Chapter 3: The Effects of American Recession-Fighting Policies on Economic Freedom

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Since the end of 2007, the world has experienced a sharp and deep decline in economic activity, which in this paper for the sake of brevity will be referred to as "the current recession." The United States has initiated many costly and extensive policies to fight this recession that are likely to have detrimental effects on economic freedom in that country. This chapter considers these detrimental effects in the context of monetary policy, fiscal policy, and the growth in regulation and reductions in property rights. The introduction gives a brief historic and systemic perspective on the current recession.

Introduction—business cycles and market economies

Market economies have always been, and always will be, subject to recessions caused by exogenous shocks like wars, civil unrest, and unpredictable events like natural catastrophes and epidemics. In modern times, recessions have also been caused by central banks' inflationary policies and over-investment in risky, new commercial activities. These periodic recessions are characterized by decreases in national output and high unemployment rates and serve an essential function: they lead to the reallocation of resources that makes the economy operate efficiently. They should be viewed as the cost of using markets to organize economic activity, which historically has produced growth in income and overall human well-being unmatched by other economic systems.

The superiority of market economies in producing high levels of incomes and human well-being is clear from many studies that use the data found in the Fraser Institute's annual publication, *Economic Freedom of the World*. In addition, as Lipford (2007) has shown, the greater economic freedom, the smaller the frequency, depth, and length of recessions.

Automatic stabilizers

As a norm for the evaluation of recession-fighting policies it is useful to consider that market economies eliminate recessions without deliberate government intervention. They do so through automatic stabilizers involving financial markets and government budgets. In financial markets, recessions result in a lowering of the demand for money. If the monetary authorities maintain the pre-recession level of the money supply, interest rates fall and investment and borrowing by consumers are stimulated, eventually leading to a return of prosperity. The balanced budgets of governments turn into deficit during recessions through declines in tax revenues and increased spending on social-benefit payments. The resultant fiscal deficit provides the public with more disposable income than would have existed in the absence of the deficit. As a result, the economic downturn is slowed until the stimulating effects of lower interest rates start the recovery part of the business cycle. Economic freedom remains unchanged if, over the full cycle, the money supply remains the same and there is no change in inflation. It also remains unchanged if deficits during the downturn equal surpluses during the boom, so that over the full cycle the level of debt is unchanged.

Keynesian economics has challenged the view that these automatic stabilizers can be counted on to eliminate recessions. The monetary-policy model is criticized on the grounds that lower interest rates do not necessarily lead to more borrowing and spending. The experience of the Great Depression is often cited as evidence. However, Friedman and Schwartz (1971) and others showed that the main problems of that period were due to the fact that the Federal Reserve allowed the money supply to shrink.[2]

1 This paper was completed at the end of May, 2009 and, therefore, does not reflect changes in policies and actions by the US Congress after that time.

2 Friedman and Schwartz (1971) argue that the Federal Reserve allowed the money supply to shrink during the Great Depression

Recently, a number of studies[3] have shown that during the Depression many other government policies prevented the operation of automatic stabilizers. Thus, new social programs like unemployment insurance and pension plans were created but they failed to increase consumer spending because taxes were raised to pay for them. New laws encouraged the exercise of union power and payroll taxes were imposed. Both of these policies raised the cost of labor and increased unemployment. To the extent that interest rates were lowered, the investment they normally would have brought was discouraged by a wide range of policies, like the legal harassment of the owners of capital, mandated wage increases in major industries, higher tariffs on imported inputs, outright restrictions on output and the imposition of marginal tax rates of 90% on high personal income that discouraged entrepreneurship and risk-taking.

The conclusion reached from the preceding analysis is that economic freedom will remain unchanged if market processes free from deliberate government intervention are allowed to restore prosperity and correct the dislocations that give rise to the recession in the first place. As will be seen below, the present recession has resulted in many deliberate government policies that are likely to have serious negative effects on economic freedom and will create new distortions.

1 The recession and monetary policy

During the current recession, the Federal Reserve did not repeat the errors made during the Great Depression. In fact, the Federal Reserve eased monetary policy to levels unprecedented in its history. The Federal Funds rate as an indicator of monetary ease is shown in figure 3.1 for the period from the 1950s until April 2009. As can be seen, the rate was very close to zero in April 2009. This level had not been reached since the 1960s or during any of the later recessions. In fact, the "target rate" for these funds of between zero and 0.25 existing in May 2009 has never been seen before.

The Federal Reserve in practice lowers the Federal Funds rate by increasing the supply of reserves of commercial banks, mainly through the purchase of Treasury bills. The commercial banks use these reserves to make loans in the private sector, except for a small fraction that they are required to keep on deposit with the Federal Reserve. Borrowers spend their loans and these payments end up on deposit with other banks, which in turn have reserves that they can use to make loans. This process of lending, spending, and redepositing of funds leads to an increase in the money supply and credit in the economy.

