NATIONAL REVIEW ONLINE

Why We're Not All Keynesians Now

By: Veronique de Rugy – May 2, 2013

As I mentioned earlier this week, Paul Krugman recently declared that Keynesians have won the economic debate. This claim has now been echoed by others – this piece, for instance, by Henry Blodget over at *Business Insider* asserts that "The Economic Argument Is Over — Paul Krugman Has Won."

While I disagree, there is no doubt that Keynesian thinking is appealing to many on both side of the aisle. During the Bush years, for instance, Republicans used Keynesian arguments to make the case for lower taxes (cut taxes so people can spend money and jump start the economy) and to implement a $152 billion stimulus in 2008 composed of tax rebates and similar revenue-side releief. And as Chris Edwards at the Cato Institute noted recently, we "read news stories almost every day which simply assume that government spending is good for the economy. Any defense or nondefense spending restraint will hurt economic growth, it is assumed. Even a recent AEI study seemed to accept this Keynesian concept."

And yet, there are several reasons — good reasons — why, in spite of the wide appeal, not everyone is a Keynesian now.

First, on the question of whether government spending can stimulate the economy, the academic debate is far from over. To get a resolution, economists would have to agree on the size of the spending multiplier, and it would have to be higher than 1 (meaning that government spending actually creates more economic activity than the dollar spent by the government). But they don't agree. No one knows for sure what the impact of government spending will be on the economy. Some economists say the multipler could be as big as 3, others argue that it is below 1, and some even argue that it's negative.

Second, the wide range of estimates exists, in part, because there is a wide range of circumstances in which stimulus might be applied. For instance, economists have found that to get a more potent effect from stimulus, the spending needs to take place during hard times, when, among other things interest rates are low, exchange rates are fixed, debt levels are low, and/or stimulus hasn't been tried already. The United States does have low interest rates (which we shouldn't take for granted over the long run) but, for the most part, many of the conditions required to get a large multiplier aren't there for us. At best, we should be skeptical about the claims of a large multiplier for the U.S. right now. At worst, we should open to the idea that the multiplier is below 1, and that government spending won't stimulate the economy at all.

Third, in theory, for the stimulus money to juice the economy the recipients of government spending also must go spend the money. That doesn't always happen. In fact, there isevidence that during a balance-sheet recession – a recession that results in a large collapse in net wealth, like the one we just went though – the government spends money but the recipicients don't. Why? Because with personal wealth diminished and

private credit constricted, consumers are likely to use their stimulus money to rebuild what was lost, i.e., paying off debts and saving. The same is true for state and local governments who, as we know now, have used their ARRA dollars to reduce their budget gaps rather than to increase infrastructure spending or other government purchases. In other words, a big chunk of the money that was supposed to be spent never actually made it into the economy.

Fourth, the studies that obtain large multipliers do so by assuming that stimulus funds will be distributed just as Keynesian theory says they ought to be. Keynesian economist and former Obama economic adviser Lawrence Summers has offered a widely accepted summary of how fiscal stimulus ideally ought to be applied. In fact, he argues that stimulus “can be counterproductive if it is not timely, targeted, and temporary.” For instance, as we found out this time around, there aren’t many shovel-ready projects, which makes timely spending very hard. Also, the politics of government spending, the nature of public-choice economics, often gets in the way of targeted spending (meaning that the money is using idle resources and putting them back to work). Studies that have looked at whether the stimulus spending was targeted found that the money wasn’t targeted toward high-unemployment states and that a large chunk of the money was used to poach workers from existing jobs rather than hire new workers from the unemployment lines. The assumption that things will be different next time, unfortunately, ignores the wisdom of economists such as James Buchanan. And, of course, spending is also rarely temporary, because as soon as we start talking about cutting back, every possible interest group starts arguing that taking certain money out of the economy will have disastrous consequences (as we have seen during the sequestration debate).

Finally, Keynesianism is a theory of the short run. (the same is true of monetarism). Now, it’s been five years since the original crash, and I am pretty sure that this time period doesn’t qualify as “the short run.” It’s time to think about the long term, and there, Keynesian economics is counter-productive.

The debate between free-market and Keynesian economists is far from over. On that note, Caroline Baum over at *Bloomberg View* has a great piece this morning explaining why the Reinhart-Rogoff kerfuffle and the state of disarray of the European economies don’t allow Keynesians to claim victory. Also, over at *Reason*, Peter Suderman has a great piece on the 2009 stimulus. And it’s always a good idea to read economist Scott Sumner’s blog to understand the monetary-policy aspect of this debate.