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## Economics Group

Special Commentary

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# Macro Clouds, Micro Foundations, Realities for Decision-Makers

"An overconfident government throws itself into a dysfunctional culture it doesn't really understand. The result is quagmire. The costs escalate. There is no exit strategy." [1]

In the rush to solve the current economic problems policymakers base their projections of success on high-level multipliers and big-picture estimates. Often missed, however, are the on-the-ground microeconomic implications of policy proposals, a failure which has led to disappointment in the past.

What can decision-makers expect for policy initiatives and how will these initiatives affect basic hiring and investment decisions? The easy path to analysis is to rely on the broad sophism that government spending and tax cuts, along with a healthy dose of monetary easing, will stimulate sustainable economic growth. However, macro policy experiments in prior administrations, including the most recent Bush administration, were fixed on broad macro initiatives and failed to provide sustained growth due to the disregard for micro foundations. Policy actions based solely on conclusions drawn from large macroeconomic experiments and simplistic multipliers - those that ignore how households and firms will react on the micro level - will not be effective.[2] Stated differently, incentives always matter.

*Policy endeavors that appear effective when viewed at the macro level, and do not change individual incentives, do not generate a true economic stimulus.*

In 2008, former President George W. Bush's fiscal rebate program aimed to stimulate the economy.[3] Such stimulus did lead to a brief pick-up in retail spending but did not generate ongoing economic recovery. Certainly, there were other factors involved, but the basic lesson is that such "rebates" were simply handouts that did not alter individual incentives to work, save or invest. Estimates of job creation and sustainable growth owing to these macro policies were wildly optimistic. Policy endeavors that appear effective only when viewed at the 40,000-foot level, without changing individual incentives, generate no permanent stimulus to the economy. This year, President Obama's stimulus has come in terms of transfer payments, and not sustained job growth. In the latest personal income report we saw that personal income rose primarily due to these transfer payments, and as a result, household saving rates rose, but very little of the additional income was spent. There was little, if any, multiplier for the economy.[4]

Moreover, unfortunately, the disincentives of specific sector policy proposals may have negative effects on business and consumer market behavior, worsening the recession and damaging expectations for sustainable future growth. If economic policy is to have any sustainable impact on the economy, and generate any follow-on spending in the private sector, there must be a

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**[1] Brooks, David. "The Quagmire Ahead." New York Times. June 2, 2009. Brooks comments on the government's involvement in the auto industry.**
**[2] Lucas, Robert (1976), "Econometric Policy Evaluation: A Critique, "Carnegie-Rochester Series on Public Policy." 1:19-46.**
**[3] Economic Stimulus Act of 2008.**
**[4] American Recovery and Reinvestment Act of 2009.**

change at the micro level for the individual and the firm. Individuals, not models, generate sustainable economic activity.

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## Known Costs Today Outweigh Uncertain Public Benefits in the Future

For decision-makers, known costs today outweigh future uncertain benefits. Any decision-maker may have the inclination to accept that some proposed domestic policy initiatives may deliver long-run benefits to society some time in the future. However, in the short run, that same decision-maker understands that many policy proposals also generate very high levels of uncertainty and significant transition costs immediately. For example, the proposed increases in taxes on individuals and businesses may produce some expected greater equity in income as a perceived public goal but would also represent an immediate and significant negative incentive to hiring another worker or buying equipment to earn more highly taxed profits.

In another example, cleaner energy initiatives, in the name of reduced future global warming, may appear to be proper policy from an environmental view, but these proposals also suggest significant challenges and transition costs in the short run in an economic review. The movement from the current energy infrastructure to a future, greener, structure is characterized by certain, immediate costs to the firm and uncertain future benefits to society. Higher transportation costs are immediate and would lead to some combination of higher consumer prices, lower wages, reduced employment or diminished profits.

## Financial Markets

In the financial markets, tougher regulation of financial activity may indeed be warranted but, as we saw with Sarbanes-Oxley, the short-run impact is often one of heightened uncertainty and risk avoidance. In the short run, initial public offerings after Sarbanes-Oxley were not better documented or audited. Those offerings were simply not made. In a similar manner today, with so much threatened regulation on mortgages, many lenders are simply waiting for the dust to settle. Instead of better informed mortgage transactions, the threat of all this regulation insures that there is no mortgage market at all, especially for those with mixed credit history.[5]

Proposals for increased financial regulation, no matter how well intentioned, would limit the price and availability of credit relative to prior experience and therefore would increase the cost of capital. In addition, higher taxes on dividends and capital gains would also suggest a reduction on the expected rate of return on investment. In a global credit market, lower after-tax returns mean a reduced capital inflow into the United States. As we have seen in recent months, foreign direct and portfolio investment in the United States has diminished as the expected rate of return for investing in the United States has declined. Moreover, large, projected future fiscal deficits suggest ample future supply of Treasury debt and add to the risk of currency depreciation and higher future inflation.

## New Era of Private/Public Allocation of Economic Resources

Microeconomic implications of policy initiatives are likely to be more significant in their impact for the economy and investors than the broad macroeconomic "stimulus" programs that are frequently the focus of conventional analysis. For decision-makers, the incentives implied in policy proposals raise both the short-run costs and risks associated with implied economic adjustments. Such implications are negative to growth and investment returns. It should be no surprise, therefore, that the recession has been deeper and most likely the recovery will be more muted than many forecasters expect as microeconomic private sector decision-makers anticipate greater barriers to growth from macroeconomic public policy.

**[5] Enrich, David, Liz Rappaport and Jenny Strasburg. "Wary Banks Hobble Toxic-Asset Plan,"** ***Wall Street Journal*****, June 29, 2009. Another example of micro decisions offsetting the best-laid macro plans is discussed here.**

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