

ECONOMIC THINKING OF LORD KEYNES

Socialist or Capitalist?

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INTRODUCTION

Deficit financing and inflation have been subjects of great interest to students of Indian economic affairs in recent years. After the recessionary conditions in some sectors of the economy have set in, there has been a controversy whether "controlled" deficit financing is necessary to stimulate those sectors and whether the overall inflationary effect of such creation of moneys on the rest of the economy could be avoided.

The name of John Maynard Keynes is generally associated with creation of money to stimulate the economy under certain conditions. There is considerable controversy on the economic thinking of Keynes. The Institute of Public Affairs in Australia, an organisation similar to the Forum of Free Enterprise, had invited Professor Dudley Dillard, well-known American economist and an authority on Keynesian economics, to contribute a paper on this subject.

We have obtained special permission from the Institute of Public Affairs to reprint this paper as a Forum of Free Enterprise booklet as we felt that it would be of great interest to students of public affairs in India at this juncture. Our grateful thanks are due to the Institute of Public Affairs for readily according us permission.

We hope that this booklet will be found useful in India.

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"People must come to accept private enterprise not as a necessary evil, but as an affirmative good."

-EUGENE BLACK

Preface to the Institute of Public Affairs Publication

This article was contributed to "Review", by Dudley Dillard; who was then Professor of Economics at the University of Maryland, U.S.A. Professor Dillard received the degree of Doctor of Philosophy in 1940 from the University of California for which he wrote a treatise dealing with Lord Keynes' most famous work: "The General Theory of Employment, Interest and Money". Later Professor Dillard published a book "The Economics of John Maynard Keynes" in which he attempted to clarify for the general reader the meaning and argument underlying the extremely complicated body of economic doctrine which Keynes evolved. In this difficult task he succeeded better than most writers who have attempted it. It was because of our own appreciation of the high merits of this book that we invited Professor Dillard to contribute this article dealing with the essential features of the ideas of Keynes.

Lord Keynes is the outstanding figure in economics of the 20th century. His influence, both on abstract economic theory and on practical government policy, transcends and over-shadows that of all others. The judgement of a prominent contemporary economist, Sir Roy Harrod, is no exaggeration: "Few men in history," says Harrod, "have had so great an influence as Keynes in moving the minds of men on social and economic questions."

Keynes' views have given rise to innumerable disputes. Was this pre-eminent figure a socialist? Or was he an advocate of the preservation of individual enterprise? Did he believe in detailed government planning and control? Or was his advocacy of increased government intervention limited to influencing, by broad directions, the climate in which free business enterprise is carried on?

Professor Dillard's article helps us to answer these questions and makes clear the essentials of Keynes' thought. Free from economic jargon and from difficult

theoretical abstractions comprehensible only to the specialist, it is capable of being understood by the intelligent citizen interested in the central questions of modern economic and political policy. No one unable to claim some general familiarity with the work and ideas of Lord Keynes can hope to appreciate the main political and economic currents of the modern world. We are, therefore, pleased to have the opportunity of presenting Professor Dillard's article to our readers and feel that, in Australia, it will help to satisfy a long-felt and overdue need.

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By

Prof. Dudley Dillard

A popular parlour and newspaper game in the United States during 1950 has been to name the outstanding performer in various fields of activity during the first half of the twentieth century. Charlie Chaplin, for example, has received the award in motion pictures. To my knowledge, no official or semi-official judgment has been rendered in economics, but if such an award were to be made, it is safe to predict that John Maynard (Lord) Keynes would be the winner by a wide margin. In a recent scholarly volume surveying contemporary economics, Keynes' name appears more than twice as many times as that of any other economist. Keynes' most famous book, "The General Theory of Employment, Interest, and Money", published in 1936, has been the source of more discussion than any other volume in the history of economic thought in a comparable period after publication. This book already ranks along with the work of Adam Smith, David Ricardo, John Stuart Mill, Karl Marx and Alfred Marshall, as one of the greatest classics of economic literature. Keynes dominates what has come to be known as the "New Economics" in much the same manner as Einstein dominates the "New Physics."

