NOTHING FAILS LIKE SUCCESS: THE PROBLEM OF MODERN KEYNESIAN POLICY
Presented by Larian Angelo

I would like to thank the New School for hosting this talk and for inviting me. It’s always a kick to give a talk at your old school—I became an economist here and I appreciate the unique quality of the education at the New School economics department. Because it was not a mainstream department we all learned to think through problems from the perspective of different paradigms. I find the ability to not only understand, but to actually think, in different models exceptionally useful in my work.

Types of Economists
Economist is a funny sort of profession----no one outside the profession actually knows what we do and no one understands the language we speak. This works out well since for the most part no one really cares about what we have to say. Many of us have had the experience of going years without anyone paying much attention to what we think and even less to what we do. But when the economy tanks we suddenly become the most popular guests around town.

So what is the best kind of economist to be in a recession??

It is easy to be a neoclassical economist in a recession. Although you end up seeming sort of odd because you are the only one at the party who is completely unconcerned about crashing stock markets, falling housing prices, foreclosures and rising unemployment. You are unconcerned because you are utterly convinced that if we agree to do nothing it will all turn out for the best.

It is also easy to be a Marxist economist during a recession. You seem a little odd because you are the only one who is celebrating the crashing stock market, the falling housing prices the rising foreclosures and rising unemployment. You can celebrate because you are utterly convinced we should all do nothing because no matter what we do, it will all turn out for the worst.

What makes being a neoclassical economist so good is precisely the fact that no one expects you to solve the problem. In fact if you do your job well you have convinced everyone, including yourself, that there actually are no problems --- just adjustments and market corrections and pauses in the growth rate. What makes being a Marxist economist so good is that no one expects you to fix the problem since you can’t fix the problem without making the revolution and ending capitalism.

Unfortunately during a recession Keynesian economists have the hardest time because unlike neoclassicals or Marxists Keynesians believe:
1. There is a problem

2. The problem has a solution

3. And, worst of all, the solution is within the grasp of the current set of institutions associated with the world in which we live.

The biggest lie Keynes ever told was in the introduction to the General Theory when he said:

“This book is chiefly addressed to my fellow economists. ... Its main purpose is to deal with difficult questions of theory, and only in the second place with the implications of this theory to practice”.

In fact the General Theory is a set of policy guidelines attached to a theory. In Skidelesky’s biography of Keynes the volume on his work during the depression is called Economist as Savior. Economist as savior is certainly an ego boost for those of us in the profession and so, in a real sense, we Keynesians have no one to blame for our troubles but ourselves. If you are a Keynesian economist you cannot avoid policy debate and practice because your theory is judged by its effectiveness in the real world precisely because we say it should be judged by its effectiveness.

Keynesians believe that our washy- washy, cumbersome, slow moving, compromise-ridden, liberal democratic institutions are actually capable of dealing with the eruption of a major economic crisis and, in fact, can turn a crises into a manageable problem. That is to say we have a set of policy tools that can turn depressions into recessions.

And by the way---that is another reason it is hard to be a Keynesian. Marxists promise Nirvana in the future. Neoclassicals claim Nirvana in the present. Keynesians promise to turn depressions into recessions---a singularly uninspiring promise.

There are many reasons that this is a good time for all of us economists to have a discussion about economic crisis and our role as economists in resolving in economic crisis. Perhaps the most important reason we should have this discussion is that we were here when the crisis happened. As economists we are trained to believe that people don’t matter. We know that markets matter and sometimes at least some of us would say institutions matter—but people ---- not so much. But I think the notion of “living memory” matters. Living through an experience forces you to incorporate that experience into your perspective in a way that is different from reading about it. It gives you a standard against which to measure the effectiveness of policy. Living memory is important and can only happen through people.

I see the importance of living memory every day in the work I do. I do budgets for New York City and of course in the 1970s there was a landmark fiscal crisis. The people who lived through that crisis 35 years ago as junior analysts in the budget office have a fundamentally different understanding of the perils of budgeting at the local level than I...
or my cohort. We only read about the fiscal crisis---they lived it. They still talk about it today. They feel it in their bones and they understand it in their fiscal DNA. Their fiscal impulses and reactions are different from mine or my younger colleagues. That cohort is retiring and when they are all gone I think budgeting in this city will look very different.

