

FREEMarket

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THE STIMULUS DOES NOT WORK

Shawn Ritenour

Shawn Ritenour teaches economics at Grove City College (srritenour@gcc.edu).

A majority of Americans now give President Obama's handling of the economy a negative rating, and many economists and city officials are concerned that Obama's gargantuan stimulus effort has not given the expected quick boost to the economy. Some argue this is because funds have been slow in coming owing to bureaucratic red tape meant to ensure that the money spent will not be wasted. Jared Bernstein, chief economist for the office of Vice President Joe Biden (who knew that the vice president needed a chief economist?), is quoted as saying "We're hitting the right balance between speed and oversight."

Unfortunately for the American public, sound economics teaches that, regardless of how fast the money is spent or how much oversight is provided by bureaucrats, the money doled out by the stimulus plan will be wasted and will have a detrimental impact on the economy in the long term, because that is the nature of profligate government spending.

From an economic perspective, Obama's stimulus plan is equivalent to a giant welfare scheme. Instead of the money going to lower income Americans, however, it is meant to go to municipal bureaucrats of various stripes. Instead of productive American citizens determining what to do with their own scarce resources, the state is stepping in and dictating how they will be used.

Consequently, such spending is essentially government consumption, which is what vulgar Keynesians think we need now more than ever. Such economists are shocked—shocked!—to find out that Americans are now saving any increases in income instead of blowing them on even more consumer goods. Not to worry, however. If private citizens do not consume enough for official tastes, the government always can.

Certainly we can expect that when the government spends a trillion dollars this will provide a positive statistical boost to GDP, if for no other reason than government spending makes up a significant portion of GDP. Where, however, does the state get the money to spend? Ah, as Hamlet might say, there's the rub. There are only three ways the government can obtain funds to throw at all their shovel-ready projects, and all three leave in their wake negative economic consequences.

The most obvious thing the government could do to raise the funds to spend on fiscal stimulus is to raise taxes. However, this method is the economic equivalent of robbing Peter to pay Paul. Taxation directly impinges on taxpayers' well-being because ➡



they are left with less income from their labors with which to provide for themselves and their families.

Additionally, taxation reduces prosperity in the long run, because it fosters capital consumption over time. Taxation reduces the ability to save and invest in capital. Because savings come out of income and as people have less income at their disposal, they have less to save and invest. Taxation reduces the incentive to invest as well, because future rates of return on any investment will be reduced by taxes on positive income. A project that might have netted 10 percent without new taxes might only net 7 percent after taxes. If a 7 percent rate of return is not an acceptable rate for a specific capitalist, he will choose not to save and invest. If saving and investment decreases over time, capital will be consumed. Labor will become less productive, resulting in lower incomes and less prosperity. Not what you want to happen when trying to get out of a depression.

Because taxes are so politically unpopular, governments usually resort to additional ways to raise funds, one of which is borrowing. A good case can be made that government borrowing is more harmful for long-run economic progress than taxation. Although taxation reduces both consumption and investment spending, government borrowing comes entirely from the nation's pool of savings. The money that is lent to the government in treasury bond purchases is entirely money that was saved and ready for investment. Instead of being invested in productive capital accumulation, however, it is being lent to the government to fund state consumption.

When the government borrows, it becomes a major demander of loanable

funds, so market interest rates increase, making it harder for private entrepreneurs to gain access to capital for their production. As private capital available for productive enterprise shrinks, our economy becomes less productive and less prosperous.

The other source of funding turned to by the government is monetary inflation. Governments can either create money and spend it outright or they can inject money into the economy through the banking system so that people and banks can use this new money to buy up government bonds, thereby monetizing the debt. This route is preferred by governments that want to borrow more money without all those nasty rate increases.

Monetary inflation produces another set of negative economic consequences. In the first place, when the government increases the money supply, in general people hold more money than they want to at prevailing overall prices. They relieve this excess supply by spending the excess money on consumer and producer goods.

Increasing the money supply does not spontaneously increase the stock of these goods; it merely increases the amount of money being spent on the same quantity of goods. Because more money is spent, the demand for producer and consumer goods increases, so overall prices increase and the purchasing power of the dollar falls. There is, therefore, no general social benefit from inflation.

In fact, monetary inflation via credit expansion is the source of our present trouble. Artificial credit expansion—credit not funded by savings—creates the business cycle by spawning capital malinvestment. Artificial credit expansion makes many unwise investments (say,

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Ludwig von Mises Institute, 518 West Magnolia Avenue, Auburn, Alabama 36832-4501

Phone: 334-321-2100; Fax: 334-321-2119; Email: info@mises.org; Web: mises.org

in residential and commercial real estate and financial derivatives) look profitable because of the accessibility of cheap credit, so business activity expands, manifesting itself in an inflationary boom.

