The Elephant Running Amuck

October 2010

Avid readers of today's economic circumstances have likely run across the latest perspective/debate that government spending "crowds out" productive private sector spending. That crowding out supposedly inhibits economic growth. Economists suggest there is just no way a few government bureaucrats can be as efficient at spending money as Adam Smith's Invisible Hand…the millions of individual decisions which collectively are supposed to generate the most productive economic results.

A good many in Washington today will suggest Adam Smith is wrong, that a few highly educated people can surely make better overall decisions than millions of individuals pursuing their personal interests. Of course readers will most obviously know the Armchair's perspective here. If government was the answer then why didn't the Soviet Union take over the world?

Let's not get into the debate over whether we are smart enough to create a "better managed", managed economy. Instead let's dive in from the beanbag and take a look at our economy, how it is generated and what we might learn from that. Let's start out with a simple perspective. There are three things we seem to do with our personal time…

Productive Activity – How we create economic value. In this category we obviously put our job, that thing we do to earn a paycheck.

Leisure Activity – To replenish our productive batteries. This basically includes our vacations and hobbies.

Maintenance Activity – To keep the wheels rolling forward on our productive life. Without maintenance we would be a mess, limiting our productive capability.

That seems to be about it. We work, we relax and we maintain. All we do in life pretty much fits into these three groups. Certainly there is a relationship between them; without Leisure and Maintenance we wouldn't be very Productive, but without Productive Activity we would be unable to afford much Leisure or Maintenance.

If each of us spends time doing these three things, then it would seem an economy is nothing but millions of people being productive, enjoying leisure or working to maintain what they have. If this is true, then can we analyze our country's GDP relative to these activities and draw any meaningful conclusions? And is there an appropriate relationship between the amount of economic value created from Productive Activity compared to the amount we spend on Leisure and Maintenance?

To my surprise it was pretty easy to analyze this from data gathered by the U.S. Bureau of Economic Analysis (BEA). The BEA is the government agency tracking our GDP. It divides GDP into four sectors. Add them up and you get total GDP. Here they are…

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Personal Consumption Expenditures – products and services we buy
Gross Private Domestic Investment – our investment in fixed assets like factories and houses
Net Exports of Goods and Services – what we export and import
Government Consumption Expenditures and Gross Investment – what the government spends

Of course the BEA breaks these into subsectors, again pretty easy to understand. So which of these are Productive Activities and which are Leisure and Maintenance? The Armchair chooses to define them this way…

Productive Activities include…

Gross Private Domestic Investment – our investment in fixed assets like factories and houses
Exports of Goods and Services - the stuff foreigners buy from us
Personal Goods Consumption less Goods Imports – the net is our domestic goods production

All the above are things that produce primary economic value - building factories and houses, making stuff foreigners buy, selling services to foreigners, and certainly the stuff we make domestically that is purchased for domestic consumption. Below is what's left over from the overall GDP calculation.

Leisure and Maintenance Activities include…

Personal Consumption of Services less Imported Services – our total domestic services
Government Consumption Expenditures and Gross Investment – Maintenance, right?

I'm sure some would suggest that government is not Maintenance because without government we wouldn't have a framework within which to be Productive. But then isn't Maintenance the effort needed, "to keep the wheels rolling forward on our productive life"? If you don't agree that government is Maintenance then you may have a problem with this analysis, but first see the results. Below is our GDP breakdown since 1930.

Year	1930	1940	1950	1960	1970	1980	1990	2000	2009
Productive Activity	55%	56%	59%	51%	47%	47%	41%	41%	34%
Leisure/Maintenance	45%	44%	41%	49%	53%	53%	59%	59%	66%

And what did you notice? It seems pretty obvious. Starting in the 1980's we have been on a rapid change in GDP generation towards the Leisure and Maintenance areas of our economy. This should not be earth-shattering news. We have been told for years how our economy has become more and more service oriented. But if it takes the economic value of Productive Activity to be able to afford our Leisure and Maintenance, then "Houston we have a problem!"

We can see that for around fifty years our economy was almost equally divided between Productive Activity and Leisure/Maintenance. There was a slight logical aberration during the 1940's war and post Depression period, when our Production economy was cranking. But over the last thirty years we have fallen off the Productive Activity cliff. How have we been able to maintain our economy with such a dramatic swing in GDP generation? Come on…you know the answer…Borrowing!

Post the Great Depression total U.S. debt to GDP ranged between 130% and 160% until around 1980. Then it started to ramp up. As of 2008 it was at 360% of GDP! So basically, as we were decreasing our Productive Activity we were increasing our Debt in order to afford our Leisure and Maintenance

There are still a few folks stuck in Keynesianland who think we should borrow more and more to maintain the lifestyles we have become addicted to, but that seems like a Keynesian Trap. You can only borrow more if you have enough Productive Activity to pay it back.

Okay, maybe the argument should be we are "investing in our future", so those grandkids can pay off the debt. How are we so sure all this borrowing and "investing" will lead to an economy that allows our grandkids to pay off that debt? How do we really know what to invest in? Are we not back to the debate between Adam Smith's Invisible Hand and the "better managed", managed economy? And MOST important, why are we borrowing money our grandkids are supposed to pay back?

The great majority of economists, and now a lot of the common folk, seem to believe we have borrowed way too much money. Many economists talk about this debt bubble, this deleveraging and deflationary crisis we seem to still be battling. Certainly there is a debt problem, but it seems we have an even bigger elephant in the room.

We don't have enough Productive Activity to afford the massive move our GDP has taken to Leisure and Maintenance. We can only support it with more and more Borrowing, the current Washington policy. But if you notice, it took three decades to create this imbalance. What takes three decades to create is not going to be fixed in a year or two. For how much longer can we borrow to support a lifestyle we can really no longer afford?

A number of my friends think of me as a pessimist. I totally disagree. Certainly it is hard to be an optimist at this stage of the game, but I prefer to always be a realist. One good friend recently sent me a very worthwhile perspective…"The pessimist complains about the wind, the optimist expects it to change, the realist adjusts the sails" – William Arthur Ward

So how do we adjust the sails? For another Armchair…

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