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The Bush-Obama Stimulus Programs and the Future of American Capitalism

Dr. Randall Holcombe[*]

ABSTRACT

This paper discusses the implications of the measures that the U.S. Federal Government has taken in response to the recent financial crisis. It focuses on the Federal Reserve, the Troubled Asset Relief Program, the Obama stimulus package, and the bailouts of various industries by the Federal Government. This paper argues that these policies undermine the fundamental incentives of the market economy, but what we can learn from these policies to avoid similar negative consequences in the future.

I. INTRODUCTION

What is the impact of the Bush and Obama stimulus programs on the future of American capitalism? To adequately address this question, one must consider the nature of American capitalism, how it has produced the great prosperity that we have, what underlies the foundation of American capitalism, and how some of the policies of the past two years threaten those foundations.

Think about the remarkable economic progress that we have achieved—our standard of living, driving around in our automobiles, flying in planes, using cell phones, the iPod, and the Internet. The worldwide web only started in the early 1990s. This remarkable economic progress started with the industrial revolution in 1760, with developments beginning in Britain, and spreading to the rest of the world.[1] One can see the sluggish advancement of standards of living for previous generations by examining their lifestyle, food, methods of production, and consumer goods. Economic progress was so slow that people would not have noticed it in their lifetimes. Life in 1750 was not that different from life in 1650. Likewise, life in 1650

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was not that different from life in 1550 and life in 1550 was not that different from life in 550.

There were about a thousand years of remarkable advances in civilization. Ancient Rome and China had incredible advances in their civilization. However, by about 550 A.D. that economic progress essentially slowed to a crawl and virtually stopped. Essentially, someone who slept in 550 and woke up in 1550 would not see that much difference in how people lived, how they consumed goods, and how they produced those goods.

After the industrial revolution, remarkable economic progress began and is still going on today. Profits and losses in a market economy created the foundation of this economic progress. Profits give people an incentive to look for ways to be productive and to help other people, so entrepreneurs and innovators look for innovations that they can introduce into the economy. Profits play several closely related roles in an economy. Think about our economic well-being, if somebody takes resources and combines those resources into output, and the value of the output is greater than the value of the resources used to produce the input. Increased value benefits all by increasing value in the economy.

We should reward people who take less valuable inputs and turn them into output that is more valuable. In fact, the market economy does that. That is the role of profit. If somebody takes resources that have a certain value and they combine them into output that is worth less than the value of resources that they started with, they are reducing value in the economy. We should penalize people who do that. Losses penalize people who allocate resources inefficiently. Conversely, profits reward people who allocate resources efficiently. Those profits and losses provide incentives in an economy for entrepreneurial individuals who are looking for innovations if they can come up with innovations to increase value in an economy. That profit acts as a lure to give innovators an incentive to be innovative and entrepreneurial.

At the same time, that profit gives people an incentive to take risks, the possibility of losses also gives them an incentive to be prudent in the risks that they take, so that they do not take excessive risks. Profits and losses are a necessary foundation for the operation of the market economy for this remarkable economic progress that we have had over the past 250 years. That is not that long in the history of mankind. This is something relatively recent and is on-going that people tend to take for granted. If we look at the policies that resulted in the economic downturn of the past year and a half, a number of cases depict economic policies that undermine the fundamental role of profits and losses in the economy.

People talk about the health care reform bill, which is in the forefront of public discussion. People are concerned about the huge budget deficits that the Obama Administration is forecasting. This is not a partisan critique because many of these policies began under the Bush Administration. The Bush-Obama policies are a bipartisan effort to undermine the fundamental incentives of our market economy. There are four areas related to the policy. First, there is the role of the Federal Reserve. Second, there is the Troubled Asset Relief Program (TARP). Third, is the Obama stimulus package, and the fourth concern is the bailouts.

II. The Role of the Federal Reserve

The Federal Reserve was set up to be a bank for member banks. Members of the Federal Reserve System borrow from the Federal Reserve through the discount window. The Federal Reserve was established for the sole purpose of making loans to member banks. Over the years, the Federal Reserve's role has evolved. Now, one of the most important functions of the Federal Reserve is to control the size of the money supply through open market operation. Open market operation is the buying and selling of Federal Government securities.

