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Recipe for Economic Stagnation

By Andrew Foy and Brenton Stransky

As political talking heads ponder the necessity for yet *another* stimulus package our domestic economy is wallowing with unemployment approaching 10%. Politicians on the left continue to embrace the last pork loaded stimulus bill claiming that while it didn't *quite* meet expectations for curbing job loss -- things would certainly be much worse without it.

In the meantime, Republicans argue that while the government's attempt to stimulate the economy was all well and good -- the legislation was severely misguided and not enough of the new *borrowed and printed* money is getting into the economy fast enough. Lost in this debate is any discussion of whether we need government stimulus at all.

This article will very briefly review Keynes and Friedman's basic economic theories as well as empirical economic data and use this information to explain why the government's actions during the current recession will *only* act to *intensify* the downturn and *prolong* recovery efforts.

John Maynard Keynes advocated for interventionist government policy to alleviate economic recessions and depressions. Keynes argued that demand is the key variable governing the overall level of economic activity and during economic downturns economies can fall into ruts characterized by decreased demand. He promoted economic policy by the government to stimulate demand, for example by spending on public works. Keynesian economic philosophy provides the theoretical basis for the Obama Administration's policies to *rescue* the economy.

On the other side of economic and fiscal policy issues is Milton Friedman, who demonstrated that Keynesian economic policy lead to stagflation (the combination of low growth and high inflation). Friedman formulated an alternative macroeconomic policy to Keynesianism called Monetarism, which argues that the government cannot micromanage the economy because business owners, investors and consumers will realize what the government is doing and shift their behavior -- this reaction is known as rational expectations.

Monetarism (or rational expectations) in a simplified sense is like the law of gravity -- what goes up, must come down; likewise, what money the government spends today must be paid for by higher taxes tomorrow.

Rational expectations is an assumption used in many contemporary or "new Keynesian" macroeconomic models. In a recent paper, Cogan et al. used the Smets-Wouters model to evaluate the effects of the most recent stimulus plan -- The American Recovery and Reinvestment Act. The Smets-Wouters model is representative of current thinking in macroeconomics using "new Keynesian" models. The authors demonstrated that the effects of the stimulus on GDP will be *negative* past the first quarter of 2009. This means *for every dollar the government spends, the return in economic output will be much less than $1 dollar.*

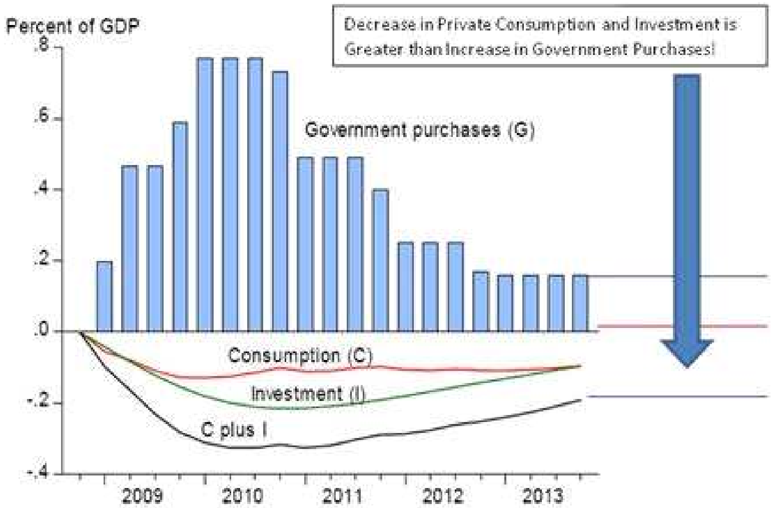

Figure 1. Change in Private Consumption and Investment versus Change in Government Spending due to The American Recovery and Reinvestment Act as projected using the Smets-Wouters model employed by Cogan et al.

In the Smets-Wouters model employed by Cogan et al. there is a strong crowding out of private investment. Both *consumption and investment decline as a share of GDP* in the first year. This negative effect is initially offset by the increase in government spending. As the government stimulus comes back down in 2013, the multiplier turns negative. The declines in consumption plus investment are greater than the increases in government spending. According to the authors, *the impact on GDP is negative for many years beyond 2013.*

At this point it is worth noting that if we *only* had to consider the effects of the most recent stimulus package the economic consequences would be bad enough. However, the Administration's plans to overhaul the healthcare system to the tune of 1 trillion over the next ten years along with climate change legislation that will affect every single business owner, investor and consumer were not taken into consideration in the projections from Cogan et al. These two pieces of legislation will *significantly compound the negative effects* demonstrated in the above model as business owners and investors know that these pieces of legislation will result in increased taxes and regulation down the road.

In a major study, highlighted by Alan Reynolds of the Cato Institute, Alberto Alesina of Harvard found that the best way to make an economy grow is to cut government spending while the best way to usher a decline is to increase government spending and taxation. Alesina et al. studied econometric data for 18 large OECD member countries to assess the effects of government spending and taxation on investment.

The authors reached three important conclusions:

1. Increased government spending reduces profits while decreased government spending increases profits;

2. Increased taxation reduces profits while decreased taxation increases profits; and

3. Economic growth is implemented by spending cuts while economic decline is implemented by increased taxation - *most importantly*, these trends hold even for large fiscal expansions and contractions.

A review of large fiscal contractions in the past only highlights Alesina's conclusions.

The Great Depression is a case study in how government intervention into the free market is not successful and most often produces results opposite of what it intends. During the depression, *15 new government agencies were created*, *government spending increased by 220%*, *taxes increased by 68%*, and *the deficit increased to 24 billion dollars*. Friedman postulated that the tremendous government intervention only perpetuated the depression -- a view that has been validated over time. He stated that, "far from the depression being a failure of the free-enterprise system, it was a tragic failure of the government."

To paraphrase Mr. Einstein - *to repeat the same mistake over and over again is stupid* - so stupid that you might start to think it's being done intentionally.

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