

## The Consequences of Keynes

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This article discusses the consequences of John Maynard Keynes for the science of political economy: the fields of economics, economic policy, and politics. It argues that the consequences of Keynes in all three fields were negative and resulted in a significant retrogression. For economics, a macroeconomic theory of an unstable capitalist economy supplanted the theory of the market process that concentrated on the individual actions of entrepreneurs and their effects on relative prices and production. For economic policy, activist tinkering on behalf of policy advisors replaced the theory of limited and hands-off governments. For politics, unrestricted politicians and continual deficits and inflation replaced restrained politicians who adhered to balanced budgets and sound money.

### Introduction

John Maynard Keynes (1883–1946) was one of the most influential thinkers in the twentieth century. In the 1930s and 1940s, Keynes and his *The General Theory of Employment, Interest, and Money* revolutionized the science of political economy.<sup>1</sup> Economic theory, policy, and politics, the hallmarks of political economy, would never be the same given the dominance of Keynes in the 1930s.<sup>2</sup> While many thought that Keynes’s consequences and his “New Economics” changed political economy for the better, in fact the outcomes were entirely negative and are ultimately responsible for many of the problems society faces today.

## Economic Theory

The consequence of Keynes for economic theory was a loss of attention to the fact that individual decision-making guided by the price system results in the coordination of economic activities in a temporal structure of production in a way that an aggregate-driven and government-managed macroeconomy cannot. The consequence of Keynes for economic policy was an elimination of institutional checks and balances and a reversal of the time-tested wisdom of the classical political economists concerning sound money and fiscal responsibility, replacing it with large budget deficits and countercyclical policy. The consequence of Keynes for politics was an unleashing of the natural proclivities of politicians to spend without regard to revenue and to perpetually increase the budget deficit without any obvious stopping point in place to curb this behavior.

The Keynesian revolution and its ensuing conquest of the economics profession was as remarkable as it was ruthless. Never before or since had one man and his book so quickly changed economics, and younger economists such as Paul Samuelson were mesmerized by its teachings.<sup>3</sup> Keynesian economics replaced the prior theory of a self-correcting market mechanism, held by other economists but most consistently championed by the Austrian economists Ludwig von Mises, F. A. Hayek, and their followers, with a theory that argued capitalist economies were inherently defective and required the steady hand of government commandeering. The theory of the market process and its emphasis on the individual actions of the appraising capitalist-entrepreneurs on relative prices and production was replaced with broad macroeconomic aggregates that emphasized the importance of autonomous mechanistic spending. The Hayekian triangle that described the temporal relationship between time preferences, the interest rate, and the heterogeneous structure of capital goods, was replaced with the circular flow national income and expenditure model, best embodied in the equation all students of economics have to repeatedly memorize:  $Y = C + I + G$ , or that GDP (Y) is a function of consumption (C), investment (I), and government spending (G).<sup>4</sup> Capital theory and the tradeoff between consumption and investment were discarded along with the coordinating role of the interest rate reflected in the loanable funds market. Savings was downplayed and consumer spending was instead emphasized due to the “Paradox of Thrift.”<sup>5</sup>

Keynes was able to completely transform economics partly because he lumped together virtually all his predecessors as “Classicals” and claimed to reinvent economics. This, reinforced with a thick technical jargon of mathematical equations, allowed *The General Theory* to look as if it were entirely new. This of course masked what he actually contributed, which was mainly the long-run underem-

ployment equilibrium (i.e., the thesis that involuntary unemployment could exist in a market economy even with flexible wage rates) and his interest-determining theory of liquidity preference and the liquidity trap. Both dealt irreparable harm to the older view of the market, in particular the latter. The liquidity trap, in which an increase in the money supply would not reduce interest rates sufficiently to stimulate investment, and the subsequent investment trap, in which even a fall in the interest rate would not stimulate investment, rendered ineffective not only expansionary monetary policy but also the self-correcting powers of markets. For Keynes, markets alone cannot get an economy out of a depression if investors are inclined to simply hoard their money.<sup>6</sup> In such a dismal world, only expansionary fiscal policy can ensure full employment. With Keynes, fiscal spending dethroned money and the market mechanism.<sup>7</sup> The loss of the latter was more enduring, because—while later generations of Keynesian economists eventually reincorporated countercyclical monetary policy—the time-honored maxim of letting the market reallocate resources on its own during a depression was lost.

