

# Are We Saved?

## What used to be a hopeful question now sounds naive in the face of an economic stimulus that has yet to take off.

*By Kristine Blenkhorn Rodriguez*

It passed with a hopeful title, H.R. 1: the American Recovery and Reinvestment Act of 2009. Its post-position is a sure indicator of the US government's priority for the upcoming year. It passed, however, without the fanfare and applause for which many had hoped. In their place, a flurry of partisanship and sniping ran rampant in our nation's capital and media outlets. H.R. 1 passed nonetheless, to the relief of the 59 percent of Americans surveyed by Gallup in early February who said they favored passage.

The numbers are staggering: A roughly \$790-billion stimulus plan, with approximately \$308 billion in new spending, \$267 billion in social services and \$212 billion in tax breaks. Yet many experts say it's not enough to dig the American economy out of its rut.

New spending programs will include approximately \$48 billion for transportation infrastructure, the lion's share of which will pay for repair and replacement of highways, bridges and roads. A significant portion will be used to modernize the US electric grid. And, of course, we will fund alternative energy research, per President Barack Obama's campaign promise.

The \$212 billion in tax breaks includes a "Make Work Pay" refundable tax credit for individuals (\$400) and families (\$800) earning under certain cutoff amounts. En masse, families and individuals who have higher education expenses will receive \$14 billion in tax credits. Families with three or more children will receive \$4.7 billion in earned income tax credits.

The numbers become even more overwhelming when you consider that US taxpayers footed the \$700 billion financial industry bailout bill last autumn. The irony is that \$75 billion of the sum total will be used to provide mortgage relief for as many as 9 million Americans, giving mortgage lenders incentives to help borrowers on the verge of foreclosure.

Missing the irony? If the US economy were a household with a checkbook and credit line gone amiss, we would have been foreclosed on long ago.

### **the average taxpayer**

It's far easier to detail the potential benefits to taxpayers who have overextended themselves than it is to discuss how a truly average taxpayer will fare. No government official or expert can accurately predict how US taxpayers will really end up paying for the bailout or the stimulus.

Mortgage holders are a key area of focus. According to Moody's Economy.com, about 13.8 million of the 52 million Americans with a mortgage owe more on their mortgage than their

house is now worth. Of those who don't, many are still struggling to pay the monthly mortgage and avoid foreclosure.

The \$75 billion Homeowner Stability Initiative will help those "responsible" homeowners who have committed to making reasonable monthly mortgage payments and have loans owned or guaranteed by Fannie Mae or Freddie Mac. The government will incent servicers for making modifications like reducing a borrower's monthly mortgage payment to 38 percent of income. It also will create an insurance fund of up to \$10 billion to discourage lenders from foreclosing on these homeowners. And it will provide \$1.5 billion in relocation funds and other assistance to those displaced by foreclosure.

Robert Wright, a financial historian, New York University professor and author of *One Nation Under Debt: Hamilton, Jefferson, and the History of What We Owe*, looks at the current crisis with a sanguinity that only those with a broad perspective can muster. "It's not like there's been a huge spike in greediness. As long as there have been humans, there has been greed that has caused problems on a large scale. Our country owes its actual existence to two such crises in the 1700s," he says.

Wright first cites the crisis that occurred when America was still a British colony in the 1760s. "Within a few years, housing prices had tripled. This was at a time when mortgages were callable by financial institutions. Many colonists borrowed against their homes, farms and shops, which worked just fine until the real estate market fell to 33 to 50 percent of its former value. Many homes were lost; farms and shops folded. Lenders were calling mortgages because they wanted their money back to invest at a higher rate elsewhere, and the value of the loans exceeded the value of the properties. Sound familiar?"

The second crisis took place in the 1780s, when America had no mother country to blame. "During the American Revolution, hyperinflation occurred. The government paid for troops by printing money—lots of money. And then there was a massive deflation a decade or so later," Wright explains.

