Keynes's Case Against Fiscal Policy: For Public Works and Full Employment

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Theme: Global Economy

Left liberal and radical economists routinely excoriate the economics profession for its failure to anticipate the dot.com and housing bubbles and the debacle of September 2008, and for its post-2008 refusal to consider the no-brainer that "static equilibrium" neoclassical orthodoxy is impotent to explain the origins of the financial meltdown and the current dynamics of the Great Recession. Far more disturbing is the adherence of soi disant Keynesians and the allegedly more heterodox post-Keynesians to a form of fiscal orthodoxy explicitly disavowed by Keynes. We expect them to know better. What most Keynesians put forward as effective policy, namely a far greater fiscal boost to aggregate demand than the Obama administration is prepared to consider, was explicitly rejected by Keynes as "too late" to revive an economy in deep slump. (1)

Aggregate demand management aims to close the "output gap", the difference between what the economy is actually turning out and what the economy could produce were it employing all available "factors of production" (capital and labor "inputs"). We shall see why Keynes regarded this approach, the same as put forward by today's left liberals and social democrats, as ineffective for generating full employment. Stimulating aggregate demand is quite different from what Keynes enjoined, the stimulation of effective demand. Government was to transfer purchasing power directly, i.e. not merely through private contractors as intermediaries, to workers via employment in public works programs.

The idea is to close the labor-demand gap, not merely the output-demand gap. To accomplish this, it will not do to try to boost "the economy" in general with the hope that the increased purchasing power eventually trickles down to the unemployed. As we shall see, seven decades of fake Keynesianism has in fact not produced a significant trickle-down effect. Full employment can be attained only by government's direct targeting of demand to those in need of employment. Any alternative policy that relies on the market to intermediate the transfer of income from government to jobless workers is bound to fail. Keynes's policy recommendations were based on that firm and well grounded conviction.

Full Employment Means Full Employment: Why Aggregate Demand Policy is Misguided

Keynes was clear that he considered literally full employment to be possible with feasible government policy. For Keynes "the real problem fundamental yet essentially simple… [is] to provide employment for everyone." (2) The task is not beyond our budgetary means: "The whole of the labor of the unemployed is available to increase the national wealth. It is crazy to believe that we shall ruin ourselves financially by trying to find means for using it and that safety lies in continuing to maintain idleness." [my emphasis] (3)

This conviction is evident in Keynes's radical conception of the output gap, the notion at the heart of conventional fiscal policy. His measure of the output gap that needed to be closed was identified with the number of unemployed that needed to be hired in order to produce full employment (4). In fact Keynes made no general use of the term “fiscal policy”, but rather wrote of “public works”. Consistent with this usage, Keynes did not formulate the problem of unemployment by estimating the number of widgets that would have to be produced to employ the unemployed. He believed, for good reason we shall see, that determining a full employment level of output was impossible. Instead, policy must target first and foremost the unemployed by directly providing wages, through public works programs, to those in need of work. It would not do to presume that new employment would be the inevitable by-product of stimulating the private demand for goods and services. These latter are produced by workers, whose wages must be the direct object of employment policy. When it comes to determining how much spending, i.e. how much national income, is required to create and maintain full employment, Keynes argued that the “calculations are in terms of equivalent men… and women, if they are unemployed..” (5) He defined “national output” by reference to the work-hours needed to employ all who needed jobs. (6) Keynes’s approach to the problem of unemployment is not production-centered; it is entirely labor-centered: “I sympathize, therefore, with the pre-classical doctrine that everything is produced by labor… It is preferable to regard labor, including, of course, the personal services of the entrepreneur and his assistants, as the sole factor of production.” (7)

Let’s see why Keynes took conventional “pump priming” to be the wrong approach to eliminating -not merely reducing- unemployment.

Pump priming as practiced in the US since the Great Depression construes fiscal policy as spiking total or aggregate demand by enhancing the means of private spending. The latter is of two kinds, consumption demand and investment demand. Government stimulates both with tax incentives and low interest rates. Reducing taxes provides more spendable income, which will presumably induce employers to add new equipment and/or hire new workers, and encourage workers to purchase privately provided goods and services. Lowering interest rates will lower the cost of borrowing and thus increase both investment and consumption. These policy options reflect the longstanding and overwhelming preference of US elites for private-sector remedies for what are in fact public ailments. President Obama has repeatedly affirmed his adherence to this non-starter.

