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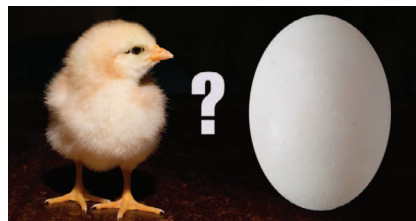
## The Capitalist Perspective

### A negative federal spending multiplier

US fiscal policy is based on the same economic theory that enticed many countries to the deficit spending that now threatens economic stability around the world. Supposedly, in times of elevated unemployment, government spending generates a “stimulus” that increases national output and creates jobs.

But according to classical economists such as David Ricardo, government borrowing and spending tend to “crowd out” private borrowing and spending. Although this perspective was all but swept from economics classrooms decades ago, debate about the effect of government spending on the economy continues behind the scenes. While in classical economics the so-called “multiplier” is zero or negative, the modern economics textbook asserts it to be positive; economists merely haggle about how big it is.

**The austerity/stimulus debate.** President Obama’s chief economic adviser, Larry Summers, was featured in a recent week-long spate of articles by prominent economists on both sides of the debate in the *Financial Times*. Acknowledging that “in normal times ... budget deficits will not stimulate output or employment,” he left the gate wide open for increased deficit spending “where an economy’s level of output is constrained by demand.”



*Correlation alone does not prove causation ... But there could be a way to bypass this obstacle.*

Mr. Summers’ textbook view of the world is one with which he said “most economists across a broad spectrum would likely agree.” However true, that merely underlines the danger of putting doctrine-driven academics in charge of real world decisions. And most of the participants in the *FT* debate are active or one-time academics.

Few, on either side, bothered to mention the classical wisdom that output is constrained, not by demand, but by the willingness of humans to put their capital to work. This simple change of orientation would rescue us from the Keynesian box. Then government spending cannot be stimulative (even when unemployment is elevated) because it can only transfer capital from one group or activity to another (and exacting a commission in the process). As

uncertainty lifts, private-sector recovery from economic shock will occur automatically. Unless, that is, it is held back by new uncertainties stemming from the actions or intentions of politicians, as is the case today.

**Historical evidence is circumstantial.** The multiplier is the Achilles’ heel of those economists who are relentlessly pushing governments into insolvency. Keynes was lionized in his own lifetime, but his prescriptions did not actually work to end the Great Depression. It’s the classical view that broadly fits the facts. Tables 1 and 2 reprint and analyze the long run historical evidence.<sup>1</sup>

As Table 2 shows, except in full-scale war, the US economy tends to grow significantly slower when deficits are high than when the budget is near balance. When the last 120 years are grouped by decade, real output grew at an average annual rate of 4.2 percent during decades in which the federal budget was at or near balance. During decades of significant deficit output grew at a rate of 2.4 percent.

Evidence of this sort will never dent current doctrine because of a “chicken-and-egg” dilemma. The fact that weak growth does correlate with high government spending is not enough to demonstrate that spending is ineffec-

1. See “Long-term economic and market performance when the budget is in deep deficit,” *Strategic Asset Selector*, H.C. Wainwright & Co. Economics Inc., April 30, 2010.

Table 1

**Federal Borrowing by Decade and Economic and Stock-market Performance**

from 1890				
decade	Federal borrowing (percent of GNP)	annualized real GNP growth	annualized stock-market return	annualized gold-price change
1890-99	0.3	4.3%	5.5%	0.0%
1900-09	0.3	4.6	10.9	0.0
1910-19	5.0	2.3	2.2	0.0
1920-29	-1.2	3.4	15.1	0.0
1930-39	3.0	0.9	-0.1	5.4
1940-49	10.4	5.6	9.2	1.5
1950-59	0.8	4.1	19.4	-1.4
1960-69	1.0	4.4	7.8	0.1
1970-79	2.7	3.3	5.9	30.6
1980-89	4.9	2.9	17.5	-2.4
1990-99	3.8	3.2	18.2	-3.3
2000-09	4.8	1.9	-1.0	14.2
average	3.0	3.4	9.0	3.4

**Data:** Historical federal debt outstanding as of mid-year ([www.treasurydirect.gov](http://www.treasurydirect.gov)) and calendar-year gross national product (Office of Business Economics/Bureau of Economic Analysis). The first column shows the increase or decrease in debt outstanding for successive decades from June 30, 1889 to June 30, 2009, together with annualized percentage changes in calendar-year real gross national product (Office of Business Economics/Bureau of Economic Analysis) and annualized ten-year total returns for large-cap stocks (Ibbotson Associates) and the price of gold (*Wall Street Journal*). We do not have gross domestic product data prior to 1929.

tive. Correlation alone does not prove causation. The fact that the government spends more when the economy is weak also implies an inverse relationship. It's a standoff. But there are could be a way to by-pass this obstacle.

**Breaking through the chicken-and-egg dilemma.** Now three Harvard Business School professors Cohen, Coval and Malloy have found a solution to the ambiguous causation problem. It seems to be the first time anyone has succeed-

ed in finding one—except perhaps in the narrow domain of defense spending. Their results indicate that government spending crowds out private activity and that negative multiplier responses are real. It could be a significant step toward unraveling the intellectual case for fiscal “stimulus.”

