KEYNESIAN VS NEO-CLASSICAL THEORY: GOVERNMENT EXPENDITURE

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ABSTRACT
Keynesian and neo-classical theories intent to handle macroeconomic issues and therefore to achieve the stability of macroeconomic situations. Keynesian theory articulates concern about a short-run economic situation, especially it faces economic turndown. However, neo-classical theory worries over a progressive increase in government spending in the long run.
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I. INTRODUCTION

Outstanding scholars and policymakers have discussed the particular role of public spending in economic growth since the global crisis of 2008. There are two well-known theories (Keynesian and neo-classical theory), which are brought to debate on the influence of government spending on economic growth. Thus, this paper aims to assess Keynesian and neo-classical theories about their assumptions and explanation.

II. KEYNESIAN VERSUS NEO-CLASSICAL THEORY

Keynesian theory with a specific assumption of sticky wages and prices always explains a positive co-movement between employment and the aggregate demand. By allowing some unemployed economic resources at the beginning, expansionary government spending makes more incentive to invest, thereby increasing employment. A high level of income encourages household consumption subject to individuals' thought as liquidity constrained (i.e., a positive change in personal income raises consumption rather than saving [1], [2]) or short sight. Even though government expenditure is over government revenues, the extension of government spending enhances not only private consumption but also national income. Also, there is a positive reaction of capital accumulation and savings to this improvement of government expenditure. An aggregate demand reacts swiftly and sharply to a temporary cut in taxes. The government intervention in economic activities, therefore, should be made to achieve full employment and to promote an aggregate demand. In the case of an insufficient amount of money, the government should take out a loan to finance spending.

Some empirical studies also found the result, which is consistent with Keynesian concept about the positive effect of government expenditure on economic growth. Yasin [3] investigated the reaction of economic growth to a positive change in government spending in 26 sub-Saharan Africa countries and employed fixed-effects and random-effects approach. Their result based on panel data from 1995 to 2005 showed that an increase in government expenditure improves the growth rate of

output. Alexiou [4] employed the fixed-effects approach to run on panel data of 7 countries in the South-Eastern Europe region during the period from 1995 to 2005. His result is that the extension of government spending stimulates economic growth. Bose et al. [5] based on panel data of 30 developing countries over the period from 1970 to 1989 and three-stage least squares (3SLS) found that healthy economic growth reacts to the expansion of government spending. Ghose and Das [6] used dynamic ordinary least square (DOLS) to run on panel data of 19 emerging market economies during the period from 1970 to 2006. Their result is a positive reaction of economic growth to an increase in government expenditure and agrees with the outcome of Bose et al. [5]. Ram [7] also used panel data from 115 countries (i.e., non-industrialized and industrialized countries). His result based on the ordinary least square (OLS) approach with a first-order autoregressive disturbance term showed that expansionary government spending contributes positively to economic growth. His outcome also is similar to the findings of Gould [8], Kormendi and Meguire [9], and Lee and Lin [10]. Knoop [11] used time-series and quarterly data of the United State of America (USA) over 400 periods (100 years) and an OLS estimation method. His result indicated that a decrease in government spending slows down economic growth.

On the other hand, other theories and research draw the opposite conclusion. The Ricardian doctrine indicates that the government uses two channels (lump-sum taxes or accumulation of debt) to increase the budget for financing public spending. This doctrine has confidence that consumers do not make a difference between (1) paying lower taxes and investing in a higher amount of bonds in portfolios and (2) paying higher taxes and purchasing a smaller amount of government bonds. The higher taxes in the future to pay back the outstanding bonds at the maturity date react to rising emission levels of government bonds today. For instance, the taxes can be cut down when the government faces a budget deficit. This phenomenon generates a short-run effect on consumption in response to an increase in permanent income. The announcement about a reduction in taxes is made immediately, and consumers anticipate this occasional reduction. On the contrary, this phenomenon creates any long-run harm based on Ricardian Equivalence—that is, rational consumers notice that widening short-run deficit causes a tax increase in the future. The consumers raise their savings to make a sufficient reserve and maintain a constant level of private consumption, even though disposable income grows in the short run. As a result, fiscal policy does not influence the aggregate consumption.

