The stimulus tragedy

By Paul Krugman
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Five years have passed since President Obama signed the American Recovery and Reinvestment Act — the “stimulus” — into law. With the passage of time, it has become clear that the act did a vast amount of good. It helped end the economy’s plunge; it created or saved millions of jobs; it left behind an important legacy of public and private investment.

It was also a political disaster. And the consequences of that political disaster — the perception that stimulus failed — have haunted economic policy ever since.

Let’s start with the good the stimulus did.

The case for stimulus was that we were suffering from a huge shortfall in overall spending, and that the hit to the economy from the financial crisis and the bursting of the housing bubble was so severe that the Federal Reserve, which normally fights recessions by cutting short-term interest rates, couldn’t overcome this slump on its own. The idea, then, was to provide a temporary boost both by having the government directly spend more and by using tax cuts and public aid to boost family incomes, inducing more private spending.

Opponents of stimulus argued vociferously that deficit spending would send interest rates skyrocketing, “crowding out” private spending. Proponents responded, however, that crowding out — a real issue when the economy is near full employment — wouldn’t happen in a deeply depressed economy, awash in excess capacity and excess savings. And stimulus supporters were right: far from soaring, interest rates fell to historic lows.

What about positive evidence for the benefits of stimulus? That’s trickier, because it’s hard to disentangle the effects of the Recovery Act from all the other things that were going on at the time. Nonetheless, most careful studies have found evidence of strong positive effects on employment and output.

Even more important, I’d argue, is the huge natural experiment Europe has provided on the effects of sharp changes in government spending. You see, some but not all members of the euro area, the group of countries sharing Europe’s common currency, were forced into imposing draconian fiscal austerity, that is, negative stimulus. If stimulus opponents had been right about the way the world works, these austerity programs wouldn’t have had severe adverse economic effects, because cuts in government spending would have been offset by rising private spending. In fact, austerity led to nasty, in some cases catastrophic, declines in output and employment. And private spending in countries imposing harsh austerity ended up falling instead of rising, amplifying the direct effects of government cutbacks.

All the evidence, then, points to substantial positive short-run effects from the Obama stimulus. And there were surely long-term benefits, too: big investments in everything from green energy to electronic medical records.

So why does everyone — or, to be more accurate, everyone except those who have seriously studied the issue — believe that the stimulus was a failure? Because the U.S. economy continued to perform poorly — not disastrously, but poorly — after the stimulus went into effect.

There’s no mystery about why: America was coping with the legacy of a giant housing bubble. Even now, housing has only partly recovered, while consumers are still held back by the huge debts they ran up during the bubble years. And the stimulus was both too small and too short-lived to overcome that dire legacy.

This is not, by the way, a case of making excuses after the fact. Regular readers know that I was more or less tearing my hair out in early 2009, warning that the Recovery Act was inadequate — and that by falling short, the act would end up discrediting the very idea of stimulus. And so it proved.

There's a long-running debate over whether the Obama administration could have gotten more. The administration compounded the damage with excessively optimistic forecasts, based on the false premise that the economy would quickly bounce back once confidence in the financial system was restored.

But that's all water under the bridge. The important point is that U.S. fiscal policy went completely in the wrong direction after 2010. With the stimulus perceived as a failure, job creation almost disappeared from inside-the-Beltway discourse, replaced with obsessive concern over budget deficits. Government spending, which had been temporarily boosted both by the Recovery Act and by safety-net programs like food stamps and unemployment benefits, began falling, with public investment hit worst. And this anti-stimulus has destroyed millions of jobs.

In other words, the overall narrative of the stimulus is tragic. A policy initiative that was good but not good enough ended up being seen as a failure, and set the stage for an immensely destructive wrong turn.