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The Economy Is Worse Than You Think

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The policies of the Obama administration have led to the weak condition of the American economy. Growth during the coming year will be subpar at best, leaving high or rising levels of unemployment and underemployment.

The drop in GDP growth to just 1.8% in the first quarter of 2011, from 3.1% in the final quarter of last year, understates the extent of the decline. Two-thirds of that 1.8% went into business inventories rather than sales to consumers or other final buyers. This means that final sales growth was at an annual rate of just 0.6% and the actual quarterly increase was just 0.15%—dangerously close to no rise at all. A sustained expansion cannot be built on inventory investment. It takes final sales to induce businesses to hire and to invest.

The picture is even gloomier if we look in more detail. Estimates of monthly GDP indicate that the only growth in the first quarter of 2011 was from February to March. After a temporary rise in March, the economy began sliding again in April, with declines in real wages, in durable-goods orders and manufacturing production, in existing home sales, and in real per-capita disposable incomes. It is not surprising that the index of leading indicators fell in April, only the second decline since it began to rise in the spring of 2009.

The data for May are beginning to arrive and are even worse than April's. They are marked by a collapse in payroll-employment gains; a higher unemployment rate; manufacturers' reports of slower orders and production; weak chain-store sales; and a sharp drop in consumer confidence.

How has the Obama administration contributed to this failure to achieve a robust and sustainable recovery?

The administration's most obvious failure was its misguided fiscal policies: the cash-for-clunkers subsidy for car buyers, the tax credit for first-time home buyers, and the $830 billion "stimulus" package. Cash-for-clunkers gave a temporary boost to motor-vehicle production but had no lasting impact on the economy. The home-buyer credit stimulated the demand for homes only temporarily.

As for the "stimulus" package, both its size and structure were inadequate to offset the enormous decline in aggregate demand. The fall in household wealth by the end of 2008 reduced the annual level of consumer spending by more than $500 billion. The drop in home building subtracted another $200 billion from GDP. The total GDP shortfall was therefore more than $700 billion. The Obama stimulus package that started at less than $300 billion in 2009 and reached a maximum of $400 billion in 2010 wouldn't have been big enough to fill the $700 billion annual GDP gap even if every dollar of the stimulus raised GDP by a dollar.

In fact, each dollar of extra deficit added much less than a dollar to GDP. Experience shows that the most cost-effective form of temporary fiscal stimulus is direct government spending. The most obvious way to achieve that in 2009 was to repair and replace the military equipment used in Iraq and Afghanistan that would otherwise have to be done in the future. But the Obama stimulus had nothing for the Defense Department. Instead, President Obama allowed the Democratic leadership in Congress to design a hodgepodge package of transfers to state and local governments, increased transfers to individuals, temporary tax cuts for lower-income taxpayers, etc. So we got a bigger deficit without economic growth.

A second cause of the continued economic weakness is the president's emphasis on increasing tax rates. Although Mr.

Obama grudgingly agreed to continue the Bush tax cuts for 2011 and 2012, his budget this year repeated his call for higher tax rates on upper-income individuals and multinational corporations. With that higher-tax cloud hanging over them, it is not surprising that individuals and businesses do not make the entrepreneurial investments and business expansions that would cause a solid recovery.

A third problem stems from the administration's lack of an explicit plan to deal with future budget deficits and with the exploding national debt. This creates uncertainty about future tax increases and interest rates that impedes spending by households and investment by businesses. The national debt has jumped to 69% of GDP this year, from 40% in 2008. It is projected by the Congressional Budget Office to reach more than 85% by the end of the decade, and to keep rising after that. The reality is even worse since ObamaCare alone will cost more than $1 trillion in its first 10 years. The president's boast that his health legislation would not "add a dime" to the national debt was possible only by combining that increased spending with proposed new taxes and with projected cuts in Medicare spending that will never occur.

Finally, there is the administration's incoherent position on the international value of the dollar. The Treasury repeats the slogan that "a strong dollar is good for America" while watching the real value of the dollar fall by 7% over the past year, and while urging the Chinese to allow the dollar to fall more quickly relative to the yuan. The lack of a consistent dollar policy adds to the uncertainty that limits business investment and hiring.

The economy will continue to suffer until there is a coherent and favorable economic policy. That means bringing long-term deficits under control without raising marginal tax rates—by cutting government outlays and by limiting the tax expenditures that substitute for direct government spending. It means lower tax rates on businesses and individuals to spur entrepreneurship and investment. And it means reforming Social Security and Medicare to protect the living standards of future retirees while limiting the cost to future taxpayers.

All of these things are doable. But the Obama administration has not done them and shows no inclination to do them in the future.

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