Clash of Classical and Keynesian Schools of Thought

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CLASH OF CLASSICAL AND KEYNESIAN SCHOOLS OF THOUGHT: WAS THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009 THE RIGHT OR WRONG DIRECTION?

WOODY R. CLERMONT

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I don’t mean to dismiss concerns about the long-run U.S. budget picture. If you look at fiscal prospects over, say, the next 20 years, they are indeed deeply worrying, largely because of rising healthcare costs. But the experience of the past two years has overwhelmingly confirmed what some of us tried to argue from the beginning: The deficits we’re running right now — deficits we should be running, because deficit spending helps support a depressed economy — are no threat at all.

And by obsessing over a nonexistent threat, Washington has been making the real problem — mass unemployment, which is eating away at the foundations of our nation — much worse.

–Paul R. Krugman, Professor of Economics and International Affairs at the Woodrow Wilson School of Public and International Affairs at Princeton University, and Centenary Professor at the London School of Economics, and Recipient of Nobel Memorial Prize for Economics in 2008

As we all know, we are in the middle of what will likely be the worst U.S. economic contraction since the 1930s. In this context and from the history of the Great Depression, I can understand various attempts to prop up the financial system. These efforts, akin to avoiding bank runs in prior periods, recognize that the social consequences of credit-market decisions extend well beyond the individuals and businesses making the decisions.

–Robert J. Barro, Paul M. Warburg Professor of Economics at Harvard University

I. INTRODUCTION

The number in the Federal government’s budget which sits at the center of heated public debate about the future direction of the United States fiscal policy is the size of the budget deficit. Robert Barro, citing to the work of British economist David Ricardo in the Funding System in 1820, argues that under the Ricardian equivalence, the deficit does not matter, and that taxation on capital income is harmful because it cuts into savings, causing consumers to

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consume more in the present and less in the future.\textsuperscript{5} Because a high tax rate will negatively affect economic efficiency, keeping tax rates at constant moderate levels are preferable to alternating periods of very low and very high tax rates.\textsuperscript{6} However, others argue that the lack of correlation between “budget deficits and interest rates, saving and investment rates, or productivity growth rates” may not be attributable to the position that Barro advocates.\textsuperscript{7} Additionally, the deficit is not as well defined as Barro would claim, studies do not support his underlying premise that older generations have altruistic ties to younger generations such that they would hand them the means to pay the debt, and that Barro’s citation to Ricardo’s work was placing undue emphasis on an “off-the-cuff” remark.\textsuperscript{8}

It has been posited that if Scottish philosopher Adam Smith were alive today, he would have argued against the wars waged by the Bush Administration and the Obama Administration, because wars raise the public debt, and thus “raised America’s cost of living and doing business, thereby undercutting its competitive power and running up larger and larger foreign debt.”\textsuperscript{9} Borrowing rather than taxing is deceptive on the American public, because Adam Smith was in favor of the “pay-as-you-go” method, which created greater accountability and more of the public making an economically informed choice.\textsuperscript{10} On the other hand, although Smith is often cited by conservatives as supporting a reduction of governmental taxation, Smith had a reasonable position on the raising of public revenue: taxation was important enough to dedicate

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\item \textsuperscript{6} ANDREW B. ABEL AND BEN S. BERNANKE, MACROECONOMICS 579 (Pearson, Addison, Wesley 2005); see also Barro, \textit{supra} note 5.
\item \textsuperscript{7} Kotlikoff, \textit{supra} note 3.
\item \textsuperscript{8} Id.
\item \textsuperscript{10} Id.
\end{itemize}
nearly one-third of the Wealth of Nations to it. Smith observed four maxims of taxation - proportionality, transparency, convenience, and efficiency – which he briefly described as follows:

1. The subject of every State ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State …
2. The tax each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, and the quantity to be paid, ought all to be clear and plain to the contributor, and to ever other person …
3. Every tax ought to be levied at the time, or in the manner in which it is most likely to be convenient for the contributor to pay it …
4. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the State.

