Competitive Enterprise Institute
1899 L Street, NW • 12th Floor • Washington, DC 20036
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Advancing Liberty – From the Economy to Ecology

August 12, 2013 **No. 24**

Praying for Growth at the GDP Altar

The Perils of Confusing GDP Growth Figures with the Real Economy

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Economists often confuse economic indicators with actual economic performance. In myriad news articles, white papers, and academic studies, they advocate for ways to boost Gross Domestic Product (GDP). Although GDP may be the best of limited measures in assessing total economic output, it is only a proxy, and proxies are imperfect. Therefore, when economists treat GDP as the be-all end-all metric to evaluate economic performance, they often propose ways to improve GDP figures, rather than the actual economy.

Recently, several economists at the Levy Institute at Bard College made this blunder in a new report recommending a "Marshall Plan"-type fiscal stimulus for Greece's moribund economy. The report compares the recovery times—the time it takes for GDP and the unemployment rate to return to pre-crisis levels—of Greece today and the United States following the Great Depression. The authors argue that fiscal stimulus in the 1930s accounted for the U.S.'s faster recovery, relative to Greece today. Therefore, they argue, Greece should be implementing fiscal stimulus, not austerity.[1] But America in the 1930s and Greece today are not comparable.

Comparing Apples and Oranges. The "stimulus" in the period that the authors examine is actually relatively small. As the chart below shows, U.S. government spending increased by roughly $1 billion from 1929-1934. That is less than 2 percent of annual GDP during 1930-1934 and less than 1 percent in 1929. In fact, public spending during the Great Depression stayed relatively constant while all other GDP components decreased. If this is what the authors are pointing to, it is misleading to call it stimulus. Additionally, the authors' references to the Marshall Plan are entirely misplaced, as the program was implemented after World War II.

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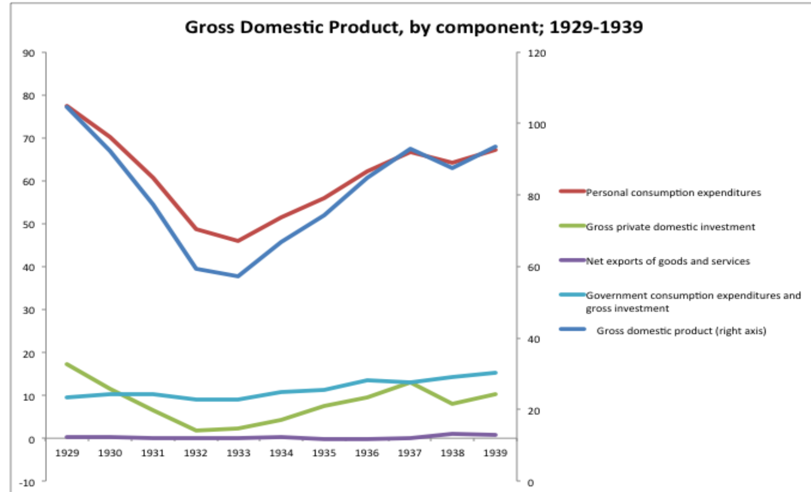
In 1934, GDP increased by 17 percent and unemployment decreased by roughly 3 percentage points compared to 1933. While government spending also increased by 20 percent compared to 1933 under President Franklin Delano Roosevelt's New Deal, ascribing the better economic performance to government stimulus simply ignores the fact that private investment increased by a massive 87 percent over 1933.



Source: Bureau of Economic Analysis; national income and product accounts tables

The increase in government spending cannot account for a knock-on effect on private investment over four times its size. Fiscal multipliers represent the dollar-for-dollar effect on the economy from one dollar of government spending. Keynesian arguments for fiscal stimulus rely on a positive multiplier effect greater than 1.00, which means that every dollar of government spending yields more than a dollar in economic activity.

