Why Stimulus Fails

Keynesian illusions once fostered prosperity. Not anymore.

by WILLIAM W. CHIP

Nearly three years after Congress enacted a $787 billion stimulus package, the U.S. unemployment rate at the end of January stood at 8.3 percent—exactly where it was the month the stimulus passed and only half a percent below where the Obama administration predicted it would be if there had been no stimulus. This "mother of all stimulus bills" failed to deliver as promised. Ominously, hardly anyone agrees on *why* it failed.

Some Democrats have argued that $787 billion was not enough. Last fall the president called for a second stimulus package of $450 billion. Two days after the president's speech, Christina Romer, former head of Obama's Council of Economic Advisers, argued that a second stimulus should be "substantially larger." The president would have proposed more in the first place, and would probably have gotten his way, had Republicans not taken control of the House of Representatives in 2010.

Many Republicans have accepted that a fiscal stimulus was needed, but they argue that the money was spent on the wrong things and would have given a bigger boost to the economy had a larger portion taken the form of tax cuts. There is no shortage of anecdotal evidence about misdirected spending, such as a February 2009 report from the American University Investigative Reporting Workshop showing that 80 percent of renewable-energy stimulus funds had gone to foreign turbine manufacturers, creating about 6,000 manufacturing jobs overseas but only a few hundred in the United States. In a September 8, 2011 editorial, the *Wall Street Journal*, citing other evidence that stimulus spending was "poorly targeted," argued that "the economy would have benefited far more if the government had instead improved the incentives for people and businesses to invest, produce and grow," presumably through lower taxes and relaxed regulation.

Although many conservatives still have faith in fiscal stimulus based on tax cuts, libertarians and Tea Partiers have condemned the very notion of stimulus spending, whether delivered through tax cuts or federal handouts, believing that government deficit spending must always make things worse. For them, the Great Satan of deficit spending is John Maynard Keynes. In a 2009 MSNBC interview, when asked about the implosion of the mortgage markets, Congressman Ron Paul responded: "We've had inflationism, corporatism, big government. We've … not had true free market capitalism. … Somebody asked me what individual is the cause of this problem? I would put them all on the shoulders of Keynes."

John Maynard Keynes, dead since 1946, was an economics don at Cambridge University who during the Great Depression advocated deficit spending by national governments to counteract unemployment. Although efforts by Depression-era governments to implement Keynesian stimulus programs were modest and of questionable effectiveness, Keynes's reputation was cemented by the experience of World War II, when deficit-financed war production generated unprecedented increases in output and employment.

Every American president since John F. Kennedy, without regard to political party, has taken for granted that the appropriate response to a sluggish economy is to enlarge the federal deficit—to increase spending without increasing taxes or to decrease taxes without reducing spending. Lest we forget, Congress authorized $130 billion of tax rebates during President Bush's last year in office in a futile effort to stem the nascent recession.

Conservative critics of today's Keynesian stimulus spending may be right, but not necessarily because Keynes was wrong. Unlike philosophy or physics, economics is a social science that seeks to explain

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the events of its time, not to reveal eternal verities. It may be that Keynes got the formula exactly right for the 20th century but that we have entered a new era in which his theory has become as obsolete as the classical 19th-century theories that Keynes himself debunked. As Keynes famously said: "Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist."

Although Keynes was by no means the best academic economist of his era, his musings about the causes and remedies of cyclical unemployment have had a greater impact on government policy in capitalist countries than any of the more carefully drawn and mathematically precise theories of his contemporaries. His keenness for practical solutions no doubt sprang in part from having begun, rather than capped, his career with senior public service.

