Published by

AMERICAN INSTITUTE
for ECONOMIC RESEARCH

Great Barrington, Massachusetts 01230

RESEARCH REPORTS

Vol. LXVI No. 13 July 12, 1999

A Keynesian Revival?

by Allan H. Meltzer*

A noted critic of John Maynard Keynes, who also is the founder and chairman of the Shadow Open Market Committee, states his views about the possibility and implications of a revival of "Keynesian" thought.

I have been asked to talk tonight about the revival of Keynesian thinking. I suspect that the stimulus for this choice of topic is the recent election returns from Germany, France, the U.K., and Italy where socialist or social democratic parties have returned to power after a decade or more of government by conservative or centrist parties. I begin with Keynes.

Keynes's Policy Beliefs

Keynes ended his *General Theory* by paraphrasing John Stuart Mill's remarks that the world is ruled by the ideas of philosophers, and that practical men act upon these ideas much more than they know. Keynes added the ideas of economists. Of course, he had his own ideas uppermost in his mind.

Like Plato's earlier proposal for a utopia in which the philosopher is king or ruler, this idea appeals to intellectuals and elitists. How enthralling to imagine a society ruled by the intellectual power of ideas that have become ideals. How attractive to think of our leaders as the very opposite of the self-serving and vain men and women who often rise to positions of power. How satisfying to negotiate with a bureaucracy dedicated to service.

Keynes believed firmly in this utopia. Many libertarians or European liberals like to quote his letter to Friedrich von Hayek, after Keynes read Hayek's famous critique of a planned economy, *The Road to Serfdom*. Keynes congratulated Hayek and praised him "for saying so well what needs so much to be said.... [M]orally and philosophically I find myself in agreement with virtually the whole of it, and not only in agreement with it, but in a deeply moved agreement."

To understand that sentence, one must read on. Keynes disagreed with Hayek both on the efficiency of a planned economy and on the need to sacrifice liberty to obtain the benefits of economic planning. Further, he accused Hayek of inconsistencies in his argument. "You agree that the line [between liberty and planning] has to be drawn somewhere, and that the logical extreme is not possible. But you give us no guidance whatever as to where to draw it.... But as soon as you admit that the extreme is not possible, and that a line has to be drawn, you are, on your own argument, done for, since you are trying to persuade us that so soon as one moves an inch in the planned direction you are necessarily launched on the slippery path which will lead you in due course over the precipice."

Keynes's letter recognizes that the practical choice lies somewhere between the extremes of complete planning and no planning at all. This judgment seems to me unassailable, as a description of what exists. In all countries, the public relies on the state, not the market, to provide some part of education, health care, and old age pensions. In developed countries the state has the dominant role in each of these activities and in others as well.

Keynes then argued that more planning was desirable, because it was more efficient. That is why he emphasized that his agreement with Hayek was about the moral dimension. "Planning should take place in which as many people as possible, both leaders and followers, wholly share your own moral position. Moderate planning will be safe if those carrying it out are rightly oriented in their minds and hearts to the moral issue."

This is, once again, the philosopher-king. Keynes left no doubt that he believed that this behavior was achievable not just by a few but by the whole planning bureaucracy. Further, he believed it was in process of being achieved. He told Hayek: "This is already true of some of them." And, as for the others, "what we need is the restoration of right moral thinking—a return to proper moral values in our social philosophy."

What an odd vision of mankind for an economist to take as his model! Men are not rational, maximizing individuals acting in their self-interest. They are Platonic philosophers working for the public good, not the crooked trees, or imperfect persons, described by Immanuel Kant.

In my book on Keynes's theories, I discussed four major flaws in his policy recommendations and the vision of the world to which his policies led. One of these is either a willingness to sacrifice freedom for government planning or a belief that freedom and planning could be reconciled.

Keynes wanted markets for consumer goods to remain free. Investment was to be planned and directed by government. At the analytic level, Keynes believed he had used the tools of economics from his *General Theory* to show that government planning of investment would increase the capital stock until there was no longer an incentive to add more. Capital would cease to be scarce; interest rates would be at zero; employment would be full on average; and output would be maximized, the most that the economy could produce. This is the basis of his claim to Hayek that planning was efficient.

