The Daily Dish

Get Ready – the Left and “Fiscal Drag”

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Eakinomics: Get Ready – the Left and “Fiscal Drag”

I understand that the current focus is, properly, on the efforts of the left to bust the budget and gut common sense in its reconciliation efforts. But I want to talk about what happens after – after whatever “success” is achieved in making the tax code more punitive and anti-growth, after the gaping holes in the current social safety net have been pushed into the background to permit a massive expansion of new social safety net programs, and after enough budgetary cliffs and other gimmicks have been put in place to disguise the $6 or $7 trillion in new spending that has been put on the books. After that, be prepared to hear about a new crisis: “fiscal drag,” also known as “not enough new spending.”

Here’s the logic. Suppose that the government fights a recession by sending out $400 billion of deficit-financed checks to essentially everyyone (this example is strictly hypothetical). Cash-starved families will immediately spend, say, 90 percent of it, thereby generating $360 billion in new receipts for other people in the economy. Those recipients will turn around and spend 90 percent of that money, producing another $324 billion round of income. The process will continue in ever smaller increments. But if you add it all up, it totals $4 trillion.

There’s even a handy formula for summarizing the impact. The so-called “multiplier” is equal to 1/(1-c), where c is the fraction of each dollar “consumed” (or spent). In this example, c=0.9, so the multiplier is 10, which transforms a $400 billion fiscal impulse into a $4 trillion demand increase.

Now, the actual numbers are not to be believed – nobody thinks they are anything like 10 and anything in the vicinity of 2 is probably heroically high. But the core belief is that a swing in federal spending has a huuuuuuge impact on near-term economic growth. Importantly to the Left, it works both ways. If you stop spending $400 billion, the swing is negative, and the economy will crater. Get ready to hear some variant of this reasoning *a lot.*

There are two problems with this line of reasoning. The first is that demand alone does not determine the amount of economic activity. As we have experienced vividly in recent months, supply issues such as labor force participation, supply chain cost shocks, and shortages can be way more important.

The second is that people are not the mindless automatons that the left likes to assume. In particular, the formula highlights the idea that people mindlessly spend c cents of every dollar. If they did, they would save the other 1-c cents of every dollar. If s=1-c is the saving rate, then the multiplier is simply 1/s.

As it turns out, this is completely contradicted by reality, especially during the past two years. To see this, consider the table below, which shows the data from the past 6 quarters. The first line is the “long run” saving rate of 7.5 percent, which I estimated using the average over the period 2017-2019. This translates into a multiplier of 13.3, shown in the third line.

As it turns out, the actual saving rate (line 2) shifted dramatically. Consider, especially, the 26.0 percent saving rate during the 2nd quarter of 2020, which occurred as the CARES Act poured trillions of dollars into the economy. The rate remained elevated, but drifted down to 13.5 percent, until it jumped up again with the arrival of checks from the December Consolidated Appropriations Act in Q1 of this year.

What does this mean? Mechanically, these higher saving rates mean that any fiscal impulse has a smaller impact on demand – the implied multipliers are shown in line 4. The final line is the actual multiplier (line 4) as a fraction of the long run one (line 3).

Hypothetical Fiscal Impact Calculations

	2020				2021	
	Q1	Q2	Q3	Q4	Q1	Q2
s*	7.5	7.5	7.5	7.5	7.5	7.5
s	9.7	26.0	16.0	13.5	20.0	10.3
LR (1/s*)	13.3	13.3	13.3	13.3	13.3	13.3
SR (1/s)	10.3	3.9	6.3	7.4	5.0	9.7
%Deferred	77.2%	28.9%	47.0%	55.5%	37.6%	73.0%

The economic lesson is that the fiscal impulse is, in part, saved to be spent later. Indeed, a lot of the impulse from 2020-21 will appear as spending in the latter half of this year and beyond. The corollary is that this action cushions any so-called “fiscal drag” that might appear to be on the books. Just treat public outcry about fiscal drag as the opportunity for a drinking game, not real commentary.

The bottom line is that the government has less of a positive impact than the left wants to believe (so far it has had essentially no impact on growth), shrinking the government is not the threat that it will decry, and the actions of a savvy private sector can shift their dollars to get the spending that it wants, not what the government dictates.