Smith was likewise skeptical of big business and corporations that would try to gain control of the government and twist it to subvert natural market forces. If left unchecked corporations will use government to “keep their power, control prices, and eliminate competition.” Because of an increase in corporate speech rights and the lack of restriction on corporate spending in campaign finance, large corporations tend to dominate political discourse, drive the global public agenda of most nations, including America, and use think tanks to shape and create a

12 Id. at 258-260 (emphasis added).
13 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS VOL. II 116 (Cook and Hale 1818) (1776) (“They will employ the whole authority of government, and pervert the administration of justice, in order to harass and ruin those who interfere with them in any branch of commerce, which by means of agents, either concealed, or at least not publicly avowed, they may choose to carry on.”).
15 Id. at 507.
16 For an example, there is the Adam Smith Institute in the UK. Introducing the Adam Smith Institute, adamsmith.org, http://www.adamsmith.org/introducing-the-adam-smith-institute/ (last visited Sep. 6, 2011) (“The ADAM SMITH INSTITUTE is one of the world’s leading think tanks. Through its research, education programmes and media appearances, it promotes free markets, limited government, and an open society. Today, these timeless
conservative fiscal policy – in this instance, one that opposes a stimulus, involves less
governmental spending, and less taxation.\textsuperscript{17}

On the other end of the spectrum, there is Paul Krugman who felt that the stimulus of the
American Reinvestment and Recovery Act of 2009,\textsuperscript{18} was not enough.\textsuperscript{19} He predicted that a
weak stimulus plan would be put forth in order to get passage through the House and the Senate,
that it would fall short, that unemployment might at best be reduced to 7.3 percent (still 2.3
percent short of full employment) which would be deemed failure, and that conservatives would
say, “See government spending doesn’t work.”\textsuperscript{20} Krugman felt that some opponents were not
being intellectually honest, utilizing questionable practices; one such example was conflating
spending (S) with investment (I), hence interpreting an accounting identity which resulted from a
formula which included G (government spending) and T (taxes), i.e. \( S + T = I + G \), as a

\begin{itemize}
  \item Ideas are more important than ever. Government spending is near 50 percent of GDP, the budget deficit has reached
    historic levels, and the state intrudes into almost every area of our lives. Businesses are tied up in red tape, and
    families struggle under a growing tax burden. The Adam Smith Institute does not aim to think about policy for its
    own sake, but to change events. It works with politicians from all sides, and engineers policies which are not just
    economically sound, but calibrated to be politically deliverable too.”). Yet such think tanks are heavily dependent on
    corporate sponsors, and bend to the will of their “paymasters” so to speak. Policy Analysis in Britain in \textit{HANDBOOK
    OF PUBLIC POLICY ANALYSIS: THEORY, POLITICS, AND METHODS} 550 (Gerald Miller, Mara S. Sidney, eds., CRC Press
    2007).
  \item Sharon Beder, \textit{Suiting Themselves: How Corporations Drive the Global Agenda} 45-46 (Earthscan 2006)
    (“These business friendly measures were also adopted in affluent countries by the governments of many different
    political persuasions during the 1980s, including the conservative governments of Margaret Thatcher in the UK and
    Ronald Reagan in the US ... not because of the power of the free market ideas themselves, or the efficacy of the
    policies in meeting their stated purposes. Rather it was because of the power of those who backed these ideas: the
    corporations ... [as p]rogressive taxation systems were destroyed and government services decimated. In the
    extreme, governments were to be reduced to little more than law and order and national defense.”).
  \item Paul R. Krugman, \textit{How Did We Know The Stimulus Was Too Small?}, N.Y. TIMES, Jul. 28, 2010,
    http://krugman.blogs.nytimes.com/2010/07/28/how-did-we-know-the-stimulus-was-too-small/ (“But the longer
    answer is that it’s all in the math: Keynesian analysis provides numbers as well as qualitative predictions, and given
    reasonable projections of the economy’s path in January 2009, the proposed stimulus just wasn’t big enough.”).
  \item Paul R. Krugman, \textit{Stimulus Arithmetic (wonkish but important)}, N.Y. TIMES, Jan. 6, 2009,
    http://krugman.blogs.nytimes.com/2009/01/06/stimulus-arithmetic-wonkish-but-important/ (“The bottom line is this:
    we’re probably looking at a plan that will shave less than 2 percentage points off the average unemployment rate
    for the next two years, and possibly quite a lot less. This raises real concerns about whether the incoming
    administration is lowballing its plans in an attempt to get bipartisan consensus.”).
\end{itemize}
behavioral relationship that S always results in I.\textsuperscript{21} He denounced the idea that debt-financed government spending somehow absorbs an equal amount of private spending, creating a loss in jobs from the lack of private investment, as being analogous to the work of barbarians in destroying and losing the knowledge of the enlightened Greeks and Romans before them.\textsuperscript{22} Krugman has felt that the political agenda of the conservatives leading them to embrace and maintain belief in Arthur Laffer’s curve, compel them to stay the course unrelentingly, and rewrite history if need be to claim that tax cuts reduce the deficit, not increase it.\textsuperscript{23} There has been a distinction made between traditional supply-side economics, and the new supply-side economics of Laffer, Jude Wanniski and Ronald Reagan: the traditional approach would be accepted by the mainstream including Keynesians, monetarists and new classicists, while the latter was considered the work of “voodoo” doctors.\textsuperscript{24}


