"A COMPOSITE AUNT SALLY OF UNCERTAIN AGE"

Bradley W. Bateman*

It was borne in on me that many disputes over Keynesian economics revolved around a construct. The figure confidently referred to as "Keynes" often turned out to be an ahistorical abstraction, located not in the context of actual arguments over policy or of actual debates over theory, but with citations form his various writings, of various dates, pressed into service in senses which could hardly have been intended. In view of Keynes's own use of the label 'classical economist' – to which his friend and critic D. H. Robertson raised pointed objection – it is ironic that the whirligig of time should have brought in one of his revenges by making the name Keynes into what Robertson called a "composite Aunt Sally of uncertain age".[1]

Two of the most fundamental questions to be answered in the Keynes versus Hayek debate are, "Which Keynes?" and "Which Hayek?" Consider the predicament that Hayek found himself in after the publication of *The Road to Serfdom*: he was made manifestly uncomfortable by the right-wing pundits and politicians in America who attributed to him an anti-state attitude that did not gibe with the kind of qualifications he had made in his book, for instance, for the importance of the welfare state.[2] Or consider the misrepresentation, propagated by James Buchanan and Richard Wagner in their famous *Democracy in Deficit,* that Keynes had argued for ever-increasing government budget deficits.[3] For better or worse, in many people's minds, these two straw men are the antagonists in the great debate.

My purpose in this essay is not to untangle all the false Keynes's from all the all the false Hayeks that have been proffered. My purpose rather is to take a fairly standard "Aunt Sally" that has been used often to represent Keynes and to argue that it is, indeed, a misrepresentation.[4]

In the process, I do *not* wish to imply in any way that there is not a fair distance between Keynes and Hayek. There is absolutely room for a debate between them. But the debate should be between an historically accurate Hayek and an historically accurate Keynes. Only then can we get at the economic, methodological, and moral differences from which we can best learn.

Meet Aunt Sally

In the minds of many, Keynes is the greatest economist of the twentieth century and, perhaps more importantly, the man who saved capitalism in the depths of the Great Depression with his theoretical breakthrough that demonstrated how to return a capitalist

* Written for *K & K*.

1 Clarke (1988), viii

2 See Caldwell (2020) for an excellent corrective to the Aunt Sally created from misrepresentations of Hayek's work.

3 See Bateman (2005).

4 This essay closely follows Bateman (2006).

economy to full employment. After many years of high unemployment, capitalism had lost its legitimacy in the minds of many people and both socialism and communism looked like viable alternatives. In this caricature, capitalism only regained its legitimacy through the application of Keynesian economic policy, most especially running large and ever-increasing government budget deficits.

An implicit part of this caricature is that Keynes was interested in fiscal policy (government spending and taxation), but not monetary policy (interest rates and the amount of money in circulation). This part of the caricature was eventually made explicit in mainstream economics, where it was formalized in the basic "Keynesian versus monetarist" story animated using the IS-LM model.

Finally, there is the idea that Keynes invented macroeconomics, or the study of the economy as a whole with his *magnum opus*, *The General Theory of Employment, Interest and Money* (1936).

In summary then, Keynes supposedly invented macroeconomics and used it to show that fiscal policy was more important than monetary policy, in particular that ever-increasing government budget deficits are the key to prosperity. And he saved capitalism with this theoretical blitzkrieg.

My purpose here is not to argue about whether Keynes is the greatest economist of the twentieth century but, rather, to lay out enough counterfactuals to show that the person described in the previous paragraph is not the historical Keynes.

Inventing the inventor of macroeconomics

Perhaps the easiest way to debunk the myth that Keynes invented macroeconomics is to point to pieces of the secondary literature that address the question of what Keynes did, or didn't, invent. It is now over twenty years since the publication of David Laidler's *Fabricating the Keynesian Revolution* (1999), which is probably the most definitive exposition of the state of macroeconomic thinking before *The General Theory.*[5] The long and the short of the history of economic ideas is that economists started theorizing seriously about macroeconomic questions in the eighteenth century, and that Keynes was himself working on the frontiers of that literature for many years *before* the publication of *The General Theory.*

It helps that the term was coined in 1933, three years before Keynes's published his book.[6] And likewise, that Keynes himself never used the term in his great book (or subsequently). The names in common currency for the study of "the economy as a whole" in the decades before 1936 were: "business cycle theory" (or trade cycle theory) and "monetary theory". So extensive was the work in these fields before 1936 that there were already recognizable schools of macroeconomic thought before Keynes published his *magnum opus* (e.g. Austrian school, Stockholm school). And, of course, there was the outstanding economist Knut Wicksell, from whom almost everyone working in the field in the early twentieth century drew inspiration.