Figure 3.2 shows the total reserves the Federal Reserve has created since 1989 (earlier years are not shown since the quantities are so small that they are barely above the axis on the scale needed to show the most recent years). As can be seen, the quantity of reserves rose sharply at the end of 2008, which is responsible for the drop in the Federal Funds rate shown in figure 3.1. Why did the Federal Reserve have to engage in such a large increase in reserves for commercial banks and the money supply? The reason is that monetary easing at the beginning of the recession near the end of 2007 did not result in the usual lowering of longer-term interest rates and increased lending by banks. It soon became obvious that this problem was not caused by the lack of reserves or high Federal Funds rates but by the banks' holdings of so-called "toxic assets." The value of these assets had fallen sharply and lowered the asset-to-capital ratio they were required to maintain by existing bank regulations. The banks also believed that under existing economic conditions all loans were very risky. As a result of these developments, banks either stopped lending altogether or demanded unusually high risk premiums on the relatively few loans they made.

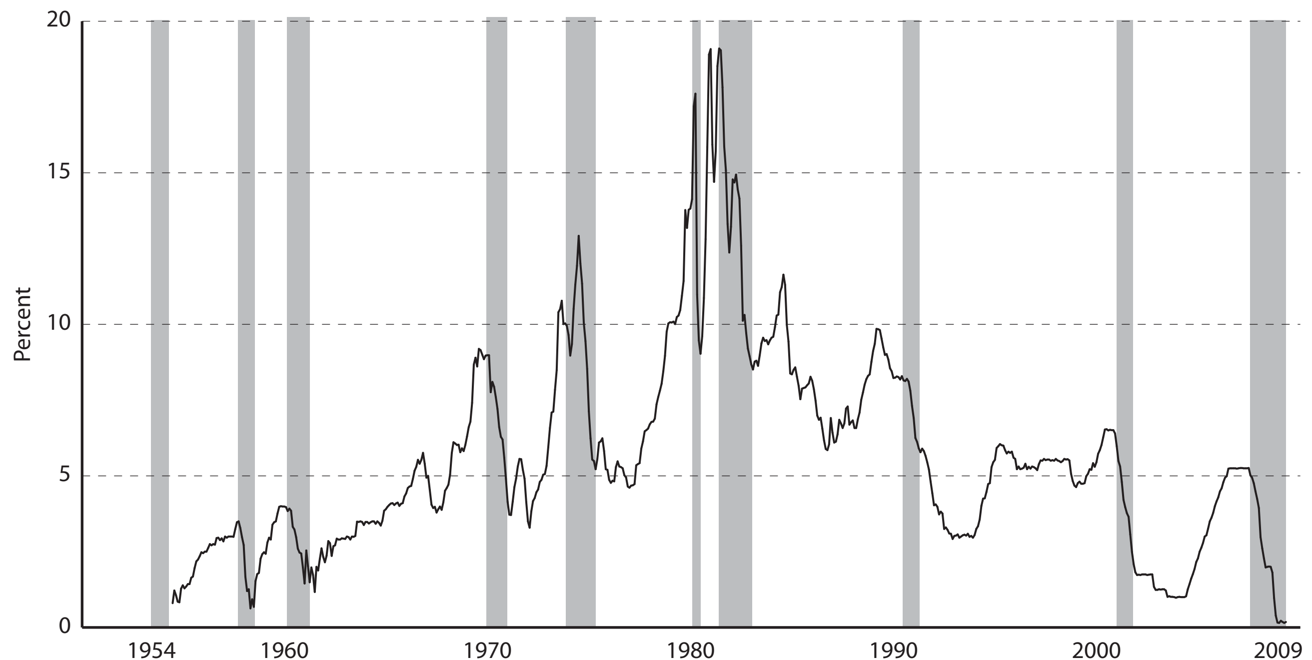
Why did the banks have so many "toxic loans" on their portfolios at the beginning of the recession? The process started when the government urged banks to lower their lending standards, so that more low-income Americans would be able to obtain mortgages and own homes. This lending resulted in the issuance of what became known as "sub-prime mortgages." Congress encouraged the issue of these mortgages by using political pressure to get the government-sponsored enterprises, Fannie Mae and Freddie Mac, to buy the mortgages issued by banks. The banks thus had available more money to issue additional mortgages, as Congress had wanted.

Fannie Mae and Freddy Mac, in turn, obtained the funds they needed to purchase the mortgages issued by selling securities that were backed by bundles of

of the 1930s and thus prolonged it. In a private meeting of economists a year before Friedman's death and the onset of the 2007 recession, he said: "I am optimistic about the future of the economy because the central bankers of the world have learned that they must not let the money supply shrink during recessions." But then he added wistfully that he still wished monetary policy was made by a computer rather than people, whose judgments often are influenced by emotions and politics.

