reviews

keynes and current economics

NEW DIMENSIONS OF POLITICAL ECONOMY. By Walter Heller. Cambridge, Massachusetts: Harvard University Press. 1966. THE AGE OF KEYNES. By Robert Lekachman. New York, N.Y.: Random House. 1966. THE NEW INDUSTRIAL STATE. By John Kenneth Galbraith. Boston: Houghton Mifflin. 1967.

The economics profession has attained a degree of public recognition as practical experts, not accorded the other social sciences. This is an invidious but true observation. Much of this reputation can be credited (or blamed) to a sequence of undermining events which took place within the economy and inside the economics profession itself. The phase of major change on this route begins with the decade of the 1930's. By now, the change is substantially complete, and we are entering a new stage. At the center of the post 1930 developments are the ideas popularly associated with John Maynard Keynes. Only recently, however, has social science knowledge permitted a clear historical perspective of the "new" economics. Events, distance, historical scholarship and theoretical synthesis have all contributed to this overview.

Three recent books, when considered together, provide a good historical view of Keynesian ideas. They also provide a basis for an assessment of the importance and the adequacy of the Keynesian element in current economics. One of these books, and the focus of this article, is *New Dimensions of Political Economy*, by Walter Heller. It deals primarily with the policy triumph of Keynes in the 1960's. Two other books are drawn upon to facilitate an interpretation of Heller's study in particular, and of Keynesian ideas in general. The first is Robert Lekachman, *The Age of Keynes*. And John Kenneth Galbraith, *The New Industrial State* is the second.

walter heller, *new dimensions of political economy*

Mr. Heller has held a vantage point shared by only a few economists. He left his position as Chairman of the Department of Economics at the University of Minnesota in January, 1961, to assume the Chairmanship of the Council of Economic Advisers under President Kennedy. Mr. Heller also served for a time in this capacity under President Johnson, but in November, 1964, he returned to the University of Minnesota.

His book is a commentary upon the Council of Economic Advisers and upon the economic policy of the 1960's. The interest and attraction

of the work derive from a freshness and realism supplied by an author who has been a part of the policy making establishment.

Heller has firm, but well reasoned opinions. He writes with the evangelistic zeal of a man who is sincerely committed to the attitudes and values of the Administrations in which he served. Yet the cost of such a close indulgent involvement is the absence of any real critique or any sense of historical and temporal relativity.

The book is an explication of two themes. First, Heller believes an important breakthrough in the application of economic knowledge took place during the Kennedy and Johnson Administrations. Advances in economic technique along with public acceptance of the ideas facilitated this achievement. A second theme is that in the 1960's, the older Eisenhower policy of smoothing the business cycle (a receding residue of classical thinking) was replaced by a new economic policy of "gap-closing and non-inflationary growth."

The role of an economic adviser. As background for the first theme, the complex matrix from which policy emerges is described with well selected detail. As is well known, economic analysis is only one of the determinants of economic policy. Of equal importance are the priorities on competing economic objectives, limited public understanding and the access of the Council to the mind of the President. Thus, an effective and acceptible economic adviser must possess expertise not only in technical economics, but also in the political and educational (or indoctrinating) task of helping "the president push out 'the bounds of the possible.' "

First in importance, however, are the analytical qualifications of the economic adviser. The economist has an analytical service to offer, as his approach is to "define problems and cast up solutions in terms that clearly tell the decision maker how he can serve one objective at minimum cost to others, for example, how he can serve the ends of full employment . . . at minimum cost to price stability." This practice of thinking in marginal rather than all or nothing terms, and of quantifying where possible, coincides with the type of analytical needs present wherever policy is being formed or evaluated.

President Kennedy possessed both knowledge of and interest in modern economic principles. As a consequence, he was sensitive to the potential role of the economic adviser. In both direct and indirect ways, Mr. Kennedy himself was an important influence in translating Keynesian analysis into actual economic policy. His response to stagnation in the economy during the early 1960's illustrates this point.

When President Kennedy assumed office, slack in the economy cost society $30 billion annually in sacrificed goods and services. Soon after his inauguration, the President demonstrated his awareness of this problem and his commitment to action, by supporting a tax cut to boost consumer and business spending. The Council of Economic Advisers urged a planned budget deficit to be induced by a cut in individual and corporate income tax rates. Economists have long recommended this type of action to deal with unemployment. But politically, it marked the first time that a deficit had been created in an open, discretionary way, with a careful calculation of the magnitudes of change needed. There were times when Mr. Kennedy harbored self doubts, due to public and Congressional resistance to unbalancing the federal budget, but eventually he became firmly committed to the Council's advice.

