

WHY I WILL NEVER BE A KEYNESIAN

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Necessity is both the mother of invention and the source of self-reflection. Nowhere is the latter more true than in social and economic affairs, where massive social and economic dislocations rightly prompt leading theorists to reexamine their fundamental beliefs in trying to figure out, as Paul Krugman framed the question: “Just what went wrong?”¹ Unfortunately, these bouts of self-doubt have led many prominent thinkers to turn their attention back to the leading economic thinker during a past depression, John Maynard Keynes, and his most famous tome—book does not quite do—*The General Theory of Employment, Interest and Money*.² The tome appeared in 1936, during the depths of the Great Depression that had been running for seven years and counting. Clearly the book did not cause the Depression, but it did not do anything to abate it either. That only happened with the onset of a far greater tragedy, the Second World War.

I confess that in my youth I purchased a copy of Keynes’s masterpiece. Dutifully, I sought to read it several times, only to give up in frustration while trying to wade through its turgid prose. Fortunately, it is not necessary to plow through Keynes in order to get some sense of his basic position. Today’s skillful

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1. See Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES, Sept. 6, 2009 (Magazine), at 36. For my response, see Richard A. Epstein, *Krugman’s Scapegoats: Rebutting the Times Columnist’s Attempt to Pin the Market Meltdown on the Chicago School*, NAT’L REV., Oct. 5, 2009, at 20. For a more technical and heated response, see John Cochrane, *How Did Paul Krugman Get it So Wrong?* (Sept. 11, 2009) (unpublished manuscript), available at http://faculty.chicagobooth.edu/john.cochrane/research/Papers/Krugman_response.doc.

2. JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* (1936).

expositors, including my colleague Judge Richard A. Posner, have provided lucid explanations of the Keynesian position.³ Judge Posner's fascination with Keynes has led to a belated confession of past sins, chief of which is an excessive devotion to Chicago-type economics on both the macro and the micro levels. Thus, he tellingly writes: "Economists may have forgotten *The General Theory* and moved on, but economics has not outgrown it, or the informal mode of argument that it exemplifies, which can illuminate nooks and crannies that are closed to mathematics."⁴ I yield to no one in the insistence that critical institutional detail often reveals far more than mathematical equations about the operation of the economic system. But that one point alone is consistent with the work of such theorists as Ronald Coase and such institutionalists as Douglass North, neither of whom is steeped in the occult mathematical arts.

Try as I may, however, I cannot yield to the same level of open-mindedness on this subject that Posner expresses. I come away from reading the new Keynesians more convinced than ever that they lack a coherent diagnosis of the origins and depths of the Depression. By implication, they lack a sensible program to shake the current economic malaise. President Barack Obama may be in the thrall of Keynesian economics, or perhaps just captured by the labor unions. But either way, any move to a larger governmental role in planning or stimulating the economy is likely to make the current recession deeper and the recovery slower than they ought to be.

To develop this thesis, I shall proceed in two parts. Part I deals with those issues that the Keynesians either forgot or swept under the table. In this context, I address not only the distinctive features in the current economic situation, but also those structural from the 1930s, many of which have still not run their course today. My point here is not that Keynes or modern Keynesians necessarily support these dangerous precedents. It is that they have nothing distinctive to contribute to their resolution that is not already understood within the standard neoclassical framework.

3. See, e.g., Richard Posner, *How I Became A Keynesian*, NEW REPUBLIC, Sept. 23, 2009, at 34.

4. *Id.* at 38–39.

Part II takes a closer look at the inner workings of the theory to explain why any centralized effort to rejigger aggregate levels of consumption or savings will only make the task of economic recovery more perilous. There is no reason to try to establish some collective priority of one type of behavior over the other. The key move is to eliminate waste so as to allow both savings and consumption to expand, without trying at the center to find what Robert Nozick rightly called “patterned principles”⁵—an effort that always turns out to misfire. The only way to move forward on both dimensions at once is to avoid the major mistakes of industrial policy identified in the first portion of this paper.

I. THE MANY SOURCES OF ECONOMIC DECAY

At first glance, we should all be impressed by the apparent breadth of Keynes’s title, which seeks to link employment, interest, and money into a single theory. Success in unifying these three large classes of events has to count as a signal achievement in economic thought. But, by the same token, that synthesis should not be regarded as a comprehensive explanation of how the economy works in practice. Its scope is incomplete, and hence it gives only weak information about how to correct perceived economic imbalances, whether during the Great Depression or today. So it is useful to mention some of the issues that are missing from the Keynesian theory, each of which plays a real role in the operation of the economy.

Free trade is the first topic not covered by Keynes’s title, nor mentioned in Posner’s recent salute to his new master. Keynes’s writing on this point seems to indicate some sympathy with the *laissez-faire* position, for he surely understood the risks of mercantilist policies.⁶ By the same token, however, Keynes also thinks that a bit of governmental oversight would not be all that bad.⁷ Indeed, it would be hard for Keynes to

5. ROBERT NOZICK, *ANARCHY, STATE, AND UTOPIA* 155–60, 218–24 (1974).

6. See KEYNES, *supra* note 2, at 335 (“[Mercantilist] advantages claimed are avowedly national advantages and are unlikely to benefit the world as a whole.”).

