

CRISIS NO MORE

The Success of Obama's Stimulus Program

BY GARY BURTLESS

The recession that began in December 2007 ranks as the worst since World War II. It carved a huge slice out of Americans' financial wealth and caused the biggest percentage decline in employment of the post-war era. Even though the stock market rebounded in 2009 and U.S. output began to grow in the second half of that year, the recession continues to take a terrible toll on the incomes and psychological health of many families.

No one should confuse the recent recession with the Great Depression, however. Two key features of that depression made it "Great"—its severity and its duration. Between 1929 and 1933, real GDP in the United States fell almost 27 percent. U.S. GDP did not return to its 1929 level until 1936. Real personal consumption declined more than 18 percent. In 1933, about one out of every four Americans in the labor force was jobless. The National Bureau of Economic Research (NBER), which is in the business of dating recessions, estimates that after reaching a cyclical peak in August 1929, the U.S. economy shrank for the next 43 months, by far the longest period of uninterrupted economic decline in the twentieth century. In the 10 downturns since World War II, excluding the most recent one, the average recession lasted just 10 months. Even the longest post-war recessions, in 1973–1975 and 1981–1982, lasted only 16 months.

As of this writing, NBER has dated the onset of the recession (December 2007) but has not yet determined its end date. The recession will not last 43 months, however. The economy began to grow again in the summer of 2009, and the unemployment rate started to decline late in the same year, less than 24 months after the recession began. Real GDP probably fell less than 5 percent from its previous peak. The number of private payroll jobs began to increase in the first quarter of 2010. The peak unemployment rate will almost certainly be less than 10.5 percent, far below the peak unemployment rate attained in the 1930s and somewhat below the peak unemployment rate hit during the 1981–1982 recession.

The tea leaves are clear: The Great Recession will not be a second Great Depression. And, as I argue below, President Obama's stimulus package, though imperfect, deserves a great deal of credit for bringing us back to the positive trajectory we're on today. Any reasonable grader of the stimulus's effects on driving recovery and combat-



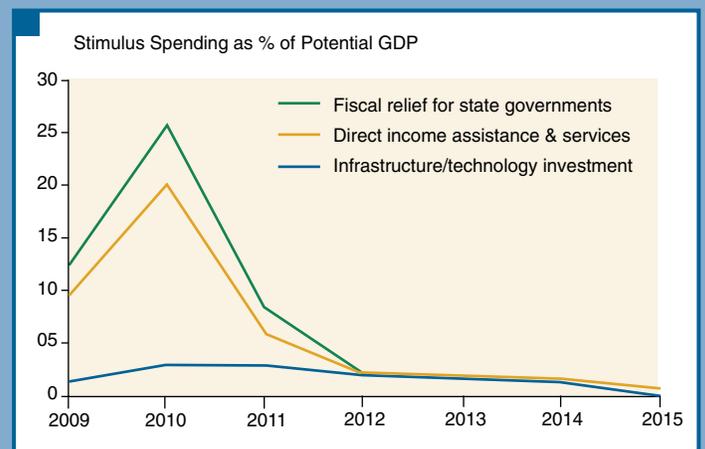
ing joblessness would give the stimulus at least a B+. In the pages that follow, I first outline the size and contours of the government's response to the recession, paying specific attention to how this response does and does not differ from government policy in recessions past. I distinguish between standard and nonstandard responses, that is, policies typical of those in other post-war recessions and those that are unusual. Then I consider the success of the policies and the public's surprisingly hostile reaction to them. Voters' sour views on the stimulus make it unlikely Congress will extend or expand the program, even if the economy takes a turn for the worse.

The Scope of the Response

Last year, in fiscal year 2009, the federal government pumped stimulus amounting to about 1.25 percent of national income into the economy. This year, the stimulus package will inject about twice that amount (see Figure 1). The stimulus dollars are targeted toward four main objectives: (1) protecting the incomes and health insurance of newly laid-off workers and other economically vulnerable populations; (2) providing immediate stimulus to consumer spending by raising after-tax household income through temporary tax reductions and increases in some transfers; (3) offering temporary fiscal relief to state and local governments in order to reduce their need to boost taxes or reduce spending in the recession; and (4) providing direct federal support for infrastructure investments and research and development projects in health, science, and efficient energy production. Figure 1 combines spending on the first two items into a single category, direct income assistance and services. In the first two years of the stimulus program, spending on this category represents by far the largest component of the federal

response. Understanding the composition of the response is key to understanding how the stimulus succeeded in pushing the economy toward recovery. As I argue below, the stimulus packages enacted in 2008 and 2009 contained both standard and nonstandard responses as compared to prior recessions. Understanding the scope and mix of the packages points us to a broader understanding of how and why the government response was crucial for heading off a much deeper crisis.

