Shadow Boxing with Keynesianism

By Peter Smith, Quadrant Online, 16 August 2015

The ordinary business of economic life goes on quite separately from forensic examinations of its innards. And it can be made reasonable sense of by anyone of inquiring mind provided theory does not obfuscate reality. Unfortunately, Keynesian obfuscation is pervasive.

… that there may be a supply of commodities in the aggregate surpassing demand … appears to me to involve so much inconsistency in its very conception, that I feel considerable difficulty in giving any statement of it which shall be at once clear, and satisfactory to its supporters.
— John Stuart Mill, *Principles of Political Economy*

Economic snake oil at best

If numbers of patients were to sicken progressively and dreadfully after prolonged medical treatment we might ask whether the treatment was any good. We might even ask whether the treatment was doing more harm than good. That's medicine. Apparently, the same scrutiny is not applied to the practice of economics. If it were, we might ask how it was possible that many developed economies are suffering from high levels of unemployment; measured, for example, at over 11 per cent across the eighteen-country Eurozone (Lithuania has recently become the nineteenth). And this, so long after the cure for unemployment—injections of government stimulus expenditure to boost demand—was given theoretical imprimatur by the followers of John Maynard Keynes and prescribed by armies of economists employed by governments. It is surely time that old-fashioned common sense kicked in and we declared, after seventy-five years and more of assiduous application, that the economic medicine has turned out to be snake oil at best and hemlock at worst.

The awesome power of vested interest

There are two impediments to a breakout of common sense. The first is the awesome power of vested interest. The second is the standard theoretical challenges to Keynesianism. Inconclusive in themselves, they have served to marginalise the most effective challenge and, in doing that, to help keep alive the fiction that we have fiscal tools to control economic affairs.

Vested interest tenaciously protects any "conventional wisdom", as J.K. Galbraith pointed out in *The Affluent Society*. For example, it would take many years of global cooling before those climate scientists wedded to global warming would ever concede the possibility of being mistaken. Keynesian economics has been around much longer than so-called global warming and has gone much deeper into the social fabric. All commentary on economic affairs, let me repeat, all commentary, is Keynesian in its orientation. If you see or hear references to the state of "demand" or "domestic demand" or "aggregate demand" or "effective demand" you know that Keynesianism is about, and you will always see or hear such references.

Keynesianism isn't just an economic theory

Moreover, Keynesianism isn't just an economic theory. Otherwise, it would never have caught on. John Stuart Mill had demolished its central premise—which is that demand in aggregate may be insufficient to take up production—in the second half of the nineteenth century, long before it was given fresh life by Keynes and his disciples. It is as much a political theory as it is an economic one. As a political theory it explains why capitalism is inadequate in maintaining full employment and must be augmented by government. Those on the Left will never voluntarily give it up. Metaphorically speaking, to steal a line from Charlton Heston, it will have to be prised out of their cold dead hands.

So there should be no illusion. Keynesianism will be extremely hard to dislodge under any circumstances. However, the extremely hard morphs into the completely impossible when conservative critics occupy a different economic world from that occupied by Keynesians. Their theoretical punches miss their mark and become air shots.

This is cryptic. It will become clear.

I start with couple of definitions of economics to provide an instructive perspective on its appropriate role in the scheme of things. I go on to consider the misapplication of demand in macroeconomics; to identify the proper role of demand in concert with supply and price in determining complex economic outcomes; to explain the conservative tilts at Keynesianism and why they fail; to expose the real flaw in Keynesianism; and, finally, to show how exposing this flaw points to the advisable course of doing nothing to boost demand through government stimulus spending. I should add that I will deal solely with market economics. Economics has very little to say about command-and-control economies—even if, for some mysterious reason, so-called socialist economists manage to find work, passing off whatever dark art they practise as economics.

Alfred Marshall, the most prominent economist in the final years of the nineteenth century and the first part of the twentieth, defined economics as "the study of mankind in the ordinary business of life". Numbers of introductory texts provide a more expansive definition. In his 1970 edition of the largest selling of all such texts, Paul Samuelson defines economics in this way:

Economics is the study of how men in society choose, with or without the use of money, to employ scarce productive resources, which could have alternative uses, to produce various commodities over time and distribute them for consumption, now and in the future, among various people and groups in society.

