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BRIDGING THE GAP BETWEEN ACADEMIC IDEAS AND REAL WORLD PROBLEMS
TESTIMONY

THE STIMULUS: TWO YEARS LATER
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By the end of 2010, the American Recovery and Reinvestment Act of 2009 had injected over half a trillion dollars into the US economy in hopes of spurring recovery and creating jobs.

The results have been deeply disappointing. Job growth has been anemic while our deficit has grown, limiting our future policy options. The predictions made at the time of ARRA's passage were too optimistic.

Why? Why has the labor market proved so stubborn? Why were the predictions so inaccurate?

There have been two explanations. One is that the economy was in worse shape than we realized. There is no evidence for this claim. It is an ex-post rationalization. The only evidence is circular—the standard Keynesian models under-predicted unemployment.

The second explanation is that the models that justified the stimulus package were flawed. Those models were broadly based on the Keynesian notion that the road to recovery depends on spending. In the Keynesian worldview, paying workers to dig holes and fill them back in promotes recovery.

This is not the first time the Keynesian worldview was wildly inaccurate in predicting the impact of changes in government spending. The most important natural experiments involving Keynesian economics took place at the beginning and end of WWII.

It was once widely believed that the New Deal ended the Great Depression in the United States. But that claim has been subject to revisionism because of the recession of 1938. So was the failure of the New Deal evidence of Keynesianism? No, Paul Krugman reassured readers in November 2008—"the New Deal didn't pursue Keynesian policies. Properly measured, that is, by using the cyclically adjusted deficit, fiscal policy was only modestly expansionary, at least compared with the depth of the slump."[1]

So what ended the Great Depression?

Many now believe it was the spending on the war. Paul Krugman made that argument last year: "From an economic point of view World War II was, above all, a burst of deficit-financed government spending, on scale that would never have been approved otherwise…Deficit spending created an economic boom — and the boom laid the foundation for long-run prosperity."[2]

[1] Paul Krugman, comment on "Fiscal FDR," The Conscience of a Liberal, posted November 10, 2008, http://krugman.blogs.nytimes.com/tag/fdr/

[2] Paul Krugman, "1938 in 2010," *New York Times*, September 5, 2010. Available at http://www.nytimes.com/2010/09/06/opinion/06krugman.html

But was there an economic boom? Certainly unemployment fell to nearly zero because of the war. But did the war create an economic boom? It was a boom for the industries related to the war. But there was little prosperity for the rest of the economy. Was America prosperous in 1943? What about Germany? Or England? Each of these countries enjoyed large levels of deficit-financed spending. Yet their peoples did not enjoy prosperity. The war was a time of austerity. Government spending didn't have a multiplier effect on private output. It came at the expense of private output.[3]

When the war ended, the Keynesians predicted mass unemployment and economic crisis because of the expected big drop in government spending and the number of soldiers looking for work. Paul Samuelson, a prominent Keynesian, warned in 1943 that when the war ended, the decrease in spending combined with the surge of returning soldiers to the labor force would lead to "the greatest period of unemployment and industrial dislocation which any economy has ever faced."

Government spending did plummet. Ten million soldiers entered civilian life. Many other millions left jobs in industries devoted to war production.[4] Yet unemployment stayed under 4% between 1945 and 1948.[5] There was a short and mild recession in 1945—while the war was still going. But soon the economy boomed as government spending shrank and price controls were removed.

We are told that the failure of the stimulus proves it simply wasn't big enough to get the job done. But it is equally plausible that the opposite is true—that government intervention in the economy prevented the recovery.

The truth is that our knowledge of the complex system called the economy is woefully inadequate and may always remain that way. We ask too much of economics. Even our best attempts to measure the job impact of the stimulus spending make this clear.

In November of 2010, the CBO announced that ARRA had created between 1.4 and 3.6 million extra jobs.[6] When the upper limit of your estimate is *almost three times* the lower limit, you know it is not a very precise estimate.

But there is no way and there will never be a way to make that estimate any more precise. And there is no way of knowing if the real number falls within this absurdly large range. To do so would require using the actual data on output and employment while holding other factors constant. The CBO did not use those data. Why not?

