The retreat from Keynesian economics

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A major revolution in economic thinking is under way—a retreat from the Keynesian ideas that have dominated economic policy for the past 35 years. In the decades ahead this revolution in economic thinking is likely to have profound effects, not only on the national economy but also on our individual daily lives.

John Maynard Keynes once wrote that the actions and beliefs of practical men in business and government are often guided by the ideas of academic economists who have written years before or, in Keynes's own words, by the "writings of some defunct academic scribbler." For the past thirty years Keynes has been that influential defunct scribbler. The influence of Keynesian thinking cannot be overemphasized and can hardly be exaggerated. Keynes's ideas stretched far beyond the specifics of his technical writings and his influence reached far beyond the economics profession. In the decades since Keynes's death, his disciples made Keynesians of most of us. From textbooks to the press, from expert advisors to civil servants and politicians, Keynesian thinking became the "common sense" of economics. Even those who rejected Keynes's obiter dicta on egalitarian redistribution generally accepted a Keynesian way of thinking about national economic management.
While some economists like Milton Friedman, Friedrich Hayek, and their students rejected Keynesian conclusions, they remained until recently a small and insignificant minority with little or no influence on policy development. Keynesian economics became the common language of policy analysis. It was therefore noteworthy but not surprising when President Nixon expressed the consensus by declaring, "We are all Keynesians now."

Fortunately, that consensus is now beginning to change. To understand why, it is important to remember that Keynes's ideas were developed in the 1920's and 1930's in Britain. When Keynes completed his major work, *The General Theory of Interest, Income, and Employment*, it was 1935 and the British economy had been experiencing an unusually high rate of unemployment for some 15 years. The traditional view that all economic fluctuations are short-lived and self-correcting seemed clearly to be false. In place of the traditional analysis, Keynes developed a theory that he believed was more appropriate to the problems of his own time. Although scholars will continue to debate whether Keynes's ideas and prescriptions were actually correct for the 1930's, it has become very clear that those ideas were not appropriate for the U.S. economy of the 1960's and 1970's when they achieved their greatest acceptance and influence.

Indeed, by the time that President Nixon declared himself to be a Keynesian, the new retreat from Keynesian economics was already beginning in the universities. The experience of the late 1960's and early 1970's had begun to make it clear to some younger economists that the Keynesian framework was not the right way to analyze the current problems of the American economy. Since then, the retreat from Keynesian economics has been gaining momentum. Fundamental attitudes about economics are changing in the universities, in Washington, and among members of the press. Some of this new thinking is reflected in what has come to be called "supply-side" economics. Although this process of intellectual change is just getting under way, it is already clear that the ideas that will influence economic policy in the 1980's and beyond will be very different from the dominant ideas of the past 35 years.

In this essay, I discuss three central ideas in Keynesian economics. In each case, the idea reflected the experience of the depression and, when applied in the very different economic conditions of the 1960's and 1970's, had very adverse consequences. I will comment on these consequences and will note the type of alternative ideas that I believe will replace the conventional Keynesian view.
The three topics are unemployment, capital formation, and government activism. Each of these topics obviously deserves much more attention than it can be given when all three subjects are discussed in a single essay. Nevertheless, I think that it is best to consider the three subjects together in order to emphasize their interdependence in Keynesian thinking and to show why the general retreat from Keynesian economics will bring changes in all three areas.

Before turning to the first of these topics, I should emphasize that although I shall be critical of Keynesian economics, I do not for a moment doubt the important intellectual contribution that Keynes made to technical economic analysis. His ideas contributed to and strengthened economic theory. They have had a profound influence on the course of economic research and on the subsequent development of economic ideas. My concern in this essay is not with Keynes's contribution to technical economic theory but with the impact of his fundamental ideas on the course of economic policy in the past several decades.¹

### Misdiagnosing unemployment

Keynes's view of unemployment can be summarized briefly as: "Unemployment is due to inadequate demand for labor." We are all so accustomed to thinking in the Keynesian way that this may seem like a tautology. In fact, it is very far from a tautology and, when applied to the American economy in the past decade, is just plain wrong.

