The Second Crisis of Economic Theory

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RICHARD T. ELY LECTURE

The Second Crisis of Economic Theory

By JOAN ROBINSON*

The title of this talk—the second crisis of economic theory—is related to the first crisis—the great slump of the thirties. It is the second crisis in our lifetime—there were others before. I should say, rather, in my lifetime. When I see this throng of superfluous economists—I am using that word, of course, in the Shakespearian sense—I am reminded how much the profession has grown since the thirties and how many more there are now to suffer from the second crisis than there were to be discredited in the first.

What was the state of orthodox opinion when the world was struck by the great slump? First of all, there was the famous Treasury View of 1929. Great Britain had been suffering from heavy unemployment while the United States was enjoying the long boom which culminated in the great bull market on Wall Street. The British situation had been exacerbated by what Keynes unkindly called *The Economic Consequences of Mr. Winston Churchill*—the return to gold at an overvalued exchange rate. In 1929 Lloyd George was campaigning for a policy of public works; Keynes with Hubert Henderson produced the pamphlet *Can Lloyd George Do It?*, which first adumbrated the theory of the multiplier and of the relation of saving to investment. To answer Lloyd George, the Conservative government produced a White Paper in which various ministers stated the case against spending money in their respective departments on housing, schools, roads, etc. The Chancellor of the Exchequer was Churchill; he could not bring himself a second time to defend deflation and sound finance. It was left to the officials to produce the argument for the Treasury. Their case was very simple. It was based on the idea that investment is governed by saving. If the government borrowed £100 million to spend on public works, there would be £100 million less for foreign investment. The surplus of exports would fall by a corresponding amount. There would be a transfer of employment but no change in the total. It is not fair to put much weight on this. The Treasury, after all, was required to say something and this was what they thought of to say. The fact that it appeared to be a respectable argument, however, certainly was a symptom of the state of opinion at that time.

In 1932, Professor (now Lord) Robbins published the famous essay in which he describes economics as the subject that deals with the allocation of scarce means between alternative uses. No doubt this was the expression of a long tradition but the date of publication was unlucky. By the time the book came out there were three million workers unemployed in Great Britain and the statistical measure of *GNP* in U.S.A. had recently fallen to half its former level. It was just a coincidence that the book appeared when means for any end at all had rarely been less scarce.

The main orthodox reaction to the slump was the argument that wages were too high. This could be backed up by statistical argument. In those old days, prices

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used to fall when there was a decline in demand, so that prices were lower relatively to money-wage rates than when employment was higher. In a style of argument nowadays familiar in another context, a correlation was exhibited as a cause. The theory that unemployment could be due only to wages being too high received solid support from the evidence.

In Chicago, Henry Simons maintained that there were two causes of the depression. One was the existence of trade unions which refused to allow wages to fall. The other was the existence of commercial banks. It must be observed that the trade unions support *money* wages while the theory required *real* wages to fall, but no one at that time had ever discussed the influence of wages on prices. Prices were conceived to be something to do with money. It was because commercial banks were always allowing the quantity of money to expand and contract that Simons regarded them as the main source of the trouble.

While the controversy about public works was developing, Professor Robbins sent to Vienna for a member of the Austrian school to provide a counter attraction to Keynes. I very well remember Hayek's visit to Cambridge on his way to the London School. He expounded his theory and covered a black board with his triangles. The whole argument, as we could see later, consisted in confusing the current rate of investment with the total stock of capital goods, but we could not make it out at the time. The general tendency seemed to be to show that the slump was caused by consumption. R. F. Kahn, who was at that time involved in explaining that the multiplier guaranteed that saving equals investment, asked in a puzzled tone, "Is it your view that if I went out tomorrow and bought a new overcoat, that would increase unemployment?" "Yes," said Hayek, "but," pointing to his triangles on the board, "it would take a very long mathematical argument to explain why."

This pitiful state of confusion was the first crisis of economic theory that I referred to.

