John Maynard Keynes Died Long Ago, Let Him Rest in Peace Once and for All

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The late revered British economist John Maynard Keynes, whose 1936 treatise *on the General Theory of Employment, Interest and Money* changed the way many economists think about recessions, once quipped that "in the long run we're all dead."[1] Well, maybe so, . . . for everyone else but Lord Keynes.

Keynes developed a brand of economics – appropriately dubbed Keynesian economics – that simply won't die, possibly, perhaps because it is so facile and useful to the political elite who constantly troll for ways to save the world from boom-and-bust-business cycles and to radically expand the federal government's role in the economy. Keynes' ghost literally has haunted the halls of the Bush II and Obama administrations where various "stimulus" packages have been concocted.

The Keynesian arguments undergirding the stimulus fiscal political froth over the past three years are remarkable facile, and remarkably unrecognized in the media for their one-sidedness. The basic stimulus argument goes something like this: if the federal government goes into deficit spending when a recession is in progress (and threatens to become a calamitous depression), the added government expenditures (unaccompanied by tax increases) will boost "aggregate demand." The greater federal spending on, for instance, a road will result in jobs for construction workers who can be expected to spend a portion, if not all, of their additional incomes on, say, bread. With their added bread sales, bakers will relay the expenditures, leading

to, say, higher car sales. The automobile workers can be expected to increase their purchases on a variety of goods, and so on and so forth.

National income – the aggregate of the income gains from the sequence of sales stimulated by the initial government road project – can grow by some multiple of the initial government spending. What is remarkable about the Keynesian fiscal story is that the initial government expenditure can be totally wasted on, for example, bridges to nowhere. The multiplier magic will still work (in the same illusory way), a point to which we will return. Even Keynes dared to advocate the waste of government spending, by burying dollars in bottles, to doing nothing. Entrepreneurs could be counted on set work digging up the buried dollars, which would give rise to the "multiplier" process, or an increase in national income that is some multiple of the expenditures on both burying of the bottles and the uncovering of them.[2]

A stimulus package (and budget deficit) of, say, $1 trillion will morph in short order, stimulus backers have assured us, into a minimum $1.5 trillion addition national income – maybe even into $4 trillion or $10 trillion in additional income (pick your multiplier, because no one in Washington really knows what it is and various econometric studies have deduced different multipliers). Besides, if the so-dubbed Great Recession is "unprecedented," as many commentators claim, then estimates of the multiplier based on historical data are hardly useful in predicting the effects of current stimulus expenditures.

Regardless, so long as the multiplier is greater than 1, Keynesianism offers the proverbial free lunch several times over, with the prospect of the increase in aggregate income giving rise over time to an increase in federal tax revenues that could, potentially, retire the accumulated national debt. Fantastic, wouldn't you say?

But if it sounds too good to be true, it is. If such income growth were possible, the country and the world would now be awash in prosperity, given that the federal government ran a deficit in fiscal 2009 of $1.7 trillion with similar deficit this year. The federal government also expects close-to trillion-dollar deficits as far as anyone in Washington can see (and few budget watchers are confident that the actual budget deficits will exceed their currently projected levels). If the Keynesian multiplier worked as advertised, why not route and an even larger percentage of the country's entire gross domestic product through Washington, D.C., which would surely result in hyper-prosperity, especially in times of high unemployment (or in times when a total collapse of the economy is widely predicted from the housing and financial bubble deflation, as was the case in late 2007 and early 2008)? Of course, many Keynesian enthusiasts have done just that, recommending stimulus packages two and three times what the Bush and Obama administration have sought over the last three years ago, with done with little to no recognition of the fact that an escalation in the size of the deficit can, at least beyond some point, curb any multiplier effect (if there were the prospects of a positive one) as the budget deficit rises and crowds out expenditures in private sectors of the economy and as the multiplier effect works its magic within the constraint of declining employment as the recovery increases its pace.[3]

Moreover, if Keynesian economics could deliver what our political leaders have promised, and people everywhere truly believed the promises of eminent prosperity from fiscal stimulus, there really would be no need for the actual implementation of sizable stimulus packages. All the government would have to do is to make a credible commitment to follow aggressively Keynesian stimulus prescriptions (if needed). Consumers and investors would go on a spending spree, putting all the empty office buildings and plants to work, in anticipation of hyper-prosperity in the near term (before we are all dead, which defined Keynes' time horizon).