During the past fifteen years there has arisen a new body of economic doctrine which represents nothing less than a revolution in economic thought. Although Keynes is by no means the sole contributor to this new doctrine, he stands unchallenged as its chief architect. Textbooks on the principles of economics are being rewritten to take account of the "Keynesian Revolution." The most important impact of the New Economics, however, is neither

in technical economic theory nor in the classroom, but in new departures which it calls for in public policy. The great depression of the thirties and the great war of the forties precipitated the acceptance of new economic policies. Some of the better-known measures which bear the personal imprint of Keynes are the various white papers on unemployment policy, the International Monetary Fund, the International Bank for Reconstruction and Development, and, probably most important of all, new fiscal and monetary policies.

How are we to account for the pre-eminent position of Lord Keynes among his contemporaries? **Personality** and intellectual genius were factors. The crux of the answer lies, however, in Keynes' unique ability to combine economic analysis on a high level of **abstraction** with penetrating insight into practical policy. This combination of qualities has characterized great economists in the past. In the hands of Adam Smith and Ricardo the **highly** abstract classical economic theory was essentially an argument for a policy of *laissez faire*. The dominant position of the classical tradition, which was the ruling doctrine for more than one hundred and fifty years, now seems to have come to an end with the work of Keynes. He repudiates more effectively than anyone else the theoretical foundations of *laissez faire*. On the positive side he formulates a system of theory which demonstrates the need for positive social action in order to reconcile private interest with public welfare.

The Old Economics in Relation to the New

Although Keynes breaks with the traditional economics, he argues not so much that it is wrong as that it is irrelevant to the main problems which confront modern industrial society. The classical theory, says Keynes, is a special case which is "misleading and disastrous if we attempt to apply it to the facts of experience." In the Old Economics the presumption is that social control is not essential to the general welfare; in the New Economics the presumption is that social control is essential

to the general welfare. The difference is sufficient to constitute a virtual revolution in economic theory and policy.

When Keynes wrote his General Theory in 1936, unemployment was the chief economic problem confronting capitalist nations. His main criticism of the existing body of theory was its inability to deal realistically with fluctuations in employment and national income. The attempts which had been made within the framework of existing theory came generally to the conclusion that unemployment was caused by interferences with the natural forces of free competition in the labour market. Wages were too high, and the market was not free to make the necessary adjustments, it was asserted. The existence of wage levels too high to allow full employment was plausibly explained in terms of the recent growth of strong trade unions and protective social legislation providing for minimum wages and liberal unemployment benefits. The Old Economics looked upon collective bargaining by labour and political action by governments as violations of the sacred principles of *laissez faire*. Unemployed men who tramped the streets looking for work had only themselves to blame for their unhappy plight. The solution suggested by the classical theory was simple: Since unemployment is caused by wages being too high, the remedy is lower wages. This line of reasoning could hardly have been convincing to the unemployed workers or to the general public. That the economists took it seriously, however, is clearly indicated by the work of the greatest living exponent of classical theory, Professor Pigou of Cambridge, a colleague of Keynes at King's College, who argued in his "Theory of Unemployment" (1933) that the remedy for unemployment was a general all-round reduction in wage rates.

Keynes objected strongly to this line of reasoning. He pointed to the obvious fact that millions of unemployed persons were willing to work for less than the going money wage rates, but could not find jobs at any price.

The fault, according to Keynes, lay in a general deficiency of demand. A theory of unemployment must account for the deficiency of demand, and a programme for increasing employment must focus on the problem of enlarging the volume of effective demand.

Keynes' Theory of Effective Demand

In non-technical terms Keynes' theory of effective demand may be stated as follows: People are employed either in producing goods to be currently consumed (consumption) or in producing capital goods (investment). Those who are employed producing consumption goods do not spend enough of their incomes to maintain the demand for the goods they produce. They save part of their incomes. Hence the demand for consumers' goods must be supplemented by expenditures out of income derived from investment goods activity.

If we visualise consumption output as production from existing factories and investment output as construction of new factories, the essential point of Keynes' theory is that full use cannot be made of existing factories unless new factories are always being built. If no new factories were built, those previously employed in construction work would lose their jobs. These workers would have less money with which to buy the products of existing factories, causing unemployment among those previously employed in existing factories. These unemployed workers in turn would have less money to spend for the products of existing factories, and hence still more unemployment would result. Each job lost in building new factories will cause further unemployment among the workers of existing factories. Looked at in terms of re-employment, one additional worker employed in building a new factory will create additional employment in existing factories. The essential point in the theory of effective demand is that investment activity results in the disbursement of income, most of which will be spent for consumers' goods, without bringing on to the market any current consumers' goods to be sold. The expenditure of income derived from

investment activity fills the gap between income received and the expenditure made out of that income for consumption goods. Another way of putting it is to say that investment is necessary as an offset to saving, which is the excess of income over what is spent for consumption.