To understand how disconcerting the slump was it is necessary to recall the atmosphere of the times. For fifty years before 1914 the established economists of various schools had all been preaching one doctrine, with great self-confidence and pomposity—the doctrine of *laissez faire*, the beneficial effects of the free play of market forces. In the English-speaking world, in particular, free trade and balanced budgets were all that was required of government policy. Economic equilibrium would always establish itself. These doctrines were still dominant in the 1920's.

The postwar atmosphere in 1919 was very different from that of 1945. Last time, the keynote was *Never again!* All schemes of reconstruction and new policies were aimed at preventing a recurrence of the prewar situation. In 1918 the mood was nostalgia. The world before 1914 appeared as normality to which all must desire to return. Of course, this was an illusion. There is no such thing as a normal period of history. Normality is a fiction of economic textbooks. An economist sets up a model which is specified in such a way as to have a normal state. He takes a lot of trouble to prove the *existence* of normality in his model. The fact that evidently the world does exist is claimed as a strong point for the model. But the world does not exist in a state of normality. If the world of the nineteenth century had been normal, 1914 would not have happened.

At the time, however, in the postwar scene, normality lay in the past. As far as the economists were concerned, they did not really know very much about that world. They knew what was in their books.

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In their books, a private enterprise economy tends to equilibrium and not only to equilibrium—to an optimum position. Trouble was often caused by politicians who were shortsighted and under the sway of particular interests. If only they would establish free trade, restore the gold standard, keep budgets balanced, and leave the free play of the market forces to establish equilibrium, all would be for the best in the best of all possible worlds. Of course, there were footnotes making cautious reservations. Indeed, in the higher reaches of the profession there was something of the atmosphere of the augurs touching their noses behind the altar. Amongst themselves, they admitted it was not really like that. But their pupils took it all literally. They formed an official opinion deeply influenced by the conception of equilibrium which could be relied upon to establish itself provided that no one tried to interfere.

The doctrine that there is a natural tendency to maintain equilibrium with full employment could not survive the experience of the complete collapse of the market economy in the thirties.

Out of this crisis emerged what has become known as the Keynesian revolution. After the war, Keynes became orthodox in his turn. Unfortunately, the Keynesian orthodoxy, as it became established, left out the point. This is not the second crisis. This is still part of the first crisis.

Consider what was the point of the Keynesian revolution on the plane of theory and on the plane of policy. On the plane of theory, the main point of the *General Theory* was to break out of the cocoon of equilibrium and consider the nature of life lived in time—the difference between yesterday and tomorrow. Here and now, the past is irrevocable and the future is unknown.

This was too great a shock. Orthodoxy managed to wind it up in a cocoon again. Keynes had broken down the compartments of "real" and "monetary" theory. He showed how money is a necessary feature of an economy in which the future is uncertain and he showed what part monetary and financial institutions play in the functioning of the "real" economy. Now the compartments have been restored in the division between micro and macro theory. Axel Leijonhufvud points out that an analysis of the harmony of an organism should be useful for dealing with the problems of its malfunctioning:

> Not so in economics. We use 'Walrasian' models for the first type of question, and 'macro-models' for the second; and we act as if this schizophrenic State of the Arts was something that we are willing to live with indefinitely. The theory of value and resource allocation deals with how economic activities are coordinated. Macro-theory deals with coordination failures—at least, that was the original problem. But the structure of the two types of models is so dissimilar that the price-theoretical content of 'Keynesian' macro-models is often difficult to distil. [p. 25]

The price theory of Keynes' system (as opposed to a "Keynesian" one) certainly cannot be fitted into Walras. Leijonhufvud has made an heroic effort to show how a theory of unemployment could be derived from a Walrasian model—Walras without the auctioneer. But this in fact was not the basis of the argument. The peculiar mixture of Walras with Pigou—supply and demand for given resources with profit-maximizing firms of optimum size—which nowadays passes for micro theory—was first blended by John Hicks after the *General Theory* was published. Walras leaves out the very point that Keynes was bringing in—historical time. I remember Keynes suggesting that Walras got his idea of crying prices from the Paris bourse, where in his day deals were really made by shouting bids and offers. A stock market can operate

