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Misdiagnosing the stagnation

Using government to jump-start economy never works

By Richard Rahn - November 12, 2012

Last Friday, President Obama said, “We can’t just cut our way to prosperity. If we are serious about reducing the deficit, we have to combine spending cuts with revenue — and that means asking the wealthiest Americans to pay a little more in taxes.”

Mr. President, with all due respect, you continue to be wrong on both assertions.

The president and many of his Keynesian supporters believe that the reason we are having slow growth and very little job creation is because of a lack of sufficient demand. This is why they passed their $833 billion stimulus bill and have promoted other big-spending projects. These endeavors have not worked — and will not work — because they have misdiagnosed the problem. The real problem is malinvestment.

When the president says, “We can’t just cut our way to prosperity,” he is ignoring the fact that much, if not most, of government spending does not meet the test of the highest and best use for the money. It does not even meet a much lower standard of spending benefits exceeding their costs. For example, Congress has extended the number of weeks that a person can receive unemployment benefits. It sounds like the humane thing to do, but many economic studies show that a high percentage of unemployed people do not really get serious about taking a job until near the end of the benefit period. The longer the period people can receive unemployment benefits, the longer people tend to stay out of work. The longer people are unemployed, the more apt they are to drop out of the work force. At first glance, extending unemployment benefits seems compassionate, but it is actually both destructive for the economy and the individual — like so many other government programs.

There are endless studies of government programs that do not work, are duplicative or are downright destructive. Every time one of these programs is reduced or eliminated, resources are freed up to do something constructive and create real jobs. The fact is, Mr. President, given the amount of bloat, misallocation and counterproductive spending by theU.S. government, we can indeed "cut our way to prosperity."

The president also wants to increase the tax rates on capital gains and dividends, and on people making more than $250,000 a year. Such tax increases are not a free lunch. The actual tax falls primarily on savings and productive investment — that is, capital formation, which is needed to expand, innovate and create new jobs. The president and his supporters are again making the error of ignoring the secondary effects of these proposed tax increases.

California keeps increasing its tax rates and yet gets deeper and deeper in the hole while losing jobs to Texas and other states that are more tax friendly. There is an enormous body of empirical evidence from around the globe showing that a country or a state cannot tax itself to prosperity, but many continue to be deaf to these lessons. To the extent the Republicans give ground to the president on increasing taxes on capital, they are, in effect, acquiescing to policies that will reduce growth and opportunity.

Another impending danger is all of the new regulations that are slated to go into effect at the beginning of 2013. Most of these new regulations — environmental, health care (Obamacare) and financial — have not been subject to adequate cost-benefit analysis and almost certainly will be destructive of jobs and growth. An excellent explanation of specifically how financial regulations misallocate resources, reduce the level of investment, undermine good management practices and increase the risk to the entire financial system can be found in a book by John A. Allison, former chairman and CEO of BB&T (the ninth-largest financial company in the United States), entitled "The Financial Crisis and the Free Market Cure" (McGraw-Hill, 2012).

The Federal Reserve continues to be a major cause of slow growth and lack of job creation. At the moment, it is stepping up purchases of mortgage-backed securities primarily issued by Fannie Mae and Freddie Mac and guaranteed by the taxpayer. Partially, as a result of these purchases, mortgage rates have been driven down to the point where a 15-year mortgage can be acquired for an interest rate almost identical to the rate of inflation. In other words, the money is, in effect, free to the borrower, who also gets to deduct the interest cost from his taxes.

On the other side of the equation, those who are responsible and save are receiving virtually nothing on their savings accounts, money market funds, etc. The 10-year government bond is now providing a return of only 1.6 percent, well under the rate of inflation. Artificially low interest rates for savers engineered by the Fed have the same destructive effect as a high tax rate on savings. Homebuyers are being subsidized at the expense of those whose savings ought to be more productively invested in new technologies and new jobs.

As long as the government continues to run deficits higher than the rate of economic growth and promulgate regulations that don't meet cost-benefit tests, the United States will continue to stagnate or worse. To date, there appears to be nothing in "fiscal cliff" negotiations that will reverse this course.