Keynes's view that unemployment reflects inadequate demand was clearly a product of his depression experience. During the 1930's the unemployment rate in Britain rose to more than 30 percent and many of the unemployed were without steady work for a year or longer. Keynes's theory of unemployment was intended to explain how such a high unemployment rate could persist and how it might be lowered by government policies that stimulated demand. Unfortunately, the theory that Keynes developed became so deeply ingrained in economic thinking, as powerful intellectual systems often do, that economists continued to think in terms of Keynes's theory long after the economy had become radically different. Textbooks, journalists, and politicians also applied these ideas to the

¹ In this essay I do not distinguish between Keynes's own ideas and the subsequent development and extension of those views by his disciples in what has come to be called Keynesian economics. On this distinction, see Axel Leijonhufvud, On Keynesian Economics and the Economics of Keynes (New York: Oxford University Press, 1970).
American economy of the 1960's and 1970's. They pictured the unemployed as a pool of prospective workers who would remain without jobs until aggregate spending increased. Based on this diagnosis, they advocated that expansionary fiscal and monetary policies—government deficits and an expanded money supply—be used to stimulate spending by consumers and businesses.

Even a quick look at the facts makes it clear that the Keynesian analysis doesn't square with the real situation in the U.S. economy. To be specific, I will describe the situation in 1979, a year when the unemployment rate was 6 percent, and therefore higher than the postwar average, but in which the economy was not actually in a recession. Although every year has some unique features, the same general picture could be drawn for most years in the postwar period. And it is a picture that stands in sharp contrast to the image of a stagnant pool of job losers who must remain out of work until there is a general increase in the demand for goods and services.

In 1979, more than half of those who became unemployed were no longer unemployed at the end of four weeks. More than half of the unemployed were less than 25 years old and half of these were teenagers, many of whom were looking for part-time jobs while still attending school. More than half of those who were officially classified as unemployed did not become unemployed by losing their previous job, but were youngsters looking for their first job or those who were returning to the labor force after a period in which they were neither working nor looking for work. Moreover, nearly half of the so-called "job losers" had not really lost their job but were just on layoff waiting to be called back to work; in manufacturing firms, more than three-fourths of those who get laid off return to their original job. In short, the unemployed typically are young, have generally not lost their previous job, and have very short periods of unemployment.

Among married men, the unemployment rate was just 2.7 per-

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2 For a more complete discussion of the character of unemployment in the United States since World War II, see my "The Economics of the New Unemployment," The Public Interest, No. 33 (Fall 1973), pp. 3-42.

3 There have been six brief recessions between the end of World War II and 1979 but these averaged only 12 months each. The unemployment problem of the American economy is not the temporary increase in unemployment during these recessions—the average increase in the unemployment rate from the peak of economic activity to the trough of the recession was less than two percent—but the permanently high rate of unemployment that has averaged more than five percent of the labor force over the entire postwar period, and that many economists now predict will remain at over six percent.
cent and this included many who were just on layoff awaiting recall. For these experienced and generally skilled workers, the labor market was actually tight and the wage rate was rising rapidly. At the other extreme of the labor force, there is a small group of low-skilled individuals—many of them young and with little education—who experience long periods without work and who thus account for a substantial share of total unemployment. But their unemployment rate remains high even when labor markets are abnormally tight because they lack skills and incentives. Yet even for them, the problem is not that jobs are unavailable but that those jobs are unattractive—at least relative to their other options.