Keynes thought the private sector unsuitable to tackle the problem of joblessness, since the private sector itself is the structural source of the inherent tendency toward unemployment. Under capitalism “[T]he evidence indicates that full, or even approximately full, employment is a rare and short-lived occurrence.” (8) Employers may be paying wages insufficient to contribute to a full-employment level of spending and/or may have gloomy profit expectations, dampening their incentive to hire and produce. Hence, it is not the responsibility of the private sector to provide all job seekers with work “any more than it is their business to provide for the unemployed by private charity.” (9) In the system of private ownership of productive facilities, it is a utopian pipe dream to talk of the “social responsibility” of business. Milton Friedman had it right: “The Social Responsibility of Business Is To Increase Its Profits.” (Cover article, The New York Times Magazine, September 13, 1970) Either government provides ongoing (see below) employment opportunities, or we shall have to learn to live with chronic and growing long-term unemployment.

The essential problems with the private sector approach to addressing unemployment are two. The first has to do with the economic disconnect between boosting aggregate demand

and raising employment. The remedy for this is to establish the connection politically, by a government policy of directly employing the jobless. The second problem is that to the extent that aggregate demand management, closing the demand gap, is successful its distributional effects are inequitable. This can be avoided only by turning policymakers' attention to closing the employment gap directly by government hiring the unemployed for public purposes. Let us look more closely.

The Disconnect Between Stimulating Private Demand and Reducing Unemployment

Keynes acknowledges that while the rate of employment and the level of national income or aggregate demand are related, they are not effectively connected. That is to say that employment is in fact a function of aggregate demand, yet the private factors determining aggregate spending are subject to inherent uncertainty, such that there is no way to guarantee that aggregate demand will in fact rise to the level required to provide employment for those ready, able and willing to work. Hence Keynes's argument that a thoroughly private economy cannot possibly deliver the most important goods -jobs- to all who need them. Neither a Romney nor an Obama administration will heed this warning. In his jobs summit speech (Decemberr 3, 2009) Obama affirmed that any politically acceptable remedy for intractable joblessness must be market-based: "[While] government has a critical role in creating the conditions for economic growth, ultimately true economic recovery is only going to come from the private sector." A recipe for permanent crisis.

Keynes concedes that employment is a function of aggregate demand. But he insists that private demand alone cannot produce full employment. Theory aside, this is a matter of historical fact. Seventy years of pseudo-Keynesian policy has failed to maintain full employment. That boosting aggregate demand does not necessarily produce full employment is due to the former's dependence upon conditions inherently uncertain and immune to government correction. In a capitalist economy aggregate demand depends on three factors: what economists term the marginal propensity to consume, the marginal efficiency of money and the marginal efficiency of investment. In plain terms, these refer, respectively, to the incentive of households to consume (rather than save) out of current income, the rate of interest, and capitalists' expected return on investment, their estimation of the prospects of future profits. Government policy is powerless to affect the first and third of these, which is why the second, e.g. the Fed's lowering of interest rates, amounts to, in Keynes's words, "pushing on a string". Nothing illustrates this better than the current impasse. In a severe slump capitalists correctly see low wages, under- and unemployment and declining sales revenues as portending low profits. No rational capitalist invests or hires in the absence of optimism about profit prospects, and government cannot change investors' pessimism. Low tax rates and dirt-cheap money will not move an employer facing penurious would-be customers. This not to say that under no circumstances can government tax and interest rate incentives induce capitalists to invest and perhaps increase profits. Keynes's point is that these inducements cannot guarantee that investors will use those profits to hire labor. The increased surplus may be simply held, or used to acquire other companies or invested in financial assets. Consumption expenditures too are subject to uncertainty. Government cannot determine whether tax cuts will be saved, spent or pledged to creditors. A good number of the unemployed are homeowners with mortgage payments outstanding. Will unemployment transfers be used to feed the family, pay medical bills, service credit card or student debt, or reduce mortgages? No one, including government, can say.

If the idea is to employ the unemployed, the only sure way is to directly offer them jobs. Only government can do this. The failures of the Obama administration illustrate perfectly that lowering taxes or making it easier to borrow are fools' errands in a major downturn.

