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Abstract

The General Theory showed that the main determinant of the level of output and of employment at any point of time was the level of effective demand. It did so in an environment of uncertainty using analysis in historical time. Unfortunately, most of Keynes's insights were soon lost to the profession. This paper considers why this occurred. The most concerted and sustained attack on Keynes's position was by Milton Friedman. Friedman argued that his work on permanent income as the major determinant of consumption invalidated Keynes use of the consumption function in *The General Theory,* with important implications for the multiplier and the efficacy of fiscal policy. The attack by the conservative right wing in America on Lorie Tarshis's excellent 1947 Keynesian textbook , also played an important part in the dilution of the Keynesian message as did the resultant rise to dominance of Samuelson's *Economics: An Introductory Analysis*. Given the great influence of Samuelson and the increasing tendency of American economics to dominate English language economics this contributed decisively to the undermining of Keynes's theory and policy.

JEL Codes: E60, E21, E12, B22, A20

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Introduction

Keynes maintained that his aim in *The General Theory* was to show "what determines the volume of employment at any time" (p.313). In particular, Keynes showed that it was the level of effective demand in an uncertain environment, rather than the real wage rate, which determined output and employment. In addition, he stressed the role of the level of income, rather than the rate of interest, as the mechanism which brought about the equality of investment and saving (see, for example, Keynes 1937, 212). In Joan Robinson's terminology this is analysis in historical time (Robinson 1962, 23-6, 1974). We take the view that Keynes shunted the car of economics onto the correct track and ask the question: what derailed it?

[1] The authors of the paper are part of the Antipodean branch of the Victoria Chick Appreciation Society, and would like to express their gratitude to Professor Chick for the inspiration she has provided for their understanding of economics in general, and the economics of Keynes in particular.

Today the goal of most economic theory is to establish the characteristics, that is, the necessary and sufficient conditions, for an equilibrium. In the context of macroeconomic analysis this may, or may not, provide helpful insights, but it cannot say anything about causation so it should not be used to demonstrate that this or that policy is appropriate, though this is often done. Keynes too was concerned about equilibrium situations but in a completely different way. He wished to show that in a capitalist economy the equilibrium, or, as Asimakopulos preferred to call it, "a state of rest" (Asimakopulos 1991 , 7), reached historically is usually one with involuntary unemployment.

In this paper, we set out some of the reasons why Keynes's essential messages have been lost to the mainstream of macroeconomics, concentrating on three particular events - Friedman's deliberate attacks on Keynes, the attacks on Lorie Tarshis's 1947 Keynesian textbook by the conservative right wing in America, and the resulting rise of Samuelson's less controversial text and the consequent rise of the neoclassical synthesis.

The first prong: Milton Friedman[2]

The reason for starting our discussion of the decline of Keynesian economics with the work of Milton Friedman is due to his explicit mission to divest economics of any semblance of Keynesianism. In a number of works and in letters, Friedman explicitly states that he regarded Keynes's contributions as detrimental to, and a definitive step backward for, the economics profession. He believed that Keynes inadvertently paved the way for an economic and political system based on planning and collective action, rather than individual choice. For this reason, Friedman's was the most concerted and sustained attack on Keynes, and in fact, much of his life's work was dedicated to a critique of all manifestations of Keynesianism.

For Friedman, as for his close friends and associates, George Stigler and Aaron Director (who referred to Milton Friedman as his radical brother-in-law), more was at stake than mere academic issues or even narrow policy concerns. Friedman saw himself as defending a version of classical liberalism, the thin blue line standing between individual freedom and the rising tide of collectivism, implicitly espoused by the dominant Keynesianism of the post-war era. In his understanding, what stood at risk was individual liberty. Keynes too described

[2] This section draws heavily on Freedman, Harcourt, Kriesler and Nevile (2016).

himself as a liberal, but he and Friedman had very different conceptions of what it meant to be a liberal. To quote Friedman:

> "As liberals we take freedom of the individual, or perhaps the family, as our ultimate goal in judging social arrangements. Freedom as a value in this sense has to do with the interrelations among people; It has no meaning whatsoever to Robinson Crusoe on an isolated island (without his Man Friday). Robinson Crusoe on his island is subject to 'constraints', he has a limited number of alternatives, but there is no problem of freedom in the sense that is relevant to our discussion." (1962, p. 12)

In contrast, Keynes took issue with such a fundamentalist position:

> "In my opinion there is now no place, except in the left wing of the Conservative Party, for those whose hearts are set on old-fashioned individualism and laissez-faire in all their rigour—greatly though these contributed to the success of the nineteenth century. I say this, not because I think that these doctrines were wrong in the conditions which gave birth to them … but because they have ceased to be applicable to modern conditions. Our [the Liberal Party's] programme must deal not with the historic issues of Liberalism, but with those matters—whether or not they have already become party questions—which are of living interest and urgent importance to-day." (1925, pp. 300-301)

Although Friedman admired Keynes's early work, he was extremely critical of Keynes's major contributions in *The General Theory* and attempted to undermine each of them. The initial problem for Friedman was to establish a plausible linkage between his own work and pre-Keynesian orthodoxy. The solution to this problem was found along two lines. The first was the invention of a University of Chicago oral tradition that was alleged to have preserved understanding of the fundamental truth among a small band of the initiated throughout the time of the Keynesian ascendancy. The second was a careful combing of the *obiter dicta* of the great neoclassical quantity theorists for any bits of evidence that showed recognition of his position, or could be interpreted as doing so.

An important example of Friedman's critique of Keynes, and a major contribution to his academic reputation, was his work on the consumption function culminating in his *Theory of the Consumption Function* published in 1957. Friedman argued that his work on permanent income as the major determinant of consumption invalidated Keynes's use of the consumption function in *The General Theory* and restored the role of the real rate of interest as the equilibrating factor for investment and saving. An important result of Friedman's analysis was to cast doubt on any possible impact of fiscal policy on employment or output by criticising Keynes's use of the multiplier. The introduction to his 1957 book makes clear the motivation that is driving his analysis:

> "The doubts about the adequacy of the Keynesian consumption function raised by the empirical evidence were reinforced by the theoretical controversy about Keynes's proposition that there is no automatic force in a monetary economy to assure the existence of a full-employment equilibrium position. A number of writers, particularly Haberler and Pigou, demonstrated that this analytical proposition is invalid if consumption expenditure is taken to be a function not only of income but also of wealth or, to put it differently, if the average propensity to consume is taken to depend in a particular way on the ratio of wealth to income" (Friedman 1957, p. 5).

In order to achieve this objective, Friedman subtly changed the definition of consumption from that utilised by Keynes. As Keynes was primarily interested in consumption as a component of aggregate demand, he focused on: "Expenditure on consumption during any period [which] must mean the value of the goods sold to consumers during that period" (Keynes 1936: 61). For Keynes the distinction between consumption expenditure and investment expenditure was determined by the source of that expenditure between consumers and entrepreneurs (Keynes 1936, p. 61). Friedman, by contrast, utilised a much narrower definition of consumption, explicitly ruling out the purchase of durable goods and instead confining it to non-durables and the value of the services derived from such durables (Friedman 1957, p 28). For Friedman, "expenditures on durable consumer goods can be regarded as capital expenditures and only the imputed value of services rendered included as consumption" (Friedman 1957, p. 20). In place of Keynes's consumption/income relation Friedman restored the rate of interest as the major determinant of consumption/saving, thereby resurrecting loanable funds as the main explanation of saving and investment. In doing so, he removed what Keynes saw as one of the central propositions of *The General Theory*, namely, that it is changes in income which equate saving and investment, not the rate of interest (Keynes 1937, 212).

When Keynes wrote *The General Theory*, the significance of durable goods expenditure in total household consumption was much less than would be the case in the post-war period. Nor was the availability of "credit for all" then a leading characteristic of capitalist institutions. Both of these factors would surely have modified Keynes's views on the consumption function and, of course, did in the writings by Keynes's followers in the post-war period (not least by Harcourt, Karmel and Wallace in *Economic Activity* (1967)). Nor was Keynes unaware of the factors and propositions that Friedman put forward in his 1957 book. A careful reading of the chapters on the consumption function in *The General Theory* will discover references to all the ingredients of Friedman's theory, together with the argument that in the short run their impact is likely to be minor, so that current personal disposable income is the major determinant of current consumption.

> "Since, therefore, the main background of subjective and social incentives changes slowly, whilst the short-period influence of changes in the rate of interest and the other objective factors is often of secondary importance, we are left with the conclusion that short-period changes in consumption largely depend on changes in the rate at which income …. is being earned and not on changes in the propensity to consume out of a given income" (Keynes 1936, p. 110).

Moreover, despite Friedman's sustained efforts to discredit Keynes's approach and policies based on it, when Jim Thomas surveyed the econometric work of various theories and specifications of the consumption function (Thomas, 1997), Keynes's short-period consumption function performed well when compared to all other approaches, (see Harcourt and Riach 1997: vol 1, p. xxvi, and Thomas, 1997, pp. 158-60).

