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PERSPECTIVE

Old Theory Of Keynesian Stimulus Comes Up Against Hard New Facts

By ALAN REYNOLDS

Posted 09/15/2010 06:17 PM ET

Dana Milbank, a new Washington Post columnist, thinks Republican politicians "managed to turn the Keynesian notion of economic 'stimulus' into such a dirty word that President Obama and his aides are afraid to let it escape their lips."

He blames "think tanks such as the Cato Institute" for not agreeing that Keynesian theory is so "unassailable" and "universally embraced" that daring to question the elixir of deficit spending "has a flat earth feel to it."

Milbank forgets that Keynesian Democrats, including the recently departed OMB director Peter Orszag, constantly hectored Republicans about the evils of budget deficits while Reagan or Bush was in office.

UC Berkeley economist Brad DeLong wrote a 2004 paper for the Center for American Progress assailing Bush's budget deficit. "A bigger deficit means less investment in America," he wrote; "And less investment in America means slower economic growth." DeLong quoted Bush adviser Greg Mankiw who likewise argued that, "government budget deficits reduce the economy's growth rate."

Milbank now claims Mankiw supports the exact opposite idea — namely, that budget deficits "stimulate" the economy's growth rate. Unfortunately, any theory that explains everything must also explain nothing.

The Republican alternative to more fiscal stimulus says Milbank, is for government to "do nothing, and let the human misery continue." Any doubts about the efficacy of fiscal stimulus, he argues, were discredited by the remarkable discovery that recessions still happen: "Economists offering alternatives to Keynes devised mathematical models showing how markets would behave efficiently. But those ideas collapsed along with everything else in 2008."

This is ignorant nonsense. Efficiency never meant markets can't be surprised and crash. Besides, academic criticism of fiscal stimulus is mainly based on fact, not theory.

Apologists for the 2009 spending spree point to an August paper by Ben Page of the Congressional Budget Office, "Estimated Impact of the American Recovery and Reinvestment Act." The only part of that paper worth reading is the Appendix: "Evidence on the Economic Effects of Fiscal Stimulus."

Page confesses that, "In analyzing ARRA's economic effects, CBO drew heavily on versions of the commercial forecasting models of two economic consulting firms. ... Because they emphasize the influence of aggregate demand on output in the short run, the macroeconometric forecasting models tend to predict greater economic effects from demand-enhancing policies such as ARRA than some other types of models do."

Even short-run predictions from such models are notoriously lousy, so CBO simulations of what might have happened under different scenarios tell us more about the models' assumptions than about reality.

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Posted By: JJTV(5) on 9/16/2010 | 9:30 AM ET

Reynolds bibliography lists the usual neo-classical economists aligned with the Chicago School and Harvard. These economists constantly cling to the Ricardian Debt Equivalence Theorem, further developed by Barro, which has no supporting empirical evidence. They also ignore our modern monetary system and the economic changes that were occuring during their model periods. Tax cuts, from a historical perspective, were not the main drivers of economic growth during the periods they claim they were.

Posted By: Harry Truman(865) on 9/16/2010 | 9:18 AM ET

Just an excuse for the Dems to spend more money.

Posted By: tommypietsch(5) on 9/16/2010 | 8:58 AM ET

All theory has been tested over the last 60 months or possiblily longer. Economic experiments always look good on paper and in the classroom. The human variable is to difficult to plan for. That is why governments like Keynes so much. If they can use it to control the economy it largely takes that varible out of the equation. Look at Europe and how stagnant they have been for so long, while the US in it short life has rocketed to the top of the economic totem pole. That should be enough for most

Posted By: kwg1(420) on 9/16/2010 | 2:56 AM ET

Keynes, Friedman, Von Mises? And the winner is Von Mises! There is no such thing as "aggregate" anything when in reality all economic transactions are individually based. We try to use statistics of the whole to deduce what the individual is going to do and we fail every time. Individuals base decisions on so many variables no one can quantify them for the billions of people walking the earth. So trying mathematically to suggest that there are constants when the subjects are completely more..

Posted By: Serfdumb(3810) on 9/16/2010 | 12:26 AM ET

Look around the world at Nations that bought into the 20th century Keynesian Revolution, it completely undermined economic stability, thus creating a constant and steady need for government intervention that eventually destroys the actual free market, leaving no alternatives but a government centered Socialist market economy. Keynes was a comrade of the Fabian Socialists and one of the goals of Keynesian Theory is the transformation of a free market economy into an official government economy.

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09/16/2010 10:00:25 AM ET

Investing Tip

Avoid laggards even if their group is strong.