

Why the Stimulus Packages Will Not Work As Advertised

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Proponents of multi-trillion dollar stimulus packages – from President Obama on down – have certainly been hammering away on a well-honed one-sided message: “The economy is in dire shape with the recession worsening by the month. A Second Great Depression could be in the country’s economic future if the federal government doesn’t become a massive spender of last resort to stimulate the economy.”

Proponents argue that their favored stimulus packages will “inject” funds into virtually all sectors of the economy, giving rise to more employment and having a “multiplier effect” on national income. As Americans have more income, they will then go out and buy what they want from other Americans. Through a chain of successive rounds of expenditures, every \$1 trillion in federal spending can be expected to lead to \$1.5 trillion in additional national income.

A very seductive argument . . . if only it were true. If the multiplier effect were as theoretically sound as the proponents claim, why not run the country’s entire gross domestic product through the federal government? Gross domestic product would expand in short order from an annual level of \$14 trillion to \$21 trillion.

Unfortunately, the message really is too good to be true for straightforward reasons: For every federal stimulus dollar spent, offsetting economic forces are set afoot. Let me count them.

First, the stimulus dollars do not magically appear for the federal government to spend as it pleases. The federal government must borrow those dollars, which means many of the

stimulus dollars will be diverted from private expenditures, at least partially negating the federal expenditures.

Second, all the proponents' exaggerated talk about dire economic conditions, partially orchestrated to win political approval for ever-growing stimulus packages, has likely caused consumers and businesses to check their expenditures, a force that has and will continue to depress aggregate demand.

Third, the expansive stimulus packages will likely prompt many people to anticipate higher taxes in the future to pay down the mounting federal debt, and expectations of higher taxes can dampen people's current enthusiasm for investing in plant and equipment and education that will yield additional future income. They can rightfully fear that any additional future income could be highly taxed. President Obama's floated proposal to raise taxes on the "rich" no doubt validated fears of higher future tax rates.

Fourth, the *real* (inflation-adjusted) debt burden of the federal government is inversely related to the inflation rate, which is to say that with a piling up of federal debt, politicians will face an ever-growing temptation to inflate away the real value of the federal debt. Such thinking can cause creditors to hold back on lending until they are compensated for expected higher inflation rates with higher interest rates. The resulting uncertainty of inflation and interest rates can undercut current consumer and investor demand, offsetting some of the stimulus effect of current federal deficit spending.

Fifth, many federal stimulus dollars are being passed along to states and local governments to expand various social and infrastructure programs that must be continued after the federal dollars run out in a year or two. For example, states will be given stimulus dollars if they raise unemployment benefit payments *and* if they continue the payments beyond the two

years covered by the stimulus dollars. Again, such conditioned stimulus expenditures can raise the specter of higher state and local taxes in the future, which can suppress current demand.

Sixth, Americans' wealth affects their current expenditures, and American's wealth is a function of the international value of the dollar. Reckless federal stimulus expenditures that increase federal debt can undermine the confidence people around the world have in the future value of the dollar on international exchange markets. If people worldwide fear the dollar will depreciate in the near term, they can be expected to sell off their dollar assets, pushing down the dollar's international value and reducing Americans' wealth, which can suppress American's current demand. China has already warned that it might unload some of its \$1 trillion of federal securities it holds if devaluation of the dollar becomes a threat from unchecked federal spending.

Seventh, some stimulus proposals include tax credits and deductions for Americans who buy certain products, for example, cars, houses and energy-efficient appliances. The anticipation of such future tax benefits can suppress current consumer and investment expenditures, further muting the effects of the stimulus programs.

Eighth, by all accounts, the country got into its economic mess because of "moral hazard," or the tendency of banks and homeowners to take excessive risks because of their being highly leveraged (which means that borrowers could gain a great deal if risky ventures with higher-than-average rates of return paid off, but that lenders would suffer losses if the risky investments failed). But the federal government's solution creates another moral hazard problem – bailing out banks through enabling buyers to leverage up to 93 percent of their purchases of so-called "toxic mortgage-backed securities." Such a stimulus solution can give rise to expectations of another financial crisis in the future, one that will cost taxpayers dearly in higher tax rates.

Ninth, in trying to spend trillions of dollars in such a short period of time through so many channels, there will be inevitable abuse and waste of stimulus dollars. Such expenditures can't really be counted as contributing to any multiplier effect, because they will not make a contribution to *real* domestic production and income (although stimulus supporters might want to think otherwise).

Tenth, we can expect the stimulus (and bailout) programs to be works in progress, with any number of changes in the direction of policy (as we have already witnessed in the area of the distribution of bonuses at AIG, the firing of GM's CEO by government, and the on-again and off-again purchases of bank's toxic assets). Such policy initiatives that are altered in mid-course, if not reversed, will create economic uncertainty that is bound to offset the stimulating effect of the stimulus expenditures. Unfortunately, economic uncertainty is compounded by the fact that no one now really knows how large government will become over the next year or two, because of the absence of any acknowledged limits in the nation's capital to what politicians are prepared to do.

There's more, but my point is clear: Don't count on stimulus packages stimulating anything, at least not on balance. Rather, fear that such a policy course will have the exact opposite effect from what proponents widely advertise with undue confidence.

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