John Maynard Keynes and the Modern Revolution in Political Economy

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Published online: 20 March 2012
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The Great Depression, more than any previous economic crisis, ignited a fundamental rethinking of the future of the capitalist system. What had gone wrong with the market system to cause such an unprecedented collapse? Was there a way to tame its “boom and bust” cycles? Could the capitalist system survive? Did it even deserve to survive and, if so, on what terms? The triumph of communism in Russia and fascism in Germany suggested that capitalism would soon give way to one or the other of these extreme alternatives.

The depression era produced three influential but widely diverging statements about the future of capitalism: John Maynard Keynes’s *General Theory of Employment, Interest, and Money* (1936), Joseph Schumpeter’s *Capitalism, Socialism, and Democracy* (1942), and Friedrich Hayek’s *The Road to Serfdom* (1944). All were works of political economy in the broad sense as they wove together the interconnected subjects of politics, culture, institutions, and economic theory. They were also works that were long in gestation in the minds of these influential economists. In this sense, they contained their considered reflections on the world crisis through which they were living. All three authors were well known in academic and policy circles long before these particular works appeared. To some extent, then, each author developed his ideas in answer to theoretical challenges posed by the others. Today, seventy or so years after they were first published, these works continue to stand as seminal statements of influential public doctrines: Keynes’s *General Theory* for orthodox liberalism, *The Road*

to Serfdom for market liberalism, and *Capitalism, Socialism, and Democracy* for conservatism and neo-conservatism, or for the belief that culture is decisive for the survival of capitalism. For this reason, some have called these economists the “political philosophers” of the 20th century.

Among these theorists, Keynes exercised by far the greatest influence in the post-depression and post-war era—so much so that at least one economist has labeled this “the age of Keynes.”¹ His *General Theory* is probably the most influential work of economics published in the 20th century, at least in the Anglo-American world. Keynes, far more than Hayek, Schumpeter or any other author of the time, went beyond diagnosis to offer practical answers to the economic crisis of the 1930s, providing policy makers with set of counter-cyclical fiscal tools by which they might at least try to smooth out the booms and busts of the business cycle. His work also re-oriented the study of economics away from the individual and the firm and toward the macro-economy. Though his theories have gone in and out of fashion over the decades, they never really lost influence among economists and, especially, policy-makers. The current financial crisis has provided still another occasion to apply Keynes’s fiscal tools.

Keynes’s theory also pointed toward a far-reaching revision in the relationship between the state and the economy in capitalist systems, with the state now assuming a steering function over the economy never envisioned by the 18th century architects of the liberal order. Keynes wanted to save capitalism from itself but the new role he assigned to the state did not necessarily mesh smoothly with the institutions inherited from the era of classical liberalism and *laissez faire*. These institutions, and the cultural assumptions

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¹ See Robert Lekachman, *The Age of Keynes* (New York: Random House, 1966).

that supported them, were designed to check the power of the state and to defeat the kinds of aims that Keynes had in mind. The Keynesian revolution in economics thus implied a second revolution in politics that would circumvent the barriers to state action handed down from the 18th and 19th centuries. Among Keynes's critics, Hayek in particular pointed to the threat his enterprise posed to the institutions that protected liberty and limited the sphere of government action.

This political dimension—the political economy of Keynesianism—never received detailed attention either from Keynes or from the influential economists who worked out the implications of his theory in the post-war era. Quite the reverse, *The General Theory*, as its ideas worked their way through the economics profession, had the effect of excising politics and political institutions from the analysis of market economies. One only has to look at any of the various macroeconomic models now in play to see that this is so. The Keynesian revolution was primarily one of economics and economic policy, and Keynes's legacy was taken over by economists who became the stewards and interpreters of his thought. It was one of the paradoxes of this revolution that it assigned new powers to the state at the same time as it diminished the role of politics in the analysis of the new system.²

This was not a consequence of which Keynes necessarily would have approved or one that was implied in his voluminous writings. Keynes was by no means solely an economic theorist but a thinker with the widest range of interests. Robert Skidelsky, Keynes's biographer, asserts that he was as much a moralist as an economist.³ As Keynes wrote in an essay on Alfred Marshall, his mentor at Cambridge, the “master economist” must possess many gifts: “He must be a mathematician, historian, statesman, and philosopher, in some degree. No part of man's nature or his institutions can be outside his regard.”⁴ Though he parted company with the great political economists of the 18th and 19th centuries, he was nevertheless a devoted member of their club, perhaps, along with Hayek and Schumpeter, the last of the great political economists. As some have suggested, Keynes was the political economist who did more than any

writer before or since to interrupt the tradition of political economy that originated with Adam Smith and David Hume.

Keynes understood capitalism to be an historical institution that evolved through different phases, with each one calling for new modes of theory and understanding. He wrote persuasively about the cultural and political forces that brought about an end to the “age of *laissez faire*.” Keynes, like the master economist he described in his tribute to Marshall, performed the roles of philosopher, historian, and economist in trying to explain why the old order collapsed and why it could not be rebuilt on its former terms. Keynes spent the interwar years wrestling with the European crisis brought on first by war and then by economic upheaval. If the old order was dead, then another had to be constructed on new intellectual foundations. This was a challenge that Keynes addressed in a series of essays and books that he published during this period, culminating in the publication of *The General Theory*.⁵

Keynes and the Pre-War Order in Europe

For Keynes and members of his generation, the “great war” of 1914–1918 shattered the foundations of European civilization and with it their assumptions about the capitalist order. The great question was whether the symbols and institutions of the old order—*laissez faire*, nationalism, the gold standard, empire, and Victorian morals—could survive in a new era of sovereign debt, despair and dashed hopes, debauched currencies, and a permanently changed balance of world power.

