

## THE ECONOMY BY OBAMA: WOULD YOU INVEST IN THIS BUSINESS PLAN?<sup>1</sup>

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For anyone who has ever tried to raise money from the VC world or any VC who has placed funds in a venture, there is always the Business Plan and what the investors present to you to justify this wonderful investment. I have been on both sides in the past almost fifty years and the current plan or plans to correct the economy enters a new phase in Government planning. On 10 January 2008 the Obama transition team places on their web site an initial draft of their plan. We reference it herein. This in itself is a first. We still cannot really find out what the Paulson Plan really is even after \$350 billion having been spent. Therefore praise should go to the Obama camp. In addition placing a plan out at this time which has most likely not been vetted by all comers is a first in the world of Washington.

The plan was authored by Christina Romer and Jared Bernstein. Romer and her husband are Professors of Economics at UC Berkeley and both are well renowned in the field of academic macroeconomics. Romer is well known for her analytical skills as is her husband. The plan is stated to be a first draft and all of the caveats are present. However one might ask, as one would with any proposed investment, if this plan needs work or if it should just be passed along. Namely should we investors just say, "We will pass on this investment at this time?" That is the classic euphemism that VCs use to tell a potential start up entity that they really have no interest, do not even come back.

We will look at the Romer Plan, excuse us Mr. Bernstein, but we will call it that. We will look at it as if it were just that, a Business Plan for a proposed new venture and see if it passes even the lowest set of hurdles, recognizing that only Congress will have to approve this plan, not some group which may have a real financial interest in the business.

There has been a great deal said about the proposed Obama Plan for the economy<sup>2</sup>. The day in Washington looks like the day for the macroeconomists. As we have stated previously, we believe that the state of the art of macroeconomics is equivalent to that of Alchemy in the 5th century, BC. One would never ask a macroeconomist to give a number and then to have them bet anything, no less their life, on it even coming close, say within 25% of what they predict. It is a best an art and, at worst, a fraud. As Professor Mankiw of Harvard states at the end of his recent NY Times article in

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<sup>2</sup> See <http://gregmankiw.blogspot.com/2009/01/obamas-multipliers.html> and the Report by Romer from the upcoming Obama White House: [http://otrans.3cdn.net/45593e8ecbd339d074\\_13m6bt1te.pdf](http://otrans.3cdn.net/45593e8ecbd339d074_13m6bt1te.pdf) and other approaches by Maudlin reference <http://www.frontlinethoughts.com/pdf/mwo011009.pdf>

discussing his own profession and speaking of Paul Samuelson, the Saint Paul of Keynesians, and Larry Summers uncle:

*"Mr. Samuelson once said, "I don't care who writes a nation's laws or crafts its advanced treaties, if I can write its economics textbooks." The coming stimulus bill, warts and all, will demonstrate brilliantly what he had in mind. "*

Indeed, that is what is about to happen to the United States and most likely the entire world. It has been eighty years since Keynes and his "revolution". We now understand business model fairly well, and this may have flowed upwards to the field of microeconomics, a little. Yet we seem not to have come to grips with macroeconomics at all. The field has two major faults. First is relies on backward looking econometric models which match models to past data in a correlative manner. This fails to reflect any underlying causal relationships and the old does not necessarily reflect on the new. Things change. Second, the essence of causal models and relationships, as we have in the detailed business plan models of the current time, are totally missing. We do not understand the "physics" of macroeconomics. Thus any plan is at best a reasoned guess, and any plan in Washington is as best a politically reasoned guess. Yet with all the negatives we at least have something to look at, a highly praise worthy and brave act on the part of Romer.

## THE PLAN ELEMENTS

The Plan issued by the Obama Office is a short13 page document dated 9 January 2009and set for release on 10 January 2009. The title is "**The Job Impact of the American Recovery and Reinvestment Plan**" and it presents the view from the new White House Staff.

In the Plan, Romer states:

*"We have assumed a package just slightly over the \$775 billion currently under discussion..."*

This seems to establish a target for the total amount requested. This may be a strategy to start "small" recognizing that Congress will always increase it, especially a Democrat Congress, or it may just be the truth and mistakenly released, something that does happen time to time in Washington.