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so, for it is dealing with stocks. Anyone who tries to introduce a flow of production into Walras immediately falls into contradictions. Either the whole of future time is collapsed into today or else every individual has correct foresight about what all others will do, while they have correct foresight about what he will do, so that the argument runs into the problem of free will and predestination. This could not be of any use to Keynes. The very essence of his problem was uncertainty. He started from a Marshallian short period. Here we are today with whatever stock of capital equipment, training of labor, and business organization that the past has produced; decisions are being taken today on the basis of expectations about the future. The Treasury View, that savings govern investment, is knocked out by the observation that investment is free to fluctuate under the influence of expectations so that income and employment are continually being pushed to the level at which overall *ex post* saving is equated to investment.

In the new macro-micro theory, this point is lost. By one simple device, the whole of Keynes' argument is put to sleep. Work out what saving *would be* at full employment in the present short-period situation, with the present distribution of wealth and the present hierarchy of rates of earnings for different occupations, and arrange to have enough investment to absorb the level of saving that this distribution of income brings about. Then hey presto! we are back in the world of equilibrium where saving governs investment and micro theory can slip into the old grooves again.

Keynes himself was not very much interested in the theory of value and distribution. Michal Kalecki produced a more coherent version of the *General Theory*, which brought imperfect competition into the analysis and emphasized the influence of investment on the share of profits. Kalecki's version was in some ways more truly a *general* theory than Keynes'.

In the orthodox micro theory, having put Keynes to sleep, perfect competition and optimum firms come back and all the problems of the New Industrial State drop out of the argument. At this very time, when the great concentrations of power in the multinational corporations are bringing the age of national employment policy to an end, the textbooks are still illustrated by U-shaped curves showing the limitation on the size of firms in a perfectly competitive market.

This is all part of the first crisis that has by no means been resolved before the second crisis sets in.

Keynes' monetary theory has also been lost. His point was that, in any given short-period situation, plans for investment are being made in the light of expectations of profit. The supply of finance has an influence on these plans—cheap money makes investment easier. In my opinion, Keynes rather exaggerated the influence of the rate of interest, but in any case it was always the rate of interest *relatively* to expected profits that had an influence. If the economy is always in equilibrium anyway, where is the room for expectations?

The strangest of all is to set up a model of a one-commodity world where there are no prices, saving governs investment, full employment is guaranteed by the real-wage rate, the difference between the future and the past is eliminated by making capital "malleable" so that mistakes can always be undone and equilibrium is always guaranteed; then when every requirement for money as a medium of exchange, a store of value and an object of liquidity preference has been eliminated from the model, money is introduced to finance the national debt.

In the one-commodity world, of course, the distinction between real and money

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wages does not arise, and with "malleable capital" the demand for labor depends on the level of wages. So Simons is proved right after all. By the one simple trick, time is abolished, Keynes is smothered, Kalecki is ignored and equilibrium theory is enthroned once more.

This is all part of the first crisis but it helps to prepare the setting for the second crisis.

What about the Keynesian revolution on the plane of policy? Certainly the twenty-five years after the end of the last war were very different from the twenty years after the first. The notion that it is the responsibility of a government to maintain a "high and stable level of employment" in its national economy was a novelty. Perhaps its acceptance as orthodoxy was mainly due to the realization that unemployment did not occur in planned economies. Private enterprise had to vindicate itself before its own employees. A doctrine that promised to show how it could do so was very welcome.

Keynes was writing and arguing *against* the prevailing orthodoxy. He had to argue first and last that something could be done. He did not have an opportunity to describe the workings of an economy in which employment policy was an accepted feature of government. He did throw out the suggestion that he did not expect either monetary or fiscal instruments to be powerful enough to maintain stability; he believed that it would be necessary to have a general social control over investment. This has not been seen in any private enterprise economy. So-called Keynesian policy has been a series of expedients to deal with recessions when they occurred. Kalecki had a much less optimistic view than Keynes of how it would work out. Unemployment could be overcome by government loan-expenditure. With very low unemployment, the captains of industry find that discipline in the factories breaks down and prices rise.

