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ECONOMIC VIEW

Don’t Let the Stimulus Lose Its Spark

By ROBERT H. FRANK

ENCOURAGING economic news has been reanimating the critics of President Obama’s stimulus program. But heeding their admonition to end the program would be a grave mistake. We need more stimulus now, not less.

Even if the economy is improving, it is still very weak. Another quarter-million jobs were lost last month, and even the most optimistic economists predict that it will be many more months, if not years, before robust employment growth resumes. Now we face an ominous new threat to recovery from sharp cuts in state and local government spending.

The more than $15 billion excised from California's budget last month was just a small fraction of recently announced cuts. Although some people object to the federal stimulus program on grounds that government spending is inherently inefficient, most recent state cuts have been for services widely viewed as essential. These cuts were mandated by laws meant to stop politicians from spending beyond their means. While such measures may be beneficial on balance, sharply reduced government spending is exactly what the economy doesn't need right now.

Through its legal authority to run deficits to stabilize the economy, the federal government can keep recovery on track by transferring revenue to states and cities. Of course, opponents of the original economic stimulus program have no desire to see it extended this way. Yet they haven't made a persuasive case. The flaws in their arguments don't rise to the absurd heights seen in recent town hall meetings on health care reform. But it is a difference in degree, not kind.

Both proponents and opponents of the stimulus program agree that unemployment is high because aggregate spending levels are too low to create jobs for everyone. Where they disagree is about the remedy. Proponents believe that sharply higher government spending will hasten the downturn's end. Opponents say no.

Stimulus proponents begin with the observation that before late 2007, total spending was enough to support full employment. But then consumption, which had been inflated by home equity loans based on illusory housing prices, fell sharply, and it is likely to remain below 2007 levels indefinitely.

That decline caused a parallel fall in investment, because most businesses already had the capacity to produce more than people wanted to buy. Here, too, spending is likely to remain depressed for many months. And with the economies of many other countries also in the doldrums, demand for American exports is unlikely to pick up the slack.

The only remaining major component of aggregate demand is government spending. Stimulus proponents, following John Maynard Keynes, believe that increased government spending — financed by borrowed funds or printing new money — is the only way to bolster aggregate demand and end the downturn quickly. Recent results suggest that this strategy is working.

In a recent column in Forbes magazine, the economist Lee Ohanian of the University of California, Los Angeles, a stimulus opponent, explained why he believes that increased government spending wouldn't help the situation. The problem, he says, is that "the higher taxes on incomes or expenditures that ultimately accompany higher spending depress economic activity." Because the short-run stimulus program has been financed with borrowed money, not higher taxes, Mr. Ohanian must have in mind future taxes needed to pay off stimulus-related debt.

His argument, and that of stimulus opponents generally, thus boils down to this striking contention: As the government spends borrowed funds, consumers will start to realize that the resulting debt spells higher taxes in the future, which will lead them to curtail their current spending. Those cuts will offset increased government spending, leaving no net stimulus.

Although there may be people who would actually spend less now to hedge against uncertain future tax bills, it's unlikely that you know any of them. As behavioral economists have been saying for decades, that's just not the way most people act. Hardly any consumers even know how big the national debt is, much less how it will affect future taxes.

MORE important, there are good reasons for believing that stimulus spending will make people's future tax payments lower, not higher. Yes, government borrowing adds to the national debt. But if the stimulus also hastens the downturn's end, it will accelerate the growth of future incomes and tax revenue. In that case, the net effect would be to reduce future taxes, compared with what they would have been without the stimulus.

And even if we run with the notion that stimulus spending will increase future taxes, it doesn’t follow that consumers will cut back on spending now. After all, we know that most people already fail to save enough for their retirement. Why would they alter their behavior to hedge against uncertain future taxes?

The recent state and local spending cuts are a major setback to the stimulus program, which many economists have argued was much too small to begin with. A small minority disagrees but has not offered persuasive arguments.

The downturn threatens every goal we care about. Doing everything possible to limit state and local spending cuts will help end it faster.

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