



KEYNESIAN POLICIES STIMULATE DEBATE AND DEBT, NOT EMPLOYMENT

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The global economy is in deep, synchronized recession, and governments are moving mountains to stop job and wealth destruction. Monetary authorities are pumping massive liquidity into credit markets and working with finance ministries to prop up, sustain and nationalize major financial institutions. Nearly every government in Asia, Europe and North America is pursuing some vigorous form of Keynesian fiscal stimulus, defined generally as debt financed consumer-oriented tax cuts and substantial increases in government spending to push up aggregate demand in the hope that output, jobs and incomes follow. But will it work?

The US recession is different from that in Japan, which differs from those in Russia or China or Germany. This observation is important to understanding the recession triggers. Perhaps without exception, every country in recession today contributed to its own economic weakness in some material way, either through the actions of its citizens, institutions, or public policies.

Weakness first appeared in the United States in the housing sector and then spread to the financial sector leading to a credit crunch that sapped the rest of the economy. Export-dependent countries like Germany, Japan, and China are suffering disproportionately from a collapse in international trade. Europe eventually succumbed to the financial distress that swept the United States in 2008. From Iceland to Italy financial institutions engaged in irresponsible, high-risk, highly leveraged lending similar to the lending in the United States mortgage market. Nor are the shocks yet over – the United States is facing new troubles from commercial real estate

while Europe is badly exposed to dubious lending to emerging markets, especially in Eastern Europe.

Eventually nations will need an honest appraisal of what went wrong in the credit markets and in the regulatory architecture. The immediate task, however, is to restore economic growth. In addition to very innovative, aggressive monetary policy responses, policy makers have pursued massive doses of Keynesian fiscal policy. The US government alone may borrow up to USD 2 trillion in 2009 to finance its fiscal policy stimulus, equivalent to nearly 15 percent of GDP.

Fiscal policy as an umbrella term refers to policies involving government revenue, spending and debt issuance. In macroeconomics, fiscal policy may simply refer to whether the budget is balanced, in surplus or in deficit. In public finance, fiscal policy is more textured, involving the composition of government spending as between direct consumption, research, infrastructure investment, etc., and the kinds of tax systems imposed to collect revenues, i.e. property taxes, individual and corporate income taxes, value-added taxes, etc.

A stimulative fiscal policy in the newly revived Keynesian tradition increases the budget deficit from one year to the next to raise aggregate demand through either increased government spending or reductions in tax levels with the expectation that increases in output and income will follow. An alternative view is that fiscal policy is stimulative when it involves reductions in marginal tax rates on productive activity. This view emphasizes the behavior of private individuals and firms responding to improved after-tax incentives.

According to the alternative view, what matters is reducing effective tax rates, not a resulting increase in the budget deficit. On the contrary, reducing government spending can augment the benefits of an effective stimulative tax cut by reducing the budget deficit, thereby relieving upward pressures on interest rates, reducing concerns of subsequent inflation, and leaving more resources available to the private sector.

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One view advocates debt-financed spending increases and incentive-indifferent tax cuts; the other advocates incentive-based tax cuts preferably coupled with reduced spending to contain or reduce the budget deficit. During this global great recession, policymakers need an answer. Which approach to fiscal stimulus is right?

The Keynesian flaw – the second half of the story

The theory behind Keynesian stimulus is simple enough. The economy is underperforming: for whatever reason total demand from the private sector – consumption, investment and the international sector – plus government demand is inadequate to allow the economy to operate at full employment. The proposed solution is to increase public sector demand and let output rise to meet the higher level of demand. Expressed in these terms, the efficacy of fiscal stimulus would hardly seem debatable.

The counter argument begins with the simple observation that if fiscal policy were so obviously effective at raising output and lowering unemployment, countries with persistently underperforming economies would have been doing it for years. Some have tried, but their economies continued to under-perform stubbornly nonetheless.

The 1960s and 1970s was the golden age of Keynesianism. Policymakers embraced persistent budget deficits combined with accommodative monetary policy to fine-tune the economy and increase employment levels. It failed. As Christina Romer, Chairman of President Obama's Council of Economic Advisers has noted, the economic ideas of the 1960s and 1970s that led to expansionary policy also led to inflation and real instability (Romer 2007).

Europeans shared in the dream of fine-tuning the economy while justifying additional spending, with similarly lackluster results. As James Callaghan, the former British Labour Prime Minister, said in 1967, "we used to think that you could spend your way out of recession and increase employment by cutting taxes and boosting government spending. I tell you in all candor that the option no longer exists, and that insofar as it ever did exist it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step" (BBC-TV 1967).

