Public Talks

Economic Myths and Party Manifestos

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Senior members of the present administration are, as it was said at the last General Election and since, slaves to the ideas of Milton Friedman. Their attempt to put his ideas into practice is held by many to be a major cause of this economic depression. Certainly the advent of the medium term financial strategy was associated with an intensification of the depression. Be all this as it may, now, many economic commentators, such as Mr. David Lomax of the National Westminster Bank, are arguing that the government have abandoned as a matter of practical policy the full rigours of so-called monetarism.

But if the government are in practice relaxing their attempts to squeeze inflation out of the system by controlling the money supply, if they are turning away from the belief that the economy will tend automatically towards a 'natural' rate of unemployment irrespective of the monetary and fiscal policy pursued, and if the commentators mean that the ideas of Milton Friedman are on the way out, then what ideas are on the way in?

As another General Election approaches[1] the issue of economic ideas is a matter for concern not only to the party of government but also to the parties of opposition. At a General Election all the parliamentary parties are subject to the same test, and at the next General Election – as at the last – the outcome is most likely to be determined by economic ideas and economic policies.

In an article published recently in the Times, this political issue of economic ideas was summed up by Gordon Tether in a jingle.

1 A General Election was anticipated within the next few months, and took place on 9th June 1983.

"Hayek and Friedman have had their day. Now we're all backing JMK." A light journalistic touch for which some authority may be claimed. As John Maynard Keynes wrote in 1936: "Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler a few years back."

But, with Gordon Tether's light journalistic touch, come some very misleading implications. By implication the jingle equates the ideas of Friedrich Hayek with those of Milton Friedman and places both in opposition to the ideas of Maynard Keynes. It implies also that the economic ideas and theories on the way in are those of Maynard Keynes. Now maybe this is what the commentators and some politicians actually believe; maybe it is what parliamentary parties would have the electorate believe; maybe it is what the electorate would like to believe; nonetheless, the implications of the jingle are misleading. They serve only to thicken up the smokescreen behind which parliamentary parties have for too long obscured their party policies and objectives. In the sphere of party politics it has become customary over recent decades to link the names of Hayek, Friedman and Keynes not with their economic theories and ideas but with economic myths. It is these economic myths that place Hayek and Friedman on the one side, and Keynes on the other opposing side, so as to make plausible opposing party manifestos.

That Hayek was one of Keynes's severest critics during the thirties is well documented and Keynes, for his part, packed a stinging counter-punch. On the occasion of Hayek's critical review of his *Treatise on Money*, Keynes in his reply turned on Hayek's then recent book *Prices and Production*.

Maynard Keynes wrote: "It is an extraordinary example of how, starting with a mistake, a remorseless logician can end up in Bedlam." (JMK XIII p. 252 and Moggridge p. 36)[2] But these were disputes on theoretical issues – that they were hard fought does not

2 The references are to the *Collected Writings of John Maynard Keynes*, and to D. E. Moggridge's widely respected 1976 biography of Keynes.

imply an implacable opposition of fundamental ideas and views as between the disputants.

In 1939 Maynard Keynes summed up his political creed in The New Statesman as “a system where we can act as an organised 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.” (see Moggridge, p. 47). More here for Hayek and for Friedman than for those party politicians who, claiming to be the inheritors of Keynes’s mantle, advocate long lists of restrictive measures – the closed shop, a statutory prices and incomes policy, and so on.

Bearing in mind Keynes’s statement of 1939 it is no matter for surprise that, on having read *The Road to Serfdom*, Keynes wrote to Hayek and although accusing him of “perhaps confusing a little bit the moral and material issues”, nonetheless, he agreed on the need for “a community in which as many people as possible, both leaders and followers, wholly share your own liberal moral position.” (JMK XXVII pp. 387-8, and Moggridge p. 46)

But of course moral issues are one thing, but when it comes to money issues then, as everybody knows, there is a direct opposition between Keynes, who held that money does not matter, and Hayek and Friedman, who hold that money does matter.