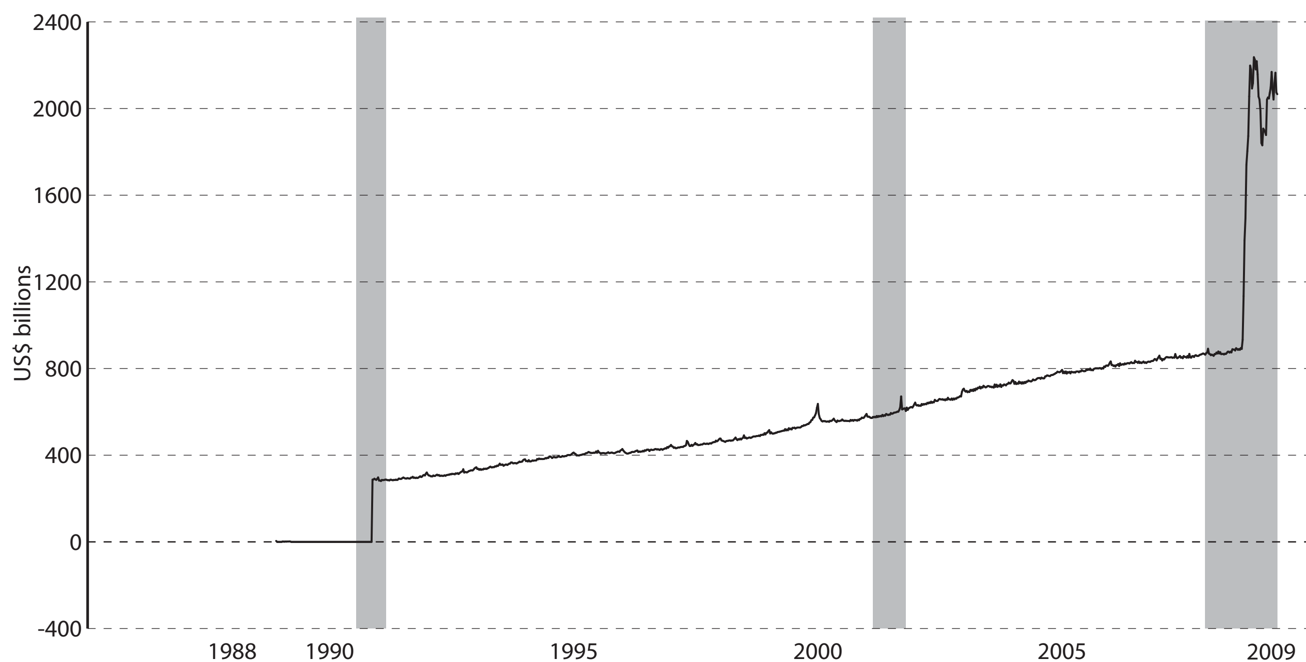
3 See recent studies by Reed (2008), Shlaes (2007), Cole and Ohanian (2004) and Folsom (2009). Vedder and Gallaway (1993) provide an excellent, earlier examination of the role played by government policies in deepening and prolonging the Great Depression and unemployment.

Figure 3.1: Effective federal funds rate, 1954–2009



Notes: [1] Data from July 1, 1954 to June 3, 2009; frequency: monthly; source of data: Board of Governors of the Federal Reserve System. [2] Shaded areas indicate US recessions.
Source: Federal Reserve Bank of St. Louis (2009). Series: FEDFUNDS, Effective Federal Funds Rate <http://research.stlouisfed.org/fred2/series/FEDFUNDS>.

Figure 3.2: Reserve Bank Credit, 1988–2009



Notes: [1] Data from November 30, 1988 to June 3, 2009; frequency: monthly; source of data: Board of Governors of the Federal Reserve System. [2] Shaded areas indicate US recessions. [3] Reserve Bank credit is the sum of securities held outright, repurchase agreements, term auction credit, other loans, net portfolio holdings of Commercial Paper Funding Facility LLC, net portfolio holdings of LLCs funded through the Money Market Investor Funding Facility, net portfolio holdings of Maiden Lane LLC, net portfolio holdings of Maiden Lane II LLC, net portfolio holdings of Maiden Lane III LLC, float, central bank liquidity swaps, and other Federal Reserve assets.
Source: Federal Reserve Bank of St. Louis (2009). Series: WRESCRT, Reserve Bank Credit.
<http://research.stlouisfed.org/fred2/series/WRESCRT>.

mortgages, which found ready buyers in life-insurance companies, pension funds, hedge funds, and banks. These so-called "mortgage-backed" securities were priced well relative to the risk of owning them. The packaging of the mortgages was seen as a method for reducing the risks associated with the holding of individual mortgages.

