The INDEPENDENT

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Fiscal Cliff a Keynesian Myth?

By David Beckworth

Many Americans rang in the New Year with heightened anticipation, as the halls of Congress were bustling in the waning hours of Dec. 31, 2012. While legislators managed to ink a deal just before the deadline and curtains closed on the year, the economic stakes from the fiscal cliff unfortunately overshadowed any close examination of whether allowing the Bush tax cuts to expire and letting spending cuts pass would push us into another recession in 2013.

Writing about the cliff, Paul Krugman warned that "bringing down the budget deficit when the economy is already depressed" would make "the depression deeper." International Monetary Fund managing director Christine Lagarde has raised the same worry, citing forecasts of the cliff's effects based on Keynesian assumptions. On those assumptions, spending cuts and tax increases depress the economy because they take money out of people's pockets. The affected people spend less money, the people who would have received their spending as income do the same, and pretty soon we are in another recession.

There are indeed reasons we fought to avoid falling off the cliff. The comprehensive increases in taxes on capital formation, for example, would do long-term damage to the economy. However, I argue that concerns about the fiscal cliff would have been needlessly exaggerated if the Federal Reserve had stabilized nominal spending. For that matter, Congress could have voted to cut spending much more deeply than our current legislation allows for, and without risking another recession.

The onslaught of the Great Recession of the 2000s began with unsustainable economic growth that followed the 2001 recession. When the economy began to contract in 2008, the Federal Reserve failed to act responsibly. By effectively tightening monetary policy, it "leaned with the wind" instead of against it. This response turned what was initially a mild recession into the Great Recession.

As I discuss in my new book, ***Boom and Bust Banking: The Causes and Cures of the Great Recession***, total federal expenditures, measured in dollars, have been spiraling downward since mid-2010. The budget deficit as a share of the economy has fallen more than 2 percent over this time. This fiscal tightening has taken place in the midst of a barrage of economic shocks including the Eurozone crisis, the 2011 debt ceiling talks, and concerns about an Asian economic slowdown

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IN THIS ISSUE

President's Letter

The Folly of "Collective Action"

President Obama claimed in his inaugural address that "preserving our individual freedoms ultimately requires collective action." Of course, this view is hardly new or "progressive," as it echoes over the ages the views of countless true believers who worship government power, that "might makes right" and "the end justifies the means." The supporter of "collective action" believes that if some enlightened elites could acquire power over all others to compel them to fall in line and obey their commands, social and economic ills would end.

However, Lord Acton noted that "power corrupts," the economist Ludwig von Mises showed government "central planning" is chaotic and destructive, Nobel laureate F. A. Hayek warned of the "fatal conceit" of Big Government, and C. S. Lewis warned that collectivism relegates a citizenry "to be classed with infants, imbeciles, and domestic animals." Indeed, collectivism has produced unimaginable horrors, misery, poverty, economic upheaval, slavery, environmental ruin, and mass deaths.

Fortunately, Obama's vision of "collective action" no longer controls the "commanding heights" of our culture. Collectivism has been shown to be a blunder of epic proportions, and the Independent Institute has been an irreplaceable factor in this intellectual revolution.

The reach of our work is skyrocketing: in the past twelve months we *have quintupled our Facebook community* to 200,000, and our combined Facebook followers now exceed 344,000, *higher than almost any think tank worldwide!* Our monthly Facebook reach now totals 10.2 million, and our media coverage has grown to 48 million viewers *per month* on TV/radio and 313 million in print. Some 30,000 articles from ***The Independent Review*** are downloaded monthly and we have more than 7,500 Twitter followers.

Especially during these difficult economic times resulting from "collective action," please join us as an **Independent Associate** Member. With your tax-deductible membership, you can receive a ***FREE*** copy of ***Boom and Bust Banking*** (p. 1), ***Crisis and Leviathan***, ***Risky Business*** (p. 5), and other publications, including our quarterly journal, ***The Independent Review*** (p. 3), plus other benefits.

David J. Theroux

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The Independent Review

The Great Depression • Fire Service in Nigeria

EACH QUARTER, the Independent Institute's journal delivers a multitude of peer-reviewed articles on topics ranging from public policy to economic history to political thought. Here's a look at two articles from the Winter 2013 issue.

Did WWII End the Great Depression?

The notion that the war ended the Depression has met growing skepticism among economic historians, thanks in no small part to the work of **Robert Higgs**, Independent Institute Senior Fellow and editor of ***The Independent Review***. In a series of articles, Higgs argues that the much-vaunted "wartime prosperity" is an illusion—a deceptive statistical artifact created by the government's diversion of production toward the war effort and away from civilian uses; price controls that masked true costs; and a military draft that helped commandeer the labor of 12 million men at below-market wages.