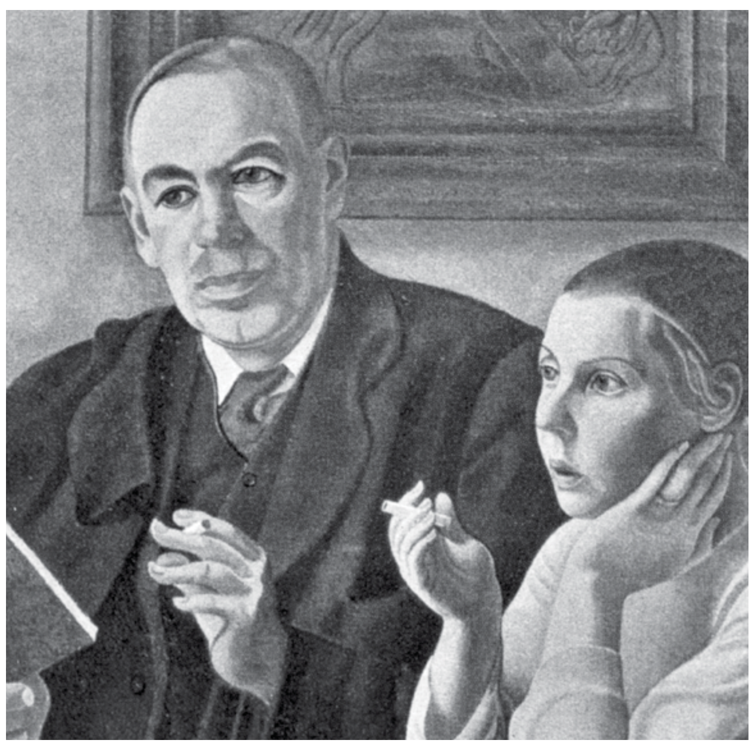
Nowadays, a brilliant American economist will spend decades ascending the academic ladder before getting appointed to the Council of Economic Advisers or some other influential position. Keynes, in contrast, was only 31 when recruited into the British Treasury at the outset of World War I and only four years later was the Treasury's senior representative to the Versailles peace conference. Even during his university tenure Keynes was no bookworm: he wrote political pamphlets, toured the Soviet Union, and cavorted with the Bloomsbury Group. He married a ballerina.

Like many of his predecessors and contemporaries, Keynes struggled to explain the extended periods of unemployment that followed economic calamities such as the 1929 stock market crash and other financial panics that had occurred in his lifetime. Why should the aggregate demand for consumer and capital goods, and for the workers that produce them, periodically plummet and remain stubbornly below the economy's capacity to produce those goods? Keynes laid out a comprehensive answer to this paradox in his 1936 treatise *The General Theory of Employment, Interest and Money*.

Nobel Prize winner Paul A. Samuelson, himself a Keynesian, has described *The General Theory* as a "badly written book." Indeed, Keynes had to spend the rest of his academic career trying to explain what he had meant. When I wrestled with *The General Theory* as a Cambridge graduate student in the early 1970s, I concluded that the most lucid explanation was, strangely enough, to be found in the preface to the French edition, from which I quote below. (As Keynes tactlessly remarked in that preface, contemporary French economists, lacking "deep roots in systematic thought," might need extra help understanding what he was talking about.)

To readers of the French edition, Keynes explained that "economics everywhere up to recent times" was dominated by the "fallacy that demand is created by supply." Keynes attributed this fallacy to French economist Jean-Baptiste Say—a put-down found in the French, but not the English, Dutch, or Japanese editions. According to what even today we call "Say's law," a drop in aggregate demand for consumer goods must be accompanied by an equivalent increase in savings, which in turn must generate a corresponding increase in the aggregate demand for capital goods.

Keynes's key insight, which sparked a revolution in economics, was that consumers and producers did not react to the economy as a whole, only to the small bits that were visible to them, which he referred to as "expectations":



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John Maynard Keynes and his wife, the ballerina Lydia Lopokova, in a 1932 painting by William Roberts

> generally speaking, the actual level of output and employment depends, not on the capacity to produce or on the pre-existing level of income, but on the current decisions to produce which depend in turn on current decisions to invest and present expectations of current and prospective consumption. … Conclusions emerge from this reasoning which are particularly relevant to the problems of public finance … and the trade cycle.

Keynes hypothesized that some systemic event, such as the bursting of a financial bubble, fosters an illusion among each of a multitude of producers that demand for his outputs is falling, engendering across-the-board cutbacks in production and payrolls, leading to genuine reductions in aggregate demand that feed upon themselves in a spiral of misinformed panic, which Keynes called the "Multiplier." In short, a widespread misunderstanding of systemic economic events creates an economy-wide illusion that the country is poorer than it really is, an illusion that self-fulfills as consumers and producers behave in accordance with their isolated "expectations."