## Economic Policy

The Keynesian overthrow of traditional economic theory and the substitution of a working market with a defective market wrought important changes for the policy world as well. Market mechanisms and time-honored *laissez-faire* policies were replaced with the discretionary actions of an all-powerful government, through skillful execution of fiscal or monetary policy. When unemployment is rising and the rate of inflation is slowing down, the government is supposed to utilize expansionary fiscal and monetary policy. When unemployment is low and the rate of inflation is rising, the government is supposed to utilize contractionary fiscal and monetary policy.<sup>8</sup> The market was purportedly shown to be inherently unstable, navigating a course between Scylla and Charybdis—inflation and unemployment—and only the steady hand of government could steer it along the proper course. In charge of the ship were purportedly the enlightened economic policy advisors who, utilizing the Keynesian theoretical and empirical apparatus, could appropriately guide the economy. It is no surprise that Keynesian economics not only conquered the ivory tower of academia but also the policy analysis domain because such economic models provided a lucrative and steady stream of work for economists who were needed to figure out the appropriate policies and their quantitative weights.

One of the unfortunate casualties of fine-tuning was the prior belief that falling prices were good, and a healthy growing economy would experience mild deflation from increases in productivity that did not need hands-on managing. Economic

theory instead replaced it with a strong deflation phobia and set an inflation target. Thus continual increases in the money supply, thereby artificially raising prices and lowering interest rates beyond what is dictated by the natural free market, would engender booms and busts. Attempts to fine-tune the economy would not successfully steer it but instead would crash-land it right into the rocky shore.<sup>9</sup>

One of the most damaging effects of the changes to economics and policy is the self-reinforcing and self-referential nature of the entire Keynesian economic theory and policy practice that makes it almost immune to any criticism due to policy failure. Statistics are collected according to Keynesian needs, which are then used together with Keynesian theory to be implemented by Keynesian policy institutions who then “test” them against Keynesian metrics. This is most easily seen in the national income accounting figures, i.e.,  $Y = C + I + G$ , prominent not only in theory but also in policy. Here, government spending is treated as equivalent to business investment spending. The latter is actually grounded in market prices and the profit-and-loss framework and is determined by what people are actually willing to pay for goods and services. Businesses are productive only to the extent they earn profits and produce the goods and services consumers actually want. The productivity of government spending, on the other hand, is merely gauged by how much government spends, and government spending lacks the crucial profit-and-loss mechanism that steers an effective allocation of economic resources. When the government increases spending, which is recorded as an increase in output, the Keynesian theories are confirmed, when in reality the headline should be that those resources would have gone to other projects that consumers valued more highly as judged by the profit-and-loss mechanism. Resources are thus squandered. If government spending were not included in this accounting, or instead treated as a burden, the outlook for Keynesian fine-tuning would look much grimmer.<sup>10</sup>

Ludwig von Mises expressed this principle best:

[G]overnment does not have the power to encourage one branch of production except by curtailing other branches. It withdraws the factors of production from those branches in which the unhampered market would employ them and directs them into other branches.... What alone counts is the fact that people are forced to forego some satisfactions which they value more highly and are compensated only by satisfactions which they value less. At the bottom of the interventionist argument there is always the idea that the government or the state is an entity outside and above the social process of production, that it owns something which is not derived from taxing its subjects, and that it can spend this mythical something for definite purposes. This is the Santa Claus fable raised by Lord Keynes to the dignity of an economic doctrine and enthusiasti-

cally endorsed by all those who expect personal advantage from government spending. As against these popular fallacies there is need to emphasize the truism that a government can spend or invest only what it takes away from its citizens and that its additional spending and investment curtails the citizens' spending and investment to the full extent of its quantity.<sup>11</sup>

