Originally published in **The Wall Street Journal**

January 20, 2010

# Missing the Target

By MARTIN FELDSTEIN

Unlike previous recessions, the current downturn was not caused by Federal Reserve tightening and therefore couldn't be reversed by lowering interest rates. President Obama was correct to conclude that boosting economic activity required a fiscal stimulus.

Unfortunately, despite the talented team of economists in the administration, most of the president's economic policies have done little to help the problem. And indeed, many of these policies have created even more problems than they solved.

For starters, the president allowed congressional Democrats to design the $787 billion stimulus package. The result was an unnecessarily large increase in the national debt for a very modest rise in gross domestic product, with too much emphasis on redistributing income and preserving public-sector jobs and not enough on raising economic activity. Only about one-fourth of the nearly $800 billion will be used for government spending that adds directly to GDP. In contrast, the funds given to households will be largely saved or used to pay down existing debts. And the dollars that went to state governments relieved pressure to use their "rainy day" funds or levy temporary tax increases.

### *Better Ways to Go*

The flaw in the stimulus package wasn't, as some say, that it was too small. It was that it was poorly targeted. Instead, Congress and the president could have gotten more stimulus from accelerating the repairing and replacing of equipment in the civilian and defense sectors. Long-term reductions in marginal tax rates of the type used by Presidents Kennedy and Reagan would also have been better than temporary tax cuts that have no positive incentive effects.

Other programs by the administration have had similar failings. "Cash for clunkers," for instance, was successful in raising auto buying and gave a temporary boost to GDP, since two-thirds of the third-quarter GDP rise was motor-vehicle production. The credit for first-time home buyers also gave a temporary boost to the housing market. But both programs just borrowed demand from the future.

In health care, President Obama has focused his efforts on adding some 30 million lower-income individuals to the Medicaid rolls or giving them means-tested insurance subsidies—a plan that may fail after Tuesday's special election in Massachusetts undid the Democrats' 60-seat supermajority in the Senate.

Because the new health law would require insurance companies to ignore pre-existing medical conditions, millions of middle-income individuals would have a strong incentive to drop their current coverage, pay a small fine for being uninsured and buy insurance only when they need expensive care.

If that occurred, then Congress would want to completely revise the health-care legislation, pushing the country closer to publicly financed insurance for all. Perhaps that was not unintended.

### *The Home Front*

Local banks around the country have cut back business lending because they fear future losses on existing real-estate loans. The administration's plan to prevent mortgage defaults by helping millions of homeowners reduce their monthly mortgage payments fizzled down to helping just a few hundred thousand. Moreover, nothing was done to reduce the incentive to default among the 15 million homeowners whose mortgages now exceed the value of their homes. And nothing has been done to deal with the $1.5 trillion of distressed commercial real-estate loans that will have to be rolled over during the next five years.

The administration's plan to induce local banks to sell impaired loans to nonbank investors so that they could start lending again was well intentioned. But it failed, despite generous proposed subsidies, because banks don't want to reduce their accounting capital.

Although solving the banking and real-estate problem is key to recovery, the president's focus on his health legislation and the public's concern about future deficits appears to have stopped him from dealing with these problems.

***A Legacy of Debt***

The enormous increase in budget deficits and in the national debt is one of the most worrying aspects of the Obama administration's first year. The Medicaid expansion and health-insurance subsidies would add nearly $1 trillion to the national debt over the next decade. Only by combining this spending with increased taxes and an implausible promise to cut Medicare outlays by $500 billion could the legislation be officially "scored" as a net reduction in the national debt.

The International Monetary Fund estimates that annual U.S. budget deficits will be about 7% of GDP from 2012 through the end of the decade. Such deficits would absorb virtually all of the nation's household and business saving, thus reducing the funds available for business investment and housing construction that are needed to raise productivity and our standard of living. It will also keep the U.S. dependent on inflows of funds from the rest of the world.

*Mr. Feldstein, chairman of the Council of Economic Advisers under President Reagan, is a professor at Harvard and a member of The Wall Street Journal's board of contributors.*