Almost 80 years separate 1929 and 2008 and all the economists who experienced the depression as economists are gone. In fact most of the people who were adults in the depression are gone and therefore we lack the living memory that would help us to judge policy and measure outcomes against a real, as opposed to a theoretical, standard.

So what does it really feel like—what does it mean---to watch the credit markets freeze and to be unable to borrow money?? What does a run on the banks look like?? What does it really mean to have mortgages that are underwater and previously secure assets lose value? What does it really mean to watch venerable firms disappear overnight?? What does a panic look like?? We are now a cohort of economists that know.

We got to watch and live through—not just read about---our government and our institutions turn a rip roaring economic crisis into a severe and miserable recession. We as a cohort can discuss the role of Keynesian economics as participants not observers. We looked out over the cliff but we did not actually fall and that near escape ---that close call-- may be making it harder and not easier to continue to pursue the Keynesian agenda.

Another reason it is a good time for a talk on this subject is that New York City, like most localities in the country, is about to get its last few stimulus payments and it is a good time to reflect on role that local government played in the execution of the a stimulus package.

**Policy Tools for Immediate Action**

Keynesian economics has a standardized set of policy guidelines that we all learned here at the New School. We learned about tax cuts, deficit spending by government, getting income to low income i.e. households with a low marginal propensity to save, and cutting interest rates. And we also know that speed is crucial.

But in order to implement these policy guidelines you need to know about the policy instruments but you also need to know about the institutions that actually carry out the policies because it is those institutions that connect policy to practice. And because governments and central banks are crucially important tools---probably the chief policy tools in the Keynesian tool kit---you need to understand the people who use the tools, and the political landscape that allows the institutions that implement the policy the space to work.

So what is a Keynesian expected to do when confronted with an exploding economic crisis?? We all know what the two immediate tasks are:
Stabilize the financial markets: namely create a TARP

Stabilize effective demand: create a stimulus program

This is precisely what the Federal government and the Federal Reserve did in the fall of 2008 and the winter of 2009. And I think we need to pause and give a shout-out and some credit to the fact that Keynesian economics is still a strong enough intellectual force to have provided two very different Presidents from two very different political parties the theoretical framework for preventing a depression. We also need to give credit to two very different Presidents for avoiding government paralysis and allowing the institutions they controlled to design and implement Keynesian policy.

**Speed Is Key**

The Obama Administration’s stimulus program was a brilliant piece of Keynesian policy that **worked**. And it worked precisely because the Administration understood the connection between theory and policy tools and understood that state and local government had to have budget relief for any stimulus package to work. Further, the Administration understood that state and local government was the best way to implement a stimulus -----better in fact than the federal government.

I would also argue that the TARP worked—not because it was a brilliant piece of Keynesian policy but because it basically flooded the financial system with as much liquidity was is necessary to stabilize the system -- and did it in a very public way. The Obama team and the Bush team got the immediate problems right---they stabilized effective demand and they stabilized the financial markets.

We all know that after the two immediate problems are under control the next set of tasks involve addressing the underlying problems that generated the crisis. This usually means addressing:

1. Problems in the distribution of income
2. Problems in the long run regulation of financial markets created by the presence of new financial instruments
3. Problems in the architecture of the social safety net
4. And I would argue problems in the division of labor between national and local government.

This long term project requires government to essentially remake the government’s relationship to society and perhaps remake society itself. And here we must admit that the President did not do as well. But first things first --let’s talk about the two immediate tasks.
Stabilize the Financial Markets: TARP
I suspect that many in this room think the stimulus was a good thing—perhaps too small—but none the less a good thing. I think I will get more resistance in the discussion of the TARP. This is the part where many of us have to hold our noses.

President Bush and President Obama share the credit for TARP. But the contrast between the stimulus and TARP could not be more striking. Where the stimulus was elegant, TARP was rather stumbling and flat footed. TARP started off as a program to buy bad assets and when it became clear that would take too much time and perhaps not work at all the policy focus was shifted and Treasury and the Federal Reserve did what struck me as the banker’s version of a late 1960s commune. And it worked precisely because of its “communitarian” aspects.