Romer and Bernstein look at the plan and try to accomplish several things. Specifically:

1. Establish the total amount
2. Create categories for the allocation of funds.
3. Determine the impact on the GDP and the employment base.
4. Assess what the impact is on constituencies.

We will focus only on the first three since the latter is just a political issue for Washington, albeit one which will have a real economic impact if this is nothing more than a giveaway.

The following Table is the Romer and Bernstein estimates of the effects of having this package and if the package is not effected. The effect of Package Increase GDP by 3.7% Increase jobs by 3,675,000. However the increase in the GDP of \$433 billion costs the taxpayers \$775 billion, a somewhat unbalanced number.

**Table 1. AGGREGATE EFFECT OS THE RECOVERY PACKAGE ON GDP AND JOBS IN Q4 2010**

	<i>Real GDP (billions of chained 2000 \$)</i>	<i>Payroll Employment</i>
Without Stimulus	\$11,770	133,876,000
With Stimulus	\$12,203	137,550,000

The following Table depicts, without any discussion of what the real efforts will be, of the impact per sector.

**Table 2. EFFECTS OF THE COMPONENTS OF THE RECOVERY PACKAGE ON JOBS IN 2010Q4**

Component	Total Effect	Direct Effect	Indirect Effect
Energy	459,000	305,000	153,000
Infrastructure	377,000	236,000	142,000
Health Care	244,000	166,000	78,000
Education	250,000	166,000	83,000
Protecting Vulnerable	549,000	140,000	409,000
State Relief	821,000	442,000	379,000
Making Work Pay Tax Cut	505,000	0	505,000
Business Tax Incentives	470,000	0	470,000
All Components	3,675,000	1,456,000	2,219,000

The above Table does have some major concerns. They are:

1. The Making Work Tax cuts are really low income give-aways and it is not at all clear what they will accomplish.
2. The Business Tax incentives include the \$3,000 per new employee tax credit which experience has shown is problematic at best and takes a great deal of time to implement. The benefit can generally be found in large service business with low income per employee and at the end of the tax advantage period the employees may be let go. This is generally not a value creating nor a sustainable plan.

3. The Stat Relief plan is merely throwing good money after bad. It is bailing out California where the State has become dysfunctional. There is negative value created here yet it does keep State Union workers on the payroll.

4. Protecting the Vulnerable is increased unemployment and food stamps. Generally useful as a stop gap but it has de minimis effect on the GDP.

5. The Energy, Infrastructure, Healthcare and Education are all Government programs. We generally have commented on them in previous White Papers but they are what one would expect.

The net conclusion is that there does not seem to be a single real tax incentive for value creation in the plan and the real large GDP multipliers are missing.

Romer and Bernstein then go onto to some detail their plan as per our comments above:

*"Among the key components are:*

- 1. Substantial investments in infrastructure, education, health, and energy.*
- 2. Temporary programs to protect the most vulnerable from the deep recession, including increases in food stamps and expansions of unemployment insurance.*
- 3. State fiscal relief designed to alleviate cuts in healthcare, education, and prevent increases in state and local taxes.*
- 4. Business investment incentives.*
- 5. A middle class tax cut along the lines of the Making Work Pay tax cut that the President- Elect proposed during the campaign. "*

## THE NUMBERS

Now it is worth an analysis of what is behind the numbers. Romer states in the Obama BP:

*"Tax cuts, especially temporary ones, and fiscal relief to the states are likely to create fewer jobs than direct increases in government purchases. However, because there is a limit on how much government investment can be carried out efficiently in a short time frame, and because tax cuts and state relief can be implemented quickly, they are crucial elements of any package aimed at easing economic distress quickly. "*

It is important to critically look at what she appears to be saying here. Professor Mankiw of Harvard states in his NY Times article:

*"In practice, however, the multiplier for government spending is not very large. The best evidence comes from a recent study by Valerie A. Ramey, an economist at the University of California, San Diego. Based on the United States' historical record, Professor Ramey estimates that each dollar of government spending increases the G.D.P. by only 1.4 dollars. So, by doing the math, we find that when the G.D.P. expands, less than a third of the increase takes the form of private consumption and investment."*

Mankiw then goes on to state the following regarding the multiplier for tax cuts:

*"The evidence, however, is hard to square with the theory. A recent study by **Christina D. Romer** and **David H. Romer**, then economists at the University of California, Berkeley, finds that a dollar of tax cuts raises the G.D.P. by about \$3. According to the Romers, the multiplier for tax cuts is more than twice what Professor Ramey finds for spending increases."*