> In this situation a powerful block is likely to be formed between big business and the rentier interests, and they would probably find more than one economist to declare that the situation was manifestly unsound. The pressure of all these forces, and in particular of big business, would most probably induce the Government to return to the orthodox policy of cutting down the budget deficit. A slump would follow.

Then the next election looms up and pressure to relieve unemployment grows strong again. So, he predicted in 1943, after the war we shall have overcome the problem of the commercial trade cycle and we shall be living under the regime of a political trade cycle. Just now the political trade cycle seems to be taking a more violent form than ever before.

The advocates of "Keynesian" policies accepted only half of Keynes' diagnosis of the instability of capitalism. He described how the level of output is determined (in given technical conditions) by investment and consumption. He described how the level of prices is determined by the level of money-wage rates. It was sufficiently obvious that if continuous near-full employment was maintained without any change in traditional institutions and attitudes in industrial relations, there would be an irresistible pressure to inflation. I think that in the United States this element in Keynes was somehow swept under the carpet. It seems that the extraordinary vogue in recent years of an argument so implausible as the Quantity Theory of Money was due to a refusal to accept the fact that the main influence on the general price level in money terms is the level of money-wage rates and the level of wage rates at any moment is more or less an historical accident, depending on conditions in the labor market over a long past. This was such a serious blow to notions of equilibrium and the rationality

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of a market economy that any theory was better, even a theory that consisted of nothing but a set of incantations.

In England the point was met by a new Treasury View—that it would be desirable to maintain enough unemployment to keep prices stable. To make this policy acceptable it had to be argued that a "small" amount of unemployment, say 3 percent, would be enough. The famous Phillips curve was used to support this point of view. After a run of years with statistical unemployment between 1 and 2 percent, 3 percent is not regarded by the workers as just a little, especially as, of course, it is not evenly spread, so that some regions are running into 10 percent and more. In any case the experimental demonstration of the Phillips curve has failed. Prices go on rising along with unemployment. Now suddenly and abruptly the second half of Keynes' theory has been accepted and President Nixon decides to alter the rules of the game in industrial relations by decree.

This is a fresh upheaval in the private enterprise economy but so far as economic theory is concerned it is still an element in the first crisis—the breakdown of *laissez faire* in face of the problem of effective demand.

The second crisis is quite different. The first crisis arose from the breakdown of a theory which could not account for the *level* of employment. The second crisis arises from a theory that cannot account for the *content* of employment.

Keynes was arguing against the dominant orthodoxy which held that government expenditure could not increase employment. He had to prove, first of all, that it could. He had to show that an increase in investment will increase consumption—that more wages will be spent on more beer and boots whether the investment is useful or not. He had to show that the secondary increase in real income is quite independent of the object of the primary outlay. Pay men to dig holes in the ground and fill them up again if you cannot do anything else.

There was an enormous orthodox resistance to this idea. The whole weight of the argument had to be on this one obvious point.

The war was a sharp lesson in Keynesism. Orthodoxy could not stand up any longer. Governments accepted the responsibility to maintain a high and stable level of employment. Then the economists took over Keynes and erected the new orthodoxy. Once the point had been established, the question should have changed. Now that we all agree that government expenditure can maintain employment we should argue about what the expenditure should be for. Keynes did not *want* anyone to dig holes and fill them. He indulged in a pleasant daydream of a world in which, when investment had been kept at the full employment level for thirty years or so, all needs for capital installations would have been met, property income would have been abolished, poverty would have disappeared and civilized life could begin.

But the economists took up the argument at the point where it had broken off before the war. When there is unemployment and low profits the government must spend on something or other—it does not matter what. As we know, for twenty-five years serious recessions were avoided by following this policy. The most convenient thing for a government to spend on is armaments. The military-industrial complex took charge. I do not think it plausible to suppose that the cold war and several hot wars were invented just to solve the employment problem. But certainly they have had that effect. The system had the support not only of the corporations who made profits under it and the workers who got jobs, but also of the economists

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who advocated government loan-expenditure as a prophylactic against stagnation. Whatever were the deeper forces leading into the hypertrophy of military power *after* the world war was over, certainly they could not have had such free play if the doctrine of sound finance had still been respected. It was the so-called Keynesians who persuaded successive presidents that there is no harm in a budget deficit and left the military-industrial complex to take advantage of it. So it has come about that Keynes' pleasant daydream was turned into a nightmare of terror.

