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Demand-Side Policy Gave Us the Big Economic Fizzle

The unstimulating stimulus ignored basic principles of economic incentives.

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Nearly five years since the recession ended in June 2009, economic policy discussions continue to focus on dubious short-term countercyclical measures to "stimulate demand." The Economic Report of the President for 2014 wastes an entire chapter rehashing the jobs supposedly "saved or created" by the 2009 fiscal stimulus and Federal Reserve easing. That analysis relies on notoriously inaccurate forecasting models to take credit for the entirely prosaic facts that (1) the last recession eventually ended just as all previous recessions did, and that (2) employment subsequently rose a bit.

This evades the key issue: Did fiscal or monetary stimulus actually "stimulate demand"?

In recent years the U.S. has experimented with demand-side stimulants on an unprecedented scale. Monetary stimulus involves pushing interest rates down to subsidize big borrowers (mainly governments and banks) at the expense of small savers (seniors). That was the reason the Fed shoved the federal-funds rate down to near zero. Even quadrupling the Fed's assets had no clear and significant impact on the sluggish growth of nominal GDP.

Fiscal stimulus involves big increases in the national debt, in the hope that taxpayers will not notice that national debt is their debt. Borrowing from Peter to pay Paul is thought to provide a net increase in their combined income or wealth, and therefore faster growth in total spending or "aggregate demand."

To find out if fiscal stimulus worked as advertised, we first need to separate deliberate increases in budget deficits from the portion caused by lost incomes and jobs. Once that separation is taken into account, we see that—according to Congressional Budget Office estimates of cyclically-adjusted budget deficits—the average increases were an unprecedented 5.7% of potential GDP from 2009 to 2012. No fiscal stimulus that large ever happened before in peacetime, and certainly not for four full years.

What happened? After such energetic demand-side stimulus, nominal GDP rose by only 3.8% a year from 2010 to 2013, and by 4% in the first quarter of 2014, compared with average GDP growth of 6.1% from 1983 to 2007. Ironically, the Economic Report of the President predicts faster growth of demand from now on—5% or more—but only after deep cuts in federal spending and euthanasia of quantitative easing. The promised stimulus from the previous fiscal and monetary binge remains undetectable—a big fizzle. Demand grew much faster (at a 6.1% pace) from 1998 to 2000, when the budget was in surplus and the Fed hiked the fed-funds rate to 6.5%.

With either monetary or fiscal stimulus, the intended boost in today's spending comes from borrowing against tomorrow's income. That impulse to shift purchases forward accounts for such ephemeral deficit-increasing schemes as the home-buyer tax credit, the cash-for-clunkers tax credit, the refundable "making work pay" tax credit and temporary payroll tax cuts. As Europe is learning, however, borrowing from the future is no fun when the future arrives.

What was thought to be a short-term stimulus to demand may end up being a long-term drag on supply. Expectations of even higher taxes on additions to future income likely discouraged investments that would have increased future income. There is an expense, and a risk, involved in expanding a small business or improving your education, and the incentive to do either is dampened if the resulting higher income—if any—shoves you into higher tax brackets that federal and state politicians seem so eager to increase again and again. Business investments that pay off only in the long term are particularly sensitive to the prospect of higher tax rates on profits.

Federal Reserve efforts to keep interest rates absurdly low have reduced the incentive to earn and save money for the future while encouraging risky debt and dodgy investments. Flattening the yield curve through Fed purchases of long bonds made it less profitable for banks to lend to small business.

The fact that employment has gradually risen from 140 million to 145.7 million since the recession ended is unremarkable. What is truly remarkable is that at the same time that job opportunities improved, the number of Americans who were neither working nor seeking work soared from 80.9 million to 91.4 million.

One economist who understands the importance of work disincentives is University of Chicago economist Casey Mulligan, author of "The Redistribution Recession" (2012), who first blew the whistle on punitive work disincentives in ObamaCare. Another is Nobel Laureate Ed Prescott, who demonstrated on this page ("Why Do Americans Work More Than Europeans?" Oct. 21, 2004) that the people of France are a third poorer than Americans only because they were deprived of incentives to work—by onerous marginal tax rates on excess effort and generous subsidies to indolence.

The demand-side panacea for weak economic growth has encouraged families and firms to spend a larger fraction of their current income and wealth—by using tax and monetary policy to punish savers and reward debtors. A supply-side solution would incentivize families and firms to produce more income and wealth by minimizing unpredictable regulation and litigation, trade barriers, unreliable money and dispiriting tax rates.

Demand-side economists focus on incentives to borrow and spend. Supply-side economists focus on incentives to work, save, invest and launch new businesses. Demand-side economists focus on the uses of income and debt (consumption). Supply-side economists focus on sources of income and wealth.

From the perspective of demand-side bookkeeping, the fact that consumer spending in 2012 accounted for 68.6% of GDP supposedly means economic growth depends on consumer sentiment. Viewed from the supply side—the sources of GDP—private industry accounted for 86.5% of GDP. If private businesses had not produced $14.1 trillion, consumers could not possibly have consumed $11.1 trillion. Economies do not grow because consumers spend more; consumers can spend more only if economies grow.

The time for demand-side gimmicks has long passed. The remarkably aggressive fiscal and monetary effort to stimulate demand did not stimulate demand. Even if it had worked, we can't pretend to be "fighting recession" forever. Today's economic predicament is not a cyclical crisis but a sustained, subsidized lethargy. Different tasks require different tools. When the number of job seekers falls twice as fast as the increased number of jobs, that is a supply-side problem.

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