THE FREEMAN
IDEAS ON LIBERTY

The Trouble with Keynes

by Russell Shannon

"*In the long run* we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again."
—*John Maynard Keynes* (1923)[1]

Keynes' remark about the inevitability of death is now famous. It is, however, a statement not of defeat but of denial. Rather than indulge in resignation and gloom, Keynes urges action. The market economy, he believes, may at least occasionally require some judicious nudging. If we can temper the impact of economic malaise, why wait?

At first glance, this position seems reasonable. Why *not* use human intelligence to alleviate problems? After all, isn't that what we do with medicine? Then why not let the doctors of economics prescribe remedies appropriate for our economic ills? Did not the founder of modern economics, Adam Smith, suggest a strong dose of laissez faire?

There are, however, at least two distinct problems with Keynes' activist approach. First is the question of whether or not we can rely on the political system to act in the recommended way. In light of Keynes' comments on other occasions, his optimism on this issue is both uncharacteristic and unwarranted.

Yet if we put this critical matter aside, another equally urgent issue emerges. To resolve today's problems, might we not create or exacerbate future problems? If we indulge in a drunken spree tonight, don't we risk a considerable probability of awakening tomorrow to a wretched hangover? In economists' stark terms, we must ask ourselves if the benefits will outweigh the costs. Let us consider each of these matters in turn.

The Proclivities of Politicians

As to the role of the state in economic matters, Keynes repeatedly expressed disillusion with, and even disdain for, laissez faire. In his most influential work, *The General Theory of Employment, Interest and Money*, he plainly stated that he favored "a somewhat comprehensive socialization of investment" as "the only means of securing an approximation to full employment."[2]

That remark is not unique. In an essay published in the *Yale Review* in 1933, Keynes turned his back on economists' traditional enthusiasm for free trade: "let goods be homespun," Keynes wrote, "whenever it is reasonably and conveniently possible."[3] Here, too, he suggested that the path to economic prosperity is paved by government intervention.

Just how extensive Keynes wished this political involvement to be is a matter of question. He expressly repudiated widespread government ownership of industry. No question, he wrote in his essay "The

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End of Laissez-faire," is "so really unimportant, so irrelevant . . . as the Nationalization of the Railways."[4] And in the *General Theory*, he asserted that "it is not the ownership of the instruments of production which it is important for the State to assume."[5]

But Keynes did espouse active involvement of government policy makers in economic matters. He held to what his early biographer Roy Harrod referred to as the "presuppositions of Harvey Road"—a reference to his childhood home as the son of a Cambridge don in England. "Reform," says Harrod, "was to be achieved primarily and principally by the discussion of intelligent people."[6] Thus Keynes offered suggestions to make financial credit and job information more abundant.[7]

Trust Not in Politicians

Yet these proposals had to be implemented through the political process, and Keynes had abundant experience to warn him against heavy reliance on politicians. After all, he attained prominence with the publication of *The Economic Consequences of the Peace*, which denounced the arrangements political leaders had made in the Versailles Treaty after the First World War. In this book, Keynes excoriated Woodrow Wilson for acceding to the imposition of terms so harsh on Germany that, he predicted, the entire European economy would suffer. Wilson was, to Keynes, a "blind and deaf Don Quixote."[8]

Keynes' comments on Britain's leader, Lloyd George—"this goat-footed bard, this half-human visitor to our age from the hag-ridden magic and enchanted woods of Celtic antiquity"[9]—were so strong that Keynes deleted them from the final manuscript. (They were published over a decade later.)

Nor are these the only instances when Keynes expressed dislike of politicians. In 1911, following a trip to Ireland, he wrote to his friend Duncan Grant, "You have not, I suppose, ever mixed with politicians at close quarters. They are *awful*. I think some of them must have been dregs anyhow, but I have discovered, what previously I didn't believe possible, that politicians behave in private life and say exactly the same things as they do in public. Their stupidity is inhuman. . . . [Most of them have] minds and opinions as deplorable as their characters."[10]

When Great Britain returned to the gold standard following World War I, Keynes objected to the harm wrought by the overvaluation of the pound. He referred to statements made by the Chancellor of the Exchequer, Winston Churchill, as "featherbrained."[11] And during the Great Depression of the 1930s, Keynes was constantly frustrated that President Franklin Roosevelt was not getting his message, even going to the extent of sending an open letter to him via the *New York Times*.[12] In fact, Herbert Stein, President Nixon's economic adviser, points out that it was not until well into Roosevelt's second term, and following additional personal letters addressed from Keynes, that Roosevelt finally accepted the Keynesian prescription of running *deliberate* budget deficits to alleviate the Depression.[13]

One might argue, then, that the policy proposals that Keynes does make fall far short of state socialism because his faith in the political system was so limited. Reducing interest rates to promote business investment and running federal budget deficits were, after all, rather simple tasks requiring no great deal of intelligence. But even then, matters can go awry.