That this piece of economic mythology is now generally accepted can be ascribed only to widespread economic illiteracy. Maynard Keynes’s three major economic works were *A Tract on Monetary Reform*, published in 1923; the *Treatise on Money*, published in 1930; and *The General Theory of Employment, Interest and Money*, published in 1936. The last years of his life were spent in setting up an international monetary system which provided the monetary foundation for 25 years of unparalleled worldwide economic growth and prosperity.

What Maynard Keynes attacked throughout his life were the rigid and out-dated ideas and practices of the Treasury and of the banking establishment – ideas and practices which may have served well enough in the nineteenth century but were a cause of recurrent disasters when carried through to the changed conditions of the twentieth century. For example, the Bank of England had opposed Keynes's proposals for what has now become known as the International Monetary Fund.

In February 1944 Keynes wrote to the Chancellor of the Exchequer: "The Bank are not facing any of the realities. They do not allow for the fact that our post-war domestic policies are impossible without further American assistance. They do not allow for the fact that the Americans are strong enough to offer inducements to many or most of our friends to walk out on us, if we ostentatiously set out to start up an independent shop. They do not allow for the fact that vast debts and exiguous[3] reserves are not, by themselves, the best qualifications for renewing old-time international banking.

"Great misfortunes are not always avoided, even when there is no difficulty in foreseeing them, as we have learnt through bitter experience. I feel great anxiety that, unless a decisive decision is taken to the contrary and we move with no uncertain steps along the other path, the Bank will contrive to lead us, in new disguises, along much the same path as that which ended in 1931. That is to say, reckless gambling in the shape of assuming banking undertakings beyond what we have the means to support as soon as anything goes wrong, coupled with a policy, conceived in the interests of the old financial traditions, which pays no regard to the inescapable requirements of domestic policies. Ministers should realise that these things . . . are what the trouble is all about." (JMK XXV pp. 412-3, and Moggridge p. 39)

In 1983 this extract may seem a little too prophetic for comfort but it could have been written, I suggest, only by a man to whom a stable monetary system is the necessary foundation for a stable and prosperous economy.

3 Small, or extremely limited.

That money matters very much with regard to the "inescapable requirements of domestic policies" is something Lord Keynes saw most clearly, but it is something which has been obscured by post-war economic myths woven for party purposes "by politicians and their obsequious back-room academics".

Milton Friedman's major contribution to the development of economic thought is contained in his essay *The Quantity Theory of Money – a Restatement*. It was first published in 1956, ten years after the death of Lord Keynes. This "restatement" is essentially a generalisation of the theory of liquidity preference as formulated and published by Keynes in the *General Theory of Employment* in 1936. It is most usefully understood as a development from the economics of Keynes, with important additions, rather than as a statement contrary to the theory of Keynes.

Friedman's contribution is of particular importance for not only has it opened the way to major advances in monetary theory but also it re-emphasised the importance of monetary policy in 'a monetary economy' – something which in the years following the death of Lord Keynes had largely been ignored by governments and their economic advisors.

That the new developments in monetary theory have come to be widely accepted as an alternative to the economics of Keynes stems from the fact that they follow from an attack by Milton Friedman on the 'real income and expenditure approach' recently developed by the so-called Keynesians. This distinction between the economics of Keynes and Keynesian economics is of some importance, for in the final years of his life Lord Keynes was prepared to admit to being a non-Keynesian. In this age of media-men it is as well to be wary of labels – the contemporary so-called Keynesians are more in the tradition of Ricardo, Marx and Kalecki than heirs to the ideas of John Maynard Keynes.

However, whilst it can be argued that on moral issues the ideas of Friedrich Hayek and the ideas of Maynard Keynes share much common ground, and that the new monetary theories pioneered by

Milton Friedman are most usefully considered as developments from the economics of Keynes, an immediate issue is employment theory and employment policy. In this, the 'natural unemployment rate hypothesis' formulated by Friedman in the late 1960s is a throw-back to 19th-century ideas prior to the *General Theor*y. In the sphere of employment theory and policy the deep divide between Friedman and Keynes is a reality not a myth. I considered Friedman's employment theory in detail last January. Sufficient for tonight to state briefly that Milton Friedman and his monetarist followers assume that any economy tends automatically towards a 'natural rate of unemployment' determined by institutional factors rather than by fiscal and monetary policies.