In fact in the Report by Romer and Romer the authors conclude (emphasis is ours):

*"In terms of consequences, there are six main findings.*

*First, **tax changes have very large effects on output. Our baseline specification suggests that an exogenous tax increase of one percent of GDP lowers real GDP by roughly three percent.** Our many robustness checks for the most part point to a slightly smaller decline, but one that is still well over two percent.*

*Second, these estimated effects are substantially larger than those obtained using broader measures of tax changes, such as the change in cyclically adjusted revenues or all legislated tax changes. This suggests that failing to account for the reasons for tax changes can lead to substantially biased estimates of the macroeconomic effects of fiscal actions.*

*Third, **investment falls sharply in response to exogenous tax increases.** Indeed, the strong response of investment helps to explain why the output consequences of tax changes are so large.*

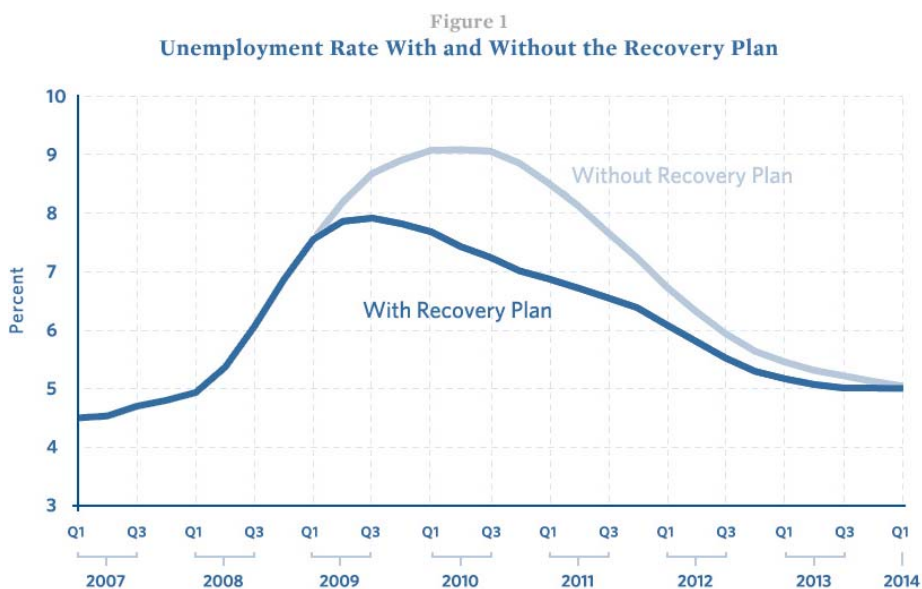
*Fourth, the **output effects of tax changes are highly persistent.** The behavior of inflation and unemployment suggests that this persistence reflects long-lasting departures of output from its flexible-price level, not large effects of tax changes on the flexible-price level of output. The last two findings concern the effects of particular types of tax changes.*

*(Fifth) The behavior of output following countercyclical tax changes is only moderately different from those following exogenous actions. This suggests that policymakers. Efforts to adjust taxes to offset anticipated changes in private economic activity have been largely unsuccessful. The most likely explanation for this finding is that countercyclical actions are rarely taken before output growth has already returned to normal.*

Finally, we find suggestive evidence that tax increases to reduce an inherited budget deficit do not have the large output costs associated with other exogenous tax increases. This is consistent with the idea that deficit driven tax increases may have important expansionary effects through expectations and long-term interest rates, or through confidence. "

Thus we are seriously concerned as to the apparent contradiction. Romer said a year ago that tax cuts give a 3X multiple and if Government spending gives a 1.2X multiple than why does she say what she says in the Obama Plan and moreover why does the Obama Plan fail to have any such high multiple tax cuts!

We continue with the details of the Plan. Romer takes her data and her plan and applies the multipliers she has found useful. There is clearly not even a comparison to what the higher tax multiplier could effect. Thus applying her models and parameters, Romer and Bernstein arrives at a projected graphic for the anticipated unemployment.