More generally, most of the unemployment that the American economy experienced over the past two decades was not due to inadequate demand but to adverse incentives and artificial barriers. These disincentives and barriers are themselves the result of government policies. Indeed, the misplaced Keynesian view of unemployment provided the rationale for these inappropriate policies. If unemployment were simply due to lack of demand, as the Keynesians believed, paying high unemployment insurance benefits would relieve financial hardship without having any adverse incentive effects. In fact, with the kind of labor markets that we have experienced in the past two decades, the existing high unemployment benefits have added to total unemployment by encouraging the unemployed to delay their return to work and by inducing employers and employees to organize production in ways that contribute to layoffs and to unemployment. Similarly, the Keynesian view that firms are deterred from hiring workers because aggregate demand is too low, rather than because wages are too high, implies that a minimum wage law could raise wages without reducing employment. In fact, the actual effect of the minimum wage has been to raise the level of unemployment among those with low skills and little experience and to prevent them from obtaining jobs in which useful skills could be acquired.

The Keynesian view of unemployment not only exacerbated the unemployment problem but also contributed to the rising rate of inflation. When economists and policy officials misinterpreted the high measure rate of unemployment as an indication of an inadequate demand for labor, they called for expansionary monetary and fiscal policies. The increasing inflation rate since the mid-1960's has been largely the result of the excess demand that was generated by these misguided monetary and fiscal policies. The Keynesian misperception of the true nature of unemployment in the postwar
American economy has thus been a principal reason for the increases in both unemployment and inflation that have characterized the past 15 years.

Fortunately, there is a growing recognition that our high permanent rate of unemployment cannot be lowered by expansionary demand policies. An important but underemphasized aspect of what has come to be called supply-side economics is the understanding that unemployment can only be reduced by policies that correct these labor market disincentives and distortions. In a very significant departure from its traditional Keynesian position, the Congressional Joint Economic Committee adopted this view of the nature of unemployment in its 1980 annual report. There is every reason to believe that in the 1980's we will see both a more realistic appreciation of unemployment in the determination of monetary and fiscal policies and a serious attempt to reform some of the labor market policies that currently raise the rate of unemployment.

**The Keynesian fear of saving**

Perhaps the most direct effect of Keynesian thinking has been to retard the process of capital formation. Keynes's own writing displayed not only a lack of interest in the potential benefits of capital accumulation but also an outright fear of excessive saving. Both of these attitudes reflected the depression conditions that so strongly influenced all of his views. It is easy to understand why this was so. The depression brought with it not only a high rate of unemployment among prospective workers but also a low rate of utilization of existing plant and equipment. Because of this low rate of capacity utilization, an increase in demand could lead to higher output without any additional capital. Similarly, adding new plant and equipment to the existing stock of capital might increase the capacity to produce but would not increase actual output unless demand was also stimulated. Since an increase in capital during the depression seemed to be neither necessary nor sufficient to increase output, Keynes's theoretical analysis just ignored the role of capital accumulation in raising potential output. As a result, the economists who followed Keynes and developed Keynesian economics placed much less emphasis on expanding the capital stock than on maintaining the level of demand.

And while capital accumulation was treated as irrelevant, increased saving was considered to be positively harmful. As I indicated in the previous section, the central message of Keynes's anal-
ysis was that the unemployment of the depression was caused by a lack of spending. This low level of spending reflected the desire of households to save more than firms wanted to invest. In short, Keynes emphasized that too much saving was at the very root of the depression. Moreover, Keynes's analysis led to the conclusion that an increased desire to save by households or businesses would not lead to more investment but would only depress the level of demand and therefore cause a further reduction in national income and employment.

The view that excessive saving could cause unemployment was not an idea that Keynes had originated. Many popular writers and even some economists, especially those in the socialist tradition, had made similar arguments for more than a century. The mainstream of the economics profession, however, had always rejected those arguments as unsound. But Keynes's position as a leading academic economist and the persuasive power of his theoretical system succeeded in converting a new generation of economists who regarded the prolonged depression as evidence that the traditional theory was insufficient and who were eager therefore for something to take its place.

The Keynesian fear of saving became a principal feature of the thinking of many of the younger economists who came to the fore in London and Washington during and after World War II. Keynes's disciples feared that the economic recovery that had occurred during the war because of the increased military spending would collapse when the war ended, sending the economy into a new depression, unless individual consumer spending rose to take the place of the reduced military spending. That fear of inadequate consumer spending or, equivalently, of excessive private saving, shaped economic policy in the immediate postwar period and influenced the institutions that continue to affect economic life.

