DAVID WENDELL ASSOCIATES, INC.
INVESTMENT COUNSEL

P.O. Box 21980
325 Corporate Drive
Portsmouth, N.H. 03802
(603) 427-0200
www.davidwendell.com

November 2012

The Fiscal Multiplier

With the elections over, Washington is now attempting to resolve its differences regarding the fiscal cliff -- the combination of tax hikes and spending cuts set to kick in automatically if Congress does not act by year-end. Some political leaders are focused on spending while others on taxes. Underlying both sides of the equation is the concept of the fiscal multiplier, used to describe how changes in fiscal policy affect the broader economy.

For example, assuming the multiplier is 1.5, an increase (or decrease) of $1 in government spending would result in an increase (or decrease) of $1.50 in Gross Domestic Product. With taxes, the results are amplified by other factors such as demand and capital investment -- one study indicated that a $1 cut in taxes increased GDP by $3. The problem is that all of this is theoretical at best and simplistic at worst.

Just a few weeks ago, the International Monetary Fund admitted that its past assumptions about the fiscal multiplier were likely wrong. It had assumed the multiplier was about 0.5 -- that is, cutting government spending by $1 would reduce GDP by only 50¢. In the wake of the financial crisis, many European countries implemented fiscal programs combining tax increases with spending cuts based on recommendations from the IMF.

Unfortunately, the prescription does not seem to be working. And for Greece and Spain, the medicine appears to be working in reverse -- their economies are deteriorating, not improving. In its October 2012 *World Economic Outlook*, the IMF announced that it now believes the fiscal multiplier actually may be much higher, ranging perhaps from 0.9 to 1.7. This means that a $1 combination of increased taxes and reduced spending may be having a negative impact on some European economies by as much as $1.70.

The reality is that neat and tidy concepts only go so far in the messy, complex real world. And as can be seen with the IMF, there are real dangers in using theoretical models to guide public policy.

With countries all over the world grappling with slow growth and high debt, all political leaders and policy makers need to be clear-eyed and pragmatic in the weeks ahead. Decisions should be based on common sense with a view to what actually has worked in the past. Now is not the time for “pie-in-the-sky” theories, “one size fits all” assumptions and other wishful thinking. We can still recover from the financial crisis, especially if we do not make it worse.

\- - - - -