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## Working Paper No. 650

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# **Fiscal Policy: Why Aggregate Demand Management Fails and What to Do about It**

by

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## **ABSTRACT**

This paper argues for a fundamental reorientation of fiscal policy, from the current aggregate demand management model to a model that explicitly and directly targets the unemployed. Even though aggregate demand management has several important benefits in stabilizing an unstable economy, it also has a number of serious drawbacks that merit its reconsideration. The paper identifies the shortcomings that can be observed during both recessions and economic recoveries, and builds the case for a targeted demand-management approach that can deliver economic stabilization through full employment and better income distribution. This approach is consistent with Keynes's original policy recommendations, largely neglected or forgotten by economists across the theoretical spectrum, and offers a reinterpretation of his proposal for the modern context that draws on the work of Hyman Minsky.

**Keywords:** Labor Demand Targeting; Aggregate Demand Management; Full Employment; Income Inequality; Poverty

**JEL Classifications:** E25, J2, J45, I38

To many progressive economists the argument that we must scrap the aggregate demand model must surely sound heretical. After all, in the face of the resounding rejection of government stimulus policies in the midterm elections of 2010 and a wave of austerity policies around the globe in the midst of the Great Recession, most of these economists are calling for *more* government spending not *less*. And whereas this author is sympathetic to the latter position, the paper will nevertheless argue that focusing on the size of the government spending misses the point of fiscal policy. The conversation must be fundamentally reoriented from focusing on general countercyclical government spending to executing some very concrete types of fiscal policies that would be implemented throughout the business cycle. The size of the corresponding expenditures will vary with contractions and expansions, but the focus of policy will always be on specific objectives. This paper argues that those objectives must include full employment, better income distribution, and poverty alleviation and that greater aggregate demand is not the answer to these problems.

The following is a qualified critique of the aggregate demand approach, including some specific policies that often receive the unconditional support from progressive economists (such as unemployment insurance and other types of income support for the poor and jobless).<sup>1</sup> It is qualified because the aggregate demand approach has some clear and immediate positive benefits, in particular it puts a floor on collapsing demand by improving aggregate incomes, cash flows, and balance sheets (Minsky 1986: 22–41). Nevertheless, this approach underwrites the wastefulness of market forces: 1) by itself failing to achieve and maintain true full employment; 2) by validating the economic structures that produce and reproduce income inequality; and 3) by institutionalizing poverty.<sup>2</sup>

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<sup>1</sup> In the current recession, for example, the White House enacted the longest-lasting emergency unemployment program in history that included the first benefit increase in a downturn in history (National Economic Council 2010: 25). It also supplemented the Temporary Assistance to Needy Families (TANF) program with emergency funds, which quietly expired by the end of 2010.

<sup>2</sup> Many Institutionalists and Post Keynesians have leveled a serious critique at the aggregate demand orientation of economic theory and fiscal policy. Joan Robinson chided the profession for its exclusive focus on total spending neglecting the structure of demand (Robinson 1972). John Kenneth Galbraith, who advocated aggregate demand management by government as essential for economic stability (Galbraith 1952), explicitly envisioned a “planned” aggregate demand which directed spending to specific industries and products (see also Waller 2008: 17). These economists reflect the original concern by both Keynes and Commons that theory and policy in particular must reflect an understanding of structural economic changes (Keynes 1964 [1936]; Commons 1934; see also Whalen 2008). And whereas fiscal activism is generally endorsed by heterodox economists, this paper argues that the way to target total demand in a manner that accounts for the structural changes in the economy is to specifically target the unemployed.

## LABOR DEMAND TARGETING: A KEYNESIAN APPROACH

Prior to the rise of the Welfare State, economists like J.M. Clark (1932) and J.M. Keynes (1964 [1936]) had stressed that market economies, which were uniquely suited to improving human wellbeing, had two fundamental failings: they were incapable of generating full employment and of improving the income distribution when left to their own devices. Four decades after the rise of “big government” and its considerable experience with fiscal activism, H.P. Minsky (1986) had made the exact same assessment. Furthermore, economists’ tacit acceptance of this failure is embedded in the very policy responses that are generally adopted: pro-growth and pro-investment policies supplemented by income and in-kind support for those who are left behind.

