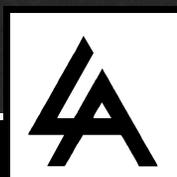
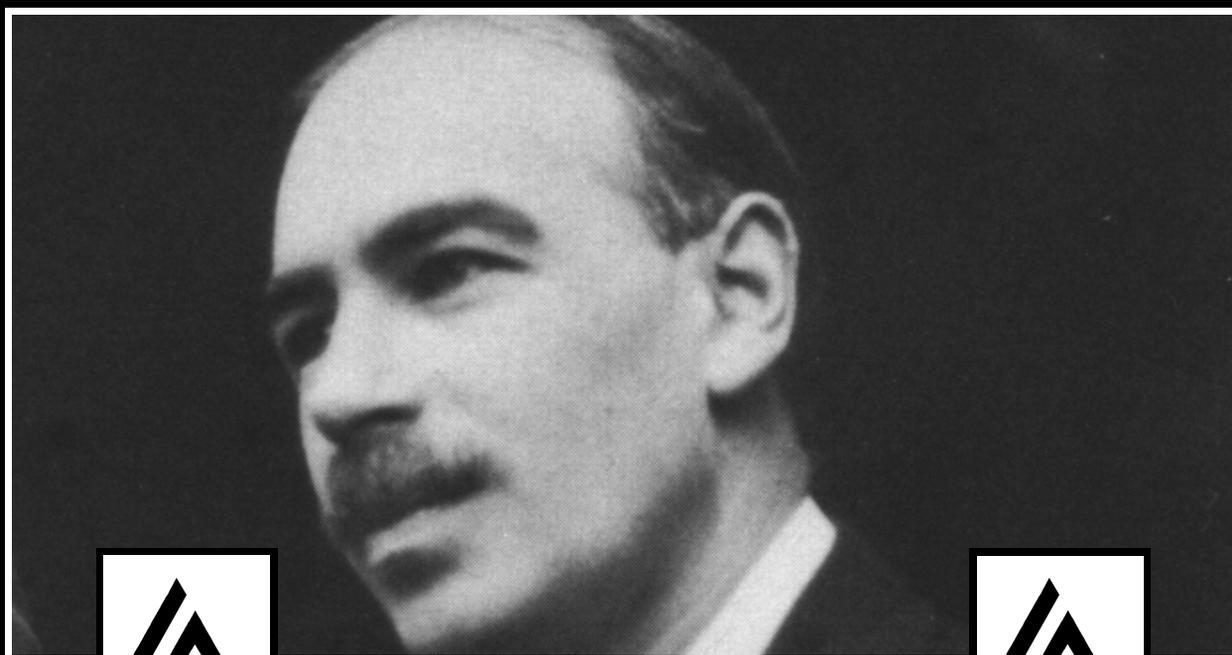
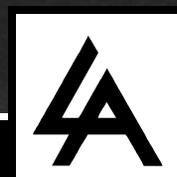


# THE CRITICS OF KEYNESIANISM: A SURVEY



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# THE CRITICS OF KEYNESIANISM: A SURVEY

BRYAN CAPLAN

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**“He who knows only his own side of the case, knows little of that.” — John Stuart Mill**

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## AN OVERVIEW

John Maynard Keynes' *General Theory* marks a turning point in intellectual history. In less than a decade since its publication, the numerous converts to Keynesianism attained dominance in both the academic and political realms. Their hold on these positions has, since the 1970's, weakened under the combined force of theoretical criticisms and practical failures. This theoretical criticism is not a coherent edifice; rather, this criticism consists of disparate strands of dissent from both the general principles and the specific applications of Keynesianism. This paper, then, will survey these criticisms of Keynesianism, describing them, classifying them, and tentatively evaluating them.

One of the important barriers to a thorough study of anti-Keynesian doctrines is that Keynesianism is a broad tendency of thought rather than a rigid set of theorems. Still, there are certainly basic assumptions that all species of Keynesianism share. By stating them explicitly, it will be possible to see what portions of the Keynesian system the major schools of critics reject.

Two fundamental postulates underlie Keynesian theories of all types:

1. Unemployment is caused by insufficient aggregate demand.
2. The proper means to eliminate unemployment is for the government to increase aggregate demand through discretionary monetary and fiscal policies.

This definition is admittedly simple, but will prove its worth by both distinguishing Keynesians from non-Keynesians, and by allowing a clear way of classifying the many schools of Keynesianism's critics. Roughly speaking, there are those who criticise the first postulate, and those who criticise the second. The first group includes rational expectations, sectoral shifts, real business cycles, the more extreme forms of monetarism, Austrians, and, perhaps inadvertently, Keynesians who concentrate on microfoundations. The second group adds moderate monetarists, public choicers, and advocates of free banking.

The critics of the first postulate can be split into two main factions. The first approach, which focuses on the micro-economic assumptions of Keynesianism, spearheaded the modern wave of criticism but no longer part of cutting-edge discussion; the second and more popular approach emphasizes the influence of real variables such as supply shocks, sectoral shifts, and search.

The early critics observed that Keynesians had not fully explained the microfoundations of their models, and that this sin of omission led to dangerous long-run consequences. Unemployment, Friedman and others explained, is not

caused by insufficient aggregate demand per se; it is caused by excessive wage rates. Increasing aggregate demand only effects employment if, due to nominal wage rigidity, the real wage falls relative to prices. A Phillips' curve, then, does not describe a set of long-run equilibrium positions. It works only so long as the market does not anticipate what is going on. The widely varying pattern of inflation and employment combinations both between countries and within countries in different historical periods testifies to the power of this insight.

Other modern critics of Keynesianism doubt that money illusion is possible or relevant; at least, it matters much less than Keynesians seem to think. Think of it this way: all economists, Keynesians included, agree that some positive amount of unemployment is the natural and inevitable result of freedom of contract, due to quits, dismissals, search and other frictions. Moreover, all economists agree that a change in real factors can affect the rates at which workers find and lose jobs; hence, there will always be some fluctuations in employment. Given this, is it possible that real factors have caused employment fluctuations rather than aggregate demand fluctuations? There are many variations on this theme. Robert Barro simply doubts that a "strong" correlation exists between real and nominal variables. David Lilién argues that sectoral shifts can account for about half of recent cyclical unemployment normally thought to be caused by fluctuations in aggregate demand. The radical divergence between this approach and Keynes' should be obvious.

The second group of critics, whether or not they agree with the first group, have a decidedly different orientation. They argue that, even granted the Keynesian view that unemployment is caused by insufficient aggregate demand, that there are better means to cure unemployment than active fiscal and monetary policies. For example, they argue that active intervention makes the economy unstable, since policy can change with the winds of opinions of politicians and the central bank. No one can know policy in advance, so they may make actions which, though reasonable given their ignorance of future policy, are foolish in light of the policy that actually happens. Such critics advocate rules to strictly delimit options of monetary and fiscal authorities, such as a balanced budget amendment, or a constitutionally fixed rate of money growth. This criticism is typical of both monetarists and rational expectationists.