The process just described resulted in the purchase of homes by Americans who previously were unable to afford them. These increased purchases raised the prices of homes, which allowed the owners of these homes to take out second mortgages, the proceeds of which some of them used to make their monthly mortgage payments. Some home owners used these proceeds also to purchase consumer goods. Others used the increased value of their homes to justify purchases financed through credit-card and car loans. The banks' ability and willingness to make such loans was bolstered when these obligations also were securitized by other financial intermediaries and sold to private wealth holders. It is important to note that the overall demand for funds lent in the financial markets through the mechanisms just described was met by the Federal Reserve through its easy monetary policy.[4]

The increase in housing prices and growing indebtedness of borrowers ended near the end of 2007. The decline started when some of the sub-prime mortgages became delinquent and the housing bubble burst. Defaults on normal mortgages, credit-card, and other loans began to rise. Consumer spending generally decreased, unemployment rose, and the economic downturn snowballed following the pattern found in all such events.

When the recession started, the value of the securities backed by mortgages and other loans fell sharply. The main reason for this fall in their values was that there were no accepted methods for valuing them, especially as defaults on the loans rose. The fall in the value of the securities was aggravated by the existence of the so-called Basel-II regulations that required banks to maintain a specified ratio of assets to equity[5] and forced them to sell some of these securities.[6] The recession and overall pessimism about economic conditions worsened as some of the financial intermediaries that had held toxic assets reached high levels of financial distress. One of the most prominent of these, Lehman Brothers, actually declared bankruptcy. Sales of automobiles declined sharply and the automotive sector looked to government for help to avoid bankruptcy.

In the wake of these developments, bank lending slowed dramatically and in spite of very easy monetary

4 The growth in mortgages and loans under normal circumstances would have resulted in higher interest rates, which would, in turn, have slowed the growth down. However, during this period, some foreign government agents accumulated large surpluses and used them to extend credit in the global financial markets. According to Mezzacapo (2009), central bank holdings of foreign obligations in the world at the end of 2008 were valued at $7.4 trillion, of which $2.2 trillion was held by China alone; at the same time, the sovereign wealth funds of energy-producing countries, mainly countries in the Gulf but also Norway and Alberta, came to nearly $3.5 trillion, of which the Abu Dhabi Investment Authority alone held $875 billion. These estimates suggest that central banks and sovereign wealth funds flooded global credit markets with about US$9.6 trillion, most of which found their way into the American credit market and sustained the credit bubble (Mezzacapo, 2009: 94, table 1; 97, table 2).

The Federal Reserve could have stopped this process by raising interest rates and thus curtailing the amount of money borrowed in the United States, but the result would have been a global recession at that time since the high savings of the central banks and sovereign wealth funds would have been unmatched by global spending, resulting in an excessive growth of inventories and eventually reduced output and employment.

This view of the genesis of the global financial crisis of 2008/09 is held by Ben Bernanke, the head of the Federal Reserve, Alan Greenspan, the former head of the Federal Reserve, and others like Martin Wolf, editor of the *Financial Times*. It is heavily criticized by John Taylor (2009) and Anna Schwartz (2009), who believe that all of the problems were caused by excessively easy monetary policy of the Federal Reserve. For a more detailed analysis of this phenomenon, see Grubel (2009).

5 The Basel-II regulations are more complex than can be described here. Thus, the total value of banks' assets is a composite in which individual assets are weighted according to their riskiness. In addition, there is tier-one equity consisting of residual ownership rights and tier-two equity, whose owners have limited voting rights but receive preferential treatment in the distribution of profits. In spite of these regulatory details, the essential point made in the text remains valid.

6 A final factor contributing to the deep reduction in the prices of these securities was the requirement that banks had to report their value on the basis of the latest recorded market transactions for comparable assets. This so-called rule of pricing known as "mark-to-market" has been blamed by some analysts like Jim Forbes as one of the main driving forces behind the deterioration of the quality of banks' balance sheets. He and others recommended modification of this rule, which the guardians of accounting rules did in early 2009 over the protests of many who felt that there was no substitute for market-determined values. The modified rules suggest that under certain conditions the rule could be suspended and other valuation procedures could be used, as long as they were properly justified in the financial reports of financial intermediaries. For an uncompromising view on the essential need to use mark-to-market principles, see Hanke and Tatom (2008, October 23).

policy. Since market economies cannot function under these conditions, the Federal Reserve took measures to deal with the unprecedented problem. It did so in a number of ways. One involved the purchase of newly issued equity shares of financial troubled banks in order to raise their required capital-to-loan ratios. Another led to loans to financial firms like Bear-Sterns and to firms in the automobile sector. The Federal Reserve paid for these equities and loans through increases in the deposits of commercial banks. This new policy is known as "quantitative easing." It produced most of the dramatic increase in the Federal Reserve's liabilities shown in figure 3.2.

