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A $300-BILLION 'STIMULUS' BILL, WITH QUESTIONABLE ECONOMIC BENEFIT

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There should be no illusion about the $300-billion "stimulus" plan now being promoted by the Democratic Majority. It will not address the *core* problems of the current financial crisis and economic weakness. It may even worsen them by adding hundreds of billions of dollars to Federal deficits and debt, which are already reaching historic highs.

The Democratic proposal has several fundamental problems:

- It adds $300 billion to the deficit and the debt, taking both to record levels.
- It does little, if anything, to benefit the economy.
- It adds to U.S. borrowing costs, and weakens the dollar.
- It is a costly and ineffective means of addressing a financial crisis in the economy, as demonstrated by past experience, particularly that of Japan.
- Its spending and deficit increases are *already* being used to justify job-killing higher taxes.

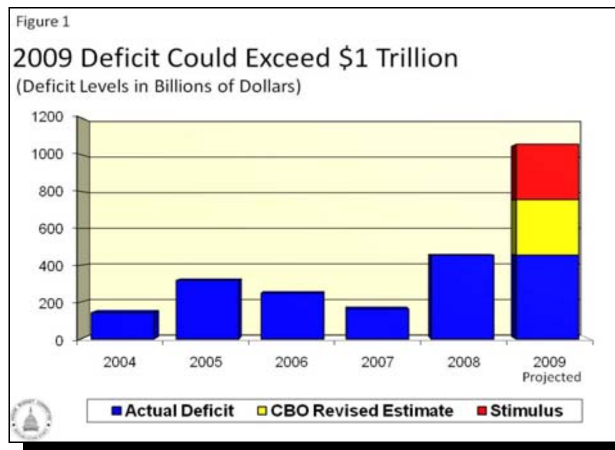
This paper summarizes the principal flaws in the "stimulus" concept, and the significant hazards of enacting another huge round of government spending in the current economic climate.

INCREASING THE DEFICIT

In the report accompanying the House budget resolution for fiscal year 2009 (H.Con.Res. 312), the Budget Committee Majority wrote: "The economy is dragging anchor, impeded by record deficits and mountainous debt." Yet today the Democrats are encouraging a spending plan that would drive the deficit as high as $1 *trillion* in the current fiscal year. This casual new attitude about deficits was expressed by Representative Barney Frank, Chairman of the Committee on Financial Services, who said: "I think at this point there needs to be a focus on an immediate increase in spending; and I think this is a time when deficit fear has to take a second seat. I do think this is a time for a very important kind of dose of Keynesianism."[1]

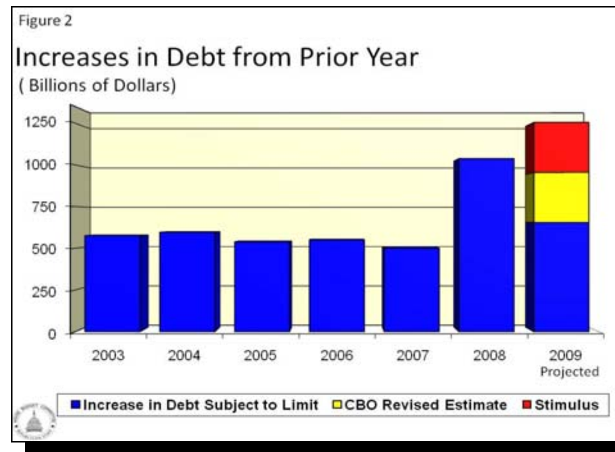
[1] On CNBC's *Closing Bell*, 20 October 2008.

After 3 years of declines, the deficit for fiscal year 2008, which ended on 30 September, totaled $455 billion, more than twice the gap at the end of fiscal year 2007. This reversed several years of progress against deficits, which had receded from $413 billion in 2004 to $162 billion in 2007.



This deficit increase does not include the costs of the Fannie Mae and Freddie Mac bailout, the Economic Stabilization Act, or the effects of recent weakening in financial markets and the economy. The Congressional Budget Office [CBO] has estimated that, taking these additional factors into account, the deficit for fiscal year 2009 could reach $750 billion.

Yet the Majority's recommended stimulus plan would add up to $300 billion to that deficit, widening the budget gap to more than $1 trillion (see Figure 1). At that magnitude – about 7 percent of gross domestic product [GDP] – it would be the largest deficit, as a share of the economy, since World War II. It would require substantially more government borrowing, or taxes, or both; and it would swell the government's already growing debt.



Higher deficits also will raise borrowing costs and weaken the dollar in global markets.