Other critics, especially with a public choice slant, doubt whether the government actually would choose to pursue the "optimal" policy even if it knew exactly how to achieve it. They think government actors are self-interested, not angelic servants of the public good. Put otherwise, they view government actions as endogenously determined by the motives of the officials and the incentives of the system, rather than

exogenously determined by the wise advice of Keynesian economists. Some possible motives that would deter the quest for “optimal” policies are: the desire to win elections by subsidizing favored groups when expansionary fiscal policy is not needed, or to obtain seigniorage by economically unjustified expansionary monetary policy.

A final notable band of theorists of the second group think that central banking is an ineffective way to maintain monetary equilibrium. Instead, they endorse “free banking”, a system whose mildly unconventional characteristics will be described later. Free bankers argue that unregulated banks would expand or contract their liabilities by varying their reserve ratios in response to changes in the demand to hold money — and that they would do so automatically in response to profit-and-loss indicators. In their view, this compares favorably with a central bank, which cannot easily discover how to adjust the money supply in response to changes in demand to hold or currency-deposit ratios. Since both the workings of free banking (which has, incidentally, existed historically, and is not merely idle hypothesizing) and the reasons why its proponents think their system would improve upon central banking are relatively unknown, this essay will devote extra space to their critique.

### MONETARISM’S AND RATIONAL EXPECTATIONS’ MICROECONOMIC CRITIQUE

Monetarists and rational expectationists have, it is fair to say, completely destroyed naive Keynesianism with their attacks on its microfoundations. In modern discussions Keynesians as well as anti-Keynesians agree that if wages were perfectly flexible, involuntary unemployment would be impossible. And, even if wages are not perfectly flexible in the short-run, almost everyone agrees that, first, wages are flexible in the long-run, and, second, that this implies that a permanent trade-off between inflation and unemployment is impossible.

It is true that all participants to the macroeconomic debate now accept this microfoundational critique of Keynesianism. Still, the power of this attack is clear from the fact that Keynesian theories mitigate, and anti-Keynesian theories emphasize, the practical importance of this fact. Let us, therefore, investigate the classic statements of this critique, then examine the work that builds on it.

The microfoundational criticism was forcefully expressed in 1962 by Murray Rothbard, just as the American government for the first time invited leading academic Keynesians to prescribe proper policy for the nation. Rothbard bluntly stated,

Keynesian and neo-Keynesian ‘compensatory fiscal policy’ advocates that government deflate during an ‘inflationary’ period and inflate ... to combat a depression. It is clear that government inflation can relieve unemployment and unsold stocks only if the process dupes the owners into accepting lower real prices or wages. This ‘money illusion’ relies on the owners’ being too ignorant to realize when their real incomes have declined — a slender basis on which to ground a cure.<sup>1</sup>

Rothbard’s thesis was ignored by the academic community at the time, but other critics, notably Milton Friedman and Robert Lucas, successfully advanced similar objections after America experienced rising unemployment and rising infla-

tion simultaneously — a phenomenon inconsistent with Keynesianism in its naive form. Writing in 1968, Friedman criticized the Keynesian view that increased aggregate demand increases employment:

But it describes only the initial effects. Because selling prices of products typically respond to an unanticipated rise in nominal demand faster than prices of the factors of production, real wages received have gone down — though real wages anticipated by employees went up, since employees implicitly evaluated the wages offered at the earlier price level.<sup>2</sup>

Robert Barro is a leading advocate of replacing the Keynesian model with an alternate, “market-clearing” model. After defining the model, he summarizes its implications:

The theory predicts that changes in the monetary base are neutral. In particular, a one-time shift in the quantity of base money leads to proportional changes in nominal variables, but to no changes in the real variables.<sup>3</sup>

Barro then makes a novel move. Economic theory, he says, must explain the effect of nominal variables on real variables only to the extent that the effect exists. Surely no one would disagree with this. Barro then proceeds to examine the historical evidence of relationships between nominal and real variables.

Barro’s econometric methods have drawn fire from critics. We shall focus only on his conclusions. In the United Kingdom, he says, there is a negative relationship between wage inflation and unemployment for 1862-1913; no relationship from 1923-39; and a positive relationship for 1947-84. For the United States, there is a negative relationship for 1890-1913, with no relationship over 1923-39 or 1947-84. Extending the comparison to seventy-eight nations, he concludes that there is no significant relationship between real GNP growth rates and inflation, currency growth, or M1 growth. Barro notes that it is possible to explain even such relationships as do exist by unique historical shocks to the real economy. He concludes that,

At least in the long run, it is untrue that more inflation leads to a lower unemployment rate, or that to have low inflation a country must accept a high unemployment rate.<sup>4</sup>

Barro then turns to the evidence for short-run relationships between real and nominal variables. He here limits his analysis to the United States; first he discusses the period of 1890-1940, then the period from 1947-1984. In the earlier era, Barro finds no evidence that changes in the monetary base have real effects, but thinks that there is good evidence for a relationship between real output and changes in the ratio of M1 to the monetary base — specifically, banking panics and changes in reserve requirements. For post-World War II, Barro says that anticipated monetary expansion had no real effect, while a 1% increase in unanticipated money normally increases real GNP by 1% over a one or two year period.

Here is Barro’s calm conclusion to this chapter:

it is the nonneutral effect of the monetary base — to the extent that it exists — that conflicts with our theory. Although this result deserves some weight in our thinking, it is probable that the weight has usually been too large.<sup>5</sup>

Here we see the important features of the rational expectations' critique of Keynesianism. First, although the market-clearing theory fails to perfectly explain the data of history, Keynesianism has severe empirical problems of its own. Whatever their claims to be more interested in "facts", than their opponents, Keynesians have made strong assertions without sufficient evidence. Second, Barro does not claim that nominal variables never effect real variables. He argues that the closeness of their causal relationship has been over-rated.

## THE SECTORAL SHIFTS HYPOTHESIS

Most macroeconomic models treat the economy as a single market. Then, if unemployment rises, we can usually assume that it is caused by insufficient aggregate demand. But some economists, notably David Lilien, have noted that the economy can also be treated as composed of several markets or sectors, and that more unemployment could be caused by shifts between sectors with total demand unchanged. Lilien then shows that if the percentage of persons who lose their jobs increases temporarily — as might happen due to a large sectoral shift — then the natural rate of unemployment rises. This change is not a deviation from the natural rate that might be easily corrected by demand adjustments. Instead a sectoral shift represents a change in the natural rate itself. If wages were perfectly flexible, Lilien's problem would not arise. But even if wages are not flexible, traditional Keynesian policies would not really solve the problem. As Lilien states,

Such policies may have been successful in delaying or smoothing the cyclical pattern of unemployment, but since inadequate demand was not the source of unemployment, aggregate demand policies were not an appropriate cure.<sup>6</sup>

Lilien's statistical support for his sectoral shifts hypothesis has been challenged — for example, by Katz and Abraham.<sup>7</sup> Their dispute is too complicated for this paper. What seems important about sectoral shifts, whether or not it has in fact been important in modern times, is that if it were true, a jump in unemployment would not necessarily indicate aggregate disequilibrium. It might be a short-run change in the natural rate in disguise. So a fall in employment is not ipso facto grounds for expansionary monetary or fiscal policy. One must also show that the job losses are not mainly the result of sectoral shifts.