You will notice that both definitions have an observational ("study") orientation rather than an interventional one. Taken at face value this would put economists at one with, say, palaeontologists. But, particularly since Keynes came on the scene, economics has not just been about studying how economic affairs unfold but also about changing how they unfold. Where would we be, you might ask, if economists had remained largely in palaeontologist mode? Today, with deficits, debt and unemployment abounding almost wherever we look, it is a fair question to direct at those who've made their business intervening for the past three quarters of a century.

Keynesian obfuscation is pervasive

As an academic discipline, economics can be opaque. This is no particular criticism of economics. Every academic discipline delves into complex minutiae that few understand. However, taking a cue from Alfred Marshall, the ordinary business of economic life goes on quite separately from forensic examinations of its innards. And it can be made reasonable sense of by anyone of inquiring mind provided theory does not obfuscate reality. Unfortunately, Keynesian obfuscation is pervasive.

The key villain in the piece is the concept of domestic demand (made up of an aggregate of spending by consumers, businesses and government), which is littered throughout the updates and analyses of all public and most private sector economists. Take the constituents of domestic demand in turn. Consumer demand sums what people spend in shops. It is presented as contributing to growth. Really! This is akin to assessing how well you are doing by totting up what you spend rather than what you earn. Now, if we were told the value of consumption goods produced it would be meaningful. To add to the confusion, consumer spending is conflated with business investment spending as though they are comparable. Investment spending creates economic value. Consumer spending eats it up. They are not remotely comparable; they are apples and oranges. Then there is the final insult to intelligence, which adds a lemon to the mix. Government spending (ex-transfer payments) is assumed to add one dollar of economic value for each dollar spent. There's stretching belief and then there's that.

Keynesian economics and cognitive dissonance

Demand expressed in aggregate form is meaningless. Only minds befuddled by Keynesian economics can accommodate it without suffering cognitive dissonance. Keynesian economics takes demand out of its proper bailiwick in microeconomics, forms it into congealed aggregates, and misapplies it in macroeconomics where it has no business being.

The proper place of demand is in "price theory", where it refers to the separate demands for individual products. Changes in the demand, supply and price of different products mold the course of economic change and development. The process is interactive among literally thousands upon thousands of products, underscoring the difficulty of intervening in economic affairs. Each demand elicits a supply response; thus the pattern of production is determined by the pattern of demand. And, as Adam Smith perceptively told us, prices fall out of the interplay between demand and supply. But, critically, this relationship is a two-way street. Prices are a determinant as well an outcome. They ration demand in one role and, in another, steer the allocation of resources from one product to another.

The "marginal revolution"

The explanation for the way in which demand, supply and price hang together was enriched by the so-called "marginal revolution". This theoretical development began in the 1870s through the work of Carl Menger, William Jevons and Léon Walras and was embraced, if not coincidently developed, by Marshall. Marginal theory simply says that, in a rational and completely informed world, a business continues to supply a product until the incremental contribution it makes to revenue meets its incremental cost. Equivalently, a consumer continues to buy a product until its incremental value or utility meets its market price. In practice, businesses and consumers live in a messy world bereft of fine calculations. Theory and practice diverge. Still the theory is instructive in providing a benchmark to weigh experience. And it is particularly instructive in a world that won't keep still.

Think of a happy state of "general equilibrium", where all products produced in an economy are profitably produced and exactly matched at prevailing prices by the demand for them. Hold that thought. Now superimpose a dynamic environment characterised by technological progress and innovation on the supply side; by changing tastes on the demand side; and by incomplete knowledge and that most common of human characteristics, to wit, mistaken judgments. The result is a state of imbalance (disequilibrium) which characterises all market economies.

Disequilibrium, which was well recognised among classical economists of the nineteenth century, consists of a mismatch between the supply of some products and the demand for them at profitable prices. Mill put it this way in *Principles of Political Economy*: "the demand may be for one thing, and the supply may unfortunately consist of another". It is vital to understand that in these circumstances—which always prevail to one extent or another—self-corrective forces are at work.

A market economy abhors disequilibrium. Though the process ever fails to produce general equilibrium, relative prices are constantly adjusting to rid the economy of individual demand-and-supply mismatches. Liken them, if you like, to antioxidants fighting free radicals in a living system. (See my article "Economic Growth in a Finite World", *Quadrant*, December 2014, which explores capitalism as a living system.)