Conventional fiscal policies stem from a fundamental misreading of the policy recommendations by Keynes who, by contrast, emphasized direct employment and structural reform. It is important to briefly overview the precise nature of the government action that Keynes envisioned. It is well-known that Keynes favored a broader socialization of investment as the solution to macroeconomic stability (Keynes 1964 [1936]: 378). Nevertheless, there is considerable evidence to suggest that the precise strategy for achieving this objective is in the form of a permanent direct job creation for all who are unable to find a job *both in recessions and in expansions*, with special attention being paid to specific regions and distressed areas (Tcherneva 2011). This policy recommendation can be pieced together from the following arguments that can be found in Keynes’s writings.<sup>3</sup> First, the primary objective of fiscal policy is to ensure genuine full employment.<sup>4</sup> Second, aggregate demand effects are asymmetric. Whereas collapsing demand can quickly damage long-term expectations and rapidly increase unemployment; once expectations have been upset, boosting aggregate demand improves them only slowly and never sufficiently enough to generate full employment. Third, the solution to the problem of unemployment is not increasing aggregate demand, but fixing the point of effective demand at its full employment level (Tcherneva 2011). Employment equilibrium is a function of three key independent factors—the marginal efficiency of capital (*mec*), the marginal propensity to consume (*mpc*), and the marginal efficiency of money (*mem*). Since none of these factors are

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<sup>3</sup> Note that Keynes himself did not explicitly lay the details of a program for full employment despite the appeal by James Meade (Skidelsky 2001: 270).

<sup>4</sup> For Keynes that meant less than 1 percent of peacetime unemployment, or the sort of levels of unemployment that the economy has been capable of achieving during wartime (Keynes 1980: 303).

under the direct control of policymakers, fixing them and keeping them at the full employment point of effective demand is impossible via a policy of fine-tuning overall government spending. Instead, full employment could be secured over the long run by direct means that would also permit policymakers to employ structural changes as needed—that method is via “on-the-spot” employment (Keynes 1982: 171) for all of the unemployed at all stages of the business cycle in a program that would offer job and retraining opportunities to the cyclically, structurally, and long-term unemployed, as well as to new entrants in the labor force, part-time job seekers, or anyone else who has not found employment in the private sector (Keynes 1980: 357).<sup>5</sup> Keynes envisioned fiscal policy in the form of direct job creation for three main reasons: 1) such an approach has the highest primary and secondary employment creation effects of any fiscal policy;<sup>6</sup> 2) it can direct demand to the periphery of economic activity, including lagging urban or rural areas; and 3) it can be a useful institutional tool for the broader socialization of investment that would attain and maintain full employment over the long run.<sup>7</sup> This was the original Keynesian recipe for fiscal policy for full employment and macroeconomic stability: a solution that did not rest on boosting the government’s demand for *output* but on boosting its demand for *labor*.<sup>8</sup>

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<sup>5</sup> For details of this reinterpretation see Tcherneva (2011). Key findings are the following: 1) public works were not “depression solutions” and that must not be discontinued near full employment, as this is precisely the time when private industry is less capable of absorbing any additional workers (Keynes 1982: 150); 2) Keynes’s policy was not one of targeting industry, but of targeting the unemployed; 3) the measure of output in current or real prices do not account for the loss of labor as a result of changes in aggregate demand (Keynes 1980: 71); 4) potential output is fundamentally flawed in measuring the full employment level of output (Keynes 1980: 72–72) and it must be measured in terms of number of men and women that might be employed (Keynes 1980: 280–307); 5) instead of closing the demand gap for output, Keynes specifically argued for closing the *labor* demand gap (Keynes 1980: 280–307); 6) the unemployed must be hired via direct means in expansions as well by taking the contract to the worker (Brown 1936); and 7) unemployment is not to be used as an inflation fighting tool (Keynes 1980: 374).

<sup>6</sup> See specifically the Macmillan committee deliberations (Keynes 1981: 174–175).

<sup>7</sup> Public works are a preemptive measure—they do not wait until unemployment has considerably developed to deal with it. They are a long-term program of direct job creation and public investment that ensures that the jobless are immediately absorbed in the public sector as they lose their private sector work. Aggregate demand, Keynes argued, is policy measure that is “too late” (Keynes 1982: 394).

<sup>8</sup> Whether such a Keynesian fiscal policy is executed through the proposals for the Employment of Last Resort (Minsky 1986) or some other public employment program that guarantees the right to work is subject to debate, but the objective and method to achieve it were clear in Keynes’ writings: true full employment over the long run through a program of direct job creation.

