The Keynesian Path to Fiscal Irresponsibility

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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

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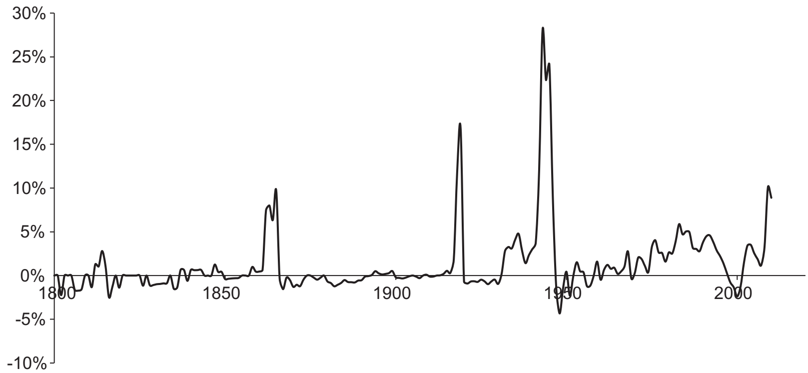
timely fiscal adjustments. These are problems that are widely recognized as troublesome. They are not my concern, however, since I shall argue that even if Keynesian remedies could be implemented in a timely manner, there are other serious problems undermining Keynesian hopes for moderating the decline, 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 (see Figures 1 and 2). The prevailing view was that such downturns would correct themselves through market adjustments, with increased government spending being neither necessary nor desirable.

That view is certainly supported by economic performance during most of U.S. history. Representative of this performance was the impressive economic growth with low unemployment and increasing real wages in the post–Civil War period, during which the federal budget was either in surplus or balanced for 27 straight years with a surplus in 24 of those years (see Figure 1). In addition to a short and mild recession that started before the Civil War was over, there were two other economic downturns during the 27 years after the Civil War, the longest one starting in 1873. All three downturns recovered in response to market adjustments, with no attempt to shorten it with increased government spending. Despite (or more likely because of) the lack of any Keynesian stimulus, even the duration of the 1873

FIGURE 1
Deficits as Percentage of GDP



Source: U.S. Census Bureau, *Historical Statistics of the United States.*

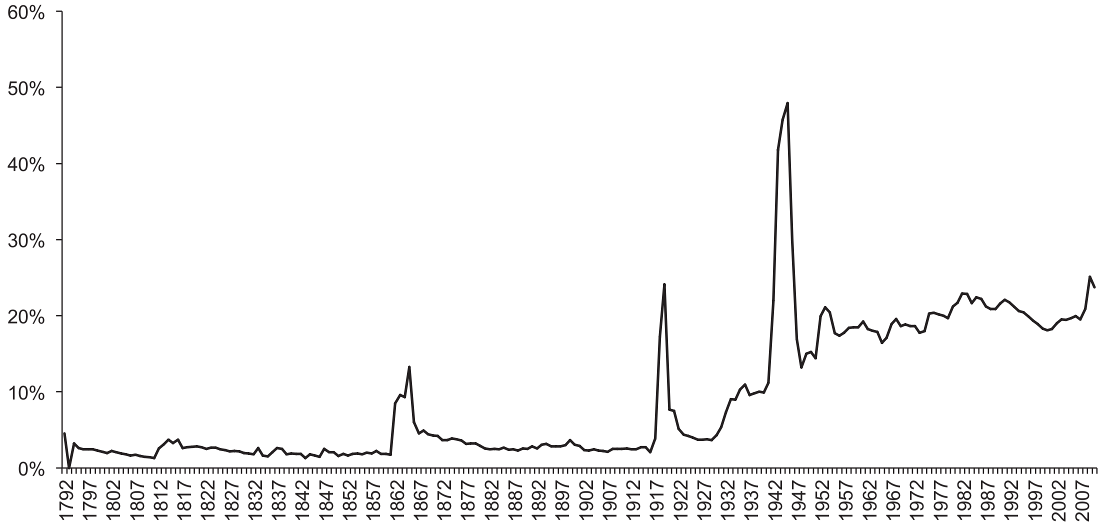
economic decline was far shorter than the Great Depression of the 1930s.[1] Even with falling tax revenue, the federal budget remained in surplus through the 1873 downturn, with the first post–Civil War budget deficit not occurring until the 1893 downturn, with that deficit caused by a decline in federal revenues, not an increase in government spending. The 1893 decline was a serious depression, though economic recovery took far less time in response to market forces than it did during the Great Depression, when the economy was supposedly being stimulated with unprecedented peacetime federal spending and budget deficits as well as a host of government regulations (see Figure 2).

