The Classics and Mr Keynes

Steven Kates*

Peter Clarke. *The Keynesian Revolution and its Economic Consequences*. Edward Elgar, 1998. Pp.240. ISBN: 185898 5900. £49.95.

On this much Peter Clarke and myself are in agreement. There was a Keynesian Revolution and it did fundamentally change the way in which economic issues are conceived and economic policies are formed. But Clarke sees Keynes as having done the world a great deal of good while I see Keynes having done it quite considerable harm. Both of us base our views on substantially the same facts. I should also state from the outset how much I enjoyed the book and how stimulating I found it. Even while he and I disagree on many issues, I found Clarke's discussion penetrating and informative.

The Keynesian Revolution and its Economic Consequences is a series of ten essays which attempt to identify Keynes's policy legacy. What difference does it actually make that Keynes wrote the *General Theory* and published it when he did? To this question, Clarke brings the tools of an historian, although one who, by now, has a rich and detailed background in economic theory. But because it is a series of essays loosely bound together, there is no sustained chain of argument. These are more in the nature of fragments held together under a general theme. This review will deal with a number of the more important fragments.

Dating Keynes's Ideas

Clarke is entirely right about the importance associated with dating Keynes's ideas. As he wrote in the preface:

> "The whole dispute over dating the evolution of Keynes's ideas - which it is tempting to dismiss as a scholastic quibble - has masked a deeper issue about the nature of those ideas and about the grounds on which they can be said to have been properly grounded." (Clarke 1998: 12)

Dating does matter because it brings to light the question of what were the factors influencing Keynes in crafting his theory as he did, or, as stated by Clarke, "the question of when Keynes's ideas took shape is inextricably bound up with the issue of what those ideas were" (ibid. 77). There has been an extensive literature on the steps taken between the *Treatise on Money* published in 1930 and the *General Theory* published six years later. While there are similarities between the two books, no one has ever been in doubt that the latter work is entirely different. So what happened, and when did it happen?

Clarke makes a large play of the letter written to Harrod in 1936 in which Keynes outlined the genealogy of his ideas. Of this letter, Clarke writes:

> "The status this document has acquired can be inferred from the fact that it has been so often quoted in recent years and never challenged." (ibid.: 83)

Having myself challenged the chronology provided by these letters (Kates 1994, 1998), I was interested to find that they had the authority Clarke claims for them. The Harrod letters present a picture of a slow accretion of ideas, an edifice built brick by brick, which would ultimately be crafted together into the argument of the *General Theory*. First this idea and then that until a full blown theory had been put together. But what is left out is the initial conception of effective demand as Keynes's organising principle. Without an organising principle of some kind, there would have been no thread to bring the different strands together. Because what the Harrod letter leaves out - as does every chronology - is the role played by Malthus in influencing Keynes to put together a theory of effective demand failure which he almost certainly would never have done had he not read Malthus just when he did.

Since it is not in dispute that Keynes was in the midst of reading Malthus's correspondence to Ricardo in late 1932, and since Keynes also wrote of his excitement in reading Malthus's *Principles*, also in late 1932, Malthus's role is no minor issue. Malthus was the nineteenth century's single most important advocate of effective demand failure as the principal cause of recession and unemployment. That Keynes should have read Malthus and then immediately begun to structure his own explanation for recession based on demand failure was surely no coincidence but was a straightforward matter of cause and effect. I can hardly see how it could be otherwise, which is why I cannot accept Clarke's judgement that "no sooner had [Keynes] stumbled upon his new theory than he sought to establish a distinguished if unsuspected ancestry for it" (Clarke 1998: 94).[1] That is, it was Keynes who independently came to these conclusions and then fathered onto Malthus his own concept of effective demand which he had already worked out before he came to read what Malthus had written. Clarke merely sees Malthus providing Keynes with a name for his new concept, not the concept itself (op. cit.: 95).[2] Although this is the standard fairy tale found throughout the literature, it seems utterly threadbare given Keynes's new-found interest in Malthus's economic writings precisely at the moment everyone identifies Keynes's change of direction.

