DR. GEORGE REISMAN SYLLABUS SUPPLEMENT 7

XII. EXPOSITION AND CRITIQUE OF KEYNESIANISM

A. The Essential Claims of Keynesianism

1. The denial of the fact that a fall in wage rates and prices can achieve full employment. Call for government budget deficits as the solution. Keynesianism and Consumptionism. Implied opposition of the Keynesian doctrine to the quantity theory of money.

2. The reasons for Keynesianism's influence: the hostility to a free market in labor—the influence of the exploitation theory. The difficult position of economists. The earlier abandonment of classical economics, especially the wages fund theory and the view of saving.

3. Neo-Keynesianism: Pigou and the Pigou effect. Weakness of Pigou's position. The latest incarnation of Neo-Keynesianism.

B. The Keynesian System: The Unemployment Equilibrium Doctrine and Its Basis; the IS Curve and Its Elements

1. The meaning of the unemployment equilibrium—see *Capitalism,* p. 868, Figure 18–1. Same essential idea as Consumptionism.

2. The meaning of the IS Curve: *the relationship between the "marginal efficiency of capital" (the rate of profit), on the one side, and the volume of output and employment, on the other, for equilibria of investment and saving.*

3. The IS Curve claims that as output and employment expand, the rate of return on capital falls. The Keynesians claim that at the point of *full employment* and its corresponding output, the rate of return would either be negative or, if not negative, at least unacceptably low—somewhere below 2% is the usual estimate. See *Capitalism,* p. 869, Figure 18–2.

4. Derivation of the Keynesian aggregate demand curve and the unemployment equilibrium from the IS curve—see *Capitalism,* p. 870, Figure 18–3.

5. The meaning of the Keynesian argument is that full employment can't exist, because if, somehow, it did, the rate of profit would be too low. Businessmen would then start to hoard, and the hoarding would reduce output and employment until the rate of profit was raised back up to an acceptable level. This is supposed to be the reason why a fall in wages and prices is useless to achieve full employment: the problem is, allegedly, that the physical output corresponding to full employment simply imposes an unacceptably low rate of return on capital. The level of wages and prices is thus held to be irrelevant.

6. Derivation of the IS Curve from a. the production function, b. the saving function, c. an equality of saving and investment, d. the marginal efficiency of capital schedule. See *Capitalism,* pp. 867-875, especially Figure 18-4, on p. 871.

7. A fall in wages and prices is held to be useless in achieving full employment, because all of the relationships above are supposed to hold true *in physical terms.* N_f of employment means Y_f of output, means S_f of saving, requiring I_f of investment, which causes too low a rate of return. These same physical relationships allegedly hold irrespective of the wage and price level. Specifically, at a lower wage and price level, no more physical investment is profitable (yields more than 2%) than before. See *Capitalism,* p. 874, Figure 18-5 and the surrounding discussion.

Thus, there allegedly still can't be an outlet for saving in excess of this given physical amount of investment. And thus there still can't be an output greater than the one that produces such a level of saving, nor, finally, a volume of employment greater than the one that produces such a level of output. Full employment can't exist or be maintained because it would produce a physical volume of output out of which there would be a physical volume of saving requiring a physical volume of investment that would put the rate of return below the minimum acceptable rate. (See Keynes, *General Theory of Employment, Interest, and Money,* p. 261—quoted in *Capitalism,* p. 875.)

8. The fall in wages and prices and the pile up of funds in the "liquidity trap."

9. The Grounds for the MEC Doctrine—why the "marginal efficiency of capital" (rate of profit) is supposed to fall: (see *Capitalism,* pp. 875–876.)

a. Rising purchase prices of capital assets as net investment increases—the additional net investment perceived as an additional demand for capital assets, which raises their purchase price.
b. Lower selling prices of products as more capacity comes on stream as the result of additional net investment.
c. Operation of law of diminishing returns see Keynes on these points: *General Theory* p. 136—quoted in *Capitalism,* p. 875–876.