Most New Deal programs had a multiplier effect on the private sector that was either small or sometimes even negative—between 0.5 and 1.5.[2] In other words, each dollar of government spending led to an increase in private spending of $1.50 at the high end and sometimes even a decrease, depending on the program. Therefore, the prospect of one dollar of government stimulus leading to $4.00 in private investment—the level that would be required for the 20 percent increase in public spending to account for the 87 percent increase in private investment in 1934—is untenable. Multipliers simply do not reach such high levels.

A 2011 survey of the academic literature found that fiscal multipliers throughout the 20th and 21st centuries have mostly remained between 0.8 and 1.5.[3] Essentially, government "stimulus" could not have been responsible for the 1934 recovery and will not spur a similar recovery in Greece today—especially when government spending already accounts for more than half of every dollar spent annually in the Greek economy,[4] which also faces the fiscal drag associated with a debt-to-GDP ratio of over 160 percent.[5]

Ignoring Structural Factors. The authors confuse Greece's deep structural woes with the more cyclical phenomena that affected the United States in the 1930s. Their advocacy of fiscal stimulus and criticism of structural reforms promoted by the European Union and International Monetary Fund (IMF) stem from this misunderstanding. Even if fiscal stimulus were an effective stabilization tool during recession, Greece does not meet the criteria for its proper Keynesian use: a cyclical downturn.

Greece faces deeply entrenched inefficiencies in regulation, bureaucracy, and property rights protections. The World Bank ranks Greece dead last among developed countries in its 2013 *Doing Business* rankings, which take into account such factors as the time and administrative procedures required to start a business and the efficiency of enforcing contracts through the court system.[6] Greece ranks equally dismally in The Heritage Foundation/*Wall Street Journal* 2013 Index of Economic Freedom—117th overall, well below the United States, which ranks 10th. In addition to the above deficiencies, the Index points out pervasive corruption and extremely rigid labor markets.[7]

It is simply not possible to compare contemporary Greece with 1930s America—or America today. The Levy Institute report compares two incomparable events: Greece's current economic crisis—the result of three decades of out-of-control government growth—and the U.S. Great Depression, which came about from years of misguided monetary policy (the specifics of which are debated to this day). Yet, the authors of the Levy Institute study create the illusion that the two crises are comparable by limiting themselves to only two measures of economic performance—GDP and unemployment.

Misguided Policy. Pumping money into the Greek economy may boost GDP and even spur hiring for a short time, but it will not lead to self-sustaining growth driven by private investment over the long run. Only fundamentally reforming the Greek economy can accomplish that. But the Levy Institute's report pays little heed to this reality. Instead, it measures success with short-run GDP and unemployment projections through 2016.

The Levy Institute's proposal is as impractical as it is ineffective. It advocates for the European Investment Bank (EIB) to extend €30 billion ($39.88 billion) in quarterly loans to the Greek government to fund a supposedly stimulative "expanded public service work program" that is left unexplained in the paper. But it is the policy of the EIB to finance a maximum of 50 percent of a project's cost.[8] The other 50 percent would have to come from private markets or another European Union institution. Given the EU's reluctance to shell out repeated bailout tranches to date, the prospect of dishing out even more euros for a project not directly related to Greece paying back its debts is a non-starter.

That leaves the private market as the other option. But if Greece were able to obtain financing from private markets, the EU, IMF, and European Central Bank would not be buying up its debt in the first place. Any reasonable investor would be reluctant to finance the expansion of the Greek public workforce as a continuation of the clientelism that has characterized Greek politics since 1981.[9]

Conclusion. If Greek policy makers really want their country's economy to recover, they should pursue austerity and market reforms with zeal. European countries that have implemented austerity programs of various types since 2008 saw their 10-year government bond yields decline by 9 percent against Germany's within six months.[10] Austerity bodes well for these countries in the long run, too. Each one-point gain in economic freedom among European countries—as measured by the Heritage/*Wall Street Journal* Index—led to a 14 basis point decrease in the cost of government borrowing.[11]

Decreases in the cost of government borrowing mean lower costs for private borrowing as well, which means more credit going to businesses to create jobs.