Neo-classical theory prioritizes a balanced budget in hypotheses policy and assumes fully used economic resources at general equilibrium. Neo-classical economists foresee that individuals only design their consumption plans with finite time (i.e., personal life cycle). The budget deficit extends the total life consumption due to a transfer of taxes to the next generation. In terms of completely used economic resources, the enhancement of private consumption leads to a decline in savings, raising the interest rates to balance the capital market. Unrelenting deficit drives out private capital accumulation and also the economy.

Notably, Hall [12] applied the neoclassical model to investigate a temporary change in government purchases on output without an effect of externalities, a distortion of taxes, and unemployment. He also assumes that the government

purchases do not influence households' marginal rate of substitution between current and future consumption and between consumption and work. This analysis is based on wealth analysis in the labor market to examine the effect of government purchases. He expresses that the massive extension of government purchases does not improve the significant growth of output. By relying on purely neoclassical general-equilibrium with full employment, productivity reacts positively to an increase in employment. If a reservoir of unemployed workers does not exist to keep the wage unchanged, a decline in wages responds to an increase in labor inputs, thereby reducing labor supply. The neoclassical model reasonably foresees much lower output growth and a sharp decrease in consumption. With his assessment, two features (i.e., a markup price over cost and elasticity of wages with respect to labor supply) determine a degree of the negative impact of large government purchases on economic growth. Armey [13] argues that public spending exceeds government revenues, thus harming economic activities than helping them. The primary reason is that the generated amount of money in the economy is smaller than the sum of money taken out. This situation destroys jobs, shrinks the rate of output growth, and stunts development.

Some empirical studies suggest the result (i.e., negative response of economic growth to the extension of government expenditure) in line with neo-classical theory. Dar and AmirKhalkhali [14] investigated the impact of government expenditure on the rate of economic growth in 19 OECD countries over the period from 1971 to 1999. Their result based on random coefficients model showed that the expansionary government expenditure slows down the rate of economic growth in OECD countries. Fölster & Henrekson [15] employed panel data of 23 rich countries in OECD countries and an OLS approach to estimate the relationship between government spending and the growth rate of output. Their result based on annual data from 1970 to 1995 is consonant with the findings of Engen and Skinner [16], Landau [17], and Dar and AmirKhalkhali [14]. Hasnul [18] examined the influence of government spending on economic growth in Malaysia and used an OLS approach to run on annual data from 1970 to 2014. Their result indicated that the expansion of government expenditure drives out economic growth of Malaysia.

III. CONCLUSIONS

From my perspective, the Keynesian theory tries to deal with the short run. During an economic downturn, the government has to make expansionary public policy to enhance employment and to stabilize real wages; even though the government has a budget deficit. The government has to deal with this issue in the short run rather than wait until the recovery of the market itself over the long run. The assumption of Keynesian theory about some underemployed labor at the initial time is an appropriate phenomenon for economic recession or depression and some developing countries. During an economic recession, many firms, which are operating in the economy, can cut down their employees or be bankrupted, thus increasing unemployed labor. Some developing countries have less incentive for investors to invest. The reason seems that non-industrialized countries have poor public services, especially education, health, and infrastructure. A large part of the population in some developing countries has low education status, thereby leading them to have limited capacity for thought and skilled work. If government increases

its expenditure on those services, government spending creates a pleasant environment for investment.

In my point of view, neo-classical theory concerns the long run because of the shift of taxes to subsequent generations if the expansion of government spending takes a hundred years, thereby leading to an increase in taxes in the future. The subsequent generations also have to pay for these taxes because present generation makes a consumption plan for personal life. The neo-classical theory assumes initially full employment, thereby seeming an appropriate phenomenon for developed countries. By following this reason, developed countries have a pleasant investment environment due to the high quality of public services (i.e., education, health, and infrastructure). At the initial time, there is massive investment in the economy and abundant skilled labor with long-sight.

The purpose of both Keynesian and neoclassical theory seems to stabilize the macroeconomic situation. A few of the glib one-liners delivered are "long run as a consequence of the short-run and waiting for recovery of market itself; the economy is dead"

IV. REFERENCES

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