What was missing from this "pre-existing" literature on "the economy as a whole" was a theoretical explanation of what caused employment to rise and fall. Previously, most

5 See also Laidler (1991) and O'Brien (1993)

6 The term was first used by Ragnar Frisch, the Norwegian economist who would, many decades later, win the Nobel Prize.

"macroeconomic" work involved the study of the causal links between the quantity of money in circulation or the price of money (the interest rate), on the one hand, and the overall price level (inflation and deflation), on the other hand. People understood intuitively that inflation and deflation caused employment to fluctuate, but no one before Keynes had a model to explain the linkages. That is the lacuna that Keynes filled. Hence the full title of his book: *The General Theory of Employment, Interest and Money.*

Perhaps the most definitive scholarly treatment of the *originality* of Keynes's theoretical work is Don Patinkin's *Anticipations of the General Theory? (1982).* And while it would be incorrect to say that there is absolute consensus about the origins and originality of *The General Theory*, there is widespread acceptance that Patinkin correctly identified what separates Keynes from his contemporaries: his theory of how employment is determined in a market economy.[7] For instance, prior to Keynes's theoretical apparatus, economists had to depend on *ad hoc* narratives about how swings in inflation and deflation affected employment. It is crucial, of course, to explain inflation and deflation, if for no other reason than to try to limit them; but ultimately, in order to understand how "the economy as a whole" operates, one needs to be able to understand what drives employment and output.

Thus, it is not the case that Keynes "invented macroeconomics". Macroeconomics was a vital enterprise before Keynes started working in the field. But what he did was to close a gap in macroeconomic theory. He created the model that allowed economists to show how something like the Great Depression could happen.

Aunt Sally's purse

The word fiscal comes from the Latin word *fisc*, which means purse. Thus, *fiscal policy* deals with the government's "purse": both what goes into the purse (its collection of taxes) and what comes out of the purse (what it spends on goods and services). And, of course, it is this ability to collect revenue and spend money that defines "Keynesian economic policy" and "Keynesianism", especially spending more money and/or cutting taxes to stimulate the economy. For in the model that Keynes developed in *The General Theory*, it is easy to show that increasing government expenditure, while holding all other things unchanged, will increase employment; likewise, it is easy to show that cutting taxes, while leaving all other things unchanged, will raise employment.

The question for our purposes is what uses Keynes suggested for the government's purse. Perhaps the first thing that needs to be said is that his suggestion was *not* running a deficit on the government budget. This was a fairly consistent message through time on Keynes's part, but it seems worthwhile looking at three episodes over the last twenty years of his life to verify that he was not the deficit monster of Buchanan and Wagner's nightmares.

The first episode is his work with Hubert Henderson to promote the Liberal Party platform in the general election of 1929. Together they published the election pamphlet *Can Lloyd George Do It? in* which they argued for a two-year commitment for the government to spend £250 million on public works projects. But while they referred to these public work projects (such as building housing and roads) as "loan-financed expenditures", the did not mean by this that the government should run a deficit.

7 I have disagreed with many of Patinkin's interpretations of Keynes's work (Bateman 1996). But on the question of what constitutes the original contribution of The General Theory we agree.

To understand why their recommendation did not mean running a deficit, one must understand the arcane world of British fiscal policy at the time; in particular, that government bonds (gilts) were of indefinite maturity, but that the government also created a sinking fund to re-pay (retire) the gilts. The sinking fund was collected as a part of annual tax collection with targets set for re-paying fixed amounts of bonds when the sinking fund got large enough. Keynes and Henderson proposed that the money for the public works projects be borrowed from the sinking fund, which meant that the revenue generated from the projects could be used to repay the "loans" from the sinking fund. Thus, the government would be taking money out of its own purse to invest in new capital projects that would generate cash to replace what had been taken out of the purse.

This is probably one of the central reasons that Keynes never recommends using government budget deficits in *The General Theory.* He had an alternative funding strategy. As early as 1924, he had begun proposing that the government re-work its budgeting process to reflect standard accounting practices, separating out the capital budget from the "ordinary" budget. He suggested calling these two budgets, respectively, the Public Capital Budget and the Exchequer Budget.

