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Draft of Chapter One, John Meynard Keynes

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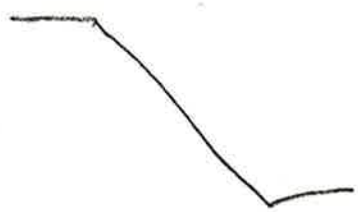
Chapter I

> Is the fulfillment of these ideas a visionary hope? Have they insufficient roots in the motives which govern the evolution of political society? Are the interests which they will thwart stronger and more obvious than those they will serve?

With these questions John Maynard Keynes opens the last section of the final chapter of his monumental, widely heralded if imperfectly understood General Theory, published almost half a century ago, in 1936. The revolution in economic theory he launched ~~by him~~ turned out to be one of approach rather than ~~fact~~ ~~xxxxxxx~~ substance. His major contribution may be said to ~~it is fair to say,~~ lies in the changed perception of economics both in the public and political arenas. Rather than seeing economics as an abstract presentation of natural forces that guide and control the destiny of nations and people, we now look upon it as a policy science. Yet the revolution in economic thought Keynes believed he had ~~to have~~ set in motion has been aborted. His truly pioneering insights into the workings of capitalism have either been overlooked, ignored, or misinterpreted in the construction of today's standard theory. Though in its emphasis on policy approaches it may be called Keynesian, except for semantics standard theory owes little to Keynes. In fact, it is fair to say that it adheres far more to pre-Keynesian doctrines than to the ideas developed in his great work.

Keynes's basic theme proclaims that given its cyclical nature, a capitalist economy with its institutionalized Wall Streets and Cities is a basically flawed structure--i.e., business cycles are intrinsic to a financially sophisticated capitalist economy. These cycles are often mild, and even if painful, essentially benign. Their movements, whether up or down, toward depression and unemployment or boom and inflation, are generally readily corrected and offset. However, if from time to time the booms get out of hand and speculation becomes rampant, then they, via crisis and debt deflation, turn into deep and serious depressions. And although the flaw in capitalism is not always serious, the periodic recurrence of depressions with their toll in human suffering, decline in output, misallocation and misuse of resources, is. The question posed by Keynes is whether a better organization of economic affairs is possible, an organization that offers the economic efficiency implicit in decentralized markets free of booms and depressions in a climate conducive to social justice and individual liberty.

Much discussion has been devoted to the real meaning of Keynes. There are various schools of Keynesians, conservative liberal, and radical--Keynesians who believe that Keynes was merely a refinement of existing theory and others who believe that he marked a sharp break with previous theory. But regardless of the view of what Keynes was all about it must be agreed that to the extent that the existing institutional arrangements were in the main set in the years prior to 1936 or even 1938, the legislation determining our institutional set-up could not have been enlightened by perceptions drawn from the Keynesian revolution. All that we can possibly have had during the past twenty years were Keynesian policy operations within a legislated economic structure that, in its intellectual foundations, is mainly pre-Keynesian.



Even though the full force of Keynes's insights into the workings of a capitalist economy ~~were~~ was not absorbed into the dominant economic theory and analysis, enough of his message--i.e., that our economic destiny was controllable--came through, and conscious management of the economy became an avowed aim of government in the post-World War II era. The Employment Act of 1946 setting up the Council of Economic Advisors and the Joint Congressional Economic Committee constituted a commitment to attempt such management.

When in the days of Copernicus and the voyages of discovery evidence accumulated that existing theories about the shape of the earth were no longer valid, no one suggested ~~to change~~ changing the planetary system or the shape of the earth to make them conform to the prevalent theory. And although economic systems are not natural systems--an economy is a social organization created by man either through legislative action or an evolutionary process of invention and innovation--they too cannot be scotched to accommodate preconceived notions. Our economic institutions, be they trade unions, corporations, or governmental bodies, have not always been here, nor are they essential. Our economy can be changed both in details and in overall character. Still, even though in the republic of our minds we can conceive of institutions and usages that differ from ~~that which~~ those we now have, in striving toward something better we must build on what exists. Therefore, if we aim to do better, we need to know how that which we have functions. We have to understand how our economy works if we are to determine what changes will in fact make things better, however we may define "better." Since we cannot mandate results, only processes, we can achieve desired policy objectives only to the extent that the results we aim at are consistent with the processes of our economy as ~~conditioned~~ shaped by ~~existing institutional arrangements~~ us.