I work in government budgets not in the financial sector and in keeping with the sense of this talk which could be summarized as “know your policy tools” I asked people who work in the bond market about TARP. What bankers and bond brokers have said is that the reason TARP worked is that the architects of TARP eventually understood that a financial panic is not just about the public being panicked about the condition of the banks—it is also and maybe more importantly --about the banks being afraid of each other.

For much of the decade financial institutions had passed bad assets among each other like the kids game of hot potato or like a game of hearts with about 20 old maids. In the fall of 2008 the banks were afraid of each other because they all knew they had passed bad assets to each other but nobody knew what level of bad assets---or hot potatoes -- other guy might be holding. Nobody knew who was holding what.

The second TARP approach just recapitalized everyone. No banks would be singled out as faltering. The new TARP approach just gave money to everyone and sorted it out later. Some banks got more than they needed and some got less-- but it was this refusal to discriminate between solvent and insolvent institutions that stabilized the financial markets. Although the federal government initially threw about $700 billion at the problem much of this appropriation will be recovered. But the cost of the program was less important than the fact that it banks, and bankers, a way to trust each other again.

Stabilize Effective Demand: Stimulus at the National Level
With a focus on spending and progressive tax cuts, the American Recovery and Reinvestment Act (ARRA) is a textbook Keynesian stimulus package. A total of $787 billion with $500 billion—64 percent for spending and $280 billion—36 percent for tax cuts.

Progressive Tax Cuts
ARRA pushed tax cuts away from business and toward low and middle income families. Only $10 billion in tax cuts went to business while 88 percent, $247 billion went to individuals. Among individuals the tax cuts were progressive: A “Make- Work- Pay – $400- per- person credit” worth $116 billion, an alternative minimum tax (AMT) patch worth $70 billion and a set of tax cuts explicitly targeted to low and middle income families (the EITC plus the Child Care Credit plus the elimination of tax on unemployment benefits) worth $27 billion. In total over 86 percent of tax cuts to individuals---$213 billion--- went to low income or middle class families insuring that funds will be spent quickly.

**Spending With a Focus on Relief for States, Local Governments and School Districts**

The stimulus concentrated much of its’ spending “fire power” on several forms of budget relief for lower levels of government. States received $58 billion in additional federal revenue and $87 billion in budget relief through a reduction in the cost of the Medicaid program. The federal government increased its FMAP (Federal Medical Assistance Percentages) shifting the Medicaid burden from the states (and from the counties where the states require local contribution) to the federal government.

The stimulus also provided additional education aid worth $48 billion –much of it Title 1funding for students in poverty and IDEA funding for mandated special education costs and $20 billion in additional aid for Health. Because Education and Health are areas where state and local governments spend money, I would argue that $213 billion out of $501 billion or 43 percent of the stimulus was used to provide budget relief for state and local government.

Another $99 billion went to help individuals impacted by the recession and $ 98 billion went for infrastructure.

**Timing:**

The stimulus was intended to be spent quickly: $718 billion or 91 percent was scheduled to be spent in the first three years (Fiscal Years 2009, 2010 and 2011). ARRA was signed into law on Feb. 2009 and as a special boost to speed the recovery the FMAP relief was retroactive to the start of the recession. This made a huge difference to states and localities struggling with the fall in revenues during the winter of 2009. For example, New York City got a federal check for $300 million for retroactive (October 2008 to March 2009) FMAP relief.

So we have a stimulus package that directs tax cuts to low and moderate income families, directs spending to individuals impacted by the recession and to state and local governments who spend the money immediately. It’s was a well designed Keynesian package.

**Stimulus at the Local Level**

Observing the stimulus from the perspective of New York City can be very interesting because we embody all levels of local government. We are a city, we are five counties,
and we are a school district. We are also the fourth largest budget in the US (only the US, the state of California, and the state of New York are bigger) and have a tax structure that, like most states, relies on a personal income tax and several business taxes rather than just the property tax as is common for most localities. New York State also forces a large share of Medicaid costs onto its counties so the City has a large Medicaid bill.

The stimulus provided three important areas of budget relief for New York City:

1) $2 billion for education, to be spent in City Fiscal Years 2010 and 2011

2) $1.1 billion for work force development to be spent mostly in City Fiscal Years 2009 and 2010

3) Approximately $2.8 billion of FMAP relief.

