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RETHINKING KEYNESIANISM 10 YEARS AFTER THE GLOBAL CRISIS

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For many years Keynesian fiscal policy became very popular and was used by governments to fight slowdowns and recessions. In the 1980s and in the next three decades, this policy lost much appeal among economists in academia, though less among governments. The financial crisis of 2007–2008 and the following Great Recession brought a sudden revival of interest in and use of fiscal policies. This paper outlines the main criticisms that were directed at the Keynesian fiscal policy from the beginning. Some of these criticisms are less-known than others.

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1. INTRODUCTION

Counter-cyclical, stabilization, or Keynesian fiscal policy had its origin, if not necessarily its first application in the decade of the 1930s during the Great Depression. It was a time when in the United States the unemployment rate had reached 25 per cent of the labour force and national output had fallen by 27 per cent, while wholesale prices had plunged and made real interest rates and wages high. The theoretical justification for the use of counter-cyclical fiscal policy was provided by John Maynard Keynes in *The General Theory of Employment, Interest and Money,* published in 1936. In that book, Keynes argued that governments could address recessions and unemployment at a little cost using fiscal deficits.

By the time the book was published, in 1936, some governments, including that of the United States, had already initiated major public works, such as the Hoover Dam in Arizona, in part to provide employment to some of the unemployed workers. This was a kind of primitive employment-creating policy that governments had occasionally used in the past in different countries. These policies were not initiated or influenced by Keynes' book or by the Keynesian theory, including the impact of the Keynesian multiplier. But, in the 1930s, at least some of these primitive policies might have been influenced by the intense activism of Keynes in the media before 1936 (Wapshott 2011).

It has been observed that in 1933, Jacob Viner, "had already pointed to the use of fiscal policy to counter a depression" (Van Overtveldt 2007: 82–83). Ironically, he had done it in the first issue of the *Public Policy Pamphlets*, issued by the University of Chicago in 1933 – i.e. *before* Keynes' *magnum opus* was published. The pamphlet had been signed by 11 economists of Chicago that in addition to Jacob Viner, included Henry Simons, Paul Douglas and other leading economists. The pamphlet reflected Viner's views and suggested that "the federal government should not balance the budget during [the] depression". It added that "[i]tems such as emergency outlays, public debt retirement, and expenditure for investment and public works should not be financed from current taxation" (Overtfeldt, 2007: 83). This kind of "golden rule" applied to fiscal policy was not suggested as a *general* policy to do deal with downturns, but to apply solely to what was considered the *unique* situation that had been created by the Great Depression". The Chicago economists also expressed concern that in the long run "…the credit of the government [could become] seriously impaired" by the deficit financing (Gideonse 1933: 5–6).

Keynes' analysis in 1936 was concerned with both dealing with the on-going deep crisis and with downturns generally. It also showed little concern for interest in the long run implications of the policies that he was advocating. He famously asserted that, "in the long run we are dead". Therefore, we should focus on the short run and ignore the long run. Keynes' theory was based on "aggregates" or on "macro" statistics for whole economies. In this aspect, *The General Theory* departed from the economics that had interested most economists in the past and created a new field of economics that came to be called "macroeconomics" or "income theory". Such a field had not existed before Keynes.

Keynes and his followers claimed that income theory could explain macro developments for whole economies, such as business cycles, economic crises and related changes in the aggregate concepts of consumption, saving and employment. This was a radically novel way of looking at and addressing economic questions. Macroeconomics shifted the attention and the focus of economic analysis from the actions of individuals and enterprises as it had been in traditional price theory or of economic analysis to that of major aggregates.

It also put the government at the centre stage of economic policy. In a climate up to that time, it had been mostly characterized by *laissez faire* thinking, by scepticism about governmental intervention and by a belief by the mainstream economists that in the long run capitalism could solve many social and economic problems. Economists had expected and preferred that governments stayed out of economic decisions and to *laissez faire*, to let the private sector do its thing, except for the creation of genuine public goods, the protection of property rights and persons, and the enforcement of contracts, for which classical economists agreed that the government had a role to play.