Against this, the *General Theory of Employment* as formulated by Maynard Keynes states the volume of employment in any economy to be determined by the point of intersection between the aggregate demand function and the aggregate supply function.

It follows, since the aggregate demand function is directly influenced by government spending policies and the aggregate supply function by government tax policies then in any economy the volume of employment – or if you prefer the rate of unemployment – is determined largely by fiscal policy. When one brushes aside the post-war myths and incorporates the latest developments in monetary theory, then unemployment is determined by fiscal and monetary policy combined.

Thus, it might seem reasonable to conclude that on the employment issue there is on the one side Milton Friedman and the monetarists who believe fiscal policy to be relatively unimportant and on the other side Maynard Keynes and the Keynesians who believe fiscal policy to be all important.

Yet this conclusion also perpetuates a myth. Although on matters of employment theory and policy there is a deep divide between the monetarists and the ideas of Maynard Keynes, there is just as deep a divide, although different, between the contemporary Keynesians and the ideas of Maynard Keynes.

Forty years on we tend to forget that *Full Employment in a Free Society* was written by William Beveridge, and not by Maynard Keynes. Keynes did not relate his concept of full employment to any particular rate of unemployment; for Keynes, full employment was a theoretical benchmark that coincided with a point of true inflation where any further increase in aggregate monetary demand could not expand output and employment, but only raise prices.

It was William Beveridge who defined full employment as a condition in which the number of registered unemployed is not greater than the number of registered vacancies. It was William Beveridge who transformed the concept of full employment from the theoretical benchmark used by Keynes into a post-war party political slogan implying a near zero rate of unemployment.

According to the records, Keynes had considerable doubts as to the feasibility of the original Beveridge Plan and, in particular, doubts as to Beveridge's quantification of full employment and its use as a policy target.

Again, a post-war full employment Budget was the idea, not of Maynard Keynes, but of Nicholas Kaldor[4] and first published in the Economic Journal of April 1943.

A couple of years later, in the Economic Journal of December 1945, Colin Clark published an article which on the basis of statistical evidence from many countries concluded that when general government tax revenue plus the borrowing requirement persistently exceeded 25 percent of the net national product at market prices then economic forces were set in motion leading to rising costs and prices with some restriction of output.

Clark concluded Kaldor's budget proposals to be unfeasible, as if implemented, they would necessitate a tax take the equivalent of

4 Nicholas Kaldor (1908–1986) advised the Labour government from 1964 onwards, and also produced some of the early concepts for the introduction of Value Added Tax (VAT). He is also regarded as one of the authors of the Selective Employment Tax (SET), which was introduced in 1966, and was subsequently replaced by VAT as part of Britain's entry into the EEC. He was Professor of Economics at Cambridge University from 1966 onwards.

35 percent of the estimated post-war U.K. net national product at market prices. Clark went on: “It may be contended that the tax payer will be more ready to meet the proposed payment into extra-budgetary funds because these provide him with health and other services which otherwise he would have had to pay for in any case. Even if this argument is accepted, the remaining burden, at 30% of the national income, is definitely excessive.”

Since 1945 here in the U.K. burden has always exceeded 30% and we have suffered also persistent inflation. In 1975 the burden peaked at 51% and was associated with a 27% rate of inflation.The rate of unemployment has also been on a rising trend since 1955 and the present level is comparable to that experienced in the early thirties. Similarly the U.K. rate of growth has been on a declining trend since 1955, and over recent years it has been all but non-existent.

It was as early as 1923 that Maynard Keynes wrote with reference to France: “The level of the franc is going to be settled in the long run, not by speculation or the balance of trade, or even the outcome of the Ruhr adventure, but by the proportion of his earned income which the French taxpayer will permit to be taken from him to pay the claims of the French ‘rentier’.”

