Stimulus: A History of Folly

James K. Glassman

Before he was sworn in as President, Barack Obama began to lay out his plans for reviving an American economy that, it would later be discovered, had declined 3.8 percent in the fourth quarter of 2008, its worst performance in 26 years. About the first part of his project, "stimulating" businesses to invest and consumers to consume through government spending and tax remittances, he was forthcoming and enthusiastic. About the second, stabilizing the financial system, he wished to reserve judgment.

He anointed the stimulus proposal with a convenient and vivid metaphor. "We're going to have to jump start this economy with my economic recovery plan," he said on January 3. According to the image, one can jolt a dormant economy into action just as one can hook up polarized cables to a car battery, clamp a defibrillator to the chest, or breathe into the ear of a reluctant lover. Suddenly, the object of our attention will be back in action, aroused.

Alas, the questions raised by a proposed stimulus—whether to apply it, what sort it should be, how much it should cost, and when it should begin and end—are far trickier to answer than problems involving dead batteries. And, remarkably enough, history and economic research offer no conclusive answers. The recession that began in 2008 could turn out to be the worst slowdown since the Great Depression of the 1930's. For three-quarters of a century, economists have been studying it diligently. And even now they cannot come to a definitive conclusion about the cause of that depression, the reasons for its severity and duration, or what cured it. In an introduction to a book of essays on the Great Depression he compiled in 2000, Ben S. Bernanke, then a Princeton professor and now chairman of the Federal Reserve Board, wrote, "Finding an explanation for the worldwide economic collapse of the 1930's remains a fascinating intellectual challenge."

Today, of course, the challenge is more than intellectual.

When he wrote in 1936 that "practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist," John Maynard Keynes surely did not have himself in mind. But, in times of trouble, Americans still cling to Keynes, or at least to the caricature of him as the economist who said you could spend your way out of a recession. His big idea was that, left to its own devices, an economy can fall into a slump and just stay there. Self-corrective mechanisms will not necessarily work on their own; they will need help.

Prosperity depends on investment, on businesses building new plants, buying new machines, and em-

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ploying more workers. In a typical case, when an economy slows, businesses reduce their demand for credit. At the same time, worried consumers save their earnings in banks, and by doing so, add to the store of money available for lending. These two forces—as well as actions taken by the Federal Reserve Board—combine to push interest rates to levels so attractive that businesses start borrowing again, and the economy picks up. The Great Depression, however, was atypical. The economy slowed and interest rates fell, but businesses were so frightened about the future that they refused to invest; instead, they did the opposite, shutting plants and firing workers. As for consumers, while they may have wanted to save, they lacked the cash to put away. Because they were out of work, they depleted what savings they had.

Keynes argued that when businesses and people cannot or will not invest, government must fill the gap. The key is speed. The means, Keynes wrote in *The General Theory of Employment, Interest and Money* (1936), really do not matter so much:

> If the Treasury were to fill old bottles with bank notes, bury them at suitable depths in disused coal mines which are then filled to the surface with town rubbish and leave it to private enterprise on well-tried principles of laissez-faire to dig the notes up again, . . . there need be no more unemployment and with the help of the repercussions, the real income of the community would probably become a good deal larger than it is.

Of course, Keynes favored large public-works projects over the burying of bottles. Building roads in the right places, for example, would both put people to work and provide the basis for more commerce. At first, Keynes emphasized government spending as stimulus, but when pressed in 1933, he advocated tax cuts as well—specifically in response to criticism that public-works projects do not put cash into the system quickly enough.

The dire situation for which Keynes prescribed a cure bears distressing similarities to our own. Interest rates set by the Fed stand effectively at zero percent, but banks are recalcitrant about lending and even businesses flush with cash are hesitant to invest. It appears that the current sickness occurred because the Fed, in an effort to keep the economy stimulated after the collapse of the tech-stock bubble and in the wake of September 11, cut interest rates far too much during 2001 (from 6.5 percent at the start of the year to 1.75 percent at the end) and waited too long to raise them, making credit so easy that businesses expanded beyond all reasonable bounds, and banks, flush with cash and trying to make higher returns, shoveled money at borrowers with poor credit; risk aversion disappeared, and loans, especially to home buyers, went bad. Booms do, after all, create their own busts.

In response, Congress last year voted funds for the Treasury to use to shore up financial institutions—the widely maligned Troubled Asset Relief Program, or TARP—and the Fed opened wide its lending window. Those actions forestalled mass failures, but banks, chastened by their past overindulgence and worried about depleting their capital, still do not want to lend. So while government action proved necessary (and remains necessary) to maintain public confidence in the banking system, it became clear those actions could not and would not mitigate the parlous effects of the recession that, we were told late in 2008, had begun at the end of 2007. So the question becomes: In a world in which monetary adjustments do not appear effective, can tax and spending policies pull us out of the slump?

