

WHY STIMULUS SPENDING IS NOT WORKING

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Recent economic data indicate a dearth of evidence in support of any positive results of government efforts to stimulate the economy through deficit spending. Even though federal debt has grown \$2.9 trillion since early 2008, GDP has only grown an anemic \$.2 trillion. During the same period private, i.e., non-federal, debt remained virtually unchanged while the unemployment rate rose and hovers near 10 percent. All of this evidence points to a near zero government expenditure multiplier. But there may be something else at work.

A sudden and deliberate surge in government spending--and the resultant federal deficits of epic proportions--may displace a near equivalent amount of new private borrowing (spending). Not replace but *displace* new private borrowing. Mortgage modifications, Cash-for-Clunkers, extended unemployment benefits among other 'relief' programs actually discourage consumer borrowing; federal bailouts and tax credits likewise dampen business borrowing; and federal grants to states reduce the need for state and local governments to borrow.

Displacement is not to be confused with 'crowding out' as the latter occurs in response to upward pressure on interest rates incurred by increased government borrowing--assuming no concurrent decrease in private borrowing. Displacement occurs when the presence of federal government borrowing becomes a perfect and costless substitute for private borrowing.

If this hypothesis is correct then in the face of the massive increase in federal deficit spending (borrowing) over the past 18 months an equivalent amount of new private borrowing would be forgone and increases in the economy's total debt would be limited to the new federal debt. Sufficient time has elapsed since the recent onslaught of federal borrowing to evaluate the validity of this hypothesis. The accompanying table shows the outstanding debt from each major sector of the US economy assuming a base line of one year prior to the signing of the Stimulus into law and nine months prior to the TARP law. (The amounts shown for Federal Debt list only the amount held by the public.)

As stated earlier, federal debt held by the public increased more than \$2.9 trillion or over 56 percent since the first quarter of 2008. Total economy wide debt (including financial and foreign borrowing) increased by just over \$2.8 trillion. That is, the increase in publically held federal debt is responsible for the entire increase in total economy wide debt (Gross federal debt increased \$3.3 trillion over the same period. www.treasurydirect.gov). With no new private borrowing over the past 18 months, the net effect of federal stimulus spending is near zero. The concomitant meager growth in GDP serves as confirmation of this conclusion. It appears, therefore, that the increase in the federal deficit would have been more productively allocated to

business tax cuts. As testament to this sentiment, the future former Chair of the President's Council of Economic Advisors, Christine Romer, and her husband, David, have just published research in which they conclude that "...a tax increase of 1 percent of GDP reduces output over the next three years by nearly three percent." Imagine what a one percent *cut* in income taxes would do?

To be fair, advocates of the federal stimulus spending, including Professors Paul Krugman and Alan Blinder believe the federal government did not spend enough. They would argue that even though there is little or no demonstrated increase in private borrowing the federal deficits were needed to *replace* the foregone private borrowing.

Replace or displace that is the question. In my view the weight of the argument comes down on the side of displacement. After all, why would individuals, businesses, as well as state and local governments borrow to provide for certain expenditures/programs when the federal government volunteers to do it for them?

The lesson learned from this recent experiment in fiscal policy is the futility of government 'stimulus' spending. The beauty of selective business tax cuts lies not in the stimulative effect of the resulting deficits but the incentive effect on investment spending and concomitant job creation.

OUTSTANDING DEBT BY SECTOR: USA
(Billions \$)

Year.qtr	Total	Household	Business	State	Federal	GDP
2008.1	32166.1	13914.2	10806.2	2230.1	5225.5	\$14,373.9
2008.2	32432.7	13916.1	10986.2	2227.2	5303.1	\$14,497.8
2008.3	33108.5	13904.6	11134.9	2246.3	5822.7	\$14,546.7
2008.4	33615.8	13843.0	11164.8	2246.5	6361.5	\$14,347.3
2009.1	33948.4	13800.3	11153.6	2273.0	6721.4	\$14,178.0
2009.2	34309.7	13744.5	11074.0	2296.0	7195.2	\$14,151.2
2009.3	34541.4	13657.2	10989.9	2327.9	7566.5	\$14,242.1
2009.4	34654.8	13602.1	10892.5	2354.7	7805.4	\$14,453.8
2010.1	35010.1	13542.2	10921.0	2379.9	8166.9	\$14,592.4

Source: www.federalreserve.gov