Economic policy in the 1960's. In his second and closely related theme, Walter Heller considers the economic record of the 1960's. He

stresses a break with the economic policy of the preceding decade. A not too tacit assumption of policy during the 1950's, was that resilience inhered in the private economy to restore full employment after a recession. Such a sanguine diagnosis, left for the federal government only the limited role of softening recessions and dampening overly buoyant booms.

But as the economy stagnated in the late 1950's and the early 1960's, economic reality contradicted the older diagnosis. In contrast, an Administration willing to apply Keynesian analysis was well equipped to deal with the situation. The label for the policy embarked upon is "gap-closing and non-inflationary growth."

Several existing Keynesian tools were introduced to implement the approach. One of the central implemental concepts is "GNP gap." The notion is a simple one. It refers to the difference between actual production and potential production. The higher the level of unemployment of economic resources, the greater will be the GNP gap. The amount of gap for past periods can be estimated, or one can calculate future potential deficiencies in spending and production. The concept points directly toward a quantification of the amount of demand creation (or destruction) required of public policy. Policy action can take either the form of a change in the levels of tax rates, government expenditures or some combination of the two.

In this context, Heller observes that the 1964 tax cut derives directly from the economics textbook. And the response of the economy to the lower taxes was very nearly of the same magnitude as predicted. But by 1966, inflationary pressures had developed due to heavy spending on the Vietnam War. And inflation is an unsolved policy problem. As is common knowledge, resistance to higher taxes makes it difficult to raise tax rates. However, inability to proceed with sufficient speed is even more of a problem. Heller pleads for a grant of authority to some governmental agency to enable it to temporarily raise or lower taxes as required by inflation and unemployment.

Although Heller led in advocating tax cuts as an instrument in boosting demand in 1964, he suggests that in the future (beyond Vietnam), other alternatives will hold higher priority. For example, increased federal government expenditures will be necessary "to repair the ravages of the growth process. If as byproducts in our quest for growth, we destroy the purity of air and water, generate ugliness and social disorder, displace workers and their skills, gobble up our natural resources, and chew up the amenities in and around our cities, the repair of that damage should have first call on the proceeds of growth."

A second avenue of need is the easing of state and local tax pressures. Heller feels strongly that federal revenues should be shared with the states. This subject has long been of interest to Heller and as a result the space devoted to it considerably exceeds that dictated by the major theme of the book.

Appraisal. The reviewer is in agreement with many of the well reasoned and empirically grounded views offered by Heller. Yet both the analysis and the mood of the book are unsatisfactory and disturbing at points.

Heller, in effect, announces a new era of economic truth in government policy. The cause for rejoicing is the widespread acceptance of Keynesian analytical ideas by the larger public. Since these Keynesian analytical concepts have been widely held by the economics profession, Heller's enthusiasm over public acceptance is understandable. And he

has played an important role in their wider dissemination. But there is a real danger of a new dogma developing to replace the old. In fact this hardening process is already quite advanced.

The rigidifying coalescence is brought out by Heller's statement concerning dissent: "Minds have opened, and the area of common ground has grown. Doubters, disbelievers, and dissenters remain. Some vaguely feel it's 'too good to be true.' Others cling to beliefs too long cherished to flee before mere facts. But they are increasingly outside the main body of economic policy consensus."

Since economic truth can not be pinned down once and for all, dogma, regardless of its form, is a problem to be guarded against. Heller's attitude is far from complacent on the new problems we face. Nonetheless, there is an overemphasis on Keynesian control of effective demand as a solution to unemployment and inflationary problems. Their point of critique will be further developed later.

robert lekachman, *the age of keynes*

Robert Lekachman's historically sensitive study, *The Age of Keynes,* is a refreshing work to place beside that of Walter Heller. The book is a sympathetic and perceptive history of Keynes' life and ideas. And Lekachman does not detach the theory from time and circumstances. "If Keynes had survived into the 1960's, he would surely be busy inventing a new and better post-Keynesian doctrine, directed at eliminating poverty and gross inequality of income distribution and improving the quality of English and American daily life."

The development of Keynes' thought. Lekachman's work is a case study in the origin and diffusion of an economic idea. Keynes' ideas emerged out of a process of interaction with his talented colleagues at Kings College, Cambridge. Keynes proceeded slowly, borrowing from others, making successive approximations over two decades, until finally he fully and systematically developed his ideas. He was no different than others in experiencing the vise like grip of the older traditional theory. At an early stage, both he and his close colleague, D. H. Robertson, considered and pondered temporary departures from full employment. But to construct a *general* case of equilibrium output at less than full employment, as Keynes did in *The General Theory,* required considerably more boldness and originality in thought and action. The steps in the development of Keynes' thinking can be seen through a chronological examination of his writing.

