



Larry Summers

Paul Krugman

## Fiscal Factoid

**A**ccording to the *Oxford English Dictionary*, a factoid is “an item of unreliable information that is reported and repeated so often that it becomes accepted as fact.” The standard Keynesian fiscal policy prescription for the maintenance of non-inflationary full employment is a fiscal factoid. The chattering classes can repeat this factoid on cue: to stimulate the economy, expand the government’s deficit (or shrink its surplus); and to rein in an overheated economy, shrink the government’s deficit (or expand its surplus).

Even the economic oracles embrace the fiscal factoid. That, of course, is one reason that the Keynesians’ fiscal mantra has become a factoid. No less than Nobelist Paul Krugman and, until recently, President Obama’s economic guru Prof. Larry Summers weighed in with the fiscal factoid in separate articles which appeared in the 15 May 2011 issue of *The New York Times Magazine*. Prof. Krugman asserted that the U.S. “economic policy should be concerned with jobs, jobs and jobs.” And to generate more jobs, Prof. Krugman recommends – you guessed it – “continuing budget deficits.” Prof. Summers sings from the same song sheet. The lack of jobs keeps Prof. Summers “in cold sweats at night.” And when he was operating as the Director of President Obama’s National Economic Council, his advice was clear: “the president was told that there was no danger of doing

too much fiscal stimulus, and that we should do as much as we could from an economic point of view.”

Some people – particularly some with a conservative turn of mind – pooh-pooh Prof. Krugman’s and Prof. Summers’ musings. This attitude is worse than a crime, it is a blunder. Statements made by the likes of Nobel laureates and former Presidents of Harvard University carry weight – even if those statements amount to nothing more than factoids. The famous “Dr. Fox Lecture,” which was presented at the University of Southern California’s Medical School, illustrates just how so-called “experts” can effectively work and influence a crowd. The lecture was presented by Dr. Myron Fox – an advertised heavyweight – to an academic audience. The response to Dr. Fox’s lecture was unanimously favorable. Little did the audience know that “Dr. Fox” was an actor who had been cloaked with an impressive fake curriculum vitae and trained to deliver a nonsensical lecture filled with contradictory statements, double-talk and non sequiturs. When the big guns sound off, they are heard.

The cold, hard facts can silence the big guns, however. One of the most notable cases involves the fiscal factoid. Prime Minister Margaret Thatcher made a dash for confidence and growth via a fiscal squeeze. To restart the economy in 1981, Mrs. Thatcher instituted a fierce attack on the British fiscal deficit, coupled with an expansionary monetary policy. Her moves were immediately condemned by 364 distinguished economists. In a letter to *The Times*, they wrote a knee-jerk Keynesian response: “Present policies will deepen the depression, erode the industrial base of our economy and threaten its social and political stability.” Mrs. Thatcher was quickly vindicated. No sooner had the 364 affixed their signatures than the economy boomed. People had confidence in Britain again, and Mrs. Thatcher was able to introduce a long series of deep, free-market reforms.

As for the 364 economists (who included seventy-six present or past professors, a majority of the Chief Economic Advisors to the Government in the post-WWII period, and the



**Do Fiscal Stimuli Stimulate?** (United States)

	Levels of (as a % of Potential GDP):		Changes in (as a % of Potential GDP):	
	Output Gap	General Government Structural Balance	Output Gap	General Government Structural Balance
2001	-0.4	-0.1		
2002	-1.5	-2.9	-1.1	-2.8
2003	-1.5	-3.7	0.0	-0.8
2004	-0.5	-3.2	1.0	0.5
2005	0.0	-2.3	0.5	0.9
2006	0.3	-2.0	0.3	0.4
2007	0.0	-2.3	-0.2	-0.4
2008	-1.8	-4.7	-1.9	-2.4
2009	-6.0	-6.8	-4.2	-2.0
2010	-4.8	-7.5	1.2	-0.7
2011	-3.7	-8.1	1.1	-0.6
2012	-2.7	-5.7	1.0	2.4
2013	-2.0	-4.4	0.7	1.3
2014	-1.4	-4.3	0.6	0.1
2015	-0.9	-4.8	0.5	-0.5
2016	-0.4	-5.3	0.5	-0.5

Sources: International Monetary Fund, *International Financial Statistics*, May 2011 and Author's Calculations.