The checks states and localities received from retroactive FMAP were crucial in managing state and local budgets and by extension the national economic crisis. Localities needed the retroactivity from FMAP because they experienced absolute year over year revenue declines and many were having difficulty with cash management. Between Fiscal Years 2008 and 2009 tax revenues in New York City fell by nearly $3.0 billion( over seven percent), and while the City did not have a cash crisis things were getting a little “close.” The next to last thing you want in a financial crisis is to have states and localities jamming the market with short term borrowing needs. The absolute last thing you want is to have states and localities shut out of the market when they need to do short term borrowing.

If the short term benefit of retroactive FMAP was as a cash bridge, its’ intermediate term benefit was precisely the opposite. FMAP did not come into state budgets as revenue that must be appropriated; it came in as a reduction in costs. Like unrestricted aid, FMAP is pure budget relief that is not directed to any particular agency or program but because it does not need to be appropriated it generates no political bickering and requires no political action. Requiring no action is key because in politics inaction trumps action every time. If you position prevails by doing nothing chances are you will win.

As a policy matter FMAP was also more evenly spread over time avoiding steep spending cliffs: $458 was spent in Fiscal Year 2009, $664 in Fiscal Year 2010, $856 in Fiscal Year 2011, $395 in Fiscal Year 2012 and $422 in Fiscal Year 2013 (projected estimates).

**Local Government as a Policy Instrument**

As we saw earlier, ARRA was focused on putting federal dollars into state and local budgets and this was clearly a reason it worked so well.
As economists we all know that only the federal government can do counter cyclical fiscal policy because only the federal government can run budget deficits. States and localities must balance their budget—either by law or because credit market will not let them borrow money for deficit financing indefinitely. When an economic crisis begins the budgets of state and local government go into deficit and, usually, they must address this deficit within their fiscal year or by the following fiscal year. States and localities must increase taxes and/or cut spending, which as we know removes effective demand from the economy making the economic slowdown worse.

If ARRA had not focused spending on budget relief for state and local governments, state and local governments would have been cutting their budgets and raising taxes while the federal government was pursuing expansionary fiscal policy. Without direct federal revenue injections into state budgets the states are forced to essentially undo or counteract the federal government’s fiscal policy. They will reduce their spending and balance their budgets as happened during the long recession of the early 1990s.

ARRA focused fiscal policy on budget relief for localities. This meant that instead of balancing their budgets and counteracting fiscal policy as was usually the case during recessions, states and localities became the primary tool for implementing fiscal policy.

And states, localities and school districts were exceptionally willing partners in this approach to fiscal policy. State and local governments were fueled by stimulus and became effective demand machines. Even conservative Governors who did not want aid were forced to take stimulus by their legislatures. And states and localities not only spent the stimulus—they spent it quickly. Let me give you an example of the speed and effectiveness of local budget relief as fiscal policy:

In January 2009 when New York City released its’ Preliminary Financial Plan the City and the State were sinking into a recession. At almost $23 billion the Department of Education is the largest agency budget in the City (it is also a budget that is bigger than the budgets of over half the states in the US) and local assistance for education is one of the largest areas of state spending. The City was scheduled to lay-off 14,000 teachers due to a cut of over $700 million in state support for education.

Three months later, when the City published the Executive Budget in April, only three months later, and the lay-offs were gone. They were gone because in February the Congress passed and the President signed ARRA. This allowed the City to immediately recognize almost $1.3 billion in additional federal stimulus money for Fiscal Years 2009 and 2010. As long as the City had sufficient cash reserves it could spend the money before it arrived—as is usually the case with federal aid. Ultimately the City will receive $6.64 billion of stimulus for the expense budget and $2.2 billion for the capital budget. Fully 85 percent of this aid was received—and will be spent between Fiscal Year 2009 and Fiscal Year 2011. I would argue that the City spent the $2.0 billion for education immediately— we announced the lay-offs would not happen because of ARRA
Nothing Fails Like a Keynesian Success:
Structural Changes
So if the Obama Administration did well in the immediate tasks—stabilizing the financial markets and stabilizing effective demand—why did such a decisive, swift, well structured and successful first phase of Keynesian economics not result in the increased political capital needed to move a long term agenda?? Some would argue that Americans are anti-Keynesian but polling data does not support that conclusion at least for the more long term Keynesian propositions.

