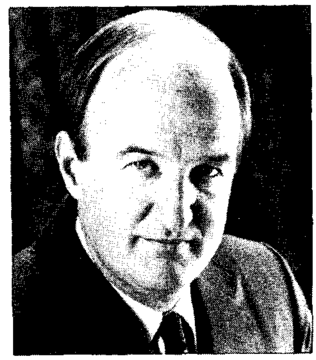


New Keynesians Finally Reject Keynes's "General" Theory

"When people attempt to save more, the actual result may be only a lower level of output . . ."
—Paul A. Samuelson[1]

"Higher saving leads to faster growth . . ."
—N. Gregory Mankiw[2]

The two quotations above dramatically demonstrate the stark contrast between the "old" Keynesians and the "new." Samuelson and the old-style Keynesians start with the "general" theory of unemployment equilibrium and end with the classical model of full employment as a "special" case. As long as there are unemployed resources—which, according to the old Keynesians, is most of the time—thriftiness is bad and expansionary monetary and fiscal policy (i.e., inflation and deficit spending) are good. For 50 years, this "demand-management" model has been the standard approach in college economics.

The New Keynesian Revolution

Now along comes a new generation of economists, known as "new" Keynesians, who have wisely changed their way of thinking. In the most popular textbook on macroeconomics, author N. Gregory Mankiw reverses the standard Keynesian pedagogy. Mankiw, you may recall, is the young Harvard economist who was paid a $1.4 million advance last year to write the next "Samuelson" textbook. (See my column, *The Freeman*, October 1995.)

His mammoth advance was due, in part, to the success of his previous textbook on macroeconomics, last published in 1994. *Macroeconomics* may be a harbinger of what's to come. In a brilliant move, he begins with the classical model and ends with the Keynesian model, just the opposite of Samuelson & Company. Mankiw states in the preface, "in the aftermath of the Keynesian revolution, too many economists forgot that classical economics provides the right answers to many fundamental questions."

Under Mankiw's long-run "general equilibrium" model, what are the effects of an increase in government spending? Crowding out of private capital. "The increase in government purchases must be met by an equal decrease in investment. . . . Government borrowing reduces national saving" (p. 62).

Economic growth is discussed up front, not at the end, as most textbooks do. Using the Solow growth model, Mankiw takes a strong pro-saving approach. He maintains that "the saving rate is a key determinant of the steady-state capital stock. If the saving rate is high, the economy will have a large capital stock and a high level of out-

Dr. Skousen is an economist at Rollins College, Department of Economics, Winter Park, Florida 32789, and editor of Forecasts & Strategies, *one of the largest investment newsletters in the country. For more information about his newsletter and book,* Economics on Trial, *contact Phillips Publishing Inc. at (800) 777-5005.*

put. If the saving rate is low, the economy will have a small capital stock and a low level of output" (p. 86). What is the effect of higher savings? It's positive. "An increase in the rate of saving raises growth until the economy reaches the new steady state," although the law of diminishing returns suggests that "it will not maintain a high rate of growth forever" (p. 86). Mankiw writes favorably toward those nations with high rates of saving and capital investment, and even includes a case study on the miracles of Japanese and German growth (examples virtually ignored in Samuelson's textbook). He supports efforts to increase the rate of saving and capital formation in the United States, including the possibility of altering Social Security from a pay-as-you-go system to a fully funded plan, though he does not discuss outright privatization (pp. 103–4).

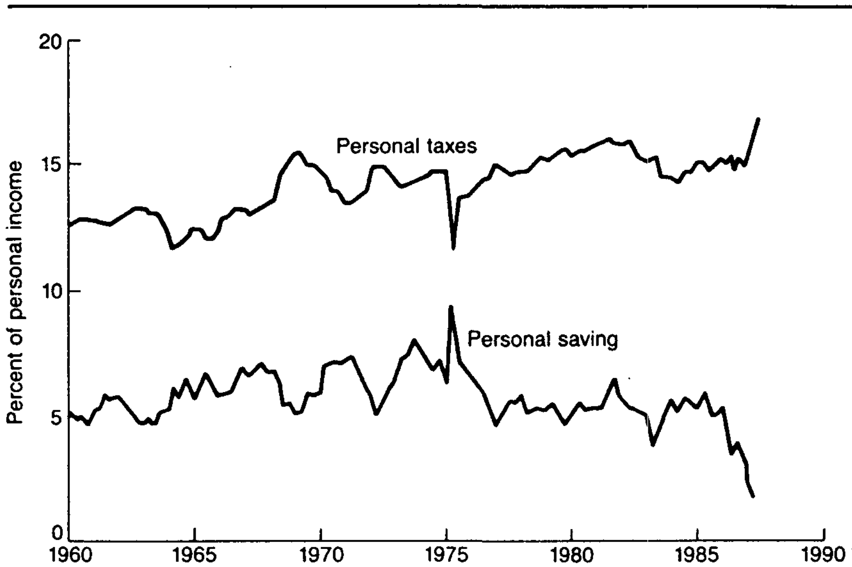
The cause of unemployment? Relying on the "natural" rate of unemployment hypothesis, Mankiw suggests that unemployment insurance and similar labor legislation reduce incentives for the unemployed to find jobs (pp. 121–5). He provides evidence that unionizing labor and adopting minimum-wage laws increases the unemployment rate (pp. 127–30). He offers a case study on Henry Ford's famous $5 workday as an example of wages determined by productivity.