Of course, this did not happen. Failure occurred at two levels. In developed countries, government policies often encouraged consumption and did not work to sustain a higher average rate of investment. The variability of investment in housing, an active concern of government in many countries, has been noted frequently. When fiscal restraint is required, many countries reduce public investment or reduce support of private investment, opposite to Keynes's proposal. To control budget deficits or government spending, governments are less in-

---

* Allan Meltzer is the Allan H. Meltzer University Professor of Public Policy in the Graduate School of Industrial Administration at Carnegie Mellon University and a Visiting Scholar at the American Enterprise Institute in Washington, D.C. This article is the text of his address to the Progress Foundation International Economic Conference held at the Hotel Savoy, Zürich, Switzerland, on June 3, 1999. Professor Meltzer is the author of, among other works, *Keynes Monetary Theory: A Different Interpretation*, and a founder and chairman of the Shadow Open Market Committee, which was organized to issue policy statements about current events to government agencies and to the public.

clined to reduce transfers and more inclined to raise tax rates, reduce defense spending or nondefense capital outlays. The investment tax credit in the United States, intended to encourage investment, was started and ended seven times in two decades with uncertain effects on the timing of investment spending. In both developed and developing countries, public investment projects are often wasteful and unproductive. Prestige projects such as national airlines or supersonic commercial aircraft, highways in the Amazon, or development or expansion of steel capacity are a few of the many examples of projects that do little to further Keynes's goal of raising per capita income or achieving a more efficient allocation of a country's resources.

Keynes's error with respect to investment planning is a surprising failure to understand or foresee the way in which the political process operates. It is surprising for two reasons. First, Keynes had considerable experience with government bureaucracies. Although he was highly successful in influencing decisions in his late years, his experience prior to World War II was very different. His campaigns against the return to gold at the prewar parity and against the Treasury view of deficits in the depression are two of his best known failures to persuade governments to change course. There are many others. Second, Keynes's criticism of the Labour Party, written during the 1920s, emphasizes the difficulties of control of the party agenda and its actions by the knowledgeable, intellectual leaders of the party—people such as himself:

> "I do not believe that the intellectual elements in the Labour Party will ever exercise adequate control; too much will always be decided by those who do not know *at all* what they are talking about; and if—which is not unlikely—the control of the party is seized by an autocratic inner ring, this control will be exercised in the interests of the extreme left wing—the section of the Labour Party which I shall designate the party of catastrophe."

Were these problems unique to the Labour Party? Keynes seems to have been convinced that he and others like him could control the agenda and its implementation by other (nonsocialist) parties. He must have recognized that Labour would achieve power, that, at some time, the "party of catastrophe" would control the agenda, and that his program would be pushed aside, replaced by a program chosen by "those who do not know at all what they are doing." How could his program bring stability or achieve an economic optimum if at times it would be run by people who did not share his objectives?

The usual attempt at explanation invokes his basic beliefs, often called the "presuppositions of Harvey Road" after Keynes's family home in Cambridge. This suggests that Keynes remained a Victorian patrician who believed to the end that Britain could be run by an intellectual elite. This is at best a partial explanation. Keynes tells us that he retained many of his early beliefs late in his life, but the same is true of many people. We know that he was surprised and displeased to learn at the Savannah conference that the International Monetary Fund would be run by a large, well-paid bureaucracy. He had hoped that intellectuals, including himself and others like him, would influence the development and that Harry White would serve as managing director. He did not foresee, at least in this instance, the administrative and political consequences of his proposals. Yet, he was very much aware of the influence of competing pressure groups and sectional interests in the United States. He failed to recognize that these pressures and interests, often reflected in votes, were at work in Britain and elsewhere. He failed to see that pressures for income redistribution, not disinterested intellectuals, would have a large role in the policymaking process.

Keynes never resolved the conflict between the goal of raising living standards by increasing efficiency and stability and the means of achieving the goal. He criticized governments for not choosing policies to reduce uncertainty, but his proposals increased opportunities for behaving in the ways he criticized and offered no incentive to behave otherwise. Further, he favored policy rules but did not reject discretion. An early statement reflects his ambivalence:

> "The State must never neglect the importance of so acting in ordinary matters as to promote certainty and security in business. But when great decisions are to be made, the State is a sovereign body of which the purpose is to promote the greatest good of the whole. When, therefore, we enter the realm of State action, *everything* is to be considered and weighed on its merits."

We know that Keynes was not blind to the conflict over the direction and aims of public policy. Keynes believed that he had not sacrificed freedom and enterprise for planning. He believed that, in his *General Theory*, he had found a way to reconcile state direction, higher living standards, increased efficiency, and economic freedom for consumers. Joan Robinson, one of his most devoted followers, wrote:

> In his heart Keynes was just as committed to "freedom" as any neoclassic. When it came to drafting the last chapter of the *General Theory* he produced a version that was all on that side of the question. He sent it to me saying: "I know this won't do. It is just how it welled up" (or words to that effect)... The last chapter was redrafted.