This applies not only to Greece, but to all European countries enduring economic pain. Keynesian stimulus proposals not only fail to address structural problems affecting each country, they also miss one hugely important practical question: Who will finance new government expenditures in countries that have been raiding the public coffers for years? Americans have experience with this, with the promised jobs and GDP growth of the $787 billion federal fiscal stimulus in 2009 having never materialized.[12] Yet, President Obama and many economists continue to advocate for more of the same.

Calling for more spending is easy. Diagnosing and fixing structural problems is difficult. The former policy keeps refilling the punchbowl while the latter takes it away when everyone has had too much. Economists must stop seeking easy answers to hard questions and bring GDP back down to its proper place among other economic indicators. Its growth is a useful measuring stick, not a panacea for a nation's economic woes.

Notes

[1] Dimitri Papamiditrou, Michalis Nikiforos, Gennaro Zezza, "The Greek Economic Crisis and the Experience of Austerity: A Strategic Analysis," Strategic Analysis, Levy Economics Institute at Bard College, July 2013, http://www.levyinstitute.org/pubs/sa_gr_7_13.pdf.

[2] Price Fishback and Valentina Kachanovskaya, "In Search of the Great Multiplier for Federal Spending in the States during the Great Depression 1," Seminar Papers, University of Arizona, 2012-2013, http://econ.arizona.edu/docs/Seminar_Papers/2012-2013/fishback20121015.pdf.

[3] Valerie Ramey, "Can Government Purchases Stimulate the Economy?" Working Paper, University of California San Diego, 2011, http://weber.ucsd.edu/~vramey/research/JEL_Fiscal_14June2011.pdf.

[4] See Eurostat, "Government revenue, expenditure, and main aggregates," http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database.

[5] Countries implementing fiscal stimulus with debt-to-GDP ratios above 60 percent (Greece's debt level nearly three times that) experience fiscal multipliers of zero in the short run and -3 in the long run, as increases in public debt may have the contractionary effect of signaling future fiscal consolidation. See: Ethan Ilzetzki, Enrique Mendoza, and Carlos Vègh, "How Big (Small?) Are Fiscal Multipliers?" Working Paper, University of Maryland, 2012, http://econ-server.umd.edu/~mendoza/wp/IMV_032612.pdf.

[6] International Finance Corporation, Doing Business, World Bank, 2013, http://www.doingbusiness.org/rankings.

[7] Terry Miller, Kim Holmes, and Edwin Feulner, eds., 2013 Index of Economic Freedom, published jointly the *The Wall Street Journal* and The Heritage Foundation, http://www.heritage.org/index/explore.

[8] "What is the EIB?" European Investment Bank, 2013, http://www.eib.org/about/index.htm.

[9] See George Th. Mavrogordatos, "From Traditional Clientelism to Machine Politics: The Impact of PASOK Populism in Greece," *South European Society and Politics*, Vol. 2, No. 3, 1997, http://www.tandfonline.com/doi/abs/10.1080/13608749708539516#.UgFT2pLvuLh.

[10] Calculated from regressions on Eurostat data (Long-term interest rates) and on austerity program data from: Matthew Melchiorre, "The True Story of European Austerity; Cutting Taxes and Spending Leads to Renewed Growth" *OnPoint* No. 184, Competitive Enterprise Institute, June 26, 2013, http://cei.org/onpoint/true-story-european-austerity.

[11] See author's regression analysis in: Melchiorre, "Are Markets Rational When It Comes to Economic Fundamentals?" OpenMarket.org, Competitive Enterprise Institute, July 19, 2013, http://www.openmarket.org/2013/07/19/are-markets-rational-when-it-comes-to-economic-fundamentals/.

[12] Richard W. Stevenson, "Early Economic Projections Could Haunt Obama in 2012," The Caucus Blog, *The New York Times*, November 4, 2011, http://thecaucus.blogs.nytimes.com/2011/11/04/early-economic-projections-could-haunt-obama-in-2012/?_r=2.