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Keynesian Economics vs. Regular Economics

Food stamps and other transfers aren't necessarily bad ideas, but there's no evidence they spur growth.

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Keynesian economics—the go-to theory for those who like government at the controls of the economy—is in the forefront of the ongoing debate on fiscal-stimulus packages. For example, in true Keynesian spirit, Agriculture Secretary Tom Vilsack said recently that food stamps were an "economic stimulus" and that "every dollar of benefits generates \$1.84 in the economy in terms of economic activity." Many observers may see how this idea—that one can magically get back more than one puts in—conflicts with what I will call "regular economics." What few know is that there is no meaningful theoretical or empirical support for the Keynesian position.

The overall prediction from regular economics is that an expansion of transfers, such as food stamps, decreases employment and, hence, gross domestic product (GDP). In regular economics, the central ideas involve incentives as the drivers of economic activity. Additional transfers to people with earnings below designated levels motivate less work effort by reducing the reward from working.

In addition, the financing of a transfer program requires more taxes—today or in the future in the case of deficit financing. These added levies likely further reduce work effort—in this instance by taxpayers expected to finance the transfer—and also lower investment because the return after taxes is diminished.

This result does not mean that food stamps and other transfers are necessarily bad ideas in the world of regular economics. But there is an acknowledged trade-off: Greater provision of social insurance and redistribution of income reduces the overall GDP pie.

Yet Keynesian economics argues that incentives and other forces in regular economics are overwhelmed, at least in recessions, by effects involving "aggregate demand." Recipients of food stamps use their transfers to consume more. Compared to this urge, the negative effects on consumption and investment by taxpayers are viewed as weaker in magnitude, particularly when the transfers are deficit-financed.

Thus, the aggregate demand for goods rises, and businesses respond by selling more goods and then by raising production and employment. The additional wage and profit income leads to further expansions of demand and, hence, to more production and employment. As per Mr. Vilsack, the administration believes that the cumulative effect is a multiplier around two.

If valid, this result would be truly miraculous. The recipients of food stamps get, say, \$1 billion but they are not the only ones who benefit. Another \$1 billion appears that can make the rest of society better off. Unlike the trade-off in regular economics, that extra \$1 billion is the ultimate free lunch.

How can it be right? Where was the market failure that allowed the government to improve things just by borrowing money and giving it to people? Keynes, in his "General Theory" (1936), was not so good at explaining why this worked, and subsequent generations of Keynesian economists (including my own youthful efforts) have not been more successful.

Theorizing aside, Keynesian policy conclusions, such as the wisdom of additional stimulus geared to money transfers, should come down to empirical evidence. And there is *zero* evidence that deficit-financed transfers raise GDP and employment—not to mention evidence for a multiplier of two.

Gathering evidence is challenging. In the data, transfers are higher than normal during recessions but mainly because of the automatic increases in welfare programs, such as food stamps and unemployment benefits. To figure out the economic effects of transfers one needs "experiments" in which the government changes transfers in an unusual way—while other factors stay the same—but these events are rare.

Ironically, the administration created one informative data point by dramatically raising unemployment insurance eligibility to 99 weeks in 2009—a much bigger expansion than in previous recessions. Interestingly, the fraction of the unemployed who are long term (more than 26 weeks) has jumped since 2009—to over 44% today, whereas the previous peak had been only 26% during the 1982-83 recession. This pattern suggests that the dramatically longer unemployment-insurance eligibility period adversely affected the labor market. All we need now to get reliable estimates are a hundred more of these experiments.

The administration found the evidence it wanted—multipliers around two—by consulting some large-scale macro-econometric models, which substitute assumptions for identification. These models were undoubtedly the source of Mr. Vilsack's claim that a dollar more of food stamps led to an extra \$1.84 of GDP. This multiplier is nonsense, but one has to admire the precision in the number.

There are two ways to view Keynesian stimulus through transfer programs. It's either a divine miracle—where one gets back more than one puts in—or else it's the macroeconomic equivalent of bloodletting. Obviously, I lean toward the latter position, but I am still hoping for more empirical evidence.

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