Tim Congdon

‘Empirical evidence shows that whereas Friedman knew what he was talking about, Keynes did not’

Does expansion of public expenditure increase total spending in the economy? Do increases in the budget deficit boost demand and employment? For many people, the answer is a matter of common sense. As Lord Skidelsky observed in a Standpoint Dialogue with me last December, “the surest way to get aggregate spending up is by the government spending the money itself”. Skidelsky and others subsequently organised a letter to the Financial Times in February, claiming that “fierce spending cuts” might tip “the economy back into recession”.

The claim that changes in the budget deficit, or “fiscal policy” for short, can alter output and employment is often said to originate in John Maynard Keynes’s 1936 classic, The General Theory of Employment, Interest and Money. Skidelsky, who has written a magnificent biography of Keynes, and a large number of like-minded commentators revere him as the greatest economist of all time. However, the validity of an idea depends on neither its appeal to common sense nor the sanctity of its author. In our world of scientific method, what matters is consistency with fact.

Milton Friedman—who died in 2006 aged 94—is usually seen as Keynes’s intellectual antithesis, with his contrasting emphasis on the importance of money and monetary policy to macroeconomic outcomes.

Friedman derived part of his success from his insistence that theoretical propositions had to be empirically validated. Much of his work was on the topic that Keynes had made so central to public policy, namely the relative effectiveness of fiscal and monetary policy. Friedman’s verdict on the historical record was trenchant.

In January 1996, two British economists, Brian Snowdon and Howard Vane, asked him in an interview, “What role do you see for fiscal policy in a macroeconomic context?” Friedman’s reply was curt: “None. One of the things I have tried to do...is to find cases where fiscal policy is going in one direction and monetary policy in the opposite. In every case, the actual course of events follows monetary policy. I have never found a case in which fiscal policy dominated monetary policy and I suggest to you as a test to find a counter-example.” Friedman was undoubtedly most interested in US experience and data.

Does his assessment of the virtual irrelevance of fiscal policy also apply in the UK? Contrary to the beliefs of Skidelsky and his fellow correspondents, over the last 35 years the UK provides decisive evidence in support of Friedman’s view.

In 1977, public sector capital expenditure cuts were the most drastic since the war, yet the economy recovered in 1978. In 1981, the Thatcher government raised taxes by three per cent of national income and was roundly condemned by 364 economists in a letter to The Times, on the grounds that the fiscal contraction would deepen an alleged “depression”. Instead, aggregate demand started to grow within months of the Budget, and the next eight years saw large increases in output and employment. After a bad recession in the early 1990s, the Major government combined tax increases and spending cuts from 1992 to 1996, and again the economy enjoyed above-trend growth.

On this basis, Friedman was as right about the UK as about the US. The relationship between public spending and demand assumed by the Keynesians does not hold in reality, whatever its superficial plausibility. Hundreds of Keynesians may sign letters to newspapers asserting otherwise, but fiscal policy is ineffective. Reductions in public spending can be accompanied by above-trend growth in domestic demand, a point that is likely to be confirmed again between 2011 and 2014 if the Tories are in power. By contrast, monetary policy is highly effective. Changes in the quantity of money have immense macroeconomic power, and matter vitally to asset prices, profits and jobs.

I would like to make two recommendations. The first is to the Treasury. UK officialdom has never seen fit to calculate and maintain a consecutive series for “fiscal policy” as commonly understood, that is changes in the structural (or cyclically-adjusted) budget deficit. My recommendation is that the Treasury calculate such a series for the past, keep it up-to-date on a regular basis and publish it prominently.

The second is that Skidelsky & Co put together data on changes in the quantity of money and in the structural budget deficit over any period they like, and to regress changes in domestic demand on the two variables. They will find—to their dismay—that whereas Friedman knew what he was talking about, Keynes did not.