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TWO INTERPRETATIONS OF KEYNESIAN ECONOMICS

DR. BURNS ON KEYNESIAN ECONOMICS

Alvin H. Hansen

THE Twenty-Sixth Annual Report of the National Bureau of Economic Research, written by the Bureau's new Director of Research, Dr. Arthur F. Burns, carries the intriging title, *Economic Research and the Keynesian Thinking of Our Times*.[1] In Dr. Burns' own language, the theme of his first report "is to relate the work of the National Bureau to the Keynesian thinking of our times." The "opinion," he says, "is widespread that Keynes has explained what determines the volume of employment," and "this opinion reflects a pleasant but dangerous illusion." [2]

Unhappily the history of economic theory and empirical research suggests that ours is a field of study in which we shall never be able to reach perfectly *definitive* conclusions. As economists, we have to be content with something less than that. There is very much in pages 11–27 which suggests that Dr. Burns believes that once the massive studies of the Bureau are completed this situation will be remedied. Perhaps; but one is entitled to be skeptical. The mere accumulation of "precise and tested knowledge" of a limited set of facts, important as this is, will not provide us with a definitive understanding of economic developments which is no longer subject to doubt by competent economists.

On page 13, for example, Dr. Burns refers to three widely differing hypotheses with respect to the thirties. Now the plain fact is that an enormous amount of research on this period has already been done by economists and research agencies all over the world, private and governmental (including invaluable researches of the National Bureau). These have yielded a vast knowledge of the thirties. Yet interpretations and judgments differ. Dr. Burns, however, roundly alleges that "no one has as yet presented an interpretation of the thirties that weighs carefully and dispassionately the many conflicting pieces of evidence" (p. 13). And the inference plainly is that as soon as this is done there will no longer be room for divergent views, or differences of competent opinions. The evidence to date is against this overly simplified view. Economics is not that kind of subject. We need only call to witness any of the vast researches of the last decade, including the recent important work of Burns and Mitchell on *Measuring Business Cycles*. We shall never reach a point when competent judgment will not widely differ, nor shall we ever be able to achieve a truly "scientific guide to governmental policy" (p. 11). Economics can nevertheless be useful even though it cannot reach that level of perfection.

Competent and honest opinions will differ in the future as in the past. The value of Keynes' work, as of any other contribution to economic knowledge, has to be judged on a less pretentious plane than that of some of the more exact natural sciences. The only realistic question is whether or not Keynes has given a fruitful direction to the study of income determination and employment.

It is not altogether clear from the pamphlet what role Dr. Burns assigns to theory. He says (p. 20) that the studies of the Bureau "abound in subtle theoretical analysis," but on page 21 he scorns "speculative excursions from the dreamland of equilibrium." Yet, apart from the somewhat colorful language used, this phrase

[1] Twenty-Sixth Annual Report of the National Bureau of Economic Research, Inc., New York, 1946.

[2] In this connection, attention may be called to the statement (p. 11) dealing with Keynes' great influence during the past decade, stimulated by the depression and the war experience. "This experience has convinced many that democratic governments can, if they only have the will, readily subdue business depressions." Dr. Burns refers in this connection to the various White Papers (British, Canadian, Australian) announcing the assumption by these governments of responsibility for the maintenance of a high and stable level of employment. I am not certain what impression other readers may have gotten from this section, but to me the inference appears to be that Burns believes that these governments, misled by Keynes, have embarked upon a mistaken policy. A clarification of his position on this issue, in view of what is said in various sections of the pamphlet, would be helpful.

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suggests to me precisely the central concern of theoretical economics, namely analysis of the equilibrium between conflicting forces and tendencies.