The increase in aggregate demand from consumers and investors would obviate the need for massive stimulus spending (other than a few dollars committed to convince consumers and investors that the government meant business). A stimulus-induced prosperity would be a self-realizing expectation; prosperity could be fabricated out of the pretense of Keynesian stimulus policies.

The reality is that Keynesian economics, as advertised by its advocates, is the kind of political snare and delusion that should be expected from the ruling class who seriously believe that the survival of the American way of life depends crucially on them, and not on supposedly failed flawed and failed financial and other markets. Indeed, it is unlikely that even the advocate of aggressive stimulus action are not as confident in their predictions as they exude.

In the 1960s, Keynesianism was followed as fiscal religion, and economists way back then found, by the 1970s, it to be a snare and delusion for a simple reason: the political version of Keynesianism is a one-sided theory, with almost total emphasis on what the federal government spends and virtually no attention to the potential private-sector offsets to the greater deficit spending by government and with no attention to how current fiscal policies could have negative long-run real income effects that can feed the current generations expectations of an impaired economic future for the country and world, which can, in turn, affect people's current spending and investing plans in the country and around the world.

The late great economist Milton Friedman frequently peppered Keynesian enthusiasts in the 1960s and 1970s with a remarkably simple question that needs to be remembered today: where does the government get the money it spends on roads (or bridges to nowhere)? Friedman followed with an equally revealing observation: when the government engages in deficit spending (and the Federal reserve doesn't monetize the debt, which is at the heart of

stimulus theory), it must borrow the extra funds from someone or some firm who could have spent the funds on private-sector projects. An increase in government spending could be totally offset by a decrease in – or a partial, if not total, "crowding out" of -- private spending, and even state and local government spending, as lendable funds are diverted from private to public uses, with no net increase in aggregate demand – and no net multiplier effect. Indeed, with inevitable waste in government spending projects, the multiplier effect could as easily be negative as positive.

Okay, the Congress can't wave its magic fiscal wand to transform its spending authorizations in to actual expenditures – stimulus. It takes time for contracts to be negotiated and for even "shovel-ready" projects to get underway, which is to say there will be a necessary lag before the stimulus can be felt, no matter how large the stimulus budget is, and the best estimates are that no more than $300 billion of nearly $900 billion 2008 stimulus bill was spent in 2009.[4] This means that the multiplier effect will necessarily be weaker and longer in coming than the Keynesian enthusiasts promise in the heat of political debates.

Also, in a down economy, some of the funds the government borrows to cover whatever stimulus expenditures made could have remained idle, which can mean that the increased in government spending is not totally offset. But Friedman still has a point: the multiplier effect of greater government spending will be muted at least somewhat and maybe in large measure. Few commentators who tout the glories of stimulus packages and report the difficulty that small and large businesses and consumers have in finding credit, never seem to make the connection, which is that government borrowing can dry up credit available for nongovernmental purposes. Why should banks loan their available funds to people for risky private projects when they can loan their funds at little risk to the government that has the 300-million-plus American taxpayers

in tow to cover the debt with future taxes? And credit will get ever tighter and more expensive, as already apparent in news reports, as the recovery progresses and the federal (and state government) do not pull back on their deficit spending.[5]