The CBO in their November 2009 estimates of the impact of the stimulus spending said that "because isolating the effects would require knowing what path the economy would have taken in the absence of the law. *Because that path cannot be observed, the new data add only limited information about ARRA's impact*."[7]

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[3] See "Wartime Prosperity? A Reassessment of the U.S. Economy in the 1940s," Robert Higgs, Journal of Economic History (March 1992) for further discussion of the standard of living of the average American family during the war.

[4] See David Henderson, "The U.S. Postwar Miracle,"Working Paper 10-67, November, 2010, Mercatus Center, George Mason University, http://mercatus.org/sites/default/files/publication/U.S.%20Postwar%20Miracle.Henderson.11.4.10.pdf

[5] See "Labor—U.S. Census Bureau, Table D 85-86, http://www2.census.gov/prod2/statcomp/documents/CT1970p1-05.pdf

[6] *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from July 2010 Through September 2010,* Congressional Budget Office (Washington, D.C., 2010) Available at http://www.cbo.gov/ftpdocs/119xx/doc11975/11-24-ARRA.pdf

[7] *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output as of September 2009,* Congressional Budget Office (Washington, D.C., 2009) Available http://cbo.gov/ftpdocs/106xx/doc10682/Frontmatter.2.2.shtml

That is a fancy way of saying we cannot evaluate the effect of the stimulus on job creation. The economy is too complex. Too many other variables change at the same time.

We don’t have a reliable model of the economy in its current state. The CBO’s results are fake science--what the economist F.A. Hayek called scientism—the use of the tools and language of science in unscientific ways.

Economics is not a science like physics that can tell us where Mars will be in June of 2012. We do not know where the unemployment rate will be in June of 2012.

In his Nobel Prize lecture, Hayek said this about macroeconomics:

“I confess that I prefer true but imperfect knowledge, even if it leaves much indetermined and unpredictable, to a pretence of exact knowledge that is likely to be false.”[8]

Our current theories of macroeconomics are not testable or confirmable with the available evidence. We should be honest in admitting as much.

So where does that leave us?

What we do know is that entrepreneurs and risk-takers are acting very cautiously out of fear of the future. Government policy needs to do what it can to reduce that fear. That means a stable set of rules and a lower level of government spending. Those are the best ways to encourage the investment necessary for sustainable innovation and job creation.

We also know that we are consistently running deficits of over a trillion dollars a year, deficits that were initially justified on the grounds that they would produce prosperity. That has not proven to be true. We need to cut spending in order to grow the economy. We need to take a different path—an approach that is fiscally more prudent and that puts spending decisions in the hands of the consumers and investors rather than in the hands of bureaucrats. Cutting spending and reducing government's control over the economy is the road to stability, the road to prosperity, and the road to recovery.

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8 “The Pretence of Knowledge,” Nobel Prize Lecture by F.A. Hayek, December 11, 1974, http://nobelprize.org/nobel_prizes/economics/laureates/1974/hayek-lecture.html

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His latest book is The Price of Everything: A Parable of Possibility and Prosperity (Princeton University Press, 2008). Told in the form of a novel, it's the story of how prosperity is created and sustained, and the unseen order and harmony that shape our daily lives.

He is also the author of The Invisible Heart: An Economic Romance (MIT Press, 2001) a novel which discusses an array of public policy issues including corporate responsibility, consumer safety, and welfare. His first novel, The Choice: A Fable of Free Trade and Protectionism (Prentice Hall, 3rd ed., 2006) was named one of the top ten books of the year by Business Week and one of the best books of the year by the Financial Times when it was first published in 1994.

Roberts is the host of the award-winning weekly podcast, EconTalk and blogs at Cafe Hayek. He is a frequent commentator on National Public Radio's "Morning Edition" and "All Things Considered." In addition to numerous academic publications, he has written for The New York Times and the Wall Street Journal. He is a founding advisory board member of the Library of Economics and Liberty website. His rap video, “Fear the Boom and Bust,” created with filmmaker John Papola, has been viewed over 2 million times and has been translated into eight languages.

Before coming to George Mason University, Roberts was at Washington University in St. Louis where he was the founding director of the Center for Experiential Learning at the John M. Olin School of Business and a Senior Fellow at the Weidenbaum Center on the Economy, Government, and Public Policy. Roberts has also taught at the University of Rochester, Stanford University, and UCLA.