CARNEGIE ENDOWMENT
FOR INTERNATIONAL PEACE

A Man for All Seasons

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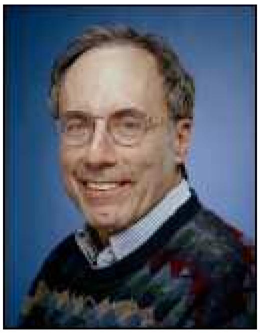

When the economy goes south, one name invariably surfaces on the lips of pundits and economists: John Maynard Keynes. That is because the twentieth century's greatest economist is generally associated with the idea that markets require government intervention in order to function properly. During boom times, when the market seems to be working, no one has any use for Keynes's skepticism toward unrestrained capitalism. But, during recessions--when the economy grinds to a halt and Washington suddenly looks like the only thing that can save it--Keynes invariably enjoys a revival. The current economic crisis, our country's worst since the Great Depression, is no exception. Everyone, it seems, has spent the past months rediscovering Keynes.

But the tendency only to turn to Keynes for technical advice in bad times doesn't really do justice to his worldview. Keynes's ideas were not just a prescription for an ailing economy; they were a complete theory of capitalism, one meant to be relevant in both good times and bad. They were also more than just an economic program; his ideas about capitalism--spelled out most thoroughly in his 1936 work, The General Theory of Employment, Interest, and Money--were developed in tandem with his political philosophy. Keynes saw each as bound up with the other. "The most pressing reforms which are economically sound do not, as perhaps they did in earlier days, point away from the ideal," Keynes wrote in 1932. "On the contrary, they point toward it." Keynes, in other words, was interested in more than manipulating the levers of policy to keep economies thriving. He was interested in how economics intersects with political questions of equality and fairness and justice.

This fall, the Bush administration and the incoming Obama administration have had to confront not just narrow technical questions about budget deficits, interest rates, tax cuts, and savings, but also broader political questions about the proper relationship between government and the economy. Without our realizing or anticipating it, the entire panoply of concerns that Keynes faced in the 1930s has come back to us. Turning to him for answers is therefore an understandable, and wise, move--but only if we treat his ideas as what they are: not quick-fix steps for a battered market but long-term principles for creating a functional and just economy.

Keynes, the son of a Cambridge don and of the town's first female mayor, entered Cambridge University in 1902 during what turned out to be the twilight of the British empire. British industry was being challenged by German and American rivals, but unemployment hovered around 5 percent--virtually full employment. This appeared to confirm the theory--which Keynes learned from Cambridge economist Alfred Marshall--that market economies reach a natural equilibrium of supply and demand at full employment.

Like his parents and other members of what was called the "educated bourgeoisie," Keynes was a loyal member of Britain's Liberal Party. Once advocates of political reform and laissez-faire individualism, the Liberals had, by the early twentieth century, embraced an agenda that called for government to alleviate the externalities of capitalism through programs like social security and unemployment insurance. They were similar in outlook to many pre-New Deal American progressives.

As Robert Skidelsky makes clear in his masterful threevolume biography, Keynes was a "new Liberal"--but with Bloomsbury's aesthetic idealism and disdain for vulgar capitalism thrown in. "I want to mould a society in which most of the existing inequalities and causes of inequality are removed," he declared. He initially thought this could be accomplished through classical economics. But, in the 1920s, he decided otherwise.

In the wake of demobilization after World War I, Britain had suffered a steep recession and unemployment climbed above 15 percent. According to classical theory, the economy should have eventually returned to a full-employment equilibrium--which is what Keynes expected would happen. But it didn't. Instead, the unemployment rate hovered around 10 percent for the rest of the decade, then shot above 20 percent after the Great Depression hit Britain in 1930.

Moreover, the remedies suggested by classical economics--wage cuts, balanced budgets, and the gold standard--simply made things worse. Not only did unemployment rise, but social unrest spread. In 1926, an attempt to cut miners' wages led to a general strike. Keynes sympathized with the strikers whom he saw as "victims of cruel economic forces which they never set in motion."

Over the next decade, Keynes attempted to devise policies that would restore full employment--and a new theory of capitalism to back them up. He argued that market economies, if left to their own devices, could reach equilibrium at well below full employment. This challenge to classical economics rested on his reinterpretation of the relationship among three core economic activities--investment, savings, and consumption.

According to classical theory, if unemployment were to rise, consumption would decline, but savings would increase. The increase in savings would lead to lower interest rates, which would lead to greater investment, which would lead to the restoration of jobs--in short, back to full employment. But Keynes rejected this logic. During a recession, lost jobs and wage cuts would lead to a reduction in consumer demand, which meant less incentive for businesses to invest and banks to loan.