On the issues of post-war U.K. government taxing and spending Keynes came down firmly on the side of Colin Clark rather than on the side of the full employment Budget of Nicholas Kaldor – today, the influential so-called Keynesian. In a private letter to Colin Clark dated 1st May 1944 Maynard Keynes wrote: “In Great Britain after the war I should guess your figure of 25% as the maximum tolerable proportion of taxation may be exceedingly near to the truth. I should not be at all surprised if we did not find a further confirmation in our post-war experience of your empirical law.”[5]

Perhaps, as the economic depression continues to deepen, of more immediate importance is the fact that the contemporary

5 As quoted, for example, in IEA Hobart Paper No. 26, *Taxmanship*, p. 21.

Keynesians have wrenched asunder the concepts of aggregate demand and aggregate supply which Keynes brought together into a coherent whole. Contemporary Keynesian policies are based, not on an idea of Maynard Keynes but on the reverse of an idea – ‘Supply creates its own demand’ – that dominated nineteenth century policy makers.

For contemporary Keynesians the dominating idea is ‘Demand creates its own supply’. Having quantified full employment as a near zero rate of unemployment, contemporary Keynesians assume the existence of unemployment to be a proof of a deficiency of aggregate demand that can be made good only by additional government spending financed by more taxation and borrowing.

Thus the economics of Keynes differs fundamentally from ‘Keynesian economics’. The latter does not take into account the aggregate supply function. It assumes the existence of unemployment to be proof of a deficiency of aggregate demand. It does not take into account that for any economy in given conditions there is a limit to the amount of general government spending that can be financed by general government tax revenue and borrowing. Further, the analysis of Keynes does not support the conclusion that the existence of unemployment is a proof of a deficiency of aggregate demand.

Thus, when we sweep away the misinterpretations and the myths, we find much common ground between Friedrich Hayek and Maynard Keynes on the important moral issues, whilst the differences between Milton Friedman and Maynard Keynes are in the sphere of employment theory and policy rather than in the sphere of monetary theory and policy. We find also that the differences between contemporary ‘Keynesian economics’ and the economics of Keynes are deeper and more extensive than any difference between the ideas of Maynard Keynes and the ideas of Friedrich Hayek and Milton Friedman.

Further having swept away the misinterpretations, the misconceptions, and the post-war economics myths, we discover that the assertion “Now we’re all backing JMK” is a nonsense. So far as our parliamentary parties are concerned, it amounts to a wholly false accusation.

For example, a few weeks before Christmas the Labour Party announced their five-year plan to expand output and reduce unemployment to about one million: *Programme for Recovery*. It is based on contemporary Keynesian analysis. It diagnoses a deficiency of aggregate demand, and to remedy this deficiency it proposes to increase government spending up to £25 billion a year coupled with a 30% devaluation of sterling. It is admitted that these measures on their own would lead to double digit inflation and a balance of payments deficit of in the region of £18 billion a year. To constrain the balance of payments deficit to £1 billion a year with an inflation rate of 8% a year the programme proposes the extensive use of central government control – exchange controls, import controls, price controls, and so on. It proposes “to control earnings and incomes through an agreement with the Unions.” Keynesian analysis and Keynesian remedies? Such a programme may be passed off today as Keynesian but neither the analysis nor the proposed measures are derived from the ideas of John Maynard Keynes. The Labour Party at least does not intend to “back JMK.”

The other major opposition group, the Liberal SDP Alliance,[6] claims to be the true heir to the ideas of Maynard Keynes. In the 1920s Keynes often spoke in support of the Liberal cause and in 1929 he wrote in association with Hubert Henderson a political pamphlet called: *Can Lloyd George Do It?*

However, more relevant today is Keynes’s reply to a questioner at a public meeting. The Manchester Guardian of 29th May 1929 reported him as replying: “The difference between me and some other people is that I oppose Mr. Lloyd George when he is wrong and support him when he is right.” In this instance Mr. Lloyd

6 The Liberal SDP Alliance had been established to contest the forthcoming General Election of June 1983.

George was right, for Keynes had formulated the proposals included within the pamphlet (Harrod, p. 396).[7]

Published more than 63 years after *Can Lloyd George Do It?* the Alliance policy document *Back to Work* most certainly does not include proposals formulated by Keynes to remedy the present economic depression. As a matter of fact, *Back to Work* is based, not on the economics of Keynes, but on 'Keynesian economics'.

