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THE MAIN STREET ECONOMIC RECOVERY PROPOSAL: Will It Bring Us Out of Recession?

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FEAR OF A deep recession has led policy makers to propose an unprecedented stimulus package to save the economy, a sort of Main Street economic recovery package that would rely heavily on government-sponsored infrastructure projects to create jobs and stimulate economic activity.

The problem is real. The unemployment rate is 6.7 percent and rising: 10.3 million American workers are unemployed, and 2.7 million jobs were lost in the last year alone. If history is any guide, however, the bailout the government proposes won't work.

Instead, policy makers should focus on the fundamentals of economic behavior and the incentives faced by individuals, governments, and entrepreneurs. Reducing taxes, insisting on fiscal prudence on the federal level, and encouraging it on the state and local level by cutting, rather than increasing, public spending would do far more to help the economy than any of the proposals currently being discussed in Washington.

BACKGROUND

IN EARLY OCTOBER, on the heels of the Wall Street bailout bill, Senator Harry Reid and House Speaker Nancy Pelosi proposed a \$61 billion Main Street economic stimulus bill to help state governments close rapidly growing budget shortfalls.¹ The idea quickly gained support. On October 29th, Governor Corzine of New Jersey, Governor Paterson of New York, and Douglas Palmer, the mayor of Trenton, New Jersey, made a case for both fiscal relief for states—through increased funding for Medicaid, food stamps, and unemployment benefits—and for economic stimulus in the form of highway and bridge repair, alternative-energy initiatives, and school construction.

Post-election estimates of such a package rose to more than \$150 billion. The incoming Obama administration adopted and advanced the idea, promising to “create millions of jobs by making the single largest new investment in our national infrastructure since the creation of the federal highway system in the 1950s.”² Total projected spending skyrocketed to at least \$500 billion and may reach as much as \$1 trillion over two years.

spending.⁴ This supposedly creates new employment that may eventually lead to an increase in the economy’s income (i.e. “aggregate” income) that is greater than the initial increase in government spending. This overall increase is due to the multiplier effect. As an individual employed by the government consumes a portion of her income, the recipients of that spending do the same, creating new income for someone else, which in turn leads to new consumption, and so on.

Government cannot create wealth. When the government directs resources to government-identified uses, there is no guarantee that these funds are being put their best possible uses.

In late November, President-elect Obama asked state and local governments to communicate their needs. On December 8th, the U.S. Conference of Mayors released a preliminary report of 11,391 “ready-to-go” projects requested by 472 cities surveyed. The report claims the \$73 billion in projects will create 847,641 jobs. By January the list could easily double as a little over one-third of cities have responded as of this writing.³

Some version of this request will likely form the basis of the new spending bill in January, but will this approach put the economy on the road to recovery?

WHAT’S THE ECONOMIC RATIONALE?

THE CURRENT ECONOMIC crisis began with a severe tightening of credit in the housing market followed by the default of several major U.S. investment banks. In this period, consumer spending has fallen dramatically. Drawing upon the work of economist John Maynard Keynes, some commentators see the “capitulation” of American consumers as an aggravating cause of the current downturn.

According to the Keynesian view, during recessions people hoard money rather than spend it. That means less money is invested, leading the economy into recession as unemployment increases. The remedy: stimulate spending and investment.

The idea is to boost the total sum consumers spend (i.e. “aggregate” spending) in the economy by increasing government

CAN STIMULUS SPENDING SAVE THE ECONOMY?

THOSE WHO SUPPORT stimulus spending argue government must spend because consumers won’t. There are many problems with this view.

First, the notion of “aggregate” is spurious because it considers the economy as a homogenous system with one representative consumer who invests and spends. It overlooks the fact that each individual is in a specific situation and adjusts to his or her circumstances all the time. It also provides the government with the false certainty to act as if it had full knowledge of the situation.

Second, where does government get its money? Government spending comes from three sources: taxes, debt, or inflation (or a combination of these). These all boil down to one primary source: taxation. Government’s remedy is to increase public spending by raising more in current or future taxes. Taxes simply transfer (current or future) resources from consumers to government, displacing private spending and investment.