\textsuperscript{22} Krugman, \textit{supra} note 21.

\textsuperscript{23} Paul R. Krugman, \textit{Getting to Crazy}, N.Y. TIMES, Jul. 14, 2011, http://www.nytimes.com/2011/07/15/opinion/15krugman.html?_r=1&ref=opinion (“Mr. Bush squandered the surplus of the late Clinton years, yet prominent pundits pretend that the two parties share equal blame for our debt problems. Paul Ryan, the chairman of the House Budget Committee, proposed a supposed deficit-reduction plan that included huge tax cuts for corporations and the wealthy, then received an award for fiscal responsibility. So there has been no pressure on the G.O.P. to show any kind of responsibility, or even rationality — and sure enough, it has gone off the deep end. If you’re surprised, that means that you were part of the problem.”).

\textsuperscript{24} Paul R. Krugman, \textit{Redo that Voodoo}, N.Y. TIMES, Jul. 15, 2010, http://www.nytimes.com/2010/07/16/opinion/16krugman.html (“But the real news here is the confirmation that Republicans remain committed to deep voodoo, the claim that cutting taxes actually increases revenues. It’s not true, of course. Ronald Reagan said that his tax cuts would reduce deficits, then presided over a near-tripling of federal debt. When Bill Clinton raised taxes on top incomes, conservatives predicted economic disaster; what actually followed was an economic boom and a remarkable swing from budget deficit to surplus. Then the Bush tax cuts came along, helping turn that surplus into a persistent deficit, even before the crash.”); BRIAN SNOWDON, HOWARD R. VANE, \textit{MODERN MACROECONOMICS: ITS ORIGINS, DEVELOPMENT AND CURRENT STATE} 300 (Edward Elgar Publishing 2005) (“While supply-siders claimed that the incentive effects of the Reagan tax cuts were responsible for the US recovery after 1982, Tobin (1987) argued that Reagan’s policies amounted to ‘Keynesian medicine, demand tonics masquerading as supply-side nostrums, serendipitously administered by anti-Keynesian doctors.’”).
Part II of this Essay will explore the Barro point of view. Part III of this Article will explore the Krugman viewpoint. Finally, this Essay will conclude as to which of the two viewpoints is better reasoned.

II. ROBERT J. BARRO’S ARGUMENTS

Unlike Paul Krugman who is branded as a liberal spendaholic ignoring the argument that forcing firms to increase spending will result in the further loss of jobs, Robert Barro is far more critical of government spending, and in his piece The Stimulus Evidence One Year On, he evaluates the effect of increased government purchases (the spending multiplier) and increased taxes (the tax multiplier) on national income. He posits that if we increased $300 billion in government spending in 2009 and 2010, that United States would lose $180 billion in private spending those years. He reaches this math, by using spending multipliers of less than one (1), as he uses 0.4 for 2009 and 0.6 for 2010. He decries the use of a 1.5 multiplier by Christina Romer and “Team Obama” as being just as much voodoo as the Laffer curve, because even a 1.0 multiplier would mean added public goods are in effect free to society. He extends the reasoning that a multiplier greater than 1, necessarily means that GDP rises at an output greater than the increase in government purchases, such that building bridges to nowhere and filling useless holes, will leave leftover excess goods and services that increase private investment – in his view, a fantasy.