He notes that bailouts really are more of a 20th-century concept. "In the 18th and 19th centuries, the government didn't tend to bail anyone out." Rather, says Wright, Hamilton's Rule applied (developed by Alexander Hamilton during the panic of 1792): "Central banks raised the interest rate (above the prevailing rate under normal circumstances, but much less than market rates during the panic), but lent to anybody that wanted to borrow and could post sufficient collateral. The notion was that companies that had taken on excessive risks would fail but all solid companies would be able to put up sufficient collateral to survive. The collateral and the high rate of interest meant that the socialization of risk, while still present, was minimized, and most of the profits accrued to the central bank. Hamilton's Rule also minimized moral hazard because risky companies expected to fail and nobody expected to profit from adverse market conditions."

Many taxpayers rightly construe bailouts as private-interest handouts that come at their expense. "And, statistically, you can't prove that any bailout since the 1970s has worked," says Wright. "Of course, statistically, you can't prove that they haven't either. But the moral hazard element

can't be ignored. You're rewarding people for taking on excessive risk, and they get a bailout from their more cautious brethren if all doesn't go well."

Dirk Van Dijk, director of equity research at Zacks Investment Research, is a bit less controversial in his opinions. "Even some of the things in the package that are not terribly effective are not horribly bad either," he says.

Van Dijk cites taxpayer rebate checks, which he says probably will be used to pay down personal debt or to save. "Even if everybody used the \$400 they get to pay down a credit card bill—which is zero stimulus to spending—there is still a net benefit for the individual paying down the bill."

He is in favor of anything that helps the "tapped out middle class." "The distribution of income in this country is more out of balance than at any time since 1929. In 2006, when the last data was available, the 400 highest-income individuals paid an effective tax rate of 17 percent. You and I are paying 15 percent off the bat just for Social Security."

Van Dijk does see the other side, though. "For the past several years, many people acted like there were ATMs in their kitchens. They'd roll 10 grand of credit card debt into a refinanced mortgage, go from 18.5 percent interest to 6.5 percent, and now it's all tax deductible," he says.

Scott Hamer, president and CEO of Community Bank-Wheaton/Glen Ellyn, Ill., sees a very different trend now. "A large segment of our account holders are senior citizens who live off the interest from their investments," he explains. "A one-time tax break might help slightly but it's certainly not enough to make them go out and spend. We've grown rapidly in deposits since the beginning of the year. People are just looking for a safe place to keep their money."

### **big business and the markets**

"It's big business that profits from this stimulus package," says Van Dijk. "They're better set up to act as contractors on government projects. Small businesses may be helped to a much lesser extent as sub-contractors."

Jerry Mills, founder and CEO of B2B CFO, a CFO firm focusing on mid-market entities, thinks the gains for certain sectors are not offset by the losses big business will incur as the result of raised corporate and capital gains taxes. "Cut those and this stimulus package makes more sense. Not a lot more, but some," he says.

Mills isn't even bullish on alternative energy, despite the flurry of activity certain to result from the funds earmarked for it. "If the market demands alternative energy, then the free market will bring it to pass without this package," he says. "I like alternative fuels, but forced government involvement will put it back a decade or so. Consumers won't buy unless there's a demand. I don't see it."

Talk to Mills for a few more minutes and a Draconian picture comes into focus: "In 12 months or more the stimulus will depress the markets. Our national debt is skyrocketing; taxes will have to

pay for that, which means more money out of big business' pockets. That means fewer dividends, lower stock values and a lower market."

Again, Van Dijk is more optimistic. "I see a net positive for equities markets in sectors where large firms will be beneficiaries of the stimulus spending: Engineering and construction firms, alternative energy companies, and electric companies—the smart grid project is a potential goldmine for them. Investment spending on things like infrastructure puts jobs here and now and leaves something of value going forward."

He's bullish on spending that provides ROI, though, and says infrastructure fits that bill. "One person's vital infrastructure project will naturally be another person's pork simply because of the localized geographic impact of most infrastructure work. The building of the George Washington Bridge between New York and New Jersey brings residents of those states a huge ROI. To most Californians, it was pork. But in tolls alone, it paid for itself quickly. And to New Yorkers, while the Golden Gate Bridge may be a great piece of architecture, it's pork."