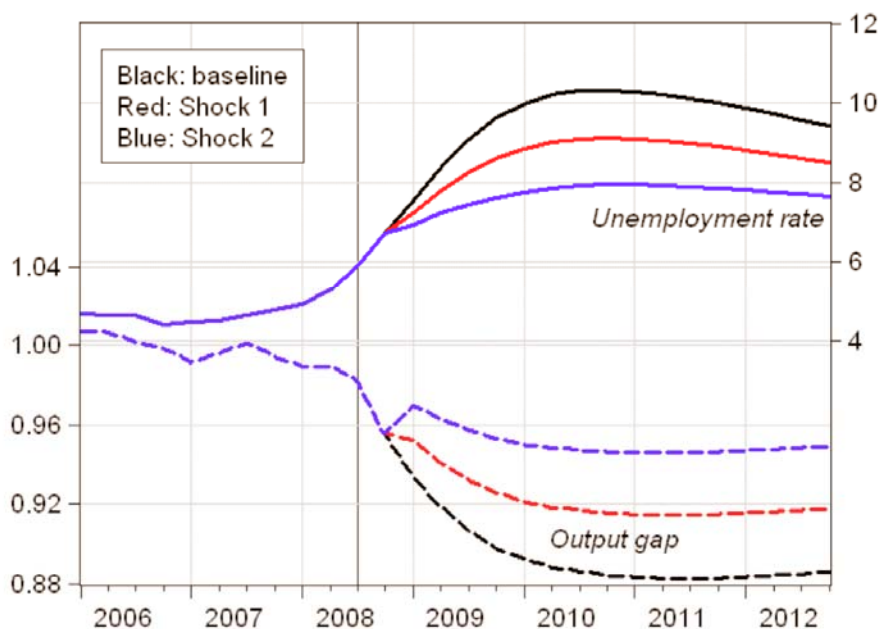
In contrast the same analysis is performed by Bard College and is presented by John Maudlin and he states:<sup>3</sup>

<sup>3</sup> See <http://www.frontlinethoughts.com/printarticle.asp?id=mwo011009>

"Just to give you a picture of what economists think about the effect of the stimulus, let's turn to the Levy Economics Institute of Bard College, which is one of my favorite sources for original economic insight (<http://www.levy.org/>). They are a rather conservative lot. The graph below shows what two different levels of government stimulus will mean to the economy. They graph unemployment at no stimulus (top black line) and at two levels of "shock" or stimulus. Shock 1 is about \$380 billion and shock 2 is about \$760 billion. The dotted lines are what is known as "output gap," or the measure of the difference between the actual output (actual GDP) of an economy and what it could produce at its most efficient (potential GDP)."

The Levy Economics data is shown below for the same type of Plan.

**FIGURE 4. Output gap and unemployment**



There is an ongoing critique of Romer and the proposed effort by Mankiw<sup>4</sup>:

"The evidence, however, is hard to square with the theory. A recent study by **Christina D. Romer** and **David H. Romer**, then economists at the University of California, Berkeley, finds that a dollar of tax cuts raises the G.D.P. by about \$3. According to the Romers, the multiplier for tax cuts is more than twice what Professor Ramey finds for spending increases."

Ultimately in the Obama Plan Romer concludes:

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See:

<http://www.nytimes.com/2009/01/11/business/economy/11view.html?partner=permalink&exprod=permalink> also see <http://gregmankiw.blogspot.com/2009/01/obamas-multipliers.html>

*"Among the key lessons from the analysis are:*

- 1. The recovery plan needs to be large to counter the tremendous job loss that is likely to occur.*
- 2. The plan needs to include a range of components, such as direct government spending, state fiscal relief, and tax cuts to ensure that jobs are created quickly and throughout the economy.*
- 3. The range of components is also important for ensuring that both male and female workers benefit from the program.*
- 4. An aggressive recovery program is important for protecting all Americans from job loss, but particularly for aiding those groups disproportionately hurt by the rise in the overall unemployment rate.*
- 5. A well designed recovery plan will not only create numerous jobs, but also many jobs paying good wages and providing full-time employment.*

The Obama Plan is focused less on the economy as a whole than on sectors who in their minds are most disadvantaged. The plan needs to be large is not the result of the analysis it is an imperative resulting from the objectives of the Obama Plan. The wording of Government Spending, State Relief and then Tax Cuts clearly places the priorities in the Obama Plan order, despite the Romer recognized effect of Tax cuts. The Government expenditure in this manner may easily increase entitlements and lead ultimately to even greater long term inflation. The key element in her lessons is a balance of female equity and the underprivileged, Items 3 and 4 in the above. These were not lessons but inputs. These clearly are what were required of the Obama Plan and were not a result of the analyses.