Thus, this recommendation would involve accounting for all capital (revenue generating) projects and their financing in a separate budget from the "regular" budget that covers ordinary expenditure on current consumption. Then, just as businesses do, the government would be able to account for its investment in new plant and equipment apart from the costs (and revenues) of doing its everyday business.

Which brings us to our third "episode", which took place in Keynes's wartime work on the *White Paper on Full Employment* (1944) and the *National Debt Enquiry (1945)*. In the formal committee work and in his correspondence concerning both projects, Keynes maintained steadfastly his argument for breaking the Public Capital Budget out from the Exchequer's Budget. "It is important to emphasize that it is no part of the Exchequer or the Public Capital Budget to facilitate deficit financing, as I understand this term."[8] That is to say, the government would always collect enough taxes to pay for its current consumption under his proposed accounting schema.

Thus, not only is there is no extant evidence of any sustained interest on Keynes's part in using deficit financing to stimulate the economy, there is bountiful evidence that he disagreed with this policy as a means to prosperity.[9]

But what about monetary policy?

But, of course, despite his lack of interest in using government budget deficits to stimulate the economy, he did believe in using public works projects as a tool to restore the economy to full employment. For Keynes, the greatest benefit of such a policy was probably at one remove from the immediate effects of the projects themselves. He saw employment as fundamental to human dignity, so it is not that he saw the projects as unimportant in themselves, but rather that he believed they should be used to stabilize *private* investment and that was perhaps the channel through which he saw the most potential to sustain high employment.

8 JMK, xxvii, 406. See also 352-53.

9 Clarke (1988) describes the one time that Keynes unequivocally supported running a government budget deficit.

Keynes believed that serious unemployment, such as was experienced in the Great Depression, was the result of the collapse of business investment. He believed that the business cycle was caused by swings in the outlook of businessmen from optimism to pessimism; these swings in their "animal spirits" would cause investment in new plant and equipment to swing up and down and this would, in turn, cause employment to rise and fall.[10] A "great depression" was merely a case in which animal spirits swung down and stayed down.

Public works projects were a means to spur a change in animal spirits. If nothing else was stimulating optimism in the business community, then perhaps it could be stimulated by the prospect of an increase in employment (and prosperity) caused by the government's capital spending. Public works projects would be an obvious tool in a deep depression, but Keynes also believed that they could be used to minimize the swings of the "normal" business cycle. If businessmen gained confidence that the government would step in effectively with a programme of new road construction or new public housing when animal spirits and investment had turned down, then perhaps they would not be as subject to a fit of pessimism in the first place.

Keynes's vision was to make the swings in outlook, investment, and employment smaller and for the fluctuations that remained to be around a higher average level. He did not believe that the business cycle could be eradicated, but he did believe that it could be minimized and that the increased level of average investment would mean higher average levels of employment.

Which is why he believed that monetary policy remained an important tool. His argument was not, however, that monetary policy should be used counter-cyclically, as was the case with public works projects, but rather that interest rates should be set low and kept there in order to stimulate as much investment as possible.

The problem for monetary policy, in Keynes's assessment, was that the interest rate was potentially unstable, being the result of market psychology, rather than underlying fundamentals. If the interest rate swung up and down as market psychology shifted, this would only exacerbate further instability in private investment. Thus, in order to help minimize swings in investment and to keep employment as high as possible, he advised creating an *expectation* that the monetary authorities were committed to a policy of maintaining the interest rate at a low level. Such an expectation would be self-fulfilling if the monetary authorities (the central bank) had credibility.[11]

Aunt Sally's passport

In the 1980s, a group of historians, sociologists, and economists undertook the study of how Keynes's ideas were transmitted around the world during the Great Depression. How had policymakers in so many places come to see his wisdom and implement his recommendations? How exactly had the process of "saving capitalism" happened?

Much to their surprise, however, what the researchers found in country after country was that the policies used had been developed locally, without direct reference to Keynes's work.[12] The term the researchers coined for these policy responses to the Depression was

10 I refer here to "businessmen" because this is Keynes's construction.
11 See Keynes (1936) 198, 203-05.
12 See Peter Hall (1988).

"proto-Keynesian". They discovered that economic ideas are important to policy making, but the ideas that had been important in addressing the Depression were not necessarily Keynes's ideas.

