The Obama Economic Stimulus Package: Stimulus or Schmimulus?

Unemployment is soaring, consumer spending is plummeting

By Mike Whitney
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There's no guarantee that Obama's stimulus package will work, but there is growing consensus that something has to be done…and fast! The economy is contracting faster than anytime since the 1930s.

Unemployment is soaring, consumer spending is plummeting, and the country appears to slipping towards another Great Depression. The Federal Reserve's near-zero interest rates and massive liquidity injections haven't helped at all. That's why the focus has shifted from monetary policy to Keynesian fiscal stimulus. When businesses and consumers cut back on spending, the government has to make up for the loss in aggregate demand. That's what Obama's $775 American Recovery and Reinvestment Act is really all about. It won't fix the economy; it's just a way to minimize the shock of a hard landing. Economists Lawrence Mishel and John Irons make the case for stimulus in their recent article "How Bad Can It Get"

"Almost 2 million jobs were lost from December 2007, when the recession began, through last November, and economists are forecasting that at least another 500,000 more will have disappeared in December 2008. If so, this will be the steepest rate of job losses in the first year of any post-war recession. Without swift intervention, similar or higher monthly losses are expected to mount well into next year, and continuing weaknesses in the labor market are likely to persist for another two to three years. More than 5.5 million jobs are likely to be lost during this recession unless a major job-creating stimulus plan is enacted….

Obama is calling on Congress to pass a stimulus package that will cost $700 to $800 billion or more over two years. That amount could create 2.5 million jobs in the first year and a total of 5 million jobs in the first two years. If so, it would lower the unemployment rate by 3.2 percentage points, leading to a peak unemployment rate of around 7%. While unemployment will still be uncomfortably high, the stimulus package as envisioned by Obama would prevent double digit unemployment, give the economy a solid footing for future growth, and begin to meet long-term needs." (Lawrence Mishel and John Irons "How Bad Can It Get?" Economic Policy Institute)

Still, many people think that stimulus is a waste of money that will send deficits into the stratosphere. Libertarians, for example, argue that the cure for a credit bubble shouldn't be more credit. They want to see debts written down and balance sheets back in the black. Their prescription is similar to Treasury Secretary Andrew Mellon's in the 1930s who said : "Liquidate labor, liquidate stocks, liquidate the farmers – purge the rottenness from the system." Mellon's rant may sound consistent with free market dogma, but following his advice would lead straight to catastrophe. The markets would crash and there would be riots

in the streets. It’s better to err on the side of caution and give the economy a badly needed boost of stimulus.
Forbes recently ran an article which disputes the effectiveness of stimulus. According to the article, the European Central Bank (ECB) produced a working paper, entitled ‘The Macroeconomic Effects of Fiscal Policy’ which states:

“The empirical evidence suggests that government spending shocks have, in general, a small effect on GDP,’ and ‘can have a ‘have a negative effect on private investment…Hiking government spending does little for economies, has a minimal impact on consumer spending, hits stock prices and can put off private investment.” (Forbes)

A number of powerful Republican senators are also opposing the stimulus package, but their opposition wreaks of hypocrisy. These very same senators rubber-stamped every one of Bush’s budget-busting tax cuts and unfunded multi-trillion dollar wars which increased the national debt from $5.6 trillion in 2000 to $10.3 trillion in 2007. Unlike the libertarians, the Republican position is not based on principle.

Opponents also point to last year’s rebate checks which amounted to roughly $150 billion. That stimulus had almost no effect because only 15 percent of the money was pumped back into the economy. Most of it was used to pay off credit cards and personal debt. Obama’s team is looking for better ways to get money into the hands of the people who will spend it immediately and increase overall business activity. The velocity of money is crucial to the success of any stimulus program. Unfortunately, the current slowdown has brought business activity to a grinding halt. The Fed’s trillion dollar injections are languishing in stagnant pools on bank’s balance sheets instead of circulating through the economy where they’d do some good. At the same time, consumers are saving money for the first time since the 1950s which is just deepening the slump. Unless Obama can restore confidence and cheer up consumers the economy will continue to nosedive.

In a recent article, economist Dean Baker, blasted the “anti-stimulus crowd” pointing out their misreading of Depression-era history. He said:
“The New Deal polices substantially ameliorated the effects of the Great Depression for tens of millions of people. The major economic failing of the New Deal was that President Roosevelt was not prepared to push the policies as far as necessary to fully lift the economy out of the Great Depression.
Roosevelt was too worried about the whining of the anti-stimulus crowd that he confronted. He remained concerned about balancing the budget when the proper goal of fiscal policy should have been large deficits to stimulate the economy. Roosevelt’s polices substantially reduced the unemployment rate from the 25 percent peak when he first took office, but they did not get the unemployment rate back into single-digits. (“The Anti-Stimulus Crowd: The Fear of Success” By Dean Baker, UK Guardian)

Critics of stimulus oftentimes forget that increases to the deficit cannot be measured on a one to one basis. For example, $775 billion in stimulus does not necessarily mean that $775 billion is added to the deficit. Economist Andy Harless makes this point in his article “Dynamic scoring”:

“Suppose that, at the beginning of the fiscal year, Congress appropriates $100 billion extra for infrastructure projects. At the end of the fiscal year, how much higher will the deficit turn out to be, compared to what it otherwise would have been?

The obvious answer, and the one that usually seems to be implicitly assumed by the media and the pundits, is $100 billion. But if you think about it carefully, it should become obvious that the obvious answer is the wrong answer.