FIGURE 1 Expected stimulus spending under the American Recovery and Reinvestment Act of 2009, fiscal years 2009–2015



Sources: Congressional Budget Office and Joint Committee on Taxation

Standard Responses

It is not unusual for the government to accelerate spending on public infrastructure projects during a recession. Congress also often provides temporary tax cuts to stimulate consumption and business investment when the economy is weak. It did so again in this recession. In fact, the tax cuts in the American Recovery and Reinvestment Act (ARRA), mostly for households, account for about 45 percent of total stimulus spending in 2009 and 2010. In addition, Congress nearly always offers extensions of unemployment benefits when joblessness is high. It did so in this recession too.

The most important protection American workers receive when they are laid off is unemployment insurance (UI). Newly laid-off workers are typically eligible for up to six months of UI benefits after they lose their jobs. By the standards of other industrial countries, the six-month limit on benefits is rather short. Of the 21 richest industrial countries, 15 provide jobless benefits that last a year or more. Unemployed workers in these countries receive much better social protection if their unemployment lasts a long time. Unemployment protection lasts longer in the United States when the jobless rate soars. When a state's unemployment rate rises above a certain threshold, workers in that state are supposed to receive additional weeks of benefits, with the number of extra weeks linked to the increase in the state's unemployment rate.

In every recession since the late 1950s, Congress has enacted a federally funded extension of UI benefits. The extension in 1975–1977 was particularly generous, providing the unemployed with benefits that could last up to 65 weeks. Congress provided somewhat less generous special benefit extensions in more recent recessions. The benefit extension provided in the 2009 ARRA was far more generous than that offered in any previous U.S. recession. By the fall of 2009, laid-off workers in high-unemployment states were eligible for federally funded benefit extensions that could last up to 73 weeks, providing them with a total of up to 99 weeks of benefits after a layoff. In 2009, Congress also funded an increase in unemployment benefits equal to \$25 per week, or about 8 percent of the previous average benefit amount. In sum, the 2008 and 2009 stimulus packages greatly expanded the income protection available to the unemployed, both in comparison to the protection ordinarily available in a recession and in relation to the protection offered in other industrial countries. The generosity of U.S. benefits is still far less than it is in some other rich countries, but at least in this

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recession we are closer to the Organisation for Economic Co-operation and Development's (OECD) average.

Nonstandard Responses

In addition to these traditional actions, the Obama administration and Congress also took a number of more unusual steps to lessen the adverse effects of the recession. One of the most surprising was the provision of generous federal subsidies to help unemployed workers pay for health insurance. This subsidy, which was originally limited to nine months per worker, covers 65 percent of the cost to laid-off workers of continuing their coverage under their former employer's health insurance plan.

Most working Americans who are not poor receive health insurance through an employer or the employer of another wage earner in the family. Employers typically pay for most of the premium cost of the insurance. When workers are laid off they ordinarily lose the employer subsidy. The total, unsubsidized cost of health insurance is notoriously high, around \$5,000 a year for single workers and \$13,000 for workers with a spouse and one or more child dependents. These premiums are 10 percent and 32 percent, respectively, of the average year-round wage of American workers. Not surprisingly, comparatively few workers can afford to pay the full cost of these premiums after they are laid off. The result is that many laid-off workers lose their health insurance when they lose their jobs. In no previous recession were laid-off workers offered a generous public subsidy to pay for an extension of their private health coverage.

Two other aspects of the 2009 stimulus package were exceptional. First the ARRA provided unusually generous fiscal relief to state governments. Second, it offered large, though temporary, incentives for states and young adults to invest in education and training.

By my estimate a little more than one-fifth of the 2009 stimulus package, or a total of \$175 billion, will be devoted to providing fiscal relief to state governments. This relief is provided in a variety of forms. Some federal grants were authorized to help pay for local law enforcement, for example. Nearly \$30 billion was authorized to fund aid for particular aspects of state and local education. Most of this was targeted at education for the economically disadvantaged and for children who have learning or other disabilities. Since state educational spending is fungible, however, it is likely that the extra federal funds earmarked for one educational purpose can be reallocated to other educational

functions at the discretion of state and local policymakers.