## THE FLAWS OF AGGREGATE DEMAND MANAGEMENT

Modern policy will do well to embrace the original Keynesian policy vision, not only because of the merits of the targeted approach, but also because of the demerits of the aggregate demand approach. As Minsky (1961 and 1968) and others have carefully explained (see for example Galbraith 1970; Robinson 1972; and Stanfield 1999), aggregate demand operates on top of a specific economic structure that translates this broad based macro-demand into specific demands for specific products, produced in specific communities by specific workers. It is only by pure chance that aggregate demand will be such that it will generate enough jobs at the right places for all of those who need them at high enough wages to support themselves and their dependents (Minsky 1965: 177). Three important shortcomings of the aggregate demand approach will be considered here: the failure to produce and maintain full employment, the tendency to erode income distribution, and the reinforcement of the vicious cycle of poverty.

### **Failing to Produce Full Employment**

We can augment the Keynesian analysis above by suggesting that aggregate demand fails to pin the *mpc*, *mec*, and *mem* at the level of full employment, not only because of the inherent subjectivity of consumer behavior, investor expectations, or liquidity preference of the community as a whole, but also because of the inherent heterogeneity of labor. Minsky (1973) went to great lengths to explain that a pro-growth/pro-investment strategy is bound to fail due to the peculiar nature of investment and finance.<sup>9</sup> But aggregate demand measures fail in one other respect: they work through a fundamentally flawed trickle-down mechanism in labor markets as well. As government increases its total demand for goods and services, it first improves the conditions of the skilled, employable, highly educated, and relatively highly paid wage workers, who normally experience comparatively fewer spells of unemployment and manage to build considerable job tenure. Pumping more aggregate demand in the economy improves the employment and income conditions of those workers who will then increase their own demand for products and services that will trickle down to the less-skilled and low-wage workers and, eventually, to the least skilled individuals at the bottom of the income distribution. Training and

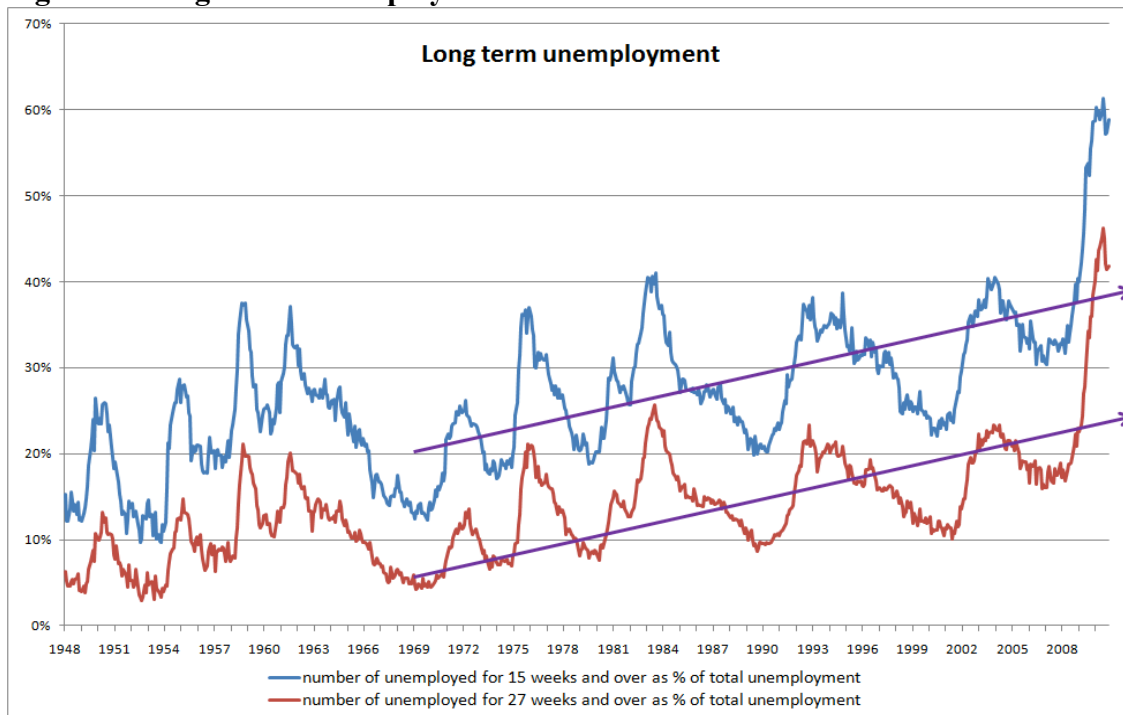
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<sup>9</sup> See also Wray's (2008) discussion of the "Domar problem."

