Insight

Role Reversal: Europe Rejects Big Government Stimulus

DOUGLAS HOLTZ-EAKIN | JUNE 7, 2010

The news out of the G-20 meeting in South Korea is that Europeans are rejecting U.S. Treasury Secretary Geithner's calls for more fiscal stimulus. Small wonder.

The Administration's Keynesian stimulus bill was originally $787 billion, but because unemployment is higher than expected it has grown to over $1 trillion (including interest). The scale is genuinely staggering – it is larger than the entire Pentagon budget – and it was done in essentially three weeks.

There are numerous flaws that suggested from the get-go it would be an inefficient effort:

- The money takes too long to go out, producing spending in 2011 and 2012, too late in hitting the economy.
- The tax cuts did not improve incentives by cutting tax rates. Instead, they were disguised spending programs taking the form of refunds and checks.
- The sheer scale, with many programs ramping up by 100, 200, or 300 percent, guarantees there will be waste and inefficiency.
- It is not genuinely focused on stimulus – it includes elements that are really the Administration's domestic policy agenda. There are billions of dollars for health information technology, energy, infrastructure, and education that are not about stimulus.

There is great evidence that it has been terribly effective. The chart below shows actual GDP during 2009. It also shows what would have happened if the trajectory at the start of 2009 had continued the entire year (labeled "Continued Decline") – that is, the graphical version of “the economy was falling off a cliff.” The shaded area is the difference – the additional GDP from not continuing to decline – and totals $268 billion.

Stimulus tax cuts and spending in 2009 were roughly $260 billion. Thus, if one attributes all improvement in GDP to the stimulus – no role for the Fed, no role for mortgage relief programs, no role for worldwide economic improvement – then stimulus essentially broke even and provided no multiplier effects. Of course, these assumptions may be too pessimistic. Using the same logic, if the economy had been flat in 2009, stimulus would be responsible for $63 billion in additional GDP – a payoff of only 25 cents on the dollar.

This is not terribly surprising. This kind of fiscal fine-tuning was business as usual in the 1970s. The upshot of that approach was high inflation, no consistent reductions in unemployment, and ultimately pervasive distrust in the ability of the government to accomplish any of its goals.

Un the U.S. recession 8.4 million jobs were lost; construction lost 1.9 million jobs, manufacturing lost 2.1 million jobs, and services have lost 3.5 million jobs. As a result of the job losses, the unemployment rate in January, February and March of 2010 was 9.7 percent, in April we jumped up to 9.9 and May returned to 9.7. Most analysts expected it to rise before it declined. Including discouraged workers and those working less than full time involuntarily, 17.1 percent of the labor force was underemployed in April, and reduced to 16.6 in May, but this number is largely due to the hiring of temporary Census workers.

European leaders looking at this evidence must be mystified as to why the Administration would want them to repeat such fiscal folly and labor market pain.