25 Amity Schlaes, The Krugman Recipe for Depression, WALL STREET JOURNAL, Nov. 29, 2008, http://online.wsj.com/article/SB122792327402265913.html (“As a result of such policy, pay for workers in the later 1930s was well above trend. Mr. Ohanian’s research documents this. High wages hurt corporate profits and therefore hiring. The unemployed stayed unemployed.”).
27 Id.
28 Id.
29 Barro, supra note 2; also see Barro, supra note 26.
30 Barro, supra note 2 (“Of course, if this mechanism is genuine, one might ask why the government should stop with only $1 trillion of added purchases.”).
In *Voodoo Multipliers*, Barro reiterates this vein of thought, observing that even just a multiplier of 0.8 which was assumed for wartime, has to be greater than whatever the proper multiplier ought to be for peacetime purchases.\(^{31}\) The proper starting point ought to be 0, and a rise in government purchase necessarily is followed by a decrease in the other parts of GDP, namely investment, but also consumption and net exports.\(^{32}\) The ratio of social cost to unit of additional government purchases is 1 to 1.\(^{33}\) There can be no such thing as a free lunch or a “shovel-ready project” – to defray such costs, he suggests a value-added tax, a form of regressive, not progressive taxation which will only ultimately affect consumers, but which will allow incentives for businesses to recoup and offset previous taxes paid, so as to give them a stake in collecting the tax more accurately.\(^{34}\) Yet he does so reluctantly, because it would encourage government expansion and ultimately his recommendation that government spending must be decreased.\(^{35}\)

As for taxes, he argues that an increase in marginal tax rates reduce GDP by a multiplier of minus 1.1, which he argues as being more conservative than the figures floated by David and Christina Romer, and that using their numbers would actually strengthen his argument.\(^ {36}\) Using his formula, if taxes were increased by say $400 billion, the GDP would have been lowered by $440 billion. In essence, government spending under Barro’s view is not only a zero-sum game (deficit spending has no effect on GDP ultimately), it results in corresponding losses over a five-year period.\(^{37}\) However, while Barro’s tax multiplier might be spot on, spending multipliers in


\(^{32}\) *Id*.

\(^{33}\) *Id*.

\(^{34}\) *Id.; Alan Schenk, Oliver Oldman, Value Added Tax: A Comparative approach* 9 (Cambridge University Press 2007).


\(^{37}\) *Id.* (“Thus, viewed over five years, the fiscal stimulus package is a way to get an extra $600 billion of public spending at the cost of $900 billion in private expenditure. This is a bad deal.”).
excess of 1, contrary to Barro’s assertions are not unreasonable in a recession, because savings rates are higher and capital is not being fully utilized resulting in a “zero bound” which means that government purchases should be substantially raised to address the gap.\textsuperscript{38}

As Lawrence Christiano, Martin Eichenbaum, and Sergio Rebelo put forth in their work, \textit{When is the government spending multiplier large?}, while it is true in a friction-less business cycle that the multiplier is typically less than 1, the multiplier can be much greater than 1 when the nominal interest rate is nonresponsive to government spending – this occurs when the zero lower bound on the nominal interest rate binds.\textsuperscript{39} Apparently due to investment being at zero, the corresponding aggregate saving must also be at zero, but the shock is so great, that the real interest rate has not fallen enough to reach the proper equilibrium.\textsuperscript{40} Marginal cost falls, prices decline, future deflation is expected (the deflationary spiral), but the rise in real interest rate, leads to an increase in desired saving, so the total fall in output required to reduce desired saving to zero is very large.\textsuperscript{41} The government spending (from say a stimulus), would lead to a decrease in interest rate, a rise in inflation combating the deflation, and a large rise in output which positively affects the GDP.\textsuperscript{42} Therefore, Barro is wrong in that he ignored the shock that made the zero bound binding, and he additionally used suspicious low-end spending multipliers as if he were simply ignoring the zero interest rates.\textsuperscript{43}