Keynes's reflections on the war and the damage it did to the social order were set out in *The Economic Consequences of the Peace*, the sensational expose of the Paris Peace Conference that he wrote in a few months near the end of 1919 after serving as a member of the British delegation to the Conference.⁶ In that book Keynes foretold that the Treaty of Versailles, unless revised, would lead to financial ruin across Europe and, possibly, to a new and more ruinous war. The book was widely popular, turning Keynes into an international celebrity. It ran through five editions and was translated into eleven languages within a few years. Keynes's manifesto was not so widely acclaimed in diplomatic circles in Washington, Paris, and London where it was condemned as too pessimistic about the future course of world affairs, too sympathetic toward Germany, too negative about President Wilson's role at the Conference, and too

² Many economists assert that their field has moved well beyond Keynes, as some prominent figures now reject his theories altogether while others have revised or refined them to take account of new developments or to integrate them with classical theories of the individual and the firm. Understandably, they view Keynes as an economist and economic theorist rather than as a political economist and architect of a revolution in political ideas and institutions. It is in this latter area where his influence may turn out to be most enduring.

³ See Robert Skidelsky, *Keynes: The Return of the Master* (New York: Public Affairs Press, 2009), Chapter 6.

⁴ See Keynes, “Alfred Marshall,” in *Essays in Biography* (New York: Norton and Company, 1963), p. 141.

⁵ J. M. Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt, Brace, and World, 1965). The original edition was published in 1936 in London.

⁶ J. M. Keynes, *The Economic Consequences of the Peace* (New York: Skyhorse Publishers, 2007). Original edition published in 1919.

heavily focused on the economic aspects of the Treaty at the expense of its political achievements. One prominent reviewer condemned it as “an angry book,” a reference to the fact that Keynes had resigned in protest from the British delegation in order to write it. Some later blamed Keynes (unfairly and inaccurately) for encouraging appeasement in the 1930s because of the role his book played in discrediting the Treaty.⁷

Keynes began the book with an insightful chapter titled, “Europe before the War,” a melancholic reflection on a golden age of Europe blasted away on the battlefields of France and Belgium. “What an extraordinary episode in the economic progress of man that age was that came to an end in August, 1914,” he wrote. He marveled at the economic progress made across the continent beginning around 1870. Before that time, most states, except for Great Britain, were largely agricultural and self-sufficient. Trade was carried on mainly within local markets. After that time, industry and population grew steadily as trade across the continent accelerated, widening the sphere of prosperity and the reach of modern comforts. The gold standard maintained stable currency values and facilitated trade and capital flows. By 1914, Keynes wrote, “the inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep.”⁸ The generation that came of age before the war had seen the world remade by the explosion in capitalist enterprise.

Germany was at the center of this surge in trade and wealth, its population increasing from 40 million to nearly 70 million between 1870 and 1914, while the populations of France and Great Britain expanded much more slowly (each had populations of about 40 million in 1914). German industrial output expanded at an even greater pace, spurred on by the rapid and efficient introduction of the factory system. By 1900 Germany was a main European supplier of steel and coal. Germany quickly assumed a role of important trading partner for every other European nation, including Great Britain. The German economy developed within a few decades into the main pillar of continental prosperity. “The German machine was like a top,” Keynes wrote, “which to maintain its equilibrium must spin ever faster and faster.”⁹

Keynes identified a cause of this rapid growth in a psychological disposition among all classes to save and invest their new wealth rather than to exhaust it in consumption. The wealthy, in particular, were greatly responsible for the accumulation of capital because “they were not brought up to large expenditures, and preferred the power which investment gave to them to the pleasures of immediate consumption.”¹⁰ They had “the cake,” so to speak, but on the condition that they abstained from eating it. The laboring classes accepted this arrangement because, while they lacked the resources to consume, the wealthy lacked the temperament to do so—and thus the proceeds from labor were continuously plowed back into the building of more factories and railroads. Much of this surplus was invested in America, which in turn sent back surplus foodstuffs to support Europe’s growing population. The duty of saving, he observed, became a prescribed virtue, and the growth in wealth “the object of true religion.” Yet rapid population growth both in Europe and America put pressure on agricultural prices, a trend that Keynes identified as a destabilizing factor in the economic affairs of Europe.¹¹

The tragedy was that in time all this wealth would be consumed in war, and consumed in a way that turned it into an event of unprecedented destructiveness. The war permanently disrupted the delicate balance among the various factors of trade, psychology, population, and investment upon which the pre-war order was constructed, leaving millions on the continent starving and destitute when the war was finally concluded. The suffering was magnified by comparison with the comfortable lives Europeans enjoyed before 1914 and with the optimistic hopes for the future that everyone entertained just a few years before.

Here is where the Peace Conference failed, Keynes said, because instead of trying to re-establish the commercial life of Europe, to heal wounds, and relieve immediate suffering, the leaders of the great powers preoccupied themselves with political boundaries, balance of power calculations, revenge and reparations, and (in the case of Wilson) abstract principles that could not be shaped into practical remedies. Instead of re-integrating Germany and Austria-Hungary into the life of Europe, so that trade could commence once again to permit the vanquished to earn the credits with which to

⁷ This case was made most famously in Etienne Mantoux’s *The Carthaginian Peace, or the Economic Consequences of Mr. Keynes* (Oxford, U.K.: Oxford University Press, 1946). Mantoux, a French economist, argued that Keynes exaggerated the flaws in the Treaty and also that his attacks on it later paralyzed Western leaders when Hitler repeated them. Mantoux was killed in action in 1945 while fighting for the Free French Forces, after he completed his manuscript but before it was published.

⁸ *Ibid.*, p. 6.

⁹ *Ibid.*, p. 7.

¹⁰ *Ibid.*, p. 11.

