



This is an excerpt from the Spring 2017 issue of *The Linneman Letter*.

Not All Spending Is Equal

Do not worry about the Congressional Budget Office (CBO) deficit forecasts relating to proposals by the new Congress and administration. These forecasts are never remotely close to actual budget deficits. This is partially because they fail to incorporate the many unforeseen economic twists which invariably occur over a 2-3-year window. But it is also because these forecasts are mandated to exclude any feedback between

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lower tax rates. This makes these forecasts “non-political” but hopelessly flawed and over-simplified in terms of forecasting budget deficits. CBO forecasting is like analyzing what would happen to the revenue of a building if you cut rents and ignored the fact that lower rents result in more space being leased.

This patently nonsensical approach is exactly how the CBO forecasts are created. Ironically, these forecasts use macroeconomic models which assume that government spending (“G”) always generates a multiplier effect on economic activity. That is, positive feedback of tax cuts are ignored, but it is always assumed for increased government spending. As we have discussed in the past, such macroeconomic models completely fail to accurately predict economic outcomes because they assume that the response of the economy to government spending is the same whether government spending is completely wasteful or highly productive. It is as if you assume that the impact of capital expenditures on your building’s NOI is the same irrespective of whether these capital expenditures are useful. These macro models are equivalent to saying that install-

ing new elevator cabs every day creates as much NOI growth as spending the same amount repairing a very leaky roof. When viewed in this context it is obvious that the underlying macro models used in these forecasts are worthless. Further underscoring this worthlessness is the fact that macroeconomic models in no way incorporate the regulatory burden on businesses and individuals. Do you recall discussing regulatory burdens in your macroeconomics class? No. But everyone knows that economic growth

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is highly sensitive to having an appropriate regulatory framework. The simple truth is that too much regulation strangles growth, while too little regulation squanders resources. Yet macroeconomic models completely ignore the regulatory framework. Hard to believe, but true.

As a result of President Trump saying that he plans to allocate \$1 trillion for infrastructure spending, these nonsense models spewed out increased GDP growth forecasts, due to the fact that these models mechanically assume that more government spending always creates growth. These forecasts were made without knowing any details as to which specific infrastructure spending will occur. Of course, it requires a careful analysis of each individual infrastructure project to determine whether expected benefits exceed expected costs (including the opportunity cost of using the resources in the private sector). Only after analyzing each specific infrastructure proposal, and summing the results could you have any idea as to whether the \$1 trillion infra-

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structure plan will add to, or subtract from, the economy's growth. For example, what if the entire \$1 trillion was used to build, say, a wall? Okay, we won't go there, but what about an eight-lane bridge from San Francisco to Tokyo? That would certainly be infrastructure spending, and it certainly is a lot of "G," but it would waste \$1 trillion of scarce resources on a hopeless project, reducing the well-being of the U.S. economy and GDP growth. A \$19 trillion economy simply cannot afford to squander \$1 trillion. Certainly these resources could be employed far more productively in the private sector, causing GDP to grow faster than when diverted into wasteful government spending. Saying that greater infrastructure spending increases growth without knowing which infrastructure is involved is like saying a company that invests more will always have greater profit growth, without knowing whether the investment projects are value-creating or value-destroying.

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A great irony of the current political scene is that after 10 years of Democrats saying that greater government spending was needed to stimulate the economy, and Republicans arguing that increased government spending would reduce growth, these parties have now swapped tunes. Suddenly, Republicans "believe" that greater government spending enhances growth, while Democrats now "believe" that fiscal restraint improves growth. Government spending in and of itself never stimulates growth. Growth occurs only when resources are moved from less productive, to more productive uses. If resources taken from the private sector are more effectively utilized in the public sector, then higher growth ensues. That this is rarely the case is not for theoretical reasons. Rather, it is because the reality of politics generally swamps the concern for greater productivity via better resource allocation. Simply stated, if I am running for office,

Supply-Side Growth Is All There Is

It is interesting to hear many economists (and most politicians) say that supply-side driven growth is simply too small to count on, and that only profligate macroeconomic policies can generate growth. Were this true, the U.S. economy would not have grown for most of its history, as for most of U.S. history there were no grand macroeconomic policies, but rather only supply-side driven growth.

Supply-side growth is indeed small, perhaps a mere 2% a year per capita of increased productivity on a sustained basis in the best of circumstances. But it is the only path to growth. Annual real growth of 2% per capita means a doubling of living standards every 36 years, and a quadrupling every 72 years. This growth means about a 5-fold improvement over a lifetime. Supply-side driven growth has raised the living standards not only in the U.S., but in post-USSR Russia, its satellite states, India, and China. Government spending does not create growth. China's explosive growth only occurred when supply-side reforms occurred and macro policies receded. When China was "all government", there was no growth. And now after a period of stunning supply-side driven growth, China's growth has declined as its government has expanded its reach. As Frank Sinatra sang in response to the lyrical question, "Is that all there is?"; the answer is "yes!"

government resources are best spent in my district even if they are less productively used than in the private sector, as it helps me buy votes for my election. This is true of both Republicans and Democrats, and explains why most (though not all) government spending is growth-reducing. Sadly, history has proven all too vividly both in the U.S. and other countries that most government infrastructure spending is wasteful. This is most clearly demonstrated in Japan over the last 26 years, where non-stop largely wasteful infrastructure spending has drained resources that could otherwise have been used more productively in the private sector, to the detriment of economic growth. Similarly

President Obama's honest attempt to pursue "shovel-ready projects" quickly devolved into the brutal reality of Congressional pork barrel politics.

Remember that a morsel of privately-provided fresh food is far more productive than \$1 trillion of rotten and putrid food provided by the government. Forget these macro models and simply ask yourself if the dollars spent are being put to use more productively than if the same dollars remained in the private sector. This simple approach yields far better economic growth forecasts than all the fancy macroeconomic models in the world.

About Dr. Peter Linneman

Dr. Linneman, who holds both Masters and Doctorate degrees in economics from the University of Chicago, is the Principal of Linneman Associates. For over 30 years he has provided strategic and financial advice to leading corporations. Through Linneman Associates, he provides strategic and M&A analysis, market studies, and feasibility analysis to a number of leading U.S. and international companies. In addition, he serves as an advisor to and a board member of several public and private firms.

Dr. Linneman is the author of the leading real estate finance textbook, *Real Estate Finance and Investments: Risks and Opportunities*, now in its fourth edition. His teaching and research focuses on real estate and investment strategies, mergers and acquisitions, and international markets. He has published over 100 articles during his career. He is widely recognized as one of the leading strategic thinkers in the real estate industry, and was named among the top 30 "Most Influential People in Real Estate" by Commercial Property Executive in 2013.

He also served as the Albert Sussman Professor of Real Estate, Finance, and Business and Public Policy at the Wharton School of Business at the University of Pennsylvania until his retirement in 2011. A member of Wharton's faculty since 1979, he served as the founding chairman of Wharton's Real Estate Department and the Director of Wharton's Zell-Lurie Real Estate Center for 13 years. He is the founding co-editor of *The Wharton Real Estate Review*.

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