The Independent Review, Winter 2013

Additional support for this thesis comes from the lead article in the winter issue, "The Reality of the Wartime Economy: More Historical Evidence on Whether World War II Ended the Great Depression," by economics professors **Steven Horwitz** and **Michael J. McPhillips**, both from St. Lawrence University.

Horwitz and McPhillips show that the letters, diaries, and newspapers of the war years corroborate Higgs's thesis: They offer qualitative evidence that the average American saw continued material deprivation and hardship, rather than rising living standards.

An illuminating example comes from a series of newspaper ads by an electrical utility in northern New York that sold consumer appliances. Soon after U.S. entry into the war, the ads' messages changed: Increasingly they urged consumers to buy their wares before production was discontinued. Eventually, the company's inventory was refitted or turned to scrap metal for war purposes, and consumers had to invest more in maintaining their appliances and searching for expensive spare parts on the black market. By then the ads had, Horwitz and McPhillips write, "shifted to encouraging people to buy war bonds as the company became part of the war propaganda effort."

"The Reality of the Wartime Economy" is available at www.independent.org/publications/tir/article.asp?a=915.•

Lessons from Nigeria

No one would mistake Lagos, Nigeria, for paradise. Litter blankets streets. Blackouts occur daily. Traffic moves at a snail's pace. And the public restrooms . . . let's not go there!

Yet, in one realm chaotic Lagos performs well above average: fire safety. Despite a dearth of fire-fighting equipment, building fires are very uncommon.

This outcome isn't the product of strong building regulations. (Lagos effectively has none because almost no one can find where they are buried in the municipal code.) Nor is Lagos's safety record due to the watchfulness of particularly conscientious government agencies. (The city is infamous for political corruption.)

No, Lagos owes its superior fire-safety record to a "secret" method that people from around the world could easily duplicate—if only they would think outside the box.

What's its method?

Lagos's success comes from a reliance on market alternatives and private firms to provide fire safety.

This finding comes from **John M. Corbin** (Professor of Economics and Public Policy at the Universidad Andrés Bello in Santiago, Chile), whose lengthy article, "The Enterprise of Fire Safety in Lagos, Nigeria," draws from the author's extensive field research, including interviews with private- and public-sector fire departments.

"The evidence from Lagos," Corbin writes, "shows that market alternatives and private firms have been responsible for the best successes in improving building fire safety, whereas government measures to improve safety have been irrelevant or unreliable."

Prof. Corbin's article is available at www.independent.org/publications/tir/article.asp?a=918.•

The Independent Institute in the News

Center on Entrepreneurial Innovation

Research Fellow Art Carden: On Fox News, 11/23/12

Following Hurricane Sandy, Carden spoke out against price-gouging laws motivated by natural disasters: "Merely passing a law saying you're not allowed to charge more say than $10 per flashlight is not going to guarantee that poor people get flashlights. In fact, a law against price gouging is going to prevent people from bringing more flashlights to the market ultimately."
http://www.independent.org/multimedia/detail asp?m=300 •

Research Fellow **Art Carden** on Fox Business Network's *Stossel*.

Senior Fellow William Shughart: Syndicated Op-Ed by McClatchy Newspapers in *New York Newsday* (among many others), 12/6/12

Grover Norquist is spot-on. No matter how federal government spending is financed, higher taxes just kick the can down the road. The disorder in the federal government's fiscal house can be set right only by getting rid of harmful and foolish spending programs that America's taxpayers can't afford. There are plenty to go around.
http://www.independent.org/newsroom/article.asp?id=3517 •

Center on Law and Justice

Research Fellow William Watkins: Op-Ed in *USA Today*, 10/10/12

Large districts with hundreds of thousands of residents make it impossible for most people to rub shoulders with their congressional representative and make it less likely that the representative can truly identify with his or her constituents. It's time to make our representative body representative again. One House member for every 710,767 residents is not representative government. It's a sham, and a shame. The public knows it, and that's why they tune out.
http://www.independent.org/newsroom/article.asp?id=3466 •

Center on Global Prosperity

Senior Fellow Alvaro Vargas Llosa: Op-Ed on FoxNews.com, 11/17/12

What we are seeing in France, as elsewhere in Europe, is the collapse of the welfare state. President Hollande thinks the solutions to his country's severe deficits, huge debt, loss of competitiveness and economic stagnation are more tax revenue, more financial stimulus, and more government generally. . . . You know the drill. But France's fiscal problems, like our own, are a symptom of too much, not too little, government.
http://www.independent.org/newsroom/article.asp?id=3498 •

Center on Peace and Liberty

Senior Fellow Ivan Eland: On Russia TV, 11/28/12

In response to the U.S.'s foreign policy in Egypt, Eland offered: "I think the United States has done far too much intervention in the Middle East, and Egypt is a very important country but I think the problem is best left to Egyptians. Whatever happens should be an Egyptian solution to the problem."
http://www.independent.org/multimedia/detail.asp?m=321 •

Senior Fellow **Ivan Eland** engages with Peter Lavelle on RT's *CrossTalk*.