education programs supplement pump priming in order to upgrade the skills of those who are considered unemployable, in the hope that the generalized boost to demand would eventually generate specific demand for their labor. Such policies are also fraught with inflationary contingencies (Minsky 1973: 98) because they work in a way to boost the wages of workers at the top of the income distribution first and of those at the bottom—last. Furthermore, as Keynes warned, the closer we are to full employment the more any given increase in total spending results in greater price increases and incrementally smaller employment increases (Keynes 1964 [1936]: 285). These inflationary pressures then prompt policymakers to abandon the aggregate demand approach *before* full employment is reached. Additionally, as Minsky had explained, the emphasis of this approach on private investment also generates inflationary forces through the process of financing capital assets (Keynes 1964 [1936]: 285).

After seventy decades of postwar aggregate demand management policies, we can restate the conclusion of Keynes, Clark, and Minsky that policy has decidedly failed to produce and sustain true full employment. Furthermore, a quick look at the long-term unemployment rate in the United States over that time illustrates a clear upward trend (figure 1).

**Figure 1: Long-Term Unemployment**



**Source:** Bureau of Labor Statistics and author's calculations



After every recession, when long-term unemployment skyrockets and aggregate demand policies work to reduce it, they fail to bring it back to its previous lows.<sup>10</sup> In other words, the failure to generate anything close to true full employment has had the effect of exacerbating long-term unemployment. More than that, it also corroborates the very processes that generate income inequality.

### **Sanctioning Income Inequality**

This form of bastardized Keynesian trickle-down economics (to use Joan Robinson's colorful modifier) from the high-skill/high-pay workers to the ones who are low-skilled and with low-pay only validates and supports the very structures that produce the unequal within-labor income distribution (Minsky 1973: 93–95). But aggregate demand also aggravates the inequality between the labor and capital shares of income. As Minsky argued, conventional pro-growth/pro-investment aggregate demand policies include investment tax credits, accelerated depreciation, direct contracts with guaranteed profits, and other policies that directly favor capital incomes. These high capital incomes result in a revaluation and appreciation of asset prices and the widespread realization of capital gains, which further bolster the financing of capital assets and investments, thereby boosting capital incomes further. And since capital income is more unevenly distributed than labor income, these practices worsen overall inequality further (Minsky 1973: 93–95).<sup>11</sup> The trouble with aggregate demand policies is that they not only ignore how the initial income distribution is generated but also tend to favor rentier incomes and profits, as well as high wage workers, thereby bankrolling the very processes that generate income inequality between factor incomes, within labor income, and within capital income.<sup>12</sup>

There are two ways to improve the income distribution through policy. One is to work within the existing structures that produce certain factor income shares and to redistribute income through various income redistribution schemes *after* it was earned and those shares have been determined. The other policy is to change the very way income is earned. The Keynesian

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<sup>10</sup> Note that throughout the entire postwar era, short-term unemployment (unemployment for 14 weeks or less) as a percentage of total unemployment has been on a continuous downtrend.

<sup>11</sup> Priming the pump even in recessions tends to erode the income distribution because aggregate demand directly feeds into profits via the Kalecki (1954) equation, while unemployment increases simultaneously.

<sup>12</sup> It should be noted that the Great Recession is witnessing one of the greatest income transfers to the top in history. Aggregate demand as currently practiced directly increases income inequality via tax cuts to the wealthy, the socialization of financial losses via the Troubled Asset Relief Program, and the large-scale investment subsidies and contracts to firms at a time when they continue to slash employment and wages.