THE TRACK RECORD is discouraging. Despite Franklin Roosevelt's aggressive spending, unemployment reached 25 percent in 1933, fell only to 14 percent by 1937, and was back up to 19 percent in 1939.* In the end, the New Deal did little or nothing to resuscitate the economy. Certainly, inept monetary policies helped prolong the Great Depression, as did tax increases, constant interventions in the conduct of business, and the erection of global trade barriers, beginning with the Smoot-Hawley Tariff in 1930, more than two years before Roosevelt took office. There was a stretch of twelve years from the stock-market crash to Pearl Harbor, and, during that time, fiscal stimulus simply did not jump-start the economy (or, in Keynes's own metaphor, "awaken Sleeping Beauty"). Now, some do attempt to make the case that Roosevelt did not increase government spending enough during the early and mid-1930's and that it took World War II and the unprecedented infusion of government dollars into the economy to provide the stimulus that finally pulled America from the swamp.

But even if that were true—and considering the fact that federal spending tripled during the Great Depression, rising from 3 percent of the country's gross domestic product to nearly 10 percent in

* For some perspective, the unemployment rate in January 2009 was 7.2 percent.

1939,* it does not seem the likeliest explanation—it still does not offer much in the way of guidance through our current thicket. Few economists today believe the United States could tolerate the kind of budget deficits that developed during World War II, which ran more than 50 percent of gross domestic product, or about $7 trillion annually in current terms. When the federal government ramped up its spending during the war, it had not yet grown into the entitlement cash machine it is now, spitting out trillions of dollars a year in retirement and health-care benefits.

Not only was the stimulative effect of Great Depression fiscal policy non-existent, but follow-on efforts during the ten subsequent recessions proved equally ineffective. As a result of that hard-won experience, the consensus until recently among economists was that attempts at stimulus through emergency fiscal policies—as opposed to monetary policies and the automatic effects of increases in unemployment assistance and decreases in tax payments—were useless at best. Typical was the statement of Martin Eichenbaum of Northwestern University in the *American Economic Review* in 1997: "There is now widespread agreement that countercyclical discretionary fiscal policy is neither desirable nor politically feasible." Martin Feldstein, then president of the National Bureau of Economic Research, agreed. Fiscal stimulus, he said in 2002, "has not contributed to economic stability and may have actually been destabilizing."

A good place to turn to understand the failure of the jump-start is the work of Frédéric Bastiat, a French politician of the early 19th century. "In the economic sphere," he wrote,

> an act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these effects, the first alone is immediate; it appears simultaneously with its cause; it is seen. The other effects emerge only subsequently; they are not seen; we are fortunate if we foresee them.

To prove his point, Bastiat described what happens when a vandal breaks a shopkeeper's window. The *seen* effect is that repairing the glass creates economic value in the payment to the glazier, who then has money to buy a new suit or hire a part-time employee. What is *unseen* is that the shopkeeper has to pay the glazier with money that he would otherwise have used to buy a suit or add an employee. "The broken-window fallacy, under a hundred disguises, is the most persistent in the history of economics," wrote the economic journalist Henry Hazlitt in 1946.

Like payments for broken windows, tax rebates and new roads (the seen) do not come free. The stimulus money that flows to taxpayers, government agencies, and businesses has to come from somewhere (the unseen). During a recession, it is usually borrowed, and the anticipation of taxpayers is that they will have to repay these loans, which means their taxes will rise in the future. This knowledge makes people anxious about spending the extra money, or even about investing it in the kind of ventures that help an economy grow.†

Lately, however, economists have become more sanguine about the power of fiscal stimulus, in large part because of the apparent success of the tax-rate reductions and rebates in 2001 and 2003 (although such a conclusion may ignore the monetary effects of the huge cut in interest rates). A summary of a conference held in May by the Federal Reserve Bank of San Francisco stated that "the consensus" against stimulus "has unraveled and perhaps even begun to emerge on the opposite viewpoint." Last year, Jason Furman and Douglas Elmendorf of the Brookings Institution wrote, "Fiscal policy implemented promptly can provide a larger near-term impetus to economic policy than monetary policy can." And, in a paper delivered to the American Economic Association in January, Feldstein himself switched sides and said he now favored tax cuts *and* government spending.