Center on Health and the Environment

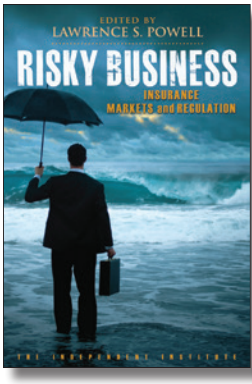
Research Fellow John C. Goodman: Op-Ed in *The Wall Street Journal*, 10/17/12

The Affordable Care Act established a federally funded risk pool—the Pre-Existing Condition Insurance Plan—that allows individuals with disqualifying conditions to buy a policy for the same premium a healthy person would pay. Out of a population of more than 300 million, some 82,000 have signed up as of July 31. . . . That is not a misprint. Yet, this plan was cited as the principal reason for spending $1.8 trillion over the next 10 years and in the process has turned the entire health-care system upside down.
http://online.wsj.com/article/SB10000872396390444799904578048301788487428.html •

New Book

Insurance Regulation Is 'Risky Business'

The states have regulated the American insurance industry for about 150 years, but a movement is afoot to shift to some sort of federal regulatory system. But which specific reforms would best serve consumers *and* promote a healthy, competitive insurance industry?



Both sides are crucial to the equation, but too often politicians have pandered to one at the expense of the other, according to economist **Lawrence S. Powell** (Whitbeck-Beyer Chair of Insurance and Financial Services, University of Arkansas).

"Insurance is too important to society and to commerce to be left as a political pawn," Powell writes in his editor's introduction to ***Risky Business: Insurance Markets and Regulation*** (The Independent Institute, 2013), a book that features more than a dozen contributors.

One example of politically inspired folly arises in the wake of hurricanes and other natural disasters, when lawmakers consider prohibiting insurers from adjusting the premiums of homeowners insurance.

Such restrictions ultimately harm the consumer by preventing insurers from rebuilding their loss reserves after a catastrophe. Sometimes insurers must respond by leaving the market. After Florida imposed premium caps following Hurricane Andrew in 1992, the state-owned Citizens Property Insurance Corp. found itself underwriting policies for more than 50 percent of the houses in the state!

Another example is when regulators prohibit insurers from using certain information in pricing and underwriting risk, such as personal credit ratings. Studies going back to 1949 show that consumers who make their debt payments on time are less likely to file insurance claims, making them a better risk for the insurer. Where insurers *are* permitted to use credit-based insurance scores, they can offer coverage to drivers they would otherwise deem too risky to serve.

As noted, momentum is building for a move away from state-based insurance regulation. One reason is that the current system of 56 separate jurisdictions in the United States adds billions of dollars in duplicative regulatory costs. Creating a more uniform system would potentially save consumers an estimated $3.19 billion to $5.27 billion per year.

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Student Seminars Bring the Challenge of Liberty to Light

Few students have the opportunity to learn the moral and economic principles of free markets and free societies. Yet these principles are essential for understanding, appreciating, and preparing them for the world they will soon enter. **The Challenge of Liberty Summer Seminars** help high school and college students understand real-world issues they will encounter throughout life.

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Oakland, CA • July 22-26

The INDEPENDENT INSTITUTE

Speaker Forum

Obamacare and the Healthcare Crisis

THE NATION'S healthcare system is ailing, but the Affordable Care Act (a.k.a. Obamacare) is more likely to worsen its ills than to cure them. Fortunately, there's no shortage of ideas for restoring its health.

This was the theme of Research Fellow **John C. Goodman's** Oct. 4 talk at the Independent Institute's headquarters in Oakland, Calif., "Replacing Obamacare and Curing the Healthcare Crisis."

The new healthcare law cannot make good on its promises, Goodman explained. After it goes fully into effect in 2014, many people will have more trouble getting healthcare than they have now. That's because the law will increase the demand for health screenings for the 30 million newly insured, but it won't increase the supply of doctors and other care providers. The resulting shortages will hit the most vulnerable populations the worst.

The first step toward improving American healthcare, according to Goodman, is to lift restrictions that reduce access to high-quality healthcare. Under current regulations, for example, doctors are not allowed to accept payments directly from Medicaid patients, and many doctors choose not to participate in the program. This causes major problems for low-income people.