At the time of writing (end of May 2009), the quantitative easing and the very large increase in commercial bank deposits with the Federal Reserve have begun to restore bank lending. However, financial market conditions are far from normal and there are few signs that the recession has reached its bottom. What remains is the effect of quantitative easing on economic freedom.

The effect of monetary policies on economic freedom

Quantitative easing affects economic freedom by increasing the risk of inflation. The purchase of the toxic assets by the Federal Reserve has resulted in the very large increase in the high-powered money base shown in figure 3.2. Such additions to the money base are analytically equivalent to "printing money," a policy that had caused all of the major hyperinflations in the world like that in Germany during the 1920s and Zimbabwe in recent years. If this money base is not reduced and inflation develops, economic freedom as measured in Area 3: Access to Sound Money of the EFW index will decrease. Moreover, if the fight against inflation leads to wage and price controls and other regulatory interventions, economic freedom as measured in Area 5: Regulation of Credit, Labor, and Business may also decline.

However, these threats to economic freedom are uncertain and will develop only if the Federal Reserve fails to sell securities and decrease the high-powered money base to a level consistent with stable prices once the economic recovery occurs. The leadership of the Federal Reserve is committed to such a policy, according to remarks made by its Chair, Ben Bernanke (2009) in January 2009 at the London School of Economics. Nevertheless, many students of the Federal Reserve doubt that it will deliver on this promise. Allan Meltzer is one of them and bases his views on the lessons learned from his study of the history of the Federal Reserve, which was recently published in two volumes containing 1,400 pages (2002). In an address given earlier this year (2009), he deals with current conditions and suggests that heavy political pressures will make it unlikely that the Federal Reserve will reduce the high-powered money base enough and in time to avoid inflation. John Crow (2009) agrees with Meltzer. He had much practical experience dealing with politicians and public pressures when he was the Governor of the Bank of Canada during the late 1980s, when the country faced strong inflationary pressures and the interest rates had to be high to deal with them.

An important argument that politicians will use in their demand that monetary policy not be tightened in the wake of economic recovery is that the timing and magnitude of the effects policy changes have on the real economy are highly uncertain. Therefore, higher interest rates imposed today, when economic activity is on the rise, could cause the recession to return promptly. For most politicians, inflation is the less of an evil and threat to their re-election than unemployment and recession.

In conclusion, the preceding analysis suggests that the active monetary easing used by the Federal Reserve in the wake of the current recession runs the risk of generating inflation and through it a reduction in the economic freedom index of the United States. However, the magnitude of this reduction can be assessed properly only once the recession has ended and the rate of inflation is known.

2 The recession and fiscal stimulus

Fiscal stimulus is a popular term for government policies that result in a government's accumulating deliberate budget deficits in excess of those produced by the operation of automatic stabilizers. Sources of this stimulus are tax cuts and spending increases. These deficits are designed to raise the incomes of the public and their spending, which will slow the reduction and ultimately reverse the trend. The idea that such deficits are required to deal with recessions stems from traditional Keynesian economic theory, which dominated university textbooks from the end of the Second World War until the 1970s. Thereafter, monetarist models, the theory of rational expectations, and other theoretical developments, all backed by many empirical studies, implied that fiscal stimulus may not be expected to speed up economic recovery and may delay it.

Whatever may be the merit of fiscal deficits in reducing the size and length of recessions, the American Recovery and Reinvestment Act of 2009 (ARRA) (*An Act etc.*, 111-5, H.R. 1) was signed into law on February 17, 2009. Table 3.1 is taken from the summary tables at the end of the official US government document outlining the features of the bill (United States, Office of Management and Budget, 2009).

Table 3.1: Budget totals for the *American Recovery and Reinvestment Act of 2009*, US$ billions and % of GDP

