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The Keynesian Path to Fiscal Irresponsibility

The basic idea behind Keynesian policy for achieving stable economic growth is straightforward, and superficially plausible. When the economy is in a downturn with underutilized resources, Keynesians believe the federal government should increase aggregate demand by increasing deficit spending through some combination of more spending and lower taxes. With the aid of a multiplier effect augmenting the government's increase in aggregate demand, the economy will move back toward full employment. In contrast, they believe that when aggregate demand exceeds the productive capacity of the economy, the federal government can prevent inflationary overheating by reducing demand with a budget surplus generated by some combination of less spending and higher taxes. The resulting decrease in government demand will be augmented by a reverse multiplier effect, which will reduce inflationary pressures by bringing aggregate demand back in line with the economy's productive capacity. As discussed by Keynes and his early followers, there was nothing fiscally irresponsible about such a policy. While the budget would not be balanced on a yearly basis, it would be balanced over time as budget deficits intended to moderate recessions would be offset by budget surpluses used to restrain economic exuberance.

Of course there are problems with Keynesian policy that have to do with the difficulty of forecasting economic trends and making timely fiscal adjustments. These are problems that are widely recognized as troublesome. They are not my concern, however, since I shall argue that even if Keynesian remedies could be implemented in a timely manner, there are other serious problems undermining Keynesian hopes for moderating the decline, duration, and frequency of economic downturns. The first problem is that Keynesian prescriptions are filtered through a political process being driven by many competing agendas, of which balanced economic growth is only one. The second problem is that both Keynesian economics and the political process are almost entirely focused on short-run demand-side concerns while largely ignoring the long-run importance of economic productivity. The result is a political dynamic that has increasingly turned Keynesian economics into a prescription for fiscal irresponsibility that undermines economic growth without promoting economic stability.

Fiscal History before the Great Depression

From 1792 until 1930 the federal budget averaged 3.2 percent of gross domestic product. Peacetime spending (excluding the Civil War and World War I) averaged 2.7 percent of GDP. Over that 139-year period, the federal budget was roughly in balance, with federal deficits occurring in only 38 years. Those deficits occurred almost entirely because of spending increases during wartime or reduced revenues during economic downturns. The prevailing view was that such downturns would correct themselves through market adjustments, with increased government spending being neither necessary nor desirable. . . .

An important lesson from this experience, indeed from the entire U.S. experience until the early 1930s, is that while market economies suffer from occasional recessions, they recover and continue growing without the need of increased government spending and budget deficits called for by Keynesian prescriptions.

The fact that market economies self-correct from economic downturns without fiscal stimulus does not imply that federal spending was unimportant to U.S. economic success during the nation's first 140-plus years. The federal budget was spent primarily on such activities as providing national defense, infrastructure, law enforcement, and establishing standards on weights and measures. These activities create an environment that unleashes the power of private enterprise and entrepreneurship to create wealth. But as important as what the federal government did to promote economic success, what it did not do was just as important. It did little to override the decisions of consumers and producers with regulations and spending programs as they pursued their interests in response to market incentives. Government action was limited by the prevailing view that prosperity resulted from people keeping most of their earnings because it is their investments and spending choices that do the most to create productive jobs and general prosperity. The idea that the federal government

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could promote prosperity by spending more of the nation's wealth would have been widely dismissed as foolish.

Fiscal History in the Modern Era

A clear divide in U.S. fiscal history took place in the early 1930s. The proximate cause of this divide was the Great Depression, but it can be traced to a shift in the prevailing political ideology that began in the late 1800s with the populist and progressive movements. Those movements were rooted in a growing belief that market economies required the detailed guidance of the federal government. Beginning as a minority view, it became increasingly accepted that only through government regulation of economic decisions and the stimulus of more federal spending and transfers could economic growth be maintained and economic output be distributed fairly. By the 1930s this belief was sufficiently widespread to give political traction to the idea that more government spending (particularly deficit spending) and control over the economy could reverse the economic downturn that became the Great Depression. This view was given intellectual impetus with the 1936 publication of *The General Theory of Employment, Interest and Money* by John Maynard Keynes, which provided an argument for the use of fiscal policy by central governments to smooth out business cycles. The result was that federal spending expanded and its composition changed.

With the ideological shift, supported by the intellectual acceptance of Keynes's *General Theory*, politicians found themselves with an excuse to do what most had always wanted to do—take more money from the general public and transfer it to favored groups (or voting blocs). The benefits are invariably less than the costs, but they are visible, readily appreciated, and easily credited to politicians. Predictably, beginning in the 1930s federal spending began increasing as a share of GDP. It was about 4 percent of GDP in 1930, increased during the Great Depression and spiked to a historical high of about 47 percent during World War II. The federal government share of GDP then dropped to about 13 percent in 1948, reached a bumpy plateau in the early 1960s at slightly below to slightly above 20 percent that lasted for over 40 years, and then escalated rapidly in late 2008 to an estimated 25 percent in 2011.