With one important exception it is indistinguishable from the Labour Party's Programme for Recovery. The exception is very important, for the Alliance does not propose to rely on agreement with the Unions for the control of earnings, but proposes to enact a statutory prices and incomes policy backed by severe penalties on those who ignore the centrally imposed norms.

This idea of a statutory prices and incomes policy did not enter the Liberal Party programme until some 30 years after the death of Lord Keynes. It was put forward by Mr. John Pardoe on the advice of Professor Peter Wiles of the L.S.E. Now, Professor Wiles set out his non-Keynesian Marxist approach most clearly in an article published in the Economic Journal of June 1973. He concluded the U.K. economy to be suffering from "cantering cost inflation" caused by excessive pay settlements.

Peter Wiles went on: "Our choice is either to let it rip forever or to sharply restrain it. We can do this either by massive unemployment or strong anti-union measures, up to and including the installation of a Communist government" (p. 377).

Although admitting that the political and legal risks of strong anti-union measures – such as a statutory prices and incomes policy – might be smaller than is often alleged, Peter Wiles then spelt out the political consequences of detailed intervention. He wrote: "It will often fail of its overt purpose – just as the monetarists assert of the less detailed Keynesian interventions. It brings new laws to evade, and so diminishes respect for all laws. It

7 The reference is to the standard biography of Keynes by Sir Roy Harrod: *The Life of John Maynard Keynes*, published in 1951.

makes possible political discrimination by economic means, and so threatens freedom. Above all any programme of detailed intervention, honestly designed to have a serious effect on inflation, involves a head-on clash with the trade unions, which probably means bloodshed."

To lay claim to the traditions of Maynard Keynes, and at the same time advocate a statutory prices and incomes policy, goes beyond – as the words of the originator of that policy make very clear – well beyond the creation of an economic myth for the purposes of putting over a party policy. Maynard Keynes was a man who when faced with the enactment of compulsory military service, for which he was not liable, and admitting to the possibility of "conceivable circumstances in which I should voluntarily offer myself for military service" felt bound to object to a Tribunal on the grounds "I am not prepared on such an issue as this to surrender my right to decision, as to what is or is not my duty, to another person, and I should think it morally wrong to do so." (See Moggridge pp. 20-21.)

"Now we're all backing JMK." When applied to the policies of the major parties of opposition it is more of a sick joke than an amusing journalistic jingle. So where does the party of government stand?

In an interview put out last week by LBC, the Chancellor of the Exchequer[8] informed us that with inflation reduced to the lowest levels for ten years and with further reductions in the pipeline there existed now for the British economy a firm base for the expansion of output and a reduction of unemployment. To take advantage of this opportunity all that is needed, he asserted, is a significant reduction in aggregate costs per unit of output so that firms could expand profitably to meet an aggregate demand existing already.

Here surely is the authentic voice of John Maynard Keynes echoing over the decades to call attention to the importance of the aggregate supply function in relation to aggregate demand.

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8 At this time, prior to the General Election of June 1983, Sir Geoffrey Howe.

The analysis of Keynes treats these aggregate costs per unit of output as components of the aggregate supply price – namely, the take-home pay of employees, tax revenue, and a net disposable profit margin just sufficient to make it worth the while of firms to produce the output of a given amount of employment.

Government estimates show that over the past 25 years, since unemployment was around 1%, take-home pay has fallen in real terms, whilst aggregate net disposable profits have fallen from around 10% to around zero.

The only component that has increased, indeed multiplied, is tax revenue, and in particular that part of tax revenue which is included within the pay bargain tax wedge – PAYE and social security taxes imposed on employers and employees.

Pay bargain taxes	1960	1981
Take-home pay of employees	100	91
Net disposable profit margin	100	31
General government taxation	100	148
Pay bargain tax wedge	100	233
All other tax costs	100	113

Table 1: Pay bargain taxes, 1960 to 1981

For this chart, I have taken as the base year 1960, for in that year we more or less attained the post-war political policy target of full employment with stable prices. Inflation was less than 1% and unemployment was 1½%. Money cost per unit of output increased by six times between 1960 and 1981, but very largely this was the result of inflation; whether or not it constitutes a disaster depends to a great extent on the rate of inflation of our competitors and the rate of exchange as between our countries.