7. See *id.* at 337–38 (“[I]f we contemplate a society with a somewhat stable wage-unit, with national characteristics which determine the propensity to consume and the preference for liquidity, and with a monetary system which rigidly links the quantity of money to the stock of the precious metals, it will be essential for the maintenance of prosperity that the authorities should pay close attention to the state of the balance of trade.”).

maintain a strong free trade perspective given his own view that we cannot trust laissez-faire capitalism to determine “the current volume of investment.”⁸ The connection between the foreign and domestic markets is too intimate to let international trade run its course. Yet notwithstanding Keynes’s doubts on the subject, vibrant international trade is clearly important to the overall health of the economy today, and it was also important (albeit at a smaller level) when transportation and communications costs were higher during the Depression. This observation is hardly new; the debate over free trade came to a head just before the passage of the Smoot-Hawley Tariff Act of 1930,⁹ which put a serious kibosh on international exchange. The basic mechanics of comparative advantage as they apply to free trade have been well discussed in the work of Adam Smith¹⁰ and David Ricardo,¹¹ in the late eighteenth and early nineteenth centuries. Their insights were widely disregarded by the Republican Party, whose 1928 platform revealed protectionist preferences that later became law.¹²

The danger of this protectionist position was not completely lost in the pre-Keynes years. In 1930, a large group of economists, 1028 in all, led by Paul Douglas of the University of Chicago, drafted an impassioned plea to Congress not to pass the legislation.¹³ That denunciation of Smoot-Hawley noted that any tariff increase would force distortions in domestic and foreign

8. *Id.* at 320 (“In conditions of *laissez-faire* the avoidance of wide fluctuations in employment may . . . prove impossible without a far-reaching change in the psychology of investment markets such as there is no reason to expect. I conclude that the duty of ordering the current volume of investment cannot safely be left in private hands.”).

9. Pub. L. No. 71-361, 46 Stat. 590.

10. See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (R.H. Campbell & A.S. Skinner eds., Liberty Classics 1981) (1776) (ending with an attack on mercantilist policies).

11. See DAVID RICARDO, PRINCIPLES OF POLITICAL ECONOMY AND TAXATION (E.C.K. Gonner ed., G. Bell & Sons 1919) (1817).

12. See Anthony O’Brien, Smoot-Hawley Tariff, <http://eh.net/encyclopedia/article/obrien.hawley-smoot.tariff> (last visited Feb. 24, 2010) (quoting the 1928 Republican Party platform to say that “we realize that there are certain industries which cannot now successfully compete with foreign producers because of lower foreign wages and a lower cost of living abroad, and we pledge the next Republican Congress to an examination and where necessary a revision of these schedules to the end that American labor in the industries may again command the home market, may maintain its standard of living, and may count upon steady employment in its accustomed field”).

13. An account of the relevant events, including the decisive letter, is found in *Economists Against Smoot-Hawley*, 4 *ECON. J. WATCH* 345, 345–58 (2007).

markets that would reduce overall levels of production to the detriment of consumers, encourage retaliation that would only make matters worse, hamper those in local service industries who had nothing to fear from foreign competition, and harm farmers by forcing them to pay more as consumers and shutting down their access to foreign markets. The letter even quoted President Herbert Hoover's cautionary words that "[i]t is obviously unwise protection which sacrifices a greater amount of employment in exports to gain a less amount of employment from imports."¹⁴ There may be some doubt as to the exact extent of the damage caused by Smoot-Hawley given that total exports and imports were less than six percent of Gross Domestic Product at the time.¹⁵ But there can be no doubt that it had a negative effect. President Hoover may have known all this, but the business pressure for protectionism was tough to resist. World trade shriveled, and, in part because of poor economic circumstances, a climate of unrest led to the rise of fascism and Nazism.

It is not, of course, proper to charge Keynes with fostering these counterproductive maneuvers. It is sufficient to say that his general theory neglected to warn against such misguided government interventions, which are easily condemned within the standard neoclassical framework. So even if we were to classify Keynes and Posner as ardent champions of free trade, nothing about that position stems from the unique insights of a Keynesian theory.

Nor should we regard these insights as unimportant today. We are blessed insofar as there is no powerful coalition in support of a return to Smoot-Hawley. The defenders of protectionism tend to rely instead on more modest claims, such as the inability to conduct "free and fair" trade—fear the "fair" in this formulation—with nations that do not maintain appropriate labor or environmental standards. Concern for fair trade has, for example, stalled various bilateral free trade agreements with Colombia.¹⁶ But this effort to use trade policy to meddle in the internal business of for-

14. *Id.* at 349.

