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A Second Economic Stimulus Bill Will Fail—Just Like the First

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The struggles of the U.S. economy have been foremost on the minds of voters and politicians. The housing industry has been in a downturn for more than two years, and the financial industry is in major upheaval, all of this despite a major economic stimulus package becoming law earlier this year. Indeed, six months after Congress passed the first economic stimulus bill, the U.S. economy teeters more on the brink of serious recession than before. On almost every economic measure one could choose, economic activity is slower now than at the beginning of the year, and this record indicts, as does nothing else, the ineffectiveness of Congress's first stimulus legislation.

Undeterred by this dismal record, lawmakers are once again planning major economic stimulus legislation. Democratic majority leaders have discussed passing a second stimulus bill, this time for $50 billion, by the end of September 2008.[1] A second stimulus bill should not attempt to repeat those elements of the first stimulus bill that consisted primarily of merely handing out money from the government.

Congress should:

- Not enact another stimulus bill that will increase the deficit while doing little to help the economy;
- Not repeat the failed policies of the first stimulus bill; and
- Remember that more government spending is not a solution to a slower economy.

Talking Points

- The new economic stimulus proposals rely on increased government spending, which is a proven failure. The provisions of the proposals will merely redistribute money from one group of people to another.
- Highway and infrastructure projects take too long and do not create new jobs; they transfer jobs from one sector of the economy to another.
- More government spending does not stimulate the economy.
- Congress should learn from its previous mistakes and should not enact a stimulus bill that increases the deficit and will not boost the economy.

This paper, in its entirety, can be found at: *www.heritage.org/Research/Budget/bg2186.cfm*

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The First Stimulus Bill

The size of the first stimulus bill of 2008 was $150 billion, with more than $100 billion in tax rebates mailed to American individuals and households. This rebate was based on the assumption that people would immediately spend this rebate and thereby boost the economy.

The bill was a failure because it merely shifted income from one sector of the economy to another. The government cannot create new purchasing power or dollars; it can only change the allocation of dollars. To create the rebates, then, government had to take money away from another part of the economy. While the tax rebate may have boosted some consumption in the second quarter of fiscal year (FY) 2008, only a small part of the rebate checks were spent.[2] As mainstream economic theory would predict, large portions of the rebates were likely saved or used to pay down debt.

As housing prices continue to fall, unemployment continues to rise, and financial markets continue to shed valueless assets, the failure of the first stimulus bill becomes more and more apparent. Rebates failed in the 1970s, 2001, and again in 2008. Unfortunately, Congress is attempting to repeat this same failed experiment of income shifts and temporary spending increases.[3]

New Stimulus Proposals in Congress

Over the summer, congressional leaders called for a second stimulus package to strengthen the economy. The Chairman of the Senate Appropriations Committee, Senator Robert Byrd (D–WV), released details of a Senate version likely to be debated this month.[4] This bill focuses largely on infrastructure and disaster recovery projects, but will do little to stimulate the economy in the near future.

The initial Byrd proposal was $25 billion, but already there are calls to double or triple that amount. Senator Byrd's initial proposal contained $10 billion for infrastructure, energy, and economic recovery, the bulk of which would be spent on additional highway funding; $10.1 billion for additional natural disaster relief, much of which is allocated for victims of Hurricane Katrina, which occurred over three years ago; and $4.04 billion is spread across a wide range of programs, including money for NASA and other programs that are usually part of the annual appropriations process instead of an economic recovery bill.

Expanding Washington Is Not Stimulative

The problem with Byrd's stimulus proposal is that it is a return to failed policies. History has shown that expanded government reduces productivity and economic growth. Massive Keynesian spending hikes in the 1930s, 1960s, and 1970s all failed to increase economic growth rates. Yet in the 1980s and 1990s—when the federal government shrank by nearly 20 percent of gross domestic product (GDP)—the U.S. economy enjoyed its greatest expansion ever.