Over the past year and a half, under Chairman Bernanke, Federal Reserve policy has changed substantially. This was a bipartisan effort. These things began during the Bush Administration when Ben Bernanke was appointed chairman of the Federal Reserve by President Bush. Of course, one of the major events that we saw in September 2008 was the Federal Reserve bailing out AIG. It is without precedent that the Federal Reserve would spend $85 billion to bail out American International Group (AIG) as it was on the verge of collapse. Later, the treasury used TARP money to take over AIG with the Federal Reserve, but the Federal Reserve has never bailed out private companies like this.[2] It is unparalleled that a company taking losses and about to go bankrupt was rescued by the Federal Reserve.

The Federal Reserve has started making loans to financial institutions that are not member banks or members of the Federal Reserve System. In fact, they are not even banks. The Federal Reserve began making loans to investment banks and other financial institutions. This is new and unprecedented in Federal Reserve history.

A third action taken by the Federal Reserve was to purchase securities that are not issued by the Federal Government. It now owns and has on its balance sheets securities that it bought from financial firms that are not banks. The Federal Reserve is not sharing information about the securities that it is holding. In 2009, Bloomberg News sued the Federal Reserve under the Freedom of Information Act claiming that they have a right to get the information about what assets the Federal Reserve has purchased and what assets it is holding. As of now, the Federal Reserve has not divulged this information and it is under dispute as to whether that ought to be public information.

Again, it is unprecedented for the Federal Reserve to be buying financial assets from banks that are not members of the Federal Reserve System, and financial institutions that are not even banks. Before the financial crisis, it could be fairly said that the Federal Reserve, while it controlled the money supply and had much to do with regulating banking, was neutral in the way that it operated in the economy and that most firms were treated the same way under objective rules. Now, the Federal Reserve has decided it is going to step in, rescue some firms, and buy financial assets from other firms.

Essentially, the Federal Reserve is engaging in an industrial policy similar to what the Japanese government has been doing for the past half-century. During the 1980s, Japanese industrial policy was heralded as a great way for government to manage economic growth in a high growth economy. Many believed that the reason for Japan's high growth rate was that the Japanese government was getting actively involved in picking preeminent firms in the economy, then helping and supporting those firms. Many in the United States believed that the U.S. should emulate Japanese industrial policy to raise the U.S. growth rate.[3] However, since the early 1990s, the Japanese economy has stagnated, and few still mention the virtues of Japanese industrial policy.

Yet, what the Federal Reserve is doing now is moving exactly in that direction. The Federal Reserve is managing industrial policy in the United States. This is troubling because in helping some firms and choosing not to help other firms, the government is picking winners and losers in the economy, which is undermining the fundamental role of profits and losses in an economy.[4] Former Treasury Secretary Paulson worked for Goldman-Sachs, so it is probably no coincidence that Goldman-Sachs is one of the former investment banks still thriving.[5] Other investment banks like Bear Stearns and Merrill Lynch were acquired, and still others like Lehman Brothers failed.[6] This is because the Federal Reserve, with assistance from the Treasury, was supporting some firms, but not supporting other firms, which sets a very dangerous precedent.

III. THE TROUBLED ASSET RELIEF PROGRAM

The second item of importance is TARP. In late September 2008, Secretary Paulson concluded that the financial system was in a significant amount of trouble. Inter-bank lending had nearly frozen up and financial markets were following suit. The problem, according to Secretary Paulson, was that banks were holding on to certain toxic assets such as mortgagebacked securities that were difficult to value. One might make a loan to a firm that ended up going under next week because of problems with its assets.[7]

Secretary Paulson's solution was the establishment of TARP, which was intended to use $700 billion to buy up those troubled assets. The government would then be holding the toxic assets under TARP, and the banks would get money from the Treasury. The goal was to give other financial institutions an assurance of their financial soundness to help reinvigorate the financial system and get inter-bank lending flowing again. Secretary Paulson claimed that this was an emergency.[8] After about a week of debate, TARP passed through Congress in early October 2008.[9] In retrospect, it seems that it was not necessary because the TARP money was not used for that purpose.

