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An Alternative to the Neo-Classical Paradigm: One View.

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The subject matter of this symposium is what unites economists who are more or less dissidents from todays dominant view. Fundamentally the dissidents are united in dissent: we agree that the synthesis of Keynes and the classics, usually labeled "the neo-classical synthesis", is a poor tool for understanding and therefore for guiding policy for the American economy. However, when it comes to what it is we offer that is better, we might very well part company. This symposium is designed to explore whether, or to what extent, we part company or agree in our positive alternative. Is there a common core to what we dissidents individually assert to be the better? As my contribution I will try to put forth in a capsule form my criticism of what is, and my views as to the "better" alternative.

As I see it the neo-classical synthesis is a most unnatural union; in particular it is based upon a peculiar interpretation of Keynes' General Theory. First of all the contribution of the classics to the synthesis relates to the behavior of an abstract economy. Keynes in The General Theory deals with the behavior of a financially sophisticated capitalist economy. In the synthesis the ground rules are those of the classics, the analysis is carried out by abstracting from institutional detail. Cut off from a deep analysis of financial and pricing institutions, special institutional features are introduced into the neo-classical synthesis to provide rigidities or barriers to the achievement of "equilibrium."

As Joan Robinson has pointed out, the rigidity usually emphasized by neoclassical economists as the cause of persistent disequilibrium - the sluggish response of the labor market to excess supply - is within Keynes' system a stabilizing factor, by providing a fixed point that constrains debt-deflation processes. If, in Keynes' system, labor market flexibility ruled then the economy would be less, not more, stable!

It is my view that the Keynesian Revolution stands as an aborted intellectual revolution; the thread of theory which took off from Mr. Hicks' Mr. Keynes article ignored Keynes' basic viewpoint. The General Theory is an introduction to business cycle theory; it is a powerful formulation of why capitalism is flawed in that under capitalist institutions steady state growth is impossible. To Keynes the essential flaw in capitalism is not the stagnant persistent depression, of which much was made in the 1930's. The essential flaw in capitalism centers around the tendency for steady growth to evolve into a boom, and for the boom to sow the seeds of its own destruction in a crisis. The crisis is followed by a debt-deflation process which leads to a stagnant depressed state.

In Keynes' view a capitalist economy has a number of distinctive states - or modes of behavior: steady expansions, booms, crisis, stagnation, etc... Each mode is transitory, breeding structural and behavior determining relations which decreases the likelihood that the state or mode of behavior will persist.

In Keynes, the analysis of speculation and of finance is fundamental to this multiple state behavior of a capitalist economy. Instead of "adding" money, finance, and uncertainty to a price system that determines real phenomena, Keynes begins with specualtion and virtually ignores the determination of relative prices and the allocation of resources between "ships and sails and sealing wax..."

We can, I believe, distinguish two threads of "economic theory." One thread looks at economics as investigating how the quantity, price, and mode of production of pins are determined. Another thread looks at economics as investigating how "the surplus" is determined, controlled, and used. In the neo-classical synthesis, using production functions and invariant preference systems as the basic constructs, the surplus is generated just like any other commodity's price and output. So we have productivity and thrift, a supply of saving and a demand for investment, determining the current contribution to the surplus, to accumulation.

To Keynes, and to any observer of what goes on, the surplus does not emerge unless investment activity is financed. Under capitalism the fundamental determinant of the quantity of investment financed is the current speculation posture of wealth owners and financial institutions. The key to an understanding of how a capitalist economy functions is found in the speculative demand for money, properly understood as the liability structure used to finance both investment and positions in the stock of real and layered financial assets.

Thus the current state of liquidity preference, along with the cash flows generated by current income production and committed by existing liability structures, are the fundamental determinants of system behavior: of whether the economy is moving along steadily, booming, in crisis, or stagnating.

Neo-classical economics and Keynesian economics differ in their basic theoretical perspective. The only way the synthesis was achieved was by ignoring the structure underlying Keynes' contribution: a structure whose revolutionary significance Keynes may not have fully appreciated.

As I see it the task before economics today is to return to the rich set of ideas that were current in the late thirties; ideas which received their richest embodiment in The General Theory. We need to begin anew to construct economic theory for capitalist economies.

The main thrust in pure price and welfare theory of the 1930's was the Lange-Lerner explanation of the economics of a decentralized socialist society. Modern price and welfare theory is an outgrowth of this thrust. There is a bit of paradox here: today's defenders of capitalism rest their case on a model which achieves relevance in a socialist context, and I propose that the fullest critique of capitalism requires not a study of abstract economies but the building of a body of theory that fully encompasses the significance of the special financial institutions of capitalism.

Toronto, December 28, 1972