10. The Keynesian solution: "fiscal policy," i.e., federal budget deficits, to absorb the allegedly excess saving at full employment—see *Capitalism,* pp. 876–878.

C. Critique of the Keynesian Analysis

1. The declining MEC argument and the fallacy of context dropping. The ability of *lower wages and prices* to achieve full employment is the context. The three reasons advanced for the declining MEC as net investment increases contradict this context.

a. Lower, not higher, purchase prices of capital assets.
b. Lower costs of production to offset lower selling prices.
c. Increasing returns to capital, not decreasing returns as employment expands.
The first of the three reasons claims that a fall in wages and prices could not achieve full employment because a *rise* in wages and prices would not.
The second claims that a fall in wages and prices could not achieve full employment, because if there were no fall in costs, but only in selling prices, the rate of profit would be reduced.
The third reason claims that a fall in wages and prices cannot achieve full employment because if what occurred as wages and prices fell was an increase in capital relative to labor as employment increased, there would be diminishing returns to capital. The actual fact is that an increase in employment means *increasing* returns to capital, because it means more labor relative to capital. If ever capital were "too abundant," the surest cure would be more labor—more employment rather than less.

2. The Keynesian claim that a fall in wages and prices cannot achieve full employment, because at full employment the rate of return on capital would be too low, implies that *the rate of return is lower in the recovery from a depression than it is in the depression.*

3. The Keynesian argument claims that in a depression saving and net investment are at their maximum limit, and that the problem is that full employment requires that they be carried still further. Actually, in a depression, saving and net investment are extremely low or even *negative.*

4. Our previous discussion of the determinants of the rate of profit showed that the rate of profit and net investment *are positively related,* i.e., that more net investment and more profits go together virtually dollar for dollar, because while profits are the difference between sales and costs, net investment is the difference between productive expenditure (which is almost equivalent to sales, since it embraces the expenditure for capital goods and for labor by business) and those same costs.

5. The actual reason the rate of profit is so low or negative in a depression is the same as the reason net investment is so low or negative—namely, that productive expenditure has fallen, taking sales revenues with it, while costs, especially depreciation costs, fall only with a lag. The restoration of net investment would be accompanied by a rise in aggregate profits virtually dollar for dollar and would thus sharply raise the rate of profit.

6. The restoration of net investment is prevented by *the failure of wage rates to fall.* When wage rates fall, the costs of individual investments will be sharply lower. Until wage rates fall, investment expenditures are postponed. In this way, as previously shown, the failure of wage rates to fall operates to deepen the depression, because it causes the postponement of investment expenditures, the consequent wiping out of profitability, and thus of the ability of business firms to repay their debts. This, in turn, causes more bank failures, a further reduc-

tion in the quantity of money and velocity of circulation, and thus necessitates greater wage cuts than would have been the case if they had come quickly.

7. Further Errors in the Keynesian Analysis: The contradiction between the marginal-efficiency-of-capital doctrine and the multiplier doctrine; critique of the "paradox-of-thrift" doctrine; critique of the saving function; critique of the liquidity-preference doctrine; the balanced-budget multiplier.

D. Critique of the Keynesian Policies

1. Budget deficits.

a. Promote expansion in size of government—if more government spending is the goal, then any and every government program appears justified—see Keynes, *General Theory*, p. 129, p. 131; quoted in *Capitalism*, pp. 35, 544
b. Actually, budget deficits are *deflationary*, unless financed by inflation of the money supply; if not so financed, they threaten government bankruptcy, and thus a fall in the velocity of circulation of money and a contraction of the money supply insofar as it is backed by government debt.