## EXPLANATIONS OF WAGE-RIGIDITY

### A. Implicit Contracts

The success of the microfoundational criticisms of Friedman, Barro, and associates can be seen in the wealth of attempted responses. No longer do the conversants debate whether wage rigidity is necessary for Keynesian theories and policies to work; now they discuss why wage rigidity exists. Since everyone agrees on the major premise, that wage rigidity is necessary for Keynesianism to be true, the debate focuses on the minor premise, of how wage rigidity is possible.

Probably the first major attempt to explain wage rigidity was "implicit contracts" as advanced by theorists such as Costas Azariadis.<sup>8</sup> This theory begins with plausible assumptions: workers are risk-averse, and therefore prefer a certain and stable series of payments to one that varies with

their short-run, fluctuating productivity; employers, in contrast, are risk-neutral. Hence, we have a clear situation where both parties may gain by shifting the burden of risk through a system of insurance. The result: wages become rigid because market participants desire it.

Some economists misinterpreted Azariadis' conclusions. They observed that implicit contracts make wages rigid. Next, they made the plausible jump that while this is reasonable from the point of view of those making the contracts, it allows the familiar Keynesian results of possible involuntary unemployment and a wide role for discretionary monetary and fiscal policies.

However, this view is wrong. Azariadis never made the above conclusion, and in a later article, Akerlof and Miyazaki showed explicitly that it is specious. Put simply, if workers are risk-averse to drops in wages, they are surely even more risk-averse to losing their job altogether. If faced with a choice, risk-averse workers would clearly prefer "implicit insurance" against job loss to a "policy" that covered them against the lesser hazard of a pay cut. Akerlof and Miyazaki state this thesis clearly:

Because unemployment in many Keynesian macro-models is caused by rigid wages, by a parallel argument it has been held that the smoothing of wages caused by implicit contracts results in non-Walrasian fluctuations in employment. The present paper questions this last claim on unemployment; for it is demonstrated here, if workers can (implicitly) make contracts with the firm, they can also readily insure against employment variations (i.e. layoffs) and, as a result, implicit contracts even with sticky wages will lead to full employment, in most instances, rather than to unemployment.<sup>9</sup>

So we find a curious conclusion. Implicit contracts, rather than being the underlying defect that prevents the efficient operation of the labor market, turns out to be another way for individuals to quietly better their condition through voluntary exchange.

### B. Efficiency Wages

Even though implicit contracts theory cannot explain involuntary unemployment, Keynesians see that its basic approach is persuasive to economists since it relies on traditional assumptions. Implicit contracts theory assumes that firms maximize profits and, more broadly, that economic institutions are not brute facts but instead the rational solution of market actors to problems. Efficiency wage theory is another explanation for involuntary unemployment that shares this basic approach. Put simply, it argues that firms may prefer to pay above market-clearing wages rather than face the consequences of cutting them. And since firms' sole desire, by assumption, is to maximize profits, efficiency wage theory tries to explain why paying a lower price for labor may, on the net, be an unwise move. The most plausible case of this is in undeveloped countries where cutting laborers' incomes may leave them unable to secure their bare sustenance — leading to poor work performance.<sup>10</sup>

But what matters this for industrialized nations where everyone earns well above a subsistence income? Here, advocates of efficiency wage theory point out other plausible cases where employers might gain by paying above the market wage. First, they might do this to reduce shirking.

Workers paid more than their opportunity cost would work more diligently lest they find themselves replaced by another worker eager for a high wage. Second, they might do so to solve an adverse selection problem: namely, workers willing to work for unusually low wages may be less able than those who insist on holding out for normal wages.<sup>11</sup> In its pure form, efficiency wage theory can explain some involuntary unemployment but cannot explain why nominal changes should make any difference. Yellen agrees in principle, but argues that if one weds efficiency wage theory with the assumption that employers set wages according to “rules-of-thumb” — that they only optimize perfectly in the long run — Keynesian results follow. Be that as it may, “rule-of-thumb” behavior could yield Keynesian results all by itself. So efficiency wage theory seems somewhat skew to the whole issue of why nominal changes have real effects — although it can explain why involuntary unemployment might exist even in the long run.

Efficiency wage theory shares a major defect with Keynesian theory generally: it does not boldly state its basic assumptions upfront.<sup>12</sup> The critical underpinning of efficiency wage theory is imperfect information of employers. If employers could perfectly monitor workers, efficiency wage behavior reduces to compensating wage differentials. Jobs that demand more effort would pay more, those that require less effort, that openly condone “shirking” as part of the benefit package, would pay less. But when employees can potentially fool their boss about how much effort they put into their job, the bosses may rationally choose to give their employees more money so that they will fear job loss and cheat less. Here is a plausible analogy that shows why an employer might pay efficiency wages:

It is instructive to contrast the labor market and certain product markets. Firms that rent bicycles, cars, or video cassettes wish to deter misuse and damage but are not usually thought to create rents with their pricing. Instead they rely on deposits. At least in part this is because denying future access to those who misuse products is likely to be difficult. On the other hand, landlords often price apartments below the market to insure loyalty on the part of their tenants rather than relying on a huge security deposit.<sup>13</sup>

Efficiency wage theory is, therefore, reducible to two aspects: compensating differentials and imperfect monitoring. No economists think that there is anything wrong with compensating differentials. As for imperfect monitoring, critics of efficiency wage theory note that it could be solved by auctioning off jobs to workers in exchange for security bonds. Workers would place a suitable bond with their employer. If caught shirking, they would be fired and lose their bond; if not caught shirking (either because they don't shirk or because no one notices) they would get their bond back at the end of the period. (In a multi-period setting, presumably, the employer would keep the bond until the employee chooses to quit.) Advocates of efficiency wages concede that this would work if employees were willing, but suspect that legal restrictions and damage to worker morale kill the labor market's cure in the cradle. This is a complicated issue, but it is clear that the market has many tools to whittle away at the power of efficiency wages.

A close cousin of efficiency wage theory based on rational behavior is efficiency wage theory based on “sociological” considerations. Here, it is fair to say, “sociological” is a

euphemism for behavior that economists would call “irrational”. Thus, they may posit “partial gift exchange” behavior where employers pay workers more than the minimum necessary to secure their services, and the employees respond by applying more effort than their job description demands. Or workers may retaliate against their employer if they feel that their wages are unfair. The standards for “fairness” would be set by prevailing customs.<sup>14</sup> This species of efficiency wage theory is more open to criticism than its profit-maximizing relative, since it is hard to imagine that the situations that it describes could be stable. Since the individuals aren't acting optimally, they create profit-opportunities for anyone who is willing to act optimally. One could draw an analogy between sociological theories of employment and sociological theories of racial discrimination. Neither can show why sub-optimal behavior does not beget the seeds of its own destruction by creating blatant profit opportunities for anyone willing to break with the suboptimizing herd.

