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Washington Could Use Less Keynes and More Hayek

The late Austrian economist offered good reasons to be skeptical of government action.

By DICK ARMEY

"In the long run, we are all dead," John Maynard Keynes once quipped. An influential British economist, Keynes used the line to dodge the problematic long-term implications of his policy proposals. His analysis of the Great Depression redefined economics in the 1930s and asserted that increased government spending during a downturn could revive the economy.

President Barack Obama and congressional Democrats (very few of whom likely have read Keynes's 1936 book "The General Theory of Employment, Interest and Money") have dug up the dead economist's convenient justification for deficit spending in defense of their bloated stimulus legislation. But none ask the most important question: Was Keynes right?

According to Nobel economist Friedrich Hayek, a contemporary of Keynes and perhaps his greatest critic, Keynes "was guided by one central idea . . . that general employment was always positively correlated with the aggregate demand for consumer goods." Keynes argued that government should intervene in the economy to maintain aggregate demand and full employment, with the goal of smoothing out business cycles. During recessions, he asserted, government should borrow money and spend it.

Keynes's thinking was a decisive departure from classical economics, because arbitrary "macro" constructs like aggregate demand had no basis in the microeconomic science of human action. As Hayek observed, "some of the most orthodox disciples of Keynes appear consistently to have thrown overboard all the traditional theory of price determination and of distribution, all that used to be the backbone of economic theory, and in consequence, in my opinion, to have ceased to understand any economics."

Classical economists up to that time had emphasized a balanced budget and government restraint as the primary goals of fiscal policy. The simplistic notion that "aggregate demand" drove investment and employment threw all of that out the window, but it had one particular convenience for policy makers. Government spending is, according to Keynes's construct, a key component in determining aggregate demand, so more spending, even to resod the Capitol Mall or distribute free contraception, drives the economy in the short run.

A father of public choice economics, Nobel laureate James Buchanan, argues that the great flaw in Keynesianism is that it ignores the obvious, self-interested incentives of government actors implementing fiscal policy and creates intellectual cover for what would otherwise be viewed as self-serving and irresponsible behavior by politicians. It is also very difficult to turn off the spigot in better economic times, and Keynes blithely ignored the long-term effects of financing an expanded deficit.

It's clear why Keynes's popularity endures in Congress. Intellectual cover for a spending spree will always be appreciated there. But it's harder to see any justification for the perverse form of fiscal child abuse that heaps massive debts on future generations.

Today, one problem with manipulating the economy through "discretionary" spending -- that part of the budget not mandated by one entitlement or another -- is that entitlements have grown large enough to influence the economy, a phenomenon unheard of when Keynes was alive. Medicaid, Medicare, Social Security and other entitlements are becoming larger factors in economic decision making than what Congress spends on, say, roads. Discretionary spending is becoming irrelevant as a fiscal tool.

Of course, despite Mr. Obama's campaign promises to adhere to "Pay As You Go" budgeting, no one seems terribly worried about paying for what will likely be a trillion-dollar stimulus package. What everyone should agree on is that the money has to come from somewhere, either through higher taxes, borrowing or printing.

If the government borrows the money for the stimulus, then it will either have to print money later or raise taxes to pay it back. If the government raises taxes to pay for the stimulus, it will, in effect, be robbing Peter to pay Paul. If the government prints the money, it will increase inflation, which will decrease the value of the dollar. That would, in effect, rob Paul to pay Paul back with devalued currency.

Taking money out of the private economy -- either through taxes or inflation -- and spending it in a way that doesn't offset the loss of money with real economic gains is worse than doing nothing.

Years ago I developed the "Armey Curve" to explain the negative burden government has on prosperity. The idea, borrowing liberally from Arthur Laffer's curve (which demonstrates that tax revenues fall when the tax burden gets so high that it no longer pays to work), is that at some point the burden of government spending exceeds the private economy's ability to carry it. "Stimulus" spending often does more harm than good, because it takes more money out of the system than it creates and thereby destroys jobs and leads to stagnation and diminished prosperity for all.

Hayek, who famously debated Keynes in a series of articles after the release of "General Theory," gave what I believe to be the most devastating critique of government action to stimulate "aggregate demand." Hayek viewed the boom and bust of the business cycle as primarily a monetary phenomenon created by governments' artificial inflation of money and credit.

Sound money policy, conversely, allowed the disparate knowledge of millions of economic actors to be conveyed through the price system, rationally allocating capital and labor through relative prices. The problem with government attempts to manipulate the economy through fiscal policy -- spending that takes resources away from those who are productive and redistributes it to politically favored interests -- is that it is audacious. It assumes that government knows better how to spend and invest than individuals acting in their families' best interest.

"The real question," according to Hayek, "is not whether man is, or ought to be, guided by selfish motives but whether we can allow him to be guided in his actions by those immediate consequences which we can know and care for or whether he ought to be made to do what seems appropriate to somebody else who is supposed to possess a fuller comprehension of the significance of these actions to society as a whole."

In reality, no one spends someone else's money better than they spend their own. The charade of the current stimulus package, chockablock with earmarks to favored pet constituencies and virtually devoid of national policy considerations, is the logical consequence of Keynesianism in action. It is about politics and power, not sound economics, and I believe that the American people will reject it.

Mr. Armey, a former economics professor and former majority leader of the House of Representatives, is chairman of FreedomWorks Foundation.

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