If Keynes's sympathies lay with freedom, his policies often sacrificed freedom. In addition to state direction of investment, he favored a cartel to help the Lancashire producers in the 1920s, commodity price stabilization schemes in the 1930s and 1940s, and capital restrictions and eventually rigid exchange controls. He changed his position on tariffs when he became convinced that they would ameliorate the unemployment problem in the early 1930s. I believe he was capable of convincing himself that the restrictions he proposed were beneficial socially and therefore justifiable. Most often, he failed to foresee their consequences.

The Keynesians

Keynes favored government planning of investment. He was never an inflationist or a consistent advocate of the use of fiscal manipulation to adjust the economy. One can find some contrary statements in his writing, particularly in the late 1920s when he favored public works spending to increase employment after Britain returned to the gold standard at an overvalued exchange rate. But one looks in vain for passages in any of his major works advocating what are called Keynesian policies—business cycle fine tuning or trading more inflation for less unemployment. Keynes was too good an economist to believe that such a tradeoff could endure.

Keynes believed that inflation was caused by printing excess money, not by hiring workers, as in contemporary theories of the tradeoff. Unlike many of his alleged followers, he did not favor price controls or government administered guidelines to control inflation. He favored monetary restriction.

There are many differences between Keynes's writings and the interpretations of his followers in Britain and the United States. One of the key points on which Keynesians focussed attention was that government could control the economy's total spending by changing its own expenditure and tax rates.

This policy proposal may live on in economic textbooks, but it is not currently in the forefront of government policy discussion or decisions in Europe or the United States. Despite the election results, and some SPD rhetoric in Germany, the Maastricht treaty binds the European Central Bank to a primary goal of price stability, and the Stability and Growth Pact restricts the use of budget policy to a narrow range.

U.S. or European governments may err. I believe the Federal Reserve has erred recently by being much too expansive for some time. But, as long as the memory of the 1970s inflation remains strong, central banks are more likely to correct their errors than to compound them, as they did in the 1970s.

And, the public shows a preference for balanced budgets.

Japan offers a possible counter-example. The government has used traditional Keynesian policies in an attempt to increase aggregate demand without depreciating its exchange rate. After years of large expenditure and deficits much larger than Keynes ever proposed or favored, evidence of response is lacking. Permanent tax cuts, advocated by many Keynesian economists, are impossible: With outstanding government debt about 100% of total income, a second 100% in unfunded (government) pension liabilities, more than $500 billion of liabilities to bailout the banking system, and additional unfunded liabilities for health care, future tax increases are a certainty. The public does not, and should not, assume that tax cuts are permanent, so they save their tax rebates. This behavior is consistent with Friedman's permanent income theory of consumption, inconsistent with traditional Keynesian theory.

French and Italian voters tolerated restrictive budget policies on the way to Monetary Union, despite an unemployment rate of 10% or more. Prime Minister Thatcher won reelection despite (or perhaps because of) her decision to work toward a balanced budget in the midst of a severe recession in the early 1980s. And the Clinton administration heaps praise on itself, and receives praise from many groups, for the reported budget surplus. None of these countries show a return to Keynesian policies.

What Remains?

A different type of policy—also called Keynesian—remains active. Keynes's followers, or those who acted in his name, found in his work what is not there: the intellectual case for government activism to redistribute consumption and income from politically less favored to politically more favored groups. Although not the intention, in practice, the favored groups were generally those who had a larger share of voting power than of wealth or income.

It is only with hindsight that people everywhere recognized the very high costs of many of these policies. It has taken many years to accumulate enough evidence to convince skeptics that freedom provides a powerful stimulus for change or innovation in new products, services, and productive processes and that high tax rates and inflexible labor markets destroy incentives and slow growth.

This is not to claim myopia. Let me suggest some reasons why it has been difficult to agree on the effects of free choice and free markets on living standards in this century. First, private property and the market system take time to show their superiority. It takes time for small differences in growth rates to show up as large differences in living standards. Often the cumulative effect becomes large only after a decade or more. It was only in the 1980s that the balance of so-called informed opinion shifted from the belief that the Soviet Union would overtake the market economies to the knowledge that it would not.

There is a romantic belief that redistribution is morally just and economically beneficial, that the state will use its power for good ends. Recent publication of *The Haunted Wood,* telling the stories of Americans and some Europeans who spied for the Soviet Union in the 1930s and 1940s, reminds us that most of these people became spies out of conviction. Most were not venal; they did not take money. They claimed that they were working to make the world a better place. Klaus Fuchs and others who gave away vital information about the atomic bomb professed that the world would be safer and better if the Soviet Union, not the United States, had atomic weapons. They could not prevent the United States from developing the atomic bomb, but they could, and did, work to cancel the military advantages by spying for the USSR, the country that they believed was morally superior.