Also, in a 1972 *Journal of Political Economy* article, Friedman claimed that *The General Theory* was riddled with arguments based on Keynes notorious liquidity trap, trying to picture Keynes as a one idea economist who could not be viewed as an influential figure, let alone a seminal one. In fact Keynes mentioned the liquidity trap only in passing, as a theoretical possibility which was most unlikely ever to occur in practice.

The post-war period saw the successful implementation of Keynesian policies at the domestic level. This period, often called the "golden-age of capitalism", came to an end in the first half of the 1970s. With the phenomena of stagflation, following the rapid rise in the price of oil, discrediting Keynesianism in many eyes, Friedman's ideas came to dominate both the economics profession and economic policy. As a result of Friedman's writings, governments became committed to the idea of monetary targets, and many OECD countries tried to implement these.

In addition to the misrepresentations of what Keynes had said in *The General Theory* already noted, Friedman ignored the fact that, as its title suggests, *The General Theory* is not about policy. As Victoria Chick pointed out "Perhaps the first thing to learn from reading *The General Theory* is what is not there. Keynes said very little about policy in the book" (1987, p. 5). In fact, as central banks soon discovered, fixed money supply targets, as suggested by Friedman, proved impossible to implement, mainly due to the endogenous nature of the money supply.

A new consensus arose with regard to monetary policy, which accepted Friedman's argument for policy rules, modified to incorporate the view that the money supply could not be controlled. Instead, interest rates became the appropriate tool of monetary policy. Keynesian economic policy made a brief comeback as a result of the global financial crisis, with many governments implementing expansionary fiscal policy in the hope of moderating the rise in unemployment. However, these were generally short lived and Friedman's ideas about the implementation of monetary policy continued to be influential, though in a modified form. Moreover, the majority of Keynesian economists also contributed to the problems this caused. Given Victoria Chicks' extensive work on financial institutions and the economy it is not surprising that she laments the "fact that mainstream Keynesianism ignored the need to develop the financial side of government policy (and has never integrated a theory of the behaviour of financial institutions into its main corpus) has left the policy-makers prey to what some would feel was less than constructive advice." (1983, p. 275).

The Tarshis Incident[3]

Lorie Tarshis went to Keynes's lectures in the first half of the 1930s, in which Keynes set out the framework of what became *The General Theory* in 1936. This framework became,, and remained, Laurie's when he wrote about the theory of output and employment as a whole. Aggregate supply and aggregate demand dominated, with Lorie putting great emphasis on the aggregate supply function. As a Canadian he much more emphasised macroeconomic behaviour in a small open economy.

After active service in World War Two Lorie taught at Tufts before going to Stanford in 1947. He began writing a textbook, *The Elements of Economics. An Introduction to the Theory of Price and Employment* (Tarshis 1947). Part 4 of this was 250 pages in which Keynes's theory was set out in terms of the aggregate demand and supply curves of *The*

[3] This section draws on GCH's oral history of Lorie Tarshis, Harcourt 1982

General Theory. Tarshis's explicit purpose was "to introduce Keynes to the world". (Tarshis 1996 66)

Initially the book took off well with scores of departments prescribing it; but in the summer of 1947 while he was teaching a summer course at Williams, he began to get disquieting calls from Boston about attacks on the book, "on the grounds that the book was Communist-inspired". (Tarshis 1996, 67) The President of Williams stood firm. His economists told him that it was a good book, he told the trustees that it was to be prescribed and he defended the employment of Lorie himself. It was an anti-new dealer, Merwin K. Hart, who led the attack through the offices of a writer, Rose Wilder[4]. Her attack was sent to every trustee of every university in the country, warning against the book (Tarshis 1996, 69). William Buckley, Jr., took up the attack later, devoting a chapter in *God and Man at Yale* to Lorie's book, quoting vigorously out of context (Tarshis 1996, 70-71). While Lorie had belonged to the Socialist Club at Cambridge, as well as to the Marshall Society (hardly a hotbed of Reds), he was sufficiently under the influence of Keynes both to want to, and to believe it possible to make capitalism work. (Tarshis 1996, 67) John Kenneth Galbraith played an important role in getting the A.E.A. to stand up for Lorie and academic freedom generally. Lorie says he received a lot of support from the profession itself, even if some of it consisted of people saying how embarrassed they were to be required by the trustees to take his book off their reading list. With some people for friends.... The upshot was Lorie's book sold respectably at 10,000 or so a year, did well in Europe and especially in Sweden, but it was never the bestseller it otherwise would have and should have been.