The government is going to use most of that money to hire people and to buy things. Many of the people it will hire are people who were previously unemployed. Many are leaving other jobs which will subsequently be filled by people who were unemployed. These previously unemployed people, who may have been collecting benefits, will now be paying taxes. Those taxes will reduce the deficit, as will the reduced benefit payments. Moreover, for the businesses from which the government purchases, their profits will rise, and they will pay additional taxes on those additional profits. And they may expand and hire new people, or retain people that would otherwise have been laid off. And (if you believe in a multiplier effect), all the newly employed people, as well as the owners of the businesses, will spend more money, thus providing more profits and more employment for others, who will also pay taxes and stop collecting benefits. And so on. The ultimate effect of the original expenditure on the budget deficit will be considerably smaller than $100 billion.

This is called dynamic scoring."

The goal of any stimulus plan should be to get the economy back on track while giving the taxpayer gets the biggest "bang for his buck". According to most economists, tax cuts just don't do the trick because they don't stimulate spending as much as other things, like public works programs or extending unemployment benefits. According to the New York Times: "Tax breaks usually produce less than $1 of stimulus for every dollar they cost… Spending on public construction projects, like highways and bridges, produces the most economic activity".

Unfortunately, Obama has included $300 billion in tax cuts to placate the Republicans so he can move his plan quickly through Congress. This is a mistake. The stimulus has to be targeted if it's going to do what it is supposed to do. Ideally, the $775 billion will act like a fiscal defibrillator jolting the economy back to life. But that means that the money should be efficiently deployed to the sectors where it will produce the best possible results (which excludes tax cuts)

Getting a stimulus bill signed and implemented is urgent. It shouldn't be delayed until February, which is what the Republicans are calling for. The economy is in deep trouble now and its going to get worse.

Former Secretary of Labor, Robert Reich gave his estimate of how much it would take to get the economy through the next few years in a recent blog-entry "Stimulus Plan: The Need and Size":

"In my judgment, this will require a stimulus of about 6 and a half percent of gross domestic product, or a total of some $900 billion, spread over two years. That's my estimate for the shortfall in private demand. But the federal government should stand ready to spend larger sums if necessary to get the economy back on track toward full capacity. The danger is not that the government will do too much; the danger is that it will do too little, too late.
Without such action, I estimate that another 3 million jobs will be lost in 2009, unemployment will rise to 10 percent of the workforce by the end of this year, and under-employment – including people working part-time who would rather be working full time, and those too discouraged even to look for work – will reach 15 percent. Without federal

action, next year could be even worse.”

Nobel prize winning economist Joseph Stiglitz supports the stimulus plan with the proviso that other structural changes be made to improve the financial system and address (economic) inequality. In his article “We Need Longer term Solutions” Stiglitz says:

“The United States Federal Reserve, which helped create the problems through a combination of excessive liquidity and lax regulation, is trying to make amends – by flooding the economy with liquidity… In some ways, the Fed resembles a drunk driver who, suddenly realizing that he is heading off the road starts careening from side to side.

We need not just temporary stimuli, but longer-term solutions. … First, we need to reverse the worrying trends of growing inequality. More progressive income taxation will also help stabilize the economy, through what economists call “automatic stabilizers”. It would also help if the advanced developed countries fulfilled their commitments to helping the world’s poorest by increasing their foreign-aid budgets to 0.7% of GDP.”
Economist Dean Baker makes a pitch for devoting funds to state and local governments and green technology in his article “The Highway to Hell: Bad Infrastructure”:

“The amount of stimulus required to offset the impact of the collapsing housing bubble and the plunging stock market is substantial, but there are good ways to spend large amounts of money. The huge shortfalls incurred by state and local governments are an obvious place to start. The National Conference of State Legislatures has identified close to $200 billion in budget shortfalls in the 2009 and 2010 fiscal years. Since state governments are required under their constitutions to balance their budgets, these deficits are leading to large cutbacks and tax increases. These cutbacks and tax increases will worsen the recession.

There is a wide range of “green” initiatives that President-elect Obama can include in the stimulus package in addition to weatherizing buildings. For example, he could provide subsidies to public transportation agencies to cover the cost of lower transit fares. He could also pay people (presumably mostly lower-income people) to turn in older, more polluting cars and get them off the road. Such measures can both help reduce greenhouse gas emissions and boost the economy.

The other obvious way that Obama can boost the economy is with health care spending. Some of the money going to the states will be through state Medicaid programs. However, Obama could usefully spend much more money subsidizing Medicare for people who do no currently have insurance. This will be an important down payment on health care reform.”

Progressive economists are taking advantage of their opportunity to give their opinion on the best way to spend the public’s money. Nearly all of them support extending unemployment benefits, food stamps, child tax credits, more funding for welfare, public works programs, and green technology. It’s all part of a social consciousness that puts the public good above private interest. An alternate vision of America lives on, despite eight years of Bush.

Stimulus alone cannot fix the economy. It’s just a way to avoid the full crushing-impact of a deep recession. The financial system will have to be re-regulated; the banks will have to write down the losses on their bad assets, restrictions will have to be placed on the amount of leverage that is allowable, and consumers will have to adjust to a world where interest rates are higher and credit a little less available. The stimulus is just a reminder that the system needs structural change so that present crisis is not repeated. That means, prosperity should be built on the solid foundation of wages that keep pace with production instead of credit-fueled speculative bubbles which end in disaster.

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Articles by: **Mike Whitney**