

No. 58  
September 2009

# MERCATUS ON POLICY

## WILL THE STIMULUS BILL CROWD OUT GOOD ECONOMICS?

By Veronique de Rugy  
and Garrett Jones

MERCATUS CENTER  
George Mason University

**O**N FEBRUARY 13, 2009, President Obama signed into law the American Recovery and Reinvestment Act (ARRA), with the promise that this \$787 billion stimulus would “create or save” 3.5 million jobs over the next two years, mostly in the private sector.<sup>1</sup> The basis for the law was a study by Christina Romer, the Chairman of the Council of Economic Advisors, and Vice-President Biden’s chief economist Jared Bernstein, who warned that without an economic stimulus, unemployment would reach 9 percent by the end of 2010.<sup>2</sup>

Since the president signed the stimulus package into law, the U.S. economy has shed more than 2 million jobs and the unemployment rate has climbed to 9.7 percent, higher than the White House predicted it would have reached *without* the stimulus.<sup>3</sup> By examining the government’s ability to create jobs through spending, this Mercatus on Policy shows that in the best-case scenario, the stimulus will mostly shift jobs from privately funded to publicly funded ones. In the worst-case scenario, the ARRA will destroy jobs and halt economic growth.

### PROMISES, PROMISES

THE STIMULUS BILL draws on the views of economist John Maynard Keynes. According to Keynesian thought, a fall in demand causes a fall in spending. Since one person’s spending is someone else’s income, a fall in demand makes a nation poorer. When that poorer nation prudently cuts back on spending, it sets off yet another wave of falling income. So, a big shock to consumer spending or business confidence can set off waves of job losses and layoffs.

Can anything stop this cycle? Keynesians say yes: Government spending can take the place of private spending during a crisis. If the government increases its own spending, it will cre-

ate new jobs. These new workers should consume more, and businesses should then buy more machines and equipment to meet the government's and revitalized public's demands. This increase in gross domestic product is what economists call *the multiplier effect*. It means that one dollar of government spending will end up creating *more* than a dollar of new national income.

## Historical evidence from throughout the world has shown that high government spending *hurts* the economy in the long run.

### STICKY WAGES: KEY TO THE MULTIPLIER DEBATE

AS APPEALING AS the Keynesian story sounds, some economists have always had doubts. Historical evidence from throughout the world has shown that high government spending *hurts* the economy in the long run.<sup>4</sup> It's a *negative* multiplier. In the short run, a big drop in the demand for workers cannot cause mass unemployment by itself. If all of those workers really want to work, wages will fall until they all have jobs. That's how markets end a glut, whether it's a glut of workers or a glut of blue jeans: with lower prices.<sup>5</sup> If recessions really are caused by a fall in demand (and nothing else), workers' wages should fall enough to keep people from losing their jobs. It's just a matter of waiting for it to happen.

But it won't happen, the Keynesians explain, because of "sticky wages."<sup>6</sup> Wages and salaries don't change on a daily basis the way that stock prices and gas prices do. Those prices are fluid, but wages are rather . . . sticky. Thus, if a company hits a sales slump, the salespeople will earn fewer commissions, but the company won't instantly cut the pay of most workers. Most companies would rather fire a few people than reduce everyone's salary.<sup>7</sup>

If a *fall* in demand means mass firings, then a *rise* in demand should mean mass hirings. As long as wages are sticky, a rise in demand from anywhere in the economy—from consumers spending a tax rebate, a new government construction program, or an investment tax credit—will mean some unemployed workers will get jobs somewhere in the economy. Even if government spending is inefficient, pork-laden, and paid for

with future tax increases, in theory, it still creates some real jobs and some real output in both the government sector and private sector. But as we'll see, things are different when we move from the chalkboard to the real world.

### THE KEYNESIAN ASSUMPTION: BUSINESSES DON'T EXPLOIT WORKERS

IN A WORLD of sticky wages—the world in which most of us live in on a month-to-month basis—a Keynesian stimulus starts to sound reasonable, especially if we are willing to overlook the longer-term consequences of this policy, such as debt, higher taxes, or inflation. But the Obama Administration said the stimulus bill would create jobs over the next four years. Are wages sticky for that long? Eventually, won't businesses find a way to cut wages and hire those millions of unemployed workers? Stimulus defenders have only one answer: "No." They maintain that millions of unemployed workers won't push wages down very much and firms won't take advantage of their plights; wages can stay too high for years.

This is quite an assumption. The Keynesian belief that wages *never* adjust to a fall in demand seems as extreme as the alternative Real Business Cycle belief that wages *instantly* adjust to a fall in demand. That's why most macroeconomists have come down somewhere in the middle, a position known as "New Keynesian Economics."<sup>8</sup>

New Keynesians—including Obama economic adviser Larry Summers and Bush economic adviser John Taylor—teach that government spending can only grow the economy for as long as wages remain sticky. After that, more government hiring means less private-sector hiring. *Keynesian success lasts only as long as it takes for wages to adjust.*

It beggars belief that wages could stay sticky for four years. In the midst of a deep recession, even two years of wage stickiness seems quite a stretch, which makes the government's decision to push off most spending into 2010 quite puzzling in pure Keynesian terms. The government is waiting for the market to start healing itself before it does most of the spending. As wages grow more flexible in coming months and years—as they surely will when the unemployed bid for scarce jobs—the Keynesian multiplier should shrink. Even if \$1 of government spending could raise GDP by \$1.50 this year, as the CBO's model assumes, it's hard to believe that \$1 of government spending in fiscal 2011 will raise GDP by nearly that much.