Spending-stimulus advocates claim that government can "inject" new money into the economy, increasing demand and therefore production. But that assumes Congress has a vault of money sitting there waiting to be distributed. In reality, every dollar that government "injects" into the economy must first be taxed or borrowed from the economy. No new spending power is created. It is merely redistributed from one group of people to another.

Spending-stimulus advocates typically respond that redistributing money from "savers" to "spend-

1. Bureau of National Affairs, "Democrats Seize on Wall Street Woes to Push Second Stimulus Package, September," September 16, 2008.
2. Martin Feldstein, "The Tax Rebate Was a Flop: Obama's Stimulus Plan Won't Work Either," *The Wall Street Journal*, August 6, 2008, at *http://online.wsj.com/article/SB121798022246515105.html?mod=opinion_main_commentaries* (September 18, 2008).
3. Rea S. Hederman, Jr., "The House Stimulus Package: The Good and the Bad," Heritage Foundation *WebMemo* No. 1778, January 24, 2008, at *http://www.heritage.org/Research/Economy/wm1778.cfm*.
4. Press release, "Byrd Comments on Second Stimulus Supplemental Appropriations Bill, Releases Details of Chairman's Mark," Committee on Appropriations, U.S. Senate, July 30, 2008, at *http://appropriations.senate.gov/News/2008_07_31_Byrd_Comments_on_Second_Stimulus_Supplemental,_Releases_Details_of_Legislation.pdf?CFID=56280987&CFTOKEN=86348298* (September 18, 2008).

ers" will lead to additional spending. That assumes that savers store their savings in their mattresses, thereby removing it from the economy. In reality, nearly all Americans either invest their savings (which finances business investment) or deposit it in banks (which quickly lend it to other customers to spend). Therefore, the money is spent regardless of whether it is initially consumed or saved.

This does not mean that government spending has no economic impact at all. Economic growth requires productivity growth, and policies that alter productivity rates will accordingly alter the amount of economic output. In other words, government spending cannot significantly affect demand since it merely redistributes existing purchasing power, but it can alter supply by altering the productivity rates of people and businesses.

And that effect is mostly negative. History has shown that most government spending *reduces* productivity and economic growth. Most government spending reduces economic growth due to: [5]

1. **Taxes.** Government spending is financed by taxes, and high tax rates reduce incentives to work, save, and invest;
2. **Reduced incentives.** Social spending often reduces incentives for productivity by subsidizing leisure and unemployment;
3. **Displacement.** Every dollar spent by politicians means one dollar less that is allocated based on market forces within the more productive private sector; and
4. **Inefficiencies.** Government programs are less efficient than those in the private sector.

Mountains of studies illustrate how government expansions reduce economic growth:[6]

- *Public Finance Review* reported: "[H]igher total government expenditure, no matter how financed, is associated with a lower growth rate of real per capita gross state product."[7]
- *The Quarterly Journal of Economics* reported: "[T]he ratio of real government consumption expenditure to real GDP had a negative association with growth and investment," and, "Growth is inversely related to the share of government consumption in GDP, but insignificantly related to the share of public investment."[8]
- *The Journal of Macroeconomics* discovered: "[T]he coefficient of the additive terms of the government-size variable indicates that a 1% increase in government size decreases the rate of economic growth by 0.143%."[9]
- *Public Choice* reported: "[A] one percent increase in government spending as a percent of GDP (from, say, 30 to 31%) would raise the unemployment rate by approximately 0.36 of one percent (from, say, 8 to 8.36 percent)."[10]

Economic growth is driven by individuals and entrepreneurs, not by Washington politicians. The outdated idea that transferring spending power from the private sector to Washington will expand the economy has been thoroughly discredited. The U.S. economy has soared when the federal government was shrinking, and it has stagnated at times of government expansion. A strong private sector has provided America with significantly stronger economic growth than that of many European economies.