More specifically, the Keynesian fear of saving led to a wide variety of anti-saving policies—policies designed to encourage consumer spending and borrowing and to discourage saving. In this way, the United States and Britain were very different from the other major industrial nations of Europe and from Japan. In these countries, Keynes's intellectual and professional influence was much weaker than in the U.S. and Britain. And the possibility of a new depression caused by inadequate spending seemed to be a far less serious problem than the urgent need to rebuild and replace the capital stock that had been so severely damaged during the war. As a result, those countries developed policies that were designed
to encourage saving while the United States and Britain developed policies to discourage saving.

Unfortunately, our policies have been very successful in depressing the rate of saving. The United States and Britain have had the lowest saving rates in the industrial world during the past two decades. And since the amount of saving that any nation does effectively limits the amount of investment that it can make, these low saving rates have caused correspondingly low rates of investment.

Although there is a growing awareness that the United States has a low rate of saving and investment, few people realize just how low it is and how it has fallen in recent years. The failure to understand the extent of this problem has led, at least until recently, to an inappropriate complacency about capital formation. The evidence that has supported this complacency is that for the past two decades the United States has saved about 15 percent of gross national product. Since what is saved is invested, this has implied that we devote about 15 percent of GNP to investment. That may seem at first to be a reasonable allocation of our national income. A 15 percent saving and investment rate is about three-quarters of the average among the major industrial countries of the OECD, and therefore perhaps not too low for an affluent and relatively mature economy. And certainly any family that devotes 15 percent of its income to saving is making a reasonable provision for the future.

But these figures and this type of reasoning are totally misleading. Although 15 percent of GNP has been devoted to investment during the past 20 years, three-fifths of that investment has been needed just to replace the capital stock that is wearing out. Only six percent of GNP has actually been devoted to net investment, i.e., to increasing the net capital stock. This six percent net investment rate is less than half of the average net investment rate of the other industrial countries of the OECD. Half of our net investment has gone into housing and inventories, leaving only three percent of GNP for increases in the real net stock of plant and equipment used by our nation’s businesses.

Over the past twenty years, this investment caused our stock of plant and equipment to grow at an annual rate of just 3.8 percent. During those years, the number of workers in our labor force grew at an annual rate of 2 percent. The amount of capital per worker therefore increased at only 1.8 percent a year. In the other major industrial countries, the amount of capital per worker grew more than twice as fast and this in turn was reflected in their more rapid growth of productivity.
Our low rate of saving and investment became even lower in the past five years. In the second half of the 1970's, the share of national income devoted to net capital formation dropped to two-thirds of the average over the previous 15 years. As a result, the rate of growth of the stock of plant and equipment fell to less than three percent a year. And since the rate of growth of the labor force increased to more than 2.5 percent a year, the amount of capital per worker remained essentially unchanged. As a result, capital formation ceased to make any contribution to the growth of productivity during these years.

This bleak picture of capital formation in the United States is based on official government statistics. Because the government's method of estimating the capital stock makes no allowance for the special effect of the OPEC price rise, the official statistics understate the extent of our capital formation problem. The sharp jump in petroleum prices caused much of our capital stock to become economically obsolete and useless long before it would normally have worn out. In effect, OPEC destroyed a substantial portion of our capital stock. Since the official statistics do not recognize this, they overstate the growth of the capital stock in the period since 1973. A more realistic measure of the capital stock would probably show an actual fall in the amount of capital per worker during the past five years.

**Growth and the investment imperative**

Our low rate of capital formation means that we as a nation are passing up the opportunity to earn a high rate of return and to raise our future standard of living. Careful statistical calculations show that additions to the stock of plant and equipment earn a real net rate of return (before tax but after adjusting for inflation and real depreciation) of about 11 percent. Thus, by giving up a dollar's worth of consumption today, we can enjoy an additional 11 cents worth of consumption each year for the indefinite future. Or, equivalently, an 11 percent rate of return means that by giving up a dollar's worth of consumption today, we as a nation can have two dollar's worth of consumption (at today's prices) in just six or seven years. (Of course, while this high rate of return is available to us as a nation, because of taxes we as individual savers cannot on average do nearly as well. But I shall return to taxes and the difference between the pre-tax and after-tax rates of return below.)