Taxation comes with costs. Higher taxation encourages tax avoidance, which causes people to change their behavior. They may engage more in non-taxed activities, such as household production. Economists explain that these behavioral changes create a “deadweight loss,” i.e. resources that could have been created but aren’t—we are all impoverished as a result.

Third, government cannot create wealth. When the government directs resources to government-identified uses, there is no guarantee that these funds are being put their best possible uses. Government lacks the incentive to identify relevant, socially beneficial investments. Unlike entrepreneurs, government officials are not guided by profits and they do not suffer losses if they misallocate resources. Only entrepreneurs, who risk their capital, are positioned to identify and exploit opportunities for wealth creation. At best, government spending displaces jobs and misallocates resources, producing a “negative multiplier effect,” zeroing out any positive effects created by new government spending.

Fourth, we don’t know what portion of income newly government-employed individuals will consume. They may choose to spend now or later. As crisis brings greater uncertainty,

many people may choose caution: spending less now is a safety mechanism. The multiplier effect, however, is predicated on consumption estimates that may not work in times of crisis, even with new government employees.

Fifth, there is no particular virtue attached to consumption. In order to consume, one has first to invest and produce, but the decision to invest and produce is one that belongs to the entrepreneur; it means nothing outside of the context in which an entrepreneur finds herself. Investing cannot be seen as an “aggregate” category.⁵

Finally, government-generated job counts are taken as evidence of guaranteed economic activity. But for economic benefits to occur, it matters how jobs are created. Jobs created by the private sector result from entrepreneurial innovation and trade. This process leads to real productivity gains and higher standards of living. At the end of the day, the government cannot replicate what only private entrepreneurial activity can do.⁶

GETTING THE DIAGNOSIS RIGHT

INCREASING GOVERNMENT SPENDING bypasses why people are operating in safety mode. Lenient mortgage and monetary policies led some to invest in housing on the bet that rising real estate prices would be a quick, high-payoff investment. The bubble has burst. Real estate prices are adjusting to a level that reflects peoples’ true capacity to own property. In this adjustment period, home (and other) prices are falling. Nobody knows when these prices will stabilize, so people are adapting to this uncertainty.

Government stimulus policies begin with the view that overall demand is lower than overall supply. There are cars, houses, and other goods to be sold, but people don’t want them at current prices. In short, demand and supply are out of sync.

Without government intervention, how long will demand and supply remain out of sync? Not long. As entrepreneurs lower prices and consumers adjust their behavior, prices will lead demand and supply towards equilibrium.

In markets, demand cannot stay low relative to supply without prices adjusting, but the current aim of government is to override the necessary downward adjustment in prices needed to restore certainty. Delaying these price adjustments does not solve the supply and demand gap. It only pushes uncertainty into the future passing a greater debt burden onto the next generation. Moreover, if lack of fiscal prudence and structural budgetary problems are part of the reason for the current crisis, greater public spending only adds insult to injury.

POLICY OPTIONS FOR CONGRESS AND THE NEW ADMINISTRATION

The bet of the economic recovery proposal is that since increased public spending will be debt-financed, the high-taxation policies of the 1930s will be avoided. But debt has to be paid somehow, someday. Increasing public debt can only push the U.S. Treasury further on the road to bankruptcy rather than making the economy healthier.⁷

Fearing deflation, the Federal Reserve has engaged in a massive expansion of its total assets.⁸ An expansionist monetary policy accompanied with a stimulus package will simply delay recovery. This will induce inflation, which will have to be dealt with through a contraction of the Fed’s balance sheet, creating another crisis.⁹

Instead of engaging in activist fiscal policy, the government should announce a policy of fiscal prudence promoting lower public spending and thereby creating a good context for entrepreneurial activity.

1) Let the price mechanism run its course.

Prices in some economic sectors have been artificially inflated for too long. Downward adjustment of prices will release resources from unprofitable sectors to more profitable ones where they are most useful.

2) Restore a climate favorable to entrepreneurial discovery and innovation.