Japan in the 1990s is the modern poster child for Keynesian stimulus having embarked on massive government infrastructure projects producing wonderful new roads, bridges, waterworks and airports (Eggertson and Ostry 2005). Net government debt rose as a share of the economy from 15 percent in 1990 to 60 percent in 2000 (IMF World Economic Outlook Database 2009). Japan was left with beautiful infrastructure, a mountain of debt and the now-resumed lost decade.

Recent experience in the United States with Keynesian policy is no less discouraging. The United States ran a budget deficit in 2008 of USD 459 billion, or 3.2 percent of GDP, up from a deficit of 1.2 percent of GDP in 2007. This two percent of GDP increase represented a powerful dose of Keynesian stimulus and yet the recession accelerated markedly. Again, an explicit policy of Keynesian stimulus failed.

According to the Congressional Budget Office (CBO 2009), the US government is expected to run a deficit of USD 1.8 trillion in 2009, or 13.1 percent of GDP. This would amount to a stunning USD 1.4 trillion or nearly 10 percent of GDP of Keynesian stimulus. Despite this massive jolt of deficit spending, the CBO and others project the real economy to decline significantly. The numbers tell the story in black and white. Either these forecasters believe the economy would have contracted by 11 percent or more in 2008 but for the stimulus, or they believe Keynesian stimulus will be as ineffective in 2009 as it was in 2008.

For 2010, CBO projects a deficit of USD 1.4 trillion under President Obama's budget, a decline of USD 466 billion, or 3.5 percent of GDP. Under the Keynesian theory, the deficit needs to *rise* slightly to have a neutral effect on the economy in the short run. A drop in the deficit of 3.5 percent of GDP under this theory is then massively contractionary. Keynesians should be in a panic. Most forecasters, including CBO, appear calmly to ignore this phantom contractionary pressure in their own economic forecasts. Apparently, forecasters outside of the political realm do not believe in Keynesian theory, either.

Simple observation has its place, but how does the Keynesian stimulus approach break down in theory? Keynesian stimulus theory ignores the second half of the story – deficit spending must still be financed and

financing carries budgetary and economic costs. Proponents generally acknowledge the long-term budgetary costs, but ignore the offsetting near-term economic costs.

In a closed economy, government borrowing reduces the pool of saving available for private spending, either investment or consumption. Government lacks a wand to create real purchasing power out of thin air (with the fleeting exception of monetary expansions, discussed below). Government spending or deficit-increasing tax cuts increase demand as advertised, and government borrowing reduces demand by the same amount. The dynamics in an open economy are slightly more complicated but the final outcome for output is unchanged. An open economy permits a government to finance its deficits by importing saving from abroad as the United States has done for years, rather than by tapping domestic sources. However, an increase in deficit spending met by an increase in net imports of foreign saving must in turn be matched by an increase in net imports of goods and services to preserve the balance of payments. Thus, the increase in domestic demand due to deficit spending is fully offset by a reduction in demand arising from net exports. Once again, Keynesian stimulus is of no effect.

What if the extra government borrowing soaks up idle savings in an underperforming economy, proponents may ask? In troubled economic times, those who can save more often do so, directing their saving toward very safe investments like Treasury Bonds and bank deposits. (The US personal saving rate is already up significantly.) However, these cautious savers almost never withdraw their savings from the financial system entirely by stuffing cash into mattresses and the like. Aside from the occasional mattress stuffer, even savings held in the safest of instruments remains part of the financial system, working to find its most productive uses through the available channels. Borrowing to finance Keynesian stimulus then remains a subtraction from the funds available to the private sector.

Suppose widespread fear spurred savers to engage in rampant mattress stuffing, withdrawing purchasing power from the economy and creating large amounts of truly idle savings. This has happened before, and could be happening now. Surely Keynesianism works then? Not likely. Nothing about a flood of government bonds engulfing capital markets to finance a surge in wasteful government spending is likely to

convince the mattress stuffers that their concerns are misplaced. Such deficit spending is then a competitor for an even smaller pool of available private saving. Worse, mattress stuffers are likely to increase their mattress-based saving in the face of a surge of profligate, irresponsible government spending. Keynesian “stimulus” would then be an economic depressant.

Printing money to make fiscal stimulus work

Government cannot create real purchasing power by whim, dictate, or debt, but the monetary authority can create the illusion of purchasing power through a policy of monetizing debt and increasing cash liquidity in the economy. Combining an obliging monetary policy with increased deficit spending may create the illusion that fiscal policy is effective, but as Mr. Callaghan attests, it is temporary and only an illusion.

