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The Misdirection of Resources and the Current Recession

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by

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I have spent my academic career in the economic analysis of law and in the broad area of "political economy." I am not a macroeconomist. So why I have been writing and speaking on this subject in recent months?

The simple answer is that we are at cross-roads with regard to the role of the State in our lives. This is a matter that no political economist can ignore. The impetus for a vast expansion in the role of the State is coming from our current financial and economic situation mediated by urgent macroeconomic policy advice. This past Sunday's *Washington Post* proclaims that almost all economists agree that even a flawed package is better than none and time is of the essence![3]

So the political economist must now think about a whole new complex of issues.

Unfortunately, much of the policy advice offered recently by commentators, including many economists, is shockingly superficial. It is reminiscent of the simple prime-the-pump ideas of the early Keynes and does not acknowledge Keynes's own cautions and qualifications after the *General Theory* was published, especially in his advisory work for the UK Treasury in the 1940s.

As a *micro*economist, however, I wish to emphasize the resource-allocation issues that characterize both the current situation and its underlying causes. I do this because the macroeconomic way of thinking typically ignores all this. In doing so, it ignores the complexity of our system and generates policies that will not bring lasting recovery.

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[3] "Economists Agree Time Is of the Essence for Stimulus," *Washington Post*, February 8, 2009. http://www.washingtonpost.com/wp-dyn/content/article/2009/02/07/AR2009020702159.html?hpid%3Dtopnews&sub=AR

Before I make my microeconomic points regarding stimulus, I wish to make a very general point regarding the process by which the stimulus is being considered and approved. I believe that recent experience supports the claim that the economist and political philosopher Friedrich Hayek made in *The Road to Serfdom* in 1944. Democracy and central planning are incompatible or, at least, in deep tension.

His argument was that "society" does not naturally have a comprehensive hierarchy of values about how resources should be spent. Therefore, any large-scale plan – like the current stimulus package – will, if considered in detail and with the requisite amount of time, reveal deep disagreements among various political constituencies. The current "stimulus rush," as I have called it, is only partly about the perceived economic need to do something fast. After all, according to the Congressional Budget Office Analysis of the House bill, most of the spending will not take effect in the current calendar year. Furthermore, there is no economic evidence that a program passed in the next few days will be noticeably more effective than one passed in mid-March or mid-April. I believe the real reason for the rush is the belief that if the bill is not rushed through its support will crumble as the people find out what is in the bill and evaluate it according to their different values and opinions. This is indeed the case.

But what this experience exposes is that when the State moves beyond its generally agreed-upon basic functions the legislature will be seen more and more as an "ineffective talking shop" and democratic values of deliberation, discussion and consulting-constituents must be seriously compromised.

Let me now move on to the microeconomic aspects of stimulus. I am focusing on the so-called economic rescue and not "financial rescue" which, although related, has its own unique set of problems. I have four major points. The last one is about "solutions" insofar as they are possible.

1. *We must remember that the current economic state of affairs was caused by the excessively low interest-rate policy followed by the Federal Reserve from about mid-2002 through the third quarter of 2006. This policy resulted in significant economic distortions or imbalances.*

To say that it was "caused" by the Fed's policy is not to say that once this occurred that other problems in the financial sector did not play a significant compounding role. Yet, were it not for the unsustainable misdirection of resources that we are now calling the "housing bubble" we would not be faced with our current major problems.

Low interest rates tend to favor consumer durable goods (like houses and automobiles) and capital projects because the present value of these are increased relative to what they would be at higher rates. Resources then tend to move into these areas as entrepreneurs react to market demand.

However, when interest rates rise, these areas are differentially affected on the downside. Mortgage rates and other bank lending-rates rise. Capital projects that were unfinished at the time of the rise will experience the movement of resources out of these areas. Those – like homeowners – who borrowed on the assumption of continuing low rates will find that they cannot pay off their loans. Banks which loaned on this assumption, and those who purchased securities based on these mortgages, will lose capital. This will hurt the availability of credit from bank sources and from the continued securitization of other assets.

But note what has happened at a fundamental level. There has been *resource misallocation* revealed at the time interest rates rose. Too many resources had gone into various sectors in a way that was not sustainable. This was going on during the period of low interest rates but was not visible. The rise in rates revealed that it had been a mistake all along.

Recent research by John Taylor suggests that if the "Taylor Rule" had been followed during 2002-06 much of the housing bubble would have been avoided and therefore the subsequent price reversal and associated financial difficulties would have been much less severe.[4] (The Taylor Rule adjusts the federal funds rate in accordance with the degree to which the actual and desired inflation rates differ, and the degree to which actual output differs from full-employment output. It would raise rates when inflation is higher than desired and lower them when output is below full employment.)

