Commentary

A Second Stimulus Package? Yikes!

Alan Reynolds, 07.10.09, 12:00 AM ET

"Calls Grow to Increase Stimulus Spending," says a recent front-page *Wall Street Journal* headline. Author Deborah Solomon claims, "Some economists are pressuring the White House to enact a second round of stimulus spending." The article mentions only two economists, however, one of whom heads "a left-leaning Washington think tank" (the Economic Policy Institute) that always tries to pressure the government to spend more. The other, a former Bush official, dreams of "something that is relatively fast and thoughtful" like "personal tax cuts." But asking Congress to do something fast and thoughtful is like asking fish to fly.

Ironically, another headline in the same paper on the same day said, "Spending Spooks India's Sensex." The article read: "Indian stocks fell 5.8% Monday amid concern the proposed government budget will add to the country's fiscal deficit."

Investors understand that increased government spending diverts valuable resources away from the private sector and ends up imposing even more demoralizing taxes on labor and capital.

A major study of 18 large economies by Alberto Alesina of Harvard and three colleagues appeared in the 2002 American Economic Review. This paper, "Fiscal Policy, Profits and Investment" found that the surest way to make economies boom can be through deep cuts in government spending--the exact opposite of the "fiscal stimulus" snake oil.

Ireland, for example, slashed government spending by more than 7% of GDP from 1986 to 1989--nearly as much as the 8.4% of GDP the U.S. spends on Social Security and Medicare combined. The Irish economy suddenly switched from a 0.2% pace of economic growth in the early 1980s to annual real GDP growth of 7.2% from 1989 to 2001. With GDP doubling every decade, government debt dropped from 125% of GDP to less than 40%.

By contrast, Japan spent trillions on Keynesian "stimulus" schemes after 1991, doubling the ratio of national debt to GDP. Amazingly, they are doing it still. Japan's "lost decade" of economic stagnation is now approaching two decades with no end in sight.

Spending cuts ensured much lower tax rates in Ireland, including substantial cuts in personal income and payroll tax rates and the VAT, as well as the famed 12.5% corporate tax. Similar fiscal restraint in India, while it lasted, facilitated cutting the top income tax rate to 30% from 60% at the start of yet another "economic miracle."

By contrast, because of the huge debts piled up by "fiscal stimulus" schemes, Japan felt compelled to add new taxes on consumer spending, land, securities trading and capital gains.

The Alesina study acknowledges that spending cuts were conducive to pro-growth tax policies, but that same study also found that big government spending is inherently bad for economic growth. The authors noted that government hiring lures skilled workers away from private businesses, and so private employers are forced to raise wages even if that means reduced hiring. Artificially boosting labor costs per employee, in turn, depresses profits and investment. They also found that a reduction of 1 percentage point in the ratio of government spending to GDP leads to an immediate increase in the ratio of private investment to GDP, which adds up to 0.8 percentage points after five years. In other words, government spending (regardless of whether it is financed by borrowing, taxing or printing money) will eventually "crowd out" private investment on nearly a dollar-for-dollar basis.

The authors (Alesina, Ardagana, Perotti and Schiantarelli) concluded that fiscal policies that "have led to an increase in growth consist mainly of spending cuts, particularly in government wages and transfers, while those associated with a downturn in the economy are characterized by tax increases."

In reality, the so-called stimulus package was actually just a deferred tax increase of $787 billion plus interest. As in the case of India's recent spending spree, and the endless "fiscal stimulus" fiascoes in Japan, the U.S. stock market reacted very badly to the last huge increase in government spending as it passed through the House and Senate.

The bond market too has suffered periodic setbacks from the incredible magnitude of Treasury borrowing. Peter Orszag, President Obama's budget director, co-authored a 2003 study with Bill Gale, claiming "a sustained 1% of GDP rise in projected deficits would raise current yields by between 20 and 60 basis points." [*Editor's note: 100 basis points equal one percentage point.*]

Orszag and Gale were probably wrong about that. But the current budget deficit is five times larger than the deficit in 2003 when Orszag, Robert Rubin and others were warning that deficits threatened "financial and fiscal disarray." We're swimming in uncharted waters. With Treasury now borrowing at levels that provoke credit rating agencies to warn of a downgrade, it is plainly foolhardy to contemplate further increasing the Treasury borrowing under the oxymoronic guise of "stimulus spending."

Whether we are talking about India, Japan or the U.S., all such unaffordable spending packages have repeatedly been shown to be effective only in severely depressing the value of stocks and bonds (private wealth). To call that result a "stimulus" is semantic double talk, and would be merely silly were it not so dangerous.

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This column is in lieu of Elisabeth Eaves' column, who is away this week.