Dr. Burns begins with the statement that Keynes and his followers, by and large, "still seek to arrive at economic truth in the manner of Ricardo and his followers" (p. 4). This evidently means by the method of theoretical analysis, i.e., by searching for fruitful general hypotheses whose deductive implications are carefully assessed. Fortunately, this charge is indeed true as far as it goes. It is, however, only fair to add, as Professor Schumpeter has recently pointed out, that Keynes' theoretical work has given a tremendous stimulus to empirical research.[3] No inconsiderable amount of current econometric and statistical studies stems from the Keynesian analysis; and the methodology, and validity, of this empirical research, quite properly, is continuously subjected to vigorous critical analysis. Nevertheless, it is quite true that economists, whether Keynesian or non-Keynesian, do indeed "seek to arrive at economic truth in the manner of Ricardo"; they have, however, at their disposal statistical tools and a wealth of empirical data unavailable to Ricardo and his followers.

In this first section of the pamphlet there is, I feel, a methodological misconception with respect to theoretical analysis; this applies to Ricardian theory no less than to Keynesian theory. The validity and usefulness of the Ricardian analysis does not depend, as Dr. Burns suggests, upon whether per capita income rose or fell in the 19th century (see pamphlet p. 4). Nor would the Keynesian analysis be proven false if during the next fifty years we should experience sustained full employment (p. 8). Indeed Keynesians are perhaps the most optimistic (possibly quite wrongly) with respect to such a possibility. Theoretical analysis is one matter; speculation about the future course of events is quite another. The "correctness and the scientific character" of the Keynesian (and Ricardian) theoretical apparatus has nothing to do with speculations about fifty years hence. Indeed, Dr. Burns himself at one point in effect recognizes this (p. 8, 8th line from bottom). But then why did he write the section dealing with the "fate of the Ricardian system" (p. 5)? Individuals may use wrong data in their analyses; they may misuse theory. If so, that would be a proper subject for criticism. But this would have nothing to do with Keynes' theory of income determination. And even if Keynes himself could be shown (as may well be the case) to apply his theory at times wrongly, that would not invalidate the theory itself.

If the Keynesian tools of analysis stand up as well as the Ricardian (which, while greatly improved are still the *foundation* of all modern price and value theory), they will have a useful future. And, of course, the theory is far from being final, any more than Ricardo's system was final. A distinguished English economist recently said at Harvard that every economist in Britain is now a Keynesian (including Pigou) in the sense that all use the Keynesian terminology and the Keynesian theoretical apparatus. That, of course, does not mean that they are all followers of those economic policies which Keynes espoused during the Great Depression.

The central part of Dr. Burns' critical analysis of Keynes' theory is continued in pages 5–11. The theory, he says, can be simply put without misrepresenting its essence. But he begins straight away with a marked departure from Keynes' terminology. He uses the words "planned"[4] and "intended investment." Keynes, however, uses the words "rate of new investment," "volume of investment," and "current investment" (Chapters 3, 18). This means the actual investment made in the period in question. Consider now Burns' illustrative figures. With an initial income of $16 billion, with new investment of $2 billion, and with a marginal propensity to consume of ½, income would rise to $20 billion. Now in his interpretation of Keynes, on page 9, Dr. Burns first assumes that "intended investment" (whatever that may mean) is $2 billion as indicated in the

[3] See this REVIEW, XXVIII (1946), p. 196. Also in *The New Economics*, the volume on Keynes edited by S. E. Harris, Professor Tinbergen shows that Keynes has given a great stimulus to econometric research.

[4] The Swedish economists have used the concept of "planned investment" but that would be another story. Also Harrod in his *Trade Cycle* uses "intended investment" in a special sense.

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figures cited above. Later, he assumes, (p. 9, lines 13, 14) that the "intended investment" changes. Accordingly, in the period in question it turns out that the actual investment was not $2 billion and therefore, of course, income would not rise to $20 billion as first suggested. "Our data (what data?) therefore do not determine a unique size of national income" (p. 9). This "now you see it, now you don't" business is a very strange affair. The illustration is far from putting forth the Keynesian theory "without misrepresenting its essence" (pamphlet, p. 5).