Recognizing the existence of a problem is a step toward its solution, but such recognition must be coupled with an analysis of the nature of that problem and an understanding of the processes involved, in this case processes governing the behavior of our economy, and finding approaches that will deal with the problem without violating fundamental democratic and economic tenets. Without an understanding of the economic processes, and without a passionate, ~~pay~~ even irrational commitment to democratic ~~ideas~~ ideals, our programs for reform and change can become the instruments of demagogues who, playing upon popular fears and frustrations, offer panaceas without specifying methods. Scientific skepticism wedded to a vision of a better world must necessarily act as a constraint on unrealistic aspirations. There are limits to that which can be attained, and they are set by how things work. And even though perfection lies beyond our reach, we can offer something better than what we now have and what we have had in the past.

Today, as we enter the last quarter of the twentieth century, our economic world is in disarray. After two apparently secure decades of progress, instability marked by bursts of accelerating inflation, by higher chronic and higher cyclical unemployment, by bankruptcies and crises in energy, transportation, food supply, welfare, and urban affairs, has become the order of the day. The synthesis of economic policy and social ~~synthesis~~ that seemingly served us so well for ~~f~~ twenty years has broken down. What we need now is a new approach, a policy synthesis fundamentally different from that of the past.

Although vital concerns like personal safety, honesty, and integrity ~~go far beyond~~ transcend ~~the~~ pure~~ly~~ economic ~~scope~~, putting our economic house in order must head our list of priorities, for the malfunctioning of the economy lies at the root of the current crisis. If the economy can be made to work well, and basic security and a sense of personal worth become the general condition, with work available to all, many of our profound social problems will diminish. And if the domestic economic house is put in order, international economic concerns ~~are likely to~~ may well be reduced to manageable proportions~~ as well~~.

In an era in which enough has gone wrong so that the need for economic change and reform is recognized, any program of change and reform that is going to succeed ~~in making things better~~ has to be rooted in an understanding of economic processes as they ~~are~~ function within the ruling set of institutions. ~~The~~ That understanding ~~of economic processes~~ is the realm of economic theory. But even as institutions and usages are not ordained by nature, so economic theory is not handed down from on high. Economic theory ~~results from acts~~ is the product of creative imagination; the concepts and constructs by which our theory orders the universe are the result of human thought. There is no such thing per se as national income, aside from a theory which tells us how to combine elements in the economy into this special index number; demand curves do not confront sellers — customers do; the way in which money and finance affect system behavior can only be perceived within a theory which allows money and finance to affect what happens.

An economy that is inequitable and inefficient can possibly survive; an economy that is unstable cannot. Over the past decade our economy has exhibited a growing tendency toward instability. Unless we understand the reasons for that instability we cannot deal with the problems involved. Policies lacking a theoretical base resemble a striking out at unknown magical forces.

The central problem ~~thus~~ is the economic crisis, or rather, three concurrent crises: one in the economy itself, one in economic theory, and one in economic policy. These three crises are as deep and as significant as ~~the crises~~ those of the 1930s. Our future rests upon understanding the issues and developing approaches that reflect greater insight into the world in which we live.

The most interesting of these three crises may well be that ~~of~~ in economic theory. ~~It is a~~ This crisis, ~~that~~ which exists independently of the problems posed by the behavior of the economy and the breakdown of the post-World War II policy synthesis, ~~It originated in~~ was triggered by the telling points on orthodox theory scored by Piero Sraffa, Joan Robinson, and Robert Clower in the 1950s and 1960s. It is a basic contention of their critique that the manner in which economic theory is taught in graduate schools and offered up in college texts--essential components of the intellectual equipment of all students and practitioners of economics during the past thirty years, and of the intellectual basis of economic policy in capitalist democracies--is seriously flawed. The ~~flaw concerns the~~ question ~~of~~ whether conclusions based on the analysis of abstract theoretical models can be applied to the operations of our type of economy. Specifically, economic theory, especially the highly mathematical concepts developed in the postwar period, maintains that an abstractly defined market mechanism will lead to a coherent, if not optimum, result <u>if</u> the market mechanism does not have to deal with time, money, uncertainty, the ownership of capital assets, and investment--in other words, if the concerns of corporate boardrooms and Wall Streets can be ignored. If, on the other hand, these factors are important and relevant, if the financial organizations of the Wall Streets significantly influence the course of events, then economic theory fails to furnish the theoretical underpinnings for a view that coherence is the result of a decentralized market mechanism. In fact, the Wall Streets of the world generate essentially destabilizing forces, and from time to time the processes that center on them engender serious threats of financial instability--i.e., of incoherent economic behavior.