Paul Samuelson's Text

The book that rose to fill the vacuum left by the Tarshis incident was Paul Samuelson's text: *Economics*, which first appeared in 1948, and went through 19 editions until its final revision in 2009 (the last eight editions were jointly written with Nordhaus).
Samuelson acknowledged that his text was written in a "scientific" manner so as to avoid some of the criticisms levelled against Tarshis: "I wrote carefully and lawyer-like so that there were a lot of complaints that Samuelson was playing peek-a-boo with the Commies."

[4] Rose Wilder Lane was the daughter of Laura Ingalls Wilder, author of the Little House on the Prairie series, and a prominent writer and journalist, as well as being extremely influential in the libertarian movement.

(Samuelson 1996, 172). Elzinga (1992) documents how Samuelson attempted to avoid the right-wing backlash, by circulating mimeos of the text and meeting with detractors. (865) According to Colander and Landreth, Samuelson's "book gave Keynesian economics an aura of scientific legitimacy. To fight against his text was not only to fight against a policy prescription, it was to fight against scientific models. Because Keynesian models could be reduced to a simple mathematical model, it was not questionable on political grounds. It was simply 'positive economics'.

Most Keynesian economists would not agree, and would not classify Samuelson's work as Keynesian. Certainly there was little analysis in historical time, with his analysis being more Walrasian with little role given to causal analysis, while unemployment (in the short run) was seen as the result of rigidities. Tarshis, for example, states that "Paul Samuelson was not in the Keynesian group. … That he became a Keynesian was laughable." (Tarshis 1996, 64) Joan Robinson, in a number of places, refered to Samuelson work (explicitly his text) and the neoclassical synthesis as "bastard Keynesian doctrine". (Robinson and Wilkinson 1977, 199-200

In the third edition of *Economics* Samuelson wrote:

> "In recent years 90 per cent of American Economists have stopped being 'Keynesian economists' or 'anti-Keynesian economists'. Instead they have worked toward a synthesis of whatever is valuable in older economics and in modern theories of income determination. The result might be called neo-classical economics and is accepted in its broad outlines by all but about 5 per cent of extreme left wing and right wing writers[5]." (1955, p. 212)

This synthesis combined the belief that the decisions of firms and individuals were rational enough that the standard methods of microeconomics worked well with a belief that this rationality did not usually hold at the macro level and prices and wages did not do enough to avoid equilibrium at a level less than full employment. According to Samuelson:

> "We always assumed that the Keynesian underemployment equilibrium floated on a substructure of administered prices and imperfect competition. I stopped thinking about what was meant by rigid wages and whether you could get the real wage down: I knew that it was a good working principle, good hypothesis to explain that the real wage does not move down indefinitely as long as there is still some unemployment. Thus I assumed a disequilibrium system, in which people could not get on the supply-of-labour curve." Samuelson 1996, 160-61

Unfortunately, by 1955 Hicks' ISLM analysis had become the typical tool for macroeconomic analysis. There was general agreement that it was safe to assume that the IS

[5] Today it is probably close to 99%, with the 1% including heterodox economists such as Victoria Chick and the authors!!

curve sloped downwards and was intersected by an upward sloping LM curve .However, there was uncertainty about the relationship between interest rates and investment and hence about how steeply the IS curve sloped downwards. Some thought that it might be virtually vertical. Few doubted that active policy with fiscal policy playing a lead role was as important as Keynes thought it was for counter-cyclical policy. Monetary policy helped, but mainly just by being accommodating.[6]

The neoclassical synthesis then deteriorated further by implicitly or explicitly assuming that in the longer run what happened during the business cycle did not affect in any way the long-run growth path,. Again Victoria Chick has summed up admirably what is happening.

> "Keynes's system was — and is — disliked chiefly for portraying the economy as something other than the interaction of purely *rational* decisions. But labour is not being irrational when it suffers unemployment; to a great extent *it has no choice*. Speculators are not being irrational; they are making money. Bankers are not being irrational in lending to businesses for projects which do not eventually pay off; they are making their best guess, and if it is not right and the Bank of England is prepared to pick up the tab, who are they to complain? *The General Theory* is, on the whole, realistic. Keynes's critics are mostly romantics, people who see the world not as it is, but as they would like it to be. Realists have always been savaged by romantics. That does not mean that the realists are wrong." (1987, p. 12) (Italics in the original)

When they write on longer-run (i.e. longer than the business cycle) growth theory, neoclassical economists claim that they are drawing out implications of Solow's growth theory model, or if they are Australian economists, the Solow-Swan model. This is a case of ideology swamping the plain meaning of the texts. Though for different reasons in each case, both Solow and Swan make it clear that they do not subscribe to the belief that policies carried out during a recession have no effect on the longer-run trend rate of growth