If by "intended investment" is meant investment plans which are not carried out, such "intended investment" has obviously no relevance for income determination. Investment actually made in fixed capital was presumably "intended", while part of the net investment in inventories may at times be "unintended." In any event, the actual investment in any given period is the relevant factor. This does not mean, however, that I regard investment as an unexplained and unexplainable datum given by some *deus ex machina*. On the contrary, significant analysis can be made of the factors affecting its behavior over time.

If Dr. Burns merely wishes to stress the volatile character of investment outlays, he will find numerous passages in Keynes which discuss this matter with unsurpassed clarity. Keynes is well aware that the "volume of investment is subject to highly complex influences" (*General Theory*, p. 314). Expectations of the future, subject to sudden and violent shifts (Chapters 12, 15, 22) play an important role. But whatever these influences, it is the investment actually made in a given period which is relevant. Dr. Burns' statement in this section (pp. 5-11 of the pamphlet) does not, I believe, accurately take account of Keynes' writings.

As time unfolds from day to day, the rate of investment at any moment is a given amount; and whatever that given amount is, the flow of income is affected by the magnitude of the actual rate of investment. The rate of investment may indeed be constantly fluctuating, rising or falling, or it may run along for a time at a fairly stable level. Any change in the rate of investment is likely to induce, after some time lag, changes in the rate of consumption, the magnitude of such changes depending in large part upon the behavior pattern of the community with respect to the effect on consumption expenditures of changes in income. And various factors, both long-run and short-run, may modify from time to time this relationship. Thus, as the flow of investment unfolds, income rises or falls by a magnified amount according to the actually prevailing marginal propensity to consume.

Consider Dr. Burns' statements (pp. 9-10) concerning the indeterminacy of Keynes' income system. If he believes that the consumption schedule and levels of actual investment must be moved capriciously by the dynamic process of adjustment to the equilibrium level, I am forced to disagree both on the basis of theoretical and statistical studies. If he is saying simply that there are dynamic effects of the approach to equilibrium, he is saying nothing that is not already admirably stated in Keynes. In this connection the reader may find it interesting to turn to Professor Taussig's [5] temperate remarks concerning the "penumbra" area of price determination. These highly interesting comments, elaborating dynamic aspects of the problem, were, however, not believed by Taussig himself to be damaging to the Marshallian theory of supply and demand. Similarly, researches all over the world, including no doubt studies by the National Bureau, are hourly engaged in elaborating and improving the Keynesian income theory.

There is, I feel, a misconception with respect to Keynes' view that the consumption function is fairly stable. Keynes never held that it is rigidly stable or cannot be changed. Moreover, the *shape* of this function need not be linear in order to be stable. The marginal propensity

[5] *Quarterly Journal of Economics*, April 1921, p. 394-41. Taussig modestly begins his criticism of the theory of demand (which resembles somewhat current criticism of the consumption function) with the statement that his suggestions do not alter "the essentials of received economic theory." He concludes by saying: "No one supposes that economics is an accurate science." The "mathematical equations and deductions . . . stand for tendencies: they are compact statements of the underlying trend." Thus he ends by defending the theory of demand. The words just quoted could quite properly be applied to the consumption function. It may be added that in this article, Taussig anticipates some of the things so admirably said by Keynes in his famous Chapter 12 in the *General Theory.*

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to consume may vary with each stage of the cycle, as indeed Keynes believed it did (see *General Theory*, p. 120). Seasonal movements (of a nonfortuitous and therefore fairly dependable character) might conceivably, as Dr. Burns suggests, be found to exist. Moreover, the *secular* upward shift of the consumption function referred to in Burns' pamphlet (p. 19) has long been recognized (see, for example, my own *Fiscal Policy and Business Cycles*, p. 233, and Paul Samuelson's chapter in *Post-War Economic Problems*).[6]