The American public supports policies that would produce a more equitable distribution of income (they support collective bargaining rights even for government workers by 2 to 1). They support progressive taxation (72 percent believe we should deal with the deficit by rising taxes on households with income about $250,000). They support the social safety net (75 percent believe the government must provide health care for the elderly and 56 percent believe they should provide it for the poor).

So why does the Administration lack the political capital to move forward?? Although I believe the Administration miscalculated by choosing health care reform as the next item on the agenda ---and I’ll talk about an alternative proposal on health care later--- I also believe there are two other problems:

1. Nothing fails like a Keynesian success and

2. The public is more comfortable with long term than it is with short term Keynesian policies.

Nothing Fails Like a Keynesian Success:
Short Term Fiscal Policy
So if the Keynesian approach succeeded at least in the short run stabilization of both the financial markets and effective demand --if it avoided a depression why are we in such hot water??

I think it may be the economic theory equivalent of that tee shirt we always see --- you know the one that says “my grandma came to NYC and all I got was this lousy tee shirt.”

Well basically --- My President spent $787 billion and avoided a depression and all I got was this lousy recession.

While a couple of quarters with a 10 percent rate of unemployment is certainly better than a decade of 25 percent unemployment---a recession just is not that inspiring. And recessions are especially uninspiring when you do not know what a full blown depression looks like. The intelligent use of Keynesian economics avoided a disaster but disasters avoided are difficult lifts in the public debate. Once again living memory matters.
I cannot imagine that anyone thinks we were not looking down at the abyss in the fall of 2008. We were certainly closer to a melt-down than any time since 1929 and as we talk about the role economists should play I think it would be a good idea if some of us could make a compelling case that TARP and ARRA prevented a depression. If we could spend a little less time talking about what the two Administrations did not do and more time talking about what they did do we might be in a better position to do more. Although assigning economists a public relations task is not usually a formula for success, I think we can make a contribution to the public debate by finding a way to speak intelligently about why deficit spending is a central tool in the Keynesian tool box and an effective policy during economic downturns.

While the public seems to be uncomfortable with deficit spending at the rhetorical level, budgets are strange things in the political discourse. No one actually wants to balance the budget at any time but everyone—everyone that is but us Keynesians---say we should balance the budget all the time.

Of course Keynesians say we should balance the budget sometimes—that is we should balance it during the expansion phase of the business cycle. But when we want to balance the budget people are even less interested in budget balance then they usually are precisely because we are enjoying the good times and in the good times no one is worried about a little debt.

Most Keynesians are more layered and nuanced as people than their economic theory. Most of us Keynesians are also political liberals. We believe the role of government goes beyond stabilizing the economy. We believe government should make the world, not just the economy, better. Keynesians who believe government has a limited role except during the downturn are few and far between so we Keynesians usually do not have much interest in balancing the budget either.

Make no mistake---the people talking the most about budget balance these days—the right-wing in Congress-- have no interest in balancing the budget either. Dropping the top tax rate from 35 percent to 25 percent will not balance the budget. Just as we Keynesians believe government is a force for good that must be supported, the right wing believes government is a force for evil that must be starved. In fact if we were honest we would admit that we Keynesians want bigger government and the right-wing wants lower taxes and we have a structural budget deficit because the compromise position is to have both.

The problem is we Keynesians need a federal government that is functional and trusted by the American people while the right wing wants and needs just the opposite. Accepting structural deficits that persist during an economic boom hurts us more than it hurts the right wing.

We must make a case for fiscal policy that is consistent and that means fiscal policy in both directions. Because we Keynesians cannot shy away from the deficit during the downturn we must embrace the budget surplus during the expansion. We cannot be
like the faux deficit hawks who call for tax cuts under the guise of cutting the deficit. We cannot be faux Keynesians who call for increases in government spending under the guise of fiscal policy.

We need to separate out what we think the size of government should be, from what we think the focus of government spending should be, from what we think the correct level of progressivity in taxation should be, from what we need to do to stabilize the economy during the downturn. We Keynesians cannot be credible deficit doves during the recession unless we are credible deficit hawks during the expansion. We need to argue for structural balance in the federal budget—meaning that we have a structure of current law in spending and taxation that generates a deficit during a contraction, a balanced budget during ordinary economic times and a budget surplus that we use in ways that slow the economic expansion.

