Managing For Success

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Why Is "Stimulus" A Key Component To A Dynamic Recovery?

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In applying the principals of modern economics, government stimulus can play a very important role in shaping the duration and depth of a recession. The right type of stimulus can shorten the duration and severity of a recession. Whether a recovery is flat or "V" shaped, may depend on the right type of stimulus.

But what is meant by "stimulus?" When politicians use the term "stimulus" they usually mean government spending. To an economist, stimulus may in part be spending, but not all spending is "stimulus."

Why isn't all spending considered the right type of "stimulus?" We analyze "stimulus" by looking at its impact, such as the amount of *multiplier effect* (additional dollars resulting from the initial spending), the *velocity effect* (the rate at which the dollars turnover in the economy), and whether the impact is *immediate*. We also look at whether the spending is out of existing government revenue or out of borrowed dollars, since each has different ancillary effects.

Moreover, not all "stimulus" is government spending; "stimulus" can be the opposite, tax cuts. Tax cuts, like spending, represent the application of government revenues. By foregoing revenue when taxes are cut, the government promotes private sector spending, which under the right circumstances can have critical immediate impact and substantial multiplier and velocity effects.

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These distinctions between types of spending and their stimulative effect are very important. ***What is a simple example of spending that is immediate, but has little multiplier or turn over effect?*** Assume you normally drink five glasses of water per day.

Suppose as a "stimulus" the government paid you to drink an additional or sixth glass of water today. It has the immediate effect of promoting water production and consumption. But once the glass of water is drunk, there is no multiplier. All the government bought was one glass of water beyond normal, and to get the next glass drunk, the government must pay you again. *When the government stops paying, the extra drinking stops.* Since it does not promote continuous drinking by you or others, there is no velocity or multiplier effect.

Similarly, if you have lost your job and the government gives you a dollar, it merely replaces a dollar you used to get from your employer. Such payments may be very important, but they are not stimulus.

In terms of how government spending affects economic activity in a downturn, it is not the impact of how the first dollar affects economic activity, but how quickly the dollar is turned over in the economy and its multiplier effect that is important. That is why not all spending is "stimulus."

To stimulate the economy, spending must be a catalyst to future accelerated private sector spending. ***Is infrastructure spending stimulus?*** To be sure, infrastructure spending can over a longer time frame have both a multiplier and a turn over effect. Abraham Lincoln was a supporter of government spending on infrastructure such as public roads and canals as well as railroads. He believed that in our free market economy, improved transportation fostered the creation of new businesses through providing the means to move people, goods and services to and from new and expanding markets. Thus, in Lincoln's view, government spending to facilitate improved transportation had a positive stimulative effect on the economy. In Lincoln's time the Government was also making frontier land available for new farms.

So his concept of Government funding infrastructure was coupled with putting frontier land to work. If you create a new farm, started by clearing previously unproductive land, hire people to work the farm, buy equipment to run the farm, and ship food to consumers, these dollars turnover and create new added dollars. This was the type of stimulus Lincoln was proposing. While this transportation spending in the long run had multiplier and turnover effects, it was not immediate.

What are some of the ways to determine what infrastructure spending is appropriate in a recession? Spending where the multiplier and turnover effect happen quickly will best stimulate the economy. The more severe the recession the more important that the effect be immediate. In a recession, you also want to limit Government borrowing as much as reasonable under all of the circumstances.

When the government borrows dollars, those dollars generally are removed from the private sector dollars otherwise available to finance increased economic activity. Possible by-products of heavy deficit spending are higher interest rates, inflation, reduction in capital available to the private sector, reduced job creation and a weak dollar.

The government today believes that "green" spending is like Lincoln's non-recession transportation infrastructure spending and will help end the recession. ***Is government spending on solar panels and wind mills, stimulus or are we observing a modern day Don Quixote?***

The goal of recession stimulus is to immediately create additional new sales, on an accelerating basis, with rapid turnover. To create the demand for and capacity to manufacture solar panels and wind turbines is not a quick process, for among other reasons, alternative fuels are substantially less expensive. To change the disadvantageous cost differential, the alternative fuels must become substantially more expensive or solar power and wind power must become substantially less expensive. Neither is possible in a relatively short period of time.

Thus, spending on solar and wind power are not recession "stimulus." The disadvantageous cost differential means that we would need to artificially

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withdraw disposable dollars from the economy while simultaneously increasing the price of alternatives in order to justify consumers using solar and wind power.

Such a substantial change, under current circumstances, reduces discretionary disposable income spending by reallocating it to an expenditure that does not have an immediate high turnover/multiplier effect. This reduces other purchases and has a decelerating effect. Thus, spending on solar and wind power reduces immediate velocity and is the opposite of recession "stimulus." It may even be inflationary, in effect placing an additional "tax" through higher costs for power or other items.

We would also need to add substantial infrastructure such as improved capacity to store and transmit the new power created by this means. We must keep in mind that the role of Government is different in a recession than during normal times. In the long run this may be very beneficial, but it is not what will retain jobs or create immediate new ***additional*** employment (the amount by which new jobs exceed the number of existing jobs lost because of the change). For example, it will take a very large number of new jobs to replace all of the mining jobs lost and those in all the industries that support the mining industry, if we artificially put an end to the use of fossil fuels like coal to generate electricity.