Often they must spend inordinate amounts of time searching for a doctor who will see Medicaid patients, and then they must travel farther and put up with longer waiting times in order to get care—or else they may rely on crowded hospital emergency rooms for care that would have cost less had it been delivered at a doctor's office.

Above: Research Fellow John C. Goodman addresses the Independent Institute Policy Forum, "Replacing Obamacare and Curing the Healthcare Crisis."
Below: Goodman signs copies of his book, ***Priceless: Curing the Healthcare Crisis.***

One way to fix this problem, Goodman explained, is to make Medicaid operate like food stamps, with enrollees getting a voucher whose value they could augment with their own funds. This would also enable Medicaid patients to choose from a wide array of doctors.

Goodman offered many more proposals, all drawn from his pathbreaking Independent Institute book, ***Priceless: Curing the Healthcare Crisis.***

To watch this event visit www.independent.org/events/detail.asp?eventID=157. •

photos: Stephan Babuljak

David Beckworth: Fiscal Cliff a Keynesian Myth?

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that have kept economic uncertainty elevated. Yet nominal spending has been incredibly stable, growing at about 4.5 percent a year. The recovery has been sluggish, but the Fed appears to have kept fiscal contraction and other economic shocks from ending the recovery.

The Fed could counteract the effects of this fiscal crisis, too. It could best do this by explicitly adopting a nominal-spending target. The more credible that target, the less the Fed would have to do to reach it: Private-sector expectations of future spending powerfully influence current spending levels. Knowing that the Fed would do whatever it takes, including aggressive open market operations, to maintain steady nominal GDP growth would create confidence and more economic certainty for households and firms—regardless of whether the government was cutting spending. The effect should be to offset every dollar of reduced government spending by roughly a dollar of increased private spending.

The Fed cannot undo the effects of any bad policy Congress enacts. It can't, for example, restore incentives to work, save, and invest if legislators stifle them. What the Fed does have the power to do is to keep the Keynesian nightmare from taking place. We may have temporarily averted the fiscal cliff, but it still looms in the distance. The threat of another recession is real, but if it comes, it will be because the Fed failed to do its duty. •

New Book: Risky Business

(continued from page 5)

But creating a federal regulatory system carries a risk: It might cause mischief that cuts across state lines. Politicians therefore should learn from the European Union. There, lawmakers are adopting a principles-based approach to regulation. This allows insurers more flexibility in managing risk than the often politicized and stifling approaches of our state governments. Insurance regulation is risky business indeed.

To purchase ***Risky Business***, visit www.independent.org/store/book.asp?id=102. •

Praise for *Risky Business*

"*Insurance is one of the most pervasive and yet least understood industries.* **Risky Business** *offers in one convenient place clear and compelling explanations of both its economic foundations and its regulatory strengths and weaknesses.*"
—Richard A. Epstein, Laurence A. Tisch Professor of Law, New York University

"*Lawrence Powell has brought together a wonderful group of leading insurance and risk scholars to produce the most insightful book on property and casualty insurance industry in many years.*"
—Roger E. Meiners, Goolsby Distinguished Professor of Economics and Law, University of Texas at Arlington

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Funded by a grant from the Atlas Network, the MyGovCost mobile app will be a convenient way to get all the latest information on the go from MyGovCost.org and the Independent Institute. For more information, visit us at: www.mygovcost.org. •

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Today, the Institute stays true to both our purpose and our entrepreneurial roots—with an astounding 86¢ of every dollar going directly to program services! As the numbers at right show, we deploy contributions both efficiently and effectively—producing results far exceeding organizations many times our size.

Of course, what truly matters is winning the war of ideas for liberty. We remain dedicated to doing so, every day, with every dollar. Current projects include our expanded **MyGovCost.org** website dedicated to informing and empowering those increasingly concerned about government spending and debt; and projects on immigration, education, the economy, and civil and economic liberties.

With your help, we can reach, engage, and empower even more in 2013! For more information on how you can invest in our mission for liberty, please see **www.independent.org/donate** or contact **Terra Strong**, Development Associate, at 510-632-1366 ext 149 or tstrong@independent.org. •

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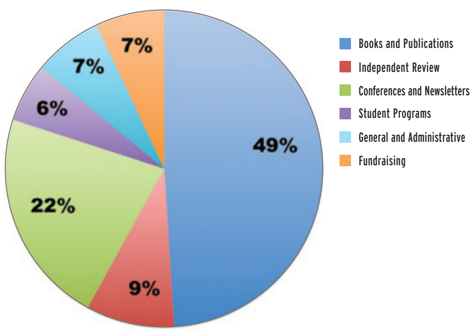

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