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RSC Policy Brief:
The Economic Consequences of "Stimulus" Spending

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In light of Congressional consideration of economic stimulus legislation, the RSC has prepared the following policy brief analyzing the efficacy of deficit-financed spending as a response to the current crisis.

Executive Summary:

- **History:** Many economists point out that there has never been an example of deficit-financed spending leading an economy out of a deep recession and to a prolonged recovery. For example, Japan failed to come out of a severe economic downturn during the 1990s, despite ten stimulus packages in eight years. And for various reasons, including the extremely high unemployment rates throughout the New Deal period, the U.S. during the 1930s does not provide a useful example for today's economy of "stimulus" spending leading to economic recovery.

- **Borrowing Capacity:** The U.S. national debt has increased by more than $2 trillion over the previous two years, and may grow by another $2 trillion just in 2009. There is no precedent for the U.S. borrowing this much money so quickly. This added debt burden will not only decrease economic growth over the long-term, but it may also make any "stimulus" counter-productive, even in the short-term.

- **Complexity of the U.S. Economy:** The U.S. workforce has become more educated and specialized. One of the consequences of this trend is that it may be difficult to alleviate unemployment through government-driven approaches. For example, according to Alan Reynolds, the "stimulus" bill targets almost 40% of the total money to health care, education, and state and local governments. These three sectors of the economy are either at or near full employment. Market solutions may do a better job alleviating unemployment than government-driven solutions, which are heavily influenced by political considerations during the legislative process.

- **Timing and "Stimulus" Spending:** Many economists are skeptical that "stimulus" packages can work in practice because it is hard to time the economy. For example, much of the spending in the House-passed version of the "stimulus" occurs in FY 2011 or later. By that point, what the economy may require is deficit reduction. The risk is that the legislation does too little to immediately impact the economy, while doing too much to worsen the long-term budget outlook.

- **Long-Term Effect:** CBO notes that the Senate-passed stimulus will, because of borrowing costs, decrease GDP by 0.1% to 0.3% within a decade. A "stimulus" bill might also lead the federal government to permanently absorb a higher percentage of the economy, which many conservative economists argue would also reduce the living standards of future generations.

- **A Growth-Based Solution:** Doing nothing on the one hand, or passing a massive "stimulus" spending bill on the other hand, are not the only two options. RSC Members have proposed the Economic Recovery and Middle-Class Tax Relief Act (H.R. 470), a bill aimed *not* at temporarily increasing consumption, but instead at making the U.S. economy more productive over the long haul. House conservatives also believe in taking action now to make our long-term budget outlook sustainable, which will increase future living standards, and reassure markets during the current crisis.

Background: According to the National Bureau of Economic Research, the U.S. has been in recession since December 2007. Mark Jickling of CRS has produced a chart which examines 26 potential causes of the financial crisis: Causes of the Financial Crisis. But certainly one leading factor is the housing bubble, which the federal government helped create through the lending practices of Fannie Mae and Freddie Mac, the Community Reinvestment Act, the various provisions in the tax code, and government subsidies designed to incentivize home ownership. See here for the RSC Policy Brief Understanding the Current Housing Market, which analyzes the housing bubble and its financial ripples throughout the economy.

The U.S. Congress is currently considering a $1.1 trillion (including interest) "stimulus" bill. Proponents of this legislation argue that it will make up for a portion of the U.S. economy's expected output gap and increase employment (compared to a baseline that assumes the legislation is not enacted). On the other hand, skeptics of the legislation argue that, in the long-term, the legislation will function mostly as a transfer of resources from the more productive private-sector to the less-productive public-sector, while burdening future generations with an unmanageable debt burden. And, in the short term, skeptics of the legislation argue that the threat to the nation's credit rating outweigh the benefits of a temporary increase in consumption.

A History of "Stimulus" Packages: Many economists argue that there is no example of deficit-financed stimulus spending resulting in an economic recovery. According to the Heritage Foundation, during the 1990s, Japan passed 10 "stimulus" bills in eight years, and along the way built the largest debt (180 percent of GDP) of the world's advanced economies.[1] But even so, Japan failed to come out of its downturn.

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[1] Heritage Foundation, "Learning from Japan's Big Debt Spending Failure." Available online at The Foundry (accessed February 10, 2009).

Many supporters of “stimulus” legislation will instead cite the Great Depression in the U.S. as the model for “stimulus” spending leading to economic recovery. But this analogy does not work for several reasons:

- The largest federal deficit during the Great Depression was 5.9% of GDP, and in many years it was much lower (in 1937 it was just 0.5% of GDP). Not counting spending from this stimulus package, the FY 2009 deficit is already projected to be 8.3% of GDP.
- Leading up to the Great Depression, private savings was high. Leading up to the most recent crisis, private savings is low.
- Leading up to the Great Depression, the federal government ran a surplus for eleven straight years (every year from 1920 to 1930). Leading up to this most recent economic crisis, the federal government has run a deficit in 43 out of the last 48 years.
- During the Great Depression, infrastructure projects didn’t face the review process that exists today. Consequently, it is simply not possible (absent dramatic changes to, among other things, environmental regulations) for infrastructure spending to work as it did in the 1930s. That is why actual infrastructure spending is such a small percentage of the “stimulus” spending.