Even his early publication, *Economic Consequence of the Peace,* 1919, evidenced a concern with instability in the capitalist world. His writings on economic theory begin slightly later. First in his *Tract on Monetary Reform,* published in 1923. In it he pointed explicitly to the destabilizing effects of a fluctuating price level. And " 'deflation is, if we rule out exaggerated inflations . . . the worse; because it is worse, in an impoverished world, to provoke unemployment than to disappoint the rentier.' " One of the functions of state policy ought to be the stabilization of the standard of value.

In 1930, Keynes' next major work, *Treatise on Money,* came out. It carried the analysis one further step away from the self adjusting and full employment model of the classical economists. Keynes denied the classical assumption of an automatic interest rate mechanism equating investment and full employment savings. There is much in the *Treatise*

which anticipates the later *General Theory*. But the break in the link between savings and investment contains ambiguity and is not general.

At this early stage, D. H. Robertson and Keynes worked together on the break in the relationship between savings and investment. Besides this help, in 1931, Keynes received further aid from R. F. Kahn of King's College, Cambridge. In this year, Kahn published an article defining the concept of the multiplier—the relationship between a change in investment and the alteration in the size of national income which that change caused. The multiplier became an important concept in Keynes' major work, *The General Theory of Employment, Interest and Money*, 1936. Nonetheless, Keynes must be given full credit for the basic insight of a general equilibrium at less than full employment.

In *The General Theory*, Keynes' earlier insights are carried to their logical limits. The main relationship involves the determination of output and employment levels by the magnitude of effective demand. The latter, in turn, depends upon the spending decisions of consumers, business firms and governments. And there is nothing inherent in the economy to bring demand up to a full employment level. However, government expenditures and taxation are the policy controls. They hold the potential of regulating effective demand at the desired level.

Diffusion of Keynesian ideas. In both Great Britain and the United States, political instinct preceded economic analysis. In the former, as early as 1924, Lloyd George preached public investment as the remedy when private investment failed. And in the United States the New Deal public works projects, at least to 1938, were instinctive responses to circumstance, rather than policy inferred from theoretical analysis.

Lekachman's account of the diffusion of Keynesian ideas in the United States is an interesting one. Young economists, such as Alvin Hansen, Seymour Harris and Paul Samuelson, were the first converts. Then in order of acceptance came junior government officials, senior government officials, certain labor, farm and business interest groups, and only recently, the public at large.

The response of the well known Keynesian economist, Alvin Hansen, illustrates the initial mixed reaction felt even by the younger economists. Hansen's negative first impressions can be seen in his review of *The General Theory*. In a cool and reserved appraisal, he concluded that: " 'The book under review is not a landmark in the sense that it lays a foundation for a new economics.' " Soon after this review was written, however, Hansen's appraisal underwent a rapid change. By 1938, he had not only accepted Keynes' premises, but he added the pessimistic hypothesis that the American economy had entered a period of long-run stagnation.

As World War II drew to a close, the ferment over Keynes' ideas extended to a political level. Liberal members of Congress embarked upon a course to institutionalize Keynesian analysis and policy. A fear of postwar stagnation overhung this effort. A very spirited fight ensued, and ended with at least modest victories for the liberal forces. Congress passed an act which charged the federal government with responsibility for maintaining high levels of employment. It also requested the President to submit an economic report to Congress. In addition, the act created both a Council of Economic Advisers, and a Joint Economic Committee in Congress to study and act upon the Report of the President. The legislation did not come up to the expectations of the liberals, but it nonetheless laid the basis for the achievements Heller describes.

Appraisal. While Lekachman carefully develops the intellectual avenues leading to *The General Theory,* he unfortunately neglects circumstance as a force propelling the intellectual process. For example, unemployment swelled as a political and social problem during the later nineteenth and early twentieth centuries. And in the 1930's the situation became acute. This issue struck classical economic theory (with its assumption of automatic full employment) at its most vulnerable point. The political irrelevancy of advice based upon classical analysis is illustrated by Pigou's testimony before the British Macmillan Committee in 1931. When asked to explain why unemployment was so high he could extend no aid more useful than a diagnosis that " 'The relative demand for labour in different occupations has altered, and the transfers of labour appropriate to those alterations have not taken place.' " It was the workers who must initiate the solution, not the government. All that the laborers needed to do was to shift jobs and accept lower wages if necessary. Then unemployment would disappear.