The new way or new approach suggested by Keynes has not only placed government at the centre of action but also required the correct measurement and the availability of various economic aggregates (investment, consumption, savings, imports and exports). At that time, good measures of these statistics were still lacking. As a consequence, the Keynesian analysis contributed to the generation of better national accounts statistics. In the years that followed the publication of Keynes' book, the generation of the necessary statistics attracted the attention of some major economists (Kuznets, Meade, Koopmans, and others) and contributed to the development of more reliable national accounts.

2. EARLY CRITICISMS OF THE GENERAL THEORY

Given the dramatic economic conditions that existed during the Great Depression and the difficulties that classical or traditional economists were having in explaining and dealing with it, from the very beginning few economists (besides Keynes' colleagues at the University of Cambridge) were willing to accept the new "miracle drug" that Keynes was offering to deal with the Depression, without closely questioning its theoretical basis. As a consequence, the early and often sharp criticism that *The General Theory* received from several of the major economists of the time (Schumpeter, Hayek, Viner, Robertson, Pigou, Knight, von Mises, and others), had less of the negative impact that it might have had in normal times and it did not kill it. To some economists, it seemed that Keynes had provided a plausible explanation of the Depression and a road map that indicated how it might be possible to get out of it at reasonable costs.

Nevertheless, the style of the book attracted strong criticism even from some of those who would later become Keynes' strongest supporters. For example, the young Paul Samuelson wrote that: "It is a badly written book, poorly organized… arrogant, bad tempered, polemical", and "it abounds with mares' nests and confusion". J. K. Galbraith wrote that: "this volume is deeply obscure", but added the interesting observation that "[p]erhaps had it been otherwise (….) it would not have been so influential" (Wapshott 2011: 146–147). W. Leontief would later make the same observation during his theory classes at Harvard University, when the author of this paper was a student there.

When *The General Theory* was first published, the main criticisms were based on a few important points: The first was whether the "general theory" could truly be called *general* as the book's title claimed, or it dealt with a special, isolated or rare economic phenomenon. The on-going Depression might have been a unique experience, and thus not likely to occur again. For most economists, who had been mainly interested in the long run performance of economies and on the factors that contributed to it, this was seen as a major shortcoming.

The second point, stressed especially by some of the main exponents of the Austrian School, especially by Schumpeter and Hayek, and also by members of the Chicago School, was that Keynes had misunderstood the true nature of the capitalist system. He had not appreciated its vitality, the role that *innovation* played in that system; and also the damaging role caused by interfering with the free and smooth working of the economy. A recession reduces *current* output, but it does not necessarily slow down the process of innovation. Some economists have argued that it may even stimulate it. Other critics saw *The General Theory* as a fundamental and perhaps political attack on the capitalistic system and on the market economy.

The third point, recognized early, especially by Jacob Viner, was that the Keynesian policies suffered from the danger of being difficult to reverse when they were no longer needed. This danger existed especially at a time when labour unions had become powerful and citizens were pushing governments to play larger economic roles. To give weight to this criticism, it could be mentioned that only six years after the publication of *The General Theory*, in 1942, the *Beveridge Report*, a report that recommended the creation of a mature welfare state in the UK, would become a bestseller in the middle of the war. When the war was over, the Report provided the blueprint for the welfare system that the UK would create in the late 1940s (Tanzi 2018a: 41–43). In the later years, the Viner's concern would be given more weight by economists, adherents to the School of Public Choice, established by James Buchanan (Mueller 1989). It would also influence some of the later criticism of Keynes' policies.

The early critics stressed that the strength of capitalism was its dynamic and forward-looking nature. This nature made investment decisions depend on *expectations* about the future, the impact that innovation had on them and on investment, and less on current developments. They stressed that investment decisions did not depend solely on current income, as Keynes assumed. Later, Milton Friedman (1957) argued that consumption does not depend only or mainly on current income, but on *permanent income*. Permanent income depends on expectations about future earnings and consumption depends on access to credit and on accumulated wealth. In today's world, "credit ratings" have become an important factor in many persons' current consumption. *Wealth* is also an important factor in determining consumption, especially for the rich and the retired individuals. Therefore, in the view of these critics, current developments, such as falls in current income (and also in consumption), had less of an impact on *new* investment than Keynes' theory had assumed. Later, economists, such as Lucas, Barro and others would give additional roles and greater importance to expectations.