Notes:

1. A positive (negative) change in the output gap implies an economic expansion (contraction).
2. A negative (positive) change in the general government structural balance implies a fiscal stimulus (contraction).
3. The output gap is the difference between the actual level and the trend level of national output.
4. The general government structural balance is the difference between revenue and expenditure in a cyclically normal situation, with the business cycle midway between a boom and a recession.

president, as well as nine present or past vice-presidents, and the secretary-general of the Royal Economic Society) they were not only wrong, but came to look ridiculous. In the U.S., the peddlers of the fiscal factoid have never suffered the intellectual humiliation of their British counterparts. In consequence, Profs. Krugman and Summers can continue to peddle snake oil with reckless abandon and to influence policy in Washington, D.C. and elsewhere.

Let's take a closer look at the fiscal facts and the effectiveness of the Keynesian fiscal elixir. Nobelist Milton Friedman addressed the issue in a 1999 *Wall Street Journal* column (8 January 1999). Prof. Friedman wrote:

*The Keynesian view is that government deficit spending is cyclically stimulative whether it is financed by borrowing or by*

*newly created money. The monetarist view is that spending financed by newly created money is cyclically stimulative whether the spending is by the government or the private sector. Government spending financed by borrowing may or may not be stimulative depending on how much private spending is crowded out by government spending. Either outcome is possible, depending on conditions.*

*It is not easy to distinguish between these views on the basis of empirical evidence, because fiscal stimulus generally is accompanied by monetary stimulus. The relevant evidence is provided by those rare occasions when fiscal and monetary policy go in different directions.*

To test whether the Keynesian or monetarist view was supported by the empirical evidence, Prof. Friedman recounted two episodes in which fiscal and monetary policies moved in different directions. The first was the Japanese experience during the early 1990s. In an attempt to restart the Japanese economy, repeated fiscal stimuli were applied. But monetary policy remained "tight," and the economy remained in the doldrums.

Prof. Friedman's second example was the U.S. experience during the 1990s. When President Clinton entered office, the structural fiscal deficit was 5.3% of potential GDP.

In the ensuing eight years, President Clinton squeezed out the fiscal deficits and left office in 2000, with the government's accounts showing a structural surplus of 1.5%. Ironically, the two years in which Prof. Summers was President Clinton's Secretary of the Treasury (1999-2000), the U.S. registered a structural surplus of 0.9% and 1.5% of GDP. Those years were marked by "tight" fiscal and "loose" monetary policies, and the economy was in an expansionary phase. (Note: I have included President Clinton's entire tenure in office.)

## Average U.S. Federal Government Expenditures as a % of GDP

	Historical	Obama's Budget	CBO Extended-Baseline Scenario	Commission's Proposal	Ryan's Proposal
Eisenhower I	18.3				
Eisenhower II	17.9				
Kennedy - Johnson	18.6				
Johnson I	18.7				
Nixon I	19.5				
Nixon - Ford	20.0				
Carter I	20.8				
Reagan I	22.8				
Reagan II	22.1				
Bush I	21.9				
Clinton I	20.8				
Clinton II	18.8				
Bush I	19.2				
Bush II	20.1				
Obama I 1st Half	24.4				
Obama I 2nd Half		24.5	23.7	23.9	23.3
President ?		22.5	22.5	21.8	20.7
President ?		22.7	23.2	21.8	19.9

Sources: Congressional Budget Office, Office of Management and Budget, House Budget Committee, National Commission on Fiscal Responsibility and Reform and Author's Calculations.

Prof. Friedman concluded with the following remark: "Some years back, I tried to collect all the episodes I could find in which monetary policy and fiscal policy went in opposite direction. As in these two episodes, monetary policy uniformly dominated fiscal policies."

We can further demonstrate the existence of the fiscal factoid by comparing changes in the output gaps and general government structural balances. In the accompanying table, the first column records the output gap. When the gap is positive (negative), actual output is above (below) the economy's potential. The second column in the table is the general government's structural balance. When it is negative (positive), a fiscal deficit (surplus) exists. The third and fourth columns record the changes in the output gap and general government structural balance, respectively. A positive (negative) change in the output gap implies an economic expansion (contraction), and a negative (positive) change in the general government structural balance implies a fiscal stimulus (consolidation).

If the fiscalists (Keynesians) are correct, we should observe an inverse relationship between changes in the rate of growth in output (the third column of the table) and the budget balance (the fourth column of the table). From 2001 through 2016, as projected by the International Monetary Fund, the U.S. economy does not behave in the way that Prof.

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Krugman and Summers and other Keynesians have asserted and proselytized. Indeed, the number of years in which the economy responded to fiscal policy in an anti-Keynesian fashion was more than double those in which the economy followed the Keynesian dogma. Prof. Friedman is right, again.

