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Unintended Consequences of Well-Intended Policies

In the early 1960s, when JFK was in the White House and William McChesney Martin was Fed chairman, Keynesian economics was in full bloom. One of its major tenets is the Phillips Curve, which posits a stable inverse relationship between the rate of inflation and the unemployment rate. Yale professor James Tobin and others argued that the social outcome could be improved by a more activist monetary and fiscal policy. Specifically, they contended that the unemployment rate could be lowered while only resulting in slightly higher inflation.

The argument posited the notion that economic policymakers had sufficient knowledge to intervene or fine-tune the economy with tools like those of a surgeon. Presidents Johnson, Nixon, and Carter (two Democrats and one Republican) followed this policy. At one point, President Nixon made the famous statement that "We are all Keynesians now." Moreover, as the White House led, the Fed chairmen of the era – Martin, Burns, and Miller – generally acquiesced.

To judge the effectiveness of this policy, an objective standard is needed. Arthur M. Okun, Yale colleague of Tobin, developed such a standard, which he called the Misery Index – the sum of the inflation and unemployment rates.

Under the activist, Phillips Curve-based policy, some reduction in unemployment was temporarily achieved. However, inflation accelerated much more than was anticipated, and the net result was higher unemployment and faster inflation, an outcome not at all contemplated by the Phillips Curve. The Misery Index surged from an average of 6.7% in the 1950s, to 7.3% in the 1960s, to 13.6% in the 1970s, with peak rates above 20% in the early 1980s.

Many US households suffered. Wages of lower-paying positions failed to keep up with inflation, and when higher unemployment resulted, many of those people lost their jobs. Those on the high end had far more resources that enabled them to protect their investments and earned income, so the income/wealth divide worsened. A half-century later, the United States has never regained the prosperity of the 1950s.

Working independently in the late 1960s, economists Milton Friedman and Edmund Phelps, who would both eventually be awarded the Nobel Prize in economics, had determined that while the Phillips Curve was observable over the short run, this was not the case over the long run. While the economics profession debated the Friedman/Phelps research, the US had to learn its findings the hard way.

Growing Evidence of the Long-term Depressants from Activist Policies

In addition to the compelling evidence that more active monetary and fiscal policy involvement did not produce beneficial results over the short run, three recent academic studies, though they differ in purpose and scope, all reach the conclusion that extremely high levels of governmental indebtedness diminish economic growth. In other words, deficit spending should not be called "stimulus" as is the overwhelming tendency by the media and many economic writers.

Whereas government spending may have been linked to the concept of economic stimulus in distant periods, these studies demonstrate that such an assertion is unwarranted, and blatantly wrong in present circumstances. While officials argue that governmental action is required for political reasons and public anxiety, governments would be better off to admit that traditional tools only serve to compound existing problems.

These three highly compelling studies are:

- Debt Overhangs: Past and Present, by Carmen M. Reinhart, Vincent R. Reinhart, and Kenneth S. Rogoff, National Bureau of Economic Research, Working Paper 18015, April 2012;
- Government Size and Growth: A Survey and Interpretation of the Evidence, by Andreas Bergh and Magnus Henrekson, IFN Working Paper No. 858, April 2011;

• The Impact of High and Growing Government Debt on Economic Growth – An Empirical Investigation for the Euro Area, by Cristina Checherita and Philipp Rother, European Central Bank, Working Paper Series 1237, August 2010.

These papers reflect serious research by world-class economists from the US, Europe, and Sweden – and they all confirm the detrimental consequences of extreme governmental indebtedness.

Misery on the Rise Again

In the past year, Okun's impartial arbiter averaged 10.5%, the highest on record for the third year of an officially recognized economic recovery and almost double the average of the 1950s. The latest readings have occurred despite US gross public debt in excess of 103% of GDP and with the Federal Reserve's unprecedentedly large balance sheet that approaches nearly $3 trillion.

Other measures of well-being confirm the Misery Index. The Poverty Index in 2011 appears to have reached 15.7%, the highest reading in five decades. Not surprisingly, two unenviable records have been set: 46 million, or 14.6% of the population, are now in the food stamp program, up from 7.9% in 1970 and a record-high 41% pay zero national income tax.

In the eleven quarters of this expansion, the growth of real per-capita GDP was the lowest for all of the comparable post-WWII business cycle expansions. Real per-capita disposable personal income has risen by a scant 0.1% annual rate, remarkably weak when compared with the 2.9% post-war average. It is often said that economic conditions would have been much worse if the government had not run massive budget deficits and the Fed had not implemented extraordinary policies. This whole premise is wrong.

In all likelihood the governmental measures made conditions worse, and the poor results reflect the counterproductive nature of fiscal and monetary policies. None of these numerous actions produced anything more than transitory improvement in economic conditions, followed by a quick retreat to a faltering pattern while leaving the economy saddled with even greater indebtedness. The diminutive gain in this expansion is clearly consistent with the view that government actions have hurt, rather than helped, economic performance. Sadly, many of those whom the government programs were supposedly designed to help the most have suffered the worst.

The Way Out

The original theoretical argument in favor of deficit spending originated in J.M. Keynes' The General Theory of Employment, Interest and Money. A search of Keynes' work reveals no recognition of the "bang point," or the condition where a government engages in deficit spending for such a prolonged period of time that a massive buildup of debt leads to denial of additional credit to the government because of fear that the existing debt will not be repaid. Nor did Keynes address the situation where a large number of countries are all simultaneously getting deeper and deeper in debt and there are gradations of debt among these countries – serious shortfalls in the basic Keynesian theory.

Keynes, as opposed to some of his interpreters and predecessors, may have implicitly recognized that a bang point could occur, because he did not recommend constant budget deficits. Instead, he advocated cyclical deficits, counterbalanced by cyclical budget surpluses. Under such a system, government debt in bad times would be retired in good times. However, Keynes' original proposition was bastardized in support of perpetual deficits, something Keynes himself never advocated.

Milton Friedman, whom many consider to have been the polar opposite of Keynes, also never addressed the concept of a bang point, but he may also have understood implicitly that such a situation could occur. The reason is that Friedman advocated balanced budgets, which if followed or required constitutionally as Friedman argued, would prevent a buildup of debt. This view was largely rejected as being inhumane since in a recession, government policy would not be responsive to unemployment and other miseries of such a condition. What should have been discussed is whether some short-term misery is a better option than putting the entire country and economic system in jeopardy, as numerous examples in Europe currently illustrate.

The most sensible recognition of budget policy came not from Keynes nor Friedman, but from David Hume, one of the greatest minds of mankind, whom Adam Smith called the greatest intellect that he ever met. In his 1752 paper Of Public Finance, Hume advocated running budget surpluses in good times so that they could be used in time of war or other emergencies. Such a recommendation would, of course, prevent policies that would send countries barreling toward the bang point. Countries would have to live inside their means most of the time, but in emergency situations would have the resources to respond.

In the context of today's world, this approach would be viewed as unacceptable because it would limit the ability of politicians to continue their excessive spending, thereby saddling future generations with obligations and promises that cannot be honored. But isn't Hume's recommendation exactly what we teach our children in preparing them to manage their own personal finances?

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