Prices of products in "oversupply" fall, as the prices of products in "undersupply" rise. In the light of this, businesses change course to seek increased profits. Employees change their occupations. Consumers alter their patterns of expenditure. The fact that not everything goes smoothly or to plan is by the way. Allowed time, the direction of adjustment, taken as a whole, is inevitably beneficial. It can’t be otherwise. Left unhindered, prices eventually move towards restoring equilibrium, and rational economic actors “follow the money”.

Irrational exuberance

When the economy falls into serious disequilibrium it is usually because certain asset prices suddenly plunge, having been driven far beyond realistic levels. There can be any number of reasons for untoward increases in the prices of particular assets. Irrational exuberance, as former Federal Reserve Chairman Alan Greenspan once called it, can take hold of markets. Sometimes markets can be distorted by the actions of government. Think of the government-fomented inflation of US house prices before the financial crash of 2009.

Whatever the cause of the disequilibrium, a great deal of sorting out is required. Businesses directly participating in constructing the assets which have fallen in price falter and employ fewer people. Businesses depending on these businesses falter and also employ fewer people. Businesses which cater to the needs of employed people find their sales falling and they falter. Confidence plummets and the economy goes into recession. Or, as Mill instructively describes it, the economy suffers a “temporary derangement of markets”. Imagine you are a public sector economist. What do you advise should be done?

Borrow and spend, or to “print money” and spend

You don’t take a lead directly from Mill, having never read his work at university. What you advise the government of the day to do is to borrow and spend, or to “print money” and spend. You do this because you have studied Keynesian economics and this tells you that domestic demand in the economy must be boosted to restore economic activity and confidence. Suddenly the separate demands for individual commodities, each subject to market forces, become congealed in your otherwise sound mind. Nevertheless, choices must be made among lumps of demand.

Any old spending will do and the more the better

You would need to decide on whether to advise the government to spend money on some combination of, say, building school halls or public housing; or manufacturing cars; or installing roof insulation; or constructing bridges and roads; or funding research; or simply handing out cash. How do you decide what to spend money on and how much? Does it matter? Well, if you’re a thoroughgoing Keynesian like, say, Paul Krugman, than any old spending will do and the more the better.

Now board an H.G. Wells time machine and ask Mill what should be done. When he’d recovered his composure he would tell you that the economy is already trying to sort itself out. Relax, he might say, all will be well. Make sure the government is placing no barriers in the way of economic adjustment. However, if you insist on spending large lumps of government money on this or that, it will almost certainly hold up recovery. Unfortunately, this is hard to prove.

Keynesians and their critics are occupying different worlds

Controlled experiments can't be performed on economies and their complexity clouds cause and effect. Conservative economists have entered the fray only to leave Keynesianism unscathed. It is time to revisit my cryptic comment above that Keynesians and their critics are occupying different worlds. First, consider the Keynesian world of unemployment.

Assume carpenters are sitting around doing nothing, their tools idle. Nearby timber is rotting away. Nails and screws are rusting away. Along comes the government fixer.

Well now lads, he says, if you make some desks and tables for our schools we will pay you with money that we will either borrow or print. Behold from nothing come useful desks and tables. Multiply this instance by others and production and income grow, instilling a second round of confidence which prompts more investment and production. The government borrowing and/or money printing is accompanied by comparable growth in production, income and tax receipts. The circle is complete. Keynesianism apparently triumphs.

Second, consider the world of conservative critics. Arthur Laffer (adviser to President Reagan and famous for the "Laffer Curve") provides a neat account of the conservative position, which he reprised in a recent talk to the Institute of Public Affairs. Laffer leans on a classification developed by statistician-economist Evgeny Slutsky in the early twentieth century, which divides the price effect on the demand of an individual product into an income and a substitution effect, and employs it out of its original context to analyse government stimulus expenditure.

In this case, the "income effect" stands for an argument that the increased income of those receiving government moneys will be largely offset by a decline in income of those having to pay additional tax to fund it. It is usually assumed in this argument that taxpayers are rational and far-sighted and will respond equally to the anticipation of future additional taxation as to immediate additional taxation. The conclusion is that stimulus expenditure will not generate additional net production.

