Recession Ready: Fiscal Policies to Stabilize the American Economy

A new book by The Hamilton Project and Washington Center for Equitable Growth, titled *Recession Ready: Fiscal Policies to Stabilize the American Economy*, offers detailed proposals from leading economists and policy experts for better fiscal policy responses to recessions. These proposals aim to strengthen our automatic stabilizers: policies that inject money into the economy in a downturn and withdraw stimulus when the economy is strong.

Direct Stimulus Payments to Individuals

A proposal by Claudia Sahm of the Federal Reserve would boost consumer spending during recessions by:

- **Creating a system of direct stimulus payments to individuals** that would be automatically distributed when the unemployment rate increases rapidly.

Issue Overview

- **Since the mid-1970s, a typical recession has entailed a slowdown in real consumer spending growth of about 2 percentage points**, with substantially larger slowdowns in growth in 1973 and 2008.
- **Direct stimulus payments to individuals are effective** at boosting consumer spending in response to a recession. Evidence from recent stimulus programs indicates that large, automatic, and salient payments have the strongest stimulus benefits.
- **Providing automatic, direct stimulus payments to individuals would help both families and the economy**, and establishing a permanent, robust program ahead of the next recession would provide a timely defense early in a recession and a commitment to sustained support in a severe recession.

The Challenge

During recessions, consumer expenditure in the United States slows markedly—and, in many cases, declines. Consumer spending makes up about 70 percent of aggregate expenditures in the economy, and sharp slowdowns in consumer spending can exacerbate employment losses and reduce production, making a recession even worse. Consumers should therefore be a key focus of the effort to stabilize the economy.

Sahm notes that policymakers have often used stimulus payments and tax rebates to individuals to support consumer spending in recessions. There is mounting evidence, accumulated over the past decade, that finds broadly distributed, lump-sum payments to individuals directly boost spending and help stabilize demand, making these types of payments effective responses to recessions. Larger one-time payments lead to more spending more quickly than payments that are smaller or more spread out. In addition, the more salient the stimulus payment is to the individual, the less likely the money will be saved (rather than spent) and the more likely it will boost consumer sentiment.

The Path Forward

As a response to these problems, Sahm proposes distributing stimulus payments to individuals automatically in response to recessions. Drawing on the lessons learned from stimulus payments made during the Great Recession, this proposal would offer lump-sum annual payments to individuals when the national unemployment rate rises rapidly.

- **Automatic lump-sum stimulus payments would be made to individuals** when the three-month average national unemployment rate rises by at least 0.5 percentage points relative to its low in the previous 12 months.
  - The trigger depends on recent changes in the unemployment rate, as opposed to a fixed unemployment rate threshold, in order to accommodate changes over time in the natural rate of unemployment. Based on data from past business cycles, Sahm's trigger would have quickly identified every recession in the past 50 years and never would have incorrectly signaled a recession.
- **The total amount of stimulus payments in the first year is set to 0.7 percent of Gross Domestic Product** (about 1 percent of real consumer expenditures).
  - In typical recessions, consumer spending growth slows by about 2 percentage points. The direct payments in this proposal are intended to offset about half of this slowdown and would be a substantial commitment to stabilize the economy.
  - All adults would receive the same base payment, and parents of minor dependents would receive one-half the base payment per dependent.
- **To ensure that payments continue in prolonged recessions and slow recoveries,** after the first year, any second (or subsequent) year payments would depend on the path of the unemployment rate.
  - An increase of 2 percentage points or more from the initial unemployment rate would result in a second year's payments with aggregate stimulus again equal to 0.7 percent of GDP.
  - After the second year, and after the unemployment rate has peaked (whichever comes later), the total stimulus amount would be scaled down as the unemployment rate declines.
  - Annual payments would continue in the third (and subsequent) years until the unemployment rate is no more than 2 percentage points above the level at the time of the first payment.
- **In order to deliver a broad-based stimulus,** payments will not be restricted to households with taxable income. Coordination with the IRS, the Social Security Administration, the Department of Veterans Affairs, and other agencies that deliver benefits will help to reach nonfilers.
- This proposal could be paired either with higher taxes or lower transfers to individuals outside of recessions.

Adding a new automatic stabilizer for direct stimulus payments to individuals would be a commitment to increase government support to households in a recession. Importantly, Sahm argues that automatic stimulus payments to individuals should be thought of as a first line of defense in a recession and not a replacement for discretionary fiscal policy or other automatic stabilizers, which could add to stimulus as macroeconomic conditions evolve.

About the Author

Claudia Sahm is an economist at the Board of Governors of the Federal Reserve System. The views in her proposal do not necessarily reflect those of the Federal Reserve System.