About these matters there are I think, misconceptions of the Keynesian theory notably on pages 8, 11, and 19, in Burns' pamphlet. Note, for example, such statements as that the consumption function is "fixed" (p. 8); that it has a "certain shape" (p. 8); that the consumption function is "practically invariant" (p. 11); that the savings of business enterprise are correlated "simply and uniquely" with income payments (p. 11); that "monopolistic practices of business firms can safely be neglected" (p. 11); that "private investment will not be influenced appreciably by the character of fiscal policy pursued by government" (p. 11).[7]

Let the reader compare the highly rigid picture which he gets from the discussion of the Keynesian determinants of income as stated in Burns' pamphlet, with the flexible treatment found, for example, on pages 119–25, 147–64, 194–208, 245–71 of the *General Theory*. Expectations, waves of pessimism, and optimism, psychological factors play an important role in Keynes' analysis. Note, for example, the following from page 249 of the *General Theory*: "Thus the position of equilibrium will be influenced by these repercussions; and there are other repercussions also. Moreover, there is not one of the above factors which is not liable to change without much warning, and sometimes substantially. Hence the extreme complexity of the actual course of events." There is a shocking difference between the real Keynesian theory as found in the pages cited above and the statement which Burns gives of the theory. This any reader can verify for himself. Evidence of any close reading of the *General Theory* is not apparent at any point in Burns' pamphlet.[8]

It may be added that the means of changing the consumption function as discussed in the literature are far more complex than indicated in the pamphlet.[9]

The discussion (pamphlet, pp. 20–21) of Keynes' chapter on the Trade Cycle is, I feel, particularly unhappy, and contains, moreover, some misconceptions of Keynes' view. An author may rightly be criticized on what he sets out to do, but not on something he makes no pretense of doing. Keynes' chapter does not pretend to set out definitive statistical

[6] S. E. Harris, editor (New York, 1943). In this connection note the following from the *General Theory* (p. 95): ". . . the propensity to consume may be considered a fairly stable function, provided that we have eliminated changes in the wage-unit in terms of money". See my discussion of this in connection with the secular upward drift of the consumption function in this Review, xxviii (1946), p. 184.

[7] On the last point, for example, compare with the following from Keynes: "This means, unfortunately . . . that economic prosperity is excessively dependent on a political and social atmosphere which is congenial to the average business man" (*General Theory*, p. 162). And again: "With the confused psychology which often prevails, the Government programme may, through its effect on 'confidence', increase liquidity-preference or diminish the marginal efficiency of capital, which, again, may retard other investment unless measures are taken to offset it" (p. 120).

[8] The last paragraph on page 7 relating to recent developments in income theory discloses a mistaken view with respect to the nature of these contributions. From the *General Theory* on, it has always been recognized that expenditures financed by progressive taxation (effecting a redistribution of income) may raise income and employment. The authors of new contributions (see Trygve Haavelmo, "Multiplier Effects of a Balanced Budget," *Econometrica*, October 1945 and the literature there cited; also Haberler, Goodwin, Hagen, and Haavelmo in *Econometrica*, April 1946) take this for granted, and go on to discuss the question whether tax-financed expenditures may be expansionist even though there is no re-distributional effect upon the propensity to save.

[9] It is only fair to add that I myself, apart from the violent distortions caused by a great war and the reconversion period, regard the schedule of consumption in relation to disposable income (corrected for the secular upward drift) as one of the most stable regularities in all economic behavior. But I do not hold that it is "fixed" or that it is "practically invariant," or that it could not be changed by a change in the tax structure, by social security measures, by minimum wage legislation, by changes in the ratio of wages to profits, by sustained and continuing full employment, by institutional changes affecting savings such as payroll deduction plans, by life insurance reaching an asymptotic level, etc.

The demand functions for individual commodities or groups of commodities typically reveal a lower order of regularity than does the consumption function. Yet these relationships disclose ordinarily sufficient regularities to make the demand schedule concept a useful and valid tool for economic analysis.

