Neoclassical Versus Keynesian Approach to Public Policy – The Need for Synthesis

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Abstract

The global economic recession following the financial crises once again revived the debate over the efficacy of Keynesian solution to deal with the crises. Most of the country went in to offer bailout packages from the public budget which could be the reminiscent of such policies adopted earlier – New Deal of President Roosevelt of US is case in point.

Keynes was the first person to provide theoretical justification for the deficits in public budget to raise the aggregate spending level in the economy which, in turn, would raise the employment level. Keynesian advocacy would have remained unheeded had the crises of 1930s not occurred. The crises offered the opportunity to put the Keynesian solution to test. The approached worked. But by the end of the decade of 70s this approach was abandoned and neoclassicism not only resurfaced but became the bases for the policy not only for nations but for multilateral financial institutions as well. It was the crises again which brought back the Keynesian wisdom to relevance.

The present paper assesses the two approaches in the historical context to find if synthesis between neoclassical and Keynesian approach is possible to make the public policy more effective.

Keywords: Deficits, Public budget, Global crises.

1.1 Introduction

The economic ideas are produced by material circumstances. In the initial stages of economic development ideas generally seek to discover the principles that explain the working of the economic system. In the process these ideas influence the economic system as well and help a great deal in its evolution. As economic development proceeds the complexities of the economic system also grow. If the ideas are unable to offer solution to such complexities they are abandoned howsoever powerful they might have been in terms of their influence on public policy at some point in time (The case in point is mercantilist philosophy). With economic system gaining maturity the competing ideas directed at influencing the public policy also emerge. There have been only few economic doctrines in the history that had profound and lasting influence on public policy. Neoclassical and the Keynesian doctrines fit the bill. One of the major debates of all times in economics which are still on is with regard to the role of the government in the economy and the abovementioned doctrines represent two different approaches to the public policy.

1.2 Neoclassical Approach

The group of economist collectively called classical economist developed a policy prescription about economy the core of which was the limited role it would assign to the government and a belief in the self equilibrating capability of market termed by Smith 'invisible hand'. As government was not assigned the role in the economy beyond providing some basic services (public goods) and to create apparatus whereby market functions efficiently there was hardly any role for the fiscal policy to regulate things in the economy. Smith, hailed as father of 'classical political economy' (the name by which economics was then known), maintained public budget to follow the prudence of a family budget where expenditures are advised to be limited to the income and the borrowing only in the emergencies.

The classical economists whose ideas and beliefs are the bases for the neo classical approach to public policy had the unwavering faith in the capability of market to produce efficient outcome as far as the utilization and allocation of productive resources are concerned. While fluctuations in the economic activity were not ruled out but they would be addressed by the forces of self correction activated by the economy itself. Thus the governments attempt to intervene would amount to injecting the sources of instability. Fiscal profligacy was considered to be one such source of instability. This approach, enunciated by Smith – Ricardo – Say, rules out the possibility of glut and unemployment as it assumes – rather unrealistically – the wage flexibility. The model produces 'zero GNP gap' and hence no macroeconomic instability. If economy ever experiences the unemployment or glut it would be a short term phenomena as the self correcting mechanism would become activated (Malthus, amongst the classical economist, though was in disagreement with this proposition about the impossibility of glut). Balanced public budget was recommended because whatever ways such deficits would be financed would produce distortions in the economy. All the competitive allocations are supposed to be efficient in terms of Pareto optimality where no one, through reallocation, can be made better off without making someone worse-off.

At least twice in the history of economic doctrine the classical theory faced serious challenges. Each time it bounced back and those who helped its resurrection came to be called 'neoclassical economists' and the policy prescription 'the neoclassical approach'. First time when 'marginal revolution' in the latter part of 19^{th} Century had relegated it to irrelevance especially with respect to the question of value (however its relevance for public policy remained undiluted) it was Marshall who resurrected it through his 'great synthesis' and restored its relevance. Next serious challenge came in the form of great depression of 1930s. The self correcting capability of market was put to severe test by the crises. The problem emerged was not that market can not function but the time lag involved in the occurrence of imbalance and its correction by the market. It was particularly significant as the people were made to suffer longer than their tolerance level by the economic crises resulting in doctrine of market economy becoming discredited.

1.3 Keynesian Approach

Not only that the kind of full employment as envisioned by classical economists could never be attained by any country (at least it is not documented) there occurred a severe depression in West Europe, UK in particular, and USA during 1873 - 1897. But still the efficacy of classical theory in guiding public policy could not be successfully challenged. It was during 1920s that Keynes offered different paradigm to public policy which was diametrically opposite to that of classical vision of balanced public budget.