Why would Keynes try to hide the fact that he had taken the central concept of his *magnum opus* directly from Malthus? In part, it may have been that Keynes was concerned that if the pedigree of his "new" idea were known, it would be of itself discrediting. But the more important reason is, I think, stated quite nicely by Clarke although in a different context:

> "Keynes's thirst for originality and his readiness to shock made him susceptible to the temptation of striking an iconoclastic pose. Once doubtful of an orthodox proposition, he was not the man to dissimulate conformity. He began toying with the imagery of himself as a heretic." (ibid.: 116)

It is one thing to have recognised a concept in someone else's writing, it is quite another to have come up with the idea oneself. It was this "thirst for originality" which, in my view, caused Keynes to disguise, as best he could, the origins of the single most important concept introduced by him into mainstream economic theory. That effective demand failure had until then been considered an abject fallacy is neither here nor there.

The Nature of the Keynesian Revolution

A second theme developed by Clarke is the nature of the Keynesian Revolution. He attempts to identify what it was precisely that was revolutionary in the *General Theory* and from that, what it was that flowed from theory into policy. I think Clarke is right in identifying demand failure as the critical issue, but even here he tends to cloud the question. In his preface he writes: "I accentuate a distinction between the theory of effective demand and the *General Theory*, given that I have come to attach more significance to uncertainty" (ibid.: 12). He comes back to the issue in his essay "Keynes in History" (ibid.: 138).

Distinguishing between a theory of uncertainty, which is the supposed meaning of the *General Theory*, and a theory of effective demand, which Keynes was working towards in 1932, is one of the more important strands in Keynesian scholarship. Many have argued, taking the lead from Keynes's 1937 article, "The General Theory of Employment", that the Keynesian Revolution is about uncertainty and its influence on decision making. Aside from Keynes's arguments on uncertainty not having been particularly novel (see Lavington 1912 in particular as well as Knight 1921), such considerations could hardly be said to have taken economics into a new direction. It may appeal to scholars with a bent for philosophical questions, but as economics, even in 1932 it was old hat. The concern with business confidence is as ancient as the study of the cycle itself. To say that confidence is low, and that business decisions are being influenced by such lack of confidence, is to say no more than business is uncertain about future trends and has become more tentative. Where it can be taken beyond that is hard to say.

The extensive literature on the significance of the *General Theory* is one that can only have occurred because it has generally been conducted in terms of theory isolated from policy. One of the great merits of Clarke's essays is that they embed Keynesian theory into the policy positions Keynes wanted to push. Because once the *General Theory* is looked at through the policies it leads to, and were intended to lead to, it ought to be clear that the central point is effective demand failure and how to correct it. This should also be obvious from its origins in Malthus.

Clarke, as have many others, makes a large play of Keynes's intuition. Even before he had the theory to back it, he believed that state intervention was important. In regard to Keynes, Clarke wrote:

> "His quest for remedial policies did not wait for the fruition of his theoretical insights. While he was still essentially a neo-classical economist himself, accepting the theoretical assumption that disequilibrium created its own self-correcting forces - albeit forces which might be thwarted in the real world - Keynes had already committed himself to a radical policy stance which invoked state intervention. His rationale was that government, representing the common interest, had a unique role to play. It could be described variously as that of supplying an initial impulse or a further acceleration, of priming the pump, or of offering a makeweight through public expenditure to a deficiency of effective demand. This is the vision of political economy which we immediately recognize as Keynesian." (op.cit.: 19)

Of all the myths associated with the Keynesian Revolution, this may be the most easily disproved. There was nothing novel in having advocated public works in time of recession. It was found throughout mainstream literature. In fact, Clarke himself points out just how commonplace the notion of public works was.