\textsuperscript{38} Michael Woodford, \textit{Simple Analytics of the Government Expenditure Multiplier}, Columbia University Working Paper, pp. 35-37, Jan. 27, 2010, also available at http://www.columbia.edu/~mw2230/G_ASSA.pdf (“Thus a value of 2 on the vertical axis means that if r\textsubscript{L} is equal to -4 percent per annum, it would be optimal to increase government purchases by an amount equal to 8 percent of GDP.”).


\textsuperscript{40} \textit{Id}.

\textsuperscript{41} \textit{Id}.

\textsuperscript{42} \textit{Id}.

\textsuperscript{43} Clive Crook, \textit{Good for America as far as it went}, \textsc{Financial Times}, Mar. 7, 2010, http://www.ft.com/cms/s/0/8a7e5d96-2a1b-11df-b940-00144feabdec0,s01=2.html#axzz1XZIvhd2 (“In this case, according to modern macroeconomic theory, and contrary to Mr Barro’s thinking, fiscal stimulus can indeed have powerfully beneficial effects – especially if monetary policy is constrained, as it is today, by interest rates that have
III. PAUL R. KRUGMAN’S ARGUMENTS

In *Bad Faith Economics*, Krugman argues that conventional monetary policy of cutting interest rates through the Fed is no longer an option unless the informed speaker is being deliberately obtuse.\(^4^4\) If the Taylor Rule prescribes a Fed funds rate of -6 as the solution to the problem, then it is clear that a conventional approach of a monetary policy plus automatic stabilizers will not be enough to stop the zero lower bound dilemma.\(^4^5\) However, John B. Taylor indicates that -6 percent is a miscalculation, that in fact, the Taylor Rule calls for 0.75 percent.\(^4^6\) In fact, Taylor is highly skeptical of Krugman’s approach that somehow a bigger stimulus would have worked, as like Barro, he found the spending multiplier to be small (0.5).\(^4^7\) Nonetheless, he is not as convinced about the zero bound, as he thinks that those coming up with those calculations are using policy rule coefficients in their formulas that are too high, and reflective of inferior economic performance which leads to bad policy.\(^4^8\)

Krugman also has observed in the past that China’s trade surplus has imposed an additional drag on America’s economic recovery, as well as those of other nations in the world as “[t]he International Monetary Fund expects China to have a 2010 current surplus of more than $450 billion — 10 times the 2003 figure. This is the most distortionary exchange rate policy any

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\(^{4^4}\) Paul R. Krugman, *Irregular Economics*, N.Y. TIMES, Aug. 25, 2011, http://krugman.blogs.nytimes.com/2011/08/25/irregular-economics/ (“Meanwhile, there’s actually a lot of evidence for a broadly Keynesian view of the world. Not, to be fair, for fiscal policy, mainly because clean fiscal experiments are rare. But there’s huge evidence for sticky prices, lots of evidence that monetary shocks have real effects — and it’s hard to produce a coherent model in which that’s true that doesn’t also leave room for fiscal policy.”).

\(^{4^5}\) Id.; see also Woodford, *supra* note 38.

\(^{4^6}\) Id.; see also Woodford, *supra* note 38.


major nation has ever followed.” By China’s conduct in devaluing their currency, and engineering a trade surplus, the result becomes an anti-stimulus to the economies of many nations. Krugman thinks that for all of the yelling that we could do at the Fed to do more, the Fed is pulling back its quantitative easing, in the face of renmibi undervaluation and other troubles, that the zero lower bound has left 70% of the world’s economies in the liquidity trap. However, at least one commentator has argued that Krugman flip-flops on the issue of what the Fed could or could not do, and whether it is right for a nation to undervalue its currency.

