THE DAILY CALLER

PRINT PAGE

Alan Blinder and Mark Zandi's Keynesian black box

11:04 AM 07/28/2010

In a recent *Wall Street Journal column*, Princeton economist Alan Blinder wonders why 64 percent of Americans do not believe the $849 billion "fiscal stimulus" bill "saved or created" many jobs. "The main reason," he explains, "appears to be that the White House's January 2009 forecast was too optimistic—projecting, for example, an unemployment rate around 8% by the end of 2009 if the stimulus passed." He thinks that's unfair.

Ironically, Blinder's next column relied on the same failed forecasting model that lead the White House astray in January 2009. Specifically, he asked us to take seriously the fact that:

> "Mark Zandi of Moody's Analytics [economy.com] used his model to estimate that extending unemployment insurance benefits has almost five times as much "bang for the buck" as making the Bush tax cuts permanent."

We should have learned from the White House's reliance on Mr. Zandi's forecasts in January 2009 that magical "multipliers" yanked from some forecaster's black box are evidence of *nothing*. They simply reveal dubious assumptions built into that forecasting model. Yet the White House and Congressional Budget Office, as well as Professor Blinder, keep citing such models as if they were evidence the "stimulus" (spending) was effective. On the contrary, recent academic studies of real world events have been unable to find a multiplier effects even half as large as Zandi's model assumes. They find the addition to GDP is significantly *smaller* than the addition to the national debt – a bad bargain indeed.

In 2009 one of the new studies appeared in The *Journal of Applied Econometrics* by Andrew Mountford (University of London) and Harald Uhlig (University of Chicago). They found "the best fiscal policy to stimulate the economy is a deficit-financed tax cut." Moreover, "fiscal expansion through government spending" will soon begin to "crowd out both residential and non-residential investment" resulting in a bigger government but a smaller private economy.

The economy.com model, by contrast, simply assumes-away any positive incentive effects of lower tax rates, or disincentives from higher tax rates, because "the level of resources and technology available for production is taken as given."

If the economy.com model could predict *anything*, why was Zandi so upbeat about housing in January2008? And why was he likewise so upbeat about the jobs alleged created by President Obama's stimulus bill in January 2009? In reality, no macroeconomic model has proven more accurate than judgmental guesswork even for short-term forecasting. Attempting to use such models to predict the effects of higher tax rates or larger transfer payments has been considered disreputable since 1976, when University of Chicago Nobel Laureate Robert Lucas penned his famous "Lucas critique" of the whole idea.

In 1984, in OECD Economic Studies, James H. Chan-Lee and Hiromi Kato conducted a rigorous study of such economic models in 14 countries. They concluded:

> "Most [national economic] models remain broadly income/expenditure systems of a fundamentally Keynesian inspiration . . . However, few embody fully-specified stock or wealth effects in expenditure functions. And none seems to embody the latest theoretical thinking on expectations or supply-side effects. Considerations such as these may serve to limit the contribution that economic models can make to policy analysis."

As that OECD study suggested, failure of Keynesian models to account for expectations is a serious flaw. The so-called stimulus spending was financed with borrowed money, so the government will eventually have pay it back or let taxpayers face higher interest expenses forever. As the neo-Keynesian Harvard economist Greg Mankiw notes:

> "That means higher future taxes, on top of the future tax increases that President Obama already will need to impose to finance his spending plans. . . . It is plausible that . . . businesses may be reluctant to invest in an economy that they expect to be distorted by historically unprecedented levels of taxation in the future. The more the government borrows, the higher taxes will need to go, the more distorted the future economy will be, and the less attractive is investment today."

To turn Mankiw's point about around, spending cuts reduce fears of future tax hikes and thus stimulate the economy today. The *IMF Research Bulletin* in March 2006 cited several studies that found *reductions* in government spending "can have expansionary effects, since they can contribute to a consumption and investment boom owing to altered expectations regarding future taxation."

As the 1984 OECD report noted, the failure of Keynesian models to account for supply-side incentive effects is another fatal flaw. CEA Chairman Christina Romer, in a 2007 study with her husband David, found "that a tax increase of one percent of GDP lowers GDP by about 3 percent." They investigated whether the effect was mainly due to demand (spending) or whether "tax changes could have large supply-side effects." The evidence suggested that "the important effects of tax changes . . . are on incentives and productivity rather than on disposable income."

In January 2009, the Obama administration embarked on a nearly random $849 billion spending spree on the basis of a flakey forecast from a for-profit forecasting group. Alan Blinder now abuses the same source to support his own Robin Hood policy preferences. Fool me once shame on you. Fool me twice…

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