The economists of the Austrian School and classical economists in general, who at that time were in the majority, blamed economic rigidities imposed by labour unions and by government rules, such as inflexible nominal wages, import restrictions and excessively restrictive monetary policies for interfering with the working of the market, and thus for preventing adjustment. They argued that if nominal wages had been flexible, trade had not been restricted, and monetary policy had been less restrictive, employment and wholesale prices would have been higher, *real* interest rates and wages would have been lower (because of less deflation), and the Depression would have been shorter and less deep.

Economists could have also called for attention and probably some of them did, to the very sharp depression that the United States had experienced from January 1920 to July 1921 and Germany from 1901–1902. The US depression in 1920 had reduced wholesale prices even more sharply than the Great Depression in the 1930s; it had reduced industrial production by one third, while the Dow Jones Industrial Average had fallen by half and had made profits and employment collapse. Unemployment had increased from 1.4 per cent in 1919 to 11.7 per cent in 1921. In that episode, the US administrations then in power, (Presidents Wilson's and Harding's) had kept the public budget in balance, while the Fed had even *raised* nominal interest rates. Yet, that depression had lasted only for 18 months, before the economy recovered. Innovations had made the enterprises resume their investments, looking at the future, in spite of the collapse of *current* incomes. Similarly, in an earlier depression unemployment had increased from 3 per cent in 1892 to 18.4 per cent in 1894, but the economy had recovered soon after. The same had happened with the German depression in 1901–1902 (Ashley 1904, Chapter V). This was an indication that expectations about the future and innovations are, or may be, more important than current income, and also that economies can recover without government fiscal stimulus programs.

Historically, economies have experienced many periodic fluctuations. For the USA, the National Bureau of Economic Research has identified no less than 33 business cycles between December 1854 and the present time. 19 of these cycles occurred *before* the Great Depression and *before* the publication of Keynes' book. While the Great Depression was a deep economic crisis, possibly made longer by misguided economic policies, it was not an isolated case of deep economic downturn (Gordon 1952). The important point to make is that, before Keynes and before the Great Depression, economies had experienced many downturns, some very deep and that they had *always* emerged from them, *on their own*, without the assistance of governments that Keynes had advocated.[1]

Therefore, questions could be raised about why governmental intervention was needed at all, as Keynes argued. Contrary to the past experiences, he seemed to assume that countries in recessions would be stuck in them forever in the absence of fiscal stimuli. Some recent economists, such as Paul Krugman, Larry Summers, Joseph Stiglitz, Oliver Blanchard and others seem to share that belief today. Both the Great Depression and the Great Recession were preceded by sustained periods of distortions, as had other downturns. Those distortions probably contributed to the depth and length of the downturns that followed (for example, financial speculation in the 1920s and a housing and financial boom in the early 21st century).

In spite of the early and sharp criticisms from the leading economists of that time, the Keynesian views survived and the policies suggested by Keynes started to attract followers. Initially, the followers were mainly young economists; later, they came also from some of the earlier mature critics. Alvin Hansen, for example, went from being a sharp initial critic to becoming one of the strongest promoters and advocates of Keynesianism. So did Paul Samuelson.

By the late 1940s and 1950s, the Keynesian ideas had spread widely and the "Keynesian Revolution" had arrived (Klein 1947). The success was in part due to the fact that Keynes had "offered a new [and relatively simple] explanation of the Great Depression, one that many could understand". Furthermore he had "outlined a clear way in which the (….) economy might be rescued from slowdowns by the recommended action of governments" (McCraw 2007: 273).

1 More on this in Makin (2018).

Importantly from an ideological and political point of view, the Keynesian Revolution had removed individuals and enterprises from the centre stage of economic action (as they had been in classical or Marshallian economics) and had replaced them with the action of governments. The government had become the main actor in the Keynesian Revolution and the role of the monetary policy was under-appreciated.

