Sequestration has come to America and cries of disaster are heard. President Obama, in a speech on February 19th, 2013, suggested, “…these cuts are not smart, they are not fair. They will hurt our economy. They will add hundreds of thousands of Americans to the unemployment rolls.” The Congressional Budget Office (CBO) agrees, predicting a GDP decline of 0.6 percent and a loss of 750,000 jobs because of sequestration. Bloomberg’s survey of economists likewise agrees, forecasting a loss of 0.5 percentage points of GDP and 350,000 jobs. Our research suggests these dire warnings may be overblown. In fact, since WWII, reductions in government spending have normally preceded increases in economic output.

Cries of doom are based loosely on the Keynesian theory, which looks to the government as an engine of growth, thus reduced spending is considered a negative. Mathematical models, not real world data, are widely used by economists who make these predictions. To look at “real world” data, we studied contrasting government actions in major economic downturns. There were three or four such instances: Harding and Coolidge in the 1920s, facing a very severe economic downturn (unemployment said to be 20%+), cut taxes and reduced government spending. These actions preceded very strong economic growth now called the “Roaring ‘20s”. However, Roosevelt’s appetite for a much greater role for government and higher taxes in the 1930s coincided with the “Great Depression.” Similar policies by the Obama administration have thus far not corrected the “Great Recession.”

We also considered findings by Barron’s economic editor, Gene Epstein, who reviewed post war periods of budget surpluses. Two of the three examples he used, 1954 and 1987, saw surpluses lead to higher economic activity, not slow-downs. (A surplus of 0.9% in 1956 did coincide with slower growth.)

To analyze the data, we reviewed every calendar quarter since 1947. Using the Bureau of Economic Analysis data (in nominal dollars) along with the Bureau of Labor Statistics and other standard references, such as Standard & Poor’s and Bloomberg, we noted the rare instances of spending cuts, and considered the impact.
We found, in nominal terms, the economy grew on average 6.7% on a year-over-year basis since the 1940s. Where government spending fell, the next year’s economic gains averaged an impressive 7.3%. Further, rather than hurting the employment situation, Americans found more jobs available with stronger real (inflation-adjusted) take home pay. Additionally, stock returns were robust and inflation was restrained.

This is in sharp contrast to periods where Washington has tried to lead the way with a Keynesian approach of higher government spending. Historically, periods of higher spending have been followed by a year’s worth of discontent. Gains in the economy, stocks, employment and disposable income were, unfortunately, subpar. Meanwhile, inflation accelerated to uncomfortable levels. Details are summarized in the table nearby.

After reviewing these findings, and for those still uneasy about the future, we offer these words. By Washington standards, the size of the spending reductions is relatively small. Over the next seven months, sequestration means a reduction in budgeted federal spending of about $85 billion. This represents only 2.4% of the federal government’s spending in 2012. Actual cash reductions will likely be much less. In fact, even with an $85 billion sequestration, government spending in 2013 is projected to rise by over $14.5 billion, according to the Congressional Budget Office. Only Washington can spend more money and call it a cut!

To be sure, reductions in the rate of government spending can create unfortunate dislocations and hardships in some areas. The haphazard nature of these cuts ensure many worthwhile programs and personnel will suffer needlessly. Overall, industries and regions most reliant on Washington’s favor, especially the defense area which is sustaining the larger cuts, will be especially affected. Still, the ultimate effect for the nation could be positive. Perhaps the humorist Will Rodgers put it best when he quipped, “Things in our country run in spite of government, not by aid of it.”

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