The **Role of Investment**

Employment depends on the volume of effective demand, and the volume of effective demand depends on expenditure for consumption and expenditure for investment. Expenditure for consumption varies in a regular manner with changes in income, such that when income increases, consumption will increase, but by less than income. If more men are put to work, incomes will increase and expenditure for consumption may be expected to increase in a fairly regular and predictable manner. But an increase in income does not, according to Keynes' theory, bear any regular or predictable relation to investment expenditure. Because investment expenditure does not increase when income increases, there is no reason to expect that the gap between income and consumption expenditure will be filled, and, unless it is filled, the increases in employment and income cannot be sustained. When there has been no increase in investment demand (expenditure), entrepreneurs who temporarily expand output will suffer losses because the new (consumption) demand will be less than the value of the output. Entrepreneurs will be led by these losses to return to the former, and lower, level of employment and output. The significant conclusion is that employment cannot increase unless investment increases. If investment does increase, then employment may be expected to increase. Reduced to somewhat over-simplified terms, Keynes' theory is that employment depends on the volume of investment.

The next significant question then becomes: What determines the volume of investment? An adequate answer to this question would necessarily involve detailed technical discussion. Only the broad outlines of the analysis can be indicated here. The inability of private

enterprise to provide continuous Pull employment arises from a failure of the demand for investment to be sufficient to fill the gap between income and consumption expenditure at full employment. How does Keynes account for the lack of sufficient investment? In advanced industrial societies most private investment takes the form of capital assets which are expected to yield a return over a period extending some years into the future. The inducement to invest depends, therefore, upon the investor's estimate of what is going to happen to his prospective investment in the future. Now the outstanding characteristic of the future, at least so far as economic life is concerned, is that we know very little about it. Estimates concerning the future are at best vague and uncertain, and can hardly be reduced to a rational, scientific basis. Estimates which are made are not as a rule held with much confidence by those who make them. There is a tendency for investors, lacking confidence in their own judgment, to rely upon the judgment of others, who likewise lack confidence in their own estimates of the future. Reliance upon the judgment of others gives some basis, a conventional basis, for action, but it does not remove the basic uncertainty. It does mean that investors tend to think alike at any one time. The resulting mass psychology finds its highest institutionalized form in the stock exchanges. When conventional beliefs turn out to be poorly founded, as they surely will in many cases, there ensues a sweeping revision of estimates and a loss of confidence. A deep pessimism enshrouds the investment market, bringing with it a sharp fall in the volume of new investment and therefore in employment.

Public Investment and Fiscal Policy

In a severe depression characterized by extreme pessimism it probably will be impossible to stimulate private investment on a scale sufficient to provide a tolerable level of employment. In the event private investment is inadequate, Keynes advocated public investment on a scale sufficient to lift the economy out of depression. The

type of public investment is, generally speaking, less important than its volume, although it is naturally preferable to direct public investment toward projects of the greatest social utility. The primary **purpose** of whatever investment is made, is to distribute income, the expenditure of which will stimulate private enterprise to produce more consumer's goods. The cumulative effect of Investment upon income, described above, will tend to yield a multiple increase in national income. For example, an increase in public investment of one million pounds may result in a rise in national income of three million pounds. In this case, government investment would have **distributed** enough new income to cause private enterprise to increase the output of consumers' goods by two million pounds. Keynes always viewed public investment as **an** aid to private enterprise and not as a substitute for it.

In order to have income-generating effects, government spending must be new spending and not merely a substitution for private expenditure. In depression, therefore, spending should be loan-financed rather than tax-financed, since it is generally valid to assume that income taken away from the public in the form of taxes would have been spent if left in private hands, whereas **money** borrowed, especially from banks, will normally represent a net addition to total spending. The desirability of unbalanced government budgets in times of depression now appears to be widely accepted by liberal statesmen as well as by the great majority of economists. Liberal business groups like the Committee for Economic Development in the United States seem willing to accept this type of **programme**. Conservative groups like the United States National Association of Manufacturers do not accept it. The extent to which public opinion has moved in the direction of the new philosophy of deficit-financing, better termed income-generating expenditures, is perhaps indicated by the mid-year economic report of President Truman in 1949, when he said it would be foolish in the face of the then increasing unemployment and falling national income to take money away from people in the form of

taxes in order to balance the federal budget. The old idea that government budgets should be balanced every year is related to the *laissez faire* philosophy that government should be as inconspicuous as possible in **economic** affairs.