¹¹ Keynes pointed more than once in the book to destabilizing effects arising from the pressures of population on resources. He speculated that the Russian Revolution was caused more by rapid increases in population than by Lenin’s tactics or the Czar’s mistakes (p. 8). Later, when addressing the challenges of feeding the populations of Central Europe, he touched again on this Malthusian theme: “Some of the catastrophes of past history, which have thrown back progress for centuries, have been due to the reactions following on the sudden termination of temporarily favorable conditions which have permitted the growth of population beyond what could be provided for then the favorable conditions were at an end.” (p. 131)

repay the victors, the Treaty imposed harsh penalties designed to isolate and dismember them.

Most observers expected the French, British, and American leaders who controlled the conference to craft a treaty that incorporated President Wilson's Fourteen Points, which, as everyone agreed, pointed away from a punitive settlement. Wilson's program, after all, was the basis upon which Germany agreed to the armistice. Nevertheless, after six months of negotiations, the Conference adopted a regime of reparations and territorial concessions designed to punish Germany by making her bear most of the costs of the war. One aim, insisted upon by France, was somehow to reduce Germany to an economic and military parity with France which, due to rapid growth in German population over the previous half century, could not be accomplished absent unrealistic measures either to shrink Germany or to stretch France. This, according to Keynes, was one sign of the wrongheaded approach taken by the victorious powers. "My purpose in this book," he wrote, "is to show that the Carthaginian Peace is not practically right or possible. The clock cannot be set back. You cannot restore Central Europe to 1870 without setting up such strains in the European structure and letting loose such human and spiritual forces as will overwhelm not only you and your 'guarantees,' but your institutions and the existing order of your society."¹² Here was one of the chief errors against which Keynes persistently inveighed—the delusional campaign to restore a pre-war order in Europe.

Keynes reserved his sharpest words for Wilson, who he said would do nothing that was not "just and right," except that Clemenceau and Lloyd-George, taking the measure of the American president, found it all too easy to cloak their national designs in terms and phrases that seemed to meet the requirements of fairness, self-determination, and collective security.¹³ Wilson was thus convinced that securing the League of Nations outweighed the many imperfections in the Treaty, which was far from being the case. Wilson was so thoroughly "bamboozled" by these masters of European intrigue—so judged by Keynes—that he headed back to America comfortable in the illusion that the Treaty established the foundations for true peace.

In thus pointing the finger of blame at Wilson, Keynes recognized that a solution to the European situation would have to come about through the intervention of the United States since she had come out of the war with reserves of wealth that Europe would not be able to match for years or decades to come. Great Britain and France sought heavy reparations from Germany partly to pay for the war, partly to

punish the Germans, but partly also to use the proceeds to repay American banks for loans taken out to underwrite the war. The amount of these loans, some \$10 billion payable at 5% annual interest, represented a burden on European economies that would prove difficult to bear under conditions of post-war austerity. If, in an act of generosity and statesmanship, Keynes argued, the United States (along with Great Britain, which was owed sums by France and Italy) would agree to cancel the inter-ally war debts, reparations imposed upon Germany might likewise be scaled back to a level that the Germans could afford to pay without bankrupting themselves.¹⁴

This proposal went nowhere, due mainly to American opposition to any plan to cancel debts owed to U.S. banks. It may have been a moot point anyway, since the U.S. Senate rejected the treaty and the United States soon withdrew from European affairs. The proposal to cancel debts was also criticized because it seemed to strike at established conventions regarding the sanctity of contracts and the obligation to pay debts, another point on which Keynes broke with pre-war conventions. It would not be until after the next war that the cancellation, restructuring, or the rolling over of sovereign debts became a routine aspect of international finance.

Keynes correctly foresaw that the twin burdens of German reparations and inter-ally war debts would weigh heavily upon the international system and would return to bedevil statesmen and central bankers for years to come. Efforts to revise the Treaty and to deal with war debts continued throughout the 1920s. The German inflation of the 1920s, the Great Depression, and even Hitler's rise to power and the war that followed have been traced by historians to the issues of debt and reparations that Keynes identified in *The Economic Consequences of the Peace*. By the eve of World War II, his assessment of the flaws in the Treaty was widely accepted, even in political and diplomatic circles. As the war neared its end, American and British planners were determined to avoid the errors of 1918 and 1919. The remedies Keynes proposed in 1919—relief, reconstruction, renewal of trade, cancellation of debts, renouncement of reparations, and integration of the vanquished into the post-war order—were generally accepted in 1945 as guideposts for the post-war order.

The Economic Consequences of the Peace marked a turning point for Keynes when he concluded that the ideals and institutions that were the foundations of pre-war prosperity could no longer serve as the bases for progress in the post-war era. As he wrote, "The forces of the nineteenth century have run their course and are exhausted. The economic motives and ideals of that generation no longer satisfy

¹² *Ibid.*, p. 20.

¹³ Keynes presented a devastating portrait of Wilson in Chapter 3 of the book, comparing him to a "nonconformist minister" whose temperament was essentially "theological, not intellectual." Wilson had noble intentions, but not the political skills to give them effect.

¹⁴ Keynes develops this remedy in detail in the last chapter of *The Economic Consequences of the Peace*. See pp. 154–161. This was in essence the proposal that was rejected at the Peace Conference.

us. We must find a new way and must suffer again the malaise, and finally the pangs of a new industrial birth.”¹⁵ He had not yet developed the comprehensive critique of classical economics that evolved into the premise for *The General Theory*. Yet it was clear in 1919 that the financial and cultural assumptions of Europe’s liberal civilization had been badly shaken. The faith in automatic progress through saving and self-discipline had been shattered. Workers would henceforth demand a greater share of the fruits of capitalism than they were willing to accept prior to 1914. Governments would have to take the lead in feeding their populations, establishing stable currencies, and re-starting commercial activity. All of this pointed toward new roles for the state, labor unions, and corporations in the evolution of capitalism.

