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THE ECONOMIC ANTIDOTE

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Europe – No More Tricks in the Keynesian Bag

Watching Europe twist in the wind is very educational. For decades, European politicians have perfected the art of defending the Keynesian myth that government spending and government jobs actually do create wealth.

They are not alone in this practice…for example, here in the United States, Mark Zandi from Moody's is well known for his estimates of multipliers. These multipliers – which show how much a dollar of government spending will boost GDP – are used to support government spending. Zandi argued that $1 spent extending unemployment benefits would increase GDP by $1.63, and $1 for infrastructure would add $1.59 to GDP.

To a supply-sider, this talk of multipliers is ridiculous. However, proving that they do not exist is sometimes problematic. There are so many moving parts in an economy (for example Fed policy, regulatory policy, tax rates) that it is impossible to prove a multiplier does or does not exist by looking at short-term economic trends. After all, the Fed is super easy today and new technology is coming on line – so the question becomes whether current growth in consumer spending and jobs should be attributed to the Fed and tech; or to government spending?

The good news for those who are serious about finding an answer to this question is that we do have a long-term experiment. It's called Europe. Europe has been the Economic Petri Dish for experiments in Keynesian theory. And the results are spectacularly bad. Despite government spending of nearly 50% of GDP, European economies have been a mess. Unemployment, living standards and overall economic growth have lagged significantly.

Between 1980 and 2008, unemployment rates in Europe rose well above unemployment in the US. Only recently, as the US has massively expanded the size of its government, have these unemployment rates converged again. Now, all of them are at very high levels.

Faced with these facts, what did European politicians do? Well, they did lots of things – after all, their bag of tricks is deep. First, they moved the goal lines. They started talking about "happiness." They argued that growth rates and jobs were not the important measures of economic success…happiness was. And for a long time they got away with this. As long as they could borrow and make people happy, it worked.

Today, Europe is not growing…and it's not happy, either. The most disappointed person in the world is the 54-year old Italian or Greek who thought they were about to retire to a happy, upper-middle-class, worry-free existence. But Santa Claus is no more. The European welfare state is dead.

The Bag of Tricks is now empty. European politicians and economists have borrowed just about everything they can and they have no more room in the back of closets or under the rug to hide or sweep government spending and debt. They can't devalue their currency and inflate to make things look better, they can't fool the bond markets anymore and the only people left who believe that they can possibly spend their way out of this are teaching in American classrooms.

Italy has debt equal to 100% of GDP, a nominal GDP growth rate of about 1.8%, and interest rates of over 7%. In other words, debt service costs are higher than the economic growth rate. Greece is in worse shape by this measure.

There are only two ways out. Austerity – spend less than you take in and use the difference to pay down debt. Or default – like Greece. The stand-up thing to do is austerity. You borrowed the money, you should repay it. None of this is a surprise, or at least it shouldn't be. The Continent has known for a long time that growth rates were weak and that pension funds were underfunded. While government can and should do certain things, modern day politicians around the world have pushed it so far that government spending has become harmful to economic growth. Keynesian multipliers are less than zero – government spending subtracts from growth.

The obvious question at this point is whether or not the US has reached this point? The answer is, "not yet." Government spending in the US is hurting growth, but underlying productivity is still able to create new wealth. Entrepreneurs are pulling a very heavy wagon, but they are still making progress. The US is still ten years away from facing the kinds of problems so prevalent in Europe. There is still time to avert disaster in the US.

The next question is whether or not problems in Europe will drag the US down, too? Our answer is, "no." Banks in Europe may become zombie banks like those in Japan…they may be propped up by central bank or IMF money, but a contagion can be avoided either by action in Europe or actions in the US.

The real fix is to throw the Keynesian bag of tricks in the trash and pull out a supply-side bag of fixes. Cut spending, hold tax rates low and increase freedom. That's what creates wealth.

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