

THE LEGACY OF JOHN MAYNARD KEYNES: KEYNESIAN ECONOMICS AND
ITS IMPACT ON THE ECONOMIC STIMULUS PACKAGE OF 2008

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In the early 1930's the world saw the most widespread and devastating depression in history. Poverty spread, unemployment rose, and economies stood stagnant. These results were partially attributable to the Great War and the unreasonable reparations Germany was forced to pay. As Germany failed to pay these reparations, governments who were relying on these payments began defaulting on their own loans. As a result, economic turmoil ensued. British economist John Maynard Keynes decided, as a result of a falling British economy, to come up with new, revolutionary ideas that could be used to pull economies out of depression. Some of these ideas were presented in Keynes' essay "The World's Economic Outlook," in which he argues that deficit spending is one way to overcome economic depressions.ⁱ He later published the remainder of his theories in his most famous book, *The General Theory of Employment, Interest, and Money*. Despite the revolutionary and controversial nature of these ideas, today they have grown into an entire school of modern thought: Keynesian economics.ⁱⁱ

In light of the United States' recent economic turmoil, it appears that Keynes' theories have been deeply examined by American economic and political leaders. After several meetings and much discussion, President Bush announced in January of this year his plans for an economic stimulus package that will be put into effect in the coming months.ⁱⁱⁱ When analyzing John Maynard Keynes and his economic theories, it is apparent that the introduction of this economic stimulus package is directly influenced by Keynesian economics. It is also possible to speculate possible outcomes of the economic stimulus package based on the current American economic situation and Keynesian economics.

What is Keynesian economics?

Keynesian economics is a series of complex theories on the total spending in an economy and its effects on output.^{iv} The majority of this field derived from Keynes' monumental book *The General Theory of Employment, Interest, and Money*. Alvin Hansen, author and former professor of economics at Harvard, wrote that "along with Darwin's *Origin of Species* and Marx's *Das Capital*, the *General Theory* is one of the most significant books which have appeared in the last hundred years."^v The ideas Keynes' presents in this book have been analyzed, tested, and molded over the past decades into the finished product referred to today as Keynesian economics.^{vi}

Keynesian economics is in direct opposition to the classical field of economics. Before the 1930's, the classical views dominated economic policy. However, the emergence and popularity of Keynes' views created two competing schools of thought. Keynesian economics dominated the mid to late twentieth century, influencing Roosevelt's New deal and the creation of organizations such as the International Monetary Fund, which still plays a major role in world economics today.^{vii} The late twentieth century was dominated primarily by the classics, as technology boomed and markets surged. These two schools of thought still compete today, with people identifying themselves as Keynesian, classical, or somewhere in between.

In Chapter Two, "Postulates of the Classical Economics," of *General Theory* Keynes discusses classical theories and gives his response to them.^{viii} This is where Keynesian economics got its start, and where the disagreements with the classical economists begin. One of the central beliefs of Keynesians is that aggressive government action can be used to stabilize the economy. Keynesians believe macroeconomic shifts

significantly reduce economic well-being.^{ix} These “macroeconomic shifts” are commonly referred to as the business cycle, or the alternating rises and declines in the level of economic activity. Keynesians would like to see a more compact business cycle, and believe government action is an effective way of accomplishing this task. Classical economics argues that business cycles *may* be efficient, and government should intervene with the markets very little, if at all.^x Classicists also argue that governments are neither knowledgeable enough nor capable of improving free markets. Keynesians and classicists also disagree when it comes to key beliefs regarding unemployment and inflation. Keynesians believe unemployment is a more serious problem than inflation, whereas classicists believe they are of equal importance. Active government and an emphasis on unemployment are vital to Keynesian Economics, as well as being the primary areas of disagreement with classical economic theory.

Another key to Keynesian economics is the belief in the “multiplier effect.” Keynes theorized that a chain reaction takes place throughout the economy whenever a change in spending takes place. For example, if investment increases in an economy by a small amount, economic output in that economy could grow by a much larger amount because the investment amount will be “multiplied” throughout the economy.^{xi} The “multiplier effect” is a powerful tool that Keynesians believe is critical in controlling market behavior. Using the multiplier effect in conjunction with economic government policy, Keynesians believe they can successfully control and lessen economic recessions.

What is an economic recession?