Keynes did not reject the institutions and assumptions of the pre-war order because he disagreed with them (though in a deep sense he did) but because he concluded that they could not be adapted to the conditions of the post-war world. This was a point that the politicians did not yet understand as they dithered over borders, reparations, and abstractions like the League of Nations while the populations of Europe starved and established states were overturned in revolutions. He would later write that, “Half the copybook wisdom of our statesmen is based on assumptions which were at one time true, or partly true, but are now less and less true day by day.”¹⁶ Robert Skidelsky asserts that in *The Economic Consequences of the Peace* Keynes staked a claim for “the economist to be Prince.”¹⁷ The book was an extended lecture on the illusions of the politicians juxtaposed against the realism of the trained economist. More than that, it was a call for economists (*political* economists) to step in where the politicians had failed to chart a path out of the crisis brought about by the war.

The Evolution of Capitalism

In “The End of Laissez Faire,” a pamphlet he published in 1926, Keynes rejected as illusory the principles of natural liberty and enlightened self-interest that lay at the heart of the economics of free markets and *laissez faire*. “The world is not so governed from above that private and social interest always coincides,” he wrote. “It is not a correct deduction from the principles of economics that enlightened self-interest always operates in the public interest. Nor is it true that self interest generally is enlightened.”¹⁸ This was

something of a caricature of the foundational assumptions of market economics, which did not insist that enlightened self-interest always operates in the public interest, but that it will do so more reliably than other principles of economic organization. Nevertheless, after rejecting these suppositions, Keynes went on to defend collective action, in which individuals act through the agency of the state, as an equally legitimate means of pursuing the general interest.

In that essay Keynes focused on the organizational evolution of capitalist economies as a factor that undermined the operation of free and unregulated markets. He went on to argue that the aim of socialists to eliminate the profit motive from economic life was already taking place through the market process as small producers gave way to large corporations. An interesting and important phenomenon of modern life, he wrote, is the tendency for large enterprises to socialize themselves. He suggested that, “A point arrives in the growth of a big institution—a big railway or public utility enterprise but also a bank or insurance company—at which the owners of capital are almost entirely dissociated from the management, with the result that the direct personal interest of the owners (the shareholders) becomes quite secondary.”¹⁹ As organizations reach a certain size, managers are increasingly interested in other goals besides profit, such as stability, reputation, and independence. Keynes also welcomed the development of semi-autonomous not-for-profit institutions such as universities and scientific societies that promote the general interest in different spheres of activity. In their blindness to these developments, socialists were as much stuck in the past as the statesmen at Paris who tried to resurrect the pre-war order.

As business enterprises grew larger and as new kinds of organizations emerged, the profit motive was gradually withering away as an inducement for enterprise. The modern corporation organized itself around a more complex array of motivations. The separation of management and ownership in large enterprises was one sign of the evolution of capitalism beyond the age of *laissez faire*, an era when entrepreneurs controlled the enterprises they created. Keynes thus envisioned an emerging system of capitalism in which large business enterprises and not-for profit institutions operated along side government in common efforts to promote the public interest. The friction between the public and private spheres, so much an aspect of the old order of liberalism, was similarly giving way to a new order of cooperation among large institutions.

¹⁵ *Ibid.*, p. 146.

¹⁶ Keynes, “Am I a Liberal?” in *Essays in Persuasion* (New York: Harcourt, Brace, and Col, 1932), p. 337.

¹⁷ Skidelsky, *John Maynard Keynes: Hopes Betrayed, 1883–1920* (New York: Viking, 1986), pp. 384–85.

¹⁸ See Keynes, “The End of Laissez Faire,” in *Essays in Persuasion*, op. cit., p. 312.

¹⁹ *Ibid.*, pp. 314–315. This was an early statement by Keynes of a theme later developed by Adolf Berle and Gardiner Means in *The Modern Corporation and Private Property* (1932) where the authors worked out the legal and financial implications of the growing separation between ownership and management in business corporations.

The separation of ownership and control in large organizations implied that experts might assume new powers in the direction both of political institutions and private corporations, a concept that Keynes first broached in *The Economic Consequences of the Peace*. While this seems like a modern or technocratic concept, it also had a traditional pedigree, at least for Keynes. Roy Harrod, his friend and biographer, suggested that Keynes assumed that important economic decisions would always be in the hands of experts operating in the public interest, much in the way that central bankers are allowed to control interest rates and the supply of money without close political supervision. As a member of his country's intellectual aristocracy, Keynes (according to Harrod) "tended to think of the really important decisions being reached by a small group of intelligent people, like the group that (later) fashioned the Bretton Woods plan."²⁰ Keynes, according to Harrod, approved of this as a normative matter; he also thought it to be an element in the evolution of modern capitalism.

Keynes was optimistic that the slump of the 1930s was but a temporary lapse in the onward march of capitalist development. He dismissed claims that the depression marked the end of prosperity or the collapse of the capitalist system. In an essay on the "Economic Possibilities for Our Grandchildren," he wrote that, "We are suffering, not from the rheumatics of old age, but from the growing pains of over-rapid changes, from the painfulness of readjustment between one economic period and another."²¹ This was the painful adjustment from the age of *laissez faire* to the age of institutional capitalism.

Keynes calculated that over the previous one hundred years the standard of living of the average European and American had grown by at least four-fold, and that over the next one hundred years it would advance by between four and eight times. Within two or three generations, then, the necessities of the comfortable life would be available to all. More profoundly, man's long struggle for survival would be near an end. The vices of money, profit, and self-interest might then wither away altogether in a new age of plenty and leisure. The moral values of work, thrift, and self-interest are erroneously associated with capitalism when in fact they are called forth by scarcity, poverty, and need. These moral values will disappear when, through capitalist enterprise, scarcity is eventually overcome. Mankind can then turn its attention to activities that make life worthwhile: art, music, literature, and philosophy. This, according to Keynes, will establish the final stage of capitalism when our civilization will be able to live off its accumulated capital.