At the same time, other independent sectoral shifts have been occurred in the U.S. economy. In particular, the Big Three automobile companies have for many years been experiencing a decline in their ability to compete with others, including foreign manufacturers assembling cars in the United States. The market has been revealing that the allocation of resources going into the former firms is a mistake – that capital is being destroyed in this area – as market share was lost. Yet the fall in interest rates temporarily masked many of the problems as the demand for automobiles in general and other consumer durables rose. Between 2002 and 2006 household borrowing grew at an annual rate of 11 percent.

2. Stimulus should not stimulate or reinforce the misallocation of resources.

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[4] John Taylor, "The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong" (November 2008). http://www.stanford.edu/~johntayl/FCPR.pdf

For the microeconomist the notion of stimulus-in-general is a crazy-making idea. What is the object of stimulus?

a. Trying to prop up housing prices or injecting capital into areas of misallocation is a bad idea. It prevents the market's corrective mechanisms from working. Wealth should not continually be destroyed after the errors of the bubble have been revealed. This is the proverbial practice of throwing good money after bad.

Some economists, notably Glenn Hubbard and Chris Mayer, have tried to calculate – on the basis of historical experience – what mortgage rates, and hence housing prices, should be now *relative to fundamentals.* They believe that housing prices are too low by perhaps 10-15%.
Hubbard and Mayer believe that they have fallen too much because as the value of mortgage-backed securities is either unclear or too low, banks lack the capital to lend in the housing market and elsewhere. So there is vicious cycle of feedback effects.[5]

The great difficulty here is that trying to gauge the correct market prices, for both mortgages and houses, is not a practical exercise. Markets are valuable precisely because no one knows what the "right" price is. Prices are the outcome of a process of discovery in which trial and error have their crucial roles. At least this much should have been learned from the failure of socialist economies and the debates on socialist calculation in the 1940s.

One of the problems in evaluating mortgage-backed securities is doubtless due to confused expectations on the part of market participants. Will the markets be allowed to find their bottom? What kind of political intervention will there be in the housing or mortgage markets? What will be the effect of that intervention?

b. Stimulating sectors through government spending is likely to create its own form of unsustainable resource allocation.

In some cases, it will attempt to restore, perhaps due to political considerations, depressed markets to their previous condition, when that previous condition was an overexpansion. In other cases, it will prop up certain sectors like "infrastructure" and whatever else the near-trillion dollars will be spent on. Assuming, *as we are told,* these expenditures are temporary, what happens when the resources shift out of these previously-favored areas? This is likely to

[5] Glenn Hubbard and Chris Mayer, "First, Let's Stabilize Home Prices," Wall Street Journal Opinion, October 2, 2008. http://online.wsj.com/article/SB122291076983796813.html

occur if the government spending is inconsistent with the voluntary preferences of consumers-savers-investors.

More importantly, will lenders and related businesses know *when* the stimulus will end or shift?[6] If not, *policy uncertainty will compound our problems*. Investors and economic decisionmakers will be unable to calculate expected returns on possible investments in which they can have reasonable confidence. Consequently, extenders of credit will have poor guidance as to what they should do. (In fact, the current uncertainty is to a certain extent derived from the policy uncertainty about the future.)

The idea would have to be that government spending would stimulate output "permanently" *outside* of the directly-stimulated sectors. The evidence is meager but not encouraging. In a recent New York Times article Greg Mankiw suggested:[7]

> In practice, however, the multiplier for government spending is not very large. The best evidence comes from a recent study by Valerie A. Ramey, an economist at the University of California, San Diego. Based on the United States' historical record, Professor Ramey estimates that each dollar of government spending increases the G.D.P. by only 1.4 dollars. So, by doing the math, we find that when the G.D.P. expands, *less than a third of the increase takes the form of private consumption and investment. Most is for what the government has ordered…* (Emphasis added).

3. Stimulus should create net economic value and not destroy it.

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[6] J.M. Keynes argued in 1942 that to be effective in creating employment building programs, for example, must be certain in both extent and duration:
"The difficulty of predicting accurately the appropriate pace of the execution of the building programme is extremely tiresome to those concerned. You cannot improvise a building industry suddenly or put part of it in cold storage when it is excessive. Tell those concerned that we shall need a building industry of a million operatives directly employed – well and good, it can be arranged. Tell them that we shall need a million-and-a-half or two million – again well and good. But we must let them have in good time some reasonably accurate idea of the target. For it the building industry is to expand in an orderly fashion, it must have some assurance of continuing employment for the larger labour force." (Keynes, Collected Writings, vol. XXVII, p.268).

[7] N. Gregory Mankiw, "Economic View: Is Government Spending Too Easy An Answer?" January 10, 2009.
http://www.nytimes.com/2009/01/11/business/economy/11view.html

In a sense, it is easy to create employment: As Keynes suggested, we can bury old bottles with money in them and then ordinary incentives will get people out there digging.[8]

But employment (work!) is not a goal in itself. Wealth or value is. If we could get value without work, that would be a very good thing.

