OPINION

The Stimulus Didn't Work

By John F. Cogan, John B. Taylor And Volker Wieland

Is the American Recovery and Reinvestment Act of 2009 working? At the time of the act's passage last February, this question was hotly debated. Administration economists cited Keynesian models that predicted that the $787 billion stimulus package would increase GDP by enough to create 3.6 million jobs. Our own research showed that more modern macroeconomic models predicted only one-sixth of that GDP impact. Estimates by economist Robert Barro of Harvard predicted the impact would not be significantly different from zero.

Now, six months after the act's passage, we no longer have to rely solely on the predictions of models. We can look and see what actually happened.

The data show government transfers and rebates have not increased consumption at all.

Consider first the part of the package that consists of government transfers and rebates. These include one-time payments of $250 to eligible individuals receiving Social Security, Supplemental Security Income, veterans benefits or railroad retirement benefits—and temporary reductions in income-tax withholding for a refundable tax credit of up to $400 for individuals and $800 for families with incomes below certain thresholds. These payments, which began in March of this year, were intended to increase consumption that would help jump-start the economy. Now that a good fraction of these actions have taken place, we can assess their impact.

The nearby chart reviews income and consumption through July, the latest month this data is available for the U.S. economy as a whole.

Consider first the part of the chart pertaining to the spring of this year and observe that disposable personal income (DPI)—the total amount of income people have left to spend after they pay taxes and receive transfers from the government—jumped. The increase is due to the transfer and rebate payments in the 2009 stimulus package. However, as the chart also shows, there was no noticeable impact on personal consumption expenditures. Because the boost to income is temporary, at best only a very small fraction was consumed.

This is exactly what one would expect from "permanent income" or "life-cycle" theories of consumption, which argue that temporary changes in income have little effect on consumption. These theories were developed by Milton Friedman and Franco Modigliani 50 years ago, and have been empirically tested many times. They are much more accurate than simple Keynesian theories of consumption, so the lack of an impact should not be surprising.

Indeed, one need not have looked any further than the Bush administration's Economic Stimulus Act of 2008 to find plenty of evidence that temporary payments of this kind would not jump-start consumption. That package made one-time payments and rebates to people in the spring of 2008, but, as the chart shows, failed to stimulate consumption as had been hoped. Some argued that other factors such as high oil and gasoline prices caused consumption to fall during this period and that consumption would have been even lower without the stimulus, but no significant impact of these rebates is found even after controlling for oil prices.

Consider next the government-spending part of the stimulus package. The Obama administration points to the sharp reduction in the decline in real GDP from the first to the second quarter of 2009 as evidence that the package is working. Economic growth was minus 6.4% in the first quarter and minus 1% in the second quarter, so the implied improvement of 5.4 percentage points is indeed big. But how much of that improved growth rate can be attributed to higher government spending due to the stimulus? If we rely on predictions of models, again we see disagreement and debate. According to our research with modern macroeconomic models, the increase in government spending would add less than a percentage point, a relatively small portion. The model predictions cited by the administration's economists suggest a much larger portion: two to three percentage points. Prof. Barro's model predicts zero.

So let's look at the data on the contributions of government spending and other components of GDP to the 5.4 percentage-point improvement. By far the largest positive contributor to the improvement was investment—which went from minus 9% to minus 3.2%, an improvement of 5.8% and more than enough to explain the improved GDP growth. Investment by private business firms in plant, equipment and inventories, rather than residential investment, were the major contributors to the investment improvement. In contrast, consumption was a negative contributor to the change in GDP growth, because consumption growth declined following the passage of the stimulus package.

One is hard put to see what specific items in the stimulus act could have arrested the decline in business investment by such a magnitude. When one looks at monthly investment indicators—such as new orders for nondefense capital goods—one sees a flattening out starting early in the first quarter of 2009, well before the package went into operation. The free fall of investment orders caused by the financial panic last fall stabilized substantially by January, and investment has remained relatively stable since then. This created the residue of a very large negative growth rate from the fourth quarter of 2008 to the first quarter of 2009, and then moderation from the first quarter to the second of 2009. There is no plausible role for the fiscal stimulus here.

Direct evidence of an impact by government spending can be found in 1.8 of the 5.4 percentage-point improvement from the first to second quarter of this year. However, more than half of this contribution was due to defense spending that was not part of the stimulus package. Of the entire $787 billion stimulus package, only $4.5 billion went to federal purchases and $17.7 billion to state and local purchases in the second quarter. The growth improvement in the second quarter must have been largely due to factors other than the stimulus package.

Incoming data will reveal more in coming months, but the data available so far tell us that the government transfers and rebates have not stimulated consumption at all, and that the resilience of the private sector following the fall 2008 panic—not the fiscal stimulus program—deserves the lion's share of the credit for the impressive growth improvement from the first to the second quarter. As the economic recovery takes hold, it is important to continue assessing the role played by the stimulus package and other factors. These assessments can be a valuable guide to future policy makers in designing effective policy responses to economic downturns.

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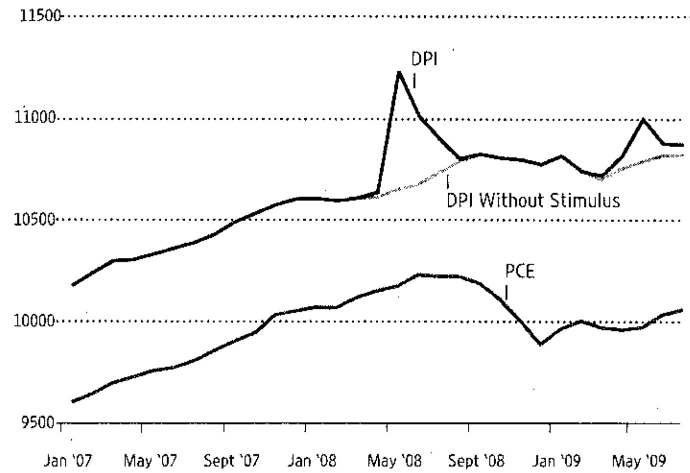
Rebates Fail to Jump-Start Consumption

(DPI = disposable personal income; PCE = personal consumption expenditures)



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