Congress created two temporary programs to provide general fiscal relief to the states. One gives almost \$50 billion to be divided among the states “in order to minimize and avoid reductions in education and other essential services.” In exchange for the grants, state governments must show they are making unspecified progress in a number of broad areas. All 50 states have submitted applications for these funds, and the applications will receive nearly automatic approval from federal officials.

A second form of fiscal relief was provided through a temporary change in the funding formula for Medicaid, the federal-state public health insurance program for low-income Americans. Medicaid is administered by state governments, but most of its costs are financed with large federal grants. The fraction of costs paid by the federal government is determined by a formula that links a state’s federal reimbursement rate to the state’s per capita income. States with high average incomes ordinarily get 50 percent of their Medicaid program costs reimbursed, while states with low average incomes receive a higher federal subsidy rate. Medicaid is one of the most costly government programs. In 2007, benefit payments under the program represented 2.8 percent of GDP. This means the federal government’s Medicaid grants to state governments are a major source of state revenues. By changing the funding formula, the federal government can dramatically raise or lower total state revenues. The 2009 stimulus package temporarily changed the matching formula to make it much more favorable to states. The CBO estimates that the cost of the temporary formula change to the U.S. Treasury will be \$90 billion spread over three years.

All of the temporary measures just described provide immediate relief to state governments. Unlike the federal government, which can borrow unlimited funds to pay for its operations, state governments must generally cover the cost of their operations with current tax revenues, fees, or grants from the federal government. Because states were given generous fiscal relief, state legislatures did not have to cut spending or increase taxes as much as would have been necessary in the absence of federal aid.

Federal fiscal relief to the states is particularly important for education and for maintaining social protection to the poor. In the United States, education is primarily the responsibility of state and local governments. The federal government typically pays for only about 10 percent to 12 percent of the total cost of public primary and secondary schools. State and local governments pay for the rest. Since balanced budget

rules make state and local budgets pro-cyclical, state legislatures face pressure to reduce school budgets during recessions. The federal government pays for most of the cost of social safety net programs for the poor, but state governments still pay for a substantial share of these costs. Equally important, state governments are responsible for administering some of the biggest programs targeted toward the poor, including Medicaid and Temporary Assistance for Needy Families (TANF). State governments make the rules that help determine who is eligible for benefits, and they set the level of many benefits. Even though they do not pay for the full cost of the programs, when a recession occurs, many states are tempted to curtail eligibility or cut benefits. This is the opposite policy from the one urged by most economists, who think it is important for benefits to be maintained or even improved in a recession. Thus, the federal government’s unconventional policy of temporarily easing states’ strained budgets almost certainly prevented a weakening of the state and local social safety net.

A Success or a Failure?

Before 2009, state fiscal relief and temporary incentives for human capital investment rarely, if ever, played a big role in federal stimulus programs. As a result, we have little evidence to predict the short-term impact of these measures on government and household consumption. Based on evidence of state spending patterns and post-secondary educational investments in the current recession, we will learn more about the counter-cyclical effectiveness of these two kinds of policies. One encouraging sign is that payroll employment in state and local government and in education has not been badly hurt by the recession. In spite of the sharp decline in state and local tax revenues, governments have been able to maintain their pre-recession employment levels. It may be that state and local employees’ annual wages and benefit costs have been trimmed, because many governments have forced their workers to accept unpaid furloughs. However, the payroll employment statistics provide little evidence of a massive cutback in the number of state and local employees.

Anecdotal evidence suggests the federal government’s efforts to support education and human capital investment have probably succeeded. Many public and private post-secondary institutions report strong demand for places in their entering classes. Profit-making training institutions also report surging demand. If the recession has made post-secondary education and training unaffordable

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to more students, the application data provide little evidence for it. Some hard data on college enrollment also suggest college attendance remains high. The Bureau of Labor Statistics reports that 70.1 percent of 2009 high school graduates were enrolled in college last October. This is an all-time high in the percentage of graduates going on to college. The enrollment rate should have plummeted if students couldn't afford to attend college or if post-secondary institutions had been forced by budget cuts to slash their staffs.