### C. The Insider-Outsider Approach

The last major explanation of wage rigidity that we will examine is in many ways a throwback to an older theory of unemployment that blamed current employees' use of violence and sabotage to deter potential competition from the unemployed. Mises, clearly sympathetic to this theory, writes:

The labor unions are practically free to prevent by force anybody defying their orders concerning wage rates and other labor conditions. They are free to inflict with impunity bodily evils upon strikebreakers and upon entrepreneurs and mandataries of entrepreneurs who employ strikebreakers.<sup>15</sup>

A updated version of this is known as the “insider-outsider” approach.<sup>16</sup> Here, the insiders are current workers — possibly but not necessarily unionized. The outsiders are unemployed workers who would be willing to do the same job as those currently employed for the same or slightly lower wages. There is thus a clear conflict of interest between these two groups. Earlier theorists such as Mises focused on the use of violence and sabotage to deter “strikebreakers”. But the insider-outsider theorists implicitly note that this is a crude and needlessly bloody method for the insiders to secure their ends. It is also possible for them to refuse to share their firm-specific training and knowledge with new workers — thereby reducing the marginal product of the outsiders below what it otherwise might be. Or, attacking the problem from the other direction, the insiders might be unfriendly toward outsiders or otherwise artificially worsen working conditions, thereby raising outsiders' reservation wages to such a point that they prefer to be idle. The success of these tactics depends strongly upon the employers' imperfect information of the insiders' conduct: else, the employers would probably retaliate.

This theory has some virtues that other explanations lack. Some versions can explain why short-run money illusion may imply significant real effects. If insufficient aggregate demands leads the pool of outsiders to swell, the insiders' exploitation of their position can explain why wage rates do not quickly adjust to solve the problem. Conversely, it explains why an increase in aggregate demand could solve the problem by “transforming” outsiders into insiders — at least

in Lindbeck and Snower's model where an outsider only needs one period to graduate into an insider.

Still, aggregate demand management seems like a backwards way to solve or at least substantially mitigate the insider-outsider problem. The individual firms might themselves subdue the problem by adopting a seniority-based pay scale, such as the one described in Salop and Salop's "Self-Selection and Turnover in the Labor Market".<sup>17</sup> In the Salops' article, firms solve the problem of variable employee tenure by setting a pay scale dependent upon seniority to discourage turnover. Employers with an insider-outsider problem might set such a pay scale so that insiders feel less threatened by outsiders who have newly joined the firms — since they would no longer be in such direct competition with one another.

Second, rather than taking positive action to mitigate the insider-outsider problem via demand-management or industrial policies, the government could just take the negative step of repealing laws that promote the market power of the insiders. What is needed here is not a draconian police-state crackdown on labor unions, but a return to unabridged legal freedom of contract in the labor market for both employers and employees. While this would not solve the insider-outsider problem entirely, it would probably get rid of its extreme manifestations.

#### THE ARGUMENT AGAINST ACTIVE POLICY FROM UNCERTAINTY AND LAGS

Let us assume that Keynesian theory is perfectly correct. At first it would seem that Keynesian practice would follow immediately. The government should use its monetary and fiscal policies to insure the "full-employment" quantity of aggregate demand, expanding if there is a short-fall, contracting if there an excess. And of course, since the private sector is free to alter its spending patterns at any moment, the government needs the flexibility to counterbalance any disturbance. Hence, the monetary and fiscal authorities should have free reign so that nothing prevents them from correcting the defects that they alone have the ability and will to fix. But a second look here reveals that Keynesian policies do not necessarily follow even if Keynesian theory were conclusively proved. They must also demonstrate a second series of propositions about the ability and willingness of the government to act as the theory prescribes.

Critics of Keynesianism note this and react appropriately. They have challenged the ability of monetary (and fiscal) authorities to actually know when and how much they should adjust aggregate demand. In fact, one could doubt that the government will get the direction correct. On top of this, other critics question the willingness of the government to behave as the Keynesian theory prescribes. Unless we assume that government officials, unlike other human beings, joyfully serve their fellow men and never take advantage of their position, we face a clear agent-principal problem if authorities hold wide powers unchecked by clear and binding rules. So even if the "first-best" situation without agent-principal difficulties set no prior restraints on the government, it is futile to act as if such a state of affairs is really possible. Let us begin with the argument that the government discretion is harmful because they do not really know when to do what. Milton Friedman is the most famous and persuasive critic of Keynesianism on these grounds. He has two main arguments: first, that there are

"long and variable lags" between the identification of a problem and the effects of the designed remedy; second, that activist policy often itself becomes a source of instability since policy itself becomes a variable that the market must guess at.

In his classic *A Program for Monetary Stability*, Friedman summarized his empirical findings on long and variable lags:

on the average of 18 cycles, peaks in the rate of change in the stock of money tend to precede peaks in general business by about 16 months and troughs in the rate of change in the stock of money to precede troughs in general business by about 12 months ... For individual cycles, the recorded lead has varied between 6 and 29 months at peaks and between 4 and 22 months at troughs.<sup>18</sup>

If this were the case, it is difficult to see how any policy maker could know which direction to adjust his policy, much less the precise magnitude needed. Due to long lags that preclude accurate forecasting, he cannot know what the state of the economy will be when his policy takes effect. And due to variable lags, even if he knew all future states of the economy (in the absence of his adjustments, that is) he could not know which future state of the economy he should design his policies to correct.

Many Keynesians, Friedman notes, advocate "leaning against the wind". By this they mean, in some sense, that the monetary (and fiscal) authorities should try to balance out the private sector's excesses rather than passively hope that it adjusts on its own. Friedman tests the Fed's success by checking whether the rate of money growth has truly been lower during expansions and higher during contractions. He admits that this method of grading the Fed's performance is open to criticism, but decides to go ahead and see what turns up. He finds that Fed has — for the periods surveyed — been unsuccessful. "By this criterion", he explains,

for eight peacetime reference cycles from March 1919 to April 1958 ... actual policy was in the 'right' direction in 155 months, in the 'wrong' direction in 226 months; so actual policy was 'better' than the [constant 4% rate of money growth] rule in 41% of the months.

Nor is the objection that the pre-Keynesian era biased his study a good one, since,

For the period after World War II alone, the results were only slightly more favorable to actual policy according to this criterion: policy was in the 'right' direction in 71 months, in the 'wrong' direction in 79 months, so actual policy was better than the rule in 47% of the months.<sup>19</sup>

But that is not all, Friedman quickly adds. Even if the Fed had a batting average of 50-50, it would not show itself to be just as good as a constant growth rule. There would be a tie in the contest to preserve monetary equilibrium. But the variance of the discretionary policies would inject instability and uncertainty into the market, whereas the rule, being changeless, would never be an independent worry to market participants. Friedman concludes that any alternative to his growth rule must succeed far more than 50% of the time to warrant serious consideration.

