

# Why Keynesian Thinking Has Gone Out of Fashion and Why It Matters

By Gideon Rosenbluth

John Maynard Keynes was a British mathematician and economist who gained worldwide fame or notoriety in 1936 with his monumental and slightly confusing book, *The General Theory of Employment, Interest, and Money* (not his first book, nor his last). In this book Keynes explained how, according to his theory, modern capitalism generates cyclical fluctuations in unemployment, and how governments should try to eliminate these fluctuations and achieve “full employment” by a combination of fiscal and monetary policy. Keynesian fiscal policy means raising government expenditures and reducing taxes in economic recession and moving in the opposite direction in a boom. Keynesian monetary policy means that the central bank manipulates the quantity of money in the economy so that interest rates fall in recession and rise in the boom. Until the early seventies, these policies were followed with apparent success in Canada, Britain, and the U.S.

But while Keynesian thinking was the fashion, anti-Keynesian thinking had by no means disappeared. It continued as the ideology of business leaders whose main concern was high profits. They (and anti-Keynesian economists) regarded labour unions as a menace to the economy. Labour unions, according to the anti-Keynesian view, aimed at levels of wage rates that would lead to low profit rates, hence little investment in research, machinery, equipment, and invento-

ries, hence high unemployment and low productivity. If unemployment was to be reduced, it had to be, according to anti-Keynesian theory, by a free labour market in which a rise in employment followed from a fall in wage rates.

So in anti-Keynesian thinking high profits are attained by a level of unemployment high enough to maintain a sufficiently low wage level, and governments should not aim at a lower level of unemployment.

The economist best known for the theory that capitalism requires unemployment in order to generate the profit on which the system depends is Karl Marx. In his monumental and slightly confusing three-volume work *Capital* (“*Das Kapital*”), he argued that a successful capitalist economy required a “reserve army” of unemployed paupers whose competition for jobs kept wage rates low enough. This is a major cause of the “class struggle” that must arise, sooner or later, in any capitalist economy, and must lead, sooner or later, to revolution and the overthrow of the capitalist system, according to Marx.

That does not mean, of course, that the business leaders who view labour unions as the enemies of the “free market system” are Marxists. It does mean that Keynesians who want to abolish unemployment without abolishing capitalism must find other ways to assure adequate profits. They must abolish labour unions and competition among employers. Fascism and war are very helpful. But short of such extreme measures, in a democratic Keynesian economy unemployment will fluctuate, driven by its internal dynamics as well as extrinsic factors.

During World War II, although there was,

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John Maynard Keynes

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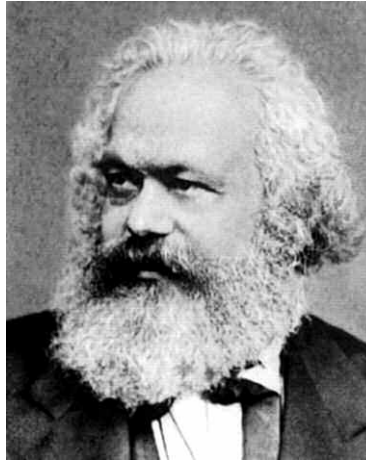
for the first time, full employment, the rise in wages and consequent reduction of profit were prevented by wage and price control. And attacks on government spending would have been seen as unpatriotic, so anti-Keynesian thinking was not pushed in the mass media.

After the war, demobilization and the end of war production created the unemployment required to prevent the erosion of profit. Moreover, public opinion favoured the interests of demobilized service personnel and war workers looking for other sources of employment. The Keynesian view was that the economy could afford government deficits to subsidize reconversion retraining, and could afford social programs supporting the families of persons exiting war-induced employment. So the Keynesian view was politically attractive.

But the preference of business leaders for substantial unemployment had not disappeared, It just had to go underground until the early 1970s, when reconversion was completed.

At that point attacks on Keynesian thinking gained support from the oil crisis of 1973. King Sa'ud of Saudi Arabia expropriated British Petroleum and took control of what was then the world's largest source of petroleum. The short-term result was an enormous drop in petroleum supplies in the industrialised world, resulting in an immediate decline in production and transportation, with a resulting jump in unemployment rates in the industrialized world. Clearly this unemployment problem could not be solved by the Keynesian prescription of increasing the **demand** for goods and services, and where Keynesian policies like unemployment insurance, welfare payments, social services were automatically activated by rising unemployment, they resulted mainly in price increases, not increased employment. We had "Stagflation."

Stagflation created an ideological environment in which anti-Keynesian theories could flourish and re-emerge in the news media, where they have persisted to this day.



Karl Marx

It is widely believed that in 1945 the government of Canada proclaimed a Keynesian policy in its White Paper on Employment and Income.<sup>i</sup> But in a study prepared for the Economic Council of Canada, Professor Robert Campbell argues at length that the government had bought into the anti-Keynesian view. He points out that in the White Paper the Canadian government stated that its objective was a **high and stable** level of employment and income, **not** "Full Employment".<sup>ii</sup>

In the White Paper, the Keynesian view that unemployment had to be controlled by influencing the **demand** for goods and services was maintained, but the emphasis was on obtaining a **stable** level of **private** income, with unemployment high enough to ensure high enough profits, and on minimizing government demand and government control.

In the reconversion period, taxes should be reduced rapidly and exports promoted. Unemployment insurance (today called employment insurance) and family allowances were to be supplemented by pensions and health insurance.

As Campbell says: "The Canadian 'full employment' commitment of 1945 was a timid and restrained one .... This limited policy commitment has not subsequently been extended .... Defining full employment has been a slippery and elusive goal .... The approach has been to define an acceptable and changing level of unemployment .... The character of the employment commitment in Canada in 1945 did not require significant institutional alterations nor changes in public behaviour or practice." It followed that "it could hardly be expected that Canadian governments would be specially rigorous in pursuing full employment" (Campbell, p.5).

The White Paper proposed that governments should budget counter-cyclically, raising expenditure and lowering taxes in the downswings of the private economy, something that would have required better forecasting than has been demonstrated so far.

The result of the abandonment of Keynesian thinking has been that in 2008 the industrialized countries went into the deepest recession since the 1930s, from which they may now be slowly emerging. Does that matter? Yes, if you care about unemployment, poverty, and homelessness. Not if you don't. ♦

<sup>i</sup> Department of Reconstruction, *Employment and Income With Special Reference to the Initial Period of Reconstruction* (Ottawa, Queen's Printer, 1945)

<sup>ii</sup> Robert M. Campbell, *The Full-Employment Objective in Canada, 1945-85*, Minister of Supply and Services, Canada, 1991.