This high rate of return on investment in plant and equipment is
the real reason why America should save and invest more. This high rate of return means that investment translates on quite favorable terms into increased productivity, a greater national income, and therefore a higher standard of living. There has been so much political rhetoric about capital formation that it is easy to forget that this increased output is the real reason to increase investment. Contrary to much of that rhetoric, a faster rate of capital formation would not create jobs and reduce unemployment. Although more capital would make the existing jobs more productive and therefore better jobs with higher real wages, the unemployment rate will only be permanently decreased by changing the incentives and distortions to which I have already referred. Similarly, an increased rate of investment will not eliminate inflation or reduce it significantly. Although more capital would raise productivity and therefore reduce inflationary pressure (at least to the extent that the higher productivity doesn't raise money wage rates), the inflation rate will be permanently reduced only by changing the monetary and fiscal policies that currently cause excess demand and foster inflationary expectations. But while more capital formation would not cure all of the problems that afflict our economy, it would raise our rate of economic growth and earn a high real rate of return.

Why then do we have such a low rate of saving and investment? What are the policies inspired by Keynesian thinking that have caused us to pass up the opportunity for a high real rate of return? On the basis of my own research on this subject, I have concluded that our low saving rate does not reflect any single policy but rather a whole range of policies that affects every aspect of economic life: tax rules that penalize saving; a social security program that makes saving virtually unnecessary for the majority of the population; credit market rules that encourage large mortgages and extensive consumer credit while limiting the rate of return available to the small saver; and perennial government deficits that absorb private saving and thereby shrink the resources available for investment. Each of these four types of policies can be traced ultimately to the Keynesian fear of saving and to the resulting desire of politicians and their economic advisors to stimulate consumer spending and aggregate demand. In addition, the high rate of inflation in the past decade, itself a result of Keynesian policies, has interacted with the structure of tax rules, credit policies, and Social Security guarantees to discourage saving even more strongly.

I believe, moreover, that the impact of this whole array of policies has been more powerful than the sum of the separate effects
of the individual policies taken alone. By its combination of anti-
saving policies and pronouncements, the government has created
an anti-saving attitude among the present generation of Americans.
In effect, while the French and German governments have been
telling their citizens in both words and incentives that more saving
would create better jobs and a higher standard of living, our gov-
ernment was induced by the Keynesian fear of saving to tell the
American public that saving less and spending more on American-
made consumer goods was the key to jobs and prosperity.

Fortunately, professional economic thinking about capital forma-
tion has now changed. There is no longer the fear that a higher rate
of saving would depress demand and raise unemployment. Instead,
there is now an understanding that a higher rate of saving is nec-
essary for increased investment and that increased investment
could make an important contribution to productivity and to our
standard of living. There is now also an active interest among not
only economists and businessmen but also among members of Con-
gress and other government officials in changing the policies that
have kept our savings rate so low. The label “supply-side econom-
ics” now provides a fashionable handle for these ideas in the pop-
ular press and in Washington. Although there have not yet been
any clear legislative results of this new direction in thinking, in the
decade of the 1980’s we are likely to see significant revisions of the
policies that currently depress private saving—including tax pol-
icies, Social Security benefits, and credit regulations.

These revisions will, I believe, be accompanied by an abandon-
ment of the idea that the monetary authorities should aim at a pol-
cy of easy money in order to stimulate investment. The easy mon-
ey approach, which has been pursued for at least the past twenty
years, has clearly failed to increase investment and has produced the
inflation from which we are now suffering. Indeed, by creating infla-
tion, the easy money policy has actually discouraged saving and
diverted investment into housing, thus doubly reducing the rate of
investment in plant and equipment. The traditional easy money
gold should be, and is likely to be, rejected in favor of a combina-
tion of tight money, high real interest rates, and fiscal incentives
designed to encourage investment in plant and equipment.