²⁰ R. F. Harrod, *The Life of John Maynard Keynes* (New York: Harcourt, Brace, and Co., 1951), p. 193.

²¹ Keynes, "Economic Possibilities for our Grandchildren," in *Essays in Persuasion*, op. cit., p. 358.

Like other writers of his time and ours, Keynes viewed the political and moral principles associated with market capitalism to be degrading and in need of replacement by a more humane system of ideals. There was thus an evolutionary or historical element in Keynes's thought as he claimed that capitalism developed in stages and also that it developed in a morally favorable direction. Institutional capitalism was an improvement over the "classical" system of the 19th century, but still a stepping-stone on a path to the final stage of capitalist development when the "economic problem" would be solved once and for all.²²

Political Economy of *The General Theory*

The General Theory is usually regarded as the more influential of Keynes's two major works because in it he laid out the theoretical case for counter-cyclical government spending policies to arrest economic slumps. *The General Theory* is a difficult work for anyone but a trained economist to understand, containing as it does a bewildering mix of abstract theory and loosely related excursions into subjects like stock market speculation and mercantilism. Even Paul Samuelson, one of Keynes's American expositors, found it to be "a badly written book," "bad tempered and polemical," and full of "mares' nests of confusions," where the reader encountered flashes of insight interspersed with tedious algebra.²³ Keynes left it to others to work out fully the implications of his *tour de force*. *The Economic Consequences of the Peace*, by contrast, contained a powerful and lucid argument that no one could misunderstand or dismiss. Nevertheless, the two works, while vastly different in these respects, hammered at a common theme—namely, the obsolescence of the pre-war order in Europe, along with its associated ideas, institutions, and assumptions.

In *The General Theory*, Keynes mounted a sustained attack on what he called the "classical" school of economics, the doctrine of free and self-adjusting markets developed by the political economists of the previous century. The classical theory, he suggested, is not a *general* theory but rather a special theory applicable to an era of small producers, independent workers, and competitive markets, circumstances that no longer obtained in modern economies increasingly dominated by large institutions and, importantly,

²² This was another of Keynes's attacks on the socialists who proclaimed that the end of history would come about through the revolutionary overthrow of capitalism. Keynes suggested that capitalism would naturally evolve toward such an end state without the help of socialists. Schumpeter seemed to take issue with this entire line of thinking, as he argued that capitalism could survive only if it maintained various pre-capitalist virtues and institutions—in other words, the moral ideals that Keynes wanted to overcome.

²³ Quoted in Robert Skidelsky, *John Maynard Keynes, The Economist as Savior, 1920–1937* (New York: Penguin Press, 1992), p., 548

by labor unions. In an early chapter, he set down and rejected one by one several of the basic postulates of “classical” political economy: for example, that supply creates its own demand (Say’s Law), that savings necessarily equal investment, and that sustained unemployment is always voluntary because workers, by adjusting their wage demands, could always find employment. If these postulates were invalid, or at least invalid in modern economies, then there could be no automatic process by which the market would self-correct.

For Keynes, the unprecedented unemployment of the 1930s posed a vexing problem. According to established theories, workers should reduce their wage demands to a point where it was profitable for employers to hire them. Yet it was obvious that this was not happening. One new element in the situation was the rise of labor unions, which permitted workers to band together to resist any reduction in their nominal wages. This, he suggested, was another of those factors that made the earlier writings of Smith, Ricardo, Mill, and others increasingly inapplicable to the new situation.

Thus, after rejecting these postulates, Keynes went on to claim that there was no necessary process of adjustment in wages, prices, and interest rates that would correct the slide in employment and output. The market might in fact reach equilibrium at levels well below full employment –and Keynes argued that this was in fact what had happened in the 1930s. Wage demands may remain above the level where businesses are prepared to hire. There might be times when very low or even negative interest rates would prove insufficient to induce people to spend and invest. As incomes fall, so also do savings and the purchasing power of consumers. Those with jobs and incomes, seeing what is happening around them, hold back on purchases, further worsening the situation. Where there is no consumer demand, there will be no investment, and thus no expansion in employment and incomes, and no progress in society. For all these reasons, slumps can be self-perpetuating and need not correct themselves by the natural operation of market processes. If this was the case, then some external intervention would be required to restore consumer demand, investment, and employment.

Keynes, having earlier rejected the economic principles of the “classical” school, went on to attack its moral postulates as well. The virtue of thrift, for example, was not as socially beneficial as many claimed. Thrift, which may make sense for individuals, leads to general harm when it is too widely practiced because it leads to the withdrawal of consumption from the marketplace. Since savings are not automatically used up in investment, excessive amounts can lead to a reduction in the wealth of the community and an acceleration of the downward economic spiral. This was his “paradox of thrift,” a not so subtle attack on the nineteenth

century proposition that thrift is a foundation for order and progress.²⁴

Keynes was by no means the first economist or public figure to call for public spending or public works projects to reduce unemployment during slumps. Spending on public works was a common theme in political platforms in the United States and Great Britain during the 1920s and 1930s. The proposals were generally set forth as emergency measures, not as systematic efforts to revive slumping economies. Keynes even recommended public works projects to President Roosevelt when the two met in Washington in 1933, before Keynes worked out the details of his general theory. Keynes also called for a greater role for the state in the management of the economy during the 1920s when there was no immediate crisis of unemployment.²⁵ Keynes, like many other liberals of the time, wanted the state to take on greater powers over the economy, with or without any broader theoretical defense of that recommendation. What was novel about his call for public spending in *The General Theory* was the broad theoretical case that he advanced for it in which public spending acts as an antidote to the failure of the marketplace.