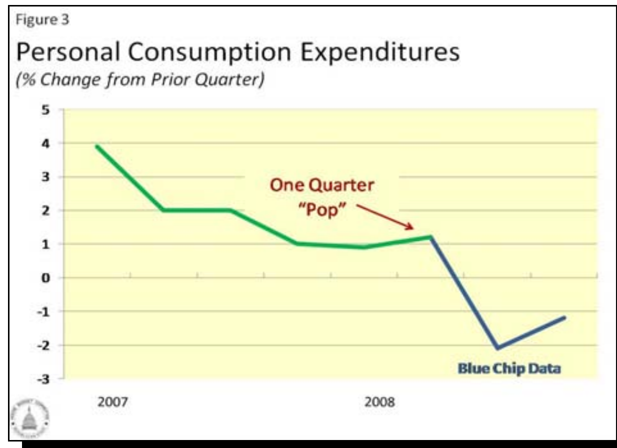
DOES 'STIMULUS' REALLY WORK?

Central to the entire stimulus debate is the question of whether such manipulations of fiscal policy actually work. Although the theory seems plausible, in practice stimulus measures typically provide only a short-term "pop" in consumer spending, and do nothing to promote long-term economic growth.

For instance, the stimulus-oriented tax rebates enacted in February this year, widely expected to avert an economic slowdown, have been judged a failure. As shown in Figure 3 on the next page, the rebates were followed by only a modest and short-lived boost in consumer spending. Meanwhile, payroll employment continued declining, along with consumer confidence, housing starts, and other key economic indicators. In August, Harvard economist Martin S. Feldstein, who had supported the tax rebate package, admitted it was "a flop." As he summarized: "The rebates added nearly $80 billion to the permanent national debt, but less than $20 billion to consumer spending." Dr. Feldstein also implied this failure would result from *any* temporary stimulus measures aimed at increasing consumer spending. "Although someone who receives a permanent annual salary increase of $1,000 typically would increase his annual spending by an almost

equally large amount, a $1,000 rise in wealth caused by a share price increase or a tax rebate would raise spending only gradually over a number of years."[2]

Some economists have questioned even the widely accepted Keynesian foundations of fiscal "stimulus." "History has shown that expanded government reduces productivity and economic growth," says a September study published by economists from The Heritage Foundation. The explanation for the failure of fiscal stimulus is obvious: government depends on the economy for its resources – not the other way around. "In reality, every dollar that government 'injects' into the economy must first be taxed or borrowed from the economy," the Heritage economists write. "No new spending power is created. It is merely redistributed from one group of people to another."[3]



In addition, the very concept of stimulus is contrary to the principles that underlie long-term economic growth. "Because short-term stimulus is focused on demand, its efficacy depends on a different set of principles than those underlying long-term supply-based policies, and it is often in tension with those principles," says CBO.[4] This helps explain why the stimulus bill enacted earlier this year produced only a short-term economic boost.

But even assuming "stimulus" spending can work, one of the most popular elements of most such proposals, infrastructure spending (which is included in the measure Democrats are now discussing), fails to meet the criterion of quickly injecting cash into the economy. Says CBO: "[B]ecause many infrastructure projects may take years to complete, spending on those projects cannot easily be timed to provide stimulus during recessions, which are typically relatively short lived."[5] (CBO, *Options for Responding to Short-Term Economic Weakness*, 22 January 2008)

A good example was the second "stimulus" bill passed by the House this year. Title I of that measure (H.R. 7110), appropriated $36.9 billion for infrastructure spending. Of that amount, CBO projected just 27 percent would be spent in 2009, 33 percent in 2010, and the remaining 40 percent in 2011 and beyond. In general, infrastructure projects require 7 years to spend out.

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[2] Feldstein, "The Tax Rebate Was a Flop. Obama's Stimulus Plan Won't Work Either," *The Wall Street Journal*, 6 August 2008.

[3] Hederman, Keen, and Riedl, "A Second Stimulus Bill Will Fail – Just Like the First," *Backgrounder* #2186, The Heritage Foundation, 18 September 2008.

[4] CBO, *Options for Responding to Short-Term Economic Weakness*, 22 January 2008.

[5] CBO, *Options for Responding to Short-Term Economic Weakness*, 22 January 2008.

THE PROBLEM IN THE U.S. ECONOMY

Another argument against the Democratic “stimulus” plan is that it will do nothing to address the *core* problems driving the financial crisis in the U.S. economy. These problems have occurred in banking and credit markets – the vital, though largely invisible, financial infrastructure of the U.S. market economy; and more fiscal stimulus will do nothing to cure their current troubles.

Financial institutions have felt the secondary effects of the bursting of the housing bubble through their exposure to mortgage-related securities and their derivatives. These institutions have faced mounting losses on these mortgage assets, some of which have become virtually impossible to value, and therefore sell. As banks have become focused on conserving capital to weather the crisis, they have been unwilling to extend credit to businesses and consumers and even other banks. Investors, meanwhile, have been shunning most financial securities except those with little or no risk. The vital flow of funding from suppliers of credit (banks and investors) to users of credit (businesses and families) has virtually broken down.

