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Special Section

Keynesian, Monetarist and Supply-Side Policies: An Old Debate Gets New Life

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Debates over how to promote a healthy economy are pervasive once more, after decades when it seemed such debates had been put to rest. The market meltdown of 2008 ended a long string of years in which monetary policy reigned supreme. Monetary policy is the regulation of money and the banking system to influence economic variables. Its adherents, the "monetarists," had faced little challenge as they de-emphasized the role of fiscal policy, defined as the control of taxes and spending to influence economic variables.

Activist use of fiscal policy was inspired by the work of British economist John Maynard Keynes. Keynesian fiscal policy—out of fashion with economists and policymakers for decades—has enjoyed a stunning revival under President Obama's new economic policy team. The size of the stimulus package started at $825 billion, even before congressional add-ons. The final package, after debate and compromise, included a mix of spending on energy, infrastructure, health care, tax cuts, and direct payments to the unemployed and disadvantaged.

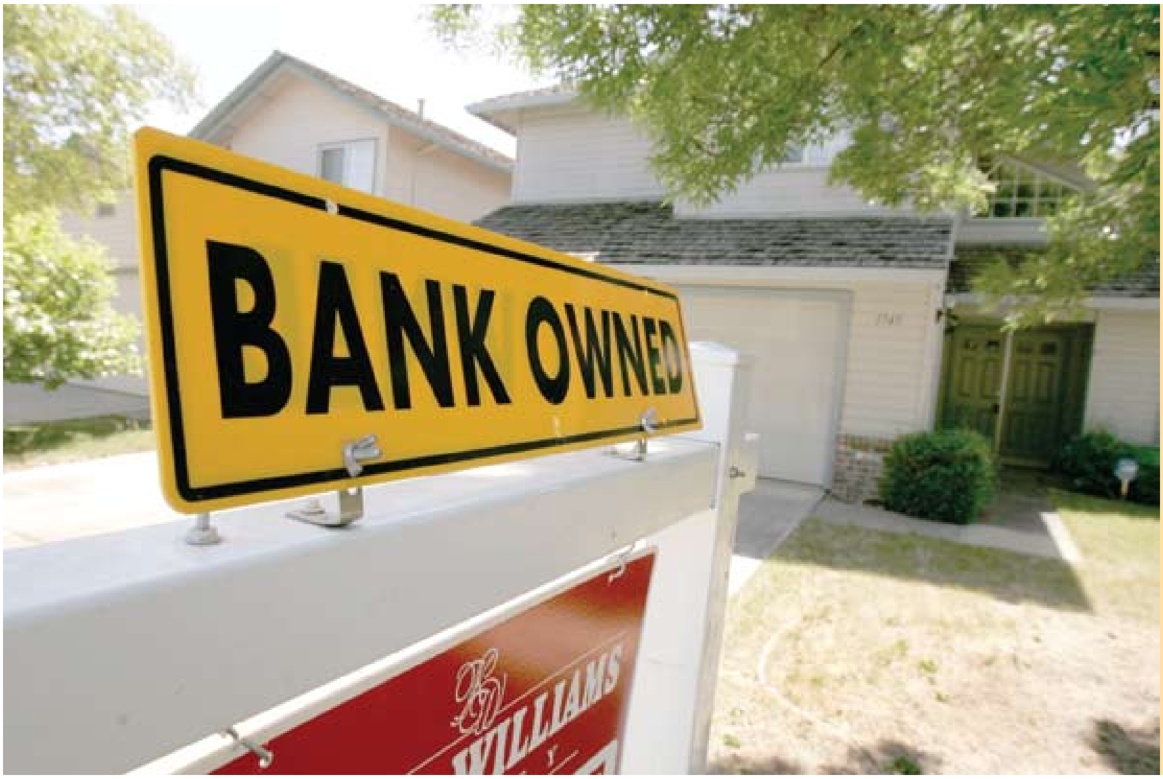
The Keynesian theory is simple. Keynes taught that economic downturns are caused by inadequate total demand ("aggregate demand"). His prescription to solve this economic affliction was for government to provide the demand that the private sector wouldn't, even if that required deficit spending. Recent discussions, covered extensively in the media, have focused on the infrastructure spending component of Obama's plan—such policy is right out of the renowned Great Depression-era economist's playbook.

