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A Third Stimulus? Don't Repeat the Same Failures

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Calls for a new stimulus bill are growing almost as fast as the ranks of the unemployed. Many politicians and economists who had advocated for the huge $787 billion second stimulus bill are surprised that it has failed to help the economy. Already, unemployment projections by the Obama Administration have proven wildly optimistic, leading Vice President Biden to say that the Administration "misread the economy."

However, misreading the economy or the snail pace in spending the stimulus money does not explain why the second stimulus has not delivered economic recovery. The reason that the second stimulus is not working stems from the misguided belief that a government can spend the economy out of a recession. If Congress enacts a third stimulus bill with a focus on more government spending and infrastructure projects, it will fail for the same reasons that the second one is failing, only this time with much higher government debt.

One definition of insanity is repeating an action over and over and expecting a different result. Policymakers should not replicate repeatedly failed policies of government spending that can only produce huge increases in government debt and a diminished economic future. Instead, they should focus on truly pro-growth policies that will enable the private sector to produce jobs and wealth. These policies, such as cutting spending and reducing tax rates, would be a radical course correction for the President but one he may be forced to consider before long.

The Second Stimulus Bill. The February stimulus bill championed by President Obama was the second of its kind in less than 12 months. President Bush and Congress enacted a smaller stimulus bill worth $152 billion that focused on rebates and some small tax breaks for businesses. By historical standards this was a robust fiscal response, but it proved ineffectual because it was largely based on the naive principle of "putting cash in people's pockets" as opposed to the operative principle that guided the very effective 2003 tax bill of improving economic incentives through rate reductions. Taken together, these two stimulus bills equal almost a trillion dollars.

The Obama Administration touted the second stimulus bill, saying that it would lower unemployment by quickly spending money on "shovel-ready" projects. Two senior economists with the Administration predicted that the unemployment rate would level off and never exceed 8 percent with stimulus plan.[1]

These promises proved false as the unemployment rate climbed from 7.6 in January to 9.5 percent in June, which far surpassed the Administration's projections. Even jobs in the highway construction

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field have fallen faster in 2009 than they fell in 2008, despite promises that the stimulus bill would quickly boost infrastructure projects.

Some stimulus defenders say that the real power of the deficit spending will drive the economy in the coming months as more money is spent faster. However, as White House Office of Management and Budget Director Peter Orszag notes, the General Accounting Office found that stimulus spending is ahead of schedule.[2] Ahead or behind schedule, the problem is not the pace of the spending; the problem is the spending.

Time to Change Course. The economic theory behind the Obama bill—and the 2008 Bush bill—is that deficit spending can increase demand in the economy and that growth and employment will follow. With all the focus on the Obama bill, it is easy to forget that absent any new policy the budget deficit increased dramatically from 2008 to 2009 due to the recession, from 3.2 percent of gross domestic product (GDP) to a whopping 11.9 percent of GDP, according to the Congressional Budget Office. If deficit spending were truly stimulative, an 8.7 percentage point jump would be more than enough to cause the economy to begin to overheat.

This is no longer an academic, theoretical discussion. We have had a very clear experiment in deficit spending as fiscal stimulus, and the experiment failed with or without the additional Obama deficit spending. It is time for the proponents of this theory to either explain what special circumstances can possibly exculpate their pet theory or admit their failure.

Why did the economy not respond? How does the theory fail? The simple explanation is that deficit spending must be financed. The additional deficit spending before and after the Obama bill is financed by borrowing. That borrowing reduces the amount of domestic savings available for investment and so reduces investment, or it increases the amount of foreign savings that must be imported and so results in an increase in the trade deficit. The composition of total demand changes, but the level does not, and so the level of economic activity is unaffected.

Dangers of a Third Stimulus. If Congress and the President pursue yet another spending-based, debt-financed bill, it will be as fruitless as its predecessors. It will also demonstrate that this Administration and this Congress are incapable of learning from past mistakes or deviating from the dictates of their ideology. Worse, they will be sowing more seeds for a harvest of higher interest rates and economic weakness.

These higher interest rates will cause the entire interest rate structure to rise from low risk to high risk for short-term and longer maturities, car loans, mortgages, business loans, and all other types of credit. These higher interest rates will sap business investment in all manner of projects, producing slower growth in the short term and slower productivity and wage growth in the longer run.

What Should Be Done. It is by no means too late to enact good economic policy. Congress and the President still have time to adopt policies to short-circuit the downturn, accelerate the recovery, and strengthen the economy for the long term. To do so, they need to focus on economic incentives and business confidence, on a rapid return to a responsible fiscal policy, and on a well-grounded confidence in a sound currency. In brief, they should:

- Scotch all talk of another spending-based economic stimulus and, instead, immediately repeal the authorization to spending any remaining sums under the first Obama stimulus bill;
- Set a target for additional, permanent spending reductions for 2010 of at least 1 percent of GDP below the existing spending baseline;
- Explicitly affirm their intention to extend the 2001 and 2003 tax relief, including the AMT patch, for at least five years;
- Reduce marginal individual and corporate income tax rates for at least five years;

1. Christina Romer and Jared Bernstein, "The Job Impact of the American Recovery and Reinvestment Plan," January 10, 2009, at *http://otrans.3cdn.net/45593e8ecbd339d074_l3m6bt1te.pdf* (July 9, 2009).
2. Peter R. Orszag, "The Road to Recovery," at *http://www.whitehouse.gov/omb/blog/09/07/08/TheRoadtoRecovery* (July 9, 2009).

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- Suspend any effort to pass climate change legislation involving additional levies of any kind on businesses now or in the future;
- Delay the implementation of the scheduled hike in the minimum wage until employment has reached its previous peak.

These will be bitter pills to swallow for the President and the majority in Congress, but it is what must be done to turn the economy around.

A Failed Experiment. The United States has pursued a clear experiment in deficit-based economic stimulus, and the experiment has failed. Continuing the experiment can only increase the national debt and delay consideration of effective alternatives. Repeating the experiment with yet another round of legislated deficit spending would be simply irrational and irresponsible.

Congress and the Administration are not powerless in the face of the economic downturn. But they should jettison their ideology to pursue policies that will help the economy in the short and long term. They must embrace a new era of responsibility.

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