Larger-scale projects, such as improving the nation's electrical grid, provide an ROI that goes beyond business, says Van Dijk. "In January, about one million people were out of power for two weeks due to bad weather. Think of the impact on productivity. We're a First World country with what's amounting to a Third World infrastructure. We can't function like that."

### **small business**

Small-business owners were not optimistic in December, according to a survey by the National Small Business Association (NSBA). While believing more could have been done to target small businesses, the NSBA is hopeful that the legislation may provide some help—however modest—to entrepreneurs. Only 3 percent of survey respondents anticipated economic expansion over the coming 12 months (compared to 21 percent anticipating it the previous August). A majority (64 percent) anticipated a recession in December, compared to just 26 percent who anticipated the same the prior August.

While tactful, NSBA Board Chair Keith Ashmus, is also realistic. "There's very little in this act that's directed specifically to small business, and what's there may or may not be of help," he says. "We wanted small-business targets included in the bill. Without those, I think the most we can hope for is a trickle-down effect. That's not enough."

Seemingly not. According to the December NSBA survey, more members were using credit cards as a source of financing (49 percent) than bank loans (44 percent). Compare those figures to the previous August when 41 percent used credit cards versus 50 percent using bank loans.

"There are lots of businesses with good credit ratings not getting financing," says Ashmus. "When businesses like those are using credit cards instead, that's trouble. They need cash flow."

In 30 years of doing business, Mills has never seen as negative a view from bankers as he sees today. "They're a lot more skeptical regarding loans and lines of credit," he says. "These are

bankers that didn't get involved in the sub-prime scandals. They say they have money to lend but it's not being lent. They're skittish."

According to Hamer, though, the publicity surrounding bankers not lending is overblown, at least for community-owned banks. "We are absolutely looking for good opportunities and are ready to lend," he says.

The stimulus package does contain some provisions that will benefit small businesses, such as the net operating loss carry-back provision, which allows a 5-year carry back of 2008 net operating losses for small businesses with gross receipts of \$15 million or less, at a cost of \$947 million over 10 years. Furthermore, the Business Stabilization Program included in the act provides \$255 million for loan subsidies and modifications. The Small Business Administration (SBA) could issue or back loans of up to \$35,000 for "viable small-business concerns," which are experiencing "financial hardship" and have a "qualifying small-business loan."

The small-business recipients of these loans would use them to make full or partial payments on their existing loans for up to 6 months. Interest would be fully subsidized, and payment on the loans would be due one year after the final disbursement of funds is made. Borrowers would have 5 years to repay.

Other provisions, while not providing immediate small-business relief, could help small businesses avoid big expenses down the road. One such provision allows for \$1.1 billion in health programs (prevention and wellness) that will be invested in immunizations, health promotion, HIV/AIDS prevention and other programs aimed at avoiding large healthcare expenditures at a later date.

Regardless of the provisions, it seems that small business' true needs were not met. When NSBA members were asked which issues Congress and President Obama should address first, reducing the tax burden clocked in as the leader at 29 percent, followed by increasing small business' access to capital at 25 percent.

"I think this stimulus package is a complete joke for small-business owners," says Mills. "I work with many small businesses every day and most of the owners when shown this package would have said, 'You might as well not do anything.'"

The litmus test will be how small businesses respond, says Ashmus. "Improving general economic activity could improve this sector. But making a million small businesses feel better and more secure about hiring one more person creates a million new jobs. We haven't done that in this package. It's well-intentioned but will its effects trickle down? That's the question."

### **the fallout**

"Any government spending acts as a stimulant; that's first-semester macroeconomics," Van Dijk contends. "But I think people are still underestimating how deep our problem runs. This is not like the 1991 downturn. Structurally, the causes are much more like the causes of the Great

Depression. This package is like triage. It'll save some of those that can be saved. Or consider it an airbag. It won't stop the crash but it will at least allow some of the passengers to live."

Not exactly words that will give you a comfortable night's sleep. But, truthfully, has any seasoned financial pro been sleeping well lately? Have you? We thought as much.