

**Background Material on**  
**the Potential Economic Impacts of the Terrorist Attacks**

**Prepared by the Democratic Staff**  
**for the Use of the Vice-Chairman and Democratic Members,**  
**Joint Economic Committee**

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## I. OVERVIEW

Overall, the effects of Tuesday's attacks on the U.S. economy are likely to be negative in the very short term but mixed and uncertain after that. The direct economic effects are likely to be similar to those of a major natural disaster such as an earthquake or a severe flood, which tend to be pronounced in the affected area but which typically have a fairly limited impact on the national economy. The loss of transportation and financial services associated with the shutdown of air travel and Wall Street has an immediate but relatively short-lived adverse impact. The subsequent rebuilding will have a positive, and *possibly* larger effect on economic activity.

Perhaps the primary economic concern for economic performance in the short run is an increasing loss of consumer confidence. Strong consumer spending was the key reason the recent economic slowdown was not a full-scale recession. Recent data indicate that declines in consumer confidence were beginning to slow spending on large consumer durables even before the attacks.

Many economists believe that the 1990-91 recession partly was due to a loss of consumer confidence associated with the buildup of hostilities in the Persian Gulf at a time when the Federal Reserve was already raising rates to fight inflation. Although the economy is similarly vulnerable to a loss of confidence now, the Fed is not similarly constrained. Fiscal restraint and exemplary growth in productivity during the 1990s held inflation down, giving the Fed greater flexibility. The Fed has already cut short-term rates by a full percentage point and has not ruled out additional cuts before the end of the year.

Specific industries face a changed environment and may need some short-term support. For example, Congress has already moved swiftly to provide the airline industry with assistance. In addition, increased risks of unemployment may call for some expansion of aid to affected workers and their states and localities. For the economy generally, spending on recovery and rebuilding (both private and public) as well as new spending to make the country more secure will provide substantial economic stimulus.

Whether the economy was poised for a recovery or about to tip into a recession was uncertain before the terrorist attacks. The attacks increase the probability that the economy will tip into recession, but the likely public and private sector responses increase the probability that the recovery will be fairly robust as well.

This document uses a question-and-answer format to look at the potential economic impacts of the terrorist attacks in more detail. It covers five main topics: general economic performance, impacts on financial markets and national wealth, impacts on specific industries, the budget outlook in the wake of the attack, and the potential impacts of some specific proposals for economic stimulus.

## II. MACROECONOMIC EFFECTS

Question: *Will the economy go into recession?*

Answer: Not necessarily. The economy was already relatively weak before the attacks, and

the devastation wrought by the events of September 11th weakened it even further. Certainly, the travel industry in general and airlines in particular will face a tough road in coming months as a result of the attack. However, increased spending by the federal government could offset some or all of those losses.

Economists define a recession as ***concurrent and mutually reinforcing contractions in many sectors of economic activity***. So far, what has kept the economy out of recession has been the relative strength of household spending. A sharp and sustained weakening in household spending, perhaps associated with a collapse in consumer confidence, could certainly instigate a movement into recession. In that event, sales falling short of expectations would trigger another round of inventory liquidations, depressing production even further.

Given the weakness in the economy prior to the attacks, it is entirely possible that the economy might have contracted somewhat in the current quarter anyway, without necessarily slipping into recession. After all, the economy only grew at a 0.3 percent annual rate in the second quarter.

We won't begin to have our first clear glimpse of the actual consequences of the attacks on the overall economy until the end of October when the Bureau of Economic Analysis releases its advance estimates of gross domestic product and personal income for the third quarter.

Question: *How have forecasters adjusted their projections since September 11?*

Answer: Although there is very little data currently available to guide forecast revisions, forecasters have lowered their estimates of economic growth for the remainder of the year. The bulk of that adjustment is concentrated over the second half of this year, with the growth projected by the end of next year pretty much unaffected by the revisions.

For example, the Blue Chip consensus (BC) and National Association of Business Economist (NABE) surveys taken since the attacks both call for downward revisions in growth for the second half of this year that exceed one percent. The BC survey now expects that real GDP in the fourth quarter of this year will have grown a mere 0.1 percent over its level at the end of last year. Similarly, the NABE survey expects real GDP to grow only 0.3 percent over that same period.

These projections contrast sharply with the assumptions underlying forecasts just prior to the attacks. In August, the Congressional Budget Office (CBO) expected real GDP to grow 1.7 percent over the four quarters ending in 2001:IV.

The forecasters appear to be predicting a return to previous expectations by the end of 2002. The BC survey expects real GDP to grow 3.5 percent over the four quarters ending with 2002:IV while the NABE survey is calling for 2.8 percent growth over that period. These consensus forecasts bracket CBO's August projection of 3.1 percent.

The surveys basically agree on what the level of real activity will be by the end of next year. By the end of 2002, the level of real GDP expected by the NABE respondents is 1.6 percent below CBO's August level; the level expected by BC respondents is 1.8 percent below CBO's level.

It should be noted that the assumptions regarding fiscal and monetary policies may vary considerably from one respondent to the next. As a result, those forecasts of real GDP may not be strictly comparable. The comparisons are only useful in getting a rough sense of the response of forecasters to the event, before having more comprehensive data.

Question: *Consumer confidence fell sharply in September. Doesn't that guarantee a decline in consumption?*

Answer: Not necessarily. The confidence measures published by the Conference Board and the University of Michigan's Survey Research Center reflect survey responses that are useful barometers of household reactions to a variety of current developments. Additionally, the indexes that summarize those survey responses are published more than a month in advance of the National Income and Product Accounts (NIPA) measures of consumption and income data for the corresponding period. As a result, many analysts find the published indexes to be useful in predicting consumption in the absence of other data.