The argument that Keynes advanced was the deficit spending by the government would raise aggregate demand and consequently the employment level in the economy. Private investment out of the current saving was not the effective means for the reason that it would slowdown the multiplier effect of investment as the determinant of multiplier is 'marginal propensity to consume (mpc + mps = 1). Government spending through created money would keep the economy growing in accordance with the multiplier value. Therefore Keynes was the first one to provide theoretical legitimacy to deficit budget and public debt. Even before the onset of depression Keynes was arguing in favor of deficit-financed public works to raise employment. "There is no reason why we should not feel ourselves free to be bold, to be open, to experiment, to take action, to try the possibilities of things."[1]

In matters of public policy the great depression was the most serious challenge the classical doctrine faced. Market was unable to offer solution to the crises of demand deficiency and thus demand induced investment in terms of Clark's 'accelerator' was not expected to be forthcoming. Though 'monetarists' would still believe the enhanced money supply would have been the better policy option as it would lower the interest rate and consequently raise the investment demand. But producers in that situation would refrain from undertaking fresh investments on account of already accumulated unplanned inventories resulting from the deficiency of effective demand. Investment cuts by the entrepreneurs would reduce the income level which in turn would reduce consumption expenditure. The process would set in motion the downward spiral in terms of income and employment. The so called stability as believed by neoclassical approach was seriously exposed. This is exactly what had happened during the crises that began with 1929 Wall Street crash in US and blown into the widespread depression in all the market economies. Thus it was not only the neoclassical policies but the capitalism itself that faced the crises for their existence. Marxian prophecy seemed to be coming true. It was at this stage that Keynes began to receive attention and emerged as the savior of capitalism.

[1] J M Keynes and H Henderson (1972) "Can Lloyd George Do It?"' The Collected Writings of John Maynard Keynes, vol. IX, p. 126

Enhanced public spending in market economies like the ‘New Deal’ in United States did actually help economies recover from depression.

Keynesian paradigm implied the government has not only obligation but the ability also to address the problem of instability. Although Keynes’ was only a short term solution it continued to be relevant because of the need for enhanced public spending during World War II that followed depression and post war recovery. It was in 1970s that Keynesian wisdom began to be questioned. On the one hand deficit spending generated inflationary pressure on the other supply side remained precarious as the large part of public spending was aimed at raising the aggregate demand rather than the output of goods and services. The emerging scenario was the inflation together with the stagnant growth popularly known as ‘stagflation’. The Keynesian prescription began to be replaced by the neo-classical approach once again. Not only the market economies but the multilateral financial institutions subscribed to this approach. The recent global financial crises and the economic recession that followed once again revived the Keynesian wisdom. Huge budgetary allocations were used to bail out the financial giants that were crumbling one after another in most of the capitalist countries.

1.4 Imperfections of Public Policy

It becomes obvious from the above analysis of historical developments that public policies in the capitalist countries have been oscillating between two competing approaches. Whereas one approach favors minimal government the other one considers government intervention desirable especially the deficit spending. None is free from limitations. The former that virtually rejects any sort of regulation and controls fails to find solution to the problem where market determined allocation is though ‘Pareto efficient but socially not desirable especially in case of goods with positive externalities – ‘merit goods’. ‘Regulations’ per-se become public goods as in the absence of which both the parties to a transaction or a contract (either formal or informal) do not stand on equal footing on account of one party enjoying market power. Further, as discussed above, non-intervention on the part of government would necessarily entail suffering when economy is going through the phase of downswing in the business cycle. Deficit spending by the government does provide answer but it leads to fiscal imprudence which is opposed by this approach. The latter, the Keynesian approach, suffers from its short term nature together with the fact that it does not prescribe any theoretically justifiable limit on deficits and often motivate politicians to go in for populist measures especially in the countries where they face electorate.

1.5 Policy Options in Developing Countries

Developing countries differ from the developed one in many respects. The major difference lies in the fact that unemployment in these countries – most of them overpopulated one – is structural not the cyclical as in their developed counterparts. They are capital starved and as such unable to deploy sufficient capital to raise the employment level. Their social sector is in miserable condition as vast segment of their population do not have access to education and health of reasonably good quality. Therefore these two goods definitely become the merit good. Since sizable segment also suffer from hunger and malnutrition and therefore food security acquires the status of merit good. In most of these countries there exist imbalances in terms of income distribution and regional development. Agriculture continued to be the chief source of livelihood for major segment of population despite some amount of development having been attained. This is because of the reason that manufacturing sector is organized along the capitalist principles and adheres to 'wage in accordance with marginal productivity of labor' the relative over population in agriculture is large.[2] Consequently agriculture's capabilities in supplying savings are severely limited. These factors not only call for not only government intervention but do justify deficit spending as well. Keynesian approach seems to suit the condition though the problems of under-developed countries were not the focus of Keynes when he propounded the theory that justify deficit.

