

Federal Stimulus Kicks Costs Down the Road

Chris Papagianis and Arpit Gupta | August 11, 2010

Today, the House returns from its six-week summer recess to vote on an emergency spending package for the states. The measure, which includes \$16 billion to help states with Medicaid costs and another \$10 billion for school districts, has already cleared the Senate.

While proponents of the bill have used the term “emergency spending” rather than “stimulus,” it’s important to remember that state-aid was a major part of the February 2009 Obama-led stimulus that totaled more than \$787 billion. Not including disbursements for transportation-related infrastructure, approximately \$174 billion of that total amount was earmarked to help states patch budget holes for Medicaid and education.

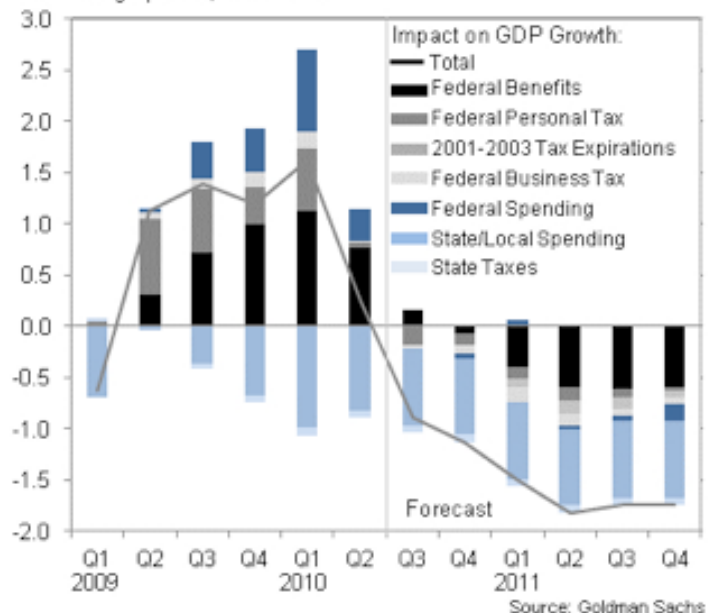
So, here we are again roughly 18 months later. States are (still) facing big holes in their budgets. And, Congress is about to pass yet another state patch or bailout.

In light of this déjà vu, we wanted to call attention to a related commentary by Nicole Gelinas of the Manhattan Institute and a (relatively) new research paper by Harald Uhlig of the University of Chicago.

1. Last week, in the run up to the Senate vote on the new state aid package, Congress Daily reported that Senator Reid and White House Chief of Staff Emanuel promised wavering members that some of this new funding (in particular, the state aid for education) would not be extended again in the future. In fact, Senator Snowe – one of only two Republicans to support the measure – said this pledge was the

Government Drag

Percentage points, annual rate



key to securing her vote for passage.

Last month, Nicole Gelinas wrote an oped calling for a new “type” of stimulus program for the states: “Cash for Cuts.” Rather than continue to help states patch over budget holes, would it not be better to provide them with incentives to address their long-term structural imbalances, like ever-rising public labor costs?

Ms. Gelinas argues for modeling this new state aid program on the most successful initiative from the 2009 stimulus measure: the “race to the top” program for additional education dollars. Like with “race to the top,” the states that develop the most meaningful long-term budget reform plans would receive more aid from the federal government in the near-term. The full proposal by Ms. Gelinas is worth reviewing because Congress may very well consider a third



round of state aid at the end of this year, despite some of the recent statements by Mr. Reid and Emanuel. In fact, the Obama Administration would be smart to propose something along these lines in next year's budget – and Congress would be wise to fast track its consideration.

2. As this site has emphasized, debates over the effectiveness of federal stimulus programs are very tricky to navigate. Evidence that the stimulus has worked is based on assumptions about the effectiveness of government spending. Many supposed stimulus “evaluations” use no empirical data at all to establish their conclusions. Indeed, it is difficult to imagine what sort of data could be brought to bear on this subject.

Throughout this “measurement” debate, Harald Uhlig (University of Chicago) has been a critic of the decision to opt for government spending and temporary tax cuts to stimulate the economy. His research has suggested instead that tax cuts that lower marginal rates can be somewhat more effective to combat rough downturns.

In a recent paper, Uhlig takes a closer look at the arguments advanced for a federal stimulus. To begin, he notes a fact that many other critics (such as Greg Mankiw) have pointed out as well – that the Romer-Bernstein estimates in support of the '09 stimulus program differ from the academic evidence (including evidence that Romer herself has advanced in the past).

Next, Uhlig examines the impact of fiscal stimulus programs over a longer scale. He calibrates a real business cycle model that generates a positive effect of government spending on output in the short-run. This conclusion is similar to the positive impacts of stimulus spending resulting from other models, such as the ones used by Romer-Bernstein.

However, Uhlig also notes the impact of this spending on future behavior. Temporary government spending does not last forever, and so necessarily must withdraw from the economy at some point. Individuals expect taxes to go up in order to pay for the stimulus package and thus alter their current behavior. After calculating the net result of these additional responses, Uhlig finds that temporary Government spending may actually lower output in the long-run. Uhlig argues:

[The] long-term consequences of massive expansions in government spending come at substantial costs in terms of total output eventually and at considerably higher long-term output costs than those of tax cuts.

His result also should give pause to those who hope to repeal the entirety of the 2001 and 2003 tax cuts. While eliminating the cuts as a part of a broader strategy to reform the tax code may make sense, repealing them in their entirety right now would be a strongly contractionary policy. In fact, Uhlig's conclusions suggest that raising taxes while increasing spending may result in *lower* economic activity than doing nothing.

While this model remains an economic theory, it is quite plausible that there is a tradeoff between boosting demand today and growth in the long-run. Remember, the Administration's estimates are also based on models. Other observers have raised this concern as well. For instance, Economists Cordoba and Kohoe have noted that:

[M]assive public interventions in the economy to maintain employment and investment during a financial crisis can, if they distort incentives enough, lead to a great depression

Sadly, this is not a risk that can be dismissed today. For instance, the hiring of temporary census workers merely disguised a very bleak jobs picture for the past few months. And, just a few days ago, Goldman Sachs estimated that the expiration of expansions in federal and state spending would put a drag on



Federal Stimulus Kicks Costs Down the Road

growth through 2011, and result in a prolonged recession.

While the stimulus was sold as a technique to permanently rescue the country from recession, we will have to face the possibility that its real legacy could be a longer recession and a deeper debt burden.