INSTITUTE FOR FINANCIAL STUDIES

# BARACK OBAMA's ECONOMIC STIMULUS PLAN

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Barack Obama's first steps as the US president-elect illustrate his intention to address the needs of voters, many of whom are low-income earners. However, his moves echo the previous administration's policy: the scale and scope of the problems and absence of a clear recovery plan prompt the authorities to focus on short-term objectives.

Tax stimulus package and setting up a 'bad' bank to accumulate toxic assets are parts of this policy.

***1. Tax cuts (approved by the Congress January 28, 2009).***

- The overall measure costs $819 billion including $275 billion in tax cuts. A total of $526 billion might be spent in the coming two years. $ 275 billion will go for tax rebates for taxpayers, tax credit for low-income people, extending lending to public works projects to create jobs and invest in the US economy as well as tax refunds to companies that would want to record current losses as the past years' profits;

- $36 billion will go towards increases in unemployment benefits including medical aid;

- $166 billion will be allocated for states and municipalities for educational ($79billion) and health programs for low-income people ($87 billion);

- $350 billion will be infrastructure spending;

- $25 billion will cover tax stimulus to encourage development of alternative sources of energy;

- $69 billion will go toward holding down middle-class Americans' taxes through adjusting the alternative minimum tax (AMT Tax Relief) (an analogue of the imputed income tax);

- besides, there is a provision to increase child tax benefits and introduce $7.5 thousand tax credit for first home buyers.

**Major drawbacks of Obama's plan**

1. The plan will require new legislation (to be worked out and passed) which might hurt applicability of the proposed measures.

2. The improvement measures primarily target low-income earners; that means that consumer activity will grow in a short term (the plan's mid and long run effect will be very weak).

3. Businesses take investment decisions relying on estimated aggregate demand and overall condition of the capital market. It means that no tax incentives would encourage companies for capital investments unless there are favorable conditions for that (tax reliefs will just trigger of malfunctioning of the market mechanisms).

4. Tax reliefs for first home buyers will hardly be an effective stimulus for making a purchase under the circumstances of a continued correction in the US house market.

5. The measures to support households would resurrect the plan adopted in February 2008. The last year's plan had a slight short-term impact on the economy – tax rebates were mainly used to repay credit card debts or saved (exactly in the line with the permanent income model).

6. We think that it is erroneous to include measures to support households and businesses in a financial difficulty and, for instance, the energy efficiency provisions in one package. Provisions like this should be viewed in the long-term perspective.

7. The plan initiators estimated that the administrative expense multiplier would total 4.6 (i. e. the aggregate effect will be 4.6 times as large as the expenses). However, the recent research revealed that the administrative expense multiplier, from the postwar period until now, has been varying from 1 to 1.4[1] (i.e. the use of state expenses as an instrument of economic activity stimulation often proves ineffective). Tax cuts might prove slightly more efficient (tax multiplier stands at 3.0[2] – the reason of such a big difference between the two multipliers has not been figured out so far). However, this is still not enough to reach the targets set in the plan. Another weak point is the plan's focus on short-term rather than long-term objectives. If the plan is carried out, the US public debt will exceed 100% of the GDP. Nonetheless, the authors, most likely, do not care about the future budget policy (all estimates are made up to 2010 while the state budget deficit in 2009 is estimated at $1.186 billion – not taking into account the newly passed plan). The plan might complicate the problem of handling future budget and debt policies – for which the authorities have no solution so far.

Thus, it may be more rational to focus on long-term objectives, such as health care and pension reforms, instead of spending huge money for short-term tasks thus badly hurting the US economy.

***2. Launching a bank to buy bad assets***

At present, the US authorities consider setting up a bank to accumulate troubled assets. It is not clear in what way this plan differs from the initial idea to use TARP funds for buying bad assets from banks. A key question would be how to value the bad assets and handle negative political consequences of laying banks' risks on taxpayers.

[1] Valerie A. Ramey, Indentifying Government Spending Shocks: It's all in the timing, NBER, Last Draft: June 2008

[2] Christina and David Romer, The Macroeconomic effect of tax changes: Estimates based on a new measure of fiscal shocks, University of California, Berkeley, March 2007