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

[1]The National Bureau of Economic Research claims the 1873 depression lasted slightly over five years, but some economists now doubt it lasted that long. For example, Davis (2006: 106) argues that its duration was around three years.

FIGURE 2
Total Federal Spending as Percentage of GDP



Source: Bureau of Economic Analysis, National Income and Product Accounts.

140-plus years.[2] 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 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.[3] 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.

[2]Our data begin a few years after the ratification of the U.S. Constitution.

[3]For an excellent discussion of this shift in ideology and its consequences, see Higgs (1987), particularly Chapters 6–8.

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.[4]

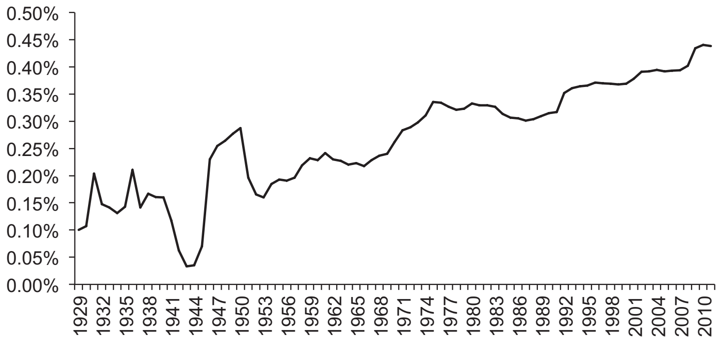
It is not just the growth of total federal spending, however, that deserves attention. As the federal spending has grown, its composition experienced a fundamental change. Except for World War II, the bulk of the growth in federal spending has gone to funding transfers from those who earn it to those 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 (see Figure 3).[5]

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

[4]Federal spending during the 40-year plateau understates the control the federal government had over resources during that time since, despite some notable examples of federal deregulation of a few particular industries, the general regulation of economic activity during that 40-year period clearly increased, as measured by size of the annual issues of the *Federal Register*.

[5]When more inclusively considered, transfers currently make up over 60 percent. It should also be pointed out that much of the income and wealth the federal government transfers does not show up in its budget. For example, it costs very little to enforce federal regulations that protect some industries from competition. Yet these regulations transfer large amounts from consumers and potential competitors to those being protected. Also, federal transfers, no matter how defined, will soon accelerate rapidly as baby-boomers continue to become eligible for Social Security and Medicare.

FIGURE 3
Federal Transfers as Percentage of Budget



Source: Bureau of Economic Analysis, National Income and Product Accounts.

"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.

Compare today's situation with that in 1887 when President Cleveland vetoed legislation that would have transferred $10,000 in federal funds to distribute seed corn to drought-stricken Texas farmers on the grounds that doing so was not a legitimate function of the federal government (see Graff 2002: 85). Today, billions of dollars each year are transferred to areas suffering from natural disasters. It is estimated that almost half of those funds are allocated on the basis of politics rather than any serious assessment of damage (Garrett and Sobel 2003).[6]

The public willingness to assign a greater role to federal government spending also extended to allow increased borrowing. In the 1930s economists began arguing, and teaching their students, that budget deficits were good for the economy. More cautious economists did mention that budget surpluses were also important during economic booms, but it was still widely argued that a