A recession is one of the four components of the business cycle. Economists have discovered that economies in general go through a repeated series of peaks, recessions,

troughs, and expansions. When combining these four phases economists have also found an overall growth trend, or increase in output over time.^{xii} The recession portion of the business cycle is a significant decline in activity spread throughout the economy which lasts for more than a few months. Governments declare recessions following two consecutive quarters of a falling Gross Domestic Product, which equates to six months of falling economic output. Generally during recessions unemployment rates rise, stock prices fall, and personal confidence in the economy sharply declines.^{xiii} The United States economy has withstood ten recessions since 1950, each lasting anywhere from eight to sixteen months.^{xiv}

How does Keynesian economics approach recessions?

As stated previously, Keynesians believe government action can successfully weaken economic recessions. Keynes first developed this theory during the beginning stages of the Great Depression. He believed that the government should utilize deficit spending in order to help maintain full employment. He then believed that the money used for this deficit spending should be paid back in full during economic expansion periods (the opposite of recessions). This concept was highly unpopular when it was first announced, because classical economic theory believed strongly in balanced budgets.^{xv} However, Keynes' new ideas gained tremendous respect when the United States implemented deficit spending during the Great Depression and put thousands of people back to work. Today deficit spending is the historical norm; however the second part of Keynes' belief, paying the deficit back during economic expansions, is not practiced. As economist Alan Binder writes, "Once policymakers take deficit spending to heart, they

can not let it go.”^{xvi} Governments have tendencies today that show they enjoy spending much more than paying back debts.

Keynesians believe that the money the government spends will then be subject to the multiplier effect. Therefore, a relatively small increase in government spending has the potential to deliver enormous gains. For example, imagine that the government passes legislation that will give money to small businesses throughout the United States. The companies would have the opportunity to spend the money how they wish, and several may choose to hire new employees to increase their product output. They would have to pay these employees wages, and many of these employees would go out and spend their earnings. The companies that receive new business from these newly hired individuals would then see a boost in revenue. In this hypothetical example, the initial money the government spent has been reused three times over. These are the hopes of Keynesians and the use of deficit spending. By putting additional money into the hands of businesses and citizens, Keynesians believe consumer spending will increase, increasing business revenue, eventually leading to reduced unemployment. According to Keynesian economics, this use of fiscal policy is a repeatable cycle that effectively weakens recessions.

What are fiscal and monetary policies?

The utilization of legislation that allows increased government spending is called fiscal policy, as compared to monetary policy which attempts to manage the supply of money; for example, the Federal Reserve cutting interest rates.^{xvii} Keynesians strongly advocate fiscal policy rather than monetary policy. The debate between fiscal and

monetary policies is one of the most contested arguments in economics today, and recent precedents have shown countries using a combination of the two.

The United States is one of those countries that use a combination of fiscal and monetary policies. The Federal Reserve and Chairman Ben Bernanke are in charge of monetary policy, while the House of Representatives, the Senate, and the President are jointly responsible fiscal policy. The Federal Reserve Open Market Committee frequently meets and discusses possible changes to monetary policy with regards to the federal funds interest rate. The most recent fiscal policy action in the United States was announced in January of this year, and passed into law in February as the Economic Growth Act of 2008.^{xviii} This came as a response to a falling GDP in the United States economy in the fourth quarter of 2007 and fears that a recession could be approaching.

What is the Economic Growth Act of 2008?

The Economic Growth Act of 2008 is a fiscal stimulus package that was passed in hopes to stimulate economic growth in the United States. President Bush first announced the stimulus package in January, hopefully giving the American economy “a shot in the arm.” Bush also added that to be effective, the package should represent about one percent of the United States’ GDP, or roughly \$150 billion, and include tax incentives to small businesses.^{xix} Surprisingly, the package was signed into law just one month after being developed, an impressive turnaround time for an often slow paced Congress. This time lag is what opponents of fiscal stimulus claim is the biggest problem. They argue that by the time fiscal stimulus is carried out, the recession is generally over, and the added spending adds inflationary pressure.^{xx} It appears, however, that in this specific case the United States has been quick enough in signing its fiscal stimulus package into law.