And, if businesses--skeptical about the rate of return from an investment--failed to invest, more workers would lose their jobs, consumption would decline even further, national income would go down, and any initial increase in savings would be wiped out. The economy would reach equilibrium with a high number of unemployed, which is exactly what happened in Great Britain in the 1920s and 1930s.

Keynes's theory inverted the relationship between savings and investment. Instead of the amount of savings determining the amount of investment, the amount of investment determined the amount of savings. It also inverted the relationship between consumption and savings. If the inducement to invest was determined at least partly by consumer demand, then the greater the propensity to consume rather than save, the greater the inducement to invest. Consuming, in short, was preferable to saving.

These two inversions had radical implications for government policy. In the past, governments had advocated budget cuts and tax increases, along with wage cuts and lower interest rates, to escape recessions; Keynes was arguing that, except for lower interest rates, these measures made matters worse. And, in a severe recession or depression, when pessimism about future business profits made lenders reluctant to finance investment, even government attempts to lower interest rates wouldn't help. What was needed instead? Budget deficits, rather than budget balancing, and public investment and income transfer programs designed to put money in the pockets of the poor--that is, the people most likely to spend, not save it.

As Keynes began developing his new economics during the 1920s, he also forged a new political outlook. Earlier, party leaders--and Keynes himself--had trumpeted the "new liberalism" as a middle ground between Tory free-market conservatism and Labour socialism. But, in the articles he wrote in the late 1920s, Keynes shifted left, advocating policies that "constructive thinkers in the Liberal party" and "constructive thinkers in the Labour party" could support. These ideas, reflecting his newfound enthusiasm for government intervention in the market, took him well beyond "new liberalism."

Keynes called for "the deliberate regulation from the center in all kinds of spheres of action where the individual is absolutely powerless left to himself. " He advocated government regulation of private as well as public investment through a new National Investment Board. He wanted government to set workers' wages and hours. He recommended that private corporations be ruled by two-tier boards, with the top tier containing employees' representatives--and that employees share in ownership and have their pay tied to profitability. He favored the nationalization of the Bank of England, but not firms or banks, which he preferred the government to regulate rather than to run or own.

He eschewed the militant anti-capitalist rhetoric of the Labour left, but he also recognized that what he was proposing was actually to the left of much of the Labour Party. "I am sure that I am less conservative in my inclinations than the average Labour party voter," Keynes wrote. In an odd way, he was even to the left of the party's self-proclaimed Marxists like John Strachey and Harold Laski who, because they didn't think capitalism could be reformed, were unable to advance any practical remedies to challenge the Tories' laissez-faire approach.

Keynes scorned these "catastrophists" in the Labour Party. He also despised Soviet communism. And he had a low opinion of Marx's economics. "My feelings about Das Kapital are the same as my feelings about the Koran," Keynes wrote Bernard Shaw in 1934. But he was sympathetic to the Fabian socialism of Shaw, H. G. Wells, and Sidney and Beatrice Webb, which had influenced the Labour Party.

After 1931, Keynes abandoned everyday politics and the sparkling style of his essays to write The General Theory. But that book, while a dry economic treatise, was also an eloquent statement of his political philosophy. "I expect to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of general social advantage, taking an ever greater responsibility for directly organizing investment," Keynes wrote. He argued that "a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment." He didn't say exactly what he meant by "socialization of investment," but it seemed to represent an attempt to bring socialist principles and a concern with "general social advantage" to bear within capitalism.

In 1939, Keynes described his political approach as "liberal socialism." "The question," he wrote, "is whether we are prepared to move out of the nineteenth century laissez-faire state into an era of liberal socialism, by which I mean a system where we can act as an organized community for common purposes and to promote social and economic justice, whilst respecting and protecting the individual--his freedom of choice, his faith, his mind, and its expression, his enterprise and his property." Keynes envisioned not just a society with full employment and economic growth, but also one that sought to eliminate poverty and afforded the educated classes time to spend on the kind of artistic pursuits that he and his Bloomsbury friends had favored. He wanted to use technical, economic means to achieve moral ends.

Keynes died in 1946. In the decades that followed, much of the debate surrounding his ideas came to hinge on a single question: Did his theories apply to all modern, capitalist economies--or were his ideas relevant only to dire circumstances like those that prevailed during the Great Depression? Keynes himself, of course, believed the former. He argued that, after World War I, Britain and the United States had entered a new "epoch" of mature capitalism in which the continued pursuit of laissez-faire policies would lead away from full employment. Unemployment, Keynes wrote in The General Theory, is "inevitably associated with present-day capitalistic individualism."