If we believe taxes should be higher as redistributive mechanism we should argue that on the basis of fairness and/or on the basis of long term stability---after all the real problem in the housing crisis was that there were not enough families with sufficient income to own a home with a conventional mortgage—but we need to separate out progressive taxation from increasing taxes to achieve long run budget balance.

If we Keynesians can become credible deficit hawks during the boom we can stand up and argue that we should not balance the budget now while the economy is weak. We all know that is what has to be said. Our job has to be gaining the credibility to say it.

Moving Forward: A Keynesian Division of Responsibilities among Levels of Government

The division of responsibility among the levels of government is often overlooked in discussions of fiscal policy. In this country we like low taxes and extensive services and this is not an approach to budgeting that works very well. However higher levels of government can cut your taxes from their level of government and get all the credit for those tax cuts and have none of the blame for service reduction or unbalanced budgets. All higher levels of government have to do is kick the problem downhill to a lower level of government.

This process has been called by many pretty names. A return to local control. Empowering the government that is closest to the people. Block granting to increase local flexibility. Devolution. Yet all the pretty names end up in the same place; costs are shifted to the local level and either local taxes are raised or services are cut. There are three main problems with the devolution of responsibility down to more local levels of government:

1) While taxation levels will, to some extent, reflect the local population’s preference for public services---taxation levels will also reflect the distribution of social services needs. Putting a greater burden on states or localities that have greater social services needs is clearly counterproductive. This also tends to produce a race to the bottom.
2) The lower the level of government the harder it is to do progressive taxation. So obviously the larger the proportion of total government spending assigned to state and local government, the smaller the proportion of total government spending that can be financed with progressive taxation.

3) The greater the proportion of government spending concentrated at the lower levels of government that cannot run deficits, the more likely you are to have pro rather than counter cyclical fiscal policy at least in the crucial initial stages of a downturn.

Cutting budgets is painful for any elected official and it is not done unless it has to be done. It is unlikely that even a very conservative federal government would move to cut spending mid-year to balance the budget. But local governments do mid-year cuts because they have to which is why devolution is dangerous and destabilizing. Unfortunately the trend in the division of responsibility among the levels of government has been down, not up, the food chain.

In 1978 federal revenue supported 23 percent of New York City’s spending. That proportion declined to nine percent in Fiscal Year 2008. The state decided to join in the devolution model, reducing the proportion of the City’s budget funded by state aid from 22 percent to 19 percent in the same time period. Devolution has been such a pronounced trend that it is hard to believe that in 1978 almost half of the City’s budget was supported by higher levels of government.

Devolution should make every Keynesian nervous. While the Obama Administration acted quickly and wisely—using the fiscal desperation of states, cities and school districts to get their stimulus package into the economy quickly---we cannot assume that we will be lucky enough to have every economic crisis happen with a Keynesian Administration and Congress.

**Keynesian Health Care Reform: Shift the Medicaid Burden to a Higher Level of Government**

Converting Medicaid to a block grant is one of the deficit reduction proposals coming out of the House Budget Committee. The Congressional Budget Office estimates that the Federal government funds only about 57% percent of the cost of Medicaid leaving states (and localities in some states) with a substantial fiscal burden. New York City spends over $5 billion per year on Medicaid and our state spends over $20 billion each year. Leaving this large fiscal burden on states can become very destabilizing during a fast-moving financial crisis.

We can begin to shift the funding burden back up to the appropriate level of government by limiting the state responsibility for the growth of Medicaid expense at some reasonable rate while requiring the federal government to finance its’ current Medicaid cost plus all growth above this limit or cap. While this would seem to fly in the face and direction of the politics of intergovernmental cost shift, it was actually accomplished in New York State. In the 1990s the counties of the State of New York were in an uproar...
over the growing Medicaid burden. Because New York is one of the few states that require a substantial local Medicaid contribution, many counties found that Medicaid was the single largest expenditure in their budget. In 2006 Governor Pataki responded to the counties need for relief and capped the local responsibility for Medicaid growth at 3 percent. When there is sufficient pressure from the lower levels of government, fiscal burden can flow back up the governmental food chain.