The monetarist theory is also simple. Its intellectual father, eminent economist Milton Friedman, argued that properly regulating the supply of money and the banking system would allow the economy to cure itself when recession set in. His primary case in point was the Great Depression, when a shrinking money supply and bank failures made an economic downturn into a national disaster.

Friedman argued that the Federal Reserve could have stopped the Great Depression by providing banks with more liquidity and stopping the money supply from falling. In fact, Ben Bernanke, the Federal Reserve chairman today, apologized to Friedman in a famous declaration, saying: "You're right. We did it. We're very sorry. But thanks to you, we won't do it again."[1] Indeed, Bernanke's Fed has been supplying liquidity to the banking system in record amounts. The monetarist prescription sees this liquidity as promoting lending, lower interest rates and greater aggregate demand. Unfortunately, the economy has not quickly responded. Unlike the Great Depression—liquidity is not the problem this time. The Federal Reserve's unprecedented actions have assured that banks have plenty of money; they just aren't lending it out. Aggregate demand has remained anemic.

Even as Keynesians and monetarists have debated how to increase aggregate demand, supply-side economists and their political allies have been insisting that demand is typically not the problem. They believe that conventional policies increasing spending will only give small upward bumps to the economy. Their cure, therefore, is tax cuts designed to increase productivity, entrepreneurship, and risk-taking. The resulting increase in aggregate supply, they believe, will lead to economic recovery.

To supply-siders, not all tax cuts are equally good. They place their emphasis on the "marginal tax rate," the percentage taxed away from an extra dollar of income earned. A marginal tax rate of 40 percent, for example, would mean that 40 cents of each additional dollar of income would be taxed away, leaving an after-tax reward of 60 cents for the person who earned the dollar. High marginal tax rates kill economic initiative, they believe, and tax cuts that leave marginal tax rates high are useless. As an example,



A foreclosed home is shown in Stockton, California, on May 13, 2008. In some areas of California, so many foreclosed homes are available to buy on the cheap that real estate agents are discouraging prospective sellers from even putting their houses on the market. In Stockton, about 85 miles east of San Francisco, roughly three of every four homes for sale are in or on the path to foreclosure.

REUTERS/
Robert Galbraith/Files

a fixed $500 tax credit to everyone would not affect the after-tax reward of earning an additional dollar of income. It would leave marginal tax rates unaffected and therefore would have no direct effect on promoting aggregate supply.

Supply-siders have pointed to economic results following the Reagan and Bush tax cuts as evidence of success. Monetarists cited the accomplishments of the Federal Reserve under former chairman Alan Greenspan in the early 2000s as evidence that monetary policy could keep an economy from faltering, even under the stresses of 9/11 and its aftermath. Now Greenspan is faulted for allowing money to grow too much, inadvertently promoting the easy-money rise of housing prices, followed by the collapse that brought on the current difficulties.

This setting has brought about a remarkable Keynesian revival. President Obama's economic team forecasts the unemployment rate, without stimulus, will rise to 8.8 percent in the United States later this year. This is markedly lower than the 10.5 percent reached during the 1981-1982 recession; yet that period of economic malaise didn't drive such an apparent conversion back to Keynesian deficit spending.

This recession is likely—when it's all said and done—to rank as particularly severe by any historical measure. However, it's not only the depth of this downturn that has returned us to 1930s-style fiscal policy. The failure of monetary policy to swiftly cure the country's economic woes, as it has in recent downturns, provides some of the impetus to revisit these theories of the past.