Keynesian policy advocates rightfully assume that if the government hikes its taxes along with expenditures, the stimulus effects of the added government spending will be seriously muted, maybe negated by consumers and investors curbing their expenditures to pay the higher taxes. The problem is that American taxpayers aren't the total fools the Keynesian advocates would like to think they are when they consider deficit spending. With the potential of a doubling of the national debt over the next ten years, many not-so-stupid Americans can anticipate that the fiscal piper will have to be paid someday in the future – with higher tax rates on future incomes. The anticipation today of those higher future tax rates can dampen private demand today, as people set aside savings for future higher tax payments and as they refrain from making all the investments today that can translate into higher future incomes – that will be taxed at higher future rates. In short, the anticipated future tax rates will lead to a curb in current private spending that will be another offset to today's stimulus expenditures. And don't forget, the Obama administration has on several occasions already indicated his support for taxing the "rich," while protecting his favored income class, the middle-class,

Then, you have the threat of future inflation from today's fiscal profligacy, with the anticipated higher inflation rate being seen as a wealth tax. If the government has little debt, it gains little by hiking the inflation rate to lower the *real* value of its debt. However, when the debt grows to enormous levels, as already planned, the government's temptation to inflate away its debt – and the wealth of bond holders – grows concomitantly.

For example, when the debt is $1 trillion, a 1 percent higher inflation rate, reduces the real value of the debt by a "mere" $10 billion a year. When the debt is $20 trillion (as it is expected to be by 2020), a 1 percent higher inflation rate trims the real value of the debt (and bondholders' wealth) by $200 billion annually, an added disguised tax burden on the debt-holding public that can be rightfully anticipated currently. This means that a mounting debt can dampen demand for government bonds and increase the interest rate government will have to pay, with the escalating future government interest payments "starving" a host of non-stimulus government programs, which can be interpreted as another offset to today's stimulus spending. Moreover, private lenders can curb their lending to the private sector, which can be another offset to the stimulus expenditures.

Of course, if debt holders begin to worry that the real value of their debt will depreciate with any future orchestrated government inflationary policy, all those foreign bondholders – most notably, the Chinese and British – can lose confidence in the international value of the dollar, which can cause them to dump their bonds and the acquired dollars on international money markets, which, in turn, can lead to a deterioration in the international value of the dollar and to a reduction in the real incomes of Americans across the board. Such a reduction in real national income can, following Keynesian precepts, cause a contraction in private demand, yet another offset to government stimulus spending.

Even if Keynesianism had validity (in the sense that a stimulus package can have a minor net effect on aggregate demand), we would still have to worry that the politics of the day would pervert the goal of reviving the economy as politicians fall over themselves to pack "stimulus packages" with "pork," designed mainly to stimulate the private economies of their supporters and not the national economy (which it has done[6]). And Congress and the administration does

appear to have become fiscally profligate as its takeover of major sectors of the economy (automobiles and banking) and public expenditures mount with no apparent caps and as new unfunded entitlements (healthcare for all) are piled on top of other massive underfunded entitlements (Social Security, Medicare, and government employee retirement systems).

As James Buchanan and Richard Wagner argued long ago, Keynesian economics provides a grand excuse for politicians to do what they love to do, spend now other people's money without having to incur the current political costs of asking people to cover the expenditures with higher current taxes.[7] Make no mistake about it, Keynesianism has the potential of transforming the United States in the not-too-distant future into a financial basket case much like Greece, Spain, and Ireland are today.[8]

The Keynesian recovery prescription never gets sillier than when advocates claim that the economic merit of the funded government projects is of little consequence. What counts is more spending. That couldn't possibly be true, given Keynesian insistence that private aggregate demand is inextricably tied to aggregate real income. If a bridge to nowhere is built (or bottles of cash are buried), the bridge is obviously of no economic value, which means it adds nothing to national income. Its construction must draw resources, at least some (if not all) of which could have been used to produce something of real value to people. Bridges to nowhere (or government waste in general) can only undermine any potential Keynesian multiplier effect. Such bridges (and government waste in general) necessarily reduce real national income in the short term and, especially in the long term, which must undermine aggregate demand (if Keynesianism is to be believed). If anything, bridges to nowhere must have a negative multiplier effect through the effect of the impairment of long-term income growth over time through the depression of aggregate demand. Of course, Keynes dismissed long-run effect of current fiscal

