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The problem with asking: Are you better off than four years ago?

By Louis D. Johnston | 09/12/12

REUTERS/Rebecca Cook

One economic alternative involves the government's policy toward the auto industry. Ford Motor President of the Americas Mark Fields, Rep. John Dingell and others pose with workers outside a revamped plant in Flat Rock, Mich., on Monday.

Are you better off than you were four years ago?

It seems like a simple question with a simple answer: Democrats say "yes" and Republicans say "no."

I was thinking about this when I saw this tweet from Daniel Altman, adjunct associate professor at the Stern School of Business at New York University: "The problem when people ask 'are you better off than four years ago' is that they totally ignore counterfactuals."

Exactly. So, what's a counterfactual and why should you care?

Counterfactuals and railroads

A counterfactual is a plausible, but not factual, alternative to an actual event. Thus, when we ask the question, "What if X happens?" we can answer by analyzing what the world would look like if X doesn't happen.

Robert Fogel, who shared the 1993 Nobel Prize in Economics, built the most famous counterfactual in economic history. He began by asking, "Did the interregional distribution of agricultural products [in post-Civil War America] depend on the existence of the long-haul railroad?"

To answer this question, he had to ask another: What would the U.S. economy have looked like *without* the railroad system constructed between the end of the Civil War and the beginning of World War I?

Fogel argued that a system of canals, river improvements and roads would have been built instead of the rail system. He then showed that about three-quarters of all agricultural output produced in 1890 was within 40 miles of navigable or potentially improved waterways. The result: in 1890, GDP was probably 5 percent higher due to the railroad. (Go here for maps Fogel created for the project.)

Fogel and his work set off a furor in both economics and history, but did so in part because he was so clear about his counterfactual world. Critics and supporters could examine the system of canals, argue whether or not it was plausible, and tear the work down to its smallest details.

Better off compared to what?

The two critical elements of counterfactual analysis are on display in Fogel's work:

- A set of clear alternatives to actual events (canals);
- A framework in which to analyze those alternatives (economic theory).

This is what's needed in today's discussions.

First, what are the alternatives to the policies pursued over the past four years? A few come to mind:

- Bank bailouts: We could have let the banks fail or we could have nationalized them as Sweden did with their banks in 1992. The Troubled Asset Relief Program (TARP) was a compromise between the two.
- Auto bailouts: We could have let GM and Chrysler fail or we could have pursued a Conrail strategy. The PennCentral was the result of a failed merger between the New York Central Railroad and the Pennsylvania Railroad; when the company went bankrupt, the federal government took over the company, renamed it Conrail (Consolidated Railroad), invested in it and eventually sold it to Norfolk Southern and CSX.
- Stimulus: We could have enacted a smaller stimulus in early 2009 or a larger program.
- Health care: We could have ignored health care reform, passed a narrower set of reforms or went whole-hog for single-payer insurance.

That's a lot of alternatives to consider.

Second, what are the proper economic tools to analyze the different counterfactual strategies? If we had a single, unified model of the economy we could feed the counterfactuals into it and find the answer. Unfortunately, we don't have such a model.

For example, Alan Blinder and Mark Zandi used the Moody's Analytics model of the U.S. economy to examine a variety of counterfactuals involving the TARP and the 2009 stimulus. They found that "the effects of the fiscal stimulus alone appear very substantial, raising 2010 real GDP by about 3.4 percent, holding the unemployment rate about 1½ percentage points lower and adding almost 2.7 million jobs to U.S. payrolls."

Blinder and Zandi were immediately challenged by other economists who protested that the Moody's model was wrong, that there were better models and so on. Again, the dispute was possible because Blinder and Zandi were crystal clear about the properties of the model in which they analyzed the alternative policies.

Show me your model

I don't really care whether President Obama or Mitt Romney thinks we are or are not better off than we were four years ago. I'm much more interested in them telling me how they think the economy works so that I can evaluate their counterfactuals.

I want them to show me their models.

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