

**ECONOMIC STIMULUS—  
OR MORE TAX-AND-SPEND?**

Presented by  
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Presented to  
**Mainstream Coalition**  
**Let's Talk Politics discussion group**

at  
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Ad Astra Institute 1

**David Burress**

- Research Economist
- Retired from KU's Institute for Policy and Social Research in 2004
- Focus on public economics, regional economics, benefit-cost analysis
- President of Ad Astra Institute

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5-8-09 2

**Ad Astra Institute of Kansas**

**Mission:**  
**A broad spectrum progressive think tank**

- 501(c)(3) nonpartisan nonprofit since 2005
- Membership organization
- Scope: Kansas state-wide policy research
  - Objective but value-driven policy analysis
  - Political strategy analysis
  - Communication analysis
- Goal: pragmatic progress for ordinary people

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**AAI's political niche**

- Strategy: fill the Kansas policy research gap
- Other Kansas think tanks --
  - Market fundamentalist tanks: distorted ideology
  - Academic and legislative tanks: non-advocacy
  - Single issue groups: loss of big picture
  - Executive policy shops: Governor sets the goals

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**Topics**

- What caused the 2008-2010 slump?
- Fighting recession
  - Stimulus
  - Bank bailout
  - Financial regulation
  - Sectoral bailout
- Managing the deficit
- Evaluating the Obama/Bernanke program
- Political aspects
- Forecasts

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**Caveat on economic assumptions**

- Economic science has both scientific and ideological influences
  - My definition of ideology: contested economic assumptions aligned with political allegiances
- However this talk is mostly post-Keynesian macro-economics, with a distinct Paul Krugman influence
- {c} denotes views contested by some economists
- I am not a macro expert. I am a micro- and public finance economist who is reasonably knowledgeable about macro.
- Predictions of turning points are always unreliable

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### Major schools of macro

- Postkeynesians
  - Emphasize market failures and need for government intervention
  - Seek policies to mitigate income inequality
- Conservatives (term not accepted among economists)
  - Many varieties with different labels
    - E.g. supply side; real business cycle; monetarist; new classical; Riccardian; Austrian
  - Emphasize government failures and ability of markets to self-correct
  - Support policies that increase inequality {c}

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### The two sides of macro

- The economy has two sides.
- The REAL side consists in supply and demand for goods and services.
- The FINANCIAL side consists in savings and loans. That includes banking accounts, mortgages, stocks, bonds, futures, etc.

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### Normal boom and bust are driven by US total supply and demand (i.e. the real side)

- Total supply:
  - the maximum total value of new stuff the US economy can produce in a period
- Total demand:
  - the total value of new stuff that people, businesses, and government are trying to buy from the US suppliers in a period.

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### The usual business cycle

- Normal growth: total demand equals total supply
  - Government should encourage investment to increase both supply and demand.
- Accelerating inflation: total demand exceeds total supply
  - Government should try to reduce demand
- Recession and depression: total demand is less than total supply
  - Government should try to increase demand {c}.

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### Editorial aside on “supply side” snake oil {c}

- “Supply side” apostles are famous for exaggerating tiny truths into huge lies (e.g. the Laffer curve), but recession brings out their worst.
  - Caveat: a majority of supply side apostles are not actually practicing economists.
- Recession=too much supply, too little demand
- Expanding the supply just makes things worse!

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### Abnormal (and especially bad) business cycle events

- Growth recession: growth persistently too slow to keep up with new employment needs (e.g. <2% per year)
- Stagflation: recession or slow growth combined with inflation above 6%/year
- Bank runs or collapse
- Deflation: falling wages and prices
- Hyperinflation: ever-accelerating inflation increasing from 100%/year

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**Recession vs. depression**  
 Rough definitions—there is no fully accepted standard

- **Recession** (mainly affects real side of economy)
  - 2 or more quarters of declining GDP.
    - GDP=gross domestic product=national income= sum of everyone’s income before taxes
  - Banks continue to function normally
- **Depression** (affects both real and financial sides)
  - A. either
    - 1 year of 10% decline in GNP, or
    - 3 years of no growth, or both; AND
  - B. Banking system collapse.
  - C. Worst case scenario: you may also get deflation (downward price spiral)

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**What caused this depression? {c}**

- Bad policy over time, especially deregulation.