The Myopia of Meddling

Let us suppose that Keynes' fantasy is realized, so that we do get in responsible positions knowledgeable and caring people who seek to ameliorate economic problems. What can we expect? If they refuse to sit back and wait for the economy to work out its long-run adjustments, what measures might they take, and with what effects?

For example, consider Keynes' proposal in the *Yale Review* that we reduce our dependence on foreign imports. If the government imposes tariffs and quotas to protect domestic industries from foreign competition, what will happen?

In the short run, we might expect a boost to our economy, as consumers switch from the now more-expensive imported products to domestic ones. More jobs will be available for workers in these firms, so the unemployment rate will fall.

But to see only these effects is to suffer from acute myopia. Henry Hazlitt, one of Keynes' harshest and most outspoken critics,[14] diagnoses this myopia in his small but significant book, *Economics in One Lesson.* Hazlitt emphasizes that *"The art of economics consists of looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups."*[15] Hazlitt followed up this point in his larger work, *The Foundations of Morality*, where he addresses the importance of developing rules that produce desirable *long-run* outcomes.[16]

Of course, when the United States adopted more restrictive trade policies in the Smoot-Hawley Act of 1930, other nations retaliated. This game of tit-for-tat destroyed the benefits we hoped to gain from higher trade barriers.[17] But such policies may backfire even in the absence of retaliation.

If we reduce our purchases of foreign goods, what happens to the people in foreign countries who formerly used dollars to buy from us? Having fewer dollars, they will likely import fewer American goods, so our export industries will suffer job losses, which will offset or even cancel the gains in our import-competing industries. Further, if we restrict imports of raw materials or semi-finished products, such as steel, then domestic firms that use these inputs, such as the automobile industry, will find themselves at a competitive disadvantage with the foreign rivals who can still buy supplies at lower prices. So, Ford will lose sales to Nissan, and GM will be hurt by BMW.

And what about our poor? Keynes worried about them, but restricting imports of "cheap" products will be especially devastating to the poverty-stricken.

For another example, take Keynes' suggestion that credit be made more abundant in order to stimulate investment and generate "multiplier" effects on the economy. In times of great recession, such a program might obviously serve us well. But we run the risk that monetary expansion will be excessive, either in amount or duration, thereby provoking inflation and a need to reverse course, which will *create* unemployment. As Milton Friedman and Anna Schwartz have documented, the monetary authorities may behave in perverse ways, as they did during the Great Depression of the 1930s, starving the economy.[18]

Efforts to use compensatory budget policies, running deficits during recessions and surpluses during periods of excessive activity, have also foundered on the reefs of political reality. The tax cuts of the early 1960s were almost impossible to reverse when the sluggish economy became overheated during the Vietnam War. Replacing the rule of an annually balanced federal budget with the Keynesian version which recommends balancing over the course of the business cycle has led to such persistent deficits that, in the 1990s, we may resort to a constitutional mandate to restore the old rule of fiscal integrity.

To take one final example of the short-run versus long-run dilemma, consider welfare. Leaving children undernourished and ill-educated will likely create long-run problems of dependence and crime which society would surely like to avoid. But payments to parents of children in such a plight encourages the production of more such children. Relieving parents of the need to provide for their families can also set an example which their children may emulate. Here we exchange one long-run problem for another, yet in our sympathy for the youth of today, we risk increasing the population of such wretched people in years to come.

In the 1920s and 1930s, when Keynes wrote, capitalistic countries passed through an era of malaise. Dramatic experiments in the Soviet Union and elsewhere had the allure of novelty. Keynes denounced Stalin's system at the end of his *Yale Review* essay, but he did not eschew experiments.

Now, following the collapse of Communism and the retreat from socialistic policies in many nations, the superiority of the market seems to be more widely accepted. The recent attempt to establish a system of comprehensive health care in the United States indicates, however, that the activist impulse is not dead.

In Alfred Hitchcock's witty movie, *The Trouble with Harry*, a man is found dead, lying in the woods on a bright New England autumn day. During the course of the film, there is much concern about how Harry got into his present state, and what to do with him. Eventually, he gets a proper burial, and the people are able to go about their normal lives.