One of the best ways to parry a metaphor is with another metaphor. Keynesians have a host of metaphors in their rhetorical arsenal; one frequently voiced is that a wise government should “lean against the wind” when choosing policy. Friedman counters:

We seldom know which way the economic wind is blowing until several months after the event, yet to be effective, we need to know which way the wind is going to be blowing when the measures we take now will be effective, itself a variable date that may be a half year or a year or two from now. Leaning today against next year’s wind is hardly an easy task in the present state of meteorology.<sup>20</sup>

Friedman’s remarks, as even his strong critics admit, are mighty and strike at the heart of any activist “stabilization” policy. By meeting Keynesians on their own theoretical turf and scrutinizing their practice, Friedman manages to produce objections that both Keynesians and non-Keynesians must take seriously.

### **THE ARGUMENT AGAINST ACTIVISM FROM CONFLICT OF INTEREST**

Early Keynesians focused more on fiscal policy than monetary policy. Specifically, they attacked the so-called “responsible” annual balanced budget. “What’s so important about the year?” they asked. Why not balance the budget over the cycle, with surpluses in boom years and deficits in bad years?

One could apply the same logic to Keynesian monetary policy. Why not adjust the position of the money supply, increasing it during hard times and decreasing it during booms? There is nothing in the insufficient aggregate demand interpretation of unemployment to suggest money should have a positive rate of change. Strangely, Keynesians leap from aggregate supply and demand curves that relate output and the position of prices to output and the rate of change of prices.

Despite this, under Keynesian management there has been some tendency toward systematic budget deficits and a strong tendency toward continuous increase in the money supply. This is true of many countries, but I will limit these brief comments to America. First, during the post-Keynesian era, the public debt in America has stayed positive and at a high level compared to pre-Keynesian peacetime years.<sup>21</sup> Moreover, there have been high deficits during boom years with continuous deficits since 1970. Second, the money supply has increased continuously since 1940 — though inflation rates have, of course, varied, drifting upwards until the early 80’s, dropping sharply, and then slowly climbing again. All this is old hat. Sophisticated Keynesianism can easily explain these facts. Why bother to bring it up? Many of the peacetime deficits occurred after fiscal policy was no longer used for short-term stabilization. And of course, when people expect positive inflation, it is movements in the rate of change of prices, not the position of prices, that matter.

The reason to bring this up is: according to Keynesian theory — even state-of-the-art Keynesianism — there is no reason why the budget would not be balanced over the cycle, and why there should be persistent inflation. But Keynesian practice has never achieved these goals, nor even loudly called for aiming at them. Some critics of Keynesianism

solve this paradox by pointing an accusing finger at the free scope that Keynesian theory grants to policymakers, unrestrained by strict and objective rules. James Buchanan and Richard Wagner, in their *Democracy in Deficit*, give a concise statement of this public choice critique of Keynesianism. Active policy gives wide powers to monetary and fiscal authorities, limited only by their ability to show that, in some way, their methods are consonant with their overall goal. But authorities can act in a way which, though not blatantly opposed to their announced purpose, really aims at some other end — an end that the voting public would not endorse if it understood the situation. In short, if we assume that the government is properly a servant of the public’s wishes, active policy creates a principal-agent problem. As Buchanan and Wagner put it,

The economy is not controlled by the sages, but by politicians engaged in a controlling competition for office ... Political decisions in the United States are made by elected politicians, who respond to the desires of voters and the ensconced bureaucracy.<sup>21</sup>

Buchanan and Wagner think that an overlooked aspect of the Keynesian revolution was its destruction of the implicit “fiscal constitution” in America. Classical public finance theory endorsed a balanced budget during peacetime. This set firm and clear limits upon government spending. Why are limits beyond simple voting necessary? The classical reason pointed to the public good characteristics of fiscal restraint. No one wants their programs cut, because the costs come out of general tax revenues rather than the pockets of the direct beneficiaries. And in the case of deficit finance — which involves intertemporal substitution of tax payments — the consumers of the government goods and services may never be taxed for them, and the people who will be taxed for them may never consume them.

But why is the principal-agent problem too severe to solve with voting? Won’t political competition work to deliver what the voters desire? Buchanan and Wagner don’t think so. There are serious differences between competition in markets and competition in politics. Market competition is continuous, while political competition is intermittent. Market competition allows the simultaneous survival of many competitors, while political competition is typically an all-or-nothing affair. On the market the consumer usually knows the attributes of the good in advance, and may have quality guarantees, while the “political consumer” votes for a good with indeterminate attributes. He receives no actionable assurances. (Imagine a “truth-in-advertising” law for elections!) Last, market transactions require unanimous consent, while political ones merely need a majority.<sup>23</sup> Each of these facts makes opportunistic behavior less costly to authorities. Keynesians have on occasion scoffed at the alleged “rationality” of market participants. Buchanan and Wagner are analogously skeptical of the rationality of political participants. Voters do not merely make errors; they suffer from “illusion”, that is, they have systematic misconceptions. The government that they live under can take advantage of this ignorance. Buchanan and Wagner explain that this is hardly beyond our common experience:

complex and indirect payment structures create a fiscal illusion that will systematically produce higher levels of public outlay than those that would be observed under single-payments structures. Budgets will be related directly to the complexity and indirectness of tax

systems. The costs of public services, as generally perceived, will be lower under indirect than under direct taxation, and will be lower under a multiplicity of tax sources than under a system that relies heavily on a single source.<sup>24</sup>

Buchanan and Wagner examine two major sources of fiscal illusion. Rejecting Barro-Ricardo equivalence, they argue that the freedom of the government to run budget deficits artificially makes government goods seem less costly vis-a-vis market goods.

The allocative bias stems from the proposition that, if individuals are allowed to finance publicly provided goods and services through borrowing rather than taxation, they will tend to ‘purchase’ more publicly provided goods and services than standard efficiency criterion would dictate.<sup>25</sup>

Another way of thinking of this is that tax increases reduce consumption of private goods, while budget cuts reduce consumption of public goods. But deficits let individuals have greater current consumption with only a vague possibility that one day they will have to enjoy less as a consequence. Different people may be paying the bills at the later date. In a sense, then, unrestrained deficit finance is a species of negative externality.

Another point implicit in Buchanan and Wagner’s analysis is that each instance of government spending gives highly concentrated benefits to a minority, while the costs are thinly spread out over the tax-payers as a whole. Thus, the lobbyists who work to maintain and expand each program will have a lot at stake, while each member of the public bears only a tiny part of the burden. The norm of the balanced budget was one method of checking this problem. Because Keynesianism gave economic justifications for deficits, this norm is no more. Buchanan and Wagner explain it this way:

The removal of the balanced-budget principle or constitutional rule generated an asymmetry in the conduct of budgetary policy in competitive democracy. Deficits will be created, but to a greater extent than justified by Keynesian principles; surplus will sometimes result, but they will result less frequently than required by the strict Keynesian prescriptions.<sup>26</sup>

The other important hidden tax is the so-called “inflation tax”, which, more than budget deficits, has increased because of the Keynesian revolution. Keynes himself argued that inflation works in a way that “not one man in a million is able to diagnose”. Buchanan and Wagner agree. To analyze inflation as a species of tax requires a degree of economic literacy that only a small minority of voters have. When governments use inflationary finance, the government receives the benefits of seigniorage, lower real interest rates, and real debt erosion, but businesses and unions take the blame.