Secretary Paulson requested $700 billion to buy those toxic assets, but that is not what happened to the money. The Treasury had trouble finding ways to buy those toxic assets, and later decided on another plan: buying equity interest in banks. Secretary Paulson's idea was to purchase preferred stocks so that the Federal Government would be a significant stockholder in U.S. banks. Instead of using the money to buy toxic assets like Secretary Paulson had proposed and Congress had approved, the money for TARP was used to partially nationalize the United States banking system.[10]

Secretary Paulson called a summit of the CEOs of the nine largest banks in the United States to inform them that the government was going to buy equity interest in their banks, and become a partial owner of those banks. Many CEOs objected, but Secretary Paulson forced them to take the federal money and have the Federal Government partially nationalize their banks by claiming he did not want some banks opting out of the program while others were in, which would identify certain banks as weak banks. As a result, every bank had to participate in the program, completing a forced nationalization of the American banking system.[11]

After that, the strings attached to this money became apparent. Congress began looking at the executive compensation of these banks and decided that some of the executives were earning too much money considering that the government had just poured $700 billion into their banks.[12] It did not matter that some of the banks originally objected to receiving the money. After seeing the degree of oversight and control that Congress wanted to exercise over them, the banks wanted to get out of the program.[13]

By this time, President Obama had been elected and Timothy Geithner had replaced Paulson as the new Secretary of the Treasury, reinforcing the bipartisan nature of the plan.[14] When the banks asked to buy back the stock held by the government, Geithner decided not to sell the stock back to them just yet. He instituted stress tests that banks had to pass and introduced certain other measures, which essentially prevented the banks from buying back the preferred stock. In other words, he enforced federal ownership of the banks.[15]

One has to wonder what would have happened if Secretary Paulson had initially gone to Congress and proposed a partial nationalization of the banking system rather TARP. Nevertheless, that is what the money was used for, once again initiating a system where the profit and loss aspect that underlies a market economy was undermined. The problem with a system like this is obvious. When the government allows firms to keep the profits, but bails them out in the event that they post a loss, it upsets the profit and loss balance. Firms should be entrepreneurial. They should take prudent risks because that is where economic progress comes from. However, on the other side, firms should be cognizant of the fact that the cost of bad decisions falls on them. Thus, bailouts remove the loss side of that equation, which ultimately will encourage excessive risky behavior on the part of executives.

IV. THE STIMULUS PACKAGE

Exacerbating the situation is the Obama stimulus package, which was about $800 billion. President Obama sought to pass the stimulus package immediately after he took office in order to prop up the failing economy and keep it from sliding further.[16] However, very little of the stimulus bill was actually oriented toward economic stimulus because much of it was spent toward fulfilling President Obama's campaign promises. A sizable amount of that stimulus money was not spent right away, and in fact, there is still more that has yet to be spent out of that $800 billion.

The irony of this is that the consensus among economists is that the economy is recovering, and yet that stimulus money is still coming into the economy.[17] President Obama's argument was that without the stimulus bill, unemployment would rise above 9%.[18] Currently, the unemployment rate is about 9.7%, so by President Obama's own metric—which may be unfair to the president, since perhaps he underestimated the severity of the recession—the economy is in worse shape now than he forecasted it would have been without the stimulus bill.[19]

The underlying logic behind this kind of stimulus spending is basic Keynesian economic policy. During his administration, one of the things that President Bush did twice to stimulate the economy was lowering income taxes. Not only did he lower the rates to give larger refunds on tax day and ensure that citizens would not be paying as much next year, but he sent out checks in the mail to people to stimulate the economy.[20]

According to the ideas of John Maynard Keynes, budget deficits tend to stimulate the economy. Keynes maintains that cutting taxes and increasing government spending provides a fiscal stimulus to the economy. Thus, increased government spending can prop up overall spending.[21] Keynes also proposed doing this without raising taxes because if taxes increase, that takes money out of the hands of the spenders in the economy. Therefore, by running a budget deficit, the economy is stimulated.