This change led to a different criticism of the new theory. It was that Keynes had developed the theory to match his *a priori* (and, presumably, pro-government) bias, because his theory required a (larger) government role in line with the one he had advocated a decade earlier, in 1926, in his small book, *The End of Laissez Faire*. However, in fairness to Keynes, it ought to be stressed that on social issues as compared with the stabilization objective, Keynes was not a strong social reformer, but was rather conservative. He would not support a large and permanent spending role for the state and a high tax level (Tanzi 2018a: 41–42, 245).

Unlike the laws of physics that if they are correct they can be assumed to have universal and permanent validity, the laws of economics and the economic theories that determine them are often or perhaps always conditioned by the circumstances that prevail at the places where and at the time when they are proposed and applied. And circumstances change frequently. When Keynes published the *General Theory* in 1936, the tax and public spending levels in the USA and in other major countries were very low (generally under 15 per cent of GDP), public debts were also low and were mostly created by wars. Fiscal deficits had not been common outside war times. (In the USA, the share of debt into GDP in 1929 had been only 16 per cent. It would increase to reach 40 per cent of GDP during 1933–1934 (partly due to the fall in GDP) and remain at around that level until 1939). Furthermore, the economies were relatively closed due to attempts by misguided governments to reduce imports in order to sustain domestic activities. When these conditions changed in future years, they could be expected to require qualifications of some of the main conclusions of *The General Theory* making the "general theory" less "general".

3. LATER YEARS' CRITICISM

While the Keynesian theory on counter-cyclical fiscal policy soon became more popular among economists (and increasingly among governments), by the decade of the 1950s it had gained wide acceptance.[2] However, some criticism continued, especially from conservative economists and politicians. By the second half

[2] Klein 1947; Economic Report of the President (1962 US) and Blinder – Solow (1973).

of the 1970s, the academic criticism had become sharper and more theoretical and it had led to a significant decline in the acceptance of Keynesian theories, especially among academic economists. A clear indication of this change was that several Winners of the Nobel Prize for Economics in those years were critics of that policy. The decline in popularity lasted until the Financial Crisis and the Great Recession starting in 2008, an event that brought a sharp and perhaps surprising revival of interest in counter-cyclical fiscal policy among some well-known economists.

By contrast, economists, who worked in national governments or in international organizations, had continued to have a more favourable view of the Keynesian policies and had continued to recommend those policies to countries that faced economic slowdowns. However, in the three decades between the late 1970s and the arrival of the Great Recession, the counter-cyclical fiscal policy had lost much of its intellectual, as compared with its popular appeal.

The criticisms of Keynesian stabilization policy had taken different forms over the decades. Some of the earlier critics had stressed what they believed were theoretical shortcomings and others had focused on operational difficulties. In the years that followed the Great Recession of 2009–2010, some of the criticism would be directed to the side effect or the *long run* effects of counter-cyclical fiscal policy. Some of these criticisms are briefly described below. A full treatment of them would require far more space than is available in a journal's article.

Operational criticisms. A still good review of the major operational issues that early critics had with the Keynesian fiscal policy is provided in chapters 20 and 21 of Musgrave's *Theory of Public Finance* (1959). These criticisms focus on "dynamic" aspects and "operational" difficulties of counter-cyclical policy. These aspects relate to the reliability of forecasts, the lags in the formulation and implementation of policies and other similar issues.[3] These critics stressed that the success of counter-cyclical fiscal policy depends a lot on timing, and therefore on the quality and the accuracy of the forecasts. They pointed out that forecasts can be and often are wrong. Further, if a government waits until a recession has arrived and become evident to everyone, it is likely that whatever action it takes to deal with it, the effects of the action will come too late to make a positive difference; they can easily make the policy *pro-cyclical*.

Once the forecast of a downturn in the economy is made and has been accepted by the policymakers in charge of economic policy, the next step is to decide how to respond. Decisions take time and mistakes are easily made. Should taxes be cut? If yes, by how much? Should they be cut permanently or temporarily?