policies because, from their perspective, in the long run we will all be dead. But Keynes, and his followers have failed to appreciate the extent to which long-run effects of short-run policies can affect people's wealth and income expectations, which can, in turn, undermine their current buying decisions. If people's expected future incomes and wealth holdings are curbed (from what they would otherwise be), then Keynesian-style income and wealth effects can be expected to kick in currently, which have to translate into at least partial offsets to stimulus packages.

Finally, when a national economy gets seriously out of whack as happened over the last decade – with housing prices rising to unsustainable levels because of an unsustainable credit binge, with the rising housing prices fueling the demand for expensive cars and large-screen televisions as homeowners used their houses as ATMs – then the only route to recovery is a painful one, with falling housing prices, lost jobs, and foreclosed homes. Houses, office buildings, and plants must be moved from those who can no longer afford them to those who can afford them and can use them productively, at the lower prices.

So much of what the government has done under the guise of *stimulating* the economy has been directed at retarding the required adjustments – and the recovery! The government has worked hard to prevent housing prices from falling as far as they must by offering tax credits to first-time homebuyers and retarding the pace of home foreclosures. The government's famous "cash-for-clunker" program did little more than cause car buyers to delay their car purchases and keep the prices of new cars from falling (although the program drove up the prices of clunkers as new car buyers bought clunkers to become eligible for the clunker cash). The cash-for-clunker program was clearly a policy clunker in itself.

Then, of course, the federal government has chosen to fight the devastating consequences of the private credit binge of the last decade with a credit binge of its own in the form of deficit

spending (with nearly one out of every two budget dollars financed with debt, or leverage). If the private credit binge gave rise to the moral hazard problem of excessive risk taking in the private sector (by banks, nonbanks, and homeowners, and credit card holders), should anyone not expect the same excessive risk taking in the political sphere when the government heavily leverages its current spending?

Moreover, many of the stimulus dollars have been used to prop up an array of financial institutions and industrial giants (GM) that, by all accounts made a multitude of stupid decisions and took excessive risks because of easy credit and executive bonus-based pay schemes. Moral hazard is at the foundation of the current economic downturn. Has the government not set up a potentially horrific moral hazard problem for the future, as executives at "too large to fail firms" take excessive, highly leverage risks, confident that they will be bailed if they and the country falters again? If so, the future moral hazard problems can feed into people's current expectation of dampened income growth into the future, which can, once again, abate somewhat current private demand as government demand expands.

At best, the government, through Keynesian stimulus policies, may be delaying the day of real reckoning for the American economy.

The array of defects in the simple-minded Keynesian view of stimulus packages can hardly be exhausted here. Suffice it to say that the current languishing state of the national economy over the past year and the current close-to-double-digit unemployment rate speak volumes about how the various stimulus packages of the past two years were grossly oversold. The recovery has been weak, not what would have been expected from the promises of the Keynesian devotees. The sad news is that all the attention to stimulus packages very likely retarded the recovery's pace by impeding the downward adjustments of the prices of houses,

cars, and other goods caught up in an array of subsidy schemes that did nothing more than change the timing of people's purchases.