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010–2014	Totals 2010–2019
Budget totals in US$ billions														
Receipts	2,524	2,186	2,381	2,713	3,081	3,323	3,500	3,675	3,856	4,042	4,234	4,446	14,997	35,250
Outlays	2,983	3,938	3,552	3,625	3,662	3,856	4,069	4,258	4,493	4,678	4,868	5,158	18,764	42,219
Deficit	459	1,752	1,171	912	581	533	570	583	637	636	634	712	3,767	6,969
Debt held by the public	5,803	8,364	9,509	10,436	10,985	11,505	12,070	12,659	13,297	13,932	14,557	15,370		
Debt net of financial assets	5,297	6,943	8,072	8,960	9,541	10,073	10,642	11,224	11,860	12,495	13,129	13,840		
Gross domestic product	14,222	14,240	14,729	15,500	16,470	17,498	18,386	19,205	20,060	20,952	21,884	22,858		
Budget totals as a percent of GDP														
Receipts	17.7%	15.4%	16.2%	17.5%	18.7%	19.0%	19.0%	19.1%	19.2%	19.3%	19.3%	19.5%	18.1%	18.7%
Outlays	21.0%	27.7%	24.1%	23.4%	22.2%	22.0%	22.1%	22.2%	22.4%	22.3%	22.2%	22.6%	22.8%	22.6%
Deficit	3.2%	12.3%	8.0%	5.9%	3.5%	3.0%	3.1%	3.0%	3.2%	3.0%	2.9%	3.1%	4.7%	3.9%
Debt held by the public	40.8%	58.7%	64.6%	67.3%	66.7%	65.8%	65.6%	65.9%	66.3%	66.5%	66.5%	67.2%		
Debt net of financial assets	37.2%	48.8%	54.8%	57.8%	57.9%	57.6%	57.9%	58.4%	59.1%	59.6%	60.0%	60.5%		

Source: United States, Office of Management and Budget, 2009: Table S–1. Budget Totals.

As can be seen, the annual deficits projected in the budget are staggering and unprecedented in peace time. They amount to $6.96 trillion over the 10 years from 2010 to 2019. Adding this deficit to the existing debt, the total in 2019 will be $15.37 trillion, an increase of 265% since the end of 2008. In 2019, the debt will be 67.2% of GDP, up from 40.8% in 2008. This will push it above 60% of GDP, which members of the European Monetary Union may not exceed to remain in good standing. The annual deficits also are very large: 12.3%, 8.0%, and 5.9% of GDP are projected for the years from 2009 to 2011, respectively. In 2008, the deficit was 3.2%. The level considered unacceptable under the Growth and Stability provision of the European Monetary Union is 3%.[7]

It should be noted that the estimated revenues in the budget are subject to much uncertainty, especially since the current crisis is deeper, developed faster, and is caused by entirely new financial pathologies than other postwar crises. By the same token, the financial system has no previous experience with the use of quantitative easing and its ultimate effect on inflation and the real economy. Moreover, there are questions about the willingness of Congress to pass some of the tax measures required to meet the revenue estimates. For example, the proposal for a cap-and-trade system aimed at the reduction of CO_2 emissions that is supposed to raise US$646 billion faces many obstacles stemming from its complexity and effects on energy costs. For these reasons, it is very likely that the ARRA budget underestimates the size of deficits that will actually occur.

The main effect of these deficits upon economic freedom arises through the operation of sub-component 5Aiii of the EFW index, which measures the share of total credit used by the government. In addition, the projected deficits in the later years could add to aggregate demand when the economy has recovered and thus produce inflationary pressures, the effects of which on economic freedom have already been discussed above. Finally, the higher government debt will have to be serviced through greater interest payments and higher taxes. Economic freedom as measured in section 1Di: Top marginal income tax rate will be reduced if tax increases raise the top marginal income tax rates and lower the levels at which they apply.

7 See European Commission, Economic and Financial Affairs (no date) for explanation of the directive requiring the EU's member countries to limit the size of their deficits and debt levels.

Composition of spending

Table 3.2 shows a simple summary of fiscal stimulus spending by the US Federal government, distinguishing spending on social services from spending on infrastructure.

Spending on infrastructure

As can be seen, infrastructure spending represents only 27.2% of the total. In principle, it merely accelerates spending that is designed to bolster overall economic efficiency and will return to its normal level and timing once the recession has ended. However, much of it is unlikely to be "shovel ready" and to have passed all of the required legislative and regulatory standards. During normal times, some of these infrastructure projects would not have been approved or would have been modified before they were carried out. Spending on such projects will be wasteful and reduce overall economic efficiency.

The data show that most of the spending on infrastructure goes for the production and distribution of energy, research into new energy technologies, transportation, and healthcare. To the extent that this spending will result in more public ownership and control of facilities that otherwise would have been operated by the private sector, economic freedom will be reduced, as shown by lower scores in component 1C: Government enterprises and investment, which measures the share of output supplied by State-Operated Enterprises and government investment as a share of total investment; and 5Cii: Administrative requirements, which measures how burdensome it is to comply with administrative requirements (permits, regulations, reporting) issued by the government.

Table 3.2: ARRA budget spending categories

	US$ billions	Percent
Infrastructure		
Energy	48	7.3
Science and Technology	16	2.4
Transportation	90	13.7
Healthcare	24	3.7
Total	178	27.2
Social services		
State education systems	142	21.7
Benefits for unemployed and poor	244	37.3
Medicaid	87	13.3
State public services	4	0.1
Total	477	72.8
Total ARRA spending	655	100

Notes: Percentages may not sum to 100 because of rounding.