It is not just the growth of total federal spending, however, that deserves attention. As the federal spending has grown, its composition experienced a fundamental change. Except for World War II, the bulk of the growth in federal spending has gone to funding transfers from those who earn it to those with the political influence to take it. Currently almost 45 percent of federal spending consists of transfer payments paid out by the big three transfer program—Social Security, Medicare, and Medicaid.

The growth in transfers seen in the post-WWII era would have been unimaginable in earlier times. It was obviously facilitated by the ideological shift begun in the Progressive Era and found expression in Keynesianism—namely, the idea that a government wise enough to manage the macroeconomy could also be trusted to promote both economic fairness and efficiency by taking from some and giving to "deserving" others. Once such transfers began growing, a reinforcing dynamic kicked in. As more groups were favored with transfers, the more other groups felt they deserved their share of the booty, and the less fair it seemed to deny them.

Chronic Peacetime Deficits

Keynes, and his early disciples, almost certainly did not imagine the chronic peacetime deficits experienced since 1960. The original Keynesian prescription called for offsetting the budget deficits during recessions with budget surpluses during economic booms, with the budget remaining at least roughly in balance over time. But given the political incentives, chronic and increasing budget deficits are inherent in the interaction between Keynesian economics and political incentives.

Political incentives, along with greater public acceptance of activist government, can explain the move to chronic deficits. But chronic deficits mean that when an economic contraction occurs it is highly likely to occur when the federal budget is already in deficit. Couple this with the Keynesian view that it is an increase in deficit spending—not the level—that is needed to stimulate economic activity. As expressed by Jared Bernstein, former economic advisor to Vice President Joe Biden, "To keep your foot where it is on the accelerator—even if it is pretty far down—doesn't add speed (or growth). To go (grow) faster, you've got to press down harder." This creates a dynamic that almost guarantees increasing deficits.

So without resistance to Keynes's orthodoxy (and there has always been scholarly resistance and some political resistance as well), the tendency is for budget deficits to become both chronic and to increase as a percentage of national income. Ultimately this does little, if anything, to reduce the likelihood of the next downturn. And, as shall be seen, when government spending and deficits increase, given their current levels, they destroy wealth by reducing the productive capacity of the economy below what it would otherwise be. So even if increasing deficit spending did impart a short-run stimulus effect, its long-run effect would still be negative since it is impossible to increase economic production beyond an economy's productive capacity. Unfortunately, this long-run cost has little effect when fiscal decisions are made in response to short-run political considerations.

Even the most enthusiastic Keynesians, if they value their reputations as economists, acknowledge that government spending and deficits can become large enough to reduce economic growth and the long-run prosperity of a nation. But even when they see the importance of restoring some semblance of fiscal responsibility, they argue that we should wait until larger deficits stimulate economic growth. For example, according to Krugman, "It's politically fashionable to rant against government spending and demand fiscal responsibility. But right now, increased government spending is just what the doctor ordered, and concerns about the budget deficit should be put on hold." This short-run view is not new.

Short-Run Politics vs. Long-Run Productivity

. . . The decline in fiscal discipline encouraged by Keynesian policy has led to expansions in federal spending that undermines the ability of Keynesian spending to stimulate even short-run economic growth. When the economy is in a recession, government spending motivated and directed primarily by short-run political concerns invariably slows up the adjustments necessary for economic recovery. Simple political calculus motivates undermining the self-correcting adjustments inherent in free markets by protecting favored groups against market discipline and distorting the information provided by market prices. For example, the recent Great Recession was largely precipitated by the government policies that motivated the excessive building of houses. Given this malinvestment, one important adjustment needed to make the best use of the existing stock of housing and redirect resources into employments more productive than adding to the housing stock is for housing prices to drop. This, of course, is a market adjustment that needed no help from government attempts to influence housing prices. And, of course, housing prices did fall. But they would have fallen faster except for the fact that the federal government spent a great deal of taxpayer money to prop them up.