The discussion over this reputed flaw has become known among economists as the Two-Cambridge Controversy--a reference to the two main centers of the dispute: Cambridge England, the home of Keynes, and Cambridge Massachusetts, the home of Nobel Laureate Paul Samuelson. Were it not for the actual crises in the economy and economic policy, the victory of Joan Robinson and her contingent in Cambridge, England, over the embattled group of Cambridge, Massachusetts, "mathematizers" would have remained the province of professional journals and written off as just another example of academic nit-picking. However, in the mid-sixties, the economy, independent of the logical flaws uncovered by the Cantabrigians, began to behave in a manner that cast serious doubts on the validity of the standard theory. After twenty years of relative tranquility and a general sense of well-being came the so-called credit crunch of 1966. Suddenly the economy failed to behave in the expected fashion: standard theory could not explain what ~~was happening~~ had gone wrong. The cry went up from officialdom and pundits alike that our macroeonomic theory had to be shelved and that we must return to the presumably tried and true methods of microeconomics. In truth, however, the economy was simply behaving in a manner to be expected of a capitalist economy with a fragile financial structure and a big government. The error lay in the economic theory of the officials and pundits, not in the economy itself.

A theory that asserts that what is in fact happening cannot happen, that sees factual evidence as the work of evil forces rather as the systemic result of the economic mechanism, may fill the need for a villain or scapegoat, but it cannot point the way toward a solution. The neoclassical synthesis--the term applied to the existing standard body of economic theory--may be a beautiful logical structure (though in fact it is not, vide the flaws uncovered by the Two-Cambridge Debate), but it cannot explain what is happening. We, need a theory that ~~may~~ sees the possibility of financial crisis as in~~herent~~trinsic to the normal functioning of the economy and that can explain why one period may be susceptible to crisis while another is not.

Only yesterday, during the glorious Kennedy-Johnson days, when the so-called Keynesian economists were the policy advisers, claims were made that the business cycle had been conquered and that we stood on the threshhold of an era of virtual unlimited growth. ~~And~~ Not only had the business cycle been eliminated, but it had now become possible to "fine-tune" the economy. And even in the Nixon-Ford years, when the Kennedy-Johnson "Keynesians" were replaced by a more conservative group, the claim that the economy was capable of fine-tuning was still being advanced. The major difference between these two sets of policies and advisers lay in their techniques, and perhaps, although this was never spelled out, in the intended beneficiaries of the fine-tuning.

~~sibly, although this was not mentioned, who was to benefit from the fine-tuning.~~

The dreams of yesterday stand in striking contrast to the disarray of today. During the past ten years or so our economy has oscillated between accelerating inflation and the threat of financial crisis. Beginning with the credit crunch of 1966, ~~The~~ we have suffered three financial near crises, each one more severe than the preceding one. Moreover, the "intercrises" years of 1966-69 and 1970-74 were marked by high and accelerating rates of inflation. Starting in the mid-sixties, the economy began to behave in an apparently incoherent fashion, with rapid shifts from threatening runaway inflation to threatening plunges into mass unemployment. And even though a flawed, inequitable, inefficient capitalist economy possibly can survive, ~~these~~ such rapid swings between the threatening collapse of asset values on the one hand and exploding asset values and runaway inflation on the other endanger its existence. If the market mechanism is to function well we must arrive at social arrangements that will constrain uncertainty and allow for predictability, for a setting in which future expectations can be based upon a reasonable analysis of past behavior. Decision-making in the past decade has had to operate with a broadened range of future possibilities. Under these circumstances the economy ceases to function normally; policy decisions tend to be erratic.

The shaping of economic policy involves both a definition of goals and the awareness that economic processes are related to the economic and social institutional structure. If the policy is to achieve the best possible or desired results it must concern itself with the design of these institutions and their operations. Institutions, whether created through legislation or evolving, tend to take on a life of their own and respond to market processes. We should not expect to solve all the problems involving the various instutions, ~~banks and other financial organizations, trade unions~~ nor can we continuously make radical changes in their structure. The best we can hope for are arrangements based on our perception of what is needed at a given ~~time,~~ period, and allow sufficient time to achieve the goals aspired to. Only ~~if~~ when the economic and social order ~~should~~ fails to perform adequately should ~~an~~ thorough-going ~~inst~~ institutional reforms be instituted.

The major outlines of our present economic institutional set-up were drawn in the Roosevelt reform era, particularly in the second New Deal, in 1935, which ~~The second New Deal~~ came into being as a response to the failures of the emergency legislation of 1933 and the spate of Supreme Court rulings invalidating various provisions of the first New Deal. But while our institutional set-up is composed largely of remnants of the early Roosevelt years, our perception of how the economy functions has been radically changed by our interpretation of the Keynesian revolution.

The emergence of instability over the past decade, particularly the instability related to the fragility of the financial system, is the result of cumulative changes in financial relations and institutional practices in the twenty years following World War II. The unintended and possibly unnoticed changes in institutions, and the speculation ~~and consequent~~ (and ~~instability~~ consequent instability) induced by the successful functioning of the economy, have invalidated the rules for monetary and fiscal policy based on the experience of the 1950s. It now is obvious that no set of monetary and fiscal manipulations can re-establish the relative tranquility of the 1950s and early 1960s. If we are once again to achieve relative tranquility and steer an even course, fundamental institutional changes similar to the basic reforms of the first six years of the Roosevelt presidency are necessary--reforms drawing on the lessons of the recent years of instability and enlightened by ~~a~~ theoretical insight into its roots.