[6]Garrett and Sobel (2003) find that more disasters are declared during election years, with those states important in presidential elections receiving more emergency funding that others. Also, whether an election year or not, those political jurisdictions represented by congressional members on committees overseeing the Federal Emergency Management Agency receive more emergency funding than other jurisdictions.

buildup of federal debt over time, even as a percentage of GDP, did not create the same problem as would a family's escalating debt, since the federal debt is (or at least was) largely owed to ourselves.[7] These arguments were music to the ears of politicians who were much more enthusiastic about spending than taxing. As the political stigma against budget deficits diminished, so did the fiscal responsibility of our political representatives as they increased the use of debt to delay and disguise the cost of their spending programs. The results can be seen from the increase in the number and size of budget deficits since 1950. Politicians were quick to turn to Keynes to justify running deficits when the economy slowed, but they forgot about him, along with his recommendation to moderate economic activity with budget surpluses when economic activity was booming. Letting the good times roll is much more fun than worrying about the bubbles and distortions that invariably result when times become too good for too long.[8]

It is clear from 19th century American economic history that solid economic growth can be achieved with extremely moderate (by today's standards) federal spending and long periods of budget surpluses—a fiscal situation that is considered contractionary by Keynesians. While modest federal spending and budget surpluses were not contractionary in the past, they obviously did not prevent the economy from occasionally stalling. But neither has Keynesian policies. Looking at the period from 1960 to the present when, until very recently, federal spending fluctuated between about 17 and 21 percent of GDP and budget deficits were the rule, eight recessions are observed. Most of those were short, lasting a little less or a little more than a year, but quite sharp in some cases. The Great Recession that began in December 2007 caused the largest drop in economic activity of any downturn since the Great Depression. And although it was officially over in June 2009, the recovery has been slow and halting, with unemployment remaining over 8 percent.[9]

[7]See Buchanan (1999) for a compelling argument against the owe-it-to-ourselves claim that government debt is less costly when the creditors are domestic than when they are foreign.

[8]Buchanan and Wagner (1977) argue that even if Keynes's economic prescriptions were sound economic policy as he presented them, once they were filtered through the democratic political process the results would be economically unfortunate.

[9]Much of the decline in the unemployment rate from the October 2009 high of 10 percent was not the result of more people returning to work but of a declining labor force participation rate.

One interesting feature of the post–World War II recessions is that seven of the eight recessions were preceded by two years of federal budget deficits, with those deficits exhibiting a moderate upward trend as a percent of GDP (see Figure 1). And in every case budget deficits were run during part of the recession. One can argue that these federal budget deficits reduced the intensity of the recessions and shortened their durations. Indeed, before the last recession the period after 1981 was sometimes referred to as the Great Moderation, with some claiming that economists had learned how to keep recessions shallow and short by fine-tuning economic activity with fiscal policy. That claim suffered a quick and embarrassing death as the Great Moderation has been replaced with the Great Recession. But Keynesian budget deficits have not fallen out of political fashion despite the fact that the truly impressive federal deficits that have been thrown at the Great Recession since 2009 to stimulate economic growth have been accompanied by unimpressive results.

The historical connection between economic downturns and deficit spending provides little support for the claim that the federal spending is stimulating economic activity. Consider the fact that peacetime budget deficits have become roughly as common since the 1950s as peacetime surpluses were during the 19th century and the early years of the 20th century. Until the end of World War II, the longest run of peacetime deficits in American history occurred during the Great Depression, which persisted throughout the 1930s despite those deficits.[10] Deficits remained fairly common from the end of World War II through 1960, with five during the

[10]Deficit spending during World War II is commonly credited with finally bringing the economy out of the Great Depression. Unemployment was dramatically reduced as almost 10 million men were drafted into military duty from 1940 to 1945 and millions of men and women were hired to produce war material. But Higgs (1992) has shown that the value of personal consumption was at best stagnant during the war, and may have been lower than before the war began. Also, Keynesian economists widely predicted that a large decline in federal spending after the war, with millions of soldiers returning home and armament industries laying off workers, would result in a return to high unemployment and depression (Nasar 2011: 385–86). Yet from 1945 through 1947, federal spending declined over 60 percent *without a recession*. Indeed, *private* GDP increased 29.5 percent in 1946 and, despite the common explanation, this increase cannot be explained by the large personal savings that accumulated during World War II since there was no reduction of private holding of liquid assets after the war (Higgs 1999: 603, 607). There was a short recession from December 1948 to November 1949, but this occurred during a year in which the federal budget was in deficit.