Ideas and beliefs, even bad ideas if widely shared, shape the political and social consensus and, thus, the environment in which political and economic decisions are made. On average, those who lived through the great depression hold a different view about the role of government than those who experienced only postwar prosperity. It is important to recall that it was only in the 1960s that Milton Friedman and Anna Schwartz published their studies showing that the great depression was the result of government failure, not private market failure. And it took many years for that view to become the established, professional view. Even now every large decline in values on the New York Stock Exchange, and other leading exchanges, is followed by speculation that another "crisis of capitalism" is at hand. And this despite the overpowering evidence showing that the 1929 stock market crash did not cause the subsequent depression.

Further, growth in output can be achieved by forcing investment as Keynes proposed. Russia in the 1930s, Poland in the 1960s, and perhaps China achieved moderate to high growth rates by forcing saving to get high rates of investment. We now know that much of the investment in Russia and Poland was inefficient. Dams, steel mills, and shipyards created jobs and income when the capital was invested and infrastructure was built. The investment was inefficient because there were no market prices directing investment toward efficient uses and few incentives for managers or workers to care about quality of product or efficient use of resources.

Asian countries relied on markets. They adopted best practice by importing capital and educating their citizens to use new technologies. For a long time, it was difficult to distinguish performance in countries like Taiwan and Hong Kong, that relied mainly on markets and private incentives, from countries like Indonesia and Korea, where government used industrial policy to direct investment and development, as Keynes proposed. It is clearer now that the more market oriented systems avoided heavy investment in industries like steel, automobiles and semiconductors with large excess capacity.

It is not always true that the market system makes correct choices and the state makes mistakes. Often it takes decades for differences to appear clearly. In the 1960s, President Kennedy was attracted to French "indicative planning" by the state. South Korea adopted a variant. Until about a decade ago, Japan's mix of private and public planning held great appeal. High savings rates, personal incentives, education and training, and some correct government decisions made these policies highly successful for a time. It is only recently that we and they have recognized that the gains came early, while losses and waste of resources were hidden in the banking system's bad loans and their counterpart, the capital investments that must be written off or sold at prices far below cost.

For sixty or seventy years, long before Keynes's ideas became popular, Sweden combined political freedom and social freedom with relatively high tax rates, and restrictions on property rights and economic freedom. Politicians that adopt and retain these measures were re-elected. Politicians that set out to reduce regulation and the welfare state met resistance from voters and lost elections. I do not think we can explain these outcomes without accepting that the Swedish welfare state rests on the consent of a majority of the governed. There is sufficient common ideology or belief to maintain the welfare state.

Much the same can be said about voters or citizens in most of western Europe. Although the size of these welfare states has increased substantially since World War II, voters have chosen to keep the welfare state and extend it. There were even demonstrations in Germany when the Kohl government tried to change an entitlement that granted four weeks in a spa every three years to three weeks every four years. Too much sacrifice!

Voting is a means by which citizens in all democratic countries have approved expansion of the redistributive and administrative state. Voting rights are distributed equally; each adult has one vote. Wealth and income are distributed unequally. The average voter has less than the average income. Unless property rights are protected, universal voting is a license to redistribute. Impediments to redistribution such as provisions of the U.S. or Swiss constitutions that weaken majority rule limit redistribution but

have not prevented it.

A vote for redistribution is a vote to increase consumption spending today even if it reduces saving, investment and future income. Those who succeed in the market place typically vote against such schemes. Those who do not succeed go to the polling place to increase their current or future consumption by redistributing income.

In countries with high unemployment, demonstrations and protests by the unemployed are rare. When they occur, protectors more often demand more benefits not more jobs. This is true not only of unemployed workers. French farmers are renowned for their ability to show their political strength. This strength depends not as much on their numbers, which are relatively small, as on their support within the larger population.

This is the enduring legacy of a type of Keynesian thinking. People have learned that they can obtain transfers from the state or, more accurately, from their fellow citizens. This is a twentieth century phenomenon. It is found in all developed economies because it increases with income. It differs in size from country to country based on political structure, cultural background, and income distribution.

This explanation of the increased role of government explains why we do not see liberal societies with limited government. Government has grown in size and power in all democratic countries. Voters rarely repeal or rescind programs that redistribute income. Traditional liberal political parties have almost disappeared in the last half of this century.