The expansion in federal spending since 1930 has been accompanied by an increase in transfers as a percentage of the federal budget and of national income. Unfortunately, government transfers and spending in general damage long-run growth in several ways. First, it has been estimated by Payne that raising another dollar in taxes costs $0.65 in lost output. Second, transfers are commonly used to finance wasteful activities such as growing cotton in the desert, turning corn into ethanol, and producing so-called green energy in politically favored companies that manage to fail despite massive subsidies. Third, government transfers create opportunities for some to capture the wealth of others, which motivates political rent-seeking that replaces otherwise productive activities, not to mention the costly efforts people make to protect their wealth from political capture. Fourth, federal transfers, and the myriad regulations that invariably accompany them, commonly provide protection against market competition, and by doing so deflect, delay, or distort the investments needed to maintain, much less increase, economic productivity. In the final analysis, when a dollar is taken from Peter so it can be transferred to Paul, Peter ends up losing more than a dollar, Paul receives less than a dollar, and the economy's capacity to create more wealth is diminished. . . .

What about the Multiplier Effect?

The demand-side perspective of Keynesian economies makes it easy to overlook the importance of productivity to economic growth. This is vividly seen in the Keynesian belief that deficit spending by government to hire the unemployed is good for the economy even when they are hired to do unproductive tasks. This belief is based on the argument that the money paid to those being hired is all additional income for the economy since it didn't require reducing the income of others with a tax. Some portion of this additional income is then spent to provide a secondary increase in income to others, which continues to produce a sequence of additional income and spending which supposedly expands the economy by some multiple of the original government expenditure. This multiplier effect was famously used by Keynes to argue that using savings to hire the unemployed "to dig holes in the ground" is better than not increasing spending.

While the idea of a multiplier effect seems superficially plausible to many, it does not receive support from the historical record. If the multiplier effect were operative, the United States economy since the end of the Great Recession in 2009 would have been growing far faster than it did for over the quarter of a century after 1865 when the federal government was spending only around 3 percent of the GDP, and running budget surpluses every year except for three years when the budget was balanced. . . .

Conclusion

Keynesians commonly talk as if they seriously believe that a depressed economy can be trapped in a high-unemployment equilibrium and that stimulus from government spending—preferably deficit spending—is the only hope for returning to full employment. A casual look at the historical record is enough to dismiss that view. The self-correcting adjustments motivated by the combination of harsh realities imposed by market discipline and profitable opportunities revealed by market prices are not only enough to restore growth to a depressed economy, but the most effective way to do so. Keynesians have persistently ignored self-correcting market forces and the depressing effect on long-run economic productivity of escalating government spending and budget deficits caused by the interaction between Keynesian policies and political incentives. The result is that Keynesian attempts to increase economic growth by moderating economic downturns are counterproductive—they do little to stimulate economic activity in the short run while they reduce the growth of economic productivity in the long run.

Some will see the argument that Keynesian spending fails to stimulate economic recovery and harms long-run growth as pessimistic. I disagree. There is nothing pessimistic in recognizing that doing the most to promote long-run economic growth while moderating economic fluctuations is hardly likely to be achieved by unleashing politicians from the constraints required for fiscal responsibility. The political implications of my argument can be seen as pessimistic, however, since it implies that the failure of Keynesian attempts to stimulate the economy generate a temporal pattern of concentrated benefits and diffused costs that yield social benefit-cost ratios of less than one but political benefit-cost ratios of greater than one. Keynesian economics is another example of bad economics making for good politics.

Indeed, my argument is more pessimistic than indicated by the political popularity of Keynesian economics as an excuse for fiscal irresponsibility. Keynesian policies can trap politicians into continuing excessive spending and chronic budget deficits even though they realize that doing so does little to stimulate the economy in the short run and harms economic growth in the long run. The problem is that reducing government spending and deficits may cause decreased economic activity and increased unemployment in the short run. People will have made decisions in response to existing levels of government spending rendering them and their investments dependent on that spending. These workers and resources will be redeployed in response to market incentives into more productive employments if government budgets were reduced, but the transition would take a length of time that is politically unacceptable, even though the temporary loss would be small compared to the long-run gain.

Keynesian policies can also trap politicians into continuing those policies by creating support for the Keynesian claim that a depressed market economy cannot return to full employment on its own. As argued above, our market economy still maintains a great deal of self-correcting resiliency in recovering from downturns despite Keynesian views to the contrary. But the spending and budget deficits that are inherent in Keynesian efforts to direct economic growth are inevitably accompanied by a host of government rules, regulations, mandates, and subsidies that are undermining self-correcting market forces. The weaker these forces become, the less politically attractive relying on them will become relative to another round of spending increases funded by yet larger budget deficits as the best response to the next recession. The unfortunate dynamic here is obvious.

But the situation is not hopeless. Even politicians can learn from experience and, more critically, the prevailing political philosophy can shift back toward the healthy skepticism toward government activism that existed for the first 140-plus years of U.S. history, which will significantly alter political incentives. In the meantime, examining the implications for long-run productivity of implementing Keynesian policies in response to short-run political incentives can hardly do any harm.

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