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5. This list was influenced by the work of Daniel J. Mitchell, "The Impact of Government Spending on Economic Growth," Heritage Foundation *Backgrounder* No. 1831, March 15, 2005, at *http://www.heritage.org/Research/Budget/bg1831.cfm*.
6. These studies were originally cited in *Ibid*. Many more studies can be found in the supplemental appendix to that paper at *http://www.heritage.org/Research/Budget/bg1831_suppl.cfm*.
7. S. M. Miller and F. S. Russek, "Fiscal Structures and Economic Growth at the State and Local Level," *Public Finance Review*, Vol. 25, No. 2 (March 1997), pp. 213–237.
8. Robert J. Barro, "Economic Growth in a Cross Section of Countries," *The Quarterly Journal of Economics*, Vol. 106, No. 2 (May 1991), p. 407.
9. James S. Guseh, "Government Size and Economic Growth in Developing Countries: A Political-Economy Framework," *Journal of Macroeconomics*, Vol. 19, No. 1 (Winter 1997), pp. 175–192.
10. Burton Abrams, "The Effect of Government Size on the Unemployment Rate," *Public Choice*, Vol. 99 (June 1999), pp. 3–4.

Highway Spending: The Myth of the 47,576 New Jobs

Nowhere is the Keynesian "pump-priming" myth more widespread than in highway spending. The current draft of the economic stimulus package contains nearly $5 billion in highway spending. Over the years, lawmakers have repeatedly supported their questionable claim that highway spending is an economic stimulus by citing a Department of Transportation (DOT) study that supposedly states that every $1 billion spent on highways adds 47,576 new jobs to the economy.[11]

One problem: The DOT study did not make that claim at all. It stated that spending $1 billion on highways would *require* 47,576 workers to do the work (more precisely, it would require 26,524 workers, who then spend their income elsewhere, supporting an additional 21,052 workers). But before the government can spend $1 billion hiring road builders and purchasing road materials, it must first tax or borrow $1 billion from other sectors of the economy—which would then lose a similar number of jobs. In other words, *highway spending merely transfers jobs and income from one part of the economy to another.* As The Heritage Foundation's Ron Utt has explained, "The only way that $1 billion of new highway spending can create 47,576 new jobs is if the $1 billion appears out of nowhere as if it were manna from heaven."[12] The DOT report implicitly acknowledged this point by referring to the transportation jobs as "employment benefits" within the transportation sector, rather than as *new* jobs in the economy.

An April 2008 DOT update to its previous study reduced the employment figure to 34,779 jobs supported by each $1 billion spent on highways, and explicitly stated that the figure "refers to jobs *supported* by highway investments, not jobs *created*" (italics in original).[13]

Stated simply, there is little reason to expect an additional $5 billion allocated to highway spending this year to boost short-term economic growth or create a significant number of new jobs.

Disaster Aid: The Broken Windows Fallacy

The stimulus spending will also likely contain billions in hurricane disaster aid. While this funding may be necessary on humanitarian grounds, it certainly should not also be considered an economic stimulus. What economists call the "broken windows fallacy" counters the idea that breaking a window and then spending money to fix it has a stimulative effect, since those repair funds would otherwise have been spent elsewhere. Similarly, disaster aid comes out of funds that could have been spent elsewhere in the economy, and therefore cannot possibly add to the total spending power of the economy.

Conclusion

Stimulus bills should not become vehicles for pork projects and additional spending under the guise of undefined "stimulus." The provisions in the second stimulus bill will do little to aid the economy since they will merely redistribute money from one sector to another, from one group of people to another. History has proven that large government spending programs are not the antidote for a slow economy. Congress should learn from its previous mistakes, including the first stimulus bill, and not consider proposals that increase the debt and do little to boost the economy.

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11. Much of the analysis in this section originally appeared in Ronald D. Utt, Ph.D., "More Transportation Spending: False Promises of Prosperity and Job Creation," Heritage Foundation *Backgrounder* No. 2121, April 2, 2008, at *http://www.heritage.org/Research/budget/bg2121.cfm*.

12. *Ibid.*

13. U.S. Department of Transportation, Federal Highway Administration, "Employment Impacts of Highway Infrastructure Investment," April 7, 2008. This report no longer appears on DOT Web site. Contact the authors for the original PDF.

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