### THE KEYNESIAN MULTIPLIER: A SURPRISINGLY WIDE RANGE OF ESTIMATES

SO, WHAT DO the data say? There aren't many studies on the issue, but two have found that government spending shrinks

the private sector, at least a little.<sup>9</sup> Looking at war spending, economist Robert Barro estimates that the multiplier of government spending is 0.8: when the government grows by \$1, the private sector shrinks by 20 cents. Economist Valerie Ramey's work on how U.S. military spending influences GDP gives a preferred estimate of 1.2, but she also finds evidence that consumer and business spending fall after a rise in government purchases. Thus, both papers support the "crowding out" hypothesis.<sup>10</sup> And Clinton Administration economist Brad Delong reports a short-run multiplier of only 0.5: a dollar of government spending shrinks the private sector by 50 cents.<sup>11</sup>

Those are estimates by leading figures in the profession. What do other studies say? Economist Patrick Van Brusselen surveyed all available multiplier estimates and found, "Government spending multipliers varied between -3.8 and +3.8; tax cut multipliers vary between -4.8 and +3.0."<sup>12</sup> The studies are all over the map. Some say tax cuts and extra spending hurt the economy in the short run; some say they help.

#### JOB CREATING OR JUST JOB SHIFTING?

IT'S OBVIOUS THAT the government can hire people. But how many of these jobs will be taken by people already working in the private sector? This is a statistic that desperately needs to be calculated over the coming years. After all, if most stimulus jobs are taken by people just switching over from privately funded jobs to publicly funded ones, that hurts any short-run Keynesian stimulus effect. In fact, in the last six months, some people *have* switched from private- to public-sector jobs. According to the *Boston Globe*, these people were willing to take a cut in pay because they valued the security and fringe benefits of a government job.<sup>13</sup> Every worker who switches to a government job for the good benefits hurts the Keynesian story.

In a 2007 paper, economists Vincenzo Quadrini and Antonella Trigari posed another important question: If a government routinely hires more workers during a recession, will the unemployed intentionally stay unemployed longer, in hopes of getting a good government job?<sup>14</sup> Since government jobs and stimulus-funded Davis-Bacon prevailing wage jobs<sup>15</sup> tend to have high wages and good benefits, there might be a strong incentive for unemployed workers to search a bit longer before settling for a private-sector job. In a simulation, Quadrini and Trigari found that when government spending stimulates the economy during a recession, it makes the typical recession worse. Many of the unemployed stay unemployed a few weeks longer in the hopes of finding a high-paying, secure, stimulus-funded job. Common sense for an unemployed worker searching for the best job possible means a longer recession for all of us. So the Quadrini/Trigari multiplier isn't just zero: it's *negative*, even in the short run.

By leaving out the Keynesian sticky-wage story, the Quadrini/Trigari story is incomplete. Likewise, a simple Keynesian story that leaves out the Quadrini/Trigari story is also lacking. If stimulus jobs paid market wages rather than high Davis-Bacon wages, this would be less of a problem, though still a problem.<sup>16</sup> And it's a problem that points in only one direction: a smaller multiplier. Perhaps it won't push the short-run multiplier down to zero (or less than zero), but a multiplier between zero and one starts to sound much more plausible—just the kind of small multiplier that Brad Delong recently found. And if that's the case, then fiscal "stimulus" grows the government at the cost of shrinking the private sector.

In other words when the government makes its slice of the pie bigger, it makes the rest of the pie smaller.

We can see the same story if we look at how the jobs are funded. Government doesn't have money. To spend it, it needs to either borrow, tax, or print it (or a combination of these). Money that is taxed or borrowed from the private sector is money that firms can't spend on goods or employees. So, just as a government stimulus usually shrinks private-sector jobs, it also shrinks private-sector wealth. In other words when the government makes its slice of the pie bigger, it makes the rest of the pie smaller.

#### CONCLUSION

PERHAPS THERE ARE good reasons to think that in this recession, government spending has a better chance than usual of helping the economy. After all, with high unemployment rates, the unemployed might just grab at the first available job. But if that's true, then we have to worry that nervous *private sector* workers will be equally willing to jump to a safe government job. A terrible job market doesn't clearly favor the Keynesian theory that government can create jobs, nor does the fact that the government has to take the money from one side of the economy to inject it on the other side support this idea. While the stimulus may appear to be a wise investment, it is really no wiser than a junk-rated mortgage-backed security: it may appear to pay off, but in reality it's quite a risky scheme.

