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Economic Stimulus Pushed by Flawed Jobs Analysis

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A recently released report by Christina Romer, chair of the President's Council of Economic Advisers, and Jared Bernstein, the Vice President's chief economist, is being widely cited by Administration officials (including the President) and Members of Congress as proof that the stimulus package currently being debated in Congress—especially the spending portion—will actually stimulate the economy.

The Romer–Bernstein report finds that the stimulus plan will create about 3.7 million jobs and reduce the unemployment rate by about two percentage points from where it would have been without the stimulus by the fourth quarter of 2010.¹ The report is supposed to lend academic creditability to a plan based on political considerations, but the estimates created are founded on loose assumptions that lack academic rigor. The report should not be relied upon as an accurate measure of the impact of the Obama fiscal stimulus plan because it relies on rules of thumb and other back-of-the-envelope calculations rather than sound economic analysis.

Wrong Multipliers. Romer and Bernstein estimate how much government spending and tax cuts will increase production, or gross domestic product (GDP). To do so, they use what economists refer to as a multiplier. The multiplier is the amount that a change in government spending or tax cuts will increase GDP. For instance, a multiplier of one means that a \$1 increase in government spending results in a \$1 increase in GDP. A multiplier greater than one means that a spending increase or tax cut has secondary effects that further boost GDP. The

secondary effects occur as the original money makes its way through the economy and businesses hire more employees or increase their pay, buy new inventory, or invest to expand operations.

The Romer and Bernstein multipliers for government spending and tax cuts were estimated by the Federal Reserve's FRB/US model and a leading private forecasting firm.² They settle on a multiplier of approximately 1.5 for government spending and about 0.99 for tax cuts.³ This would suggest that for every dollar the government spends, GDP increases \$1.50, while every dollar in lower government taxes increases GDP by just under a dollar. Romer and Bernstein, however, are uncertain of the multipliers and note as much in the report: "We confess to considerable uncertainty about our choice of multipliers for this element of the package."⁴

Romer and Bernstein are right to be uncertain of the multiplier they use, especially the spending multiplier. Economists generally estimate the size of the spending multiplier in their analyses by looking at historically *similar* experiences. Romer and Bernstein, however, rely on a model based on historical data that is not comparable to current economic conditions, because an increase in government spending as large as this one has never been tried as

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a stimulus before. Rather than take the time to estimate a more accurate multiplier, Romer and Bernstein use one estimated for much lower levels of spending and assume it applies to the massive spending program under analysis.

They then apply the spending multiplier to the proposed total spending in the stimulus package. They ignore the fact that the stimulus package contains spending on a variety of items—everything from money for the National Endowment for the Arts and new sod for national monuments to infrastructure spending. Romer and Bernstein, therefore, assume that all spending affects the economy equally.

A better back-of-the-envelope calculation would at least consider estimated multipliers from a range of different models and assumptions. Many economists have used a variety of methods and assumptions to estimate the size of multipliers for government spending and found them to be lower than those used by Romer and Bernstein.⁵

Rule of Thumb. To estimate the number of jobs created by increased government spending, Romer and Bernstein multiply the amount of government spending in the stimulus plan by the multiplier discussed above. The outcome is the increase in GDP resulting from the increased spending. They then apply a “rule of thumb” that a 1 percent increase in

GDP results in the creation of 1 million jobs.⁶ They do not justify this rule by citing any empirical or theoretical research.

The “rule of thumb” is misused because it assumes that increases in GDP create jobs. In fact, the relationship is actually the other way around. Production and work create GDP, so it is more accurate to say that 1 million more jobs produce 1 percent more GDP.

Authors Uncertain. Romer and Bernstein’s analysis is based on loose assumptions about the multiplier effects and inexact rules of thumb about job creation. It is no wonder they are uncertain of the results of their report:

It should be understood that all of the estimates presented in this memo are subject to significant margins of error.... Our estimates of economic relationships and rules of thumb are derived from historical experience and so will not apply exactly in any given episode. Furthermore, the uncertainty is surely higher than normal now because the current recession is unusual both in its fundamental causes and its severity.⁷

Romer and Bernstein are admitting that their methods are likely to lead to inaccurate results. The informal manner in which the analysis was con-

1. Christina Romer and Jared Bernstein, “The Job Impact of the American Recovery and Reinvestment Plan,” Office of the President-elect, p. 4, January 9, 2009, at http://otrans.3cdn.net/45593e8ecbd339d074_l3m6bt1te.pdf (January 13, 2008).
2. *Ibid.*, p. 12.
3. Large U.S. economic structural forecasting models are based on estimated econometric relationships. For these models to work, demand and supply must equilibrate. For analytical traction, models in the Keynesian tradition typically adjust supply to demand, effectively assuming that demand creates its own supply. Therefore any direct increased spending will pull output up, thus overestimating the implied multiplier by ignoring some of the negative effects this would have on supply variables.
4. Romer and Bernstein, “The Job Impact of the American Recovery and Reinvestment Plan,” p. 12.
5. Andrew Mountford and Harald Uhlig, in “What Are the Effects of Fiscal Policy Shocks?” (NBER Working Paper No. 14551, December 2008), have estimated the effects and compare these with other studies of various spending impacts. The competing multipliers are all less than one; see also Valerie A. Ramey, “Identifying Government Spending Shocks: It’s All in the Timing,” at <http://econ.ucsd.edu/~vramey/research/IdentifyingGovt.pdf> (January 27, 2009); Christina D. Romer and David H. Romer, “The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks,” NBER Working Paper No. 13264, July 2007; Robert Hall and Susan Woodward, “Measuring the Effect of Infrastructure Spending on GDP,” Financial Crisis and Recession, December 11, 2008, at <http://woodwardhall.wordpress.com/2008/12/11/measuring-the-effect-of-infrastructure-spending-on-gdp> (January 27, 2009).
6. Romer and Bernstein, “The Job Impact of the American Recovery and Reinvestment Plan,” p. 3.
7. *Ibid.*, p. 2.

ducted should give pause to anyone using the results of the report to support passage of the stimulus plan.

Not to Be Trusted. The Obama Administration and Members of Congress are relying on a flawed report as evidence of the effectiveness of the stimulus plan. The report should not be trusted. It is based on faulty assumptions that even the authors admit create significant margins of error. More rigorous research has shown that tax rate cuts will cre-

ate millions of jobs and cost less than the Obama plan.⁸ Taxpayers deserve better information before their money is spent on things that will not offer the return they were promised.

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8. See J. D. Foster and William W. Beach, “Economic Recovery: How Best to End the Recession,” Heritage Foundation WebMemo No. 2191, January 7, 2009, at <http://www.heritage.org/Research/Economy/wm2191.cfm>.