[3] See also Metzler (1949) and Stein (1969).

Which taxes should be cut? How quickly can the cuts become operational and be expected to affect the disposable incomes and the spending capacity of economic agents? These are complex issues that inevitably require time and expertise, and that often divide experts and policymakers.

Or, should public spending be increased? If that is the preferred choice, what can or should be increased and by how much? Some increases in public spending can be achieved quickly, but they may be difficult to reverse once made and are no longer needed. Therefore, they are likely to lead to permanent increases in spending levels and likely to higher public debt levels. Next, what difficulties will the executive branch encounter in having the size and the specifics of the increase in spending (or of the tax cuts) approved in parliament? How much is parliament likely to modify the initial proposals? What role vested interests and influential lobbies will play in modifying the proposals? And, how much time will the legislative body need to reach final decisions? Both the size of the stimulus and the timing of its introduction are likely to be affected.

Should *capital* or *current* public spending be preferred? Most, though not all of the spending for capital projects (to build roads, bridges, canals, airports, and so on) stops when the projects are completed and are put into use. However, current spending (to hire more employees, to pay higher salaries, or higher pensions, and so on) is likely to persist after the recessions end. This can contribute to future fiscal difficulties. For capital spending, how quickly can new capital projects be designed, initiated and completed? And will that spending take place and have the expected expansionary impact on the economy at the time when it is mostly needed during the downturn? Or will the economic impact be felt only or mainly when the downturn is over? Many studies have indicated that what may be thought to be counter-cyclical public spending can easily turn out to become pro-cyclical.

History indicates that most downturns are of short duration. In the past, they routinely reversed themselves without governmental assistance unless there were structural obstacles that tended to perpetuate them as happened during the Great Depression. Therefore, there is always a possibility that by the time policy decisions are made, are implemented and are having an impact on the economy, the downturn may be over. This can not only make fiscal policies easily pro-cyclical, it can also lead to *long-run fiscal difficulties*.

A common experience for countries has been that public spending goes up and/or taxes come down during a recession. However, political obstacles prevent the reversal of these actions during the normal times, when they are no longer needed and when the public debt created during the slowdowns ought to be reduced. Over the longer run, this *policy asymmetry* leads to higher shares of public spending and of public debt into GDP unless the economy grows enough (and the real growth exceeds the real interest on the debt) to prevent the growth of the share of public debt into GDP. In many countries and over the years, the increase in the growth of public debt that took place and was generated by the above asymmetry, indicates its importance (Tanzi 2016, 2018b).

Theoretical criticisms. In a recent book, Anthony J. Makin (2018) has provided a convenient list of some of the more academic or more theoretical criticisms of Keynesian stabilization policy advanced over the years. They deal with various possibilities of "crowding out" created by the government's action, when it intervenes with fiscal deficits to stimulate aggregate demand.

The *loanable funds* approach dealt with the possibility that some private investment may be crowded out by the government's borrowing. This approach was given particular importance by members of the Austrian School. During economic downturns, governments may promote higher fiscal deficits to support aggregate demand. The deficits must be financed and because of the government borrowing, interest rates will go up. Therefore, some of the loanable funds that would have been available to finance private investments, will be diverted toward the government borrowing, thus reducing private investment. It is also possible that within the private sector some funds may be diverted from productive use by family enterprises to unproductive use by consumers within those families because of the fall in their available incomes. This approach concludes that this crowding out will reduce or will neutralize some of the expansionary impact of the fiscal expansion.

A second kind of possible crowding out was suggested by Fleming in 1962 and independently by Mundell in 1963 and is referred to as the *Mundell-Fleming approach*. The theory behind it is simply that the fiscal expansion will increase domestic disposable income and domestic consumption. Therefore, it will reduce exports and increase imports. It will also increase the demand for money, and thus interest rates. If the exchange rate is flexible, the increase in interest rate will attract capital inflows, thus leading to an appreciation of the exchange rate. This latter effect will crowd out some more domestic production, reducing the positive impact on the economy of the fiscal expansion.