To understand whether governments will continue to gain power, we have to understand the forces that have fostered redistributive policies, government regulation and high tax rates in this century. War and defense have been important causes. War martials resources under government control. Governments may draft men (and women), control the use of materials, raise tax rates to very high levels, and in other ways accumulate power. Power shifts from individuals, markets, or local and regional government to the nation state. If we continue to experience military threats, the nation state will remain large and powerful. Let us put war aside.

Two forces work in the opposite direction. One is differences in economic growth; the second is new technologies. New technologies contribute to growth, so the two are related. That said, I will treat them separately because they raise separate issues.

For many years, countries like Sweden, Germany, or France could claim that large scale redistribution and high tax rates did not reduce the growth rate of income relative to growth in the United States. Many of these countries gradually closed much of the difference in per capita income with the United States that had persisted through the 20th century.

It is no longer true. Since 1991, U.S. real income (GDP) has increased much faster than incomes in the main European countries—about 15% faster from 1991 to 1998. The difference is not explained entirely by differences in productivity growth, at least not by manufacturing productivity, the only part of productivity growth that is measured at all reliably. Employment growth, particularly growth of non-subsidized employment, explains a large part of the difference.

To pay for the welfare state, and reduce tax evasion, many European governments impose high taxes on the use of labor and high tax rates on labor income collected at the source. These taxes discourage hiring and effort. Generous long-term benefits to the unemployed discourage work in the taxable part of the economy. A European worker not only pays for the benefits he or she receives but must pay to support the unemployed and their families. The unemployed, often 10% of the labor force or more, produce nothing officially, although they may be active in the under-ground economy where they evade taxes.

The gap in income between the U.S. and the European Union has widened in the 1990s. There is as yet no sign of an end or reversal.

The second force is the difference in the spread of new technology in Europe and the United States. It is hardly noticed that, in the U.S., technology has spread rapidly in the industries that were deregulated in the 1970s and 1980s—principally, financial services, transportation and telecommunications. These, recently deregulated sectors, account for a large and rising share of investment and output. And their growth has spurred demand for computers, software, and information services, some of the principal growth sectors in the last quarter century.

The income gap is a challenge to the European welfare states. If these countries close their economies, by putting up trade barriers to protect the welfare state, as many people believe they will do, inefficiency increases. The gap in real income will widen. At some point, the cost of the welfare state will become clearer. Some of their most productive workers will emigrate, as many have already done. Some of their corporations will relocate, as some Swedish corporations have done.

Until the 1980s, Great Britain was a prominent example of Keynesian and redistributive policies. As the heavy cost of these policies become more apparent, voters elected and re-elected a government that deregulated, privatized assets and lowered inflation. Voters chose higher living standards over more redistribution and regulation.

They did not throw out the welfare state, however. The role of government in education and health care increased. After stability and prosperity was restored, voters called a halt to the more liberal policies. Like voters in the United States, France, Germany, and elsewhere, they chose a candidate who promised some vague "third way."

I believe "the third way" is an admission of defeat by those who once favored government ownership, more regulation and higher tax rates. Rather than recognize that the policies they prefer have been rejected, leftist parties use a willing media to cover their defeat. The parties of the left are unwilling to articulate what the third way is or what they want.

Of course, they want power, but power to do what they do not say clearly. In practice, they want what opinion polls and focus groups tell them to want. In the twentieth century, that has rarely been limited government. Currently, it includes increased concern for the environment, better education and, with aging populations, more spending on healthcare.

The parties more disposed to limited government in principle do not promise to act very differently from the social democrats now in power. A perceived crisis or failure of the redistributive state may for a time win support for a Reagan or a Thatcher, but even these exceptional leaders leave few dents in the welfare state.

Although I have emphasized the role of the political center in shaping political outcomes, and collective choice, we should not take the current consensus as given. Our role, yours and mine, is to move that consensus in the direction of freer choice. Obvious failures of the welfare state in education, the provision of health care and pensions give us splendid opportunities to show why choice and markets are superior to government control and direction. But we cannot expect to make great progress until there is a crisis in the redistributive state.

PRICE OF GOLD

	1997	*1998*	*—— 1999 ——*	
	Jul. 10	*Jul. 9*	*Jul. 1*	*Jul. 8*
Final fixing in London	$319.80	$291.80	$262.60	$257.20

Research Reports (ISSN 0034–5407) (USPS 311–190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: $16 per quarter or $59 per year. POSTMASTER: Send address changes to ***Research Reports***, American Institute for Economic Research, Great Barrington, Massachusetts 01230.