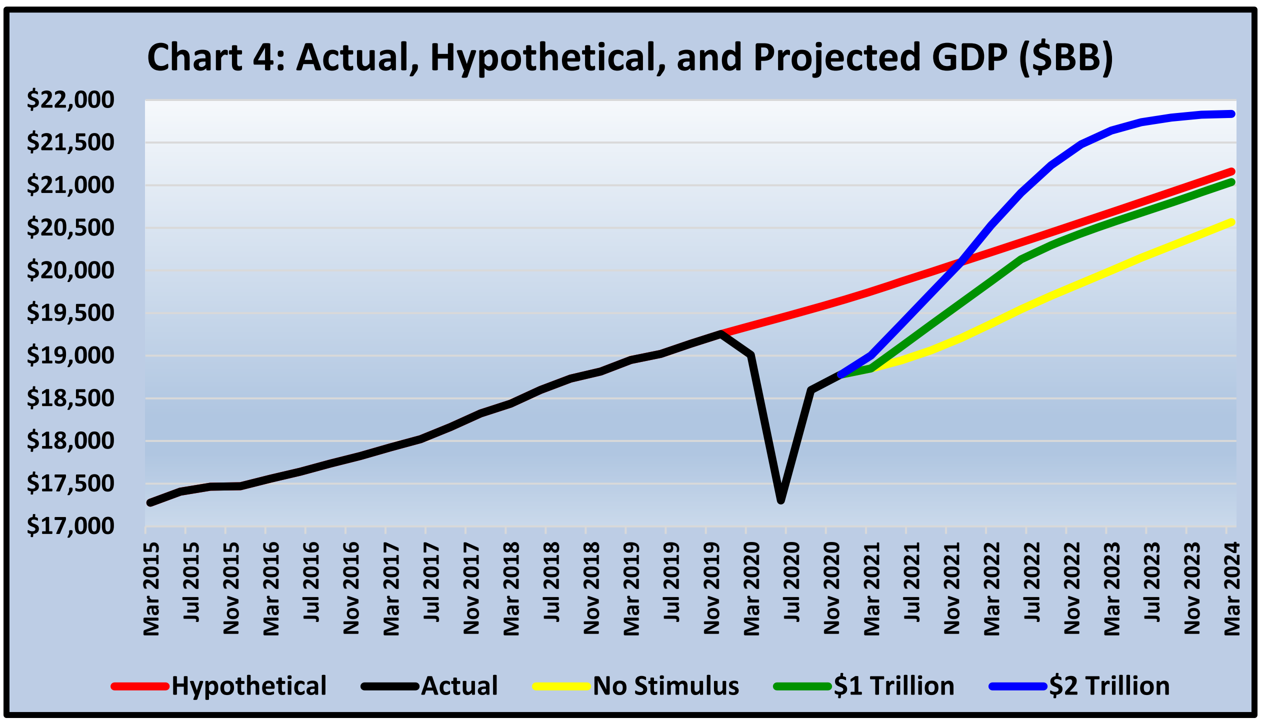
- Stimulus checks to high-earning Americans make no sense. These people already have plenty of money – they're just not spending it. Giving them more money doesn't increase their propensity to spend, but it does increase the federal debt. While the income cap for stimulus payments is certainly open to negotiation, it should probably be set a lot closer to $75,000 than to the $300,000 level proposed by the White House.

- While raising the minimum wage would be a boon for employees at the bottom of the wage scale, doing so now may deter employers from rehiring furloughed workers. The minimum wage is a legitimate topic for Congress to address, with important potential benefits and detriments to consider – but it doesn't belong in the stimulus bill.

Limiting direct payments to people earning under $75,000 would be a big money saver; along with smaller excisions of non-core items, the overall $1.9 billion price tag can be trimmed by 30% to 40% while still helping people and providing a meaningful boost to the economy. Further, dropping these proposals from the stimulus bill is politically smart. A smaller bill would be more likely to garner substantial bipartisan support, thereby insulating the final legislation from political or legal attacks in the future.

Perhaps the most important benefit of a smaller bill is that it would be less likely to overshoot the mark. An overly generous stimulus bill runs the risk of overheating the economy, as suggested by Chart 4. In this chart, the black line shows the progress of inflation-adjusted Gross Domestic Product (the total output of our economy) through last December; the red line shows the trajectory the economy would likely have taken were Covid-19 not occurred.

In effect, this red line shows the theoretical productive capacity of our economy, which had been growing by about 2.5% annually because of demographic change and productivity gains. When the black line drops below the red line (what economists call a negative "output gap"), the economy is operating suboptimally and can expand without fear of inflationary spiral; boosting output absorbs existing resources without strain.



Sources: Commerce Department Bureau of Economic Analysis, Eastern Bank Wealth Management

The yellow, green, and blue lines suggest how the economy might respond to Washington's resolution of the stimulus bill. With *no* bill, as shown in yellow, the economy would probably continue to grow, but more slowly and with a perniciously stubborn negative output gap; in other words, we would be struggling with higher unemployment and slower growth for years to come.

At the other extreme, the blue line shows what can happen if legislation includes *too much* stimulus. Economic growth would likely accelerate quickly, eventually surpassing our capacity to meet demand with increased production. When that positive output gap occurs (i.e,, when the blue line crosses over the red line), scarcity becomes a concern and an overcaffeinated economy can devolve into an inflationary downward spiral. Although not shown on this chart, this could lead to an economic boom-bust cycle of increasing amplitude and decreasing predictability – and, in turn, to higher interest rates, lower asset prices, and slower long-term growth.

Instead, the ideal size of a stimulus bill is shown conceptually by the green line: Enough boost to close the output gap quickly, getting the economy back on track without triggering inflation and without overshooting the target. While the chart labels this green line at $1 trillion and the "overshoot" blue line at $2 trillion, these are just guesses; no one can know in advance how much stimulus is "too much" versus "just enough."

Some observers worry that even a $1 trillion bill will trigger higher inflation. Indeed, perhaps *any* additional stimulus is a bad idea. These critics look at the 25% increase in the money supply over the past year (in comparison to the 2% increases seen in previous years) and expect inflation to flare up as soon as people come out of pre-vaccine hibernation.

These fears seem misplaced. Inflation, like fire, needs three things: Fuel (money supply), oxygen (consumer demand), and spark (scarcity). It is true that there is plenty of fuel already present in the economy for an inflationary fire. But consumer demand remains muted; there is no oxygen. When demand comes back, it will return in precisely those areas where there is currently abundant excess capacity: the high-touch services like travel and hospitality where millions of furloughed workers can come back to their jobs, and where existing facilities can reopen quickly. Even if oxygen returns to the economy, in other words, scarcity will still be missing.

However, an overly aggressive "go big" stimulus bill does run the risk of pumping the economy too much – that is, of pushing GDP growth above our long-run capacity. If demand exceeds our economy's ability to meet it, scarcity may arise and drive prices sharply higher. For Congress and the White House, the challenge now is to go big enough to help the people who need it, but not to go so big that we create more problems than we solve. As the Barenaked Ladies understood in their 1988 tongue-in-cheek (slightly modified) novelty hit:

> *If I had a million dollars, I'd buy you a house*
> *And if I had a million dollars, I'd buy you furniture for your house …*
> *And if I had a million dollars, I'd buy you a K-car, a nice Reliant automobile*
> *But if I had a* trillion *dollars, we wouldn't have to walk to the store*
> *If I had a* trillion *dollars, we'd take a limousine because it costs more …*
> *If I had a million dollars, I'd be rich.*

Many Americans need help – but not everyone. Too much of a good thing is still too much.