As it appears to them [the voters], their real income declines not because the government collects more real taxes but because private firms charge higher prices for their products.<sup>27</sup>

Unlike a true tax, the inflation “tax” is not likely to deter the demand for public goods, since most people do not perceive it as the price paid for government services. On top of this, since stronger government is the usual answer to perceived

private sector failures, inflation may have the additional bonus — from the government’s viewpoint — of making citizens more eager to vote for its services, more willing to smile upon its growth. If one is not yet convinced, Buchanan and Wagner have a clinching argument:

If the effects of money issue, in terms of behavioral reactions, should be, in fact, equivalent to those of a tax, there would seem to be no point in all such activities of politicians.<sup>28</sup>

Hence, the solution public choice theorists offer to the inconsistency between Keynesian theory and practice is: Monetary and fiscal authorities — the agents — take advantage of the imperfect information of the voting public — the principals — to have higher deficits and money creation than is necessary for full employment. If authorities strove unswervingly to fulfill the public good, then their free reign might be best. But in the real world such persons are few and difficult to identify. Given this, the only realistic way to solve this problem is to whittle down the sphere of independent decision-making the government holds by binding it with strict and objective rules.

Buchanan and Wagner’s derive two proposals from this principle. The first is to constitutionally bind the government to annually balance the budget. Deficits would imply proportional across-the-board cuts; surpluses would retire the national debt. The balanced-budget rule could be suspended during time of emergency with a two-thirds vote from both houses of Congress. Second, they would adopt Friedman’s constant growth rule for the money supply.<sup>29</sup>

Public choice theory, as we have noted, is like Keynesianism in one respect: Both believe that individuals are not perfectly rational Mr Spock-type creatures. They can make systematic errors. But they diverge in their analysis of which sphere of economic life systematic errors usually occur. Keynesians talk about the money illusion of market participants and the animal spirits of investors. Public choicers, in contrast, see most of the error in the political sphere, and point to fiscal illusion and the public good aspects of democracy. In a like vein, some Keynesians believe that market imperfections explain macroeconomic problems. Public choicers point to the much more extreme cases of political imperfections: the intermittent character of political competition, the all-or-nothing victories that resolve political conflicts, the lack of guarantees, the principal-agent problem, and the substitution of majority rule for unanimous consent.

One flaw that I see in public choice theory is that it does not go far enough. The analogy between voters and consumers is very weak. Unlike consumption, which benefits the individual directly, voting is a pure public good. The intelligent citizen gets no benefit for his investment in wise voting. The foolish voter pays nothing for his folly. And the voting act itself involves positive costs of time and effort.

Empirical studies of actual voter behavior by political scientists show that voter behavior is virtually the paradigm case of irrational action. Dye and Zeigler, in *The Irony of Democracy*, define the following necessary conditions for rational voting:

- (1) competing candidates would offer clear policy alternatives;
- (2) voters would be concerned with policy questions;
- (3) election results would clarify majority preferences on these questions;
- (4) elected officials

would be bound by the positions they assume during their campaigns.<sup>30</sup>

From detailed research, they find that none of these hold for the mass of voters; indeed, “large numbers of the electorate are politically uninformed and inarticulate”.<sup>31</sup> Another interesting area for public choice theorists to investigate would be the effect of government “advertising” on the voting public. Liberals such as John Kenneth Galbraith inveigh against the evils of private advertising. But surely this cannot compare to the powers of persuasion that the government possesses with its virtual monopoly on education and its regulation of television and radio.

James Buchanan, Richard Wagner, and their fellow public choice theorists have made an important contribution to the critique of the practical aspects Keynesianism — to the analysis of what they call “institutions”. Interdisciplinary cooperation with empirical political science would, I think, improve the depth and realism of their research.

### **FREE BANKING’S ATTACK ON CENTRAL BANKING**

Keynesian theory states that shifts in aggregate demand cause real economic fluctuations. Keynesians infer that the government should counterbalance random variations with contracyclical policy. At first, this inference seems obvious. But it is not. Another premise must be added to this argument to draw this conclusion: The market cannot provide this valuable service for itself. Put in the economist’s terms, it must be shown that proper adjustment of aggregate demand is a public good. If this premise were wrong, if the market could supply this service, the case for government macromanagement would be sharply hurt.

Recently, some economists pointed out these facts, and argued that the market could indeed execute these functions. To be specific, they envisage a system in which the banks become the private suppliers of this so-called “public good”. For this system to work, they believe that many regulations currently imposed upon banks must be eliminated. Hence, the system they favor is called “free banking” and its advocates may be called “free bankers”.

We shall, first, describe exactly what “free banking” is, which regulations — at a minimum — must be repealed for a system to count as “free”. Then, we will explain how free banking would replace government management of the macroeconomy, and show how free banking solves or at least substantially mitigates many of the problems government demand management faces. Last, we shall discuss some of the important objections to free banking, especially the charge that it would inadequately protect the public against bank failures.

Here are the crucial ways that free banking differs from current banking. (1) There would be no central bank with a monopoly of note issue or ability to increase the supply of base money. (2) Banks would have no legal reserve requirements. (3) Banks would be free to issue either deposits or banknotes. Banknotes would take the place of currency as it now exists. But, unlike under central banking, banknotes would not be base money. Instead, they would be “inside money” just as fully as deposits. For base money, there are several possibilities — the only necessity is that the base money be commonly accepted as valuable in itself. The most plausible options are either gold or a frozen stock of

fiat dollars. The most novel feature of this, of course, is that currency would be privately issued. This is not, however, as strange as it sounds. It has existed historically in most of the world. There is no reason to think that a system of private issue of currency would be anarchic. Economically speaking, notes would be no different than travellers’ checks. They would be a claim upon a bank that is not contingent upon the reliability of the person using it. In other words, banknotes are one step more marketable than personal checks, since checks require that a seller trust both the bearer and the bank, while the acceptability of notes depends solely on the soundness of the bank issuing them.

Free bankers argue that freely fluctuating reserve ratios would solve the problem of change in the demand to hold money. To help our understanding, let us examine how reserve ratios would be set when there are no legal requirements. Once we understand this, we will see how changes in demand to hold affect the optimal reserve ratio.

The necessary reserves for a bank — free or not — can be conceptually divided into two parts. The first part is its expected net reserves — the amount needed to cover itself against expected net clearings with other banks. The second is its precautionary reserves — the amount needed to cover itself against random fluctuations in net clearings. Banks will hold the precautionary reserves because they do not know their actual net clearings with certainty. They therefore create a protective buffer against illiquidity.

