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Fifteen fatal fallacies of financial fundamentalism: A disquisition on demand-side economics

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Contributed by William Vickrey, September 18, 1996

Much of the conventional economic wisdom prevailing in financial circles, largely subscribed to as a basis for governmental policy, and widely accepted by the media and the public, is based on incomplete analysis, contrafactual assumptions, and false analogy. For instance, encouragement to save is advocated without attention to the fact that for most people encouraging saving is equivalent to discouraging consumption and reducing market demand, and a purchase by a consumer is also income to vendors and suppliers. Equally fallacious are implications that what is possible or desirable for individuals one at a time will be equally possible or desirable for all who might wish to do so or for the economy as a whole.

And often analysis seems to be based on the assumption that future economic output is almost entirely determined by inexorable economic forces independently of government policy so that devoting more resources to one use inevitably detracts from availability for another. This might be justifiable in an economy at chock-full employment, or it might be validated in a sense by postulating that the Federal Reserve Board (FRB) will pursue and succeed in a policy of holding unemployment strictly to a fixed "non-inflation-accelerating" or "natural" rate. But under current conditions such success is neither likely nor desirable.

Some of the fallacies that result from such modes of thought are as follows. Taken together, their acceptance is leading to policies that at best are keeping us in the economic doldrums with overall unemployment rates stuck in the 5–6% range. This is bad enough merely in terms of the loss of 10–15% of our potential production, even if shared equitably, but when it translates into unemployment of 10%, 20%, and 40% among disadvantaged groups, the further damages in terms of poverty, family breakup, school truancy and dropout, illegitimacy, drug use, and crime become serious indeed. And should the implied policies be fully carried out in terms of a "balanced budget," we could well be in for a serious depression.

Fallacy 1. Deficits are considered to represent sinful profligate spending at the expense of future generations, who will be left with a smaller endowment of invested capital. This fallacy seems to stem from a false analogy to borrowing by individuals.

Current reality is almost the exact opposite. Deficits add to the net disposable income of individuals, to the extent that government disbursements that constitute income to recipients exceed that abstracted from disposable income in taxes, fees, and other charges. This added purchasing power, when spent, provides markets for private production, inducing producers to invest in additional plant capacity, which will form part of the real heritage left to the future. This is in addition to whatever public investment takes place in infrastructure, education, research, and the like. Larger deficits, sufficient to recycle savings out of a growing gross domestic product (GDP) in excess of what can be recycled by profit-seeking private investment, are not an economic sin but an economic necessity. Deficits in excess of a gap growing as a result of the maximum feasible growth in real output might indeed cause problems, but we are nowhere near that level.

Even the analogy itself is faulty. If General Motors, AT&T, and individual households had been required to balance their budgets in the manner being applied to the federal government, there would be no corporate bonds, no mortgages, no bank loans, and many fewer automobiles, telephones, and houses.

Fallacy 2. Urging or providing incentives for individuals to try to save more is said to stimulate investment and economic growth. This seems to derive from an assumption of an unchanged aggregate output so that what is not used for consumption will necessarily and automatically be devoted to capital formation.

Again, actually the exact reverse is true. In a money economy, for most individuals a decision to try to save more means a decision to spend less; less spending by a saver means less income and less saving for the vendors and producers, and aggregate saving is not increased, but diminished, as vendors in turn reduce their purchases, national income is reduced and with it national saving. A given individual may indeed succeed in increasing his own saving, but only at the expense of reducing the income and saving of others by even more.

Where the saving consists of reduced spending on nonstorable services, such as a haircut, the effect on the vendor's income and saving is immediate and obvious. Where a storable commodity is involved, there may be an immediate temporary investment in inventory, but this will soon disappear as the vendor cuts back on orders from his suppliers to return the inventory to a normal level, eventually leading to a cutback of production, employment, and income.

Saving does not create "loanable funds" out of thin air. There is no presumption that the additional bank balance of the saver will increase the ability of his bank to extend credit by more than the credit-supplying ability of the vendor's bank will be reduced. If anything, the vendor is more likely to be active in equities markets or to use credit enhanced by the sale to invest in his business than a saver responding to inducements such as individual retirement accounts (IRA)s, exemption or deferral of taxes on pension fund accruals, and the like. so that the net effect of the saving inducement is to reduce the overall extension of bank loans. Attempted saving, with corresponding reduction in spending, does nothing to enhance the willingness of banks and other lenders to finance adequately promising investment projects. With unemployed resources available, saving is neither a prerequisite nor a stimulus to, but a consequence of capital formation, as the income generated by capital formation provides a source of additional savings.

Fallacy 3. Government borrowing is supposed to "crowd out" private investment.

Abbreviations: CBO, Congressional Budget Office; FRB, Federal Reserve Board; GDP, gross domestic product; NIARU, non-inflation-accelerating rate of unemployment; NIARRU, non-inflation-accelerating rate of reduction of unemployment.

*Deceased October 11, 1996.

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