The harm of national income accounting for policymaking is not solely for government spending. In particular, there is also an overemphasis on the importance of consumption spending by not including all of investment spending. For fear of double-counting, only spending on newly produced machines and not spending on newly produced intermediate goods is included. This drastically reduces the size of investment spending and makes it look as if consumption spending drives the economy. This, combined with the Keynesian antisavings mentality, leads crude Keynesians to encourage increased consumer spending and decreased savings to get an economy out of a slump. But in reality, increased consumption spending and decreased savings actually leads to a less capital-intensive economy and stifles the recovery process during a depression.<sup>12</sup>

Keynesian calls for increased consumption spending that actually reduces economic growth, increased fiscal spending that misallocates resources, and expansionary monetary policy that initiates booms and busts. Keynesian policies do not remedy economic disturbances; they are the root cause of those disturbances. Instead, economic progress requires clearly defined and enforced private property, the free fluctuation of prices based on agreed-on contracts between consenting market participants, sound money, fiscal responsibility in the form of limited government spending and balanced budgets, and open domestic and international trade. Property, contract, and consent are the foundational rules for a free and vibrant society. The incentives and the information provided by property, prices, and profit and loss—and *not* fine-tuning—are what actually steer the social system of exchange and production so that individuals are able to realize productive specialization and increased output. In rejecting the time-honored mantras of “classical economics,” Keynes and the Keynesians moved the policy consensus away from this message, created a new vision of the role of the economist in society, and—worst of all—provided the intellectual justification for politicians to fully embrace the “juggling tricks” that Adam Smith had warned was their natural proclivity.

## Politics

With Keynes and the evolution of economics and policy came the most momentous and far-reaching consequence: politicians would now be free to embark on ongoing deficit spending. Even enlightened policymakers would be unable to stop this new dispensation. Adam Smith long ago warned that the natural practice of governments, ancient as well as modern, was to run deficits, accumulate debt, and then debase the currency in order to make pretend payments on that debt. Unless the above principles for economic growth were widely accepted, and institutional restraints limiting fiscal and monetary interventionism put in place, this juggling trick by governments would persist. From Adam Smith to John Maynard Keynes, the consensus view in economics and political economy remained consistent with Smith's dire warning about the deleterious consequences of such juggling by governments and the need to establish a set of institutions that would *prevent* it. Of course, there were always those at the edge of economics who advocated juggling in the form of government spending and especially government manipulation of the currency for short-run gain, but they were appropriately labeled as "cranks" and assigned their place in the "rogues' gallery" of economic thinkers. What Keynes did was legitimize the cranks, explicitly draw from the ideas of the thinkers in the rogues' gallery, and build a case that what was most needed was not restrictions on juggling but *master jugglers*.

This is one of the main reasons for the success of the Keynesian revolution. It broke the shackles of governments and allowed politicians to do what they always wanted. Roosevelt's New Deal and burgeoning budget deficits now had an enlightened economic macrotheory. To quote Rothbard,

[G]overnments as well as the intellectual climate of the 1930s were ripe for such a conversion. Governments are always seeking new sources of revenue and new ways to spend money, often with no little desperation; yet economic science, for over a century, had sourly warned against inflation and deficit spending, even in times of recession. Economists ... were the grouches at the picnic, throwing a damper of gloom over attempts by governments to increase their spending. Now along came Keynes, with his modern "scientific" economics, saying that the old "classical" economists had it all wrong; that, on the contrary, it was government's moral and scientific duty to spend, spend, and spend; to incur deficit upon deficit, in order to save the economy from such vices as thrift and balanced budgets and unfettered capitalism; and to generate recovery from the depression. How welcome Keynesian economics was to the governments of the world!<sup>13</sup>