Another tangible sign of a payoff from the ARRA stimulus is the continued strength in consumer spending. The severity of the recession caused private incomes to plunge. The solid dark line in Figure 2 shows the trend in real private income—labor compensation, self-employment income, interest, dividends, and other capital income—between 2007 and February 2010. Private income began to fall in the fourth quarter of 2007, fell sharply immediately after the worst of the financial crisis in late 2008, and did not stabilize until the summer of 2009. After June 2009, Americans' private incomes were more than 6 percent below their pre-recession level.

The broken line in Figure 2 shows the trend in real personal disposable income—that is, private income plus government transfers minus personal tax payments. Federal government programs and stimulus dollars cushioned the massive blow to private family incomes. Disposable income fell less than 1 percent after the start of the recession, a stunning fact too often ignored given the severity and length of the current downturn. Reduced federal taxes and increased government benefit payments, partly funded out of the stimulus package, have kept Americans' spendable incomes from falling as fast as their private incomes. Household consumption fell in the recession, in spite of the massive swing in taxes and public transfers, but

it only fell modestly. Americans were made cautious in their spending because of the drop in their personal wealth and fear of losing their jobs. But government benefits helped boost the spending of the unemployed, and lower taxes helped insulate middle class families from some of the effect of the drop in wealth. By the beginning of 2010, personal consumption spending was close to its pre-recession level.

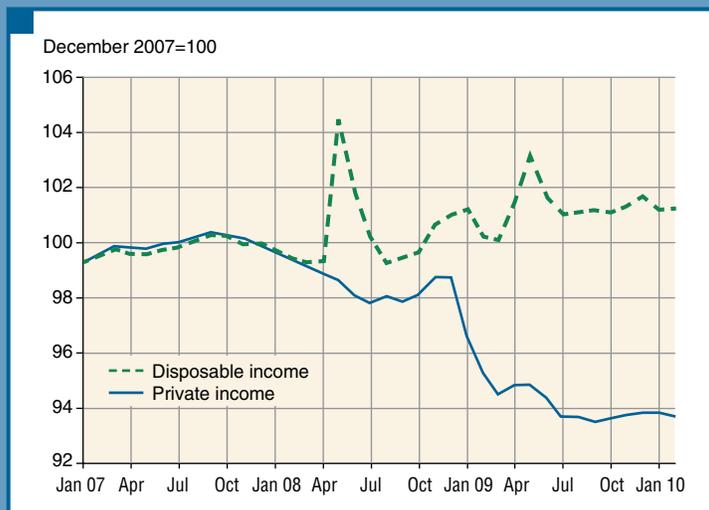
Could the administration and Congress have done better? The 2009 stimulus package should almost certainly have been larger. The administration's own forecast implied that the gap between actual and potential national output was big enough to justify a bigger package than the one Congress adopted. The political reality, however, is that opposition to stimulus spending by conservatives in the Senate precluded a larger package. In fact, Congress passed a smaller stimulus than the one the president asked for. In retrospect, the package should also have included a much bigger allocation for new government capital spending—on roads, mass transit, public buildings, and environmental capital projects. This investment would directly provide jobs to workers in construction and capital goods manufacturing, industries hard hit by the recession. The objection to this kind of spending is that the money often funds questionable projects and is spent with too great a lag to do much good. These objections carry more weight when a recession is short and when petty political considerations play a big role in deciding which projects deserve funding. In this recession, the job market downturn is likely to last a long time, so even delayed capital spending is likely to do some good. The administration and Congress should have been able to fund capital projects based on their economic merits rather than influence peddling.

Even though the government's anti-recession policies have been reasonably successful, the public regards them with deep skepticism. A CNN poll in mid-January showed that about three-quarters of Americans believe that half or more of the stimulus spending has been wasted. Forty-five percent think "most" or "nearly all" of the stimulus dollars have been wasted. This harsh verdict is unjustified, but it affects the political climate in Washington. Congress is unlikely to pass a major expansion of the stimulus, even if the economy sinks and joblessness rebounds.

The recession has been severe. Unemployment has risen more steeply than in any other post-war recession. Two administrations and Congress put into place a number of counter-cyclical policies that have prevented the recession from metastasizing into a depression. As I have argued above, there are many indications that these policies have been successful in achieving their intended goals. Unfortunately for the policymakers who supported the policies, "It could have been much worse" is seldom a winning slogan in a political campaign.

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FIGURE 2 Trend in U.S. real disposable personal income and real private income. January 2007–February 2010



Source: Bureau of Economic Analysis, U.S. Department of Commerce