It is clear that, in the long run, every bank’s expected net clearings must be zero. As Selgin explains,

A bank cannot continue to suffer a positive average net reserve demand without eventually disappearing, and it cannot have a continuously negative average net reserve demand unless it fails to exploit fully the demand to hold its liabilities and hence its lending power.<sup>32</sup>

Given this, it seems at first that, without legal reserve requirements, any ratio would be stable.

This impression is incorrect, because it neglects the fact that precautionary reserves must always remain positive, even in the long run. The variance of net clearings makes this a simple rule of prudence. Given an expected gross level of clearings, banks can estimate the expected deviation of clearings from zero and hold precautionary reserves accordingly. In the long run, then, since banks expect zero net clearings, they set their total reserves equal to their desired precautionary reserves — and it is this that determines their typical reserve ratio.

If we accept this, it is fairly easy to see how the banking system would respond to either an increase or decrease in the total demand to hold money. Selgin explains that,

Since the precautionary reserves are held against deviations of average net demand from its mean or expected value, it follows that precautionary reserve demand rises by the same factor as the variance of net clearings. Since gross banking clearings increase whenever there is an uncompensated, general decline in the demand for inside money ... and gross clearings fall when there is an uncompensated, general increase in the demand for inside money, it follows that bank reserve needs are affected by changes in the demand

for inside money even when these changes affect all banks simultaneously and uniformly.<sup>33</sup>

To illustrate this, imagine a case where banks initially have reserve ratios of 2%. Then, the total demand to hold real balances doubles uniformly. All banks find that no one's expected net clearings change. However, their gross clearings halve, implying that they need only half the precautionary reserves that they did before. It is therefore safe for all banks to simultaneously expand their notes and deposits until the previous ratio of gross clearings to reserves returns. We reach equilibrium when deposits and notes double, and the reserve ratio falls to 1%. Conversely, imagine that demand to hold halved uniformly. Once again, no one's expected net clearings changes. But their gross clearings double, implying that banks need twice the precautionary reserves they did earlier. Each bank, to protect itself, must contract its notes and deposits until they return to the previous ratio of gross clearings to reserves. This leaves the reserve ratio at 4%.<sup>34</sup>

A second, less serious problem that any monetary system must face is a change in the currency-deposit ratio. Under a system of monopolized note-issue, where currency is also base money, this can involve serious problems — as economic historians such as Friedman and Schwartz note in their *Monetary History of the United States*. The reason is this: if the central bank fully accommodates a temporary (for example, seasonal) change in the currency-deposit ratio, they create a second problem. Once the public re-asserts its normally preferred mix of currency and deposits by depositing their excess currency, the base money in the banking system will expand, increasing the money supply by a multiplied amount. If the central bank takes the opposite path and refuses to accommodate, the banks may face a serious liquidity crisis. This is not because of any aggregate change, but merely a relative shift in the public's preferences. But the real consequences may be severe — as numerous nineteenth and early twentieth century panics during crop-moving season (when the public required more currency and less deposits) illustrate. Free banking's solution to this problem is so simple it is almost stunning. Under free banking, currency is not base money. It is just as easy for a bank with full freedom of note issue to respond to a change in its clients' desired ratio of currency to deposits as it is to respond to a change in customers' desired ratio of yellow checks to white checks. The bank would be decreasing its deposit liabilities by the same amount that it increases its banknote liabilities. The limit on overexpansion of either notes or deposits — as always under free banking — does not come from legislative restrictions, but from loss of base money to other banks if one overexpands.

Selgin notes that central banking is a species of central planning; in consequence it suffers from a severe knowledge problem. The problem of central planning is that, when prices are not determined by market forces but are set by the state, there is no automatic way to correct for shortages and surpluses. Compare this to the market, where prices can freely adjust as frequently as demand or supply conditions change. Similarly, when the government is the sole supplier of a good, there is no danger that competitors will take advantage of its incompetence. Even if we assume that the central planner is benevolent and wise, it cannot know that no one could do the job better if it is illegal even to try. (Why a benevolent dictator would want to ban competition is a mystery to me.)

Can we apply this generalization to government versus market management of money, to central banking and free banking? Selgin argues that we can. The job of money management is to keep the supply of money equal to the demand for it, so that there is neither inflation nor deflation and demand fluctuations do not affect real variables. If a free bank is doing its job, it tries to avoid both over- or under-expanding its liabilities. If it over-expands, it suffers a loss of base money to other banks. If it under-expands, it loses out on the interest that it could have earned by loaning out more. A bank can see both the direction and approximate magnitude of its errors by simply checking its net clearings. This is very similar to any other market; suppliers have an economic incentive to charge neither too much nor too little, and can swiftly discover their miscalculations by checking for shortages or surpluses at a given price.

Since a central bank manages the money supply by adjusting the quantity of base money, it cannot check its performance by examining the direction and magnitude of its net clearings. This, Selgin explains, is why central banks need monetary guidelines in the first place.

When the currency supply is monopolized, as it is under central banking, the clearing mechanism ceases to be an effective guide to changing the money supply in accordance with consumer preferences. Creation of excessive currency and deposit credits by a central bank will not cause a short-run increase in its liquidity costs. This means that other knowledge surrogates (including both means for informing money-supply decisions and means for their timely ex post evaluation) must be found to replace surrogate knowledge naturally present under free banking. That is why there is need for 'monetary policy' and money-supply 'guidelines' under centralized issue.<sup>35</sup>

Just as the central planner must make Five Year Plans after it short-circuits the market's spontaneous coordination through the price system, the central banker must determine Monetary Policies because it short-circuits the banking system's spontaneous satisfaction of changes in money demand through the clearing mechanism.

Economists know that bureaucratic decisions under central planning are both slow and inaccurate. There are two reasons: imperfect information and lack of incentives. Steven Horwitz, an economist friendly to free banking, describes the information problem aptly:

... the goal of a central bank is not just to know what that money supply is but what it ought to be ... Rather than having adverse clearings determine optimal money supply decisions in accord with the wants of the public, central bankers must rely on statistical devices for estimating the course of money demand.<sup>36</sup>

These statistical devices, like other statistics used by central planners, are often inaccurate initially and take so much time to gather that they are outmoded before they can be used as a guide to action.

Selgin notes four popular monetary guidelines: price index stabilization, interest rate stabilization, adjustment to achieve full employment, and constant money growth.<sup>37</sup> Each of these has been persuasively criticized, one is "too inflationary", another "ties our hands" and so on. None is perfect. But so long as we must choose between them it is foolish to say, "A plague on all their houses". We must weigh the pros

and cons and choose the least among evils. An important point made by free bankers is that there is another, more radical option: the abolition of any centralized monetary policy in favor of market supply. “A plague on all their houses” may turn out to be wiser than it seems.

Earlier in this paper, we discussed two criticisms levelled against Keynesian practice as opposed to Keynesian theory. There was Friedman’s argument from long and variable lags, and Buchanan and Wagner’s argument from conflict of interest. Does free banking do anything to help these problems?

