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*June 20, 2010*

The most fanatical Keynesians are losing their composure. Brad DeLong, a prominent Berkeley economist and Keynesian, is virtually yelling that [“We Need Bigger Deficits Now!”](#), emphasis his. Paul Krugman does DeLong one better, calling proponents of fiscal responsibility [madmen](#).

They are following the gospel of John Maynard Keynes, who famously advocated government deficits to pay people to dig holes, increasing demand and therefore economic activity. This is, to be polite, bunk.

It is worse than that actually. The logic implies that any government expenditure funded by debt will result in sustained economic growth. The result has been a stimulus plan that completely lacks coherence. Instead, we have a hodgepodge of spending initiatives that provide a temporary illusion of growth, but that will leave us with little that is long-term, except for huge hangover of debt which will be a drag on economic activity for years.

Keynesian stimulus theory comes about because of what is called a liquidity trap, a situation where the interest rate is zero, because no one wants to invest. The logic is that you can spend your way out of a liquidity trap; that by spending, government can increase sales. Eventually the increased sales will cause businesses to invest, driving interest rates up.

It is an article of faith among Keynesian economists that if the stimulus is big enough, it will generate sustained long-term growth. Call this the [Tinkerbelle Principle](#). You only have to believe in [animal spirits](#) to have expectations of a better future.

Consequently, when the spending doesn't achieve the desired result, Keynesians always call for more deficit spending, just as we see in the above-linked DeLong and Krugman arguments. And, when that doesn't work, like a broken record, they will call for more, but there can never be enough.

There is a case to be made for expectations, but they need to be rational. The recession was similar to a bank run, which can kill a bank, even when there is no initial weakness to generate the run. In this case, we had a run on the world's financial system. Call it a regime shift from a good equilibrium to a bad equilibrium.

Can government spending alone bring us back to a good equilibrium? It can if you believe in animal spirits, but I don't.

I believe that people are not excessively stupid. Economists call this concept rational expectations, the idea that most people can see obvious consequences most of the time.

I believe that people spend out of wealth: the value of the assets they hold and the present value of future income. This may not be an easily calculated number, but people keep track of it. It is something like a fielder's response when a batter hits a ball. This is a complex problem, but fielders respond instantly. The fielders are moving in the correct direction at the correct speed to intercept the ball while the bat is still in motion.

Finally, I believe that people try to smooth consumption. That is, they like to eat a little every day rather than go without for several days and binge on other days.

Let's analyze typical deficit-financed government spending programs using these beliefs. Somebody is going to have to repay the debt someday. It can be the person who receives the money, some other person who is currently working, or some future worker.

If the person who receives the money is the one who must repay it, she will normally save it. Her wealth has not changed, she knows that she will have to repay the money, and she's not excessively stupid. She'll want the money there when she needs it. We saw this with the Bush "tax rebates." Consumers saved the rebates, and the administration did not see the consumption boost they had anticipated.

There is another possibility though. She could be what we call 'liquidity constrained', holding no cash and unable to borrow. Her wealth is still unchanged, but she wants to smooth consumption — keep it at a relatively steady level — so she may spend some or all of the money. However, this implies that her future spending stream will be reduced. We're taking from tomorrow's economy to support spending today. This may be justifiable on humanitarian grounds, but it doesn't generate sustained long-term economic growth.

Suppose it is another worker who will repay the government debt. His wealth has just decreased. He'll spend less, and, also being a consumption smoother, he'll start spending less right now. Again, there is nothing here to generate sustained long-term economic growth.

Finally, suppose it is some future worker who will repay the debt. He or she will enter life or the workforce with a debt. I'll ignore the ethical implications of enabling increased consumption by current citizens by imposing, without consent, debt on future workers; instead, I'll stick just to the economics.

Our future worker starts a career, absent some other endowment, with a negative net worth. Over the course of his career he'll spend and invest less than if he had started with a zero net worth. Again, this is not a prescription for sustained long-term economic growth.

What we have to face is that by borrowing to consume now, we are taking away from the future. This is just not the way to achieve sustained long-term economic growth.

So what to do if you are a politician who thinks something must be done?

The liquidity trap comes about because no one wants to invest. What government should do in response is try to increase demand for investment. This would increase economic activity now and in the future. Increased demand for investment can be created by investing in public capital that makes private capital more productive, and by lowering the cost of borrowing.

When the government borrows and invests the money in projects that increase private capital's productivity, it is increasing the return to capital. Increasing returns to private capital increases the demand for private capital and investment. Current and future economic activity is increased.

We have lots of examples of these types of investments, including canals, dams, highways, public utilities like the Tennessee Valley Authority, and more.

The other approach to increasing investment is to lower the interest rate. This is difficult to do directly when the interest rate is zero, but the government can achieve the same result another way. An investment tax credit effectively lowers investors' borrowing costs.

So, if the government is going to actively stimulate the economy, it would be far better to invest in public capital that improves the returns to private capital. It will also help to provide a meaningful investment tax credit. Consumers could then rationally expect their future income stream, hence their wealth, to improve. With increased wealth their spending will increase, and we will be on our way to sustained long-term economic growth.