Of importance for internal domestic policy is which of the cost components is exerting the most upward pressure and to show this one has to construct an index. The figures shown on the chart refer to 1981 – the last year for which detailed estimates are available.

Take-home pay of employees has an index figure of 91 for the year 1981. This indicates that this particular cost component fell by about 10% between 1960 and 1981. The next figure down refers to the net disposable profits of private sector companies. Here an index figure of 31 means that profits fell by more than two-thirds between 1960 and 1981. Reading down again the next figure refers to general government taxation. For 1981, this yields an index figure of 148; it means that tax costs in real terms per unit of output increased by nearly 50% between 1960 and 1981.

Of greater importance is precisely where this tax increase was concentrated and this is shown by the two lower index numbers on the chart. The real tax costs included within the pay bargain tax wedge – Pay As You Earn, Social Security Contributions, and now the National Insurance Surcharge – multiplied by two-and-a-third times between 1960 and 1981.

These taxes, by inflating the employers' labour costs directly, act to increase unemployment and reduce the competitiveness and profitability of British producers. On the other hand, all other real tax costs per unit of output together increased by only 14% and these include such items as local rates and VAT, about which there is so much complaint.

The only cost component that has increased is taxation; in particular, that part of tax revenue included within the pay bargain tax wedge, which has multiplied. To all but the blind and those that will not see the required action is obvious. If the Chancellor of the Exchequer believes his diagnosis to be right, then he must cut pay bargain taxes. This is an action wholly within his powers.

When the analysis of Keynes is applied to the government's diagnosis and their official estimates then a cut in pay bargain taxes is the necessary first step on the road out of the present depression. But the Chancellor of the Exchequer and the party of government, like all of the parties of opposition, are blinded by economic myths, some of which go back to Parliament's reaction to the economic consequences of the Black Death, which occurred in the 14th century. This first statutory prices and incomes policy led to Wat Tyler's rebellion in 1381.

In addition the present day Chancellor has his own particular myth shared with some of his Cabinet colleagues. He considers himself to be a monetarist and therefore the economic analysis of Keynes is an anathema. Do not be misled by the Chancellor's sound; Sir Geoffrey was echoing not the voice of Keynes but a ricochet off an economic myth.

The Chancellor of the Exchequer can see only one road out of the present depression. We must all work harder to produce more and then accept less take-home pay in return. He can see that our aggregate costs per unit of output are too high to meet an aggregate demand that exists already both at home and abroad. What he cannot see – and this blindness is common to both sides of the House and many outside – what he cannot see is that the high costs are the result not of the excessive pay demands of employees or their trade unions but of the excessive tax demands authorised each year by Members of Parliament.

The party of government it would seem are less influenced by the ideas of Friedrich Hayek and Milton Friedman, or even John Maynard Keynes than by the analysis of a non-Keynesian Marxist, Peter Wiles. The Alliance opposition in their document advocate a statutory prices and incomes policy and all the social evils that will entail. The party of government have chosen, albeit unknowingly, the alternative method suggested by Professor Wiles – massive unemployment and all the social evils that entails.

The ideas of economists and political philosophers are powerful and they can explain many of the international divisions and national internal dissensions that exist today, but the major British parliamentary parties accept the ideas of Hayek, Friedman and

Keynes only when they happen to coincide with long existing party objectives or would seem to offer some party advantage. Whether by intent or as the result of ignorance our parliamentary parties are prepared to perpetuate old economic myths around the names of great economists to fool the electorate into accepting economic proposals included within their party manifestos. As an irate Maynard Keynes noted to a Treasury colleague in 1940: “It is the bloody politicians whose bloody minds have not been sufficiently prepared for anything unfamiliar to their ancestors.”

In this country a prerequisite for an economic recovery is for the electorate to penetrate the myths and look beyond the labels to the true nature of the party proposals, that is to say by the electorate preparing the minds of politicians so that they may see the facts of everyday experience and are forced to propose effective and just remedies.

Treat the politicians of today as Keynes treated Lloyd George: oppose them when they are wrong; give them support only when they are right.