In most countries the monetary authority’s independence is a foundational policy principle. The monetary authority may buy significant amounts of Treasury notes and bills in pursuit of its own expansionary monetary policy as the Federal Reserve has done for many months in extraordinary quantities. But this policy is driven by monetary policy considerations. The monetary authority would take these actions whether or not the fiscal authorities embarked on a stimulative policy. The Fed’s policy goal is the same as the Treasury’s in this instance – to resuscitate the economy – but the Fed is pursuing its policies independent of the Treasury and, ultimately, it is the Fed’s policies that are effective.

In the last theoretical refuge for Keynesian stimulus, suppose the monetary authority broke its commitment to independence and opted to monetize some of the debt issued under a Keynesian fiscal policy. That is, the monetary authority subordinated its monetary policy rules and objectives to fiscal policy. In this repeat of the failed 1970s experiments, market participants would quickly gauge the shift in monetary policy, interpret it correctly, and reflect higher inflation in their pricing and expectations. The immediate effect would be to nullify the stimulative effects of the policy. The subsequent effect would be a contractionary counter-inflationary policy. Even a compliant central bank cannot make Keynesian policy effective unless the bank can consistently and persistently fool the markets. Not likely.

Casual empiricism suggests Keynesian stimulus policy does not work, and the theory behind the policy falls apart upon inspection. What does empirical research indicate?

Empirical insights on Keynesian effectiveness

One approach to testing the efficacy of debt-based fiscal stimulus turns to the data to see what stories it tells. Unfortunately, few have attempted this task in recent years. This may be due to the emergence, development and parameterization of a new consensus model in macroeconomics, the so-called New Keynesian model (Blanchard 2008; Woodford 2009). Also, most of the developed world (other than Japan) has been relatively immune to significant business cycle swings, thus dampening the demand for research on countercyclical fiscal policies in industrial nations. Part of the reason may also be the strong consensus prior to recent events that Keynesian stimulus was ineffective and that studies reporting statistically insignificant results confirming the consensus view are rarely published.

Perhaps Robert J. Barro's analysis of fiscal stimulus efficacy is the most well known and controversial. Barro argues that the clearest evidence of fiscal policy effects is likely to be found when spending ramps up rapidly during wars (Barro 2007). Examining the US fiscal policy in the periods surrounding World War II, the Korean War and the Vietnam War, Barro's analysis suggests a fiscal multiplier of 0.8, meaning that the increase in output was a fraction of the increase in government spending.

Barro further suggests that the wartime multiplier is likely to be much greater than the peacetime multiplier, and that a peacetime multiplier is likely to be near zero, so every extra dollar of government spending actually replaces a dollar of private spending leaving output unaffected. Paul Krugman among others has criticized Barro's results, noting that the wars themselves and the often attendant wage and price controls would have diminished the effectiveness of fiscal policy (Krugman 2009). However, none of his critics have as yet provided an empirical analysis challenging Barro's results.

Mountford and Uhlig (2005) using a purely statistical approach find an unexpected increase in government spending beyond what would occur through automatic stabilizers "weakly stimulates the econo-

my": a 1 percent increase in spending increases output by about 1.3 percent after one year. Proponents of extra increased spending as Keynesian stimulus may take comfort in this result, but they need also to acknowledge that the authors find a deficit-financed tax cut is the best fiscal policy to stimulate the economy.

An alternative approach to ferreting out fiscal multipliers is to use existing macroeconomic models to simulate policy effects. This approach, while of great interest to model builders, provides uncertain illumination for policy makers because the models ultimately only report what their builders have designed into them. One cannot tell whether an interesting result reflects the model or the economy the model is intended to represent.

Christina Romer, as Chairman of the President's Council of Economic Advisers, and Jared Bernstein, Chief Economist of the Office of the Vice-President, provide a recent example of the model simulation approach. They averaged the output from two quantitative macroeconomic models – one in use at the Federal Reserve Board and one from an unnamed private forecasting firm (The White House 2009). Romer and Bernstein found that an increase in government spending of 1 percent of GDP increases output by 1.6 percent.

In contrast, Cogan et al. (2009) use a state of the art macroeconomic model constructed by Smets and Wouters (2007). The Smets-Wouters model embodies the "New Keynesian" approach to macroeconomic analysis. Among the differences with older models such as those used by Romer and Bernstein, Smets-Wouters includes forward-looking or rational expectations. Cogan et al. (2009) find that the impact in the first year of a Keynesian stimulus is "very small" and that the multipliers are less than one as consumption and investment are crowded out.