What these ingenious economists did was to separate out an element of federal spending that is completely independent of the economy. They compiled a 42-year history of US senators and representatives who achieved committee chairmanship through the seniority system and were then able to increase the flow of federal earmark spending to their states by an average of 40 or 50 percent. In the following year, they found, business firms reduced their spending on new capital and R&D, experienced a decline in sales growth, scaled back their employment, and paid out increased dividends.

The results of this study make sense in other ways. When a chairmanship was relinquished by death or resignation, federal spending in that state returned to normal and most of the private-sector cutbacks were reversed. And the negative response to increased federal spending was less for firms with high capital-utilization rates and for states that enjoyed full employment.<sup>2</sup>

**Are we heading toward an equilibrium state of high unemployment?**

A large positive multiplier is the foundation for the Obama administration's fiscal policy. It builds on academic doctrine which, since the 1930s, holds that heightened unemployment is a disequilibrium situation.

To some extent that may be true. But the notion of sustained disequilibrium is an oxymoron. All natural systems tend to move back into equilibrium when disturbed. It doesn't take a PhD in economics to realize that unemployment can also result from sustained uncertainty or misconceived government policies such as “soak the rich,” as well as from fleeting economic shocks.

Table 2

**How the Economy, Markets and Gold Prices Performed****in high and low deficit decades, from 1930**

AVERAGES for decades in which federal borrowing was:	Federal borrowing (percent of GNP)	annualized real GNP growth	annualized stock-market return	Annualized percentage change in the gold price
More than 1% of GNP in peacetime (five periods)	3.8	2.4	8.1	8.9
More than 1% of GNP in wartime (two periods)	7.7	3.9	5.7	0.7
1% of GNP or less (five periods)	0.2	4.2	11.7	-0.3

**Data:** as for Table 1.

2. Lauren Cohen, Joshua Coval and Christopher Malloy, “Do Powerful Politicians Cause Corporate Downsizing?” Harvard Business School, draft, March 16, 2010. Available at [www.people.hbs.edu/cmally/pdffiles/evaloy.pdf](http://www.people.hbs.edu/cmally/pdffiles/evaloy.pdf).

Unemployment from a one-time shock should be temporary—and it usually is in practice. Unemployment resulting from a bad economic policy (such as spending or the threat of higher taxation) is a different story as the eurosclerotic folks on the other side of the Atlantic well know. It may be sustained for a long time because fresh economic damage is continually being done. In this sense, high unemployment would be a persistent and stubborn *equilibrium* situation. Add uncertainty and fear to the mix, and it should be no surprise to see high unemployment diminishing unacceptably slowly, either in 1933—or in 2010.

The idea of government action to jolt the economy out of disequilibrium is as seductive as its logic is dubious. Although Keynes' prescription for aggressive deficit spending was a failure in his lifetime, it still resulted in a tremendous victory for wishful thinking, and became a virtual axiom of modern economics. Unprecedented fiscal "stimulus" since the recent crisis is now failing too.

It would be nice to have other evidence that would bear on the austerity debate. One such contribution is a recent Goldman Sachs report: around the world, economic growth has fared much better during large spending-cut initiatives that were decisive rather than gradual.<sup>3</sup>

**Debate among nations.** But US policymakers are on another planet. In To-

ronto recently, Mr. Summers and Tim Geithner, in the name of the G-20 governments, took full credit for the US and global economic recoveries, claiming that "recovery was only possible because we took action to repair our financial system, ..." Budget deficits, they argued, should not be reduced "at the price of short-term growth." This was code for pushing other governments to maintain deficit spending over the next few years so as to gener-

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ate global demand. Allegedly, that increase in demand will, in their words, "help double US exports over the next five years, supporting several million American jobs." How tawdry to push other governments to compromise their fiscal health so as to bail out the US economy!

The doctrine of a positive multiplier has had a terrible psychological effect on US politicians. Sometimes they talk as if government is the prime source of energy in an economy which otherwise is inherently depressed or unstable. All too often, when things go badly wrong

it's seen as the fault of private business. When things go right it's seen as the result of the vigorous and intrusive acts of policymakers.

But for now the G-20 meeting in Toronto seems to have been a defeat for the Obama administration's strategy to make fiscal stimulus universal. The Group concluded that each country remains free to address its economic and budget problems in its own way. That should normally have gone without saying; it was a sign that US efforts had not persuaded Germany to back off from its plans for sharp cuts in government spending.

Other countries did a better job of consulting history. In the end, the G-20 overcame US resistance and collectively agreed to cut budget deficits in half by 2013. Thankfully, many European leaders are alert to the danger in which sovereign indebtedness places them. Led by the British and the Germans, they are determined to pare back their bloated governments even if it is over the objections of American politicians.

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3. Ben Broadbent and Kevin Daly, "Limiting the Fall-out from Fiscal Adjustments," Global Economics Paper No. 195, Goldman Sachs, April 14, 2010.



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