However, a number of statistical studies have suggested that those measures of consumer confidence do not help to predict movements in overall consumption, especially once other relevant measures (most importantly, disposable income) are available. Changes in consumer confidence may coincide with changes in consumption—although the historical data offer numerous exceptions to that association—but they generally provide no additional information once the fundamentals have been accounted for.

Question: *Some analysts argue that declines in the value of equity wealth are undermining consumption spending. Does the potential for further stock market declines represent the greatest risk to household spending?*

Answer: Probably not, for a number of reasons. First of all, the wealth effect is relatively small and protracted. Fairly generous econometric estimates suggest that, out of each additional dollar of equity wealth, consumers ultimately spend an additional 5 cents, with the effect playing itself out over many years. For large changes in wealth, the consumption response can be large though not right away. For example, the value of corporate equities held directly by households dropped about 24 percent in 2000, that after five years during which equity wealth grew at an average rate of 25 percent a year. The wealth effects of the 2000 decline were barely evident in consumption—real consumption spending accelerated in 2000, and, perhaps until recently, consumption had been growing faster than overall GDP this year. To be sure, other factors (such as income and housing wealth) have more than offset the declines stemming from the drop in the stock market.

A second reason that equity wealth is probably not the greatest risk facing households stems from the likelihood that another, more serious, risk has displaced the wealth effect: disposable income. All economists would agree that the propensity to consume out of income is larger than the propensity to consume out of wealth. Moreover, as the economy slows and unemployment rises, an increasing number of households become liquidity constrained. For those households, the wealth effect is irrelevant. Moreover, those households that are liquidity constrained during downturns are also those whose propensities to consume out of additional income are as high as can be.

Question: *What are the likely employment effects of the tragedies?*

Answer: The employment effects of the disaster are extremely uncertain. Labor markets were already weakening before September 11th and we will never know what would have happened without the attacks. We will have our first direct indications of employment situation on October 5th, when the Bureau of Labor Statistics released employment data for September. But the timing of the employment surveys—the household survey was collected during the week including September 12<sup>th</sup> and the establishment survey was collected during the pay period including September 12<sup>th</sup>—implies that the September employment data does not provide a complete picture of labor markets in September. The October data (to be released on November 5<sup>th</sup>) are likely to more fully represent the employment situation in the aftermath.

Since the attacks, airlines have issued alarming reports of layoffs—so far, more than 100,000 jobs—although the impacts of those reports on unemployment are hard to assess at this point. On the one hand, Boeing has announced that it will lay off

30,000 workers over the next year. Some portion, if not all, of that adjustment might be achieved without increasing unemployment (for example, by not filling the positions left open by retirees). On the other hand, American Airlines has announced that it plans to slash its workforce by 20,000 over the next two weeks—such a decline would probably increase unemployment by a like amount.

We don't know how many of those announced layoffs could be avoided by federal assistance to the industry.

The most serious threat to employment comes from the risk of a further substantial weakening of the overall economy. However, so far, we have no information on which to base even a range of estimates for the total employment impacts.

*Question: Since September 11th, the Federal Reserve has cut the funds rate target by a full percentage point. Nevertheless, long-term interest rates have not come down by as much as have short-term interest rates. Indeed, yields on corporate bonds have risen. Is that likely to persist?*

*Answer: In times of heightened uncertainty, the difference between long- and short-term interest rates increases. The general tendency for the yield curve to have steepened since September 11th (because long-term rates did not decline by as much as did short-term rates) reflects that heightened uncertainty, and is likely to persist for a time. That tendency will reinforce the trend already underway since the beginning of the year. Since January, long-term interest rates have remained high in spite of the Fed's multiple rate cuts (which did have an impact on short-term interest rates). Many economists agree that one key reason long-term rates have remained high is that bond markets were afraid that the recent tax cuts and spending expectations would push the Federal government into deficit spending.*

*Question: How will the attacks affect national wealth?*

*Answer: The direct effect of the attacks is to reduce the nation's capital stock and the income flows associated with that stock. The dollar magnitude of that reduction is highly uncertain. Estimates of the total insured losses stemming from the attacks range from \$15 to \$40 billion. However, property losses are likely to be a relatively small portion of national wealth. For example, the World Trade Center (certainly the single largest property loss) was recently valued at just over \$3 billion, a minuscule proportion of the total stock of physical capital. Of course, the attacks also have human impacts and the losses are simply staggering.*

*Question: The Federal Reserve has suggested that the long-term economic outlook is still*

*excellent even though the short-term outlook is cloudier. Is that correct?*

Answer: Basically, yes. Nothing about the events since September 11 should have any implications for the long-term outlook—the destruction of physical capital from the attacks is a minuscule portion of aggregate U.S. wealth. Of course, that does not necessarily imply that the United States will return to the kind of productivity growth we experienced during the latter half of the 1990s. Although that is the assumption that Mr. Greenspan has articulated, that assumption is a matter of legitimate debate among economists.

### III. IMPACTS ON SPECIFIC INDUSTRIES

#### *Travel and Tourism*

Question: *In the near term, what effect will the temporary moratorium on commercial aviation have on the economy as a whole?*

Answer: While air transportation is an essential part of our economy, the shutdown is not likely to have a large overall effect in the short run, since aviation accounts for only about 1 percent of total economic activity. The ongoing slowdown is expected to cost the airline industry several billion by year's end. This is a huge loss for the industry, but it is only a minor setback for our \$10 trillion economy. The most serious economic concerns involve the effects of a prolonged slump in the demand for air travel.