Changing course, Krugman would not be so ready to concede that calculating a Taylor Rule percent below 0 is bad policy, as he wrote in The Wrong Worries, that we have had two years of a more conservative spending policy, tax cuts, and continued use of the conventional monetary policy approach to prove that we are not on the road to recovery. In opposition to Barro and Taylor, he would say that it is “not about the size of the multiplier; it’s about the zero lower bound.” Being that the economy is in liquidity trap territory, he is skeptical that even unconventional monetary policy from the Fed could solve the problem. Nonetheless he is willing to try that, so long as it is coupled with a huge stimulus and any other bright idea because

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50 Id.
52 Scott Sumner, Krugman’s double standard, THE MONEY ILLUSION, Oct. 18, 2010, http://www.themoneyillusion.com/?p=7530 (“This is a game he’s been playing from the beginning. When it suits his purpose to claim monetary policy can do nothing (i.e. calling for fiscal stimulus or bashing the Chinese) he does so. When it suits his purpose to claim that monetary policy still has unused ammunition (as when he’s bashing the Fed, or bashing the ECB) suddenly monetary policy can do much more. His only way out is to confuse the issue—maybe it’s a 50/50 proposition. Maybe monetary stimulus will work, maybe it won’t. But notice how when he attacks China it’s all about the 50% chance it won’t work, and when he attacks the ECB it’s all about the 50% chance it will work.”).
as Jan Hatzius of Goldman Sachs opined in a report he released, the zero lower bound is likely to be a liquidity trap of serious proportions for some time to come.56

IV. CONCLUSION

The solution to a liquidity trap resulting from a zero lower bound is complex, and one not likely to be well received by the public.57 The steps to achieve the necessary level of inflation could result in an inflation scare and undermine the credibility of the central bank with the public.58 Krugman has a more realistic handle on the problem than Barro does; Barro ignores the problem altogether which is deeply troubling and leaves Krugman in the position of being the lesser of two evils.59 As one commentator observed about the role of conservatives in the political divide over the future of policy in America:

The federal tax burden has reached a 60-year low -- and they are still pushing for further tax cuts. A deregulated financial sector contributed to the excesses that caused the financial crisis, and they're still fighting, tooth-and-nail, every attempt at reregulation. History and economics tell us that cutting government spending in a period of low or negative economic growth runs a severe risk of slowing growth even further, and yet they've made deficit reduction their primary political goal.60

Therefore it is very difficult to reconcile the views of one side, that has committed itself to ignoring the country’s financial realities, not just rewriting history, but rewriting the present as well.61 There “were those who said that we’d entered a Japan-type liquidity trap, which meant that (a) there was a savings glut, so deficits would not crowd out private investment and interest

58 Id.
60 Id.
rates would stay low, (b) increases in the monetary base would just sit there, (c) the risk was deflation, not inflation."\(^6^2\) The government should not cater to the corporations, the wealthy, and those academics who cling to the fallacies striving for a balanced budget, when all of the signs point to a need for serious intervention.\(^6^3\) Increased government spending will not crowd out private investment and increase unemployment, and is necessary to fight deflation with inflation, and decrease the real interest rate. This may not be well received by the public, but Barro’s alternative of cutting taxes, and expecting low multipliers from this measure to fix the problem, is merely to continue the path of Reagan in tripling the deficit and allowing the situation to spiral out of control. That is not an answer, that is the source of the problem.


\(^6^3\) William Vickrey, Fifteen Fatal Fallacies of Financial Fundamentalism, Columbia Working Paper, Oct. 5, 1996, available at http://www.columbia.edu/dlc/wp/econ/vickrey.html ("The current reality is that on the contrary, the expenditure of the borrowed funds (unlike the expenditure of tax revenues) will generate added disposable income, enhance the demand for the products of private industry, and make private investment more profitable. As long as there are plenty of idle resources lying around, and monetary authorities behave sensibly, (instead of trying to counter the supposedly inflationary effect of the deficit) those with a prospect for profitable investment can be enabled to obtain financing. Under these circumstances, each additional dollar of deficit will in the medium long run induce two or more additional dollars of private investment.")