Keynesians occupy a non-zero-sum world

Notice that this is a zero-sum world in which publicly-funded economic activity "crowds out" private-sector activity. Income gained is offset by income lost. It is not the world occupied by Keynesians. Keynesians occupy a non-zero-sum world in which income can be gained without offsetting loss. Laffer then goes further by invoking a "substitution effect"; in this case standing for an argument that government-funded economic activity will be less value-adding than the private-sector activity that it replaces.

Who is right? It is clear, for the most part, that private-sector economic activity, driven by market forces, adds more economic value than public-sector activity, driven in haste by guesswork and political expediency. But this is only a knock-out blow if the latter is occurring at the expense of the former. My assessment is that the non-zero-sum world occupied by Keynesians is not easily demolished. Keynesians believe that unemployed resources offer the possibility of increasing production without offsetting effects. This cannot be countered effectively by invoking a crowding-out argument or by questioning the value of public expenditure. While empirically these objections may have force, they don't fly conclusively enough on a theoretical level in situations of unemployment.

Keynes's theory is an unemployment theory

It is vital to appreciate that Keynes's theory was not a general theory as he claimed, but an unemployment theory. As such, it essentially doesn't matter whether government expenditure creates more value than it (notionally) uses up. In this unemployed world, value used up is costless and therefore any value produced is a net gain.

Keynesian theory is simple enough. That is its strength. In a situation where resources are unemployed they can be used on government projects. Whatever is produced, even of scant value, is more than would have otherwise been produced. Moreover, this additional production, together with the associated spending of incomes, contributes to confidence more widely and encourages private-sector productive activity. Even producing no value is better than nothing. According to Keynes, burying and digging up bottles filled with banknotes is productive if it creates employment and, by instilling confidence, subsequently generates productive activity.

Question why the theory has been monumentally ineffective

I said at the start that economists should question a theory of economic intervention which has proved to be a failure over many years. Equally, conservative critics of that theory should question why they've been monumentally ineffective. Quite simply, in my view, they've been boxing at shadows. The real flaw in Keynesianism is that it bypasses price theory and consequently fails to account for the deleterious effect of stimulus expenditure on the role prices have in restoring equilibrium. Mill had it right, as did Ludwig von Mises, in *The Theory of Money and Credit* in 1934:

Ludwig von Mises got it right

to give an artificial stimulus to economic life by public works schemes … has had the consequence of eliminating those forces which in previous times of depression have eventually effected the adjustment of prices and wages to the existing circumstances and so paved the way for recovery.

When an economy falls into recession, the price mechanism sets to work. Prices of those resources made unemployed begin to fall, perhaps absolutely, certainly relative to those resources in demand. These price signals guide entrepreneurs and businesses in determining their future activities. Now put government-funded projects into the mix. It doesn't matter whether they use idle resources or how much value they add. They distort price signals. "Anything that prevents prices from expressing freely the conditions of demand or supply interferes with the transmission of accurate information" (Milton Friedman, *Free to Choose*, 1980).

Government stimulus spending adds discordant and confusing noise to the price adjustment process. Informed price adjustments are essential if the economy is to head in the direction of a new general equilibrium. Just maybe this new general equilibrium will not be characterised by increased production of motor vehicles or roof insulation or whatever the government decides to spend taxpayers' money on.

It is important to appreciate that those who buy things can only do so because things are produced. The wherewithal to spend turns on production and what influences it to go up or go down or to turn this way or that. We can't say *a priori* which products and in what quantities will generate a proximate match between the legion of individual supplies and demands. That can only be decided by free-market price movements; nothing else.

The more government intervenes……

The more government intervenes, the more likely it will be that an otherwise speedy recovery will become hesitant and half-baked. The insipid nature of the recoveries experienced by most economies since the financial crisis in 2009 is a case in point. An even better example is America's halting and prolonged recovery in the 1930s under the onerous burden of President Roosevelt's New Deal. The distorting effects of public expenditure were compounded by government price fixing; a heady brew, which inevitably subverted economic adjustment.

To end where I started with a medical analogy: "Do no harm" is a Hippocratic maxim which might be applied with advantage to economics. The following is what we know. The direction of economic change and development in a complex economy cannot be predicted or managed from above; controlled experiments can't be performed to test theories; and market economies have the capacity to repair themselves. In these circumstances, aside from minimising obstacles to economic adjustments which may, by the way, include making borrowing cheaper—which Keynes would have approved of—doing nothing is probably advisable.

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