When President Bush was elected, the federal budget was in surplus, and for eight years during the Bush Administration, Bush cut taxes and increased government spending, thus increasing budget deficits. If budget deficits really stimulated the economy, by the end of the Bush Administration the United States would have been in nirvana rather than in the worst recession since the Great Depression.[22]

The problem is that the analysis looks at the amount of money being put into the economy, but does not look at where that money is coming from. If the government is spending more money, that money has to come from somewhere. Under this system, consumers are squeezed and investors are crowded out through government borrowing. Thus, Keynesian economics shows the increase in government spending, but not the crowding out that occurs in the private sector. This is another policy that undermines the workings of the market economy.

V. THE BAILOUTS

Another important issue is the bailouts, which are reflected in the bailouts of the banks and the financial firms. The bailouts go further than that, of course, as the government has already bailed out General Motors (GM) and Chrysler. Again, the bipartisan nature of the policy should be emphasized. The bailouts for the auto firms started in the Bush Administration, and were initiated by President Bush himself. If you go back to last fall, the auto companies were saying, “We are running out of money. We are going to have to declare bankruptcy if we do not get an infusion of cash from the Federal Government.” They were begging for a bailout from the Federal Government. One place where automobile industry thought they could get some money was from the TARP program. Secretary Paulson said, “No, TARP money is earmarked for buying toxic assets from financial institutions. That money is not intended to bailout the auto industry.” The issue went to Congress and Congress debated it. Ultimately, they voted to deny a bailout for the auto industry. Last December, Secretary Paulson changed his mind on the TARP issue. He gave tens of billions of dollars to the auto industry to bail them out from the TARP program. TARP money was used to bail out General Motors and Chrysler, to keep them afloat and avoid bankruptcy. It was only a few months later that the Obama Administration gave them more money. In hindsight, this was not a good idea. In June, GM and Chrysler declared bankruptcy anyway. If automakers had gone into bankruptcy in December 2008, it would have been a private affair. Instead of bankruptcy, the auto industry was propped up twice, once in the Bush Administration and once in the Obama Administration, but they eventually declared bankruptcy in June. By that time, the Federal Government had a lot of money invested in those companies. As a result, the government took a significant minority ownership interest in Chrysler, and a 61% ownership interest in GM. This is a nationalized auto company. The Canadian government and the United Auto Workers also own a share of GM, but the stockholders were wiped out. In addition, the bondholders ended up with 10% of the company converted into stock.

The issue of whether it is a good idea to nationalize our auto manufactures can be debated, but it seems that the United States would have been better off keeping GM in the private sector. The country would have been better off letting them declare bankruptcy in December with no federal money, rather than turning them into a nationalized auto company as we did when they declared bankruptcy in June. Once again, that fundamental profit and loss foundation of the market economy is being undermined. Maybe GM and Chrysler could have emerged from bankruptcy. Perhaps they could have reorganized and come out of bankruptcy like Delta Airlines. Delta Airlines reorganized during bankruptcy, and now Delta Airlines is the largest air carrier in the United States. It is possible for a company to emerge from bankruptcy if they have a viable business model.

If GM and Chrysler were not able to reorganize successfully, then valuable assets could have been purchased by other firms because if a firm has assets with any value, those assets do not just disappear when the firm declares bankruptcy. If GM had factories and assembly lines and were making valuable cars, somebody else would have wanted to purchase them, and although GM might have been liquidated for less than GM would like, the assets would still be there if they were worth anything.

Another side effect of federal intervention is that the bondholders ended up getting a bad deal. The bondholders were holding secured debt. The whole idea of secured debt is that in the case of bankruptcy, you get first claim to the assets of the bankrupt firm. That did not happen because President Obama wanted to push through another package and many of the bondholders were willing to go along with it. The major bondholders in GM at the time were JP Morgan Chase, Citigroup, Morgan Stanley, and

Goldman Sachs.[23] They were okay with the Obama plan because they had taken federal money already, and therefore could not really complain when the value of their bonds eroded.