In spite of wastage and slaughter there certainly was a great increase in economic wealth in twenty-five years without a slump. This was especially true in the countries which were initially not allowed to dissipate their resources on arms and could put all their investment into productive forms so that they are now threatening the overburdened U. S. industry with "unfair competition." But even in the United States, certainly, wealth increased. Even in Great Britain, limping along playing at being a great power after the game was over, wealth increased. The socialist countries began to envy the consumer society. Capitalism with near-full employment was an impressive spectacle. But a growth in wealth is not at all the same thing as reducing poverty. A universal paean was raised in praise of *growth*. Growth was going to solve all problems. No need to bother about poverty. Growth will lift up the bottom and poverty will disappear without any need to pay attention to it. The economists, who should have known better, fell in with the same cry. Economists used to know (but they had evidently forgotten) that the decent acceptable standard of life, in any society, is somewhere about the average that that society provides. It is a law of nature that much more than half the population (for lower incomes are more numerous) is always living below the decent standard, whatever their absolute level of consumption may be.

That is not the only point. Not only subjective poverty is never overcome by growth, but absolute poverty is increased by it. Growth requires technical progress and technical progress alters the composition of the labor force, making more places for educated workers and fewer for uneducated, but opportunities to acquire qualifications are kept (with a few exceptions for exceptional talents) for those families who have them already. As growth goes on at the top, more and more families are thrown out at the bottom. Absolute misery grows while wealth increases. The old slogan, "poverty in the midst of plenty," takes on a new meaning.

Then consider the notorious problem of pollution. Here again the economists should have been forewarned. The distinction that Pigou made between private costs and social costs was presented by him as an exception to the benevolent rule of *laissez faire*. A moment's thought shows that the exception is the rule and the rule is the exception. In what industry, in what line of business are the true social costs of the activity registered in its accounts? Where is the pricing system that offers the consumer a fair choice between air to breathe and motor cars to drive about in? The economists were the last to realize what is going on and when they did recognize it they managed to hush it up again. *Laissez faire* and consumer's sovereignty were still absolute except for a few minor points discussed under the heading of "externalities" that could easily be put right.

These problems arise in the economies that boast of their wealth. Perhaps they can afford the luxury of an economics profession that builds intricate theories in the air that have no contact with reality.

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But this luxury is too expensive for the so-called developing world where the doctrines of *laissez faire* and the free play of market forces are exported along with armaments to keep them from looking for any way out of their infinitely more grievous situation.

The second crisis of theory is already far advanced. I do not regard the Keynesian revolution as a great intellectual triumph. On the contrary, it was a tragedy because it came so late. Hitler had already found how to cure unemployment before Keynes had finished explaining why it occurred. This time also the real situation is crowding upon us before we have begun to discuss our problems.

A sure sign of a crisis is the prevalence of cranks. It is characteristic of a crisis in theory that cranks get a hearing from the public which orthodoxy is failing to satisfy. In the thirties we had Major Douglas, and social credit—it can all be done with a fountain pen—and Warren and Pearson who convinced President Roosevelt that raising the dollar price of gold would raise the price of everything else and bring the slump to an end. The cranks are to be preferred to the orthodox because they see that there is a problem.

Nowadays we have plenty of cranks taking up the problems that the economists overlook. Charles Reich proposes to turn America green with a spade and hoe. J. W. Forrester proves on a computer that humanity is bound to be wiped out either by poison or by famine within a hundred years. Our distinguished Chairman [John Kenneth Galbraith] can hardly be classed with the cranks, considering the seat he occupies this year, but next year, perhaps, he will be relegated once more to the position outside the pale of those who commit *lèse majesté* against consumer's sovereignty. The cranks and critics flourish because the orthodox economists have neglected the great problems that everyone else feels to be urgent and menacing.

The whole trouble arises from just one simple omission: when Keynes became orthodox they forgot to change the question and discuss what employment should be for.