Thus he claimed that when individuals hold back on consumption or are unable to spend because of loss of income during slumps, government can step in to borrow and spend as a means of maintaining demand and generating investment, instead of waiting for the market to make adjustments that may never occur. While in such situations it would be preferable for governments to spend on useful and needed projects, he said that any form of spending would be preferable to a policy of inaction. As recovery takes place, budgets might be brought back into balance and debts incurred during slumps can be paid down.²⁶ Keynes argued that his approach represented a middle path, or a third way, between the failures of *laissez faire* and the excesses of socialism because it left intact the institutions of private property and representative government.

²⁴ In an addendum to *The General Theory*, Keynes approvingly cites Mandeville’s *Fable of the Bees* where it is argued that frugality and virtue carried to excess leads to general impoverishment. He does so in order to suggest that his theory about consumer spending and consumer demand has an extensive pedigree in the history of political economy. See *The General Theory*, Chapter 23.

²⁵ See, for example, “Am I a Liberal,” published in 1925, where Keynes urges the liberal party to adopt a platform in which the state would take a large role in “directing economic forces in the interests of justice and social stability.” In *The General Theory* he worked out the premises for a conclusion at which he had already arrived. See *Essays in Persuasion*, op. cit., p. 335.

²⁶ This idea of “balancing the budget over the business cycle” has led many to suggest that Keynes’s was essentially a fiscal conservative. Keynes’s successors, however, turned this into a long run analysis because, if governments could step in to arrest slumps after they have started, they could also use fiscal tools on a permanent basis to prevent them from happening in the first place.

Despite this defense, however, Keynes did not stop with a short-run prescription for dealing with the painful side of the business cycle. He proceeded to suggest that the state should take control of investment in order to rectify the shortage of capital that he identified as an endemic weakness of market capitalism. In his view, uncertainty would always be too great and likely returns too low to induce private investors to part with their funds at levels needed to sustain robust growth and full employment. As he wrote, “a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment.” The state, he said, unlike individual investors or businessmen, is in a position “to calculate the marginal efficiency of capital goods on long views and on general social advantage.”²⁷ Keynes foresaw a stage in the evolution of capitalism when the state could take over the investment function altogether, thereby eliminating private investors from playing any role in the allocation of capital. These speculations did not flow immediately from his theory which he tried to cast as a modest and moderate instrument for correcting endemic weaknesses in market capitalism. On the other hand, he may have viewed this as an end state that would eventually be reached through systematic efforts to apply his theory.

In terms of short-term policy, there were several attractive features to the approach he outlined. First, there was the proposal to balance public spending over the business cycle in order to bring public budgets into phase with the natural ups and downs of the market economy, which meant that Keynes was not departing all that far from the principles of fiscal rectitude. Second, he provided policy-makers with new tools to deal with slumps as alternatives for beggar-thy-neighbor trade policies like tariffs and currency devaluations. Thirdly, his recommendations involved (at least from his point of view) only modest and limited interventions into the market system. As Keynes wrote, “Apart from the necessity of central controls to bring about an adjustment between the propensity to consume and the inducement to invest, there is no more reason to socialize economic life than there was before.... It is in determining the volume, not the direction, of actual employment that the existing system has broken down.”²⁸ Policy makers need not direct spending into this or that area of the marketplace but rather simply control the general volume of spending to maintain full employment. (Of course, when allocating funds, officials cannot but help to direct them to particular areas of the economy.)

In making this case, Keynes meant to overturn not just the “classical” theory of economics but also the doctrine of limited government linked to it. In economics and economic policy, he emphasized consumption, debt, and public spending as foundations for growth over thrift, saving, and *laissez faire*. In opposition to Schumpeter, he argued that if capitalism was to be saved, it had to be placed on a modern moral foundation in which spending, consumption, and debt were no longer seen as vices. He looked forward to a stage of capitalism when scarcity would be overcome, along with the harsh moral principles associated with it. The political economists of the eighteenth and nineteenth centuries saw a strictly limited state as a basic feature of an efficiently operating market system. It was for this purpose that they devised the constitutional rules and institutional checks that we associate with the liberal states of that era. The new roles that Keynes assigned to the state were precisely the kind that liberal constitutions were designed to preclude: public debt, large public expenditures, and political management of economic affairs. Keynes understood that the revolution he proposed in economics was to be accompanied by corresponding breakthroughs in morality, culture, and political institutions.

There is little doubt that Keynes’s doctrine played an important role in rewriting the fiscal constitutions of Western democracies by providing a compelling rationale for public spending and deficit finance that dovetailed with demands coming from other directions for expanded social programs. Keynes was a principal architect of a new system that took shape in the 1940s and 1950s that involved vast changes in public finance, legal rules, political practices, and political institutions. In the United States, public budgets, along with public debt, have steadily escalated in the post war period, especially since the 1960s when Keynesian ideas were first put into systematic practice. From the late 1960s to the present, the U.S. government has achieved budget surpluses on only two occasions, notwithstanding the general prosperity of the period.²⁹ Politicians have found it easy to increase spending and to approve stimulus programs during slumps but extremely difficult to scale back such spending during recoveries. Every item of expenditure in the public budget generates an interest group whose sole

²⁷ Keynes, *The General Theory*, pp. 377–379. Of this claim, Schumpeter wrote, “It has been said that ‘the state can take the longer view.’ But excepting certain matters outside of party politics.... it hardly ever does.” See Schumpeter, *op. cit.*, p. 161.

²⁸ *Ibid.*, p. 379.

²⁹ While government debt in the United States has increased year by year in nominal terms it has not always done so in relation to Real Gross Domestic Product. During the 1950s and 1960s, government debt actually shrunk as a share of real GDP as the economy grew much more rapidly than debt, then accelerated during the 1980s, before stabilizing in the 1990s, and then increasing again between 2000 and 2011 to levels at which they will be impossible to sustain. Nevertheless, even in good times the U.S. government rarely comes close to balancing its books.

purpose is to maintain and expand it, and to show that civilization depends upon its continuation. Seventy-five years after the publication of *The General Theory*, the problems Keynes diagnosed of too much saving and obsessive thrift have given way to the opposite challenges of too much debt and obsessive spending. With the United States and the developed world facing mounting challenges of public debt and insolvent governments, the question arises as to how and on what terms the Keynesian system can be maintained in political and economic circumstances that look much different from those of the 1930s.