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Keynes proposed to offset the illusion that the private sector was poorer than it really was with the illusion that the government was wealthier than it really was. If the public was spending less than the real incomes it was capable of generating, then the government should spend more than its forecasted tax revenues. Although the government's deficit spending reduced the wealth of the taxpaying public, the Keynesian illusion of general prosperity could sustain itself as long as taxpayers, like producers and consumers, remained focused on their immediate circumstances and ignorant of the bigger picture.

Sadly, the dysfunctionality of the U.S. government and many parts of our economy today is no illusion, and producers and consumers have infinitely more real-time information about the American and global economies than did their Depression-era counterparts. In the first decade of the 21st century, both the private and public sectors in the United States had been living well beyond their means, and most people now realize that. Savings by households and corporations have risen accordingly. Unfortunately, the U.S. economy offers a shrinking menu of productive uses for these savings because our labor costs and corporate income tax rates are higher than those of our global competitors, our infrastructure has not kept up with immigration-fueled population growth, and the percentage of our workforce with globally useful skills is declining.

Nevertheless, like a general fighting the last war, President Obama faithfully followed the Keynesian prescription and attempted to turn the federal government into an engine for spending the glut of recession-induced private-sector savings that could not find productive uses. Unfortunately for him, and for us, what might have worked in an era of radios and newspapers did not work in the Internet age.

Too many people who mattered understood that a boost to aggregate demand from a blizzard of government checks to politically selected beneficiaries created only an illusion of demand for goods and services produced by American workers. It did nothing to counter the forces that are eating away at the capacity of the U.S. economy to generate jobs that pay First World wages even as undisciplined immigration policies multiply the supply of workers seeking those jobs.

In addition, 21st-century taxpayers, unlike their great-grandparents, are all too cognizant of the long-term impact of soaring federal deficits on future tax burdens and the present value of their Social Security retirement benefits. Writing in the *Washington Post*, economic journalist Robert Samuelson opined:

> When Keynes wrote The General Theory … governments in most wealthy nations were relatively small and their debts modest. Deficit spending and pump priming were plausible responses to economic slumps. Now, huge governments are often saddled with massive debts. Standard Keynesian remedies for downturns—spend more and tax less—presume the willingness of bond markets to finance the resulting deficits at reasonable interest rates. If markets refuse, Keynesian policies won't work.

Fortunately for us, the appetite of global bond markets for federal government securities appears to be insatiable—for the time being. But for a foretaste of the Samuelson scenario, look no further than the Eurozone, where the bond market's brake on Keynesianism has already been pressed to the floor. Although the Eurozone financial crisis, like the crisis here, originated with the bursting of a mortgage bubble—mainly in Ireland and Spain—fears of insolvency have since spread to the sovereign debts of Greece, Portugal, Italy, and other European states, forcing their governments to enact draconian tax hikes and spending cuts, even as businesses fail and unemployment soars.

(While some of our own state and local governments, notably California and New York, have Greek-like structural deficits, their debts do not figure into the U.S. banking system's capitalization to the degree that European government debt figures into the capitalization of major EU banks.)

To the extent that the sluggishness of the economy since 2007 reflects widespread doubts about its long-term prospects, the 2009 stimulus package may have been worse than useless because it confirmed investors' growing fears about U.S. profligacy and fecklessness. Under the circumstances, President Obama might have given the economy a bigger boost by foreswearing an old-fashioned, deficit-spending stimulus and instead declaring that, effective immediately, he would not authorize any federal spending of borrowed money unless it added convincingly to the country's capacity to produce a trade surplus that would permit the eventual liquidation of foreign-held federal debt.

Keynes taught that governments could master their economies if they could mastermind public illusions about the nation's productive capacity. In the Internet era, where everyone knows everything immediately, illusion must give way to reality. The time has come to rethink the Pavlovian resort to deficit spending—including tax cuts—as a remedy for economic slowdowns. ■