Fake Economics

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Politics and economics are interwoven. Government grants licenses, enforces contracts and the rule of law, provides fire and police protection, a national defense, and can call on resources to recover from crisis. Without these institutions, activity would slow. No one is building billion-dollar hotels in Syria, Libya, or Iraq; stability and certainty support investment.

The rule of law and stable institutions don't create growth by themselves, but they do provide the framework. It's entrepreneurs that see opportunity and reorganize existing resources in a different, more efficient, and more profitable way. That's how growth happens. Human nature, however, doesn't change. Politicians want to take direct credit for growth. Remember when Al Gore said he helped "create" the Internet?

One of the greatest myths in all of economics is the "Government Spending Multiplier" sometimes called the "Fiscal Multiplier." This concept came from a Keynesian, demand-side analysis of the economy that looks at something called the "marginal propensity to save." Someone who earns $100 but only spends $90 has a 10% marginal propensity to save. In the demand-side world, where consumption drives economic activity, the $10 in savings is seen as a negative. Having $10 less spending means $10 less in demand.

Politicians argue that taking that $10 from the saver, and giving it to someone who will spend it, increases growth. For example, Nancy Pelosi said back in 2013 that "unemployment benefits remain one of the best ways to grow the economy" because it "injects demand into our markets." She said every dollar spent on unemployment creates up to an extra $2 in GDP.

This is magic, it's like turning lead into gold. All you have to do is win election, raise taxes, put those taxes in the hands of someone with a 0% marginal propensity to save, and voila, you've created your own economic growth.

But clearly, this is a myth. Imagine we redistributed away all the savings in an economy. Without savings there would be no investment, and without investment there would be no long-term growth. That's why we focus on the supply side of the economy. From a supply-side view of the world, new inventions create growth and new inventions need savings and investment. Demand did not create the cell phone or apps. Before the inventors of Bird or Lime, consumers were not prowling the streets looking for electric scooters to ride.

From 2010-2017, real GDP grew just 2.1% per year, in spite of massive deficits and the largest share of GDP redistributed in the history of the U.S. In the past year, following deregulation and tax cuts, and the number of people receiving unemployment benefits falling to its lowest level since 1973, real GDP growth has accelerated to 3%. This is evidence that the "fiscal multiplier" is a myth.

This brings us to infrastructure spending, which many think will be one of the first things the newly divided government will agree on. Of course, good infrastructure helps promote efficient economic activity. But it won't create net new jobs. By borrowing or taxing money from the private sector to build the infrastructure, politicians harm growth elsewhere. In the long run it *may* be positive, but in the short-run, at best, it's neutral. Beware of politicians saying they can create jobs and speed growth. That's demand-side thinking, and it hasn't worked anywhere in the world up to this point.