The new era of reform should be based on the premise that a decentralized market mechanism--the free market of the conservatives--is an efficient way of handling the many details of economic life, and that the financial institutions of capitalism, especially in the context of production processes utilizing capital-intensive techniques, are inherently disruptive because they lead to instability and hence inefficiency. Thus, while admiring the properties of free markets we must realize that the domain in which free markets are effective and desirable is restricted. We must develop economic institutions that take speculation out of those aspects of production that require massive capital investments. Paradoxically enough, capitalism is flawed precisely because it cannot readily assimilate production processes that ~~uses~~ use large-scale capital assets.

In fact we have introduced a number of devices into our economy designed to constrain and contain the inefficiency and instability associated with the use of large-scale capital assets in production. Our Federal Reserve System owes its existence to the instability of asset values under capitalism. Its raison d'être is ~~to act as a~~ its role of lender of last resort. ~~The basic reason that~~ Industries are organized into the quasi-cartels of oligopoly ~~is~~ largely to regulate markets ~~to~~ and constrain the risks of large-scale movements in capital-asset values, although in a financial environment that permits speculative finance, stability through cartelization turns out to be elusive. Our trade unions and minimum wage and unemployment compensation institutions effectively prevent a large decline in money wages in times of substantial unemployment, thus indirectly maintaining capital-assets values. Much of government intervention in industry--arrangements that might be characterized as socialism for the rich--are devices to constrain and attenuate uncertainty, particularly as it affects capital-asset values.

Once we accept the proposition that economic policy can ~~determine~~ shape the course of events we cannot evade the question whom the policy is to benefit and what production will be fostered. And once we admit that institutions are man-made and at least in part the product of conscious decision, we must also face up to the effects of institutional arrangements on social policy. In other words, policy must also reflect an ideological vision; it must be inspired by the ideals of a good society. And it is evident that in addition to the threefold crisis in economics, we are also faced with a failure of vision, with a crisis in the aims and objectives that economic policy should ideally serve.

Some fifty years ago, Keynes defined the political problems as a need

> to combine three things: economic efficiency, social justice, and individual liberty. The first needs criticism, precaution, and technical knowledge; the second an unselfish and enthusiastic spirit that loves the ordinary man; the third, tolerance, breadth, appreciation of the excellencies of variety and independence, which prefers, above everything, to give unhindered opportunity to the exceptional and to the aspiring.*

Given the vast increase in productive ability since Keynes wrote these lines, we can perhaps compromise on the goal of economic efficiency. We are rich, and so we can afford to relinquish some output to achieve justice and liberty, two goals best served by an economic order that maintains and encourages decentralized markets. Since huge centers of private power and wealth are incompatible with social justice and individual liberty, a policy that willingly forgoes some of the presumed advantages of giant firms and vast financial organizations (advantages which may or may not in fact exist) seems highly desirable. In the light of recent experience, when the difficulties encountered by giant corporations and financial empires were closely linked to the instability that plagued the economy,

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*Keynes, "Essays in Persuasion," vol. 9, The Collected Writings of John Maynard Keynes, p. 311.

the very largest concentrations of private economic and financial powers should perhaps, in the interest of efficiency--assuming that stability is prerequisite to economic efficiency--be transformed into public bodies or reduced to more manageable dimensions.

Social justice rests on individual dignity and independence--independence of both private and political power centers--and dignity and independence are best served by an economic order in which income is received either by right or through a fair exchange. Compensation for work performed should be the major source of income even for the very poor. Dependence on permanent and expanding systems of transfer payments is demeaning to the recipient and destructive of the social fabric. Social justice and individual liberty demand an organization of opportunity in which everyone except the disabled and aged achieves a social minimum through the fair exchange implicit in income from work.

It would be naive to assume that all stated social ~~gaas~~ goals are consistent with each other. Because the stress on one objective may well ~~involve~~ push ~~compromise on another issue~~ other ~~objectives~~ goals into the background priorities must be set. My preference ~~lies~~ tends in the direction of personal freedom and democratic rights. I cannot attach the same importance to the safeguarding of so-called property rights as to the preservation of individual liberty and political rights.

All I have said up to this point is meant as a prelude to the main thrust of this work: the drawing up of an agenda for reform of our malfunctioning economy, coupled with approaches for the solution of overriding social problems. The proposals advanced will necessarily be painted with a broad brush. Details will have to be hammered out by the Congress, the Administration, and, let us hope, by the debate of an enlightened public willing to furnish guidance and direction. It is to these concerns that we now turn.