Free banking does not completely solve Friedman’s problem. But it does help. The inside lag for free banking would almost certainly be less than a central bank’s, because free banks would be managed by entrepreneurs who respond to current market signals rather than bureaucrats who respond to after-the-fact statistical aggregates. The outside lag would also be shorter because free banks would only adjust the supply of inside money, of notes and deposits. Compare this to a central bank, which injects a given quantity of base money and then waits for the money multiplier to do its work. A central bank cannot safely compensate a change in demand dollar-for-dollar with base money, because the base money ultimately causes a multiplied expansion of the total money supply. It is obvious that public choicers must say that free banking lacks the vulnerabilities inherent in government demand management. Free banks would not be run by politicians, but businessmen. They would be checked, like all businesses on the free market, by competitors. Efficient execution of their duties would be a private good, driven by profit-and-loss. Of course, doing a bad job would not be illegal, but the costs would be borne primarily by the capitalists. Political demand management, as Buchanan and Wagner observed, is a public good. The public bears the brunt of the burden if the authorities mess up. On top of this, the authorities can benefit themselves by deliberately “failing” (from the public’s point of view), due to the principal-agent problem. No such problem exists under free banking, since the interests of the principal are in harmony with those of the agent.

Banks can fail, and one of the buffers that prevents failure is a bank’s precautionary reserves. Some critics might reasonably object that it is too dangerous to permit banks to select their own margin of error when a mistake directly harms its customers and indirectly injures everyone who does business with these customers. Especially when the government insures deposits it seems reckless to let each bank select its own reserve ratio.

Free bankers are quite aware of this objection, and can, I think, marshal both theory and history to their defense. From the outset, one may point out that bank failures are a public bad only in the loosest sense. If a bank fails, its customers may suffer. They therefore have a direct incentive to protect themselves by selecting only sound and prudent banks. Similarly, those who trade with the customers of a bank that fails may lose out. But once again, this gives them an incentive to only accept the notes and checks of solid banks — just as merchants do today when they guard against bogus checks.

Banks depend upon their reputation for prudence just to stay afloat. A bank that helps its customers simultaneously helps itself. Economic theory thus predicts that banks would strive to bolster the security that their customers enjoy. His-

tory corroborates this. Countries without branch banking laws, such as Canada, have stoutly resisted bank failures since it is easier to pool risk. There were no bank failures in Canada during the early years Great Depression — while thousands of American banks collapsed.<sup>38</sup> In the Scottish and Canadian banking systems (once again unimpeded by branch banking laws), insolvent banks often merged with rivals who would assume the liabilities of the failed bank in full. In exchange, of course, they got their former competitor’s share of the market. Some Scottish banks announced their unlimited liability. Others wrote “option clauses” on their notes, giving the bank the legal right to suspend payment for up to six months. If the bank exercised this option, it paid interest in compensation.

The Scottish and Canadian systems were systems of the past. If free banking were reborn in modern times, there are other possible ways to supply banking security. Private, competitively issued insurance is not beyond the bounds of reason. Selgin suggests that current deposit insurance, which charges a flat-rate, subsidizes risk. He plausibly argues that private insurance would set premiums according to portfolio riskiness. Private insurers would have an incentive to monitor their customers that government insurers lack, as the recent Savings and Loan bailout brightly illustrates. Competing banks could pool risk through a system of cross-guarantees.<sup>39</sup> There is, in sum, a long list of feasible ways for the market to provide customers with the safety that they desire; this list would surely lengthen if businessmen found that whoever tried better ways earned handsome profits.

There is no need to go overboard and claim that free banking is a Utopia. Banks could err in their estimates of money demand, or they might be reckless. They might try new innovations only to find that the old ways were best. Yet these criticisms hold true of government money supply management too. If there is a social problem that can be met by the market, if there is no strong argument that the government would be better and wiser, shouldn’t the burden of proof rest upon those who favor intervention and state control? The theory of free banking argues that money supply management is not a public good, and that free banks impose no obvious negative externalities upon anyone. While it differs in form, *laissez-faire* in the supply of money is in principle just as worthy of consideration as *laissez-faire* in the supply of comic books, bedspreads, and shaving cream.

## CONCLUSION, OR FINDING THE FOREST AMONG THE TREES

The content and the conclusions of economics are open to debate, but one fact is clear: in itself, economics gives us no norms, no vision of what we should do. “Policy implications”, a phrase that economists never seem to tire of repeating, are not, strictly speaking, implications at all. They only become implications when we wed correct economics to a body of moral principles. Is economics then wholly detached from the questions that really matter? Not at all. Economics provides the political philosopher with vital tools. It clarifies our thinking, taking a solid core of common sense and refining it by purging our prejudices and organizing our concepts consistently. From our everyday familiarity with the practice of exchange, for example, we can deduce that voluntary exchange as such benefits all participants. Economics also tells us what types of societies are possible, and which are merely daydreams or pure contradiction. Thus, only after economic theory showed that

prices can peacefully coordinate the disparate actions of any number of individuals could the idea of a self-governing market order become a reasonable alternative to absolute monarchy and mercantilism.

Milton Friedman has written,

I venture the judgment, however, that currently in the Western world, and especially in the United States, differences about economic policy among disinterested citizens derive predominantly from different predictions about the economic consequences of taking action — differences that in principle can be eliminated by the progress of positive economics — rather than from fundamental differences in basic values.<sup>39</sup>

I must take issue with this statement; I think that it is usually wrong, especially about the debate between Keynesianism and its critics on which this paper focuses.

Keynesianism, while the most influential economic system of the twentieth century, did not reverse the course of history. It was rather a response to a prior change in the philosophical climate, away from the vision of society as a voluntary association of rational individuals, each pursuing his or her self-interest, and toward the view of society as an organic unit, with the mass of men as the obedient body, and the government — guided by the intellectuals — as the brain. Most texts argue that Keynesianism was the natural response of economists to the Great Depression, which seemed to flatly contradict classical economic theories. But I cannot see why it should be any more “natural”, in an economy with both market and government, to attribute the failure to the market and call for the government to rectify it. It seems at least as natural for economists during the Great Depression to attribute the problem to the government and advocate market solutions, for example, free banking and repeal of laws retarding wage adjustments.<sup>41</sup> The proper explanation for economists’ almost universal turn against the market in favor of government management is that they imbibed the philosophy of their time and translated it into their field of speciality. This is not to say that Keynesians had no convincing arguments or even that most of them were intellectually dishonest. But I do think that the Keynesian “revolutionaries” used a double standard when comparing markets and government. I think further that the driving force behind this double standard was the dominant authoritarian political philosophy, not a sober comparison of these contrary ways to organize society.

I see most of the rejoinders to Keynesianism described in this paper as belated efforts to make a sober comparison between markets and government. The quality of these arguments, I admit, varies widely. But taken together, I think that they should raise serious doubts about the alleged necessity for the government to correct the macro failures of the market. Determined moral opponents of capitalism will likely aim to make government management work more efficiently rather than abandon it. This approach seems wrong to me. Do not many of the criticisms show that the inadequacies of government management are not mere coincidence, but something inherent in the very existence of state control as such? Only if the debaters recognize this can the crucial controversy, the dispute over the nature of the just society, be resolved.

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