Hyman Minsky made explicit the radical polical-economic implication of these arguments: under capitalist conditions, the only guarantor of full employment is to change the way income is earned. The persistence and severity of capitalist crises forces upon us the notion that workers are owed an income from society as a whole, as represented by government, and not from private profit-seekers.

It is important to note that Keynes's prescriptions were not confined to the circumstances peculiar to the Great Depression. He believed that his arguments about effective unemployment policy in the 1930s were applicable to any severe recession and depression at any time. The combination of private control of investment decisions, a market in labor power and profit-driven investment decisions is sufficient to warrant large-scale public employment as the sole remedy for less-than-full employment. Commenting on the deep depression of the 1890s, Keynes wrote that "probably the only ways of absorbing current savings and so averting the heavy unemployment of 1892-5… lay in borrowing by the government… to finance… work on public utilities." (10)

The problem, then, was not this or that contraction, but capitalism as such. We shall see that Keynes saw the broad socialization of investment as a necessary condition of capitalism's viability. (11) In fact, he saw evidence for the centrality of public investment in the "liquidity trap", the very feature of today's hobbled economy which foils Obama/Bernanke's policy of quantitative easing. In the liquidity trap, as Keynes described it, money has become "a bottomless sink of purchasing power… there is no value of it for it at which demand [for money] is diverted… into a demand for other things." (12) Whoever sets the price of money, in our case the Fed, cannot know whether reducing the cost of borrowing will bolster investors' anticipations of adequate remuneration (nor whether households will consume potential supplements to their purchasing power). Capitalists size up the market and form expectations regarding the adequacy of future returns on the basis of considerations beyond the influence of current government policy. Regarding this very scenario Keynes wrote:

"For my own part I am now somewhat sceptical of the success of a merely monetary policy directed towards influencing the rate of interest. I expect to see the State, which is in a position to calculate the marginal efficiency of capital goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organizing investments." (13)

"If two-thirds or three quarters of total investment is carried out or can be influenced by public or semipublic bodies, a long-term program of a stable character should be capable of reducing the potential range of fluctuation…" (14)

Keynes's promotion of the large-scale socialization of investment presumed a rational State bureaucracy determined to advance the fundamental interests of working people. Considering Keynes's macroeconomic brilliance, his political naivete is remarkable.

The Inequitable Distributional Effects of Conventional Pump Priming

I want to stress two important consequences of Keynes's conception of government employment policy, that the size of the fiscal stimulus is irrelevant to eliminating unemployment, and that the economy is in need of employment-generating public works projects at every stage of the business cycle, not merely in downturns. The magnitude of tax incentives and interest rate reductions has no bearing on the uncertainties endemic to the private economy which stand in the way of full employment. We've so far examined Keynes's critique of the mainstream's failure to establish an effective connection between raising the overall level of demand and achieving full employment. An additional factor carried no less weight with Keynes, namely his conviction that the distribution of demand is more relevant to addressing unemployment than is the size of the government stimulus. And mainstream policy maldistributes whatever benefits it manages to muster.

Closing the employment gap, i.e. the labor demand gap, requires the direct boosting of effective demand. This sharpens the policy objective. What we need is not a general estimate of the level of overall, aggregate, unspecified demand thought sufficient to generate full employment. For the unemployed are unevenly distributed across the country, and all cities and states are not distressed in the same way. This particular labor market is especially loose, that particular city or region is in especially dire straits. To be sure, desperation is evident across the board, but many of the illnesses are site-specific. Keynes recommended stimulus where it is needed. Jobs are needed for this specific infrastructure project, in this region, requiring workers with these skills and equipment of this kind.