To create value, stimulus will have to steer clear of a number of problems.

First, it will have to attract resources that are currently producing *less* value than would be produced in uses engendered by the stimulus package. Given that more than 90% of the labor force is currently employed and that leisure does have a value, this is not obvious. The areas stimulated by government spending will not conveniently use only unemployed resources.
Second, the actual activities promoted by new government spending would have to be of positive value, especially in the aggregate. This problem will be exacerbated by the political reality that areas in which misallocations are greatest will experience the greatest pain and thus will attract compensatory spending.

Third, the debt created to finance this spending will require either higher taxes in the future or it will generate inflation. In either case, future wealth will be lost as productive activities will be penalized. Will the wealth created today, if any, be worth the cost of future losses in wealth?

4. What should be done?

The first thing to keep in mind is that activities that prevent or inhibit the re-allocation of resources out of their bubble-induced misdirected uses will only

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[8] Keynes believed that the *indirect* effects of this activity on stimulating other activities that are themselves value-enhancing would tend to increase the wealth of the community. " If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coalmines which are then filled up to the surface with town rubbish, and leave it to private enterprise on well-tried principles of *laissez-faire* to dig the notes up again (the right to do so being obtained, of course, by tendering for leases of the note-bearing territory), there need be no more unemployment and, *with the help of the repercussions*, the real income of the community, and its capital wealth also, would probably become a good deal greater than it actually is. It would, indeed, be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better than nothing" (Emphasis added). J. M. Keynes, *The General Theory of Employment, Interest and Money* (1936), p. 129.

prolong the current recession. This kind of stimulus is *not* better than nothing. It is worse than nothing.

My own preference is: First, allow market adjustments to take place. When economic agents are confident that prices will be allowed to equilibrate, they will begin to take action in both financial and economic areas. Values of resources and assets will become more transparent. It may be necessary also to devise transaction-cost reducing structures to allow for the efficient valuation of complex assets.

Secondly, the current atmosphere of uncertainty has created an increase in the demand to hold money and a reluctance to lend, borrow, invest and consume. And yet the dangers of an outright deflation seem slim. Nevertheless, a *neutral* stimulation of spending may do some good.

By "neutral" stimulation I mean one than does not encourage unsustainable lines of spending and production or reinforce the misdirection of resources. Tax reductions seem to be the only likely candidates. This is because, to the extent that they encourage economic activity, they do so in accordance with the voluntary decisions of economic agents. This are more likely to express the underlying preferences of consumers-investors and resource owners and hence be sustainable.

Simple rebates and lump-sum credits, however, are not as likely to work as reduction in marginal rates. This is because the former do not offer incentives that will tend to offset the disincentives to spend generated by generalized uncertainty.

And this reduction should be across the board. It is important that taxes on capital income be reduced. It would also be useful to cut or even abolish the corporate income tax in part to increase the internal financing of businesses and make them less dependent on bank credit or other forms of external finance.

If the tax revisions are going to favor only the "middle class" (I am not quite sure what this means), then the incentives to invest will probably not be enhanced. Even Keynes did not think that consumption spending could lead us out of slumps.[9]

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[9] In a letter to the economist James Meade in April, 1943 Keynes said," A remission of taxation on which people could only rely for an indefinitely short period might have very limited effects in stimulating consumption. And, if it was successful, it would be extraordinarily difficult from the political angle to reimpose the taxation again when employment improved." However, he goes on to say that a reduction in the payroll tax, if following a certain automatic formula of variation, might be effective in stimulating consumption (because it affects the working class the most)

However, to avoid the impact of later tax increases or inflation to pay for the current tax reductions, a credible commitment must be made to cut government spending later. A very liberal use of sunset provisions should be made in spending bills. Even more radical, but perhaps politically infeasible, is the idea the current legislation should incorporate a "sense of Congress" that renewals of spending will require a two-thirds vote in favor.[10] And, of course, a commitment to entitlement reform must be also made.[11]

Unfortunately, the temper of the times has it that tax cuts, especially for the "rich," are the cause of our woes. It also has it that middle-class entitlements are a problem only later on.

To make lasting progress toward recovery, these ideas reflecting current delusions must be fought and refuted.

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and would be easier to reverse due to its formula-like rule of variation. See J. M. Keynes, *Collected Writings*, vol. 27, p.319.

[10] The Senate Republicans introduced a "trigger amendment" that would have required cuts in stimulus once the economy experienced two successive quarters of positive GDP growth. This was a good idea but it failed to attract more than 44 votes.

[11] Additional useful ideas can be found in Jeffrey A. Miron, "CNN Commentary: Libertarian Ideas to Stimulate the Economy." February 5, 2009.
http://www.cnn.com/2009/POLITICS/02/05/miron.libertarian.stimulus/index.html