Keynes, of course, has been dead for almost 50 years. During his life, and since, his writings did much to stimulate creative and useful thought among economists. In some ways, the discipline is richer for his insights. But his preference for political activism and short-run policies is a questionable and even a dangerous legacy. For them a decent burial seems overdue. □

1. John Maynard Keynes, *Monetary Reform* (New York: Harcourt, Brace, 1924), p. 88. English edition published in 1923.
2. John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt, Brace, 1936), p. 378.
3. John Maynard Keynes, "National Self-Sufficiency," *Yale Review*, 22 (June, 1933), p. 758.
4. John Maynard Keynes, "The End of Laissez-faire," in Keynes, *Essays in Persuasion* (New York: W. W. Norton, 1963), p. 316. This essay was first published in 1926.
5. Keynes, *General Theory*, p. 378.
6. R. F. Harrod, *The Life of John Maynard Keynes* (New York: St. Martin's Press, 1963), p. 3. On this matter, see also James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977), pp. 78ff.
7. Keynes, "The End of Laissez-faire," p. 318.
8. John Maynard Keynes, *The Economic Consequences of the Peace* (New York: Harcourt, Brace and Howe, 1920), p. 41.
9. John Maynard Keynes, "Mr. Lloyd George: A Fragment," in Keynes, *Essays in Biography* (New York: W. W. Norton, 1963), p. 35. This fragment was first published in 1933.
10. Harrod, *The Life of John Maynard Keynes*, pp. 157–58.
11. John Maynard Keynes, "The Economic Consequences of Mr. Churchill," in Keynes, *Essays in Persuasion*, p. 246. First published in 1925.
12. *New York Times*, December 31, 1933, Sec. 8, p. 2XX. When Keynes met Roosevelt at the White House in 1934, Roosevelt's Secretary of Labor had the impression that the two men were mutually unimpressed. See Frances Perkins, *The Roosevelt I Knew* (New York: Colophon Books, Harper and Row, 1964), p. 225.
13. Herbert Stein, *The Fiscal Revolution in America* (Chicago: University of Chicago Press, 1969), pp. 108ff.
14. See Henry Hazlitt, *The Failure of the "New Economics": An Analysis of the Keynesian Fallacies* (Princeton: D. Van Nostrand, 1959 [Foundation for Economic Education, 1995]).
15. Henry Hazlitt, *Economics in One Lesson* (New York: MacFadden Books, 1961), p. 12. First published in 1946.
16. Henry Hazlitt, *The Foundations of Morality* (Los Angeles: Nash Publishing, 1972), pp. viii and Chapter 7. First published in 1964; republished by the Foundation for Economic Education, 1994.
17. See Jude Wanniski, *The Way the World Works* (New York: Simon and Schuster, 1978), Chapter 7. Wanniski argues that the New York Stock Exchange reflected the adverse anticipation of the impact of Smoot-Hawley.
18. See "The Great Contraction" in Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton: Princeton University Press, 1963), Chapter 7.

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Macroeconomics Reconsidered

by Kyle S. Swan

Mark Skousen's reconstruction in *The Freeman* of the debate between the Austrian and Monetarist schools on the trade cycle challenges the economics profession. In recent "Economics on Trial" columns, Skousen hands down the verdict to modern economics: *put capital back into your macroeconomics*. John Maynard Keynes, of course, took capital out of macroeconomics, masking with crude aggregates the micro foundation of the productive process. However, in the Austrian school, capital never left. Austrians consistently recognize the necessity of capital theory, especially one emphasizing the role of time. And capital and time are central to a proper understanding of the trade cycle.

The standard story of capital theory begins by defining capital as the total stock of productive wealth (identified in mainstream models as k and reckoned as a monetary value). Capital is increased by saving, and the greater is the stock of capital, the greater is output. An economy's rate of economic growth depends upon k. The marginal productivity of capital is reflected in the interest rate; capital generates interest. In this mechanical system where k is (assumed to be) automatically productive, saving necessarily generates growth. Consequently, planning for the future occurs only when individuals make conscious decisions to save.

In his debate with the American economist John Bates Clark, the Austrian Eugen von Böhm-Bawerk countered these mechanical theories by emphasizing the importance of time. Capital is the form multiperiod plans take as these plans materialize. Essentially the same debate was repeated years later between Frank Knight of the Chicago school and F.A. Hayek.

Knight, who taught Milton Friedman, described capital as a self-perpetuating fund—as a stock generating a continual flow of output in perpetuity. Like the Energizer bunny, it keeps going and going and going. . . . Ownership of capital assures a steady income. This interest income can be saved in order that a capital good may be replaced when its durability wanes. In this sense, capital reproduces itself and provides for its own maintenance.

Austrians have a very different view of production. For Austrians, production using capital is a process of converting higher-order goods (e.g., wheat) into lower-order goods (e.g., bread) to satisfy consumer demands. In the broadest sense, the economic process refines and utilizes nature's resources for the fulfillment of individual goals. Something is important and attains goods-character only if it is perceived to contribute to the satisfaction of consumer demands. The production process, therefore, depends on the purposeful decision-making and planning of entrepreneurs and investors seeking profits by using resources and other inputs to better satisfy consumer wants. Knight's vision of automatic capital maintenance ignores the very *raison d'être* of production: individual planning and de-

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