targeted demand approach can do so by directly increasing and stabilizing the share of labor income in production.<sup>13</sup> It also ensures that by employing the unemployed, it improves incomes at the bottom of the income distribution faster than incomes at the top, thus improving within labor income distribution. As Minsky had once argued, “instead of the demand for low-wage workers trickling down from the demand for the high-wage workers, such a policy should result in increments of demand for present high-wage workers ‘bubbling up’ from the demand for low-wage workers” (Minsky 1968: 338). Such a policy, far from working through the prevailing structures that produce income inequality, will begin to transform them by stabilizing incomes and employment at the bottom end by employing workers in the production of public goods and services. This latter aspect of the labor targeting approach can go a long way to reversing the tendency of the public sector to lag the private sector in providing the protective services that are required as economies expand. Thus the program can help address the problem that Galbraith once identified as “private opulence and public squalor” (Galbraith 1958).<sup>14</sup>

### **The Institutionalization of Poverty**

Finally, by institutionalizing long-term unemployment and income inequality, the current approach is also institutionalizing poverty. Minsky (1965) had observed that the 1960s decline in poverty was largely due to the fall in unemployment. Nevertheless, the pro-growth aggregate demand management policies did not reach all of the poor. By contrast, a program that secures “tight full employment” over the long run was crucial for any anti-poverty strategy. A Minskian employer of last resort or a Keynesian “on-the-spot” employment program that offers a job at a living wage to all who want one will eliminate poverty among the jobless, the low paid workers, and the poor who were previously out of the labor force but are now reentering because of the job opportunity.<sup>15</sup> In other words, a strategy that fosters “labor force attachment” is key. Minsky estimated that through such a program poverty would be virtually eliminated (Minsky 1965; 1968: 329). A job guarantee will also go a long way to eliminating poverty by providing much-

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<sup>13</sup> The redistribution of labor between the private and public sectors will depend on the level where the public sector wage is set and on the stage of the economic cycle.

<sup>14</sup> Note however that the program itself does not eliminate rentier incomes, which both Keynes and Minsky considered necessary for a stable economy.

<sup>15</sup> Today the minimum wage is well below the poverty level and 16.4 percent of full-time workers live in poverty.

needed social services.<sup>16</sup> Pigeon and Wray (1998) have confirmed the Minskian insights that even in the booming Clinton economy, a pro-growth approach does not trickle down to the bottom of the income distribution. Additionally, Bell and Wray (2004) have updated the Minskian analysis to confirm that direct job creation is an essential poverty alleviation tool.

The current approach is bankrupt from a moral and economic perspective. Aggregate demand management favors the “haves” over the “have nots” (Bell and Wray 2004): it provides handouts to the needy as the “right thing to do,” but offers no genuine employment opportunity that allows them to start climbing the economic ladder. Thus this approach is fundamentally demoralizing and inefficient. It fails to fix the economy in a way to provide a sufficient number of jobs to all who want them. Instead, it pressures the unemployed and the poor to “reform themselves” and fosters invidious policies such as the 1996 welfare reform, which produced a far more punitive program—one that requires the recipients to work, but does not guarantee the job opportunity. And indeed it has been shown that this reform has failed to lift welfare recipients out of poverty (Peterson, Song, and Jones-DeWeever 2002; Turner, Danziger, and Seefeldt 2006). The manpower of the poor and the unemployed can be mobilized for the public purpose irrespective of skill level, which in turn will be upgraded by the very work experience and educational programs that the program would offer.

## **CONCLUSION: REORIENTING FISCAL POLICY**

To be clear, income support such as social security, Medicare, child allowances, and disability support is required for many. But the indispensable safety net for those who want to work but cannot find employment cannot be a handout—it must be a job. The labor demand targeting approach can provide that safety net; it does not invalidate other policy measures, but presents a benchmark for policy action. Note that there is no clear answer to the question of what the adequate level of aggregate demand is. *More* government spending cannot be a proper policy objective, but the *type* of government spending is the place where meaningful academic and political discourse can take place. It is clear to this author that in the absence of this kind of conversation and a policy design that deals with the specific problems of unemployment,

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<sup>16</sup> Today there are 37 million Americans, including 14 million children, who rely on food assistance. That is 1 in every 8 people (Hunger Report 2010). Furthermore, 43.6 million Americans (or 1 in 7 people) live in poverty today—the highest number in 51 years (DeNavas-Walt, Proctor, and Smith 2010).

poverty, and income distribution, the generalized pro-growth, pro-investment aggregate demand strategy will remain the main tool for dealing with serious downturns. But it will also continue to fail in securing true full employment, and will keep validating those structures that produce and reproduce income inequality and poverty.

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