Bad investments, however, are not made economically sound merely because there is more money in existence. These bad investments eventually must be liquidated. The boom resolves itself in a bust whose twin children are capital consumption and unemployment. The moral of the story is that monetary inflation is not a way to sustainably generate economic prosperity.

One thing the government does do by increasing the money supply is discourage saving. This is because, as prices rise, money saved becomes worth less and less, so people are more likely to spend it on present consumption while the spending is good.

Promoting consumption is the last thing we need to build up a capital stock that has been woefully depleted thanks to malinvestment. The old economic saw cuts true: there is no such thing as a free lunch, and there is no costless way to fund government spending.

Given that Obama's \$798 billion stimulus program is a done deal, the only question is which economic poison will the government pick to drink: taxation, borrowing, or inflation? It turns out that the answer is all three. The government's fiscal response to our current debacle is a near perfect example of what not to do when trying to regain solid economic footing.

While not wanting to be identified as the great tax assessor and, hence, promising to cut taxes for most citizens, Obama is actively seeking ways to increase taxes for a host of Americans. Imposition of a national sales tax is a very live option sitting atop the Obama administration's policy table. The administration is also presently considering raising taxes on health care expenditures by taxing employer-provided health care benefits and by decreasing the deductibility of medical expenses. It wants to raise taxes on cigarettes, adult beverages, and sugar-sweetened elixirs such as soft drinks, fruit juices, iced teas, and sweetened coffee drinks.

Obama has proposed raising corporate taxes by \$190 billion over the next ten

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years. He wants to place heavier taxes on commodities and option traders. Obama is even favorably considering increasing taxes on intangible drilling, an important technique in oil and gas exploration. While taxing these specific groups may be politically doable, it cannot be good for capital accumulation and economic recovery.

It is already conventional wisdom that a huge part of the stimulus program will be funded by borrowing. Who would have thought that in his first year in office, Obama's thirst for red ink would make George W. Bush (himself no foe of government borrowing) look like the frugal presidenté.

The US government reported the first monthly budget deficit in an April in over 25 years and a record budget deficit in the month of May. The current year's official deficit is slated to be \$1.85 trillion (that's right, trillion)! The good news is that the Obama administration has things under control. They project that next year's deficit will only be \$1.25 trillion. When the US Treasury spends over a trillion dollars more than it receives in taxes, it must borrow to fill the gap. In fact, the deluge of government debt has already begun. The national debt has increased by \$804 billion in less than five months. Last week alone investors bought \$65 billion in long-term Treasury debt.

Not surprisingly, interest rates on Treasury notes have begun to rise. Already this year interest rates on 10-year treasury bonds have increased 1.4 percent, and rates for 30-year fixed mortgages increased to 5.5 percent, the highest they have been since November 2008. Higher market interest rates indicate, of course, that loanable funds are becoming relatively more scarce and we know that they are being shunted to less productive uses perpetrated by the state. Even Ben Bernanke is publicly confessing concerns that fiscal deficits like the ones being projected for the near future will serve as a serious drag on the economy.

One thing that Bernanke is not concerned about is inflation. Increasing

liquidity by expanding the money supply is his drug of choice to prescribe to an ailing economy. From the first quarter of 2008 to the first quarter of 2009, the monetary base increased from \$96.2 billion to \$820.8 billion, an inconceivable annual rate of 753 percent. Such a huge expansion understandably sows seeds of fear of hyperinflation. If banks, who are presently sitting on a mountain of excess reserves, began to feel things are closer to normal and begin making loans at pre-2008 quantities (something the government is encouraging) there will be a gigantic increase in the money supply.

Notwithstanding official worries about deflation, Federal Reserve money supply figures reveal that the money stock has already inflated at a noticeably higher rate. The Fed's measure of MZM, money of zero maturity, increased from \$8,356.8 billion in the first quarter of 2008 to \$9,385.5 billion in the first quarter of 2009. Additionally, the rate of growth in the monetary aggregates accelerated during the last quarter of last year and the first quarter of this year.

As discussed earlier, economic theory teaches us if the money stock increases, overall prices of goods will be higher than they would be without the increase, because demand for goods will be higher due to increased spending. While it is not always easy to distinguish between relative and overall price increases when price changes are occurring, it does appear that prices of many goods have resumed an upward trend.

The national average of the price of regular gasoline has increased by 58 cents since the end of April. It has increased \$1.01 since the end of last year. Agricultural crop prices have also been rising steadily this year while reserve grain inventories have shrunk to low levels. Robert Murphy has recently made us aware that the non-seasonally adjusted consumer price index increased at an annual rate of 4.3 percent last month. All of these trends are consistent with the above mentioned monetary inflation and suggests that, as sound economic analysis

tells us, the recent monetary inflation has not provided any real help to the economy in general, but is merely serving to spur increased prices.