President Bush is hopeful that by allowing Americans to keep more of their money, consumer spending should see an increase.^{xxi}

The Economic Growth Act of 2008 is primarily targeted to individual taxpayers and small businesses. It calls for rebate checks to be given to individual taxpayers who made between \$3,000 and \$75,000, and also to married couples who had a combined income of less than \$150,000. The rebate checks will equal \$600 for the single taxpayer and \$1,200 to the married couple. The law also has several provisions for businesses; giving them various tax breaks and incentives, such as bonus depreciation and expense write-offs. The bill also includes an extra \$300 allotted to taxpayers with children under the age of seventeen, with no limit on the number of children. As it stands now, the bill will cost the United States government \$158.1 billion in the fiscal year of 2008.^{xxii}

Refund checks were decided to be phased out at the \$75,000 (individual) and \$150,000 (joint) income levels primarily because the objective of this stimulus package is to increase *spending*. It has been noted that individuals earning a higher income have a larger propensity to *save* earnings than middle class income earners. Giving refund checks to high income workers, in the government's opinion, would have been wasted money and defeated the purpose of fiscal stimulus.^{xxiii}

Will this Keynesian fiscal stimulus package successfully lead
the United States economy out of recession?

Two main factors will determine the success or failure of this fiscal stimulus package. First, the question of whether or not we are truly in a recession is critical. Recessions are official when economies post *two* consecutive quarters of falling GDP, and the United States has only posted one quarter of falling GDP. Therefore, we won't

know if we are truly in a recession for another month or so. If the United States is in a recession, this package will successfully eliminate the time lag that generally leads to fiscal stimulus failure, and could potentially accelerate the economy right out of recession. If the United States is not in a recession, this package could lead to what Federal Reserve Chairman Ben Bernanke refers to as “economic destabilization.”^{xxiv} Keynes would agree the deficit spending while not in a recession will increase the fluctuation of the business cycle rather than reduce it and could lead to inflation and instability.

The second key factor is the question of what Americans will do with their rebate checks. The hopes of fiscal stimulus, according to Keynes, are that people will spend their added income rather than save it. These are the same hopes shared by American policymakers. If people spend the majority of their checks, the economy will undoubtedly accelerate. The multiplier effect will occur, and this \$150 billion stimulus could conceivably accelerate the economy by as much as five times that amount. However, with the increasing debt Americans are accumulating, the fear is that people will use their rebates to pay off that debt. This would not be seen as spending since they would be using their money on products they have purchased in the past. If this occurs, the stimulus package will have done nothing more than help Americans pay off their debts. As a result, in the short term this package would not have led to an increase in spending. In the long run this cleared up debt could lead to an increase in spending, however the economy may no longer be in a recession at that time and therefore could lead to economic instability.

The actual success of this fiscal stimulus package will probably be seen at the end of 2008. As an educated guess, it is safe to say that the package will be neither a huge success nor an absolute failure. Some Americans will surely spend their checks and see the added income as an opportunity to go out and purchase something they have been wanting for quite some time. However, other Americans will view this money as a great opportunity to catch up on some credit card debt they have wanted to pay off. The majority of the success from this package could come from businesses who utilize the tax incentives and write-offs. This could lead to drastically reduced costs and increased employment. Pure Keynesian theory would have these people spending their rebates and the economy would see a drastic improvement. However, pure Keynesian theories are not always carried out in reality. Keynes puts this notion subtly in “The World’s Economic Outlook” when he claims “the modern capitalist is a fair-weather sailor. As soon as a storm rises, he abandons the duties of navigation and even sinks the boats to which might carry him to safety by his haste to push his neighbor off and himself in.”^{xxv}

Conclusion

John Maynard Keynes is undeniably one of the most influential economists of the 20th century. His theories are to this day examined, expanded, adjusted, and practiced. Today there are almost a dozen major schools of economic thought and John Maynard Keynes has had some sort of role in influencing nearly every one of them.^{xxvi} Keynes’ ideas on aggressive government action to help reduce the impact of the business cycle are practiced daily throughout the world. Furthermore, his theories on deficit spending and fiscal policy during economic recessions are constantly considered whenever economies encounter stagnation or decline. The United States economy is currently at that point of

stagnation, and the government turned to Keynesian economics for a solution. If things fall into place with the Economic Growth Act of 2008, Keynes' seventy year old ideas could potentially increase American economic activity and save thousands of American jobs.

NOTES

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xiii. David Scott, "Recession," *Financial Dictionary*, 2003, <http://financial-dictionary.thefreedictionary.com/Economic+recession> (accessed April 14, 2008).

xiv. Ibid., 127.

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xvii. David Campbell, interviewed by author, April 10, 2008.

xviii. "H.R. 5140 – Economic Growth Act of 2008," *United States Senate*, February 1, 2008, http://rpc.senate.gov/_files/L47HR5140EconomicGrowthAct01012008SN.pdf (accessed March 31, 2008).

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