There is no reason to anticipate major shortages due to the grounding and continued reduced level of air transportation, since the vast majority of our commodities travel by truck, rail and other means. Aside from minor delays, there should also be little effect on mail delivery. Cargo flights have resumed, and the U.S. Postal Service has supplemented air delivery with wider ground-based delivery in the interim.

Question: *How will this crisis affect the airline industry in the short run?*

Answer: The temporary moratorium on commercial flights created substantial short-term costs to the industry both through the idling of capacity and the organizational problems associated with revamping security and dealing with flights that were re-routed. The immediate economic concern surrounding the temporary loss of airline income is that it could drive financially insecure airlines into bankruptcy, which could reduce air service and employment (Midway Airlines and U.S. Airways had already been facing financial difficulties).

Losses will grow as the industry continues to operate below normal levels. While the industry projects up to \$24 billion in additional losses by mid 2002, our analysis finds these to be somewhat overstated, and Wall Street analysts project losses between \$3 billion and \$5.5 billion. Major carriers have already cut their daily flights by 20 percent or more. Layoffs have already been announced by several major carriers totaling about 100,000 jobs. Even before September 11, many industry analysts were projecting large reductions in income, a trend that has persisted at least since 1999. The declining profit expectations led to one-third to three-quarter percent reductions in airline stock prices since the market re-opening on Monday.

Question: *Will the crisis have a long-term impact on the aviation industry?*

Answer: This event could have a negative long-term impact on the airline industry if it induces large reductions in air travel demand. During past events such as the Lockerbie bombing and the Persian Gulf war, air travel suffered but recovered within a year or two and continued its rapid growth. Clearly, last week's events are qualitatively different from these past tragedies; however, there is still room for optimism that, in the long run, increased security measures will help assuage travelers' safety concerns.

New security measures and requirements for air carriers are already being discussed and implemented. These measures will add necessary costs for travelers and may reduce travel demand. Heightened security will increase not only the economic costs of traveling (which may in the end be borne at least in part by the federal government) but also the time costs of air travel which together may lead consumers to look for other means of travel or to forego travel altogether. We are now seeing large increases in demand for rail travel, particularly in the Northeast corridor.

It is also possible that airlines will suffer financial losses because of legal claims against them. While it is currently unclear whether or to what degree airlines will be financially responsible for the damages sustained in the attacks, increased insurance premiums for airlines will add another stress to the industry.

These factors, together with the unfavorable economic conditions prevailing before the attack, could put long-term pressure on the industry as a whole. This could permanently reduce employment levels and, in the event of bankruptcies, the level of competition within the industry.

Question: *How will the airline assistance package impact the airline industry?*

Answer: The airline package includes \$5 billion in immediate cash assistance, \$10 billion

in loan assurances, as well as some relief from liability arising from terrorist actions. President Bush has also proposed increased federal involvement with airline security which could save airlines about \$1 billion annually. The \$5 billion is designed to offset the revenue losses suffered due to the groundstop and the ongoing flight reduction, while the \$10 billion is meant to help the industry secure longer term financing for continuing operations.

We estimate the cost of the four-day groundstop to be between \$815 million and \$1.1 billion, while Wall Street analysts expect the costs to be much smaller, with the airlines losing a total of \$2 to \$4.5 billion between September 11 and Dec 31. It seems clear that a package this large should be more than enough to offset any losses due directly to the attacks. The longer term issues are less certain and depend on how quickly air travel demand recovers.

Question: *Are there other issues not covered by the package the need to be addressed?*

Answer: There are several important issues that will require our continuing attention. One important issue is the distribution of the aid from the airline bill. The bill as passed distributes the \$5 billion cash grant among airlines according to their available seat miles prior to the attack. Available seat miles are a basic measure of an airline's capacity and would have been a more effective metric had airlines been impacted proportionally. However, some airlines were impacted more severely than others, such as USAirways, whose hub at National Airport is not scheduled to reopen until October 4. This method of distribution also means that most of the aid will go to the six largest carriers. We need to ensure that the aid package does not result in increased agglomeration and decreased customer choice in the air transportation market.

Also, the aid package says little about how the funds can be used. While there is a restriction on CEO salaries in the bill, there are no restrictions on whether the money can be used for particular expenses such as lobbying, stock dividends or employee bonuses. Nor is there any provision in the bill for airline or airport workers who have been laid off as a result of the attack. It is not yet clear which airlines will provide severance packages for their laid off employees. Legislation to deal with air industry workers is likely to come up in the near future.

Question: *Will problems in the airline industry have a substantial long-term impact on the economy?*

Answer: The increased monetary and time costs of air travel will increase the general cost of doing business, throwing sand into the gears of the economy. How much impact this will have depends on the extent of cost increases. Air transportation has important links to other sectors of the economy, but overall, the cross-sector impacts should be modest. In 1996, business spending on all air transportation

(not including air freight) accounted for just one third of one percent of total business output. Nonetheless, increased travel costs will cause some hardships for businesses that rely extensively on air travel, and, in turn, the decline in travel will have a negative impact on travel-dependent sectors such as tourism. The overall economic impact will be mitigated to the extent that businesses and consumers substitute other forms of spending for their reduced expenditures on air travel.

Question: *What are the consequences of the decision by Midway Airlines to shut down operations?*

Answer: Some media sources have attributed the bankruptcy of Midway Airlines to the halt of air traffic. However, the airline actually declared bankruptcy on August 13<sup>th</sup>, and has elected not to attempt to resume service for a number of reasons, including the overall decline in business travel. With a fleet of only 74 aircraft, Midway had played a relatively small role in meeting air travel demand, so the impact of its failure is likely to be small at the national level, though its hub in Raleigh-Durham will be adversely affected.