In recent years increasing stress has been placed on fiscal policy as a means for keeping the economy from falling into a depression rather than as a means for pulling the economy out of a depression. It seems fair to say that **fiscal** and monetary policies are the only, or at least the main, defences against depression which the United States, and I think other countries could be included, has today that it did not have before **1929**. **How** strong these defences really are no one knows because they have not yet been tested.

A minority opinion advocates interest-free financing of public investment in depression. Such a policy **would** enable large outlays to be made by the government without adding to the size of the interest-bearing **public** debt. However, this view does not appear to be gaining many new supporters, and it would involve some special difficulties in a country like the United States, where the central bank (the Federal Reserve Banks) are not owned by the government. The Keynesian idea that interest rates on securities of all types should be low has **gained** support among professional economists, and is understandably popular with Treasury officials.

Keynes emphasized the role of low interest rates as a means for stimulating private investment. He believed the monetary authority should have the power to push interest rates down to hitherto unprecedented low levels. Here the task is two-fold. First interest rates should be lowered, and second they should be kept down in order to convince the investing public they will remain permanently low. The second task is really part of the first because a major obstacle in lowering interest rates is the anticipation that they may rise again. This is particularly true of the **long-term** rate of interest. The low level of **inter-**

est rates achieved in Great Britain, the United States, and other countries during the past two decades accords with Keynes' recommendations. However, Keynes' view that **interest** rates have a considerable influence on the volume of private investment is not generally accepted.

Inflation Policies

Keynes' policy recommendations were not confined to depression measures. He also made important contributions to the theory and policy appropriate for inflation. For inflationary situations such as usually exist in wartime, he favoured indirect monetary, and fiscal controls rather than direct controls such as price ceilings and administrative rationing. The most important of his wartime suggestions for Great Britain was a plan of forced saving or deferred pay, a plan which was partially adopted by the British Treasury during the war. Keynes argued that taxation and voluntary saving would be inadequate to finance a major war without inflation, and that therefore current consumer demand should be further curtailed by **extra** deductions from employees' paychecks. The income withheld during the war as an anti-inflationary measure was to be paid after the war as an anti-depression measure. In circumstances which are potentially inflationary, appeals for voluntary saving as a preventive of inflation are not likely to be effective, unless the would-be savers are convinced that saving will be general. There is, however, no way to assure that saving will be participated in by all, except by making it compulsory. That is what Keynes' plan was intended to do. Keynes pointed to wartime inflation as another example where unrestrained self-interest is inconsistent with community welfare, and therefore requires social control. **Furthermore**, he pointed out, forced saving is consistent with the maximum freedom of individual consumer choice, in contrast **with** a comprehensive system of rationing and price control. The latter can work equitably only on the assumption that consumers have more or less the same tastes, an **assumption** which may be valid for some commodities like sugar.

but cannot be valid for commodities in general. Keynes did not overlook the need for some price **control** and administrative rationing, but he viewed them as supplementary to fiscal policy in the fight against inflation. The versatility of Keynes' general system of theory was demonstrated by the fact that the same general framework could be used to analyse inflation and unemployment.

Wage Policy

It has already been noted that Keynes **opposed** attempts to remedy unemployment through cutting wages. Since employment depends on the demand for consumption plus the demand for investment, wage policy can affect employment only to the extent that it influences one or both of these sources of effective demand. Keynes did not deny that wage cuts might have **some** indirect tendency to increase employment. His main point was the practical one that whatever might be achieved through wage policy could be done better through monetary and fiscal policy. Keynes also rejected what may be called the trade-unionist argument that the way out of depression is to increase wage rates. In the main, he contended that higher money wages would be offset by higher prices and would leave real wages and real effective demand about as they were before the wage rise. **A** survey of professional opinion would, I think, reveal that Keynes' views concerning wage policy are now generally accepted by economists. The pre-General Theory notion of the classical economists that unemployment can be remedied by cutting wages is certainly no longer accepted by economists or public policy makers. In present-day discussions of wage policy, stress is placed on the need for short-run stability of money wages and prices, with flexibility introduced through monetary and fiscal measures.