An End to the Keynesian Era?

There have not been all that many clear-cut cases in which efforts to apply Keynesian fiscal policies have rescued modern economies from recession or depression. FDR's spending policies during the 1930s are sometimes cited in this connection, but those policies were too inconsistent, quixotic, and uncertain in their effects to be judged as Keynesian successes. The Kennedy tax cut of 1964 is more plausibly cited as a triumph of Keynesian policy, since it did produce a boom, at least for a short time, and it was explicitly crafted by Kennedy's advisors as a demand-side stimulus. It is of special interest that these effects were achieved by cutting taxes rather than by increasing expenditures. There is also the argument that our modern political economy incorporates built-in stabilizers such that recessions create automatic and self-correcting deficits. In other words, we have built a Keynesian system that automatically prevents or corrects for slumps.

On the other hand, there are several contrary cases that must be considered as well, such is the British experience in the 1960s and the American in the 1970s when Keynesian policies either did not work or produced harmful effects—a major devaluation in Great Britain and “stagflation” in the United States. For the past twenty years, since the collapse in its real estate and stock markets, Japan has tried various Keynesian-type policies, including major stimulus packages and public works programs, with little success in producing sustained growth but leaving that country with a public debt roughly twice the size of its annual Gross Domestic Product. The United States also enacted a Keynesian stimulus package in 2009 to deal with a major recession, but so far with disappointing results. Once the funds were spent, the expansion slowed and unemployment rates began to creep up again, provoking calls for further stimulus spending. Meanwhile, government debt levels are approaching parity with annual GDP. In the United States, Japan, and in several European countries, governments have come close to spending whatever Keynesian ammunition they once had.

For a theory of such longstanding influence, this one has had decidedly mixed results when applied to real world economies.³⁰ Given recent experiences in Japan and the United States, some have suggested that the growth effects of Keynesian policies are becoming weaker with the passage of time. Why might this be the case? The answer lies in the fact that political processes in Western democracies gradually produce an allocation of public resources that may impede economic growth. In that circumstance, Keynesian spending policies might slow down rather than speed up growth. If this is so, then the problem lies more with the political economy of Keynes than with the economics of Keynes.

This case was first advanced in 1982 by the late Mancur Olson in *The Rise and Decline of Nations*, an insightful but somewhat speculative book in which he tried to account for the “stagflation” of the 1970s and the failure of Keynesian theories to explain it.³¹ Olson argued that democratic nations develop political rigidities over time that permit strategically placed interest groups to block breakthroughs in policy and to exploit political influence to seize shares of national income that they have neither earned nor produced. These rent-seeking groups, such as labor unions and trade associations, have strong incentives to organize around the state because the incomes of their members depend upon it. As these groups accumulate and multiply their influence over time, they win more rents for themselves but impose ever-greater burdens on the private economy, thereby blocking change or disinvestment in old industries, and producing an inefficient allocation of national income.

This is the reason, he suggests, that new states grow more rapidly than long-established ones because new states have

³⁰ It is an overstatement to say that there is a consensus any longer in the economics profession around Keynesian theories and Keynesian remedies for slumps. Such consensus as once existed evaporated during the 1970s when Keynes's approach could not account for the stagflation of that era. Even macro-economists are now divided among Keynesian, neo-Keynesian, and neo-classical schools of thought. Some economists have gone so far as to say that Keynes is a “dead letter” in their profession, surely an exaggeration but at the same time an expression of a movement away from or beyond Keynes. Nevertheless, Keynes continues to have a popular following among pundits, politicians, and many economists, as witness the continuing debate over the causes of the current slump and the effectiveness of stimulus packages. The economic crisis that began in 2008 has provided another occasion for the revival of Keynes's ideas among economists and public officials. It is unlikely that his theories will ever really die out as long as the political economy put into place in the 1930s and 1940s continues to function. For a statement of where economists now stand in relation to Keynes, see Oliver J. Blanchard, “The State of Macro,” National Bureau of Economic Research Working Paper, 2008; and Edward C. Prescott's 2004 Nobel lecture, “The Transformation of Macroeconomic Policy and Research.”

³¹ M. Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* (New Haven: Yale University Press, 1982).

yet to develop the rent seeking coalitions that strangle growth in older states. Thus, the United States grew rapidly during the 19th century and countries like Japan and West Germany did so in the decades after World War II because all three enjoyed extended periods during which markets were free to operate and interest groups had yet to organize to block change or to claim rents. In fact, as he emphasizes, all three countries went through traumatic wars and revolutions that had the salutary effect of cleaning out existing rent-seeking groups. In the United States, such groups were wiped out by revolution and then kept at bay by constitutional rules that limited the power of the central government; in Germany and Japan, they were eliminated by war, permitting those countries to start over with clean political slates. But these advantageous conditions gradually withered away as growth and affluence led to the formation of rent seeking groups that eventually created obstacles to further expansion.

The interest groups that impede growth are “distributional coalitions,” as Olson called them, or groups organized around struggles over “the distribution of income and wealth rather than over the production of additional output.”³² These are cartels or special interest groups like trade or industrial unions, public employee unions, trade associations, advocacy organizations, or corporations that try to increase the incomes of their members by lobbying for legislation “to raise some price or wage or to tax some types of income at lower rates than other types of income.” In the United States, the growth of government and its expansion into so many areas has led to the creation of myriad groups seeking state or federal appropriations for their enterprises. Distributional coalitions are not necessarily redistributive in the sense that they transfer incomes from the wealthy to the poor; rather they transfer incomes from the less to the more politically influential. Universities, symphony orchestras, museums, energy companies, and even state and local governments lobby the federal government for special appropriations. These groups or coalitions win benefits for their members not only at the expense of taxpayers but also by reducing overall economic output. The large sums diverted to their use cause the economy to operate less efficiently and to grow more slowly than it would otherwise do.