Question: *What will the impacts be on the tourism industry?*

Answer: Like the airline industry, impacts on the tourism industry will depend on a number of unknown factors, including consumer confidence, safety concerns, and the longer-term prospects for the economy as a whole. As one might expect, the health of the tourism industry is closely linked to that of the airline industry; until we are more certain about the longer term impacts on airlines, the extent of the impacts on tourism will remain unclear. With the hotel and amusements industries spread throughout most regions of the country, the impacts could be widely felt, while popular vacation areas would be particularly hard-hit. Additionally, many cities, particularly Las Vegas, have seen large numbers of cancellations for previously planned conventions and other events for upcoming weeks. The impacts of these cancellations on the hotel industry could be severe, depending on how long they persist.

## *The Insurance Industry*

Question: *What are the anticipated insurance claims associated with the terrorist attack?*

Answer: Only a few claims have been filed so we still do not have enough information to make an accurate estimate. However, private insurance firms and industry analysts estimate that claims will be in the neighborhood of \$40 billion. These estimates include claims on insurance policies covering life, property, auto, airplanes, workers compensation and business-interruption.

Question: *How do these estimates compare to other disasters?*

Answer: The upper-end estimates are about twice the cost of the most expensive natural disaster to date, Hurricane Andrew in 1992, where claims totaled \$19.1 billion. Claims from the 1993 bombing of the World Trade Center were about \$510 million. The 1992 Los Angeles riots were the most expensive man-made disaster to date, with claims totaling \$775 million. These costs were almost entirely concentrated in property insurance claims. In contrast, the recent attack will lead to claims on a variety of types of insurance policies – life, property, auto, airplane, workers compensation and business interruption insurance.

Question: *Several insurance companies went bankrupt after Hurricane Andrew, which cost less than the estimates for the September 11<sup>th</sup> attack. Will the same thing happen again?*

Answer: In testimony before the House Committee on Financial Services, insurance and reinsurance industry executives said that the industry as a whole has the capacity to absorb the losses from the September 11 attacks. Of course, some firms with large claims and limited resources may be driven out of the market. However, there have been significant changes in the insurance industry in the last few years that make it better able to spread risk and thus withstand this kind of loss.

First, the nature of this disaster is different from Hurricane Andrew. The claims for Hurricane Andrew were almost entirely on property insurance policies offered by a relatively small number of regional insurance firms. The claims that will result from the World Trade Center attack will be on a variety of policies held by many large insurance firms around the globe – property, life, auto, airplane, workers compensation and business interruption. Second, most firms now purchase reinsurance policies to protect individual insurance firms from the financial impact of many claims from a single catastrophic event.

Finally, insurance firms have amassed a significant surplus since the early 1990s. According to a GAO study last year, the strength of the stock market in the 1990s more than doubled the surplus of insurance companies in ten catastrophe-prone states, including New York. Analysts estimate that the insurance industry as a whole would be able to withstand maximum loss in the neighborhood of \$50 to \$60 billion before incurring widespread instability or bankruptcies.

Question: *Will there be any effect on insurance premiums?*

Answer: Airlines have already experienced an increase in aviation insurance premiums. According to a report in the *New York Times*, insurers can cancel policies or renegotiate terms in less than a week. Many airlines have received notice that their insurer plans to renegotiate the cost of coverage. Insurers estimate that there will be a \$1 billion industry-wide increase in war-risk liability insurance alone.

Property insurance on buildings at high risk for terrorist attacks will see an increase in premiums. Property insurance premiums for building near a high-risk area, such as offices near the World Trade Center, will likely increase to cover the threat of collateral damage from a terrorist attack.

Life and business insurance premiums may also increase (although probably not by large amounts) as insurers seek to recoup any losses from claims as result of the attack.

Firms that offer reinsurance are also planning to increase their premiums in light of the enhanced terrorist threat in the United States. Some reinsurance firms may leave the market if they suffer huge losses. In the longer run, this will decrease competition and allow remaining firms to raise prices. Insurers will likely pass this increased cost on to their customers in the form of higher premiums.

Question: *Will the insurance industry be able to cover claims from any future terrorist attacks?*

Answer: Industry officials have told Congress that while they have the resources to cover the September 11<sup>th</sup> attacks, they are concerned about their ability to cover an future catastrophic terrorist attacks. Many insurance providers anticipate that they will have to exclude acts of terrorism in future coverage because they will not be able to get reinsurance.

At least four major reinsurance firms – including Lloyd’s of London and Berkshire Hathaway – expect to pay \$1.5 - \$2 billion in claims from the September 11 attacks. As a result, industry executives expect the pool of

reinsurance to shrink, leading to higher premiums for consumers. In addition, reinsurers may no longer offer coverage for acts of terrorism. This would force insurance firms to eliminate terrorism coverage if they cannot get reinsurance against future risk. No insurance company would be willing to provide coverage for potentially billions of dollars in claims from a future terrorist attack.

In testimony last month before the House Committee on Financial Services, insurance industry executives asked Congress to consider making the federal government the “insurer of last resort” for any future acts of terrorism. Insurance providers have pointed to Pool Re in the United Kingdom as an example. In the early 1990's, the British government created a pool of funds – a combination of government funds and contributions from private insurance firms – to help the pay cost of any expensive insurance claims resulting from acts of terrorism. Insurance firms are required to pay an initial portion of the claims and then they can turn to the pooled funds to cover the rest of the cost. The advantage of this option is that it would allow private insurers to offer terrorism coverage and allow them to cover at least a portion of the claims. Critics are concerned that private insurance companies would have an incentive to refuse to pay some claims if they knew they could turn to federal dollars. As a result, the government could be held responsible for billions of dollars in claims.