11 years beginning at the start of 1947 through the end of 1960 (removing the three years during the Korean War). After 1960, however, federal deficits became chronic with deficits occurring in all but five years since then. The tendency has also been for federal budget deficits to increase since 1960. Although these deficit increases as a percentage of GDP have been persistent, they did not increase explosively until 2009 when the deficit went from 3.2 percent of GDP in 2008 to 10.08 percent. Some of this increase was due to the financial crisis and Troubled Asset Relief Program spending. But even after the end of TARP and the official end of the Great Recession, deficits have remained at about 9 percent of GDP.

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."[11] 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.

[11]Quoted in *Investor's Business Daily* (2011: A12).

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.[12] 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 (2008), "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

Economic shortsightedness is inherent in Keynesian economics and is reflected in many of Keynes comments as *The General Theory* was being written and in the book itself. For example, in a 1933 letter, Keynes encouraged president-elect Franklin D. Roosevelt not to let long-term concerns interfere with running the large budget deficits needed for short-run economic recovery (Nasar 2011: 325). Keynes's short-run perspective is also clear in *The General Theory* with statements such as, "The right remedy for the trade cycle is not to be found in abolishing booms, and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus permanently keeping us in a quasi-boom" (Keynes 1936: 322). This elevated concern with near-term consequences provides an added explanation for the appeal Keynesian economics has to most politicians.

[12]It should be obvious that if more government spending and larger deficits created value (by moderating economic downturns and increasing long-run productivity) in excess of opportunity costs, more spending and larger deficits would improve a country's credit rating instead of reducing it.

Consider the time perspective relevant to Keynesian economics in comparison to that relevant to supply-side economics, which was widely discussed in the 1980s but attracted far more political ridicule than support. The force driving economic growth according to Keynesians is aggregate demand, most of which consists of consumer demand. People can increase their demand quickly in response to government spending that increases their incomes, and the expectation is that this can have a rapid and positive effect on the economy.[13] Supply-side policies are aimed at promoting prosperity by increasing the productive capacity of the economy, and this requires innovation and investments that can, and often do, take years to bear fruit. With elections always approaching and economic downturns creating public demand for urgent action, politicians find demand-side more attractive than supply-side policies.

Also, demand-side policies can be targeted to concentrate immediate benefits on particular interest groups in ways that are easily traced back to the politicians who voted for them. Effective supply-side policies require eliminating tax preferences, broadening the tax base, and significantly reducing programs and regulations that undermine economic productivity. But these policies impose immediate costs on, and are resisted by, politically influential groups. The prosperity created by side-side policies is widely defused and gradual in coming and so is unlikely to be appreciated, or attributed to the political decisions that helped generate it even if it is. No wonder, in both economic busts and booms, politicians tend to favor demand-side policies while promising to make the tough decisions to restore fiscal responsibility in the future.

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

[13]How quickly demand-enhancing spending programs can be enacted and become "shovel ready" is another issue. But political lags exist when enacting and implementing any economic policy.

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 (see Figure 3). Unfortunately, government transfers and spending in general damage long-run growth in several ways. First, it has been estimated by Payne (1991: 186) 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.