In order to discover new business opportunities, entrepreneurs must have the confidence that they can invest and be rewarded for it. But while the institutional environment must reward entrepreneurial activity, it should not socialize losses by subsidizing failure.

- Congress and state governments should reduce taxes clearly, permanently, and for all categories of taxpayers.¹⁰
- Congress should send the message that the federal government is not a lender of last resort and that no corporation is too big to fail.
- Incentives should be set in place to restore fiscal prudence and lower spending at all levels of government. A bailout directed at states to hide past fiscal mistakes and miscalculations will only deepen structural budgetary problems.
- With potentially lower short-run revenues, governments must reduce their spending and innovate in the provision of services by working with the private sector. This will have the added benefit of creating opportunities for wealth creation and increasing employment.

CONCLUSION

IF HISTORY IS any guide, deficit spending on a grand scale doesn't work. Unemployment remained above 20 percent for the duration of the Great Depression in spite of an active job creation policy. While there are key differences between the 1930s and today, temptation is running high to re-experiment with this model by creating jobs to prop up "aggregate" demand.

Expansionist monetary policy and bad lenient housing policies have created artificially inflated prices and over investments in many sectors of the economy. This boom will end when overblown prices can fall. There is no way around it. The coming price adjustment is akin to a patient needing surgery: it will be a difficult time, but it is necessary to recover good health. Policy makers should help this process by putting their fiscal houses in order and removing barriers to resource allocation: reduce taxes, insist on fiscal prudence on the federal level, and encourage it on the state and local level by cutting, rather than increasing, public spending.

ENDNOTES

1. Many states and localities are experiencing fiscal stress due to unexpected revenue shortfalls that are insufficient to cover increases in government spending. Many governments are realizing the fallout of a long-running lack of fiscal prudence and their decisions to deepen rather than address structural budgetary problems—expanding public sector benefits, school financing decisions, and federal mandates. See Norcross and Sautet, "Crisis may finally force fiscal restraint," *New Jersey Star Ledger*, November 17, 2008 and "Who's Next in Line for a Bailout? State Governments," *Forbes.com*, November 24, 2008, http://www.forbes.com/opinions/2008/11/24/state-budget-bailout-oped-cx_en_fs_1125norcrosssautet.html.
2. President-elect Barack Obama's radio address, December 6, 2008.
3. On December 19th, the U.S. Conference of Mayors released an updated report. To date, 641 cities have submitted a total of 15,221 "ready-to-go" infrastructure projects representing \$96,638,419,313 in potential new federal spending and that would be capable of producing an estimated 1,221,677 jobs in 2009 and 2010.
4. The government can also cut taxes to increase private consumption but stimulus contenders often see it as risky because it may amplify hoarding rather than consumption.
5. In the context of investment, the spurious notion of "aggregate" also masks differences that exist among situations. It might be profitable to invest in a given line of business in some places but not in others. But this information is not available to government.
6. See for instance Israel Kirzner and Frederic Sautet, *The Nature and Role of Entrepreneurship in Markets*, Mercatus Policy Series, Policy Primer 4 (Arlington, VA: Mercatus Center at George Mason University, 2006).
7. As James Buchanan explains: "The introduction of an activist fiscal policy regime of budgetary adjustment did require that the classical precepts of fiscal prudence be abandoned and specifically that budgetary balance be dethroned as a central and overriding policy constraint." James Buchanan, "Keynesian Follies," in *The Legacy of Lord Keynes*, David A. Reese, ed. (San Francisco: Harper & Row, 1987), 130–47.

8. The Federal Reserve System's total assets have gone from \$919 billion in July 2008 to \$2,262 billion as of December 10, 2008. Federal Reserve Statistical Release H.4.1.
9. This is what happened in 1982 when the Chairman of the Federal Reserve, Paul Volker, decided to kill the Fed's expansionary policies.
10. The permanent income hypothesis states that individuals do not change their spending habits when transitory changes in their income occur (e.g. a one-time rebate, or tax reduction). It is when these changes are seen as permanent that changes in spending habits take place (e.g. a commitment to tax reform).

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