The problem is that this undermines the value of secured debt in general because firms want to issue bonds. Usually when a firm issues bonds, they are telling bondholders that, "In the event of a problem with this firm, if we declare bankruptcy, you have first claim on our assets." This is no longer the case anymore because the Federal Government took a huge share and left the secured bondholders with very little. Again, there was not too much complaining about it because the people who owned many of the bonds were people who were already beholden to the Federal Government because of the TARP program. This is another example of the negative effects of the TARP program.

When President Obama announced his plan, he complained about some of the bondholders who did not like the settlement, and who thought that they deserved more because they were secured debt-holders. On April 30, 2009, President Obama was trying to push through his plan for bankruptcy for GM and said, "While many stakeholders made sacrifices and worked constructively, I have to tell you, some did not. In particular, a group of investment firms and hedge funds decided to hold out for the prospect of an unjustified taxpayer-funded bailout. They were hoping that everybody else would make sacrifices, and they would have to make none."[24] Again, most did not complain because they were already beholden to the Federal Government because of TARP. One person who did speak out was a hedge fund manager named Cliff Asness. On May 5th, he responded to President Obama and said, "Let's be clear, it is the job and obligation of all investment managers, including hedge fund managers, to get their clients the most return they can. They are allowed to be charitable with their own money, and many are spectacularly so, but if they give away their clients' money to share in the 'sacrifice,' they are stealing."[25]

While President Obama is claiming that the hedge funds are asking for a bailout, in fact, it was only because hedge funds have not taken government funds that they could stand up to this bullying. The TARP recipients had no choice, but to go along. The President's plan takes money from bondholders and gives it to a labor union that delivers money and votes for him.

VI. CONCLUSION

By bailing out bankrupt firms, we are undermining that profit and loss mechanism that stands at the foundation of our capitalist economy. That profit and loss mechanism has resulted in the remarkable economic progress that we have seen take place over the last 250 years. The American economic system may be fragile. It has only been in place for a little more than a couple of centuries. It seems like a long time, but in the course of human events, it is not long. Now, we are cutting the legs out from under the incentives that are at the foundation of American capitalism.

Look at what has happened since the beginning of the financial crisis. Again, the bipartisan nature of this should be emphasized. The TARP program was initiated in the Bush Administration. Ben Bernanke, the Chairman of the Federal Reserve was appointed by President Bush. Many of the policies discussed were initiated under the Bush Administration. Therefore, this is not a critique only on the current Administration or on President Obama. This is something that goes back to the Bush Administration and has been a bipartisan effort.

In response to the financial crisis, we are nationalizing our banking and financial industry, we are nationalizing the automobile industry, and the Federal Government owns 80% of AIG and 61% of GM. Currently, an important policy issue is the healthcare debate. We are thinking about having the Federal Government play a much larger role in the healthcare system that it already dominates. In energy policy, we are talking about the Federal Government playing a much larger role in our energy markets. We are really looking at a fundamental transformation here in the nature of American capitalism.

Many who have been around long enough, have had a pessimistic feeling about our economic future before. The 1970s was a decade of double-digit inflation and rising unemployment. There was an energy crisis with lines at the gas pump caused by Federal Government price controls on gasoline. The Iranians were occupying the U.S. embassy. The 1970s was also the decade that brought in disco music and polyester leisure suits. There is not much good to be said about the 1970s. Despite that, Americans managed to turn things around in the 1980s and the 1990s. By 1989, with the collapse of the Berlin Wall, and in 1991 with the demise of the Soviet Union, it would appear that the virtues of the market economy over government planning would have looked so large that there would be no turning back. Over the twentieth century, in the struggle between socialism and capitalism, the strength of the capitalist economy won. With the collapse of those centrally planned economies, everybody said, “We now see, capitalism is the right way to go. Market allocation of resources is better than government planning.” It is interesting that so much of the current debate turns on how much more involved we want the government to be in our economy.

To conclude, there is a message of hope and change. Hopefully, the gloomy outlook of the Obama policy does not come to fruition. The hope is that with a little distance, we will be able to look back and see that we had a little too much intervention and that the market economy really works quite well. Hopefully, there may be some lessons that we can learn from this that will strengthen the market economy.

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