It is natural to believe that federal hiring could stimulate economic growth by providing productive employment for underutilized or unemployed workers. This would be true if government jobs created more value than they cost. There are several reasons for doubting this is the case. With the federal government spending over 20 percent of GDP there are unlikely many government jobs left to be created in which additional workers would increase economic productivity much, if any. Even if there are government jobs in which the right people could create more value than their opportunity costs, without reliable market prices and wages guiding political decisions it is unlikely those jobs can be identified and matched up with the right workers by political authorities. But assuming the information is available to place government workers in jobs where they would add to productivity, a serious problem would remain. Political considerations are typically more important than economic productivity when decisions are made on what government jobs to create, whom to hire, and how much to pay those who are hired.

Also, hiring the unemployed is not the same as hiring people who are otherwise unproductive. Spending time looking for a job in which one can make the greatest contribution with his or her skill is a productive activity. Most of the unemployed could get a job quickly if they were willing to take a low enough salary, but it does not make sense to take a job when the cost of continuing to search (including an available salary forgone) is expected to be less than the value of finding a more productive job. And not to be overlooked is that workers typically face greater incentives to be productive in private-sector jobs than in government jobs. Productivity may be reduced by motivating an unemployed worker to terminate her job search to take a high-paying, low-productive government job. Finally, even if the stated goal is to hire unemployed workers, many of those hired, particularly for jobs requiring specialized skills, are already employed, or soon will be.[14]

The negative effect of government spending is not likely reduced if the spending is financed by increasing the budget deficit—by borrowing rather than taxing. Whether government spending is financed by taxing or borrowing, the effect is to transfer productive resources from the private sector into the public sector. This does nothing to affect the productivity-reducing effects of government spending, unless the option to borrow instead of tax allows government to spend even more than if it otherwise would, in which case the loss in productivity is even greater. Maybe some of the $0.65 it cost to raise one dollar through taxation is eliminated by borrowing, but borrowing is simply a way of *postponing taxes* and it motivates people to make costly adjustments today to reduce anticipated

[14]According to Jones and Rothschild (2011), of those hired by organizations receiving stimulus funds from the 2009 American Recovery and Reinvestment Act only 42.1 percent were unemployed.

future tax burdens. Of course, government can eventually default on the debt and interest payments through inflation, but that creates its own inefficiencies.

Keynesians recognize that there are limits to the economy's productive capacity, but they fail to acknowledge that government spending has long ago reached levels that are adversely affecting that capacity. Nor do they see budget deficits as a possible drag on the ability of the economy to grow by giving politicians even more latitude to expand government spending. Indeed, Keynesians see government spending as doing more to stimulate economic output when it is financed through deficits than through taxation.

What about the Multiplier Effect?

The demand-side perspective of Keynesian economics 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 (Keynes 1936: 220).[15]

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.

[15]Of course, Keynes thought it would be even better to put the workers to productive use.

Hope in the effectiveness of the multiplier effect is also confronted with the fact that people do not ignore the future consequence of federal spending. People know that government spending is not a free lunch, even if it is financed by debt. More debt today requires higher future taxes to service interest charges and to repay the principal (see Barro 1974). At best the benefits from deficit spending are *temporary*, and as Milton Friedman (1957) established, people spend less out of temporary income increases than out of permanent increases. Furthermore, increased deficit spending creates uncertainty concerning how and when the debt will be paid back, as well as how the expansion in government spending will impact the profitability of business investments. Also, as federal debt increases, so does the political temptation to partially default on the debt through inflation, and inflation is just another way of taxing productive effort and investment, which further retards economic productivity.

Keynesian economics, in conjunction with political incentives, has created upward pressure on federal spending and budget deficits since the 1930s. The economic reality is that at current levels, federal spending is hampering the economy's productive capacity, which is undermining the ability of that spending to stimulate economic growth by increasing demand. Effective demand is always limited by how much can be produced in response to that demand. Trying to expand the economy with ever increasing reliance on demand-side Keynesian spending faces the same long-run problem as would trying to expand a firm by cannibalizing its productive capital to pay for more advertising.

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.[16] 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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[16]Clark and Lee (2011) offer other reasons for believing that a darkness-before-the-dawn scenario offers hope for a return to fiscal responsibility.

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