Nevertheless, a recovery (at this writing) appears underway (I write with some trepidation that the country might go through another dip), albeit more delayed than past recoveries (due in large measure to the fact that the economy had managed to become far more distorted via the housing and financial bubbles than was the case prior to past recessions).[9] Recent retail sales have risen for several months, the GDP in the final quarter of 2009 surprised economic forecasters, industrial production was moving up in the first quarter of 2010, and even housing sales were on the rebound.[10] But, as argued here, everyone should harbor deep skepticism that the current signs of recovery can be traced to the stimulus packages of the last couple of years, especially since the rate at which displaced workers have been finding new jobs has been the most sluggish in all recessions since World War II, partially because of the depreciation of worker while they are unemployed and partially because government policies has gradually increased the long-term costs of firms hiring and firing workers (with the most recent prospective increase in the future cost of labor coming from the recent passage of the healthcare reform bill).[11] Members of the Obama administration would have everyone believe that virtually all jobs created in the U.S. economy can be traced solely to federal policy actions, whereas in fact the administration can hardly take credit for the jobs created by such resurging American firms as Apple, Cisco, and Google who have continued to hire not because they have been direct or indirect beneficiaries of government largest, but because they have created "better mousetraps" (the iPad in Apple's case) that people want to buy and because the recession has afforded them to tap an army of skilled unemployed and employed Americans.[12]

Think the analysis here is pie-in-the-sky theory? Well, Harvard macroeconomist Robert Barro has estimated that the five-year effects of $600 billion in fiscal stimulus over the past two years will come at a cost of $900 billion in reduced private demand, hardly the type of free lunch the country has been promised.[13] The Obama administration has not been shy in its first year of floating a variety of tax hike proposals, supposedly for higher income groups. The Obama people don't seem to realize that higher taxes on the "rich" can affect the many spending, saving, and investment decisions of today's not-so-rich and even a lot of poor people. This is because many not-so-rich and poor people today can see themselves moving up the income ladder over time, only to see reduced rewards for their efforts because of the higher tax burden on the rich.

And the federal budget deficits that are expected do harbor threats of major future tax increases, as a growing list of researchers are finding from careful analysis of the projected deficits. For example, the Congressional Budget Office projects that under current law (which means current federal marginal tax income tax rates are left unchanged, the national debt will rise by more than $11 trillion between 2009 and 2020, doubling the national debt.[14] Researchers at the Tax Policy Center figure, optimistically, that if the annual deficits are reduced to 2 percent of GDP between now and 2020 and if all tax rates are raised proportionately for all income groups, the lowest federal income marginal tax rate would have to rise from 10 to 15 and the highest marginal rate would have to rise from 35 percent to 52 percent. If the deficit was lowered only by raising the top two marginal tax rates, 33 and 35 percent, those top rates would have to go 86 and 91 percent that, of course, might actually worsen the deficits, given that the "rich" would have little incentive to work, save, and invest – and so would today's lower income taxpayers many of whom expect to be much higher income earners in the future.[15]

The main upside that can come from this new Keynesian episode is that the country will learn anew an old lesson: Don't count on the federal government to wave away the country's economic troubles with some refurbished fiscal wand. The wand didn't work in the 1960s and 1970s (aside for contributing to "stagflation" in the 1970s). The wand is a pipedream that should have died with Keynes long ago. We will also relearn the wisdom of Keynes when he wrote, "Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back."[16] How true, how true -- regrettably.

But then, be assured that a recovery will come. The recovery will come, however, not from the stimulus packages, but from the efforts of millions of unemployed and underemployed Americans and underutilized businesses finding new things to do. It will also come as prices realign and as empty homes and businesses are moved, at lower prices, from those who can no longer afford them to people who can afford them and have productive uses for them. Everyone, policy makers and voters alike, need to remember the wise comment of the late Ludwig von Mises who eight decades ago, in the middle of the Great Depression, mused that a recession was the first and necessary stage of a recovery.

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[1]Keynes, John Maynard. 1936. *General Theory of Employment, Interest, and Money*. New York: Macmillan and Cambridge University Press.

[2] In Keynes' words (1936, p. 129):

> If the Treasury were to fill old bottles with banknotes [read dollars], bury them at suitable depths in disused coal mines which are then filled up to the surface with town rubbish, and leave it to private enterprise on well-tried principles of *laissez-faire* to dig the notes up again (the right to do so being obtained, of course by tendering leases of the note- bearing territory [read private enterprise will quickly figure out how to explore for the richest dollar bearing properties and the appropriate price to pay for leases to do the digging and the number of people to hire for the digging] …there need be no more unemployment and, with the help of the repercussions, the real income of the community, and its capital wealth also, would probably become a good deal greater than it actually is. It would, indeed, be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better than nothing.