Source: Basic data found in US House of Representatives, Committee on Appropriations, Dave Obey, Chairman (2009); classification of spending for infrastructure and social services produced by author.

Spending on social services

Table 3.2 shows that social spending represents 72.8% of the total. It will finance higher spending on public education; raise income support for the unemployed and poor; increase access to publicly financed medical care, and provide support of social programs under the jurisdiction of state and local authorities. Proposals for such spending increases have long been made in Congress and have failed to pass. However, Rahm Emanuel, President Barrack Obama's White House chief of staff implied that the will of Congress can be changed because, as he said recently in an interview with *USA Today*: "Every time in a period of crisis—look at the time of World War II or the Depression, look at the Civil War—people have reinterpreted what the government can and should do. We're in that moment of time now. Crises create that" (Page, 2009).

The increased social spending on education and health care in the budget is likely to be permanent and rise in the future. This conclusion is based on the experience with the social programs enacted under President Franklin Roosevelt, which expanded and remained largely intact for several decades.

The increased social spending, including income support for the unemployed and poor, lowers economic freedom as measured in components 1A: General government consumption spending as a percentage of total consumption and 1B: Transfers and subsidies as a percentage of GDP. These threats to economic freedom add to those already pending and needed to deal with the very large unfunded liabilities of the federal pension and health-care programs.

The row, State public services, in the section showing spending on social services in table 3.2 shows the planned transfers to states for their own social programs. This spending involves the same effects on economic freedom as direct social spending by the Federal government discussed in the preceding paragraph.

Taxation policies

One of the major objectives of the 2010 Budget Proposal of the Obama government is to use the tax code to increase the equalization of after-tax incomes. This is another policy that has been rejected by Congress in the past but has been made an integral part of the current

Table 3.3: Tax proposals in the 2010 US federal budget (revenue changes in US$ billions from individual-income tax provisions)

Affecting Lower- and Middle-Income Households		Affecting High-Income Households	
Provide Making Work Pay Credit	−537	*Raise top marginal tax rates*	339
Expand Earned Income Tax Credit	−33	*Limit deductions**	180
Expand Child Tax Credit	−71	*20% tax on capital gains, dividends**	118
More generous IRA and 401k	−55	*Limit itemized deduction to 28%*	318
American Opportunity Tax Credit	−75		
Total	−771	*Total*	955

Notes: *Applicable to high-income tax payers only

Source: Tax Policy Center, Urban Institute and Brookings Institution, 2009.

recession-fighting program. Table 3.3 shows how this objective is to be accomplished.[8] Lower- and middle-income households are projected to receive benefits worth US$771 billion while high-income households will see their taxes increased by US$955 billion. The higher marginal tax rates apply to couples with an income over US$250,000 and single people with an income over US$200,000. This policy will lower economic freedom as measured in the EFW index in Component 1D: Top marginal tax rate.

3 Regulation, property rights and the rule of law

Many of the policies used for fighting the current recession will lead to more regulation in several fields. Thus, the increases in the generosity of existing social programs and the creation of new ones will lead to tighter and new regulations to curb the increased incentives to cheat and to engage in the sort of imprudently risky behavior that moral hazard encourages. As already mentioned above, the transfer of funds to state governments will be accompanied by new regulations to ensure spending in ways envisioned by Congress. All spending on energy, science and technology, transportation, and health care will be accompanied by regulation and reporting requirements that are designed to prevent waste and abuse. The tax measures will add many pages to the tax code. The cap-and-trade program designed to reduce the emission for CO_2 for the sake of preventing global warming is not strictly a counter-cyclical measure but is part of the fiscal-stimulus package. Its implementation will require massive amounts of regulation. These increases in regulation will likely reduce economic freedom as measured in subcomponent 5Cii: Administrative requirements.

Bailouts, property rights, and the rule of law

The bailout of firms has been accompanied by policies that affect traditional property rights and existing contract laws. Thus, some of the bailouts were conditional on changes in existing contracts with employees, unions, and bond holders, which resulted in the termination of, or changes in, existing contracts without due process of law. The government's treatment of bondholders in the recent bailout of automobile manufacturers provides a vivid illustration of these policies. Under existing law, if a corporation declares bankruptcy, assets must be used first to satisfy fully its obligations to bondholders before the claims of contractors, unsecured debt holders, employees, and shareholders are met. When a firm is in financial trouble, of course, the parties are free to renegotiate conditions surrounding its obligations. But the recent bailout of Chrysler and General Motors established a new approach to these issues. The bailout funds prevented bankruptcy for several months during which the government modified claims for the benefit of unions, all through actions that bypassed the authority of Congress to make and modify laws and regulations. The case of Chrysler was particularly grievous. Under the government's plan, the bondholders would have