The views of these economists are undoubtedly heartfelt, but it must be recognized that one of the great attractions of Keynes's theories is that he gives you permission to do what you wanted to do anyway. Feldstein, chairman of the Council of Economic Advisers under Ronald Reagan, proposes a stimulus policy that extends the Bush tax cuts currently scheduled to expire in 2011 and increases spending on defense and national intelligence. In *their* stimulus proposal, Furman, now deputy director of Obama's National Economic Council, and Elmendorf, head of the Congressional Budget Office under the current Democratic majority, adamantly oppose extending the Bush cuts and instead want to extend unemployment and Food Stamp benefits and issue short-term tax credits, even to people who owe no taxes.

* The figures are from a paper by David Wheelock, published by the Federal Reserve Bank of St. Louis.

† The notion that people make current consumption decisions based on their lifetime income, rather than their current income, was laid out brilliantly in 1957 by Milton Friedman in his "permanent income hypothesis," which has never been seriously challenged.

Also, in the new enthusiasm for stimulus, there is not a small degree of panic; monetary policy is not working, so fiscal policy *must*! To his credit, however, Feldstein writes toward the end of his January paper, "It is of course possible that the planned surge in government spending will fail. Two or three years from now we could be facing a level of unemployment that is higher than today and that shows no sign of coming down."

The truth is that we have learned almost nothing about the use of fiscal stimulus since the Great Depression, and it is a fatal conceit to assume that we can hurriedly construct a fiscal policy that will produce the prescribed results today. Economists seem to admit this fact by advocating what they prefer anyway, for political or ideological reasons. I would feel better about stimulus if Elmendorf were clamoring for permanent tax cuts and Feldstein Food Stamps.

ON BEING presented the Nobel Prize in economics in 1974, Friedrich von Hayek devoted his Stockholm lecture to acknowledging the severe limitations of his profession. "It seems to me," he said, "that this failure of the economists to guide policy more successfully is closely connected with their propensity to imitate as closely as possible the procedures of the brilliantly successful physical sciences—an attempt which in our field may lead to outright error." Government simply cannot know enough to direct an economy successfully, and when the President claims that his fiscal stimulus plan will create (or save) at least three million jobs, he is taking a wild, and dangerous, leap. Said Hayek:

> If man is not to do more harm than good in his efforts to improve the social order, he will have to learn that in this, as in all other fields where essential complexity of an organized kind prevails, he cannot acquire the full knowledge which would make mastery of the events possible. He will therefore have to use what knowledge he can achieve, not to shape the results as the craftsman shapes his handiwork, but rather to cultivate a growth by providing the appropriate environment, in the manner in which the gardener does this for his plants.

What is that environment? First, it provides a confidence that, in a crisis, bank deposits are safe and insurance policies will be paid in full. Such confidence can be provided only by the government of the United States in its legitimate and essential role as the lender of last resort. Second, the environment supports, rather than denigrates or browbeats, productive members of society. The U.S. will not emerge from a serious recession unless businesses and investors lead it out. Third, it recognizes that Americans have undergone a financial calamity and that we need time to adjust; we cannot, like a car battery, be shocked back to life, and we aren't in the mood to have someone blow in our ear.

In fact, stimulus may be precisely the wrong metaphor. Rather than getting jazzed up, we need to be calmed down and to take the time to learn from the Great Depression, a time when government did too much, not too little. Amity Shlaes makes the argument in *The Forgotten Man*, her book about the Great Depression, that the constant experimenting and meddling of the New Deal froze investors and business operators in fear: "Businesses decided to wait Roosevelt out, hold on to their cash, and invest in future years."

Despite the warnings of Keynes, the experience of the past half-century indicates that today's low interest rates will start having a positive effect, though it still will take many months. Meanwhile, left alone, what Hayek called "spontaneous order" will find its way forward. Using a different metaphor, James Grant, in his history of credit, *Money of the Mind*, wrote, "The cycle of decay and renewal is as much a part of capitalism as it is of the forest floor." But in the 1930's, "something in the normal regenerative process was missing. There was no decisive recovery from the business-cycle bottom. People had lost their speculative courage, and the more government legislated and taxed, the more that credit sulked."

Stimulus—that is, fiscal intervention with the express purpose of speeding up the normal regenerative process that Grant describes—is unnecessary and almost certainly harmful, a policy based on hubris and anxiety, rather than on history and good sense. Under such circumstances, the proper way to analyze discrete proposals today for spending or taxing is on their own merits, not on their supposed ability to stimulate something else. There may, in fact, be a good reason for government to spend billions of dollars today on building highways, and it has nothing to do with stimulus. It is that long-term interest rates are at historic lows and that the right highways can boost the economy in the long term. There also may be a good reason, again far apart from stimulus, for revising the tax code and reforming Social Security and Medicare. It is that Americans now understand that the economic future is not so assured as they believed a couple of years ago, and it is time for decisions to be made—in a manner careful, sensible, and unstimulated.