[3] Princeton University economist Paul Krugman (among many others) insisted in 2009 in one of his *New York Times* columns that the stimulus package should be doubled, over what was then recommended by the Obama administration if the downturn in the economy were to be appropriately countered. Consider his *New York Times Magazine* article, "How Did Economists Get It So Wrong," September 2, 2009, as accessed July 7, 2010 from http://www.nytimes.com/2009/09/06/magazine/06Economic-t.html?_r=1.

[4]Barro (2010).

[5] Schwartz, Nelson D. 2010. Americans face tighter credit. *New York Times*, April 11, A1.

[6]To see an array of posts on the web over varied political pork being embedded in the various stimulus packages, undertake a Google search of "stimulus pork."

[7]Buchanan, James M. and Richard E. Wagner. 1977. *Democracy in Deficit: The Political Legacy of Lord Keynes*. New York: Academic Press.

[8]For a graphical comparison of the Greek government's current financial crisis with the growing potential for a similar crisis in the United States, see Boaz, David. 2010. The Greek model. *Cato@Liberty*, as accessed May 3, 2010 at http://www.cato-at-liberty.org/2010/04/26/the-greek-model/.

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[9]See the charts of comparative changes in GDP and nonfarm payrolls provided in Wessel, David. 2010. The big, bad. . . "Great Recession." *Wall Street Journal*, April 8, A2.

[10]For a sample of reports indicating a recovery was underway in the first quarter of 2010, see Lazo, Alejandro. 2010. Signs of housing rebound are seen. *Los Angeles Times*, April 14, B1; Reddy, Sudeep. 2010. Factory output surged by 0.% last month. *Wall Street Journal*, April 16, A2; and Hilsenrath, Jon. 2010. Bernanke sees little inflation threat. *Wall Street Journal*, April 15, A18.

[11]Sasci, Murat. 2010. Are jobless recoveries the new norm? *Economic Commentary*. Cleveland: Federal Reserve Bank of Cleveland, research Department, March 22 (no. 2010-1), as accessed on April 16, 2010 from http://www.clevelandfed.org/research/commentary/2010/2010-1.pdf.

[12]For a report on the Obama administration taking credit for 2 million jobs created in 2009, see the interview with Christina Romer, Obama's chair of the Council of Economic advisors, as reported by Wolfe, Richard. 2010. Obama's economic council claims creation of nearly 2M job. *USA Today*, January 13, as accessed on April 16, 2010 from http://content.usatoday.com/communities/theoval/post/2010/01/obamas-economic-council-clams-nearly-2-million-jobs/1.

[13] Barro, Robert J. 2010. The Stimulus Evidence One Year On: Over five years, my research shows an extra $600 billion of public spending at the cost of $900 billion in private expenditure. That's a bad deal. *Wall Street Journal, February 23, as accessed on April 6, 2010 from http://online.wsj.com/article/SB10001424052748704751304575079260144504040.html.*

[14] Congressional Budget Office, 2009, *The Budget and Economic Outlook: An Update* (August 2009) , accessed April 19, 2010 from http://www.cbo.gov/ftpdocs/105xx/doc10521/08-25-BudgetUpdate.pdf.

[15]Altshuler, Rosanne, Katherine Lim, and Roberton Williams. Desperately Seeking Revenues. 2010. Washington, D.C.: Tax Policy Center, Urban Institute and Brookings Institute, a paper prepared for presentation at "Train Wreck: A Conference on America's Looming Fiscal Crisis" held at the USC Gould School of Law, Los Angeles, CA on January 15, 2010, as accessed April 19, 2010 from http://www.taxpolicycenter.org/UploadedPDF/412018_seeking_revenue.pdf.

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[16] Keynes, 1936, p. 383.