### *The Oil Industry*

Question:     *How have oil prices been affected in the short run?*

Answer:     Global oil markets reacted immediately following the attack, with futures prices rising about 5% on the afternoon of September 11, and, as of October 1, are trading 16% below where they were on September 10 (after rising and falling a few times in between). This reflects two countervailing forces acting on the market. The first is the possibility that a broader Middle East military or political conflict will disrupt oil supplies. The second is that the economic weakness that the economy had been facing before the attacks will be substantially magnified as a result of the attacks.

The possibility of Middle East conflict put upward pressure on prices immediately following the attacks. As the U.S. and our allies prepare for a more deliberate and protracted response than the market perhaps anticipated, and as President Bush continues to build a coalition that includes Arab oil producers, the immediate fear of oil supply disruptions have subsided. This has left the market primarily subject to downward pressure based on the possibility of a substantial economic downturn in the U.S. and possibly globally. From 1997-1999, oil prices fell by half in response to falling demand due to the Asian financial crisis and other factors. For now, the investors apparently believe that a less severe

version of this is more likely than major supply disruptions. That could change quickly, however.

As events unfold, markets generally are likely to be jittery, responding to facts and rumors as they arise. Prices are unlikely to make a definitive upward move until it becomes clearer what the U.S. response (and world reactions to that response) will be. We saw a few reports of gasoline prices jumping immediately following the attack (by several dollars a gallon in some cases), but these have been isolated incidents and appear to have been corrected (with refunds being paid in some cases). The major oil companies have indicated that we have ample supplies that continue to flow across the country. They also assured us that they anticipate no large price increases as a result of the attack. U.S. supplies had been relatively low earlier this year, which was at least partly responsible for the price increases we experienced. However, through much of the summer gasoline prices have been falling as producers have maintained high output levels in an attempt to restore reserves and to bring more product to market at higher prices. This has brought reserves back to more normal levels, leaving us with sufficient supplies for the near term.

Earlier this summer, OPEC voted to reduce output by a million barrels per day beginning September 1. While OPEC has not withdrawn that decision, they decided in late September to hold output steady, targeting the \$22-\$28 per barrel range. (November 1 futures are currently just under \$23.) Officially, OPEC has declared that it stands ready to maintain supply, bringing its spare capacity on line if necessary.

*Question: What will be the effects on oil prices over the longer-term?*

*Answer:* Given what we know now, there doesn't appear to be any reason to believe that oil prices will rise significantly and persistently in response to the attack. Aside from understandable market jitters, oil prices will likely remain at these low levels until the scope of the anticipated conflict is known with more certainty or until the severity and length of the anticipated economic slowdown becomes more clear. If prices make a sustained downward move, OPEC may choose to cut output, but political constraints on major members like Saudi Arabia may prevent this from happening.

Neither Afghanistan, where Osama Bin Laden is thought to be hiding, nor neighboring Pakistan are major oil producers. If activity is contained in these areas, there is no reason why prices should rise, unless other oil producers attempt to increase prices as a political response to our actions. In fact, we have seen several Middle Eastern countries condemn the attack (including Syria and Iran, with whom we have not enjoyed the best of relationships in the past), and we

continue to maintain friendly relations with many Middle Eastern oil producers. However, if the anticipated conflict expands to include major oil producers, increases in oil prices such as we saw during the Gulf War may be possible.

As mentioned above, there are a number of factors putting downward pressure on oil prices. One is the possibility of a recession in the U.S., along with a slowing of economic activity abroad. In this scenario, the threat of high oil prices pushing the economy into recession would be moot. Additionally, if airline travel remains low, reduced demand for jet fuel in the U.S. and elsewhere (jet fuel accounts for about 8.5% of U.S. petroleum consumption) could also put limited downward pressure on oil prices if the fall in commercial demand is not offset by increases in military use. In either case, the concerns over oil prices would of course be secondary to concerns over broader economic conditions.

Question: *How would rising oil prices affect the economy?*

Answer: It is difficult to anticipate the impacts that this might have on the economy, since we can only guess how high prices might rise. However, one thing we do know is that we are more energy-efficient today than we were at the beginning of the Gulf War, so that today we use 15% less energy per dollar of output than we did in 1990 and about 17% less oil per dollar of output. Any price increase we might see would thus have a smaller impact on the economy than it would have in the past.

Additionally, we have just come through a period of high prices not only for oil, but also for natural gas and electricity as well. Over the past two years, prices of all these increased substantially before falling off this summer. While high energy prices can and have put a pinch on household budgets we did not see the kind of inflationary pressures we might have previously expected, due in part to our increased energy efficiency. That being said, the economy was facing a potential slowdown before the attack, and increasing oil prices could push us further in that direction, as they did in 1990.

#### **IV. THE BUDGET OUTLOOK IN THE WAKE OF THE ATTACKS**

Question: *What are the likely near-term budget impacts of the shock to the economy caused by the terrorist attacks?*

Answer: The near-term budget impact of the terrorist attacks has two components: (1) the reduction in the budget surplus associated with a weaker economy than had been projected, and (2) the reduction in the surplus associated with any new spending

or tax cuts made in response to the attack.

The House and Senate Budget Committees have issued a bipartisan *Revised Budgetary Outlook* that estimates the possible budget impacts of a weaker economy. Such an economic path would reduce the estimated Federal budget surplus by \$80 billion in 2002, \$56 billion in 2003, and \$8 billion in 2004 (compared with the August CBO projections).

The weaker economy along with policies that have been signed into law or agreed to on a bipartisan basis since August, are expected to lower the FY2002 unified budget surplus to \$52 billion, well below CBO's August projection of \$176 billion. This is before any additional stimulus measures, and does not include other possible claims on the surplus that were in the budget resolution or that have passed the House or the Senate but are not law.