> "Did a revolution in policy in fact need the *General Theory*? It is arguable that the intellectual synthesis Keynes pulled together in the *Treatise on Money* (1930) would have provided a better basis for winning the immediate argument over state intervention and public works. This implied no challenge to fundamental theory but mounted a strong pragmatic case that real-world imperfections in practice thwarted the process of equilibrium.... Moreover, here Keynes's arguments were congruent with those of A.C. Pigou, Dennis Robertson, Henry Clay and Hubert Henderson, all of them heavyweight economists who later proved unable to accept the *General Theory*." (ibid.: 184-5)

But neither the *Treatise* nor the *General Theory* were needed to make the case for public works during recession. The following is taken from one of the most widely used economics text in the United States during the forty years following its initial publication in 1893. State involvement to smooth out the cycle was clearly advocated:

> "It is urged by many that the government should take further steps to control the business cycle and diminish its evils.... In planning public works, the federal

government as well as the states and cities, should aim to time their expenditures in such a way as to avoid competing with private business undertakings for labor and raw materials when business is prosperous, reserving their own demands for periods of depressions. The political difficulties in the way are large, but the proposal is economically sound." (Ely *et al* 1931: 342-3)[3]

Note that public works as a means of dealing with recession were seen as "economically sound". What in fact constituted the revolution in economic thought is the introduction of the concept of effective or aggregate demand. Once the theoretical issues were conceptualised in this way, the policy response almost suggests itself. It is also for this reason that I, unlike Clarke (op. cit.:100), have no problem in believing that Keynes readily accepted the IS-LM apparatus. It was constructed in terms of demand, so that while it portrayed Keynes's vision with a fair degree of accuracy, it totally misrepresented what classical economists had believed. Demand deficiency had never been part of the classical theory of the business cycle. It is classical economists who ought to have been aggrieved.[4]

It is a problem not just with Clarke but with many commentators on the Keynesian Revolution that they have only a sketchy knowledge of the competing economic theories of the time. Classical economists did seem to know something. The business cycle did turn out to be cyclical. Even the Great Depression came to an end, and well before the onset of World War II.[5] There was a well developed theory of the cycle which had made the deepest sense to economists for more than a century. What that theory is, not one economist in a thousand could tell you today, although irony of ironies, the nearest modern equivalent is referred to as "Neo-Keynesian".

Policy Consequences and Deficit Finance

Where I found Clarke's work particularly valuable was in his discussion of the policy consequences of Keynes. These comprise the last three essays in particular and make fascinating reading. They tell the story of how Keynesian ideas began to permeate the public service, and trace how the world before the *General Theory* was different from the world after. The picture of the Treasury of the 1920s has an authentic ring, partly because it seems so similar to their counterparts today. A monastic order and keepers of the truth, holding themselves distant from sullying contact with the real world.

The discussion on the budget surplus, which was maintained more or less from the end of the war until 1973, was also an intriguing surprise. This was the period of the greatest sustained expansion in world history, so it is a revelation to discover that in spite of appearances due to the accounting conventions of the time, the British budget was in surplus during the entire period. I found the discussion on the inadequacies of the Public Sector Borrowing Requirement (PSBR) as a measure of the budget deficit completely convincing.

I was, however, surprised to find Clarke suggesting that budget deficits were not really a necessary part of what Keynes had in mind. In discussing the post-war period with its unbroken record of budget surpluses, Clarke wrote:

"Actually existing Keynesianism in post-war Britain clearly diverged in important respects from the ideas of the historical Keynes. On budget deficits, however, the policy followed for nearly thirty years seems broadly consistent with his own precepts." (ibid.: 207)