The distribution of the stimulus is left entirely undetermined in policies seeking to raise aggregate national income. In fact, pump priming has had an effect similar to the effects of affirmative action programs: the principal beneficiaries have been the better educated and better paid. When fiscal and monetary stimuli have induced recovery, the upswing is led by home construction and consumer durables. These spenders do not of course include the long-term unemployed or the very poor. The sole guarantor that those in greatest need will benefit is government in its capacity as direct employer of labor in public works projects. Government outlays are targeted (hence the political character of the endeavor) to specific populations in specific regions with specific needs. There is minimal guess work involved. "Anything we can actually do we can afford. Once done it is there. Nothing can take it away from us." (15) As the economist Pavlina Tcherneva puts it, "[N]o country is a finished proposition… [Countries]…face new challenges and develop new kinds of needs. The public sector can stand ready through a program of direct job creation to provide jobs for all who wish to work in projects that satisfy those needs." (16) The repair and maintenance of public property of all kinds could and should be an ongoing project with permanently available employment during contractions and expansions. Keynes contrasted this approach to unemployment insurance, for which "we have nothing to show… except more men on the dole." (17)

All forms of trickle-down rationale are repudiated in authentic Keynesian policy. On the contrary, as Hyman Minsky noted, "..instead of the demand for low-wage workers trickling down from the demand for high-wage workers, such a policy should result in increments of demand for present high-wage workers 'bubbling up' from the demand for low-wage workers." (18)

Most self-professed Keynesians have failed to note that Keynes regarded government stimulus to be ongoing and permanent. The considerations elaborated above, showing that the system of private investment and consumption cannot sustain full employment, are not specific to periods of slump. There is every reason to expect joblessness to persist through the expansion. And it has. Paul Krugman's characterization of Keynesianism as "depression economics" is a lie. The Golden Age habit of defining full unemployment as unemployment of no more than around 3.5-4.0 percent has no basis in Keynes.

Since truly effective policies designed to eliminate unemployment have never been adopted in the US, we should expect the pattern of joblessness since the end of the Second World war to display a worsening trend symptomatic of deeply rooted structural contradiction. Two current trends are a good measure of the depth of industrially mature capitalism's affliction. We are seeing both the mass destruction of full-time jobs, many of which will never return, and record levels of long-term unemployment (unemployed for 15 weeks or longer). Most revealing is that long-term unemployment has been rising since the late 1960s, well before the triumph of neoliberalism. The short-term unemployed have been a shrinking percentage of all unemployed throughout the entire postwar period. Looking at the business cycle over the last forty years, an ominous trend emerges: in each business-cyclical expansion, the long-term unemployment rate remains either at or above the level of the previous expansion. In a word, for the last forty years the short-term unemployed have been a declining, and the long-term unemployed an increasing, percentage of all unemployed. By Keynes's own standards, pretend-Keynesian fiscal policy has been a seventy-year bust.

"Capital Hill", as Marx might have called it, is entirely blind to the prospect of permanent and mounting joblessness. The issue is totally absent from mainstream media. At the current historical juncture, liberal, left-liberal and social democratic politics are beside the point. What then is Left? Three guesses.

(1) J. M. Keynes, Activities 1931-39: World Crises and Policies in Britain and America, in Donald Moggridge, ed., Collected Writing, volume XXI, London: Macmillan, 1982, p. 394

(2) Keynes, Activities 1940-46 Shaping the Post-War World: Employment and Commodities, Collected Writing, volume XXVII, 1980, p. 267

(3) Keynes, Activities 1922-29 The Return To Gold and Industrial Policy: Part II, Collected Writing, volume XIX, 1981, p. 881

(4) Keynes, 1980, p. 280-307

(5) Keynes, ibid, p. 298

(6) Keynes, ibid, p. 73

(7) Keynes, The General Theory and After, Part II: Defence and Development, Collected Writing, volume XIV, 1973, pp. 213-214

(8) Keynes, The General Theory of Employment, Interest, and Money. New York: Harcourt, Brace & World, Inc., 1936, p. 250

(9) Keynes, 1982, p. 151

(10) Keynes, A Treatise on Money, Collected Writing, volume VI, 1971, p. 152

(11) Keynes, The General Theory, p. 378

(12) Keynes, ibid., p. 231

(13) Keynes, ibid., p. 164

(14) Keynes, Collected Writing, volume XXVII, p. 322

(15) Keynes, ibid., p. 270

(16) Pavlina R. Tcherneva, "Fiscal Policy Effectiveness: Lessons From the Great Recession", Working Paper No. 649, Levy Economics Institute of Bard College, January 2011, p. 22

(17) Keynes, Collected Writing, volume XXI, p. 149

(18) Hyman Minsky, "Effects of shifts in Aggregate Demand on Income Distribution", American Journal of Agricultural Economics, volume 50, number 2, 1968, p. 338

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