## V. POTENTIAL FEDERAL ACTION

### ***Overview: Current actions and potential needs***

Question: *What plans has the federal government already made to provide economic assistance?*

Answer: In addition to the \$15 billion aid package for the airlines, Congress has unanimously approved (9/14) and the President has signed (9/18) a \$40 billion emergency aid bill (H.R. 2888). An immediate \$10 billion will be provided to cover a response to the attacks, repairs to facilities, and increased anti-terrorist and other security efforts. Another \$10 billion will be made available 15 days after the Administration's Office of Management and Budget submits a specific plan regarding how the funds will be allocated. The remaining \$20 billion will be added to the FY2002 budget and will be available for obligation only when amounts are specifically allocated as part of the FY2002 appropriations process. On October 2<sup>nd</sup>, the Administration indicated that they had reached agreement with congressional leaders for an extra \$25 billion [note this exceeds the \$20 specified by the emergency bill] beyond the FY2002 budget blueprint approved by Congress—with \$18.4 billion for additional defense spending, \$4 billion additional for education, and \$2.2 billion to cover additional emergency spending.

The federal government is also considering a variety of additional tax cuts or spending initiatives designed to counteract the negative economic impacts of September 11th. Some proposals are a specific response to the terrorist attacks—for example, proposals to exempt victims' families from federal income and estate taxes, and proposals to provide assistance to the airline-related workers. Other proposals seek to provide stimulus to the economy in general and

are not new ideas, but are argued to have increased merit or urgency given the fact that the September 11<sup>th</sup> tragedy has clearly increased the threat of recession.

Most policymakers are talking about a total package worth over \$100 billion, inclusive of the \$15 billion airline bill and the \$40 billion emergency aid bill. On October 3<sup>rd</sup> the Administration suggested that an additional stimulus of \$60 billion to \$75 billion (for a total of \$115 billion to \$130 billion in new federal outlays) would be appropriate. That range is consistent with the recommendations from a number of prominent economists as surveyed by the Democratic Policy Committee, most of whom advised that a total stimulus of \$100 billion to \$200 billion would be appropriate. Senator Daschle has indicated a preference for an extra \$50 billion in stimulus, bringing the total closer to the lower end of recommendations, but others have recommended that as much as \$200 billion in total stimulus be adopted.

Question: *If further stimulus is needed, what would be most effective?*

Answer: Economists have urged that programs on either the tax or spending side of the budget ledger adhere to certain principles, given the current state of the economy and prospects over the longer run. First, the fiscal stimulus should take effect as soon as possible in order to boost the economy when it is most needed. Second, any new tax cuts or spending programs—if truly addressing the short-run incremental effect of the terrorist attacks on the economy—must be temporary and easy to rescind, rather than permanently built into the budget baseline. The stimulus should be transparent – its nature should be clear to all, so that the initiative leads to less, rather than more, uncertainty.

Finally, new initiatives should as much as possible encourage our nation’s long-run economic strength and budgetary position. The pressures associated with the impending retirement of the baby boomers have not gone away. Even if the short-run goal of stimulus is to boost consumption rather than saving, the longer-run need to save remains. Proposals with long-term costs can backfire in the short-run by increasing market uncertainty regarding the governments future fiscal position and adversely affecting long-term interest rates.

Question: *Is further stimulus likely to be needed immediately?*

Answer: Although quick results are a desirable quality of any fiscal stimulus package, economists—including Fed Chairman Alan Greenspan—had initially urged caution that policy should wait at least until more information became available about how the economy was altered by the Sept. 11<sup>th</sup> disaster. The best fiscal policy depends on which markets have been affected and how they have been affected.

The severe effects on the airline industry became apparent very quickly, and a policy response was swift. But unfortunately, as of early October we still do not know much about the effects of the Sept. 11<sup>th</sup> attacks on the rest of the economy, although it becomes increasingly clear that the prospects for an economy-wide recession have increased.

Even if it is judged that fiscal stimulus need not happen immediately, decisions will have to be made fairly immediately—simply because policy implementation can lag severely behind policy formulation. In this regard, all fiscal stimulus proposals are not alike, and proposals that can be implemented more quickly ought to be given higher priority, all else constant. Another factor arguing for a quick decision may be temporarily depressing economic activity.

Question: *How will the fiscal stimulus interact with monetary policy?*

Answer: The current stimulus package is designed to offset new negative influences on economic activity and is thus unlikely to increase inflationary pressures, as long as the fiscal stimulus can be easily turned-off or reversed once the economic recovery takes hold. In such a case, the Fed's capacity to further cut interest rates should not be diminished. But if we do a huge amount of stimulus, it could limit that capacity by igniting inflationary pressures that the Fed's cuts in recent months have discounted. To the extent that the stimulus raises national debt permanently, it could also raise real long-term interest rates, which would have a negative effect on both short- and long-term growth.

### ***Tax Cut Proposals***

Question: *In terms of providing short-run economic stimulus, how would additional tax cuts compare with increased government spending?*

Answer: A fiscal stimulus delivered through increased government purchases has a direct positive effect on economic activity, boosting Gross Domestic Product (GDP) by the full dollar amount of increased outlays. But reducing taxes does not boost national income by the full revenue loss, because households and/or firms spend only a portion of their tax cuts.

A tax cut targeted to upper-income households, in particular, would provide less fiscal stimulus than broader-based tax relief, because upper-income families are likely to spend only a small fraction of the tax cut. Moreover, to the extent that households are liquidity constrained, tax cuts will have little effect, if any.

