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ARE WE KEYNESIANS?

There is plenty of room for empirical debate with respect to the efficacy of fiscal policy in general, whether monetary policy is a better tool, or what constitutes spending that will make us more productive in the future.

by Martin Kennedy

It is unclear whether we are all Keynesians, or even mostly Keynesians, now as some have suggested. Keynesianism is a somewhat elastic concept. It is safe to say that most economists believe the economy can be stimulated in the short run via deficit spending. It is also safe to say that the recently passed federal stimulus, the American Recovery and Reinvestment Act (ARRA), has enabled states, otherwise constrained, to engage in Keynes-inspired fiscal stimulus. States, unlike the federal government, must balance their budgets annually and so don't have as powerful a fiscal policy lever to pull in an attempt to counter a downturn. The recently passed federal stimulus, $787 billion in spending, includes $144 billion that has gone directly to state and local governments for "fiscal relief." This relief means that states will be able to engage in a sort of deficit spending, using expansionary fiscal policy, via the federal government.

In Tennessee, for example, the budget deficit in the current fiscal year that runs through June 2009, before the ARRA money, is projected to be just north of $1 billion out of a budget that is just over $29 billion. The roughly $4.5 billion in relief coming to Tennessee from Washington will enable the state to balance the budget without dramatic cuts in spending this year and for the next two fiscal years. So for the next 30 months, the state should be able to maintain spending levels and thereby help stabilize aggregate demand and mitigate the rising rate of unemployment. In short, the federal government is borrowing on behalf of state governments.

Theoretically, at least according to classical theory, the economy is self-correcting: markets are efficient; prices, wages, and interest rates adjust downward in response to a demand shock, and full employment returns.

Markets adjust sluggishly, countered Keynes.

> *The long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again.*

So wrote John Maynard Keynes in 1923. His influence has been dramatic—for the five decades following that statement and again today. Beyond asserting that markets don't

continued on page 12

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continued from page 11

adjust in the real world quite as quickly as they do on a classroom chalkboard, Keynes thought that below full-employment equilibrium was possible. Firms might not engage in investment projects or begin hiring even as interest rates and wage rates drop if aggregate demand is weak. Unwilling lenders could "trap liquidity" in a time of low interest rates and great uncertainty. Falling prices lead people to hoard money and reduce consumption. Reducing consumption is rational in a period of deflation, but ultimately, and paradoxically, savings could actually begin to fall as an economy deteriorates and incomes fall: the so-called paradox of thrift.

Active fiscal policy, engaging in deficit spending, could insure sufficient aggregate demand and serve to counter a downturn, according to Keynes. Government spending would compensate for reduced consumption and investment spending. Such action would "prime the pump" of economic activity. Fiscal policy, according to Keynes, should be countercyclical in nature, running deficits to counter a downturn but paying down the debt when growth resumed. Keynesian fiscal policy, properly understood, is focused on the short run. It should be viewed as a mechanism to smooth the business cycle rather than a long-run strategy to enhance growth. A recent survey of Ph.D. economists found that 85% agreed that the federal budget should be balanced over the course of the business cycle.

The recently proposed Tennessee budget, actually a plan for the next several annual budgets, seems to have embraced the smoothing concept. The Bredesen administration is using the federal money as a means to mitigate, not eliminate, spending cuts. There would be nothing smooth about having to cut $1.1 billion this year, and there would be nothing countercyclical if projected spending were not adjusted. In short, the governor's multiyear plan recognizes that the stimulus, as the concept should imply, is temporary. The proposed budget for the 2009-2010 fiscal year is about 1.5% lower than last year's budget. Without the ARRA funds, it would have been about 8.5% lower, reflecting the reality that state tax revenue is down by roughly that amount. Another way of looking at it is that state agencies planned for cuts of about 15% before the ARRA funds and now will cut by just 3.5%.

State spending in Tennessee grew faster than personal income between 2003 and 2007, but it would be hard to suggest that the current budget proposal is imprudent or that it relies on unrealistic expectations of revenue growth. Wisconsin, which has a slightly lower population than Tennessee, is looking at a $5 billion deficit this year and higher taxes in the near future as are residents in California, Illinois, New Jersey, and New York. Tax hikes are contractionary and would mitigate the stimulatory impact of the ARRA funds. The administration in Nashville is anxious to close what it sees as tax loopholes and might tinker around the edges with fees in the next couple of years, but we shouldn't expect any tax increases.

There is plenty of room for empirical debate with respect to the efficacy of fiscal policy in general, whether monetary policy is a better tool, or what constitutes spending that will make us more productive in the future. There is ample room for ideological differences with respect to the role and size of government at the federal level. Most of the ARRA money is not going to the states. At the federal level, the deficit is projected to be a whopping 12% of GDP this year. The Obama administration's projections show a deficit of 5% of GDP and falling five years out, when growth will be robust and unemployment low. The Congressional Budget Office projections show a growing deficit five years out. Their GDP growth estimates are not as optimistic as the administration's. One wonders what Keynes would have thought about running deficits, in good times and in bad, in peace and in war, which we began practicing in the early '80s.

As for Tennessee, the budget response is a problem of constrained optimization. It is not a question of what Tennessee should do in some theoretical sense but rather what the budget should look like given the sharp and now extended recession as well as how the state should respond to the ARRA funding out of Washington. There seems to be bipartisan support for the Bredesen administration plan to use the money to mitigate the impact of the recession, to prevent drastic cuts at the state level, and to adjust spending over the next two fiscal years. There will be no initiatives, like universal pre-K education, that require a substantial and permanent commitment of funds. Neither will there be any tax increase. ■

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