This primarily concerns the allocation of resources between products, but it is also bound up with the distribution of products between people. On the subject of distribution, of course, there is quite a lot in the orthodox textbooks, but it is not at all easy to make out what it means. Keynes did not need a theory of distribution for the long run though he had a vague idea of a falling rate of profit in his daydream of future civilization. He was concerned mainly with the short period, here and now, when only expectations of future profits come into the argument. What is the orthodox theory of profits actually received? Many years ago I set out to write a little book on Marxian economics; when I had written a chapter on Marx's theory of profits, I thought I had to write a chapter on the orthodox theory for comparison, and blest if I could find one high or low. Ever since I have been inquiring and probing but I still cannot find out what it is. We have Marshall's theory that the rate of interest is the "reward of waiting" but "waiting" only means owning wealth. A man "may have obtained the *de facto* possession of property by inheritance or by any other means, moral or immoral, legal or illegal. But if, having the power to consume that property in immediate gratifications, he chooses to put it in such a form as to afford him deferred gratifications, then any superiority there may be in deferred gratifications over those immediate ones is the reward of his waiting" (1890, pp. 613–14). In short, a man who refrains from blowing his capital in orgies and feasts can con-

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tinue to get interest on it. This seems to be perfectly correct, but as a theory of distribution it is only a circular argument.

The passage I just quoted came from the first edition of Marshall's *Principles*. Later he muddled up "waiting" with saving—that is, refraining from consuming income, not refraining from dissipating capital. (See 1961, pp. 642–43.) This idea seems to have been taken up in the modern orthodoxy. The rate of interest is accounted for by the discount of the future of owners of wealth. Most household saving, of course, is mainly saving up to spend later, and Marshall himself admitted that it is likely to respond the wrong way. A higher rate of return means that *less* saving is necessary to get a given pension or whatever. But there may be some savers who have the psychology required by the textbooks and weigh a preference for present spending against an increment of income (interest, dividends, and capital gains) to be had from an increment of wealth. But what then? Each individual goes on saving until the point where his individual subjective rate of discount is equal to the market rate of interest. There has to be a market rate of interest for him to compare his rate of discount to. But of course the whole thing is quite beside the point once we have accepted the Keynesian view that investment governs saving, not saving investment.

This concerns the broad division of national income between work and property or, as the British tax system describes it, between earned and unearned income. There is also the problem of the relative levels of different types of earned income. Here we have the famous marginal productivity theory. In perfect competition an employer is supposed to take on such a number of men that the *money* value of the marginal product *to him*, taking account of the price of his output and the cost of his plant, is equal to the money wage he has to pay. Then the *real* wage of each type of labor is believed to measure its marginal product *to society*. The salary of a professor of economics measures his contribution to society and the wage of a garbage collector measures his contribution. Of course, this is a very comforting doctrine for professors of economics, but I fear that once more the argument is circular. There is not any measure of marginal products except the wages themselves.

In short, we have not got a theory of distribution. We have nothing to say on the subject which above all others occupies the minds of the people whom economics is supposed to enlighten.

Here the second crisis links up with the first. The first crisis failed to be resolved because there was no solution to the problem of maintaining near-full employment without inflation. Experience of inflation has destroyed the conventions governing the acceptance of existing distribution. Everyone can see that his relative earnings depend on the bargaining power of the group that he belongs to. The professors become quite nervous when they are discussing the earnings of the garbage collectors. Now it is clear enough that income from property is not the reward of waiting but the reward of employing a good stock broker. On top of this a sudden freeze comes down. If it is successful it is to keep everyone in the position where he happened to be when the scramble for relative gains was brought to a halt and it will perpetuate the division of income between work and property that happened to exist when it set in. But it does not seem likely that it will be as successful as all that. Rather it will add a political element to the distribution of bargaining power. Perhaps this is going to create a crisis in the so-called free-enterprise economy. I am not talking about that. I am talking about the

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evident bankruptcy of economic theory which for the second time has nothing to say on the questions that, to everyone except economists, appear to be most in need of an answer.

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