The extraordinary and, at times, unprecedented policy reactions by the Federal Government have rightfully focused on jump-starting credit markets and preserving the integrity and the smooth functioning of the financial system. The Federal Reserve has lowered its short-term interest rate target by nearly 300 basis points over the past year to reduce the aggregate cost of credit throughout the economy. More important, the Fed has devised a host of new credit facilities to inject targeted liquidity into significant pockets of the credit markets that had become frozen, nearly doubling the size of its balance sheet in the process.

In addition, Congress has passed financial rescue legislation that gives the Treasury authority to address the problems in the financial system in a more comprehensive and systematic way. The Federal Deposit Insurance Corporation has also lifted its insurance limit on transaction accounts at depository institutions, and has launched a program to temporarily guarantee bank debt.

These actions, as well as others, are aimed at attacking the roots of the financial crisis: they are attempts to re-instill trust and confidence in the financial system and unlock investors’ tolerance for risk so the economy can function normally once again.

Unlike the measures described above, the Democratic “stimulus” plan now being considered is not targeted to the fundamental problems in the U.S. economy.

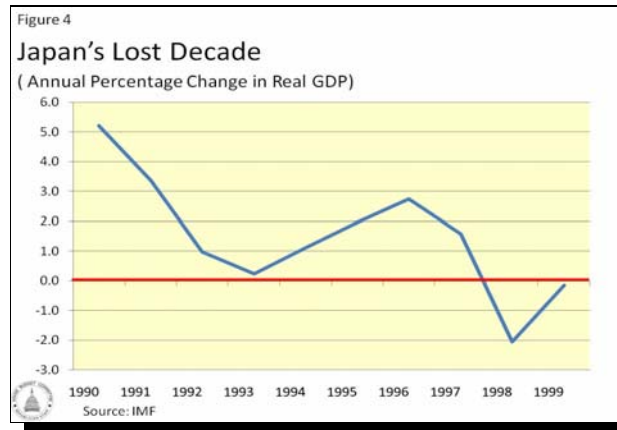
THE EXPERIENCE OF THE JAPANESE

Japan’s policy responses during its so-called “lost decade” of the 1990s can provide important lessons for the U.S., especially as Congress continues to ponder various remedies to the current financial crisis and economic weakness. In the early 1990s, Japan experienced a sharp economic slowdown resulting from the bursting of a real estate and stock market bubble. Japan’s policy mistakes throughout the decade would eventually lead to a protracted period of stagnation in which GDP grew by less than 1 percent, on average.

Early that decade, the Bank of Japan instituted an overly tight monetary policy, which eventually led to a serious deflationary crisis. But the country’s fiscal policy errors were equally as important in triggering the decade of stagnation. For instance, Japan began to pursue an aggressive array of fiscal stimulus packages after 1993. The spending, which was mostly concentrated on public

works, eventually pushed Japan's budget deficit to nearly 10 percent of GDP by 1999, while total government debt increased to 130 percent of GDP. Looking back on that decade, *The Economist* magazine concluded: "Japan's policymakers, unlike America's in the 1930s, appear to have followed the Keynesian textbook . . . yet, the economy is still flat on its back."[6]

John H. Makin, a scholar at the American Enterprise Institute, notes that Japan's fiscal stimulus essentially led to an over-investment in the public sector during the 1990s. Dr. Makin notes that these projects, such as a tunnel under Tokyo Bay and railroad lines to rural parts of the country, made little economic sense and therefore would not have been undertaken by the private sector. But the government continued to throw money at these wasteful projects. In a study of Japan's lost decade, economists at the Federal Reserve Bank of Minneapolis estimate that the government's share of the nation's total output rose to 15.2 percent in the latter part of the 1990s, from 13.7 percent in the latter half of the 1980s. This led to a crowding out of more productive investment in the private sector. Indeed, private investment in Japan over that period dipped from 27.6 percent to 24.3 percent, setting the country up for a sluggish trend in overall economic output.



But Japan's biggest policy mistake came in 1997, when the government raised its consumption tax rate from 3 percent to 5 percent. Lawmakers wanted to compensate for the large build-up in Japanese debt that resulted from the series of unproductive and wasteful stimulus packages. The combination of higher taxes, a continued fall in land prices, and periodic bouts of monetary deflation resulted in a virtual collapse of the Japanese economy.

Dr. Makin's takeaway from the Japan experience is the following: "The most basic lesson about fiscal stimulus to be learned from the Japanese experience is to avoid wasteful government spending. Rather, it is better to reduce tax rates in order to encourage private demand as well as private work effort and investment. Japan's wasteful demand stimulus created nothing but temporary relief from a chronically depressed economy . . ."[7]

It is important to note that Japan's fiscal stimulus did nothing to address the significant *structural* problems in that country's banking sector, which was one of the key factors behind its sustained malaise. Japanese banks were able to hide their bad real estate loans for an extended period of time due to an overly cosy and non-transparent regulatory structure in that country. As the banking problems were allowed to linger, fewer loans were doled out to profitable businesses, and the constriction of credit hampered growth for an extended period of time.