8 This table presents only a part of the tax proposals presented in the 2010 document from which it was taken. There are tax changes affecting business and there are revenue increases of $646 billions as a result of the sale of rights to pollute under the cap-and-trade policies aimed at the prevention of global warming. Other documents not cited here show that the effects of proposed changes in the tax code on revenue depend on assumptions made about the continuation of existing, temporary tax measures. None of these data are directly relevant to the present study that focuses on the effects of counter-cyclical policies on economic freedom.

received only 30¢ on the dollar for their secured loans. In contrast, the United Automobile Workers (UAW) would have obtained a 55% ownership share in exchange for their acceptance of reductions in their rates of compensation, already above the industry average. In essence, the government action, backed with bailout funds, provided the UAW with assets that otherwise would have been used to satisfy the claims of the bondholders.

Despite some rhetoric to the contrary, bondholders are neither mere stakeholders nor speculators. Unlike other stakeholders, bondholders have legal property rights and for the most part are not speculators since the largest bondholders like life-insurance companies and pension funds purchase bonds for their highly secure and specified yields. Modifications to bondholder agreements require that 90% of them vote in favor, but only 70% did so in the Chrysler case. Moreover, the 70% granting approval were four large banks—Citigroup, Goldman Sachs, JPMorgan Chase, and Morgan Stanley—all of which had received billions in government bailouts. Essentially, government funds were being used to seize property from bondholders, subsidize the UAW, and entice four large banks to go along with the deal. The government's actions in this case violated both property rights and the rule of law. A political process was substituted for the rule of law.

The Goldman Sachs bailout provides another illustration of politics trumping the rule of law. In this case, Henry Paulsen, Secretary of the Treasury and former CEO of Goldman Sachs, argued that, unless Congress provided US$700 billion for the purchase of "toxic assets," the entire financial system would collapse. But, after the funds were provided, the Treasury could not determine how to buy the toxic assets, mainly because their value was not established in active markets. Instead, the Treasury paid bailout funds directly to firms, including US$10 billion to Goldman Sachs (GS) and US$180 billion to the American Insurance Group (AIG), a major insurer of billions of toxic mortgage-backed securities held by GS. These payments helped GS survive the crisis because they improved its capital-to-asset ratio directly and, indirectly, because AIG was able to make good on the insurance claims held by GS.

Both the Chrysler and Goldman Sachs cases reflect political favoritism rather than even-handed enforcement of contracts and protection of property rights. While they are consistent with the principle that he who pays the piper gets to choose the tune, they are also likely to cause a reduction in the United States' economic freedom as measured in Area 2: Legal Structure and Security of Property Rights.

4 Summary and conclusions

The recession-fighting policies of the US government may or may not accelerate the end of the current recession and return to prosperity but many will almost certainly reduce the country's overall level of economic freedom through the following mechanisms.

- Monetary policy is likely to cause inflation.
- The fiscal stimulus package results in unprecedented levels of deficits and interest payments that reduce the amount of credit going to the private sector.
- Spending on infrastructure projects increases government consumption and leads to more regulation and wasteful investments.
- Spending on social programs raises government consumption and transfers. It will be accompanied by more regulation.
- Transfers for social spending to the states encroach on the traditional and constitutionally set responsibilities of the states and interfere with the integrity of the legal system.
- Tax measures found in the recession-fighting budget increase subsidies for low-income earners and raise the highest marginal income-tax rates and the level at which they apply.
- Regulation of the financial and manufacturing industries will be increased. So will the cap-and-trade system, which is found in the budget and aimed at reducing global warming.
- The bailout policies involved changes in existing rules concerning property rights, the integrity of the legal system, and the legal enforcement of contracts.

The policy implications of these findings are simple. Since reductions in economic freedom lower economic growth and the overall well-being of Americans, the policies should be evaluated in the light of these costs when they are undergoing detailed design, are implemented, and when they are reviewed in the future.

International aspects

The analysis above focused on conditions in the United States. Other countries in the developed and developing world have also been affected by the current recession and have adopted policies to deal with it. The problems facing these countries and their individual responses vary greatly. They deserve to be studied in detail.[9] However, even without such studies, it is almost certain that economic freedom in the world will decline. Moreover, the rankings of countries will change. A casual comparison of American and foreign recession-fighting policies suggests that the United States is likely to suffer a relative decline as data reflecting the current recession-fighting policies become available in future reports. However, chapter 2 of this volume, The Impact of Financial and Economic Crises on Economic Freedom (page 25), allows this analysis to conclude with a note of cautious optimism. According to this study, reductions in economic freedom, at least those related to financial crises, have resulted only in temporary reductions in economic freedom. Let us hope that this experience will be repeated once the present recession has ended.

9 See Prasad and Sorkin (2009) for data on fiscal stimulus programs of a large sample of countries.

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