The nonfeasibility of classical remedies for unemployment acted as a spur to the development of a new macro theory. Keynes and others in the Political Economy Club at King's College were concerned with unemployment. And they were responsive to the need for practical solutions.

Circumstances conducive to new theory also proceeded on a more fundamental level in the half century preceding the 1930's. Monopoly power grew in both business and labor, and financial institutions multiplied in number. These and other structural changes increased downward rigidity in prices and wages. And they made interest rates less effective as a link between investment and full employment savings.

Thus, structural changes undermined whatever full employment resilience the economies of Great Britain and the United States may have had. This factor plus long standing unemployment problems created environmental pressures favorable to a theory better able to explain modern capitalism. Lekachman incorporates external forces, such as these, only partially, and only by implication. Circumstance is not integrated into the process of intellectual change.

Despite this omission, through Lekachman's able work, we see Heller's book as the product of and a report on the culminating stage in the triumph of an idea. The first phase is the 1930's, and Heller by contrast describes the 1960's. In the former decade, unemployment policies were merely direct pragmatic responses to circumstances. By contrast, an action such as the 1964 tax cut derives from theoretical and statistical analysis of the United States economy. Keynesian analysis has become an instrument for interpreting and ordering economic reality in its own right. Furthermore, opposing ideology and attitude have receded into ineffectiveness. However, this does not sound an end to our problems of unemployment and inflation. And a reading of Lekachman suggests a basic lesson and a warning; namely, the danger in a theory becoming a dogma.

The lesson is clear if we review our experience with classical theory. The configuration of classical analysis, ideology and attitude clung tenaciously to people's minds long after it had outlived its relevance. By parallel, Heller tends to view Keynesianism with the same sense of adequacy we once viewed classicalism. He introduces appropriate qualifications and considers non-Keynesian problems, but a strong Keynesian syndrome remains. This is disturbing since there are indications that Keynesian analysis is as limited in its applicability to certain of our

unemployment and inflationary problems as classical analysis was to the employment problem of the 1930's. By contrast Lekachman's book, with its sensitivity to history, provides us with the kind of education against dogma that we badly need.

john kenneth galbraith, *the new industrial state*

Although Keynes rejected classical full employment assumptions, he nonetheless accepted much of the remainder of classical economic doctrine. For example, he accepted their theory of the firm. The result is a Keynesian model of unemployment equilibrium superimposed on an economy of small firms in competition over prices charged to consumers. Several important institutional features of our present economy are ignored. For instance, the behavior of those important industries dominated by a few firms is missing. Also absent, is the competitive instrument of large research and advertising budgets. These funds are the source of manipulation of consumer demand and of rapid technological advance.

The point is that though Keynesian theory departs from older doctrine in certain respects, yet it precariously retains a tie in with the classical atomistic world. In an economy dominated by giant power concentrates in business and labor, their exclusion from formal consideration, should, as a minimum, destroy complacency with views having Keynesian assumptions as their sole base. These considerations make Galbraith's *The New Industrial State* a second interesting book to place beside Heller's study.

Industrial organization is the primary focus of attention in Galbraith's book. But since industrial structure and behavior bear directly on unemployment and inflation, their relevance to the subject of this review is obvious.

In his usual style, Galbraith starts with his own vision of economic reality, rather than with what is assumed by conventional theory. The result is an interpretation of the behavior and the consequences of the industrial complex.

Several of the behavioral characteristics and consequences of the large industrial firm are salient to the subject under review. First, Galbraith notes the existence of downward rigidity in industrial prices. When confronted with a decline in demand, monopoly firms prefer to absorb the impact through a curtailment of output and employment rather than by a reduction in prices. Second, since pricing to achieve a target rate of profits is the rule, firms do not necessarily charge a profit maximizing price. Thus, when faced by aggressive demands of unions, or if a higher rate of profit is desired, firms may be induced to raise prices even in the absence of excessive growth in aggregate demand, and even before full employment is reached. Third, rapid technological advance is a way of life for the large corporation. This places strains on the skill requirements of the labor force and is a factor of growing importance in unemployment.

Two policy inferences follow. One is that programs to provide workers with necessary education and skill ought to hold top priority in combating unemployment. Second, just as downward price rigidities exist in the private sector, so also must upward price rigidities be established by government, if excessive upswings in prices are to be avoided.