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[6] *The Economist*, 28 September 2002.

[7] Makin, "Japan's Lost Decade: Lessons for the United States in 2008," the American Enterprise Institute, March 2008.

The more stimulative economic prescription for Japan in the 1990s would have been for the banks to disclose their bad loans, write off losses, and raise new capital. That dynamic, done mostly by the private sector, would have helped set the stage for an economic recovery.

TAX HIKES ON THE HORIZON

But whatever failures may result from the Democrats' proposed second stimulus, it will almost surely succeed in another respect: it will renew and expand their call for raising taxes on the American people. By pushing the deficit to the $1-trillion mark with their higher spending, Democrats will surely argue this widening gap demands tax increases. They already are doing so: in his appearance on CNBC's *Closing Bell* program, when asked about how to finance the proposed stimulus plan, Chairman Frank candidly said: "I believe later on there should be tax increases."[8]

The Majority's demand for higher taxes has been well demonstrated. Their budget for fiscal year 2009 calls for $683 billion in tax hikes over the next 5 years, by assuming the expiration of tax relief provisions enacted in 2001 and 2003. The Majority's budget would increase marginal tax rates, eliminate the 10-percent bracket for lower-income taxpayers, raise taxes on marriage, children, small businesses, and estates, and raise tax rates on investment, an essential component of economic growth. This tax increase would eclipse even that of President Clinton, who in 1993 used the deficit as an excuse to abandon the "middle-class tax cuts" he promised during the presidential campaign, and replace them with what was then the largest tax increase in history.

These tax increases – which will occur by the end of the next Congress unless lawmakers act to prevent them – will be widespread, including provisions shown in Table 1.

Table 1: Comparison of Current Tax Law vs. Democrats' Assumed Tax Increases
(selected provisions)

Provision	Current Law	Tax Increases in 2011
Marginal Tax Rates	35.0% 33.0% 28.0% 25.0%	39.6% 36.0% 31.0% 28.0%
Lower-Income Tax Rate	10% on first $7,825 of individuals' taxable income, $15,650 for couples; both indexed for inflation	15.0%
Marriage Penalty	$0	Average of $1,400
Child Credit	$1,000 per child	$500 per child
IRA Limit	$5,000	$2,000
Estate Tax		
Top Rate	45% – repeal in 2010	55%
Exemption	$3.5 million – repeal in 2010	$1 million
Investments		
Capital Gains Tax Rate	15%/0 (no tax for those in 10% and 15% brackets	20%/10%
Dividend Tax Rate	15%/0 (no tax for those in 10% and 15% brackets	Taxpayer's marginal rate

[8] On CNBC's *Closing Bell*, 20 October 2008.

If these Democratic tax increases occur, they will affect workers, families, small businesses, and others in a variety of ways, including the following:

- Roughly 116 million taxpayers will see their taxes increase, on average, by $1,833.
- Approximately 48 million married couples will face a total average tax increase of $3,000 per year.
- An average elderly couple with $40,000 in income will see their tax bill rise by 156 percent – from $583 to $1,489.
- A family of four earning $60,000 will face a 70-percent tax hike, with their income tax bill rising from $2,733 to $4,634.
- Tax bills for 27 million small-business owners will rise, on average, by more than $4,000.
- More than 6 million taxpayers who currently owe no taxes will become subject to individual income taxes.

Another excuse for the Democrats to raise taxes is the Alternative Minimum Tax [AMT]. Their budget includes a $62-billion tax increase to "pay for" merely *preventing the scheduled expansion* of the AMT – which was never intended to occur. This sort of AMT "offset" also was included in the so-called "Mother of All Tax Increases" proposed last year by the Democratic Chairman of the Committee on Ways and Means. The Chairman's measure also would have raised the top marginal tax rate to 45 percent.

Clearly, tax increases imposed at a time of economic weakness would be disastrous. Even worse, the Democrats' constant threat of tax hikes, now or in the future, creates a significant uncertainty about the direction of tax policy that is already stifling potential economic growth.

CONCLUSION

As noted at the outset, the Majority's proposed "stimulus" plan will do nothing to address the fundamental problems in the U.S. economy. It will, however, increase the deficit and the debt by up to $300 billion; it will increase borrowing costs and weaken the dollar; and it will lead to further calls from Democrats to raise taxes – on families, small businesses, and investors.

Thus, as usual, it is taxpayers who will foot the bill for a Democratic spending proposal that will only serve to stifle the economy, not stimulate it.