But there are two other problems with citing the Great Depression as a model of “stimulus” spending leading to recovery. First, the Great Depression began in 1929 and did not end until 1940. And the stock market did not return to the level of September 3, 1929 until 1954. If today’s economy were to go through a similar “recovery,” we would not fully escape the current recession until 2018, and the Dow would not reach its high of 2007 until sometime in 2032. Economists have differing opinions on the effectiveness of many of the government actions undertaken during the New Deal, but Megan McArdle notes:

> “Government spending went up, which naturally pushed the measurement up [GDP]. But that didn't mean the economy was healthy, and no reputable economist, left or right, claims that the Great Depression ended before 1940.”

Second, many economists note that during the Great Depression the U.S. did not actually have much of an expansionary fiscal policy. To be sure, federal spending did increase, but so did federal taxes. As Tyler Cowen puts it:

> “The New Deal’s legacy of public works programs has given many people the impression that it was a time of expansionary fiscal policy, but that isn’t quite right. Government spending went up considerably, but taxes rose, too. Under President Herbert Hoover and continuing with Roosevelt, the federal government increased income taxes, excise taxes, inheritance taxes, corporate income taxes, holding company taxes and “excess profits” taxes. When all of these tax increases are taken into account, New Deal fiscal policy didn’t do much to promote recovery.”

And here is what Christina Romer—President Obama’s Chair of the Council of Economic Advisers—said in a 1992 paper *What Ended the Great Depression?*:

> "This paper examines the role of aggregate demand stimulus in ending the Great Depression. ***A simple calculation indicates that nearly all of the observed recovery of the U.S. economy prior to 1942 was due to monetary expansion.*** Huge gold inflows in the mid- and late-1930s swelled the U.S. money stock and appear to have stimulated the economy by lowering real interest rates and encouraging investment spending and purchases of durable goods. The finding that monetary developments were crucial to the recovery implies that self-correction played little role in the growth of real output between 1933 and 1942."

Borrowing and the U.S. Economy: Even without enactment of any stimulus bill, the FY 2009 deficit is projected to be $1.186 trillion or 8.3% of GDP. This would be the largest nominal deficit in U.S. history, as well as the largest deficit as a percentage of GDP in U.S. history outside of World War II.

Since January 2007, the national debt has increased from $8.67 trillion to $10.73 trillion, an increase of $2.06 trillion or 23.8% in just two years. To put this in perspective, the increase to the national debt over just the past two years is larger than the total amount of debt accumulated by the federal government from 1789 to 1985.

The national debt may increase by another $2 trillion this year. According to the Financial Times, in February the U.S. will put forward a record debt sale. The U.S. has never borrowed so much money (in nominal terms) so quickly. The only precedent for borrowing of this magnitude in U.S. history was World War II, when the Treasury Department had the advantage of being able to rely on a very high private savings rate to finance its debt obligations.

A higher debt burden lowers future living standards (compared to what they would otherwise be). But there is also the possibility that trying to increase the debt burden too rapidly can also be harmful in the short-term if it harms consumer and business confidence. According to Jeffrey Sachs:

> "Without a sound medium-term fiscal framework, the stimulus package can easily do more harm than good, since the prospect of trillion-dollar-plus deficits as far as the eye can see will weigh heavily on the confidence of consumers and businesses, and thereby undermine even the short-term benefits of the stimulus package."

According to a recent survey, 40% of Japanese investors worry about the potential of the U.S. defaulting on its debt burden. Japan is the second biggest holder of U.S. debt. Arnold Kling argues that if such a view were to become more prevalent, that would be devastating to the U.S. economy:

> "If investors suddenly panic about our ability to repay our debt, that would truly be Armageddon. I don't think we should be tiptoeing close to that line. I'd much rather risk a deeper recession than head down the banana republic route."

Complexity of U.S. Economy and Government-Directed Stimulus: Since World War II, knowledge workers have become a larger percentage of the U.S. workforce. In 1950, 58.6 percent of the population consisted of high school dropouts. Fifty years later, in 2000, this group represented just 8.7% of the population. As the U.S. workforce has become more educated, it has become more specialized. As Arnold Kling puts it: "We have a heterogenous labor force, and that will require Hayekian market adjustment, not central planning."[2]

Another danger with a centrally-planned approach to alleviating unemployment is that political priorities may not line up well with helping workers in those sectors of the economy that are suffering the most. For example, Alan Reynolds points out that the House stimulus bill is heavily targeted to sectors of the economy that are already at or near "full employment":

> "The December unemployment rate was only 2.3% for government workers and 3.8% in education and health. Unemployment rates in manufacturing and construction, by contrast, were 8.3% and 15.2% respectively. Yet 39% of the $550 billion in the bill would go to state and local governments. Another 17.3% would go to health and education -- sectors where relatively secure government jobs are also prevalent."