The moral of the story is that we are right to be concerned that the Obama stimulus plan will not stimulate economic progress and will not usher in the next age of prosperity. Government spending merely directs scarce factors of production away from their most productive uses. Taxation, government borrowing,

and monetary inflation all produce negative economic consequences. Real economic expansion is the product of wise entrepreneurs using capital that is funded by real savings. Such economic progress results in more goods that can be purchased for lower prices. As we are seeing play out before our eyes, the only thing that government stimulus plans stimulate is capital consumption and fewer goods available for higher prices—not a recipe for economic recovery. ■

WHAT CHANGES AND WHAT DOES NOT

Murray N. Rothbard

Murray N. Rothbard (1926–1995) was dean of the Austrian School. He was an economist, economic historian, and libertarian political philosopher. This essay appeared in The Freeman, 1962.

“Why, you’d take us back to the horse and buggy.”

The basic fallacy of this all-too-common cliché is a confusion between technology and such other aspects of human life as morality and political principles. Over the centuries, technology tends to progress: from the first wheel to the horse and buggy to the railroad and the jet plane. Looking back on this dramatic and undeniable progress, it is easy for men to make the mistake of believing that all other aspects of society are somehow bound up with, and determined by, the state of technology in each historical era.

Every advance in technology, then, seemingly requires some sort of change in all other values and institutions of man. The Constitution of the United States was, undoubtedly, framed during the “horse-and-buggy” era. Doesn’t this mean that the railroad age required some radical change in that constitution, and that the jet age requires something else?

As we look back over our history, we find that since 1776, our technology has been progressing, and that the role of government in the economy, and in all of society, has also grown rapidly. This cliché simply assumes that the growth of government must have been required by the advance of technology.

If we reflect upon this idea, the flaws and errors stand out. Why should an increase in technology require a change in the Constitution, or in our morality or values? What moral or political change does the entrance of a jet force us to adopt?

There is no necessity whatever for morality or political philosophy to change every time technology improves. The fundamental relations of men—their need to mix their labor with resources in order to produce consumer goods, their desire for sociability, their need for private property, to mention but a few—are always the same, whatever the era of history. Jesus’s

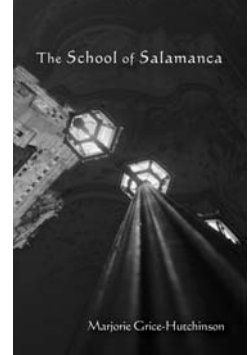
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One can see how it came to have such influence on both Joseph Schumpeter and Murray Rothbard, both of whom used this work as their major source material.

Until this edition, the book might have been very expensive except for one thing: it was completely unobtainable anywhere by any means. Even devotees of the history of thought have not been able to put a copy in their personal libraries. The Mises Institute is thrilled to bring it back to the public. **To order, see Mises.org/store.** ■



teachings were not applicable just to the ox-cart age of first-century Palestine; neither were the Ten Commandments somehow “outmoded” by the invention of the pulley.

Technology may progress over the centuries, but the morality of man's actions is not thereby assured; in fact, it may easily and rapidly retrogress. It does not take centuries for men to learn to plunder and kill one another, or to reach out for coercive power over their fellows. There are always men willing to do so. Technologically, history is indeed a record of progress; but morally, it is an up-and-down and eternal struggle between morality and immorality, between liberty and coercion.

While no specific technical tool can in any way determine moral principles, the truth is the other way round: in order for even technology to advance, man needs at least a modicum of freedom to experiment, to seek the truth, to discover and develop the creative ideas of the individual. And remember, every new idea must originate in some one individual. Freedom is needed for technological advance; and when freedom is lost, technology itself decays and society

sinks back, as in the Dark Ages, into virtual barbarism.

The glib cliché tries to link liberty and limited government with the horse and buggy; socialism and the welfare state, it slyly implies, are tailored to the requirements of the jet and the TV set. But on the contrary, it is socialism and state planning that are many centuries old, from the savage Oriental despotisms of the ancient empires to the totalitarian regime of the Incas. Liberty and morality had to win their way slowly over many centuries, until finally expanding liberty made possible the great technological advance of the Industrial Revolution and the flowering of modern capitalism.

The reversion in this century to ever-greater statism threatens to plunge us back to the barbarism of the ancient past. Statists always refer to themselves as “progressives,” and to libertarians as “reactionaries.” These labels grow out of the very cliché we have been examining here. This “technological determinist” argument for statism began with Karl Marx and was continued by Thorstein Veblen and their numerous followers—the real reactionaries of our time. ■

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