The focus on distributional issues in a society tends to increase the divisiveness of political life by bringing issues to the fore in which some can only gain at the expense of others. If distributional coalitions are small or narrow in relation to the economy as a whole, then these divisive effects will not be so significant; but as these coalitions become more numerous and politically influential, they make political life more contentious because at this point many well positioned voters will see that their livelihoods

are at stake in elections or in debates over legislation. These conflicts are more easily contained during periods of rapid growth because the advantages gained by distributional coalitions will not be readily seen as being won at the expense of others; yet during recessions, and especially in times of deflation or disinflation, these privileges will be more clearly recognized and resented by taxpayers who must support them, leading to divisive political campaigns to scale them back.

When an economy reaches a point at which distributional coalitions are omnipresent, it loses its flexibility to respond to shocks, recessions, or unanticipated changes in price levels. As Olson writes, “The economy that has a dense network of narrow special-interest organizations will be susceptible during periods of deflation or disinflation to depression or stagflation.”³³ The reason for this is that an unexpected deflation will expose above market incomes and prices in the “fix-price sector,” forcing movement out of that sector and into the “flex-price” sector where incomes, wages, and prices are set by market competition. Many will resist such moves, or not know how to make them; queuing and searching costs will be high; the adjustments will force prices to fall further in the flex price sector, reducing overall demand in the economy. An extended period of stagnation will follow as the marketplace adjusts to the distortions caused by distributional coalitions.

At this point one could say that the government should step in with the standard Keynesian remedy, borrowing money and incurring debt to arrest the deflation and to allocate funds to maintain the above market prices and incomes in the “fix-price” sector. This in fact looks very much like what the U.S. government tried to accomplish with its recent \$800 billion stimulus package, which was allocated disproportionately to public employee unions, university research programs, energy companies that could not win loans from banks, and bankrupt auto companies and their labor unions.³⁴ Olson’s reply might be that such remedies will have only temporary effects because they empower distributional coalitions that do not produce wealth and growth but seek to maintain advantages at the expense of the economy as a whole. Such policies run up debt that everyone is obliged to repay to underwrite above market incomes and prices for groups whose activities impede economic growth. In an economy in which distributional coalitions are numerous and powerful, Keynesian remedies (or at least spending remedies) may be ineffective in restoring consumer demand, private sector investment, and economic growth.

³³ *Ibid.*, p. 216.

³⁴ The General Motors (and United Auto Workers) bail out was actually paid for out of the Troubled Asset Relief Program (TARP), the \$750 billion program adopted to allow the federal government to recapitalize banks and insurance companies by purchasing “troubled” assets.

³² *Ibid.*, p. 44.

In fact, in a political sense, Keynesian spending policies may encourage over time the formation of distributional coalitions that eventually render those policies less effective.

Olson has been criticized because he suggests that such rigidities are usually cleaned out by wars and revolutions, upheavals that are far worse than the problem they would solve. In the modern age, these are obviously off the table as cures for a sclerotic political process slow to adjust to new circumstances. Of course, the business cycle might operate in market economies to disperse at least some distributional coalitions by making above market prices and wages more expensive for others to bear. Yet the objective of Keynes's approach was to "smooth out" the business cycle, thus allowing distributional coalitions to persist over the long run, even as new ones form in the process. The fact that some governments (like the U.S. government) can incur debt almost to infinity also means that this process of underwriting distributional coalitions by government spending can be extended well into the future, or at least until that borrowing capacity is called into question. But both—the distributional coalitions and the debt—are burdens on future growth.

This general problem has become more difficult and complex in the years since Olson wrote his book, at least in the United States and probably in other countries as well. Two or three decades of prosperity have permitted government budgets to grow and more of his distributional coalitions to form in order to lay claim to these expanding resources. In addition, these distributional coalitions have at length begun to band together into a broader coalition, since all have an interest in the government spending and regulation that sustains their incomes. While both political parties contain rent seeking groups, the Democratic Party increasingly looks like one large distributional coalition made up of private and public sector labor unions and

beneficiaries of public spending and regulations, while the Republican Party, with its anti-tax and anti-government groups, appears as a coalition formed in opposition to it with an eye to dismantling some of those privileges. This is the new look of the party conflict in the United States, an unprecedented formation pitting one party rooted in the public sector against a rival with roots in the private economy—a distributional coalition against its mirror image. The constitutional system, a product of the old liberal order that Keynes rejected, gives each an effective veto power over the other such that neither can be defeated or dislodged absent some fundamental shock equivalent to, say, the Civil War or the Great Depression.

The "age of Keynes" has now lasted about seventy-five years or roughly as long as the "age of *laissez faire*" that preceded it. Is this era approaching an end in the United States under the pressures of the long recession, the financial crisis, accumulating public debt, and the evolving party alignment? Keynes argued that the capitalist system evolves through stages by the development of new organizational forms and its dynamic process of invention and destruction. There is no reason even for his devoted followers to assume that the "age of Keynes" represents a permanent or final stage in the evolution of capitalism. One prospect is likely: the United States, and advanced economies in general, are as yet in the early stages of an upheaval that will test the Keynesian system to its limits.

James Piereson is a senior fellow at the Manhattan Institute and President of the William E. Simon Foundation. This article was written for a conference co-sponsored by the Manhattan Institute and *Society*. Grateful acknowledgement is given to the Marilyn G. Fedak Capitalism Project for its support.