89 Keynesianism in the United States

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Although John Maynard Keynes was British, his theoretical contributions and their policy implications had enormous influence in the US. Keynes was already an influential economist and statesman with an international reputation before the onset of the Great Depression, but "Keynesianism", the "Keynesian Revolution" and "Keynesian economics" are all inseparable from *The General Theory of Employment, Interest and Money* (1936). The US was in the grips of a major economic, political and social upheaval at the time of its publication, and US President Franklin Delano Roosevelt's (FDR's) administration had already committed to spending on New Deal relief. Keynes was far from the only economist to propose activist fiscal and monetary policies, or to criticize the prevailing neoclassical economics (which he famously called "classical" in the book). Nor was he the first to conceive of the economy in macroeconomic terms or criticize Say's law, and two major features of *The General Theory*, the multiplier concept and the notion of commodity own rates of interest, were due to Keynes's Cambridge colleagues, Richard Kahn and Piero Sraffa. Even deficit spending and public works to counter economic downturns had been promoted in the US by Foster and Catchings a decade earlier (1925).

Yet Keynes put it all together in one volume, in dazzling rhetorical style. It is the book which more than any other symbolizes the transition to the post-war era in the US and the capitalist world. Textbooks were rewritten and, within a decade of it appearing, numerous university economics departments and government advisors appeared that had a Keynesian identity. As did many others, Harvard's Alvin Hansen at first resisted *The General Theory*, but soon became its major proponent, interpreting its theory and policy implications for US readers. The Massachusetts Institute of Technology (MIT) and Yale were additional centers for Keynesian thinking, but perhaps just as important were universities and scholars with less name recognition, and there followed an outpouring of textbooks, newspaper editorials and edited readers, as well as the System of National Accounts. This institutionalization of Keynesianism in the US was assisted by Keynes making several important official trips to the US before his death in 1946, including meetings with FDR and the Bretton Woods negotiations.

Two issues are at the heart of Keynesian economics in the US, one theoretical and the other practical. The theoretical issue regards whether Keynes's demonstration in *The General Theory of Employment, Interest and Money* that there can be involuntary unemployment in macroeconomic equilibrium requires an assumption that wages, prices and/or interest rates are "sticky" (inflexible) downward, or some other market imperfection. This issue is itself rooted in the question of the nature of the relation of Keynes's ideas to what he called the "classical" theory, but is better termed neoclassical economics, the dominant approach in economics in academic and policy circles for the last 100 years and more. Both the neoclassical Keynesian and new Keynesian schools were driven by attempts to reconcile Keynes with neoclassical economics, to produce a neoclassical-Keynesian synthesis.

The practical issue is related to the theoretical issue. Keynesians have tended to be pragmatic when it comes to economic policy, preferring to use fiscal and monetary policies to pursue macro goals of full employment, price stability, and stable economic growth rather than focusing on efforts to remove the imperfections, which would permit market forces to work out the short-term Keynesian troubles. This has had the result of opening Keynesianism in the US to criticism from its opponents for not always proposing policies that are consistent with its theories. Since the stagflation of the 1970s and the Reagan revolution of the 1980s, Keynes's name has been invoked less often, though Keynesian models still seem often to be in the back of the minds of policymakers, such has been their influence. Students are taught the basic concepts, although textbooks too have become less Keynesian over the last quarter century. It is almost guaranteed that Keynes's name and ideas return whenever the economy is in recession, so that Keynesian economics has become almost synonymous with "depression economics". This seems particularly true when the economy is confronted with a financial crisis.

KEYNESIAN THEORY IN THE US

The theoretical issue most fundamental to Keynesian economics can be viewed through the various responses to Keynes's most important work, *The General Theory*. One response was that some like-minded economists became Keynesians. Keynes was not the only person thinking along the lines of criticizing the main notion of neoclassical macroeconomics, the tendency to full employment through market adjustments. In the middle of the Great Depression, this was understandable. The second response was to interpret Keynes as arguing that if prices, wages and interest rates were not perfectly flexible, then unemployment could exist. This was a strange interpretation, since that result already existed in neoclassical theory. The conditions under which the full-employment tendency held was that all markets, including factor markets had to be perfectly competitive, which is another way of saying that all prices, including factor prices such as wages and interest rates, had to be able to adjust to their equilibrium levels. If there were any obstacles to this adjustment, then unemployment could exist indefinitely. If that is all that Keynes was arguing, then he really was not saying anything new.