Timing of "Stimulus" Spending: One additional reason some economists are skeptical that an expansionary fiscal policy can lead an economy out of a downturn is that it is very difficult for policymakers to get the timing right. The House-passed version of the "stimulus" may end up being a textbook example of this—it has a very slow spend-out rate. According to CBO, only 8% of the discretionary spending in the bill ($29 billion out of $358 billion) will be spent during the current fiscal year, and 60% of the discretionary spending actually occurs in FY 2011 or later. More than one-third of the *total* budgetary impact of the legislation occurs beginning in 2011 or later. At that point, the recession will either be over or be entering its third year (which would make it by far the longest recession since World War II).

Many economists argue that this spend-out rate is far too slow for a "stimulus" bill. The risk is that the legislation does too little to immediately impact the economy, while doing too much to worsen the long-term budget outlook. By 2011, what the economy may require is deficit reduction, not deficit-financed "stimulus."

Long-Term Effect of Deficit Spending: CBO predicts the "stimulus" bill will lower economic growth by between 0.1% and 0.3% within a decade. In a letter sent to Senators Grassley and Gregg, the CBO Director states:

> "The negative effect of crowding out could be offset somewhat by a positive long-term effect on the economy of some provisions—such as funding for infrastructure spending, education programs, and investment incentives, which might increase economic output in the long run. CBO estimated that such provisions account for roughly one-quarter of the legislation's budgetary cost. Including the effects of both crowding out of private investment (which would reduce output in the long run) and possibly productive government investment (which could increase output), CBO estimates that by 2019 the Senate legislation would reduce GDP by 0.1 percent to 0.3 percent on net."

There are other reasons to believe that the "stimulus" package may hurt the economy even more in the long-run. First, it is very possible that CBO overstates the extent to

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[2] EconLog, "From Dark Age to Renaissance," Arnold Kling. Available online at http://econlog.econlib.org/archives/2009/01/from_dark_age_t.html (accessed February 10, 2009).

which spending in the bill will be for "productive government investments." It is hard for the government to spend money both fast and well. The "stimulus" may make the U.S. economy poorer by with "investments," via public spending, that show a negative return.

Second, CBO may be understating the deficit spending that will result from passage of a "stimulus" bill. This is because this bill is only one of many other proposals that Democrats in Congress will try to enact this year that will lead to massive deficit spending. The others include a $410 billion omnibus, an expected supplemental for war funding (with other miscellaneous items likely), and more money to bailout the financial industry ("TARP II").

Third, a "stimulus" may involve a permanent transfer of resources from the productive private-sector to the less productive public-sector. Federal spending will reach the highest level in U.S. history this year, and in the process, create a new, far higher, baseline for expected future federal spending. The "temporary" programs created by the legislation may become permanent. If a stimulus bill causes a permanent increase to share of the economy absorbed by the public-sector, many economists would argue that this will reduce living standards of future generations.

A Growth-Based Solution to the Crisis: The choice is not between a deficit-financed "stimulus" package that involves a massive transfer of resources from the private-sector to the public-sector, on the one hand, or doing nothing at all on the other hand. RSC Members have proposals to address both aspects of the crisis: the deep economic downturn *and* the growing debt burden.

The Economic Recovery and Middle-Class Tax Relief Act of 2009: RSC Members have introduced a pro-growth alternative that unleashes the potential of American businesses, investors, and entrepreneurs. The RSC plan provides incentive-based relief to individuals and job creators in order to reduce the burden that the government places on both employers and employees.

The Economic Recovery and Middle-Class Tax Relief Act (H.R. 470) would, among other things, reduce income tax rates by five percent across the board, lower the corporate income tax rate from 35% to 25%, repeal the AMT, make the lower 15% rate on capital gains and dividends permanent, and increase the child tax credit from $1,000 to $5,000. For a detailed summary of the legislation see here. The legislation currently has 80 cosponsors.

H.R. 470 does not propose to try to increase growth and employment via central-planning in Washington. Instead, the legislation relies on the far greater wisdom of individuals, families, and businesses. And the bill is not intended to spur consumption—H.R. 470 will increase production.

Putting the Federal Government's Fiscal House in Order: The federal government's growing debt burden will lower the living standards of future generations. There is also the risk that the growing debt burden will do economic damage in the short term if our credit rating is affected. One way to reassure markets is to do something about the nation's long-term obligations.

Last year, the Republican budget substitute proposed substantial deficit reduction, with $412 billion worth of entitlement savings over five years. Representative Paul Ryan has legislation, the Roadmap for America's Future (H.R. 6110 from the 110th Congress), that would make Social Security and Medicare permanently solvent, thus eliminating the bulk of the federal government's $56 trillion in unfunded obligations.

Conclusion: Economists will disagree about the relative importance of the factors that contributed to the current crisis long after it has ceased (economists and historians still disagree on some questions surrounding the Great Depression). Congress is considering one proposal meant to address the crisis, a $1.1 trillion "stimulus" spending bill. History provides little evidence that deficit-financed "stimulus" spending leads to economic recovery. Many conservatives would offer alternative solutions: tax relief to incentivize economic growth and job creation, and budget and spending reforms that remove the nation's long-term unfunded liabilities.

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