JOINT ECONOMIC COMMITTEE

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DON'T SPEND TO EXCESS IN THE NAME OF KEYNESIANISM

Introduction. Prominent economists and policymakers invoke Keynesian economics in support of proposals for dramatic federal spending increases of $800 billion or more by the next administration to stimulate the economy. The federal government is intervening in the private sector on a large scale already to combat the economic crisis. Is Keynesianism, which had been discredited in the 1970s, truly the answer to our economic ills? Upon examination, federal policy to date has not fully embraced Keynesianism, which does not offer assurance of lasting prosperity and indeed may pose grave risks to it.

Keynesian fiscal policy. Keynesian theory treats economic output and capacity as one-dimensional, that is, it abstracts from the composition of output and the methods of production. When a gap develops between output and notional capacity, the theory postulates a need and an opportunity for government to close it. By claiming idle resources through direct intervention and putting them to use, government forces an increase in output and, in theory, raises people's incomes as well as their expectations for the future. In this way, consumers and investors supposedly become more willing and able to make purchases and invest. Such a policy could work if there were only one set of products to produce by only one method and it made no difference who produced them. Implicit in the theory is that there is no efficiency difference between government and privately managed production and investment. The size of the government sector is not thought to matter, because private and government funding are presumed to be fully interchangeable.

The problem with this view is that the definition of productive capacity relates to the past, not to what needs to be produced or how it should be produced in the future. Reductions in output—recessions—occur because too much has been produced too fast or the wrong things have been produced, which may occur either due to errors or unforeseen circumstances. A market economy will stop producing products that go unsold or that are too costly; it will reallocate resources and employ them in new ways. During the adjustment process, output will be less than nominal capacity and income may decline. If the government intervenes to support continued generation of unwanted output, it keeps the economy on the wrong path and hinders its progress toward a new production frontier. An economy set in its ways, producing a suboptimal output mix by outdated methods will suffer declining productivity. This is what caused consternation in the 1970s when productivity slumped and stimulative tools failed to generate growth, instead only pushing up prices—an outcome called "stagflation." The experience prompted departure from Keynesian policy prescriptions in the U.S. During the 1990s, Japan also failed to restore sustained growth with a series of Keynesian stimulus packages.

Resources released from unproductive endeavors may appear to be costless but they are not. Retraining and/or relocating laid off workers positions them for renewed productive employment but preserving their old jobs or placing them in public works projects may not. The government has to tax, borrow, or print money to pay these people, and unless the value they create exceeds the income the government redistributes to them, their net contribution to the economy is zero or negative. In addition, there is a danger of large-scale misallocation of federal funds to special interests for profit or social objectives lacking public support under the guise of helping the economy recover. Invoking the Keynesian theory of job creation and income maintenance could become part of the mantra of every interest group and state government seeking to support a project with federal dollars.

Expectations of the work force and investors are not shaped by full employment forecasts alone but by opportunities for advancement and attractive returns. A growing government sector increasingly denies the private sector recuperative power and portends a future economy less responsive to changes in demand, less flexible to external shocks (such as terror attacks or oil price spikes), and slower to adopt new technologies. These prospects do not encourage consumption and investment. In reality, private and government funded enterprises are *not* interchangeable.

History misinterpreted. The industrial expansion required to conduct World War II is credited with pulling the U.S. out of the Great Depression, but in that case (a) government spending had a clear focus and a successful outcome—victory, and (b) had to overcome profoundly counterproductive monetary and banking policies as well as untimely tax and tariff hikes. The private economy had not been recovering pre-war on its own or under the "New Deal," because it lacked monetary and financial infrastructure support. The idea that we now have to match World War II spending proportions in order to overcome a presumed recurrence of market lethargy is using a false premise. Moreover, the government could not then and cannot now assure prosperity with impulsive spending. Increased federal spending likely would raise GDP for a time, but it also may delay completion of the market clearing process (working off surpluses) and corrections to the market's functioning, developments that are necessary for private investment to return in force.

Government's role. The government has a macroeconomic role by virtue of financing its own activities and its control over money and banking. Tax, interest rate, and banking policies can either compound or mitigate an economic downturn. Temporary tax and interest rate reductions will slow declines in income and the government's power to act as lender of last resort can keep credit flowing, especially to economic sectors that are healthy.

Federal stimulus so far. Earlier this year, tax rebate checks were issued that essentially offset the negative income effect of an enormous oil price spike (though that was not the initial intent). Government refrained from market intervention, allowing citizens to decide how to use the money. As a result, overall consumption did not decline, but people started driving less and turned to more fuel efficient vehicles—responses that will prompt structural adaptation to changed circumstances. Lowering marginal tax rates to increase incentives for work and investment would be still more effective in facilitating new productive output generation.

When a large part of the financial structure failed last summer, the Federal Reserve and the Treasury intervened to save several financial institutions from setting off a system wide chain of defaults. The financial system is like the electrical grid, if it goes down it takes everything else with it. The financial system is in need of repair but meanwhile hinders all parts of the economy, including those that are sound. The Federal Reserve and the Treasury have been providing capital to keep the "grid" functioning but have largely refrained from deciding how the capital is deployed, leaving that to the market. These actions differ fundamentally from Keynesianism, under which the government allocates spending.

Conclusion. The Great Depression is on everyone's mind. It feeds the fear that the economy may not pull out of the current crisis on its own. Keynesianism suggests that tax and monetary measures alone are insufficient to mobilize the economy and promises that federal spending on a large enough scale can induce the economy to grow again. Keynesians argue that World War II spending ended the Great Depression. Even accepting that premise, federal spending now merely to preserve jobs or for programs that lack sufficient public support on their own merits does not equate to winning World War II. The experience with Keynesian policies since the War suggests they may foster inefficiency, inflation, and *discourage* private investment. Congress should regard plans to push capital into politically determined channels of the economy with great trepidation. Contrary to Keynesian arguments, government cannot force the economy into sustained growth on its own terms.