Just as trading unemployment checks for pay checks doesn't add dollars to the economy, trading green jobs for existing jobs does not add dollars to the economy. Spending on Green transformative projects is normally best done when the economy is stable and can absorb the dislocation it creates during the transition.

Is government spending on the arts or academic research or similar types of projects, "stimulus" that creates a recovery in a substantial downturn? If the government supports an artist's painting a picture or a scientist or professor studying a subject that does not create real immediate opportunity for new jobs there is no multiplier effect. When the spending stops, the impact stops. Once the picture is finished it does not create more pictures.

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Spending $3,000,000 to find old damaged and abandoned lobster traps so they can be destroyed isn't stimulus. Once they are found and destroyed, the activity is over. There is no multiplier effect and no continuing stimulation.

What is the most effective form of "stimulus?" *Sometimes the most effective stimulus is not government spending, as such, but tax cuts.* We recognize that when we reduce the government's income through tax cuts, it is in a sense government spending by another means.

What long term substantial tax cuts do is leave dollars that would otherwise have been spent by government in private hands to be spent or invested as disposable income. This creates investment capital to fund economic activity and to be spent on the goods and services that the private sector desires and has already been buying.

In a recession, that concept is important, because that is where jobs and their supporting business infrastructure already exist. It retains jobs and alleviates the cost of unemployment insurance that would be spent if the jobs were lost and the dislocation created when existing infrastructure is left idle. It also maintains the type of activity that consumers want to continue supporting with non-government dollars as the economy returns to normal.

In a recession, the first step is to maintain demand for existing revenue streams to prevent layoffs and stabilize the economy. Tax cuts also make the capital available to finance new job creation, while reducing the need to replace the spending of those who would lose their jobs. History illustrates that tax cuts are a very practical way to stabilize the economy and stimulate a "V" shaped recovery.

In the past 100 years, other than the great depression, we have experienced essentially three economic downturns that look like the dislocative downturn we are experiencing today.

In the first, 1921, production slowed rapidly resulting in an average 11.7% unemployment rate. Industrial production declined 31.2% and the S&P 500 lost over 30% of its value. ***What did the government do?*** *The government cut* *corporate, personal, and capital gains taxes*. The government also reduced spending and the national debt.

What happened? In 1922, 2.4 million jobs were created, unemployment fell, prosperity returned, government revenues rose and the S&P 500 recovered and rose above where it had been.

In the second, 1961, we were sliding into a deep recession. Unemployment hit 6.7%. President Kennedy, after comparing 1921 to the depression, lead the Congress to institute the highest tax cuts in history and started a long term economic upturn.

In the third, 1982, we had a downturn which statistically looks identical to today. Among the dislocating factors was a steep rise in oil prices caused by OPEC. The unemployment level reached a high of 10.8%, production declined, and the stock market declined. The government again cut taxes and brought spending under control. Government did eventually increase spending on defense. The cumulative effect of these steps began an unprecedented period of economic change and growth that has lasted until last year.

There is no doubt that just as there are similarities between the three prior downturns and today, there are also many differences. However, sustained substantial tax cuts were immediate and created velocity with a multiplier effect. The longer term impact of this type of stimulus was to generate increased tax revenues by creating taxable profits streams. Increased government spending on new initiatives followed economic stabilization.

In a major downturn, government stimulus is usually financed with borrowed dollars. Since borrowing drains capital needed to finance recovery and expansion from the economy, the government ***must*** choose its form of stimulus with great care to avoid a double reduction in velocity and a negative impact on the economy.

By contrast with the 1921, 1961, and 1982 recessions, how did Government policy effect the recession of 1929? In 1929 we began a major downturn. The Government, including the Fed, did not act to alleviate the lack of

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available credit. The Government initially cut spending and raised tariffs, reducing foreign trade.

The government raised taxes and substantially increased spending just as the economy was leveling out. The depression deepened and became extended. Industrial production fell 52%. Today many economists believe that raising taxes, excessive borrowing, and excessive spending caused the double dip downturn that occurred between 1929 and the start of World War II.

In the current recession, the Government (including the Fed) have taken a number of actions to restore liquidity to the banking system and alleviate the lack of available credit. Some economists argue that the government's bail outs and exceptionally strong and prolonged credit infusions through lack of focus and overly broad reactions have gone too far, and are now part of the problem not the cure.

The underlying strength of the economy, coupled with factors such as substantially reduced petroleum and natural gas prices, have contributed to the free market system's ability at present to begin stabilizing the economy. Economists point to the fact that almost no stimulus money reached the economy before the current leveling began.

There are several major measures now pending in Congress that over the next five years could result in an enormous increase in the national debt with possible inflation eroding savings and investment capital. In the short run, the Government is poised to spend enormous sums over the next 14 months. Whether the spending will be a real "stimulus," or turn out to be just a glass of water whose refreshing characteristics will fade after the drink is finished, remains to be seen.

Even if it is just a drink it should end the year over year downward slide and help level the economy in 2010. If it is only a drink of water it will not create a "V" shaped recovery and restore employment to pre-downturn levels. A flat recovery will only set the stage for a far more serious double dip downturn.

What the economy needs now is "stimulus" whose velocity and multiplier affect are immediate and continuing.

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