If true, this is certainly a very different concept from the "Keynesian" economics most of us were taught. Increased government spending and lower levels of taxation are the fiscal levers for stimulating an economy in recession. Deficits created in recessionary years were to be covered by surpluses in years of higher growth. If that is not what Keynes meant, it is hard to make sense of Keynes's own 1937 statement that "just as it was advisable for the Government to incur debt during the slump, so for the same reasons it is now advisable that they should incline to the opposite policy" (Keynes quoted by Clarke: 214). Attempting to balance the budget during recession still seems to have been the farthest thing from Keynes's mind. And from the perspective of those who lived through the maelstrom of the Great Depression, it was balancing the budget that made the all important difference. In rejecting deficit financing during his budget speech of 1933, Neville Chamberlain stated:

> "At any rate we are free from that fear which besets so many less fortunately placed, the fear that things are going to get worse. We owe our freedom from that fear largely to the fact that we have balanced our budget." (quoted in Clarke 1998: 203).

Chamberlain was certainly right that 1933 was the trough of the Great Depression. The budget had been balanced, deficits rejected and recovery began from that point. The *General Theory* was published in 1936, three years into recovery, at a time when depression was almost universally a thing of the past (with the very interesting possible exception of the United States). It is one of the curiosities of the Keynesian Revolution that the theory which emerged from the experience of the Great Depression was a theory which led precisely to policies that had been rejected in turning the economy around. The actual policies adopted, the ones which led to recovery, were the very policies overturned by the *General Theory*.

It leads to the question of the extent to which theories take hold according to what the policy maker would prefer to be true. The extraordinary speed with which the theory of effective demand was adopted has been remarked upon by many. That it was a theory which appealed to young economists and was largely rejected by the older generation is well known. It swept the world and within a decade had become the standard approach to thinking about unemployment. The publication of the Beveridge Report in 1944 confirmed the importance of maintaining demand, which was an entirely new framework for thinking about the issues. It was this that Keynes had introduced into both theory and the making of policy.

In Clarke's view, however, policy makers remained deeply reluctant to adopt Keynesian policy, and even at that had misunderstood the policy message of the *General Theory* with its emphasis on public investment rather than stimulating consumption. That may well be so, but what made the Keynesian Revolution revolutionary was surely the adoption of policies aimed at increasing the aggregate level of demand. It is this, and only this, which was entirely new to mainstream economics.

Closing Comment

Peter Clarke's *Keynesian Revolution and its Economic Consequences* is a work of the highest scholarship. It is a study of the twentieth century's most dramatic change in economic theory in the hands of not only a first rate historian but also of a first rate English stylist. The essays are a pleasure to read and are filled with insight. The great value of Clarke's work is in bringing to the fore the surrounding historical context and institutional backdrop for events which were to influence the development of economic theory so dramatically. The depiction of the Treasury of the 1920s feels right. These were the forces against which Keynes was made to operate. At the end of the book, one has a better understanding of the two sides of an unequal contest. The combination of the Great Depression, Keynes's established reputation and polemical skills, and the development of a theory whose time had come swept all before it. Classical economic theory, however right it may have been, never had a chance. This is the story Clarke tells inordinately well.

* Chief Economist, Australian Chamber of Commerce and Industry, PO Box E14, Kingston, ACT, 2604. Currently Visiting Fellow, Public Policy Programme, Australian National University.

Notes

[1] The same point is made elsewhere: "Having stumbled upon his new theory, Keynes cast about for unsuspecting predecessors, a number of whom ... receive their meed of praise" (Clarke 1998: 122).
[2] This point is also made in Clarke (1988: 267).
[3] The passage continues with the observation that while higher public works may make sense in theory, "even if it could be acted upon, however, it would, at the most, merely temper somewhat the extremes of the oscillations of the cycle" (Ely *et al* 1931: 343). Experience with public works programmes since the publication of the *General Theory* have shown just how accurate this statement is.
[4] Why they were not aggrieved by IS-LM, and why they did not recognise what was being done to the theory of the cycle which had been developed over the preceding hundred and fifty years, is another story.
[5] Clarke even quotes the famous passage where, in 1937, Keynes had shifted his concerns from unemployment and had begun to worry about inflation (Clarke 1998: 214).

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