The fiscal problem that is destroying

## Reduction in Government Expenditures Relative to CBO Scenario (in billions of USD)

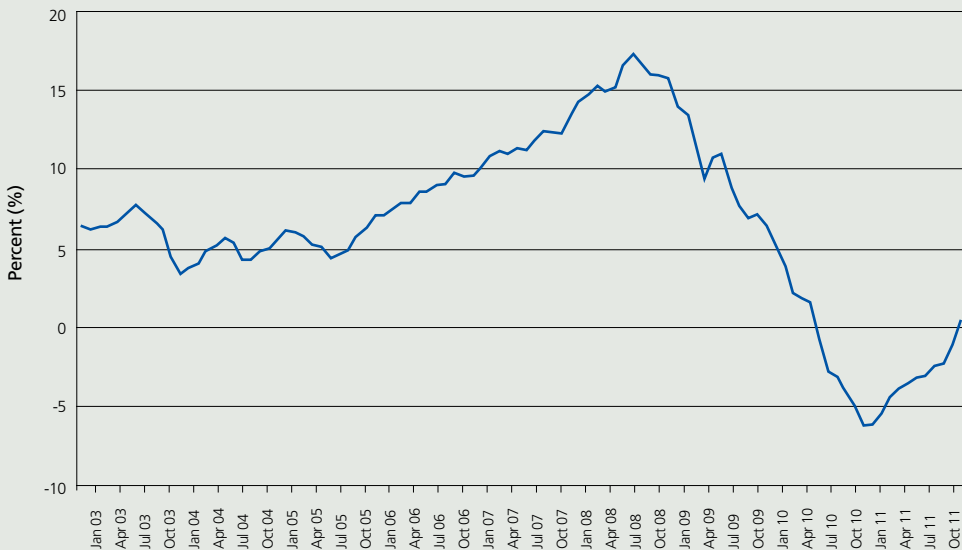
	GDP	Total Expenditures as a % of GDP -- CBO Extended-Baseline Scenario	Obama's Budget	Ryan's Resolution	Commission's Proposal
2011	15,034	24.5	120	-60	-15
2012	15,693	22.9	110	-63	63
2013	16,400	22.4	16	-115	-49
2014	17,258	22.3	17	-259	-121
2015	18,195	22.4	-18	-400	-146
2016	19,141	22.8	-38	-517	-172
2017	20,033	22.9	-80	-601	-220
2018	20,935	23.0	-105	-691	-293
2019	21,856	23.3	-109	-743	-328
2020	22,817	23.5	-114	-821	-388

Sources: Congressional Budget Office, Office of Management and Budget, House Budget Committee, National Commission on Fiscal Responsibility and Reform and Author's Calculations.

the growth in government. However, that's not the case with President Obama. His rhetoric and actions have convinced the public that government spending has experienced a regime change. They believe that the record government spending, as a percent of GDP (24.4%), during the first half of President Obama's current term, is here to say. The public believes that this will result in more taxes, or government debt, and/or inflation. This is evident when debates about alternative budget plans and scenarios associated with putting government spending relative to GDP back in the post-WWII range (see the accompanying table).

If monetary, not fiscal, policy dominates – as Prof. Friedman concluded – just what is monetary policy telling us? First, the dramatic collapse in the broad measure of money in the U.S. (see the accompanying chart) explains why President Obama's massive fiscal stimulus packages haven't worked as advertised. Second, the broad measures of money also indicate that a growth recession – below trend growth rates – will continue.

### M3 Growth (Year-over-Year % Change)



Sources: Federal Reserve Bank of St. Louis (January 2003-February 2006) and Shadow Government Statistics (March 2006-April 2011).

confidence is not the fiscal balance, however. It is the level of government expenditures relative to GDP. Since President Eisenhower took office in 1953, through the last year of President George W. Bush's administration in 2008, federal government expenditures, as a percent of GDP, ranged from a low of 18.2% under President Clinton to a high of 23.5% under President Reagan (see the accompanying table).

Even though government spending was setting new records during President Reagan's first term, the public believed that President Reagan's "fiscal conservatism" would allow him to eventually prevail and control

#### References:

Donald H. Naftulin, M.D., John E. Ware, Jr., and Frank A. Donnelly. "The Doctor Fox Lecture: A Paradigm of Educational Seduction." *Journal of Medical Education*, Vol. 48, 1973, pp. 630-635.

**Steve H. Hanke** is a Professor of Applied Economics at The Johns Hopkins University in Baltimore and a Senior Fellow at the Cato Institute in Washington, D.C.