## ENDNOTES

1. See [www.recovery.gov](http://www.recovery.gov).
2. Christina Romer and Jared Bernstein. *The Job Impact of the American Recovery and Reinvestment Plan*, January 9, 2009, [http://otrans.3cdn.net/45593e8ecbd339d074\\_l3m6bt1te.pdf](http://otrans.3cdn.net/45593e8ecbd339d074_l3m6bt1te.pdf).
3. Chris Isidore, "2 million jobs lost so far in '09," *CNN Money*, April 3, 2009, [http://money.cnn.com/2009/04/03/news/economy/jobs\\_march/index.htm](http://money.cnn.com/2009/04/03/news/economy/jobs_march/index.htm).
4. Robert Barro, "Economic Growth in a Cross Section of Countries," *The Quarterly Journal of Economics* 106, no. 2 (1991): 407–443 and Xavier Sala-i-Martin, Gernot Doppelhofer, and Ronald Miller, "Determinants of Long-Run Growth: A Bayesian Averaging of Classical Estimates (BACE) Approach," *American Economic Review* 94, no. 4 (2004): 813–835.
5. If this was how the world worked—a fall in demand caused a fall in wages, but no job losses—then we'd expect business profits to rise during a "recession." Of course, this doesn't really happen. In percentage terms, recessions are much worse for profits than for wages.
6. We could tell the same story about prices: If the demand for consumer and investment goods falls, prices can fall so that all goods get sold. In this short essay, we'll just focus on the wage side, but there's a vast economics literature on "sticky prices" as well. Leading New Keynesian John Taylor sums up the literature in "Staggered Price and Wage Setting in Macroeconomics" (working paper, Stanford University, Palo Alto, 1998), <http://www.stanford.edu/~johntayl/Papers/handbook.pdf>.
7. There's a vast theoretical and empirical literature on sticky wages, but the best work may be economist Truman Bewley's near-anthropological account of the New England economy in the early 1990s, *Why Wages Don't Fall During a Recession* (Cambridge: Harvard University Press, 1999). He surveyed business owners, managers, workers, and union leaders. His main finding is that each firm worries that if it cuts wages that will hurt morale, which will hurt the firm's long-run productivity. From the firm's point of view, it's usually better to "get trouble out the door" by firing some workers rather than have all of its employees upset over a pay cut.
8. Harvard's Greg Mankiw, CEA Chair in the George H.W. Bush administration, has a short article on the topic, "New Keynesian Economics," *The Concise Encyclopedia of Economics*, 2nd ed., <http://www.econlib.org/library/Enc/NewKeynesianEconomics.html>.
9. See Robert Barro, "Government Spending in a Simple Model of Endogenous Growth," *The Journal of Political Economy* 98, no. 5 (1990): 103–125 and Valerie Ramey, "Identifying Government Spending Shocks: It's All in the Timing," (working paper, University of California, San Diego, 2008).
10. The "crowding out" theory suggests that private consumption and investment decrease as a result of government spending increases.
11. Brad DeLong sums up a number of multiplier estimates in "Deficit Spending and the Recovery" (lecture, KQED Forum, San Francisco, September 4, 2009), <http://delong.typepad.com/sdj/2009/09/deficit-spending-and-the-recovery-talking-points-for-kqed-forum-morning-appearance-september-5-2009-9-am-pdt.html>.
12. Patrick van Brusselen, "Fiscal Stabilisation Plans and the Outlook for the World Economy" (working paper, European Network of Economic Policy Research Institutes, Brussels, 2009), [http://www.plan.be/admin/uploaded/200906111040040.nime\\_01\\_09.pdf](http://www.plan.be/admin/uploaded/200906111040040.nime_01_09.pdf).
13. Megan Woolhouse, "Now hiring, your Uncle Sam," *The Boston Globe*, May 30, 2009, [http://www.boston.com/jobs/news/articles/2009/05/30/unlike\\_rest\\_of\\_us\\_federal\\_government\\_is\\_hiring\\_a\\_lot/](http://www.boston.com/jobs/news/articles/2009/05/30/unlike_rest_of_us_federal_government_is_hiring_a_lot/).
14. Antonella Trigari and Vincenzo Quadrini, "Public Employment and the Business Cycle" (working paper, University of Southern California, Los Angeles, 2007), <http://www-rcf.usc.edu/~quadrini/papers/PublicEmployPap.pdf>, later published in *Economic Inquiry*.
15. The Davis-Bacon Act of 1931 established that construction jobs for public projects pay at least the prevailing wage for other local projects.
16. Indeed, if government jobs paid market wages, then a recession would be a great time to build roads and hospitals at a much lower cost than usual. Taxpayers could save money by hiring employees who were waiting for the private-sector to improve.

The Mercatus Center at George Mason University is a research, education, and outreach organization that works with scholars, policy experts, and government officials to connect academic learning and real-world practice.

The mission of Mercatus is to promote sound interdisciplinary research and application in the humane sciences that integrates theory and practice to produce solutions that advance in a sustainable way a free, prosperous, and civil society.

Veronique de Rugy is a senior research fellow at the Mercatus Center. Her research interests include federal budget, homeland security, tax competition, and financial privacy issues. She holds a PhD in economics from the University of Paris-Sorbonne.

Garett Jones is assistant professor of economics at George Mason University and senior scholar at the Mercatus Center.