The Ricardian Equivalence Hypothesis had been first suggested by David Ricardo in the 19th century, long before Keynes. However, it had received little backing until the decade of the 1970s. A century ago, the Italian economist Vilfredo Pareto had dismissed that theory as unrealistic, observing that "no taxpayer makes the Ricardian calculations"[4]. The theory was resuscitated in a more modern version by Robert Barro in an influential 1974 article. The Ricardian hypothesis is based on the assumption that taxpayers are rational, they can antici-

[4] Griziotti (1944: 137, my translation).

pate the future and they are good at making complex calculations. They realize that public debts created by fiscal deficits must be repaid in the future and that will require higher *future* taxes. The taxpayers will respond to this *future* possibility by increasing their *current* saving. Or, putting it differently, as Barro did in his 1974 article, the taxpayers will not consider the public bonds created by the deficits as net wealth. Therefore, the fiscal deficits will reduce current consumption (Makin 2018: 36).

Another criticism of the Keynesian theory was suggested by Robert Lucas in 1972 and especially in 1976. The "Lucas critic" also assumed that market operators are rational that they can anticipate the future and they will base their economic actions on the (rational) expectations that they have formed about the future. Therefore, they are not likely to be caught by counter-cyclical fiscal policies with surprise, when the governments introduce those policies. Being rational, they will form *rational expectations*, will anticipate the policies and act accordingly. Their actions will essentially offset the intended results of the national fiscal (and also monetary) policies.

A different and more political kind of criticism can be attributed to James Buchanan and to other members of the *School of Public Choice*, although there were already hints of it in Viner's thinking in 1933 (Viner el al. 1933; Buchanan 1970). This criticism stresses that public debt essentially transfers the cost of providing something beneficial from public spending from today's to tomorrow's citizens. The former get the benefits while the latter, who have had no role in the decisions that led to the spending, will bear the costs. Given that policymakers often suffer from a bias that makes them favour the short run (the present) over the long term (the future), the Keynesian theories reinforce that bias by making fiscal deficits more appealing to the policymakers. This creates a potentially serious ethical problem in addition to the economic problem that is created by the public debt (Tanzi 2018b).

All the above criticisms may have some validity. Their importance has been controversial and debated over the years and some attempts have been made to quantify their importance.[5] The Keynesian economists have either ignored those criticisms or have minimized their importance, while the conservative economists have given them more weight.

A peculiar empirical fact that may be worth reporting but difficult to explain, is that, especially in the United States but also in European countries, the ratio of public debt to GDP increased mainly in the period *after* 1980, a period when the Keynesian theory was supposed to have lost much of its appeal. That ratio had increased little before the 1980s, during the years of the Keynesian Revolution.

[5] For the Ricardian equivalence, see Brunila (2002) and de Mello el al. (2004).

In the USA, the share of public debt into GDP had reached a peak of 119 per cent in 1946 (because of the financing of the war) and had declined to a low level of 31 per cent by 1981. After that date, it rose rapidly (mainly during Republican administrations) to reach around 64 per cent in the mid-1990s. It remained at about that level for a decade until the Great Recession. In the years that followed, it rose rapidly and reached 108 per cent of GDP in 2017. It is forecasted to continue rising in the next years. Since the beginning of the Great Recession, a large share of the growth in public debt has been financed by the Federal Reserve Bank.

4. A SHORT CONCLUSION

This paper has presented a historical and mostly theoretical overview of the criticisms directed against counter-cyclical fiscal policy in the past 80 years. It has indicated that among economists there were always doubts about the effectiveness of this policy and about the long run consequences of its use. However, during the Keynesian Revolution, Keynes' ideas became gospel for many economists and they were endorsed and used by many governments.

It is not possible to reach a definitive conclusion as to whether the economies of many countries would have been better off today if the Keynesian policies had never acquired the following that they did and had never been followed. It is easier to sustain that one result of the use of those ideas has been growing public debts in many countries, including the USA. In some advanced economies, the levels reached by public debts are so high to invite concerns about future developments.

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