Tax policies are likely to be at a disadvantage relative to spending proposals in

terms of speed in implementation, unless the tax cuts are accomplished through immediate changes in withholding. Even rebate checks would likely take several months to get out, especially if they would go to a different group of people than those who already received the income tax rebate checks.

Spending proposals, on the other hand, would likely be swifter to implement, as long as they simply increase the generosity of existing programs through existing mechanisms. Although new infrastructure projects can take some time to plan and carry out (and hence to translate into new jobs), there are probably many projects at both federal and lower levels of government that have been planned and approved and are simply waiting for adequate funding.

*Question: What are some of the tax proposals being considered, and how do they compare, both in terms of the short-run stimulus they could provide and in terms of their longer-run effects on the budget and economy?*

*Answer: Some Administration officials and congressional Republicans continue to recommend permanent tax cuts, particularly those affecting capital income.*

Proponents of capital income tax cuts argue that business investment has been what has suffered most in this economic downturn. But a corporate tax cut would not stimulate investment in new capital, would affect the short-term cash flow of only firms that are currently profitable, and would primarily benefit higher-income households who are the least likely to need it and the least likely to spend it. The danger here is that the revenue loss will be “wasted” on profitable businesses that will take the windfalls without any of the desired change in their behavior—that is, without any increased investment beyond what they would have done without the tax cut anyway.

The immediate economic stimulus from a corporate tax cut—or any other general and permanent cut in capital income taxation—would likely be weak. It is unlikely that businesses will significantly increase investment just because of a new tax cut for capital income. There is still substantial excess capacity, and businesses are too worried about consumer demand to make plans to expand. Corporate tax cuts will do nothing for unprofitable businesses. Increasing consumer confidence and consumption is probably the most effective way to encourage investment.

Arguments that reductions in capital income taxation would provide long-run economic benefits are weak. A capital gains tax cut would do little to spur new investment because many assets do not generate capital gains, and even for those that do, capital gains already receive preferential tax treatment. Enlarging that preference for capital gains would create incentives for investors to further reallocate investments in unproductive ways, such as shifting money into tax

shelters only in order to take advantage of those tax preferences. In addition, as Robert Rubin said early this week, passing a capital gains tax cut now “could have a counter-productive effect if it caused people to be more ready and more willing to sell stocks.” Permanent corporate rate reductions do have the potential to enhance economic efficiency, because corporate income is generally taxed higher than other forms of income under current law. But the revenue loss from a permanent corporate tax cut would far outweigh the potential efficiency gains, and the deterioration in national saving would have an adverse effect on the long-term economic and budget outlook.

*Question: What tax proposals, other than capital gains or corporate tax cuts, are being considered?*

*Answer: If tax cuts are to be part of a stimulus package, they will be more effective if they are better targeted to the types of businesses and households most in need as a result of the now-expected sharper downturn. For example, on the business side, tax reductions could be geared towards small businesses or to certain types of new investment most critical to promoting longer-run economic growth. On the household side, a tax rebate could be extended to Americans that pay payroll taxes but who did not benefit from the recent income tax cut, or payroll taxes could be temporarily suspended (with general revenues transferred to the trust funds to make up for the lost payroll tax revenue). But tax cuts in general will be a useful part of the stimulus package only to the extent that they can be implemented quickly and are purely temporary in nature.*

### ***Spending Proposals***

*Question: What types of new spending initiatives might be helpful, and how would they differ in their short- and long-run economic effects from the tax proposals?*

*Answer: Any new spending proposal that is motivated by the terrorist attacks should be mindful of where the greatest new needs are—this tragedy has not eliminated the need to consider tradeoffs and budget constraints, so that it is important to consider where each dollar should go to produce the largest social benefit. Some ideas that have obvious merit and relevance include increasing and/or liberalizing unemployment insurance to help those affected by layoffs, expanding supports to low-income families, increasing federal aid to state and local governments, and increasing government spending for infrastructure projects. Most types of spending initiatives are probably easier to make temporary than are tax cuts, and easier to target to particular groups deemed most in need. In addition, any spending that is investment oriented, such as rebuilding or improving infrastructure, may produce the right mix of short-term stimulus and long-term*

contribution to the capital stock and economic growth.

### ***Defense***

Question: *What will likely happen to defense spending, and how will it affect the budget as a whole?*

Answer: It is becoming clear that Congress will approve additional defense spending for the coming fiscal year, beyond what the Administration requested before this tragedy. It does not appear that the Defense Department will be asked to reduce other areas of their budget in order to accommodate the increased spending necessary to respond to and recover from the attacks. Whether the budgets of other departments will be squeezed is uncertain, but seems unlikely in the short run. Over the longer run, however, if increased defense spending is built permanently into the budget baseline, resources left for other areas of the budget will naturally become tighter. The remaining needs in the non-defense budget, given the expansion of the defense budget, is yet another reason why any new spending or new tax cuts should not be made permanent.

### ***The Social Safety Net***

Question: *If unemployment increases either as a result of the attacks or because the economy faces a recession, is our current social safety net adequate?*

Answer: Any large-scale increase in unemployment could create new hardships. Two risks in particular stand out. First, only about a third of unemployed workers receive unemployment benefits, mostly due to eligibility requirements. If unemployment rises significantly, the number of people without a job *and* without benefits will likely increase as well. Second, under welfare reform unemployed families in some states could face additional difficulties in obtaining assistance if jobs are not available.

Question: *What role will the Unemployment Insurance program play, and are changes in that program needed to make it more effective?*

Answer: Unemployment Insurance (UI) is considered one the most important anti-recessionary government resources when unemployment rises. Its impact is automatic and immediately counter-cyclical: benefits increase during recessions and decrease during economic prosperity. Unfortunately, UI isn't as effective as it could be and some modest long-overdue improvements could be implemented to strengthen its role in stabilizing the economy during a downturn.