1.5.1 Evaluation of Public Policy in India

A look at the public policy stance in India would provide the relative suitability of two competing guiding principles (extensively discussed above) for public policy. India has been deficit financing its development plans since 1956 but stuck to 'borrowing for investment principle' as it did not incur deficit on revenue account till 1979. India went in for public regulations of its economic system. Thus the public policy instance was not exactly but closer to Keynesian one. Its industrialization, with public sector taking a lead, was rapid and agricultures growth was commendable with sufficient infrastructure having been built. It had its share of crises also but it could somehow succeed in avoiding serious fiscal difficulties. All the crises that came its way were driven by supply shocks largely on account of failure of agriculture.

India began to indulge in fiscal profligacy in 1979 when for the first time there was deficit in the revenue account of the Central government's budget which continues to this date. 1980s was the decade of the robust growth with annual average growth rate for the decade was five percent plus. It was during this decade that massive employment programs were launched. But such growth could not prevent the economy from plunging into one of the serious crises economy ever faced in 1991. All the fiscal parameters were in bad shape. Public debt had reached the level where its sustainability became doubtful.[3]

The immediate cause was the balance of payment difficulties not the domestic supply shock. But the prevailing international environment[4] forced India to switch to neoclassical mode to tide over such difficulties. Thus India's public policy instance shifted from closer to Keynesian to closer to neoclassical one. It has been pursuing such

[2] Agriculture because of its institutional arrangements defy the marginal productivity logic of wage.
[3] Seshan, A (1987), "The Burden of Domestic Debt in India" RBI Occasional Papers, Vol.8, No.1, June 1987
[4] Neoliberal policies being pursued in US and UK and the collapse of Soviet Union.

policy since than with fiscal prudence being always in focus. So much so that that it had legislated Fiscal Responsibility and Budget Management Act in 1993 and cut various subsidies to a significant extent. The growth rate the economy registered since then has been phenomenal. The economy could not be affected much by the South Asian crises in 1998 despite certain amount of integration of it with world economies. Recent economic slowdown too did not affect it to the extent it did to other economies.

The question to ponder over is if economy survived because of its greater allegiance to neoclassical policy of greater fiscal prudence, greater liberalization or globalization. Also needs to be assessed is if the earlier policy of fiscal expansion was the one crises of 1991 could be attributed to. Pursuit of answer to these questions leads to the following observations. It was not the fiscal profligacy that is culprit as fiscal expansion is supposed to have little impact on external sector. The reason was India failed to have favorable balance on its capital account sufficient enough to offset the deficit on current account of its balance of payment. Once capital started pouring in following liberalization the difficulties could be overcome. If fiscal imprudence is to be believed as explanatory factor for the crises of 1991 what explains the flourishing economy in 1999-00 when all the fiscal parameters were exactly at the same level (partly because of the pay revision of government employees) at which they were in 1991. Further the recent global economic slow down could only marginally affect the economy as the aggregate demand level could be maintained by massive increase in social sector spending especially National Rural Employment Program, revision again of salaries of the government employees on the recommendation of Sixth Central Pay Commission and allowing the States to breach the limits on deficit put by their Fiscal Responsibility Legislations. In short it is the fiscal expansion that helped not only India but the capitalist world in combating recession.

1.5.2 Lesson for Public Policy and the New Challenges

Analysis of historical data therefore suggests both the policy options have certain limitations and are not relevant in all circumstances. Public policy based on neoclassical prescription is efficient if market imperfections are absent, that is to say no body enjoys market power. But still fluctuations in economic activity cannot be ruled out. To tackle the downswing policy prefers monetary expansion which has been proved ineffective in serious crises like the one occurred in 1930s and in 2008. Moreover market failed to ensure the fair play by banking and financial institutions. Keynesian prescription, on the other hand, tackles the problem of demand deficiency quickly as it can instantly release the extra liquidity in the economy. The major limitation of this policy is it injects extra money in the economy in excess of goods and services. Therefore it is alright to clear the market when market failed to do so but offers solution only in the short run.

The meeting grounds for both the policy stances in fact do exist. The prudence demands the optimum mix of the elements from both if State's intervention is accorded the status of public good as it has the capabilities of eliminating the market imperfections and making the allocation socially desirable. This is especially relevant in view of the emerging issues relating to climate change and bio-diversity.

1.6 Conclusion

Discussion above leads us to conclusion that treating neoclassical and Keynesian as the rival approaches for guiding public policy could be erroneous. Synthesis is not only possible but desirable as well. Market could be made the efficient mechanism by creating apparatus which if functions well minimizes the market imperfections. The challenges thrown by the environmental concern in recent time demand public policy intervention as market may not offer solution. Since there is increasing realization about the limitations of market in addressing these issues it can be considered to be a big opportunity as well for the greater acceptability of State's intervention. At the same time States would do well to withdraw from the areas that are not public good. As far as merit good argument is concerned State may enter the market as big player of the game as it would help eliminate the market power that might rest with few oligopolists. So synthesis is the need of the hour.

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