The foregoing discussion of wages refers to the short run in which productivity of labour is assumed not to change. In the longer run, increases in productivity permit real wages to increase. An increase in real wages may

come about either in the form of higher money wages with constant prices, or in the form of constant money wages with lower prices. Of these two alternatives, Keynes preferred the former.

Keynes on Socialism and Capitalism

The question is sometimes asked whether or not Keynes was a socialist. Clearly he was not a socialist, at least in any generally accepted meaning of that term. His efforts at reform were directed toward the preservation of capitalism and economic individualism. In politics Keynes was an outspoken member of the Liberal Party, and disliked the philosophies of both the Labour and Conservative Parties. He believed government ownership of the means of production to be both unnecessary and undesirable. Keynes was quite hostile to Marx and Marxism. He referred to Marx's Capital as "an obsolete textbook which I know to be not only scientifically erroneous but without interest or application to the modern world." On the occasion of a visit to the Soviet Union in 1925 Keynes was impressed, on the one hand, with the economic inefficiency of Communism and, on the other hand, by the strength of Communism as a type of religious faith.

Equality of wealth and income is a fundamental tenet of socialism. Keynes believed there was social and psychological justification for significant inequalities of wealth and income, but not for such large disparities as exist in capitalist society. His theory of employment led him to the conclusion that greater equality would contribute to the maintenance of higher levels of employment and to a more rapid growth of capital. People with low incomes tend to spend for consumption a larger proportion of their income than do people with high incomes. Therefore a redistribution of income from high to low income groups would increase the community's propensity to consume, which in turn would increase employment and national income. Out of the enlarged

national income the community would save and invest more than before. The larger investment represents a greater accumulation of capital. This argument reverses the traditional or classical economics, which justified inequality of income and wealth as a necessary condition of progress on the ground that most saving and investing is done by the wealthy out of their surplus income. This classical argument like much else in classical economics would be valid under conditions of full employment, but it is not valid if one assumes, as Keynes did, that the characteristic condition of capitalism is one of less than full employment.

Keynes also believed that the wealthier a capitalist community becomes, regardless of the degree of inequality, the more difficult it is to maintain a satisfactory level of employment. He says: "Moreover the richer the community, the wider will tend to be the gap between its actual and its potential production; and therefore the more obvious and outrageous the defects of the economic system." A poor community will have little difficulty employing all its resources because it will tend to spend on consumption a large proportion of its total incomes. Only a small gap needs to be filled by investment. A wealthy community, on the other hand, will have great difficulty maintaining full employment because the gap between income and consumption will be large. Its investment outlets must be great if there are to be enough jobs for all. The very fact that the community is rich in accumulated capital assets weakens the inducement to invest because every new investment must compete with an already large supply of old investments. This version of the paradox of poverty in the midst of potential plenty is strikingly similar to the socialist view that capitalism is characterized in its historical development by a growing discrepancy between its capacity to produce and its capacity to consume. Karl Marx thought that the increasing productivity characteristic of large-scale technology would lead to depressions and wars of increasing intensity until finally capitalism would collapse. There is no lack of historical

evidence to support this view, and whatever one may think of it or of the evidence, it is one of the fundamental premises which leads Communist nations to anticipate certain victory in the struggle for power against capitalism. In socialist theory, at least in **Marx's** version of it, the ultimate determining forces of history are economic rather than military or political.

There are, however, important differences between Keynes and Marx. Keynes attributed the contradictions associated with the deficiency of effective demand to *laissez faire* capitalism and not to capitalism as such. In the long run he believed the answer to the capitalist dilemma lay in the elimination of capitalism's worst faults rather than in the elimination of private ownership of the means of production. Capitalism's special faults are associated with its monetary and financial institutions, with speculation, and with rentierism. Keynes' general position can best be characterized as that of a critic of financial capitalism and a defender of industrial capitalism. Acceptance of the positive measures advocated by him would mean the end of *laissez faire* capitalism, but would preserve the advantages of private enterprise and economic individualism. Keynes believed that the worst enemies of capitalism were those who, refusing to admit its faults, were unwilling to do what was necessary to **save** it.

The *views* expressed in *this* booklet *are not necessarily the views of the Forum of Free Enterprise.*

"Free Enterprise was born with man and shall survive as long as man survives."

-A. D. SHOFF
(1899-1989)
Founder-President,
Forum of Free Enterprise.

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