As the discussion above suggests, the disposition of monetary policy can have a powerful influence on the effectiveness of fiscal policy. Eggertsson (2006) used a model similar to Smets-Wouters to examine these questions. Her analysis explored the consequences of increased government spending when monetary policy is or is not explicitly coordinated with fiscal policy. Uncoordinated policies need not mean that monetary and fiscal policies have divergent goals. Both monetary policy and fiscal policy may react to economic weakness, a threat of defla-

tion or off-target inflation. The lack of coordination in policies means that in reacting to macroeconomic conditions the monetary authority's actions may be coincidental to fiscal policy, but not specifically intended to support fiscal policy. On the other hand, if the monetary authority sets aside its usual guidelines to subordinate monetary policy to fiscal policy goals, then it is considered to be coordinated with fiscal policy.

Eggertsson (2006) finds that fiscal policy is very effective if monetary policy is explicitly supportive, producing a fiscal policy multiplier of 3.76. However, if monetary policy remains independent, then the multiplier becomes exactly zero and fiscal policy is completely ineffective. This latter result is generally consistent with Cogan et al. (2009) who also explicitly assumed the monetary authority remains fully independent of fiscal policy.

Stepping back, Eggertsson's monetary policy focus, while understandable coming from the New York Federal Reserve staff, is perhaps not on point as a test of Keynesian stimulus. Eggertsson's results depend critically on the effects of fiscal policy on inflationary expectations. These are important issues but do not address the underlying rationale for Keynesian fiscal stimulus of increasing aggregate demand. The real message of Eggertsson is to underscore that modeling exercises sometimes tell us more about the modeler's interests than about the economic processes in which we are interested. This is not a criticism of Eggertsson or any user of such economic models, but rather a caution to those who might interpret and apply their results.

Fiscal policy that works

Fiscal policy can stimulate the economy in the short run, but only by stimulating the underlying processes of economic growth. There is no magic about the means or real uncertainty about the consequences, though the means are unpopular in today's political climate. Cut tax rates on those who produce – individuals, entrepreneurs, small businesses and large – and they will produce more of what is in demand and, in so doing, they will invest more, hire more and generate more income. This is not a matter of choosing one policy over another to stimulate aggregate demand. One could pursue an aggregate-demand neutral policy by reducing marginal tax rates while keeping total tax collections constant. An even more

effective policy would be to reduce spending to match the revenue foregone to incentives-based tax relief.

One criticism of an incentives-based approach to stimulus is that businesses will not increase production if there is no additional demand. This is true, but it also misses the point. An economy in recession generates a steady drumbeat of bad tidings, leaving a popular impression of perfect gloom. Yet the basic economic processes of prosperity at work triggering recovery are ever at work in recession. Reports of job loss reflect the net of losses over gains, but the gains can be substantial. Even in recession, many employers are still hiring, still investing, still looking for new opportunities, much as they do in normal times, just less so. A policy of marginal tax rate reductions encourages these positive forces by improving the rewards to productive activity.

For example, according to the US Department of Labor (2009), in the second quarter of 2008 (the latest data), as the recession was gathering steam, total employment declined by 223,000 workers. However, in that same period when unemployment was building, 128,000 workers found new jobs. The reported job loss figure is the net of job losses over job gains. To be sure, losses exceeded gains, hence the net loss figure. Yet 128,000 individuals found employment. The labor market is much more dynamic than the simple figures suggest. An effective stimulus policy recognizes and builds on this dynamism.

Recovery takes hold when those in a position to do so have reason to do more. Low real interest rates and lower unit labor costs are classic sources of these incentives. These incentives internal to the private sector can be given a strong boost by reducing the disincentives from taxation or burdensome regulations or government-generated uncertainties. Unless government policies have so polluted the economy as to render the landscape of opportunities a toxic wasteland, entrepreneurial spirit will seek out those opportunities and in so doing move the economy forward, and will do so.

Keynesian stimulus comes and goes

Bad policy ideas rarely go away forever. Circumstances change, memories fade, and political fashions come and go. The current global experiments with Keynesian fiscal stimulus will fail as they have failed

before. Unfortunately, the price of learning this lesson yet again is an unnecessarily prolonged recession, a weaker recovery and millions more jobs lost – and of course the massive increases in public debt.

Fiscal policy need not be ineffective. Fiscal policy can assist the private sector to address its weaknesses and failings and resume growing if tax relief improves economic incentives to help the private sector heal itself. Unfortunately, these effective policies are not in vogue today. What is in vogue is using the occasion of a deep recession to expand government in a variety of ways that would be more difficult or time consuming under normal circumstances.

Economies will eventually recover as normal corrective economic processes take hold, assisted by effective monetary policies. If the process is drawn out, then economists and policymakers will turn to alternative fiscal policies that today are out of fashion. Reducing marginal tax rates, as unpleasant as it may be for some, will work as advertised. It's all a matter of time – and incentives.

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