Perhaps the inability of monetary policy to solve the present crisis provides ample justification for massive fiscal stimulus. The pilot of an airplane plummeting toward the ground cannot be blamed for pulling levers and pushing buttons in hopes one of these actions helps. While critics would like the fiscal stimulus directed toward tax cuts, the Obama economists argue—and rightly so—that the "multiplier effect" of government spending exceeds that of a tax cut. When the government spends money, the money is spent. When the government gives money back to the people in the form of a tax cut, some is saved and the effect on aggregate demand is less direct. The Obama administration argues that the need for immediate impact tilts the evidence towards more reliance on government spending.

It is no easy task for a government to choose among the available policy cures. Several comparisons are important.

Effectiveness of government spending. Christina Romer, incoming chair of the Council of Economic Advisors, estimates the multiplier associated with government spending to be 1.57 ($1 of government spending generates $1.57 of demand for goods and services) in crafting the stimulus plan. She estimates a 0.99 multiplier for tax cuts. Such estimates seem reasonable and conform to present academic research. By themselves, they would tilt a decision in favor of a Keynesian government-spending stimulus.

Choosing the "right" projects. Among the most basic concepts in economics is the importance of choosing alternatives where the benefits exceed the costs. Projects undertaken by the private sector cannot escape this straightforward rule; generally leading to efficient allocations of capital. However, government projects are not subject to such a test—leaving little reason to think governments will be successful at choosing the best projects to undertake. In fact, given the hurried nature in which these decisions will have to be made, it's likely many of the choices will be wasteful pork barrel projects chosen for their political, rather than economic, benefits. If bridge-to-nowhere-style infrastructure projects are funded, we can expect the multiplier estimated by the Obama administration to be too high. Monetarist and supply-side alternatives involve getting the private sector to increase its own spending, thereby decentralizing the decision making. Although mistakes are certainly possible, private-sector projects necessarily pass a built-in cost-benefit test.

Estimating the employment effect. The Obama economic team estimates that its preferred stimulus package will create or save more than 3.7 million jobs. Such a result requires that the spending programs in the stimulus package primarily target and utilize unemployed workers. More likely—particularly in areas like health and energy—jobs will simply move from one productive activity to another in response to the new government spending. Creating projects that specifically target the skills and abilities of the unemployed is a nearly impossible task; suggesting that the net job creation from the plan may be significantly lower than advertised. Monetarist and supply-side economists point out that if more valuable private sector economic activity is crowded out by this massive incursion of government spending, the job creation from the plan may be negligible. This point is especially important to supply-side economists with their emphasis on increasing long-term productivity that leads to more permanent gains in employment.

Addressing the cause of the crisis. This financial crisis arose in an environment of excessive growth of the money supply. In that setting, homeowners took on too much debt and banks allowed them to do it. Critics ask: Should the answer be for our government to spend too much and take on too much debt itself? At its core, our economic problems today stem from tight credit conditions. Banks and financial institutions are holding toxic debt; financial institutions don't trust each other and have become risk averse, causing banks to hoard reserves and not make loans—bringing the economy to its knees. Monetarists see clearing up credit markets as the solution and supply-siders are pushing for lower marginal tax rates. Keynesian fiscal policy is based on the prediction that increased aggregate demand through government spending will cause incomes to rise and indirectly unfreeze the credit markets.

A common weakness of any tax cut or spending increase, whether advocated by Keynesians, monetarists, or supply-siders, is that it will increase government borrowing. That debt ultimately must be paid back. If government borrowing is excessive, at some point we will encounter a mix of high inflation, higher interest rates, higher taxes and dollar devaluation.

There are weaknesses in every proposed cure to the economy's current troubles. Monetary policy has been pursued and seems to be at its limits; supply-side tax cuts are uncertain in their impact; Keynesian fiscal stimulus seems likely to have some positive impact in the short run, but has important drawbacks. The debate among Keynesian, monetarist, and supply-side viewpoints is not over.

Note

1. Greg Ip, "Long Study of Great Depression Has Shaped Bernanke's Views," The *Wall Street Journal* (December 7, 2005).

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