1. The real economy collapse
  - A sequence of burst asset bubbles (dot coms; housing)
  - Caused by absence of financial regulation (junk bonds, junk mortgages)
2. The financial economy collapse.
  - Deregulation
  - Leading to hugely risky financial gambles

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5-8-09

**Government policy tools: managing total demand**

- Monetary policy (change interest rates)
- Fiscal policy (i.e. stimulus; change deficits)
- Tax cuts (overlaps with stimulus {c})
- Public investment (overlaps with stimulus)
- Sectoral stimulus (help specific impacted industries e.g. autos, housing)
- Do nothing

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**Government policy tools: managing financial collapse**

- Banking regulation (prevent risky investment bubbles that will crash {c})
- Banking bailout (give failing banks money)
- Banking receivership (stop me before I kill again)
- Do nothing

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**Government policy: Recession**

- It can usually be cured by lowering interest rates (monetary policy)
  - As almost all economists agree (but monetarists use different language for basically the same idea)
  - But some conservative economists think recession is good.
- It can also be cured by a Keynesian “stimulus” (fiscal policy) {c}
  - Some though not all conservative economists claim stimulus doesn’t work.

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**Lowering interest rates increases total demand**

- How does it work? Two channels:
  - 1. Borrowing: Lower interest rates make people more willing to borrow to buy cars and houses or invest in new business startups
  - 2. Wealth: lowering interest rate drives up the value of stock and bonds. People buy more because they feel richer.

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### A stimulus increases total demand

- What is a stimulus?
  - An increase in direct government spending
  - Or an increase in transfer payments
    - E.g. welfare, social security, unemployment benefits
  - Or a decrease in taxes
  - Or a combination.
- How does it work?
  - Direct spending puts people to work producing whatever government buys
  - Transfers and tax reductions give money to households, who might (or might not) buy more stuff and put people to work producing it.

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19

### Not all stimulus is equal

- Giving money to poor people (they mostly spend it) works much better than giving money to rich people (they mostly save it) {c}
- Direct government purchase works best of all {c}
- Also you need to get it spent soon.
  - Much of the Obama package won't come online for a year or more
  - Unfortunately we may still need it then.

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20

### Government budget deficit is the flip side of stimulus

- Balanced budget means that taxes pull out of the economy about the same amount of demand that government expenditures put back in.
- Budget deficit means that government is adding more demand to the economy than it pulls out in taxes.

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21

### So what's wrong with running a deficit?

- Nothing at all in the short run.
- However a deficit means an increase in the national debt.
- A certain amount of national debt is good (e.g. because people need safe treasury bonds to invest in)
- Too much national debt is bad.

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22

### So how much national debt is too much?

- Actually there are three different national debts.
- As a share of annual GDP, the US owes about:
  - 23% to American citizens
  - 22% to other branches of US government
 That's perfectly OK.
- The US owes foreigners (China, Japan, Saudi Arabia):
  - 21% of GDP.
- Internationally, these amounts are average.
- Obama could be adding another 20%. That's somewhat worrisome.
- Interest on debt is 2% of GDP, 9% of federal budget

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### So how could our growing IOUs to China hurt us?

- If they try to dump their US holdings our economy would crash but so would theirs.
- China will be buying up larger and larger shares of US corporations.
- US interest rates may gradually rise out of our control in the future.
- We might lose the ability to control monetary policy to contain recessions.
- We might lose fiscal policy control as well.

