

## The Myth of Fiscal Stimulus

By Robert Genetski

In response to the current economic crisis, Congress is set to increase government spending by close to a trillion dollars. In spite of the view of many so-called experts, there is clear historical evidence that such a move will only create more problems.

Since the federal government doesn't have any money, the Treasury will have to borrow the trillion dollars by selling bonds. Those who buy the bonds will do so by giving up their spending power to the government, which transfers it to the recipients of the "stimulus" package.

The theory behind the move is that when government takes money from some and gives it to others it helps the economy. Figuratively, it's as if we had a bathtub where the water level represents real economic activity. Some economists believe that government is so efficient that it can take a glass, fill it with water, pour it back into the tub and the water level will actually rise.

Other economists are skeptical. Classical economists believe that government tends to be so inefficient that when it pours the water out, the level actually goes down. The historical evidence on this is as clear as it could possibly be.

The first chart below shows the history of federal government spending along with the Dow Jones Industrial average during the 1920s and 1930s. For most of the 1920s government spending declined by over 50%. This decline in government spending was accompanied by major tax cuts. These policies ushered in the Roaring Twenties, a period of rapidly rising prosperity and a booming stock market.

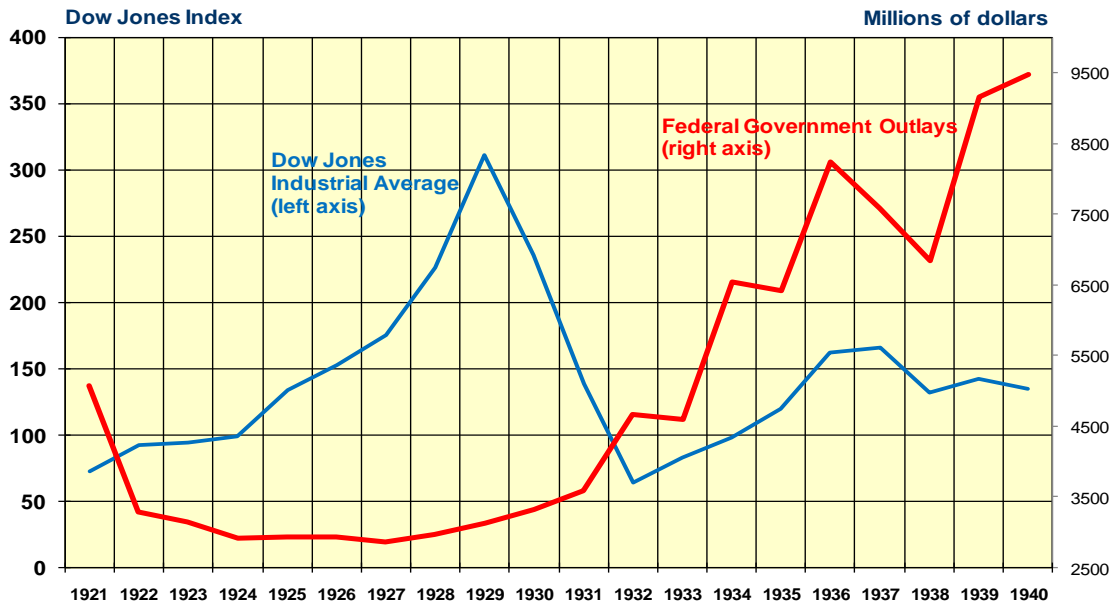
Toward the end of the 1920s, government increased its spending and the economy began to suffer. In response to a faltering economy, government spending soared. What followed is now known as the Great Depression.

The entire history of government spending going back to 1920 shows the same pattern. The second chart shows this history. It's a bit more difficult to follow since both government spending and the Dow Jones are in natural log form. The reason for using logs is that a hundred point move in the Dow is different when the Dow is at 10,000 than when the Dow was only 1,000. The use of logs enables us to view similar percent changes over long periods of time. Whenever the slope of the lines increases, it means that there is an increase in the growth rate of either the Dow or government spending. When the slope is constant it means the rate of growth is unchanged. Whenever the line shows no increase, it means that there was no increase in either of the series.

The slowdown in the rate of growth in government spending from 1953 to the late 1960s was accompanied by rapid growth and a soaring increase in stock prices. From the late 1960s to the early 1980s the increased growth in government was accompanied by a decade in which the economy suffered and the Dow failed to increase. After allowance for inflation, the real value of stocks declined sharply. In spite of a massive military buildup under Reagan, the overall growth in government spending slowed. Both the economy and stocks soared. With the acceleration in the growth of government spending during the current decade, stocks have again performed poorly.

During the 1990s Japan's efforts to stimulate its economy with massive increases in government infrastructure spending produced a decade of economic stagnation. Historical evidence is clear. It tells us what we should expect from massive increases in government spending.

### Government Spending & Stock Prices



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