Not surprisingly, the opposite view--that Keynes's economics were applicable only to a specific historical moment--was mostly advanced by conservatives. But, in the 1990s, when it seemed like capitalism had entered a new period of uninterrupted growth and full employment, liberals in the United States and Britain began writing Keynes off as well. In Prospect, a British journal identified with Tony Blair's New Labour, political scientist David Marquand declared in 2001 that Keynes's theory "was a system for the age of Fordist mass production, with its giant plants, giant unions and 'sticky' wages, not forever. "

So who was right? Did Keynes's theories accurately describe the economies that took shape in the decades after his death? Keynes believed that mature economies would be defined by several features--features which, if left unaddressed, would tend to push them toward high unemployment. One of these was the advent of labor-saving technology, typified by factory electrification in the 1920s. This new technology made it possible for core goods industries to increase their output dramatically while reducing their workforce. "We are being afflicted with a new disease ... technological unemployment," Keynes wrote in 1930. "This means unemployment due to our discovery of means of economizing the use of labor outrunning the pace at which we can find new uses for labor."

There were, of course, ways out of this dilemma. The most likely recourse, Keynes wrote, was that capitalism would find new outlets in "the field of human services." But, as it turned out, services like health care often had to be sustained by government investments and subsidies. The other recourse was that new areas of capital investment could arise--from weapons production and the development of a commercial aircraft industry to computer technology and the Internet. These new areas could also lead to a burst of employment, but they frequently depended on public investment.

Another feature of mature economies, according to Keynes, was that rising standards of living would reduce the marginal propensity to consume. The wealthier a household, the less likely it was to spend most of its income immediately. So in the absence of, say, redistributive tax policies and income transfer programs, a mature economy would likely suffer from an excess of savings over consumption. That would cause a reduction in demand, discourage investment, and lead to unemployment.

The history of Western capitalism after World War II largely confirms Keynes's ideas about mature capitalist economies. By the 1950s, most Western European countries were enjoying full employment. But that was primarily the result of the substantial new investment needed to rebuild war-torn economies. Capitalism had to start over--to remature. Once Western Europe fully recovered, its unemployment rates began to rise, reflecting the tendency Keynes had described.

Developments on our side of the Atlantic also gave credence to Keynes's theories. Post-World War II demobilization and the reduction of the defense budget contributed to a recession in 1948. And, for the next 25 years, defense spending played a large role in keeping the wolf of chronic unemployment at bay. But, after defense production began to decline in the early 1970s, unemployment began rising. It would not drop below 5 percent until 1997, when the economy was buoyed by a boom in a growing area of investment: computers and telecommunications.

These innovations, of course, initially brought new employment and higher productivity. As Keynes would have foretold, however, the boom did not solve the problem of unemployment forever. The growth of these industries eventually reached a point of diminishing returns in new jobs. In the early 2000s, employment began to drop--falling by 33 percent over the last eight years--in companies making computer and electronic products, even as output increased. These declines might have led to a prolonged recession but were offset by the huge budget deficits of the Bush years and the housing bubble. When the bubble burst, though, unemployment returned. The wolf was again at the door. And just as they had during previous downturns, Americans belatedly began rediscovering Keynes--even as many of them failed to notice that the problems he long ago identified had never really gone away, but were lurking in their economy all along.

All of which raises the question: If Keynes's economic analysis is applicable in both good times and bad, and if his related political philosophy was designed to take account of issues like fairness and justice that are always relevant, why did we ignore so many of his recommendations for so long? The answer has to do with American skepticism of government, reinforced by a powerful coalition in Washington of Republicans and business lobbyists. This coalition balked at carrying out anything but the most attenuated version of Keynes's policies--and Democrats bowed to its wishes. To remove any hint of socialism, Republican and Democratic administrations created an unwholesome stew of Keynesian liberalism and business conservatism. The result has been policies that temporarily lifted the country out of recession but left it more divided economically and prone to more serious downturns.

The most important tool that Keynes recommended for overcoming unemployment was public investment. It enjoyed what Keynes's associate Richard Kahn called a "multiplier." Public investment in a new hospital, say, creates jobs and income not only for construction workers, but for the people and businesses that service the workers. Conservatives and big business, however, have objected to public investment--for instance, in high-speed rail or solar paneling--that would strengthen government's hand in dealing with an industry or compete with private industry. It's socialism, they say--and, in Keynes's terms, it is.

Next on the list of Keynesian tools are government programs that redistribute income from the well-to-do (who have the least propensity to consume) to the poor (who have the most). As John McCain demonstrated during the presidential campaign, such redistributionist programs can also easily be denounced as socialism.

A less controversial, though still effective, tool for combating chronic unemployment is low interest rates. But it can be rendered useless during the kind of downturn Japan suffered in the 1990s and the United States is suffering today, when businesses can see only losses and banks only defaults on the economic horizon.