There are some reasons why Keynes might be interpreted in this way. In an early summary of his principle of effective demand in chapter 3, Keynes did assume money-wages to be constant (1936, p. 27). However, he also wrote that this was "solely to facilitate the exposition" and that "The essential character of the argument is precisely the same whether or not money-wages, etc., are liable to change." (Keynes, 1936, p. 27). Importantly, Keynes promises the assumption is only temporary and in chapter 19, he fully considers the impact of relaxing that assumption. If this was all, it would be difficult to understand interpretations of *The General Theory* that resort to the sticky wages argument. Second, Keynes did think that, for institutional reasons, money wages in the real world do tend to be inflexible downward. Workers resist a reduction of the real wage if it is to be brought about by a decrease in money wages, but this is not ordinarily the case if it is to be brought about by a moderate rise in prices (Keynes 1936, pp. 9–15). This is not due to money illusion (Tobin 1947), but Keynes's analysis of institutional and motivational factors. Workers resist money wage reductions to protect their relative real wage.

However, that is not the same thing as arguing that involuntary unemployment is due to money wage rigidity. Related to this is that Keynes thought it was a good thing for the economy that money wages tended to be partly inflexible. If they were fully flexible, the system might be fraught with violent instabilities (see Keynes 1936, pp. 253, 269). Again, this is not identical to sticky wages or prices being the explanation of unemployment. By page 267, Keynes has concluded that "There is . . . no ground for the belief that a flexible wage policy is capable of maintaining a state of continuous full employment . . . The economic system cannot be made self-adjusting along these lines". Nevertheless, beginning even before Keynes's death, economists began arguing that "the consistency of economic equilibrium with the presence of involuntary unemployment . . . is due entirely to the assumption of 'rigid wages'" (Modigliani 1944, p. 65). This has continued for decades, reaching perhaps its pinnacle with "new Keynesian" economics: "a Keynesian model is by definition a non-market-clearing model, one in which prices fail to adjust rapidly enough to clear markets within some relatively short period of time" (Gordon 1990, p. 1135). "The development of new-Keynesian economics in the past decade has primarily involved the search for rigorous and convincing models of wage and/or price stickiness based on maximizing behavior and rational expectations" (Gordon 1990, p. 1137). This interpretation also became central to the neoclassical Keynesian synthesis. Other price rigidities, in particular that of interest rates, also were a cornerstone of the neoclassical synthesis and, later, new Keynesian economics. Other market imperfections were also called upon by both types of Keynesians to explain involuntary unemployment.

At the theoretical level, this widespread integration of Keynesian macroeconomics with neoclassical microeconomics was based on the real balance effects (RBE) arguments, also known as the Pigou effect and the Keynes or interest rate effect. This strategy accepted some of Keynes's contributions, including aggregate analysis, money as a central determining variable, the multiplier, even a version of liquidity preference theory, but stopped short of any claims such as that Keynes "overthrew" neoclassical economics (Patinkin 1965). In Keynes, a primary feature of his vision of the contemporary capitalist economy is that macroeconomic adjustments are quantity adjustments. When there is insufficient aggregate demand, output declines. The RBE begins with the typical neoclassical vision: price adjustments. Prices fall, money wages fall owing to unemployment, and so there is a fall in the price level. This increases the real value of cash balances, which works through two routes to increasing output and employment. In the direct RBE, or Pigou effect, the increase in the real value of cash makes consumers feel richer and spend more, increasing income with multiplier effects raising output and employment. In the indirect RBE, or interest rate or Keynes effect, less cash is necessary to satisfy the transactions demand for money, increasing the money available for speculative purposes. The demand for securities rises, which bids up bond prices and so decreases interest rates. Investors borrow and spend and output, income and employment rise. This interest rate effect is sometimes called the Keynes effect because Keynes considered something along these lines as a theoretical possibility, but then he also considered why these would not be enough to reintroduce the self-correcting tendency toward full employment. In textbooks, the aggregate spending curve would shift up when the price level declined, and shift down when the price level rose. From this was derived an aggregate demand curve as a function of the price level, the standard downward sloping shape. The main counter-argument to the real balance effects, already recognized in *The General Theory*, is the impact of falling

wages and prices on the "burden of debt" (Keynes 1936, p. 264). Debt, being denominated in money, increases in value when there is deflation. This will have the opposite effect, decreasing spending.

KEYNESIAN POLICY IN THE US

Neoclassical Keynesians from Tobin to Patinkin (and even Lerner) followed Keynes in arguing that, if everything rests on the "Keynes effect" then a falling money wage is the same as monetary policy and so has the same drawbacks as monetary policy, and is much more difficult to enact (Keynes 1936, pp. 267 ff.). Why not simply use monetary policy in that case? So the theoretical argument recedes somewhat into the background. Since there had been numerous episodes of unemployment but virtually no deflation in the post-World War II industrial capitalist economies, and benchmark interest rates are controlled by the central bank, the alternative of deregulation and anti-trust, anti-union policies was not seriously considered during the so-called golden age of Keynesianism, 1946–73. Instead there was a commitment to full employment embodied in the 1946 Employment Act and "fine-tuning" (mix of fiscal and monetary policies) with a greater emphasis on fiscal policy. The use of federal government deficit spending became part of generally accepted policy. This has a theoretical aspect in a macro view of the economy that is rooted in the "two-sided" nature of saving and spending. Macroeconomics is sometimes presented as the "big picture" or bird's-eye view of the economy, while micro regards individual consumer and firm behavior, or macro is money and output as a whole while micro is value and distribution. Both of these pictures are not wrong, but they are incomplete in missing out on the "vital difference" (Keynes 1936, p. 85) which is that in micro we can disregard, at least initially, the effect of individual decisions on other individuals, but that is exactly what macro is all about. It would be "nonsense" (Keynes 1936, p. 85) to ignore the two-sided nature of spending and income and wages and saving. A wage is not only a cost, it is also an income. My spending is your income, my saving is non-spending.