Whose ideas were they? In every country, there was a different story. In Germany, Japan, France, the United States, and Sweden, for instance, politicians made decisions to stimulate the economy for practical, politically calculated reasons that did not derive from Keynes's writings (popular or scholarly). The only countries where Keyes's ideas can be documented to have had a role in the formation of policies were Canada and Britain.

How was this possible? Perhaps ironically, the answer may be the fact of what happened in the immediate *post-war* world. By then, the basic ideas of using fiscal and monetary policy to stimulate (or dampen) the economy had become widespread. Just as importantly, basic statistical analysis was emerging at this time and Keynes's model provided an easy means of framing and testing policy proposals. Finally, these were the years when national income data was first being collected (e.g. gross national product and its components. This data made it possible to statistically estimate policy effects. The immediate post-war years were truly the time of the "Keynesian Revolution" in policymaking. This success, and the widespread use of his name as a shorthand for the new demand management policies, perhaps caused people to attribute to him what had happened *before* the war. In short, his imprimatur on post-war policies of demand management may have led people to mistakenly assume that demand management polices before the war were also "Keynesian", rather than "proto-Keynesian".

To the extent that the post-war statistical and policy work employed the model he had laid out in *The General Theory*, he deserved to have his name on Keynesian economics and Keynesian policies. But it is worth remembering that this was an application off his name to a revolution in policymaking that had happened largely without reference to his work.

Conclusion

There are many possible lessons to learn from separating the historical Keynes from the composite Aunt Sally of uncertain age. One perfectly good lesson, for instance, can be drawn from a new sub-discipline within intellectual history, "reception studies". A reception study of Keynes's work(s) would examine the context in which different interpretations of the man and his work developed for the purpose of seeing what drove the various interpretations. What did the people who interpreted Keynes want him to say? What did they think they needed him to say? How did their interpretations serve their rhetorical and political purposes?

Practitioners of reception studies are careful, however, never to say what the *correct* interpretation is. There is good reason, of course, for an intellectual historian to demonstrate the virtue of humility, but this essay is *not* a reception study: not only have I not (yet) asked what people wanted from their interpretation of Keynes, I have only met the criterion of "neutrality" in reception studies halfway. After all, the act of de-constructing Aunt Sally is explicitly saying that some interpretations are more accurate historically than others.

By way of conclusion, however, I would like to return to the fundamental purpose of reception studies and ask what people have wanted from their interpretations of each of our protagonists. I would like to do this by suggesting that while the Keynes versus Hayek debate has been largely driven by the need to argue for (or against) some kind of state involvement in the economy, that the mischaracterization of each of them has driven the debate away from the real issues. Aunt Sally is likely either a hero or a villain who stops further debate; her virtue (she saved capitalism!) or her wiles (she wanted ever-larger budget deficits!) are qualities meant to stop debate, not to further it

After all, both Keynes and Hayek had much in common. They both identified themselves as liberals and therein, perhaps, lies the unrealized opportunity. Keynes was not a socialist or a communist. He repeatedly refused to identify with either ideology, insisting that he was exploring what it meant to be a liberal in a world shaped by a rapidly evolving capitalism. Likewise, Hayek spent much of his life after 1936 trying to define a new liberalism (neoliberalism). But he believed, for instance, that a healthy welfare state was necessary to support the liberal state. He was not an anti-state "barbarian".

Thus, one set of questions to which the Keynes versus Hayek debate points are: What are the possibilities of liberalism in industrial capitalism? What is liberalism under a regime of oligopolistic capitalism? How big (or small) should the welfare state be? What is the legitimate function of the welfare state in a liberal democracy? These are question that have not diminished in importance. We do not agree on the answers, but neither did Hayek and Keynes. But if these are our protagonists, there is a rich vein within the debate that remains unexplored.

Understanding that neither Keynes nor Hayek are the caricatures that normally feature in their debate offers us the chance to take the debate to a different level. Rather than creating a demon of our opponent and then depending on that caricature to demean the other position, or a hero that can easily make our point, we can dig down and see what they actually believed and what they might offer us today.

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I am still in Cambridge but have been up to London several times for theatres and dinner parties – and am off there to-morrow. I can't decide whether to go up and down the country making speeches with a view to the General Election or to sail to Russia to fight the Government. I hope you aren't deciding that after all Vienna is to be preferred to Cambridge.

Yours,

J.M. Keynes

I think my states of mind have been pretty fair lately – Thanks.
How are yours?

Keynes's letter to Ernst P. Goldschmidt (1905)
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