Recently Luigi Zingales has similarly described why Keynesianism maintains a tight grip on politicians in the modern era:

Keynesianism has conquered the hearts and minds of politicians and ordinary people alike because it provides a theoretical justification for irresponsible behavior. Medical science has established that one or two glasses of wine per day are good for your long-term health, but no doctor would recommend a recovering alcoholic to follow this prescription. Unfortunately, Keynesian economists do exactly this. They tell politicians, who are addicted to spending our money, that government expenditures are good. And they tell consumers, who are affected by severe spending problems, that consuming is good, while saving is bad. In medicine, such behaviour would get you expelled from the medical profession; in economics, it gives you a job in Washington.<sup>14</sup>

But herein lies the biggest practical problem with Keynesian economics: It purports to unleash Leviathan only when it is necessary and to tame it when it is not. But once the monster is unleashed, he cannot be easily recaptured. Despite advocating for master jugglers and enlightened economists who would supposedly be above all temptations and could control the beast, the new system created by Keynes and the Keynesians was thoroughly embedded throughout modern democratic societies. Here, self-interested politicians, armed with this new theoretical justification to enlarge government, would be biased toward budget deficits and inflation and would rarely call for the reverse. This is because budget deficits and inflation seemingly create prosperity while decreases in government spending and tight money apparently cause the opposite. No election-seeking politician would be incentivized to raise taxes, which are always politically unpopular, and when taxes did happen to be raised, they would not go toward reducing the budget deficit but instead allow an increase in government spending. Even the supposedly independent monetary authorities would be biased toward inflation and artificially low interest rates for fear of public outcry or threat of congressional oversight. The long-run effects of Keynesianism would be accelerating inflation and increasing budget deficits and debt, with all of their crippling effects on the economy.<sup>15</sup>

## Conclusion

John Maynard Keynes left his indelible mark on political economy. Economics, economic policy, and politics would never be the same thereafter. While many celebrate the influence of Keynes, a mere few lament it. Yet we are all worse off

because of Keynesian economics. In a talk given on Keynes the man, Rothbard humorously concluded with the following words:

[To] [s]um up Keynes: Arrogant, sadistic, power-besotted bully, deliberate and systemic liar, intellectually irresponsible, an opponent of principle, in favor of short-term hedonism and nihilistic opponent of bourgeois morality in all of its areas, a hater of thrift and savings, someone who wanted to liquidate and exterminate the creditor class, an imperialist, an anti-Semite, and a fascist. Outside of that I guess he was a great guy!<sup>16</sup>

We may similarly sum up the consequences of Keynes's theories on the science of political economy: in economics, a replacement of the theory of the microeconomic market process and institutions that emphasized savings with a macroeconomic view that trumpeted the virtues of increased government spending and consumption through holistic aggregates; in economic policy, a removal of the philosophy of limited *laissez-faire* governments with activist and discretionary fine-tuning; and in politics, the devolution of restrained politicians and bureaucrats into those free to embark on endless deficit spending and money printing. Other than that, the consequences were all good!

## Notes

1. John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York: Macmillan, 1936).
2. It should be noted that the growth of government and the evolution of political economy in the 1930s was not entirely due to the influence of Keynes. For example, the Great Depression, Franklin Roosevelt's New Deal, and the institutionalist economics held by some of its proponents left its indelible mark on political economy by legitimizing big government and policy planners. See Lawrence White, *The Clash of Economic Ideas* (Cambridge: Cambridge University Press, 2012), 99–125. However, Keynesian economics, by providing a new convincing macroeconomic theory of the business cycle that swiftly converted the profession, independently added on to this and accelerated the process for the reasons discussed in this article.
3. See Peter Boettke and Patrick Newman, "The Keynesian Liquidity Trap: An Austrian Critique," in *What's Wrong with Keynesian Economic Theory?* ed. Steven Kates (Cheltenham, UK: Edward Elgar, 2016), 11.
4. For more on the Hayekian triangle, see Roger Garrison, *Time and Money: The Macroeconomics of Capital Structure* (New York: Routledge, 2001). This is in addition to the AD-AS and IS-LM frameworks. That not only later Keynesians but also Keynes himself embraced the IS-LM framework, see Edward Fuller "Garrison



