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Approaching Economic Stall Speed

by Richard W. Rahn

MANY NATIONS ARE ON THE VERGE OF SHRINKING ECONOMIES

Stall speed is the airspeed at which an aircraft stops producing lift. Unless immediate corrective action is taken, such as reducing the wing's angle of attack or the weight of the aircraft, the results are not likely to be good. An economy can hit "stall speed" when it becomes burdened with too much dead-weight loss.

The eurozone economies have hit stall speed, with France, Germany, Italy and Spain, as well as most of the smaller economies, having negative growth. In addition, the United Kingdom and Japan are barely above stall speed with an annual growth rate of less than 1 percent. The United States, Canada, Russia and Brazil are in the danger zone, all with annual rates of less than 2 percent growth.

The basic questions are: Why has growth stalled, and what needs to be done to revive it? Good economists know the following:

When government grows as a percentage of gross domestic product, economic expansion and job creation begin to slow beyond a certain point. This occurs as the portion of government spending that is used to provide for protection of person, property and liberty (court systems and defense) diminishes, and the portion used for transfer payments (often explicit payments for not working) and nonproductive, bureaucratic programs increases. Studies show that government spending above 25 percent of GDP tends to become increasingly counterproductive. Government spending in France is now above 50 percent of GDP, more than 40 percent in the other euro countries and nearly that much in the United States.

Government regulations not justified on a cost-benefit basis, plus the cumulative weight of all regulations, result in a dead-weight loss to an economy. The United States now has more than 1 million regulations, and the Code of Federal Regulations runs to more than 175,000 pages spread over 238 volumes. Clyde Wayne Crews and Ryan Young of the Competitive Enterprise Institute calculate the cost of these regulations to be about $1.8 trillion per year, or roughly 11 percent of GDP. Most European countries have similar or even greater regulatory burdens.

Many studies show that high marginal tax rates, particularly on labor and capital, have a negative effect on government revenues, and on economic and employment growth (the Laffer Curve effect). A study by Cornell University professor Karel Mertens, published by the National Bureau of Economic Research, concludes that cutting the tax rate on the top 1 percent of taxpayers would lead to a statistically significant increase in GDP, and also increase the average incomes of the bottom 99 percent. Most European countries and the United States have marginal income-tax rates far above the long-term growth-, job- and welfare-maximizing rate (20 percent, according to Nobel Laureate James Mirrlees). The exceptions are a number of the Eastern European countries that have low-rate, flat-tax systems.

At some point, total government debt begins to have a negative impact on economic growth and employment as a result of the increase in default risk, the increased cost of debt service and the crowding-out effect on private and productive capital investment. Economists disagree on exactly where the danger point is, but most agree that the high debt-to-GDP ratios that all the major economies have are above or close to the danger point. Of greater concern is they are all running deficits (and have been for several years) that exceed their growth rates, meaning their debt-to-GDP ratios continue to worsen. (Note: Even most economists on the left acknowledge the need to get deficits under control over the "long run," while they are demanding more government "stimulus" spending in the short run. The problem is that the long run never comes for many of them.)

The answers to all of the above problems are obvious. If governments substantially reduced spending, cut high marginal tax rates and eliminated counterproductive regulations, their economies would rise above the stall speed and the debt, growth rate and employment problems would diminish. Competitive Enterprise Institute scholar Matthew Melchiorre has just published a paper showing that European governments' claim that they are practicing "austerity" is largely a myth. Only Bulgaria, Ireland, Latvia and Lithuania have reduced government spending and tax rates. The other countries have either increased or not cut government spending and, in some cases, even increased taxes.

The United States has slightly reduced government spending as a percentage of GDP (sequestration), but has increased taxes and regulatory burdens. Entrepreneurs are the main sources of economic growth and jobs, yet government policies in Europe and the United States have become increasingly hostile to entrepreneurs.

Those who forecast a return to real growth, well above stall speed, are actually forecasting that the political actors in Europe and America suddenly will become more rational and responsible — an example of hope over experience.

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