This leads to another crucial result, the paradoxical or counter-intuitive nature of macroeconomics, all derived from the recognition that "there cannot be a buyer without a seller or a seller without a buyer" (Keynes 1936, p. 85). The paradox of thrift is the most famous of these, but there are many. While one individual can ensure a place at the front of the line by arriving to an event early, if everyone arrives early everyone will not be first in line. Lessons for individuals do not in any way apply automatically to the economy as a whole. Related to this aspect of the Keynesian macro vision is another, namely, that the logic of an economy with unemployed resources differs from an economy in which resources are full employed. Lerner (1951, pp. 142–3) called this "topsy-turvy economics" for an "upside-down economy". There is a sense in which resources are scarce when they are fully employed, and there are the trade-offs implied in the notion of opportunity cost. Unemployed resources, alternatively, are not scarce, and there is no opportunity cost to employing an unemployed resource. Thus the Keynesian argument against "crowding out". If resources are fully employed, government use of additional resources must decrease their employment in the private sector. As Keynesians have pointed out, this may be desirable and this would also hold for the private sector. More than that, however, if there are unemployed resources, not only can government employ resources without

taking them away from the private sector, but there may even be crowding in. As Lerner put it, unemployment not only means thrift is undesirable, but labor-saving technological change and trade deficits also are to be avoided, as they will exacerbate unemployment.

This systemic view of the macroeconomy was featured most prominently when it came to fiscal policy. During the Kennedy administration in the early 1960s, with a Council of Economic Advisors including leading Keynesians such as Walter Heller and James Tobin, the President proposed a tax cut to stimulate aggregate demand. Neoclassical Keynesians, including Paul Samuelson and James Tobin, made important pleas for "common-sense" Keynesianism. Against the insistence on balanced budgets, Samuelson (1966) dubbed "[Warren] Smith's Law" the idea that the budget should never be balanced in a calendar year. If the economy was in a downturn, deficits were called for to stimulate output and employment; in an expansion, a budget surplus would prevent inflation and offset the previous deficit. Balancing the budget over the business cycle became a core of the "deficit dove" position, although there were others, notably Francis Bator (1962), who still embraced Abba Lerner's functional finance. Lerner had argued that government budget deficits and the national debt are simply accounting information and all that matter are the effects of any particular policy. Tobin (1963) brilliantly took on the "misleading" analogy made between a household budget and the government budget. The government deficit must equal the non-government surplus. Double-entry bookkeeping, balance sheets, clearly show my debt is your asset and my deficit is your surplus. If you want to decrease the government deficit, you will need to decrease the private sector surplus, if you want to balance the government budget, the private sector surplus must disappear, if you want the government to run a surplus, the private sector must go into deficit. Decreasing the national debt must decrease wealth (in the form of bonds). Later Keynesians, such as Robert Eisner (1986) and Heilbroner and Bernstein (1963, 1989), also argued that to the extent the analogy holds, it supports the appropriate use of government deficits: no one expects households and firms to be debt free, there are perfectly reasonable justifications for well-managed debt, for government as well as the private sector. In the aggregate, however, the private sector normally runs a surplus, which would be impossible if the government did not run a deficit.

The deficit hawk arguments regarding deficits causing inflation and/or high interest rates have so little empirical support that since the 1980s neoclassical economists, politicians and the media have increasingly emphasized the claim that the national debt is a burden on future generations. Keynesians have responded in several ways. First, what would our grandchildren prefer: a healthy economy, updated infrastructure, good medical care and education along with a larger debt, or less debt but a crumbling infrastructure and slumping economy? This is related to the recognition that the government is creating, not only debt, but also assets for the future. This is additionally complicated by the fact that the federal government does not keep a capital account, long a focus of the doves. Every firm, state and local government keeps both a capital account and a current account, but the federal government's investments are not accounted for.