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24

## The uneasy balance

- Government should:
  - Run a deficit during recession {c}
  - Run a surplus during normal growth.
- Because of lags in fiscal policy and lags in responses of the economy, it's hard to get it just right.
- Since WW II Democrats have done better than Republicans. {c}

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25

## Government policy: Depression {c}

- Interest rate (or monetary) policy stops working because the interest rate is already near zero
  - That's called a "liquidity trap"
- You have to use fiscal stimulus.
  - Some conservatives claim it won't work.
- You also have to fix the broken banking system
  - Needed policies: the bailout, and reregulation
  - Some conservatives claim they won't work either.
- The only conservative plan is more tax cuts for the rich. It won't work.

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26

## Other policy tools: right wing claims about tax cuts {c}

- Claims:
  - Tax cuts *by themselves* can cure recession or depression
  - Tax cuts are the *only* workable cure
  - Tax cuts do *not* depend on Keynesian stimulus
- According to:
  - Some but not all conservative economists
  - The emerging Republican party line
  - Fox news and Rush Limbaugh

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27

## Mainstream economists' response on tax cuts {c}

- Yes, tax cuts on business can have non-stimulus growth effects
- Mainly, by encouraging more investment
- ... but not during recessions
- Tax cuts also have stimulus effects
- ... but much less than direct expenditures (dollar per dollar)

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28

## Supply side policy tools (encouraging private investment)

- Tax cuts
  - Targeted tax cuts can make private investment cheaper
- Public investment
  - Private investment depends on opportunities created by public investments in: education, infrastructure, science, public services used by business {c}
- Do nothing
- Comments:
  - investment is part of today's demand, but it increases tomorrow's supply and enables tomorrow's growth.
  - contrary to supply side claims, investment policy alone can't cure a depression {c}

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29

## Another (alleged) policy tool: doing nothing {c}

- If government takes no special action, the economy will probably recover all by itself—some day.
- Some conservatives claim that anything government does will make things worse. That claim is not even definable.
- I claim there is no such thing as true inaction. We can't escape the problem of deciding what policy mix is best.

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30

### Some criteria for grading macro policy

- Is the stimulus package big enough?
- Is the stimulus package efficient? (i.e. smallest possible deficit for a given level of stimulus)
- Is the stimulus being spent on useful stuff to encourage long term growth?
- Are the sectoral stimuli justified?
- Are the sectoral stimuli efficient?

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### Macro policy criteria, continued

- Is the bank rescue plan effective?
- Is the bank rescue plan efficient? (i.e. smallest possible deficit)
- Will the bank reregulation be sufficient?
- Will the plan as whole reduce income inequality? {c}
- Will the plan as whole help create the lasting political coalition needed to sustain the plan? {c}

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### How does the Obama/Bernanke plan rate? {c}

- The stimulus package: B
  - Too small overall, too much wasted tax cut
- The bank rescue: D+
  - Putting banks in receivership would be vastly cheaper
- Bank reregulation: incomplete, signs of C work
- Growth policy: B+
  - Good mix, absence of health cost containment hurts.
- Income equality: B
  - Bank bailouts, lack of universal health coverage hurts
- Deficit policy: incomplete, signs of B work
- Overall macro grade: A-
  - Amazing coalition put together quickly

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### My economic crystal ball {c}

- The forecasters tend to expect GDP to resume increasing by the end of 2009.
- That disagrees with my (highly fallible) intuition because
  - This is first world-wide depression since the 30's
  - There are signs of deflation
  - The stimulus package appears too small
  - No alternative growth engine has been identified
  - The banks aren't out of the woods yet
- Most forecasters agree: unemployment will keep rising at least through 2010.

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### My political crystal ball {c}

- Obama pushes through some kind of health insurance reform.
- Obama pushes through a second stimulus package, if it's needed.
- Obama's mandate is then used up by
  - Excessive costs of bank bailout
  - Endless war in Afghanistan and Pakistan
  - Absence of health care cost containment
- Nevertheless Obama coasts to close re-election based on accomplishments.

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5-8-09

## END

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Ad Astra Institute      Stimulus vs deficit      36  
5-8-09