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conclusions. Note that in the introductory section of his chapter (*General Theory*, p. 313) is the statement: "To develop this thesis would occupy a book rather than a chapter, and would require a close examination of facts. But the following short notes will be sufficient to indicate the line of investigation which our preceding theory suggests."

This statement represents a moderate and cautious attitude. Yet Dr. Burns refers to Keynes' "disregard of elementary precaution." Keynes' theory, says Burns, "should account for *the* sharp and sudden transition" (pamphlet, p. 20, italics mine). But Keynes only refers to the "fact that the substitution of a downward for an upward tendency *often* takes place suddenly" (*General Theory*, p. 314; italics mine). That is quite different and is not disproved by what Dr. Burns says. Again, according to Dr. Burns' version, Keynes says that the duration of the contraction is "about three to five years" (pamphlet, p. 20). But Keynes in fact does not say this, and in terms of the criticism contained in the pamphlet the difference is highly important. Keynes says that there are reasons "why the duration of the downward movement should have an order of magnitude which is not fortuitous, which does not fluctuate between, say, one year this time and ten years next time, but which shows some regularity of habit between, let us say, three and five years" (*General Theory*, p. 317). Dr. Burns has not shown this statement to be wrong. If someone, for example, could show that the facts are that the duration ranges from 18 months to 24 months, Keynes might well have replied: "Fine, that fits quite well into my theory." The version of Keynes which Burns criticizes is a straw man; it cannot be found in Keynes.

This section contains another misconception. Dr. Burns cites three facts (top of p. 21) that are alleged to collide with Keynes' cycle theory. Not one of them collides with Keynes' cycle theory, and certainly not with the general Keynesian theory of income determination. Take Dr. Burns' third fact, that the stock of durable goods (capital goods) increases, as a rule, during contractions as well as during expansions. This means that net investment in fixed capital is usually positive even in depressions. Everyone knows that. Keynes (and most other cycle theorists including Wicksell, Spiethoff, Cassel, Robertson, etc.) does hold that the *rate* of investment fluctuates in the cycle. Kuznets' data show that this is true. Thus the sentence beginning in line 8, page 21, reveals a serious misconception of Keynes' theory. Burns asks the question how Keynes' theory can be reconciled with the "fact that the stock of durable goods in a growing society is virtually free from any trace of business cycles, increasing as a rule during contractions of business activity as well as during depressions." I had to read, I confess, this sentence several times to be convinced that it was actually there in black and white. Keynes' theory on this point is not novel. It relates, of course, to fluctuations in the rate of investment, and such fluctuations may be quite violent while still permitting some increase in the total accumulated stock of capital goods in typical depression periods. In the deep depression of the thirties, however, there was actual disinvestment for the economy as a whole.

The latter half of Burns' statement quoted above is quite all right, though he is certainly wrong, I repeat, when he asserts that it conflicts with Keynes' theory. But the first half is definitely in error. In view of the violent fluctuations in net investment, shown by Kuznets' data (and that of many others), it is simply not possible that the stock of durable goods can be "virtually free from any trace of business cycles."

Dr. Burns' pamphlet raises important issues concerning the value and validity of theoretical analysis,[10] and particularly the character and usefulness of a theoretical apparatus of the Keynesian type. The issue should not be subserved to the question of being "pro-Keynesian" or "anti-Keynesian." I am not interested in classifying economists in Schools. Labels are misleading and had better be avoided. The defense of "received doctrine," whether Keynesian or otherwise, is no concern of the scientific pursuit of knowledge; and I am not writing this note in that spirit. What is important is to make progress by utilizing to the full all available tools which promise to be useful.

[10] See T. Koopmans' review article on Burns and Mitchell's *Measuring Business Cycles*, in this REVIEW, XXIX (August 1947).