In addition, it is not even certain the deficits will be larger, since the budget is to a significant extent endogenous: an expanding economy increases tax revenues and decreases government spending. This is related to an important notion associated with the deficit dove Keynesians, that of the "full employment deficit", promoted by Heller, but developed earlier by Leon Keyserling. As jobs are created and unemployment declines,

incomes, and therefore tax revenues, rise and government spending on direct and indirect support for the unemployed and their families, such as unemployment compensation, decreases. The deficit therefore shrinks. Conversely, as unemployment rises, income and tax revenues fall, and government spending increases, and the deficit expands.

In addition, whatever debt is paid is always within rather than across generations, from those who are alive to others who are alive. In the original functional finance as laid out by Lerner (1943), and confirmed by numerous central bankers including by Greenspan and Bernanke, a sovereign money monopolist issuing an intrinsically worthless floating currency can never go bankrupt, there is no financial burden for such a currency issuer.

CONCLUSION

The 80-year history of Keynesianism in the US has left two important legacies, one economic and the other political, but these have been partly or fully abandoned by new Keynesians. The economic legacy, a theoretical contribution with crucial policy implications, is a vision of the macro system that is what Heilbroner and Milberg (1995, p. 36) have termed an "aggregative" as opposed to a "summative" approach to the economy as a whole. The aggregative approach recognizes numerous macroeconomic paradoxes and often reaches counter-intuitive conclusions, because the whole may be greater than the sum of its parts, and what is logical or true for one part of the economy (an individual firm or household) is not necessarily logical or true for the economy as a whole. This is Lerner's "topsy-turvy" economics, also recognized by Boulding (1949), who emphasized its importance outside the economy in other parts of social life. Vickrey (2004) and Eisner were equally insistent on the importance of avoiding fallacies of composition in doing macroeconomics.

The political legacy of Keynesianism in the US regards the view of the role of the State in economic matters, and social life more generally. There was a transformation in the view of the appropriate spheres for government involvement and intervention as a result of the Keynesian revolution (Weir 1992). Similar to Keynes, US Keynesians were not state socialists or Marxists in their political stances; far from it. Capitalism could be tamed, improved, its harsh edges sanded down, and social as well as economic goals regarding poverty alleviation, job creation, social security, the distribution of wealth and income pursued, but within an overall market framework.

The abandonment of these Keynesian legacies in the US by new Keynesians brings us back full circle to the article by Robert Gordon, "What is new Keynesian economics?" As the previous quote clearly demonstrated, the issue is not only all the various reasons why prices, wages, and/or interest rates might be sticky, thereby preventing equilibrium solutions, especially in the labor market. There must be "rigorous and convincing models . . . based on maximizing behavior and rational expectations" (Gordon 1990, p. 1137). He is laying out the "ground rules":

> Most new-Keynesian models combine rational expectations with maximizing behavior at the level of the individual agent. Any attempt to build a model based on irrational behavior or submaximizing behavior is viewed as *cheating*. No new-Keynesian wants to build a model with agents that *Barro . . . could criticize* as failing "to realize perceived gains from trade." So *the game* is to tease a failure of macro markets to clear from a starting point of rational expectations

> and the maximization of profits and individual welfare at the *micro* level. In short, effects of changes in nominal aggregate demand on real output and employment are derived in models characterized by equilibria in which *each individual agent takes only those actions that make him* [*sic*] *better off and in which no agent foregoes an opportunity to take advantage of a "gain from trade"*. (Gordon 1990, p. 1137, emphasis added)

The passage is remarkable for its frank admission of economic theory as little different from solving a brain teaser or a crossword puzzle. Gordon explicitly refers to the exercise as a "game" and the ground rules are individuals must at all times pursue their narrow self-interest, maximizing returns and utility, minimizing costs, and never behaving in any way except to maximize his or her advantage, never missing an opportunity to gain more. In allowing the neoclassical theorists to set the rules of the game, the new Keynesians abandon the aggregative approach, if not macroeconomics. Moreover, the individualistic approach misses out on the insights that follow from the macro vision, including ways that government can play an important role independently of promoting the smooth workings of the market mechanism. This is in addition to the loss of economic insights associated with absolutely legitimate analyses of sub-maximizing behaviors and non-rational expectations.

However, perhaps most disturbing is that the Keynesian economics in the US, that emerged in the middle of the greatest economic crisis of the twentieth century, with untold human and social costs of poverty, unemployment, inequality, homelessness and deprivation, and the hopes and dreams that emerged from overturning the wrong-headed ideas associated with the neoclassical model and the successes and accomplishments of the New Deal policies, with the ABC agencies performing invaluable services and building long-lasting projects, is turned into a "game" where only selfishness is allowed. We can only hope that the smaller but vibrant "post-Keynesian" tradition of Hyman Minsky, Paul Davidson, Jan Kregel and Ingrid Rima in the US – and younger scholars developing these ideas – can provide the basis for a theoretical structure not based solely on sticky prices and wages, and a policy commitment promoting human development, social well-being, economic prosperity and ecological sustainability.

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