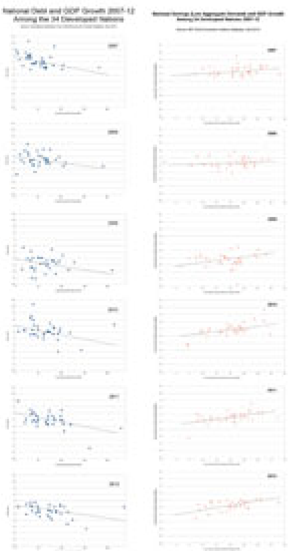
Written by **Thomas R. Eddlem** on August 8, 2012

Arthur Laffer: Wall Street Journal Op-Ed Proves He Still Has Much to Learn

Supply Side economics school godfather Arthur Laffer penned an op-ed column for the *Wall Street Journal* August 6 that claims increases in government spending inhibited economic growth during the recession, as indicated by the table nearby, which shows:

> increases in government spending from 2007 to 2009 and subsequent changes in GDP growth rates. Of the 34 Organization for Economic Cooperation and Development [OECD] nations, those with the largest spending spurts from 2007 to 2009 saw the least growth in GDP rates before and after the stimulus. [*Charts below are referenced further along in article. Please click to enlarge to readable size.*]



If true, the data would be a powerful case against big-spending leftist governments. But the data he published showed nothing of the sort. Economic growth in OECD nations in 2007-09 was no larger or smaller based on the level of increase in government spending during this period. Laffer's statement makes one wonder if he even bothered to look at the data before pronouncing his diagnosis.

Laffer was an economic sensation of the "Supply Side" school of economic thought in the 1980s, a school popular in the Reagan administration but now almost extinct. Laffer's personal credibility took a strong hit after August 2006, when he bet Austrian school economist Peter Schiff a penny that the U.S. would not fall into recession in 2007-08. "The United States economy has never been in better shape," Laffer confidently told CNBC's *Kudlow and Company*, just before the real estate and financial bubble burst. “We’re going to have a nice slowdown, but it’s not going to be a crash.” Schiff’s concise analysis turned out to be the most detailed and accurate forecast of the housing bubble’s progress on American television before the crash, an analysis he attributes to the Austrian school of economic thought.

Laffer’s *Wall Street Journal* column claimed that “The four nations — Estonia, Ireland, the Slovak Republic and Finland — with the biggest stimulus programs had the steepest declines in growth. The United States was no different, with greater spending (up 7.3%) followed by far lower growth rates (down 8.4%).” But Estonia and Finland were among the fastest to recover from the recession, and continue to have the highest growth rates in Europe, with Estonia growing at a 7.6 percent rate last year. If increases in government spending inhibited growth, why were these economies so quick to recover? Laffer argued in his column that “there’s no arguing with the data in the nearby table,” though he conveniently failed to plot them out in a chart that would have voided his conclusions. Laffer simply cherry-picked the four nations with the greatest drop during the crash, and found that those four had increased government at the most brisk pace when measured against plummeting GDP figures.

But across the whole 34 nation data-set, there was no GDP trend — up or down — simply based upon increase in government spending. That lack of a trend should be national news, however, in light of Keynesian school of economics claims that government spending stimulates an economy. Laffer was wrong in claiming that “greater stimulus spending was followed by lower growth rates,” but he was mostly correct when he wrote that “There was no discernible two or three dollar multiplier effect from every dollar the government spent and borrowed. In reality, every dollar of public-sector spending on stimulus simply wiped out a dollar of private investment and output, resulting in an overall decline in GDP.”

Indeed, a comparison of growth rates with aggregate national savings (income minus consumption and cost of government) among the same 34 “developed” nations using International Monetary Fund data shows that nations that stimulated aggregate demand (which is consumption plus government spending) since 2007 demonstrate that highly “stimulative” economies encountered no more growth (and more often slightly lower growth), while nations that save at the highest rates bounced back from the recovery a little more quickly (click on above charts).

This completely demolishes the principle expounded by John Maynard Keynes that government needs to stimulate aggregate demand during a recession by spending more to compensate for consumer savings. The Keynesian school of economic thought — nearly a monopoly of thought among policy-makers, though discredited by the housing and financial bubble — has long focused upon demand as the key to growth. The upstart Austrian school of thought — most practitioners of which predicted the housing crisis accurately — has long focused upon savings and investment as the key to economic growth.

But the greatest impact on GDP growth during the 2007-12 time period was the level of national debt: Nations carrying a high level of national debt suffered a deeper crash in 2007-09, and recovered much less quickly on average (see charts below).

Interestingly, nations with high levels of personal savings grow higher than the trend lines related to national debt, but were still dragged down by high debt. Japan, which has the largest debt-to-GDP ratio of any developed nation, has undergone some two decades of near zero growth. But because of high personal savings rates, Japan has regularly scored above the average trend line on debt/growth charts. Even nations with high levels of government social welfare spending — such as the Northern European nations of Sweden, Finland, Denmark, Norway, and Estonia — recovered quickly from the “great recession,” and are among the few developed nations still growing in 2012. Why? Because they carry low levels of national debt and have high personal savings levels.

Laffer rightly claimed that “Mr. Obama keeps saying that if only Congress would pass his second stimulus plan, unemployment would finally start to fall. That’s an expensive leap of faith with no evidence to confirm it.” Indeed, there is much available evidence now to the contrary, particularly if that stimulus involves taking on additional debt.

The path back to economic recovery is best made by following the Austrian school of economic thought and listening to the advice of America’s founders. Thomas Jefferson advised in 1813 that “It is a wise rule and should be fundamental in a government disposed to cherish its credit, and at the same time to restrain the use of it within the limits of its faculties, ‘never to borrow a dollar without laying a tax in the same instant for paying the interest annually, and the principal within a given term; and to consider that tax as pledged to the creditors on the public faith.’ ”

Photo: Supply-side economist Arthur Laffer discusses Kansas Gov. Sam Brownback’s income tax plan with reporters, Jan. 19, 2012, at the Statehouse in Topeka, Kan.: AP Images