## OBSERVATIONS AND CONCLUSIONS

In the Mankiw article in the Times he basically poses four questions which we will paraphrase. For these questions raise many more issues but they are spot on regarding the Obama Plan. The Mankiw questions are:

1. What Government spending plan provides the greatest gain in GDP? Answer, if the GDP multiplier is 3X for tax relief and 1.2 X for Government spending the answer is obvious.
2. How should the Government Spending, if any, be targeted? We all know that on the one hand infrastructure always need improvement but on the other hand the States have for the most part recklessly spent the funds already collected for other items. So why do we think they will be any better now. Just look at New York or Pennsylvania or Massachusetts. Also spending money to allow States to continue spending recklessly, such as California, does not solve the problem. They must meet the problem head-on and solve it themselves.
3. What is the End Game? Mankiw presents a key question. The money going into the economy will eventually result in some form of inflation, and it may be massive. We

have estimated that it may be as high as 23% per annum at peak! Obama will make Carter look like a fiscal genius! The end game is critical; it will require a secure base of value creation and economic growth not the reliance on Government spending. That result will make the US look like France run by dummies!

4. Mankiw Gets Back to Tax Cuts Again. The Romers' analysis and conclusions are near bullet proof; tax cuts lead to high GDP growth and also to value creation. Lower capital gains tax on value creation work is essential.

Building on the Mankiw issues we expand them a bit further.

## WHAT OF INFLATION?

We have analyzed the issue of inflation in a prior White Paper. This Obama Plan presents a clear and present danger of massive inflation in the next two to three years. That will destroy any and all of the putative advance which may be attained under this plan. Infrastructure commitments will fall short if done under current dollars or will explode is pegged to inflation.

## WHAT OF TAX INCREASES? NOW AND IN THE FUTURE?

The issue of balance, a balanced budget or some goal to reach that point may require a tax increase. However as we have shown the only true way to get out of this mess is Tax Relief, targeted at value creating efforts. Yet at some time the opposite may occur, just not yet.

## WHAT OF THE DESTRUCTION OF ENTREPRENEURIAL VALUE CREATION?

Value creation is done in an entrepreneurial manner. China is a classic example, Communist or not. We in the US have also been superb in this area but the Tax issues relating to capital gains for risk taking in the venture world are under threat. I would recommend a zero tax for any true entrepreneurial investments.

## WHAT IF THESE NUMBERS FAIL TO WORK?

The key question we must always ask is what if my model is wrong or the world changes to make my ingoing assumptions, albeit correct at the time, no longer operative? Who is in charge of adjusting? This Plan is not the BP of some start up with smart management and a cooperative Board. The White House and Cabinet folks may be smart but they have been put together in a potentially contentious manner resulting in infinite cat fights. That could be a serious problem. And Congress is not the best set of a Board of Director one could ask for. Thus the backstopping of the numbers may become the Achilles hell of this Plan.

## WHY HAS THE PLAN REJECTED PAST EVIDENCE OF TAX CUTS IN FAVOR OF GOVERNMENT SPENDING?

Again I come back to the Mankiw question. Romer has done a 180 on this Plan. Tax cuts, know to be highly effective, are effectively gutted. There are some sops that appear with the name of tax cuts but they are just that. It is critical that the tax cuts be re-instituted and held too over Congress's objections/

## WHAT CAN MAKE THIS ALL COLLAPSE DESPITE THE BEST INTENTIONS?

This is the classic question we ask the entrepreneurs we invest in and we ask ourselves in the normal course of business. What will kill the business? If it starts to happen how do we mitigate it? How can we tell if it is happening? There clearly is not a hint of any such thinking. It goes beyond the contingency plans that say one finds in the Department of Defense. It goes well beyond Congressional oversight, after all most Congressmen have never met a payroll. One needs look no farther than Barney Frank! His recent threats to the financial institutions play right into the hands of the Sarkozy-Merkel threats and just make the current managers less open to action. You just don't do that, we know you have the stick right now, stop waving it already!