Little more than one-third of unemployed workers receive unemployment insurance in an average month - and only one in six unemployed single parents at the lowest earnings levels. To fill these gaps in coverage, which disproportionately affect working women, the federal government could provide financial incentives to encourage states to extend eligibility to part-time workers. Part-time workers are most likely to be hurt by an economic downturn because they lack seniority on the job. Additionally, changes could be made to current methods of calculating eligibility that do not always take into account the most recent quarter of work, which disproportionately hurts low income workers with sporadic employment schedules.

Finally, the federal government can play an important role in stabilizing the economy by providing assistance to those states that may face difficulties in meeting their UI obligations as unemployment rises. The Labor Department recommends state programs contain enough funds to pay benefits for 52 weeks during a typical recession. However, only half of the states have enough money to cover the 52 weeks, with New York having one of the lowest levels of funding. On October 1<sup>st</sup>, Labor Secretary Chao announced a \$100 million special distribution from the federal Unemployment Trust fund to shore up state accounts. The monies are to be distributed based upon states' proportional share of funds to the UI administrative funds. Since over \$21 billion in unemployment benefits were paid in 1999, additional distributions may be needed.

Question: *Are there temporary changes that can be made via the Unemployment Insurance program as well to counteract the economic impact of the attacks?*

Answer: Unemployed workers are likely to spend any additional income they receive immediately, since they are generally facing substantial reductions in their regular income. Therefore, supplementing benefits can have an immediately stimulative, though temporary effect. Possible proposals include providing a temporary \$25 a week federal supplement to UI benefits for the duration of FY 2002, or extending Unemployment Insurance Benefits for an Additional 13 Weeks.

Question: *How well can existing support programs – such as the Temporary Assistance to Needy Families (TANF) and WIC programs – meet the needs of the newly unemployed or laid off?*

Answer: The number of people eligible for support programs like TANF and WIC is likely to increase in the wake of the September 11<sup>th</sup> attacks as people are laid off, lose their jobs or suffer the death of a spouse. Easing existing regulations and increasing funding can help states hardest hit by these events maintain their fiscal

balance and serve their neediest residents.

Federal funding to states for TANF is fixed as a result of the block grants enacted in 1996--it does not increase as program eligibility rises. Existing regulations do not offer any incentives for states to create a TANF reserve fund, so states would have to shoulder much of the cost of the increased caseload. The federal government can help ease the burden on states by loosening some TANF requirements.

First, states can currently be sanctioned by the federal government if they do not move a certain percentage of their caseload into the workforce. Many low-skill jobs may be cut back or eliminated in the next few months, making it more difficult for TANF recipients to find work. The government could temporarily suspend these sanctions.

Second, the federal government could re-establish the TANF contingency and loan funds which expired September 30, 2001. The federal government could allow states that have spent their full block grant funds on eligible programs and have exhausted their reserve funds to draw upon a the contingency fund to pay benefits for newly-eligible recipients for the remainder of FY 2002. States would be required to match federal benefit payments at their Medicaid program match rates and the fund could be set to expire after one year.

A third possibility would be for the Federal government to enact some sort of match for states with high unemployment rates whose spending levels for TANF substantially exceed their block grant funds. This match could be temporary and targeted to those areas most affected by any economic downturn.

The costs of the Medicaid program are also likely to rise substantially if the number of low-income families increases, and these costs also have a large impact on state budgets. Again, some increase in the Federal share of payments could be appropriate for those states with large increases in unemployment or poverty.

Finally, The Special Nutrition Program for Women, Infants and Children – or WIC – will also likely see an increased caseload. Funding for this program comes from an annual appropriation based on an estimated number of participants. The FY '02 request was identical to that of the previous year, and was based on the assumption that unemployment would remain very low. Additional funds would allow states to serve more eligible women and children in the coming year.

*Question: What else can the government do to support working families who lose their jobs or get laid off as a result of these events?*

Answer: As unemployment increases, many Americans will be at increased risk of losing their health insurance coverage. COBRA gives employees and their families the option of continuing their group health insurance coverage in case of certain events; termination of employment, reduction in hours, death of the employee, and divorce or separation. If an employee is terminated or their hours are reduced, they can continue coverage for 18 months. In all other events, they can continue it for 36 months.

Unfortunately, however, many unemployed people cannot afford to continue to pay their health insurance premiums while they are unemployed. Premiums for those who are unemployed are typically higher than for workers, because those who are no longer employed are not receiving employer subsidies. Further, low-income workers frequently lack health insurance even when they are employed, and such workers will not be eligible for health insurance coverage under COBRA.

Subsidized COBRA coverage for unemployed workers and their families is a measure under consideration. If the federal government picked up 50 percent of the cost of health insurance premiums for unemployed workers who chose to extend their health insurance coverage under COBRA, for example, the costs would be roughly \$3 billion in FY 2002, depending on the extent to which unemployed workers elected to take up such coverage.

Costs would be lower if expanded medicaid coverage for unemployed workers was also offered (see proposal below), because fewer unemployed could be expected continue COBRA coverage if some other form of health insurance were available.

Another option is to extend Medicaid coverage for low-income unemployed workers and their families. The costs of this proposal would depend on exactly how it was implemented, and on whether the federal government paid the full costs of the expansion or simply agreed to match spending by states which granted Medicaid coverage under the proposal.

If benefits were extended to all families with a member losing a job in FY 2002 and with incomes below 200 percent of the poverty level, for example, and if the federal government picked up the full costs of such benefits during the period of unemployment, total costs in FY 2002 would be (very) roughly \$3 billion (again depending on the level and duration of unemployment).