Swan (1956) made explicit that his main aim was to see what insights Ricardo's growth theory could provide for overcoming problems in a modern economy if a fixed factor of production, land, is introduced. Solow (1956) is explicit in assuming full employment and tends to discuss what happens in an economy in which in the long run "the real wage adjusts so that all available labour is employed" (p. 68). Nevertheless, even in 1956 Solow was not completely happy with the unrealistic nature of this neoclassical assumption and went so far

[6] .For a critique of IS-LM, both as a guide to Keynesian thought and as a useful tool for analysing macroeconomic issues see Kriesler and Nevile (2002) and Hicks (1980-811). See also Hart 2013, section 4.4. For an alternative view see Solow (1984)

as to talk about "the basic equation which determines the time path of capital accumulation that must be followed if all available labour is to be employed" (p .67).

Solow (2000) is more forthright. Neoclassical growth theory, he says, supposes

> "the available supply of labour always to be fully employed and the existing stock of productive capital goods always to be fully utilized ... This assumption of full utilization could better be made explicit by introducing a government that makes (useless) expenditure and levies (lump-sum) taxes in order to preserve full utilization but this is rarely done......Full employment/utilization is usually just assumed." (p. 350).

Moreover, in the following paragraph Solow makes an even more damaging statement as far as the conventional view of neoclassical growth theory is concerned. "The neoclassical model allows in one important effect for the interaction between fluctuations and growth: fluctuations will surely perturb the rate of investment and that will necessarily affect the path of potential output" (p. 350). As Solow discusses later in the article this is true of investment in human capital as well as investment in physical capital.

While many who identify themselves as neoclassical economists publish work that Samuelson would reject, especially those advocating reliance on monetary policy as the major anti-cyclical policy instrument, because of the great influence of Samuelson and the increasing tendency of American economics to dominate English language economics, his coining of the phrase 'neoclassical synthesis' proved to be decisive in the eclipse of Keynesian economics.

Conclusion

There is general agreement among heterodox economists that the mainstream never fully adopted Keynesian economics. This paper attempts to identify some of the reasons for this. The rise of monetarism, a legacy of Friedman, was a major rejection by the discipline of the essential features of Keynes's *General Theory*. We have argued that this was the result of an intentional campaign by Friedman and his colleagues to remove any semblance of Keynesianism, and the resultant argument for government intervention in the economy, from economics.

The second important reason for the movement away from Keynesianism was the right -wing attack on the excellent Keynesian text by Tarshis which led to its removal from most of the universities it had been previously adopted by. Its place was taken by Samuelson's text, which intentionally compromised (and lost) its Keynesian message, and became the foundation of the neoclassical synthesis which was to dominate the discipline, until the Lucasians took ove

The right-wing attack on Tarshis's economics of Keynes book led to a post-war generation of students being introduced to Keynes through Paul Samuelson's introductory text, (Samuelson 1948) and through the IS / LM analysis of Hicks/Hansen. (Samuelson's book received the tail end of the right-wing attack but this did not stop the book becoming the greatest seller ever of economics texts, nor it going into many editions.)

The full consequences of this disgraceful episode climaxed in the stagflation episode of the 1970s. Friedman and others claimed that stagflation refuted the Keynesian analysis because it refuted the proposition that inflation and unemployment could not move together in the same direction, and they had.

But this could never have been argued if Tarshis (and Keynes) had prevailed. Using aggregate supply and demand analysis from *The General Theory*, and Tarshis's book, an imported cost rise and/or an autonomous rise in the money rage rate would have caused the aggregate supply curve to rise *cet. par.*, there would be a higher level of unemployment and a higher general price level. The latter, in turn, could precipitate an inflationary process – hence stagflation. Moreover, understanding how this came about would guide the choice of appropriate policies.

That this did not come about is the ultimate tragedy that arose from the post-war education of economics students.

As Tarshis concluded in his interview in *The Coming of Keynesianism to America*: "But I never felt that Keynes was being followed with full adherence or full understanding of what he'd written. I still feel that way." (Tarshis 1996, 72) This paper accepts this assessment in the decisive case of Samuelson. However, the effects of this went well beyond theory. In the final paragraph of *The General Theory* Keynes himself wrote "the ideas of economist and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else" (p., 383). Unfortunately, this is well illustrated in current circumstances. In Victoria Chick's words the ‘romantics’ have triumphed over the ‘realists’ to the detriment of macroeconomic policy in many countries.

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