That leaves, finally, tax cuts. These arouse the most enthusiasm among Republicans and business, but are the least effective means of combating unemployment. The bulk of income tax cuts usually doesn't accrue to the people with the highest propensity to consume. Moreover, in the post-1971 era of yawning trade deficits, what is consumed is often imported. That may help employment in Japan or China, but not in the United States.

If you look at America's periodic experimentation with Keynesian policy, it has been guided from the beginning by a determination to avoid any measures that might be described as socialist. It began with what was later called "military Keynesianism"--defense spending being one kind of public investment that was politically safe. But it has increasingly centered on tax cuts. Kennedy's vaunted experiment with Keynesianism consisted of tax cuts. So did Ronald Reagan's and George W. Bush's. Whatever benefits these stimuli provided in the short term, over the long run, they have exacerbated the potential for chronic unemployment by widening income disparities and reducing the overall propensity to consume. A complete reading of Keynes would have counseled a very different approach. But that has never been the way Americans treated Keynes. Until, perhaps, now.

As Barack Obama takes office, he enjoys a great opportunity. Historically, it has often taken wars or depressions to win support for major economic reforms. Crisis, at least in American history, has generally been the precondition for significant change.

Obama also has a decided advantage over Franklin Roosevelt, the last Democrat who took office during a major downturn. Roosevelt could count on the willingness of the American public to accept radical experiments, and on the weakness of a business class discredited by scandal, but to a great extent he didn't know what to do with the power he had. In the early 1930s, Keynes's ideas were barely known, and, even later, they had to vie with classical approaches for FDR's attention. In 1937, Roosevelt, unsure of his economics, actually went back to a classical approach and erased whatever gains he had made in easing unemployment. Obama--whose chief economic adviser Larry Summers is the nephew of Paul Samuelson, a founding father of American Keynesianism--will know better than to start raising taxes or cutting spending to reduce unemployment.

Still, Obama faces extraordinary challenges in trying to implement a true Keynesian approach. Keynes recognized that a balanced and stable international monetary system--not subject to currency speculation or plagued by large trade surpluses and deficits--was a precondition for implementing his domestic agenda. He spent his last years trying to devise such a system--and some of his ideas were reflected in the Bretton Woods agreement. But Bretton Woods collapsed in 1971, leaving an imbalanced and unstable system that places limits on what a president can do. Presidents Ford and Carter discovered these limits in the 1970s when inflation, fueled by oil price shocks, blocked them from using deficits to bring down unemployment. Obama faces similar limits. He has to rely on foreign purchasers, particularly from China and Japan, to buy the bonds to finance America's large budget and trade deficits. If they balk at buying U.S. Treasury bills, interest rates will go up, creating still another obstacle to domestic investment; yet the United States cannot escape this downturn without running huge deficits. In short, Obama is going to have to focus on reforming global as well as American capitalism.

Obama will also need to venture into some areas that Keynes contemplated but previous administrations have avoided. In subsidizing banks and industries, for instance, Obama will have to concern himself with workers' wages--should a worker at Ford make more than a worker at Honda?--and exorbitant CEO salaries. And he is likely to consider proposals to include workers or public representatives on corporate boards of companies that the Treasury subsidizes or owns a stake in.

Moreover, Obama will need to venture into areas that Keynes did not anticipate. Keynes did not foresee government deciding which industries to subsidize. Government, he wrote in The General Theory, should be concerned with "determining the volume, not the direction, of actual employment." But facing the threat of global warming, finite oil supplies, and a large trade deficit, Obama will have to make decisions about the direction, as well as the volume, of domestic investment. He is going to have to pick winners and losers. Which industries will aid in reducing greenhouse emissions? Which will reduce the country's dependence on oil? And which will help reduce America's trade deficit? Obama won't be able to avoid these kinds of choices. Wittingly or not, he will be putting government in a position to shape private capitalism according to "general social advantage."

Of course, there will be objections from the GOP and business--both of which are weakened, but neither of which has lost all its clout in Washington. If Obama heeds these protests and fails to act boldly, he and the country could suffer the same fate as the Labour Party and Britain did in the 1930s. Labour took office in 1929 on the cusp of the Great Depression, but, as unemployment grew, it ignored Keynes's warnings and held back on public spending. In 1931, Labour was defeated at the polls, and didn't return to power again until 1945. Britain suffered under incompetent Tory leadership during much of the 1930s.

Disheartened over these developments, Keynes wrote in 1932 that Labour Party leaders "differed from the leaders of other parties chiefly in being more willing to do or to risk things which in their hearts they have believed to be economically unsound." That epitaph could certainly describe previous Democratic administrations, which borrowed selectively, and fitfully, from Keynes while ignoring his larger insights. Will Obama make the same mistake? Or will he become the first American president to finally, after 70 years, give the theories of John Maynard Keynes a full try?