- on Keynes,” *The Quarterly Journal of Austrian Economics* 18, no. 1 (Spring 2015): 3–21.
5. See White, *The Clash of Economic Ideas*, 133–39; Mark Skousen, *The Structure of Production* (1990; repr., New York: New York University Press, 2007), 244–46.
  6. Boettke and Newman, “The Keynesian Liquidity Trap,” 4–5. For a critique of the liquidity preference theory and the liquidity trap from an Austrian perspective, see White, *The Clash of Economic Ideas*, 133–39; Skousen, *The Structure of Production*.
  7. This is not to say that Keynes and the *General Theory* did not think monetary policy was unimportant because when there was no liquidity trap Keynes argued for expansionary monetary policy to get economies out of depressions by lowering real wages and reducing unemployment through monetary illusion on the part of the workers. Later Keynesians in the 1940s and 1950s, by adding the theory of the investment trap, argued that monetary policy and money was not important. Thus Paul Samuelson, one of the most famous hermeticians and popularizers of Keynes’s work, wrote in a 1955 edition of his textbook *Economics*, “Today few economists regard federal reserve monetary policy as a panacea for controlling the business cycle.” See Mark Skousen, *The Making of Modern Economics* (New York: M. E. Sharpe, 2001), 380. Only in the 1960s and 1970s with the advent of Milton Friedman, a monetarist who espoused the technical tools of Keynesianism, did this change.
  8. Given the inclinations of the original Keynesians and the theories of the liquidity trap and investment trap, the initial preference was to use fiscal policy. Only later, especially by the New Keynesians, did monetary policy become the preferred tool.
  9. Murray Rothbard, *Man, Economy, and State, with Power and Market* (1962; repr., Auburn, AL: Ludwig von Mises Institute, 2009), 1023–24. Interestingly enough, Keynes himself actually argued the appropriate policy would aim not for rising prices but for stable prices. While stable prices are not as harmful as rising prices, they still create distortions compared to a deflationary norm. It was only the later Keynesians who, building on his work, argued for a mild inflation target. For more see George Selgin, *Less Than Zero: The Case for a Falling Price Level* (London: Institute for Economic Affairs, 1997); idem, “Hayek versus Keynes on How the Price Level Ought to Behave,” *History of Political Economy* 31, no. 4 (Winter 1999): 699–721.
  10. Thus, despite the apparent myth of “Wartime Prosperity” during World War II, in which massive increases in government expenditure in the form of military buildup got the economy out of the Great Depression, a view still widely held by economists today, a more sober measure would reveal that the economy was unduly suffering from the massive distortion of resources into military boondoggles. For more, see Robert Higgs, “‘Wartime Prosperity’: A Reassessment of the U. S. Economy in the 1940s,” *Journal of Economic History* 52, no. 1 (March 1992): 41–60.

11. Ludwig von Mises, *Human Action* (New Haven, CT: Yale University Press, 1949), 737.
12. Skousen, *The Structure of Production*, 185–92, 325–43.
13. Murray Rothbard, “Keynes, the Man,” in *Dissent on Keynes: A Critical Appraisal of Keynesian Economics*, ed. Mark Skousen (New York: Praeger Publishers, 1992), 184.
14. Luigi Zingales, “Keynesian Principles: The Opposition’s Opening Remarks,” *The Economist* (March 10, 2009).
15. James Buchanan and Richard Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (1977; repr., Indianapolis: Liberty Fund, 2000).
16. Murray Rothbard, “Keynes the Man: Hero or Villain?” April 28–29, 1989, <https://mises.org/library/keynes-man-hero-or-villain>. This statement can be found at 39:25.