The faith in government activism

The third and most general aspect of the Keynesian approach to
economic policy is the faith in government activism: the belief that
the government should use discretionary fiscal policies to eliminate unemployment and should develop spending programs to eliminate all social problems. We must again look at the experience of the depression to understand the origin of these views which represent such a departure from pre-Keynesian economic thinking.

Ever since Adam Smith, economists believed that the economy functions best when it is disturbed least. They recognized that the price system is an efficient way to make the very complex and decentralized process of producing goods and services reflect accurately the preferences of consumers and workers and the cost of production. Although economists were also aware of the imperfections in the free market process, they generally concluded that the invisible hand was the best allocator of scarce resources.

The depression changed all that. A decade of high unemployment and no economic growth destroyed the faith in the market system of a majority of economists. In its place they substituted a belief in active government stabilization and then a more general confidence in the government's ability to solve social problems.

Because Keynes diagnosed the cause of the depression as an inadequate level of total demand, he prescribed an increase in government spending as a direct way of stimulating demand and thus output and employment. He reasoned that the previously unemployed workers who were hired to produce what the government purchased would spend most of their earnings on consumer goods, thereby stimulating another round of increased demand. This process would continue to repeat itself, thus making the total increase in aggregate demand a substantial multiple of the government's own increase in spending. From this simple idea for stimulating demand to escape the depression, Keynes's disciples developed an elaborate theory of fiscal policy designed to stabilize output and eliminate the business cycle.

It is significant that Keynesian stabilization called for government spending rather than monetary policy or tax incentives. The Keynesian emphasis on fiscal policy thus substantially changed the perceived role of the government. Government spending was no longer to be limited to the provision of necessary public services like defense and the court system. Instead, government spending could be used to stabilize employment and output. From this position, it was an easy step to the view that the government should also use its power to interfere in individual markets to cure social problems—providing retirement income for the aged, health care, housing, and the like.
The results of these new views are well known to us all. The faith in government activism led to both the excessive fine tuning of the national economy and the excesses of government spending of Lyndon Johnson's Great Society programs. The overexpanded public sector today and the growth of government regulation can be traced back to the Keynesian belief in national economic management. Fortunately, the experience of the past dozen years has begun to convince a growing number of economists to reject the optimistic Keynesian view of public intervention. In its place, there is a growing respect for the ability of the market and a new modesty about the government's ability to alleviate all economic and social problems.

The uncertain future

The legacy of Keynesian economics—the misdiagnosis of unemployment, the fear of saving, and the unjustified faith in government intervention—affected the fundamental ideas of policy makers for a generation and altered such basic institutions of our economy as the tax laws, the social insurance programs and the financial system. Changing these deeply ingrained aspects of economic life can happen only slowly. But the economics profession has undoubtedly begun to re-examine and re-evaluate the Keynesian notions that have been so dominant for the past 35 years. There is a return to older and more basic economic truths and an attempt to adapt these ideas to the changing conditions of technology and affluence. From this is emerging a new view of unemployment, of saving, and of the role of government.

There is, of course, the risk that the democratic political process—with its two-year election cycle—may not be able to look far enough into the future to adopt appropriate policies. An emphasis on the present and a disregard of the future produces monetary and fiscal policies that reduce unemployment in the short run but increase both unemployment and inflation in the long run. An inability to look ahead and to defer gratification makes it impossible to develop policies to encourage saving. And a demand for instant solutions to difficult problems causes excessive attempts to use government intervention without a proper regard for its adverse long run consequences. In economic policy, as in so many other areas, myopia is the enemy of reform.

But, despite this risk, it now seems reasonable to believe that the experience of the past dozen years has educated not only the eco-
nomics profession but also the public and the politicians. I think a new view of the economy will emerge from this experience and will bring with it better economic policies for the decades ahead.