2. Inflation

a. In the absence of a gold standard, which the Keynesians totally oppose because of the obstacles it puts in the way of money creation and deficits, deficits are in fact financed by the creation of money.
b. The Keynesians also desire the creation of additional money insofar as they believe that it can succeed in lowering the rate of interest. (If the rate of return is not already at its irreducible minimum, the Keynesians believe that increasing the quantity of money can push it lower and in the process stimulate additional investment, employment and output—i.e, they believe that in such circumstances the creation of more money permits a movement down and to the right on the IS curve.)
c. As the discussion of inflation will show, the creation of money by the government, or with the encouragement of the government, is the essence of the inflation problem—inflation *is* the government's creation, or sponsorship of the creation, of money at a rate more rapid than would be possible under a gold standard.
d. The consequence of deficits and inflation is *capital decumulation, a lower productivity of labor, and lower real wages. It is also a lower real rate of return on capital*—for reasons to be explained under the head of inflation.

3. Price and wage controls are the classic response to inflation. They in turn cause total economic chaos and culminate in a totalitarian socialist dictatorship. (See chaps. 7 & 8 in *Capitalism.*) Because the Keynesian policies lead to the inflation that results in price and wage controls, price and wage controls must be considered one of the consequences of those policies.

4. The Keynesian policies of deficits and inflation are not only not necessary for the achievement of full employment, but *do not achieve it.*

a. Indeed, deficits, by themselves, apart from the creation of money, actually cause more unemployment, by virtue of their deflationary effects noted above.
b. As shown in the discussion of unemployment, earlier in the term and in Chapter 13 of *Capitalism*, even when combined with inflation of the money supply, much, most, or even all of the extra spending can be nullified by wage increases that are just as rapid or even more rapid.
c. Throughout the middle and late '30s, the quantity of money and volume of spending in the economic system were stepped up by the adoption of Keynesian policies, and yet unemployment remained a massive problem, because growing labor union power raised wages almost as fast, with the result that growing payrolls were not able to employ correspondingly larger quantities of labor.
d. And much of the additional employment that did take place was in the form of government employment, of a make-work variety, and actually caused a drop in the standard of living of those who already were employed, since they had to produce the goods and services which the government workers consumed, and received no comparable output in return.
e. Also as shown in previous discussion and in Chapter 13 of *Capitalism,* full employment was achieved only with the coming of World War II—not because war is necessary to full employment, but because the war was financed by massive inflation of the money supply *coupled with wage and price controls.* This

combination generated sharply rising payrolls and spending of all types, and wage rates and prices were prohibited from keeping pace. The result was rapidly growing quantities demanded of everything, and the emergence of shortages, including a labor shortage. As previously explained, the full employment of World War II was accompanied by a sharp decline in the standard of living of the average person, who had to work longer and harder and who got much less in the way of goods for his efforts.

f. As previously pointed out, full employment *with prosperity* was achieved only *after* World War II, as the result of the massive reduction in the size of government spending and deficits (from 1945 to 1946, Federal Government spending fell from approximately $93 billion to approximately $45 billion and the deficit was virtually eliminated). The prosperity resulted from the release of funds from the government back to the citizens and the corresponding massive transfer of productive capacity from war production to civilian production, and the transfer of roughly twelve million government workers (most of the army and navy) back to private employment. The citizens now had vastly greater control of their own incomes and wealth and previously unproductive labor was now available for production.

5. Paradoxically, the Keynesian policies reduce the rate of return on capital.

a. This is implied in the very attempt to neutralize or seize current savings, whether by taxing them away or by absorbing them in budget deficits which will never be repaid. The savings that are seized or absorbed for the most part *come out of the rate of return.* Taking them away is tantamount to taking away part of the rate of return itself.

b. This result is evident in inflation, when both saving in real terms and the rate of return in real terms become negative, and people turn to hoarding as the result of the Keynesian policies themselves—a hoarding of the precious metals.

6. The insincerity of the Keynesian policies:

a. Even if the analysis were correct (which it certainly isn't), why not try to raise the rate of return by reducing taxes on the rate of return? Only after all taxes on the rate of return had been eliminated, would it be legitimate to talk of a problem in the private economy of too low a rate of return.

b. The doctrine of the "euthanasia of the rentier" (See *The General Theory,* pp. 375-78—quoted in *Capitalism,* pp. 891–892.) All along the problem of capitalism has been presented as the rate of profit being too low for full employment. Now it turns out that it's *too high!*