He approvingly quotes Milton Friedman on monetary theory: "Inflation is always and everywhere a monetary phenomenon." Mankiw uses numerous examples, including hyperinflation in Interwar Germany, to confirm the social costs of inflation (pp. 161–9).

Sins of Omission

Not all is right with Mankiw, however. In Mankiw's model, tax cuts have the same effect as deficit spending—by raising consumption, it "crowds out investment and raises the interest rate," he says (p. 64). However, he fails to realize that tax cuts also stimulate savings, as the graph (below)

FIGURE 13–5
Inverse Relationship between Taxes and Savings



Source: Edwin G. Dolan and David E. Lindsey, *Economics* (The Dryden Press, 1988, Perspective 11.1) from Dolan and Lindsey clearly demonstrates. Not all tax cuts will be spent on consumer goods.

Further more, Mankiw apparently assumes that government spending remains the same when tax cuts are put into effect, thus raising the deficit. He repeats the common historical error that the Reagan tax cuts enlarged the deficit, and thereby raised interest rates and lowered national savings. (p. 65) In fact, while marginal tax rates declined, tax revenues rose during every year of the Reagan presidency. Tax cuts didn't cause expanding deficits, excessive federal spending did.

The second half of Mankiw's textbook introduces all the standard tools of Keynesian modeling—aggregate supply (AS) and aggregate demand (AD), the multiplier and accelerator, and IS-LM model. The author presents real business cycle theory, wage rigidity, money neutrality and the Ricardian Equivalence Theorem, all in a bewildering effort to explain economic fluctuations "in the short run." Although he includes a section on Robert Lucas, Jr., and the Rational Expectations School, he has virtually nothing to say about the supply-siders and the Austrians, a major omission. These two schools could have cleared up a lot of confusion about macroeconomic theory and policy.

Still, free-market economists should celebrate in knowing that the profession is slowly moving in the right direction— toward fundamentally sound economics.

That's quite a feat for a man (Mankiw) who named his dog "Keynes." □

1. Paul A. Samuelson and William D. Nordhaus, *Economics*, 15th ed. (New York: McGraw Hill, 1995), p. 357. Similar anti-saving statements have existed in all previous editions of Samuelson's *Economics*.

2. N. Gregory Mankiw, *Macroeconomics*, 2nd ed. (Worth Publishers, 1994), p. 86.

BOOKS

Restoring Hope in America: The Social Security Solution

by Sam Beard

Institute for Contemporary Studies • 1996 • 220 pages • $14.95 paperback

Let's Get Rid of Social Security: How Americans Can Take Charge of Their Own Future

by E. J. Myers

Prometheus Books • 1996 • 273 pages • $25.95

Reviewed by John Attarian

Most Americans now realize that when the huge Baby Boom generation retires, supported by a slower-growing Baby Bust taxpaying workforce, Social Security will go broke. Proposals are emerging to avert disaster, with most, like those here reviewed, entailing some privatization.

National Development Council chairman Sam Beard proposes to create "100 million millionaires" through "the magic of compound interest." He would retain Social Security's mandatory tax-based character, but bifurcate the payroll tax. "Tier 1" would contain "most of your Social Security taxes," and pay benefits to current retirees. "Tier 2" would be set aside in personal investment and retirement accounts. Americans earning $10,000 or more will pay $1,240 per year into Social Security—and can become millionaires. Investing $30 weekly from payroll taxes, at 8 percent compound interest, will in 45 years amass $1,291,433 for retirement. Problem solved.

Or is it? Beard's plan is flawed at the core by double-counting these taxes. Putting $30 weekly into Tier 2 comes to $1,560—*all* the taxes on $12,580. Indeed, Beard repeatedly writes as if all taxes would go into Tier 2. But to pay current retirees present-law benefits, which Beard, kowtowing to the American Association of Retired Persons myth of Social Security as a "sacred contract," insists on doing, "most of your Social Security taxes" would indeed have to remain in Tier 1, and hence be unavailable for investment.

So much for payroll taxes and "the magic of compound interest" creating 100 million millionaires—who are only nominal anyway. Adjusted for inflation, the magician's rabbit turns mangy; $1,291,433 shrinks, Beard admits, to $229,935. Then, too, he wants mandatory participation through taxes, which he deems "exciting." Anybody excited about being coerced?

More positively, Beard furnishes handy descriptions of Chile's privatized retirement insurance and the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) plan, and makes a good case for turning defined-benefit pensions into immediately vested, portable, defined-contribution plans *à la* TIAA-CREF.

Texas businessman Edwin J. Myers has a similar plan. His chatty, digressive, and repetitive book narrates how Social Security metastasized from the modest supplemental pension that Franklin Roosevelt originally intended into a vast demographically doomed entitlement, which the elderly now look to for primary retirement income. He also explains how private defined-benefit pension plans developed; the widespread underfunding of pension plans; the reneging on pension promises following takeovers and buyouts; the Pension Benefit Guaranty Corporation; and federal and state government pension plans. While students of Social Security and pensions will learn little from Myers's exposition, its accessible level and informal style make it useful for ordinary Americans.

Drawing on the successful pension plan set up for county employees of Galveston, Texas, when they opted out of Social Security, Myers proposes Individual Security Retirement Accounts (ISRAs), financed with the worker's share of payroll taxes. Pooled into a huge mutual fund, these accounts would, through compound interest,