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Most economists, I believe, are convinced that the "consumption function," for example, is a tool from the Keynesian kit which is useful. And it is, I believe, a safe forecast that it will be extensively and fruitfully used by economists and econometricians in the decades that lie ahead. Dr. Burns' pamphlet would, I feel, have been very different had it been written from the standpoint of sympathetically exploring to the utmost extent the possible contributions to economic research which the Keynesian approach has to offer.

KEYNESIAN ECONOMICS ONCE AGAIN

Arthur F. Burns

PROFESSOR Hansen's paper in this number of the REVIEW deals with important issues of economic theory. It expresses the judgment of a leading Keynesian thinker, who has had full opportunity to weigh and refine his reasons for repudiating my interpretation of Keynes.[1] Every mature economist knows how barren controversy can be and, in fact, usually is. But Keynes' theory is now at the center of much of our economic thinking, and Hansen is its outstanding exponent. Under the circumstances, it may serve the interests of economic science to examine Hansen's strictures with some care. I am grateful to the Editors of the REVIEW for according me the opportunity.

In the following pages I shall consider the major issues raised by Hansen. Section I is devoted to the essentials of Keynes' theory of income and employment, Section II to its determinacy, Section III to the consumption function, and Section IV to the Keynesian apparatus as distinguished from the Keynesian theory. An appendix on Keynes' business cycle theory brings the paper to a close.

[1] In the November 1946 issue of this REVIEW Professor Hansen comments on the great difficulty that economists have experienced in grasping Keynes' *General Theory*. In this connection he makes the following pronouncement: "A recent example disclosing a number of elementary misconceptions is the pamphlet by Arthur F. Burns, on *Economic Research and the Keynesian Thinking of Our Times* (National Bureau of Economic Research, 1946). However, the pamphlet does strikingly reveal (perhaps inadvertently) how economic theory — whether Ricardian or Keynesian — serves the highly useful purpose of pointing up what factual data are relevant to a useful investigation" (p. 187). Since this statement was not accompanied by any evidence, I was of course interested and eager to know what my misconceptions may be. In the course of the ensuing correspondence, Hansen eventually set forth his views in some detail. I replied as fully. Hansen's paper in this REVIEW presents the critical remarks that he developed in correspondence, with such elaborations and modifications as he has deemed necessary to present his case properly before the scientific public.

I. KEYNES' THEORY OF INCOME AND EMPLOYMENT

In the essay on *Economic Research and the Keynesian Thinking of Our Times*,[2] I boldly attempted to set forth the essence of Keynes' *General Theory* in a few paragraphs. To enable the reader to follow closely the questions raised by Hansen, I reproduce the main part of the original sketch before taking up the criticisms:

> Keynes' theory of underemployment equilibrium . . . attempts to show that a free enterprise economy, unless stimulated by governmental policies, may sink into a condition of permanent mass unemployment. The crux of this theory is that the volume of investment and the 'propensity to consume' determine between them a unique level of income and employment. The theory can be put simply without misrepresenting its essence. Assume that business firms in the aggregate decide to add during a given period 2 billion dollars' worth of goods to their stockpiles, using this convenient term to include new plant and equipment as well as inventories. This then is the planned investment. Assume, next, that business firms do not plan to retain any part of their income;[3] so that if they pay out, say, 18 billion to the public, they expect to recover 16 billion through the sale of consumer goods, the difference being paid out on account of the expected addition to their stockpiles. Assume, finally, that the 'consumption function' has a certain definite shape; that if income payments are, say, 18 billion, the public will spend 17 billion on consumer goods and save 1, and that one-half of every additional billion of income will be devoted to consumption and one-half to savings. Under these conditions, the national income per 'period' should settle at a level of 20 billion.
>
> The reason is as follows. If income payments were

[2] Hereafter referred to as *Keynesian Thinking*.

[3] This assumption is not essential to the Keynesian system; I make it here in order to simplify the exposition. The figures used throughout are merely illustrative. Further, the exposition is restricted to the proximate determinants of employment in Keynes' system; this simplification does not affect the argument that follows. (This note appeared in the original essay.)

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