

# Research Notes

## How To Be A Good Keynesian

January 3, 2009

As we keep hearing, we are all Keynesians now. There seems to be a consensus that governments need to step in and spend to make up for flagging demand from consumers and business. Several governments themselves have already stated that they expect to run deficits to do so. President-elect Obama plans to spend heavily on infrastructure investments and governments in Canada are also opting for this approach.

So what is the best way for governments to do all this spending? As quickly but carefully as possible. Since monetary policy has run most of its course, it's time for fiscal spending. That spending should be mainly on public infrastructure, but only projects that generate significantly greater social benefits than they cost.

### **Infrastructure not Direct Consumption Subsidies**

Why is infrastructure a better use of public funds than direct consumption subsidies to households? At first, the direct approach seems appealing. Just send some cheques out to consumers and watch them go to the mall. We can do this quickly and seems to get right to the source of the current recession — declines in consumer spending. The U.S. already tried this method this year (even before the recession was declared) and it did stimulate some spending and growth in U.S. GDP.

Given the disastrous autumn that followed, it's clear that those rebate cheques didn't get the U.S. economy growing sufficiently again. The reason is that the underlying worries causing consumers to reign in their spending have not been addressed. A cheque for \$500 doesn't take away my worry that I may lose my job, or that my financial and housing wealth has dropped 10 to 30 percent. When consumers fear that they may losing tens of thousands of dollars, a windfall of a few hundred may be consumed, but they are swamped by the larger wealth effect. Keynesian "animal spirits" remain very

down. So consumption declines again after the cheque is spent or put against existing debt.

In more normal times, consumers saving a rebate or using it to pay off some debt would likely be a good individual decision. Those households' savings would make their way to private sector business through bank loans, bond or stock markets. But bank lending is not sufficient and many businesses are not willing to risk investing when consumer demand looks bleak.

So we need a big spender to step up. One that can and will spend big enough, for long enough, to convince the private households and business people that their well-being won't decline dramatically more. Only governments can credibly do this. If government is going to be spending, it should be on things that make sense for government to provide. Standard economics tell us that government subsidies or direct government supply of a good or service makes economic sense for publicly beneficial things that the private sector would not invest enough in. Such goods are called public goods as they generate social benefits and have characteristics that make it hard for businesses to fully recoup their investment in them. Government spending on public goods could include investments in: roads, bridges, airports, defence, city-wide wireless mesh networks, hospitals, childcare facilities, basic R&D support, environmental protection, health care facilities, transportation and so on. Clearly many of these public goods are infrastructure projects.

### **More Benefits than Costs Please**

For a given infrastructure project, the expected costs and expected benefits to society as a whole (consumers, business and governments) should all be considered and compared over the life of the asset. Identifying and putting dollar values to these expected costs and benefits of each project can be



tricky. That is the main art and challenge of cost-benefit work. Once reasonable values have been estimated over the life of the cost and benefit horizon, we discount these values back to the present. Comparing these present discounted benefits to present discounted costs allows us to rank the possible projects. The projects that are expected to deliver the greatest benefits per dollar of cost should be the first to be funded.

Projects that would not pass a cost-benefit test, i.e. costs outweigh benefits, should not be undertaken, even if we've all become Keynesians now. This would avoid the bridges to nowhere that make many of us cringe at the idea of a new era of government deficit spending. Expanding government spending should not remove the cost-benefit test requirements, only allow government officials to fund more projects, so long as all pass a benefit-cost test.

Hopefully this Keynesian moment leads us to make relatively good investments; ones that we honestly believe will benefit not just ourselves but also future generations. If we do, then they may forgive us a bit more for sending so much debt their way.

**Rose Cunningham, Ph.D.**  
**Independent Economic Advisers**  
**[rcunningham@iearesearch.com](mailto:rcunningham@iearesearch.com)**