15. O'Brien, *supra* note 12.

16. The AFL-CIO position on the Colombia Free Trade Agreement reads: "Workers across both countries oppose passage of the FTA until workers can fully exercise international core labor rights without fear, the country makes deep and sustained progress on ending impunity, and the agreement is amended to address persistent criticisms of the trade model." AFL-CIO, Colombia Free Trade Agreement, <http://www.aflcio.org/issues/jobseconomy/globaleconomy/colombiafta.cfm> (last visited Feb. 24, 2010).

eign nations is a dead loser. We should trade with them whenever it works to our mutual advantage. The lure of foreign trade should help to discipline and rationalize internal productive capacities in both nations (thus bleeding out the monopoly power of unions), and with the increase in domestic wealth, we can confidently predict an expansion in efforts at environmental protection. No one wants to live in a mansion if he cannot breathe the outside air when he steps into his backyard. And so prosperity from free trade, and not protectionism, will increase pressure for sustainable environmental improvements.

Tax policy also deserves more attention. It represented one of the key mistakes of the Hoover Administration, which in its own way was as misguided on tax matters as President Franklin Delano Roosevelt's New Deal was on social politics. In particular, President Hoover's Revenue Act of 1932 raised the top marginal tax rate from twenty-five to sixty-three percent in order to staunch the deficit at the federal level.¹⁷ We hear similar calls for higher taxes today for much the same reason: We do not want to live in a society where a huge fraction of the population has to scrimp by on the government dole or toil at low-paying jobs while the rich live in the lap of luxury. But it is a mistake to think of taxation policy solely, or even largely, in terms of income distribution. Taxation has allocative as well as distributive consequences. In many cases, the imposition of progressive taxes contributes to the decline of investment and the withdrawal of human capital from the labor markets. It becomes almost self-defeating to find moral support for the very tax regime that has helped to contribute to a societal slowdown and to the current economic distress. In general, the opposite approach is better. If the flat tax is preferred in good times, as I think is the case, it should be preferred in bad times as well.¹⁸ The advantages in good times include the simplification of the overall tax structure, the removal of incentives for people to split or assign income in counterproductive ways, and the elimination of the political risk of allowing, as now is the case in California, for a very large portion of the population to enact tax increases that only a small

17. Pub. L. No. 72-154, § 47 Stat. 169, 177 (imposing a top marginal tax rate of fifty-five percent on net income); *id.* § 11, 47 Stat. at 174 (imposing an additional eight percent tax on net income, minus certain deductions).

18. See Richard A. Epstein, *Can Anyone Beat the Flat Tax?*, 19 SOC. PHIL. & POL'Y 140 (2002).

slice of its richest citizens pay. The long term political dynamic of any steeply progressive system of taxation is to level off government expenditure, which in turn will reduce the overall level of production. In an ideal world, then, we do not constantly have to figure out how to switch tax structures as good times become bad and bad times become good. We follow instead the advice of David Hume, who thought that the stability of possession (by which he meant the institution of property generally) was the key to long-term success.

We do not, however, reside in perfect times. So one question that arises is what to do if current tax levels are high and there is no practical means to reduce them in the short run, precisely because of the strong populist impulse toward progressive taxes. At this point, we have to bite the bullet and recognize that something must be done in a second-best world to offset the loss of wealth (for both consumption and investment) in the private sector. One way to do so is to prime the pump to spend the revenue quickly. But, make no mistake about it, this spending binge by government is a distinct second-best solution. There is no reason to think that the government knows what projects to invest in, or why. To be sure, there is always room for government investment in infrastructure under any sensible theory of *laissez-faire*,¹⁹ but in general the effort should be to invest only to the point where the last dollar on public expenditure has the same rate of return as the last dollar on the private side. That ratio need not change as times get bad, especially if infrastructure were properly cared for in good times.

Yet that is not how matters sit with the new Keynesians. Posner seeks to find a larger space for public investment in a downturn by declaring that “[an a]mbitious public-works program can be a confidence builder,” seeking to tap into Keynes’s explanation of how the government can promote the “return of confidence.” But the argument ignores the obvious indignant response that a poorly run government program can destroy confidence and further demoralize businesses who think that higher taxes will snatch away the fruits of their efforts. Only by assuming the eternal and unalterable benevolence of government can one posit that all soft externalities will move in the same direction. Think of the public cynicism about the Alaskan

19. See Jacob Viner, *The Intellectual History of Laissez Faire*, 3 J.L. & ECON. 45 (1960).

“bridge to nowhere,” or foolish public expenditures that led to the construction of the Murtha-Johnstown-Cambria Airport. These projects shatter public confidence.

What is missing from this entire paean to public works and expenditures is any sense of the public-choice dynamics that make pork barrel politics the order of the day. I am no social historian, but I suspect that public expenditures were also hijacked for partisan advantage in the Great Depression. But by the same token, I think that the size of the heists are far greater in a \$787 billion pork barrel package, most of which is directed toward delayed capital expenditures that do not have (if any expenditure has) their supposed stimulus effect. In the end, it seems clear that the best solution is to lower taxes and not to leverage high taxes as an excuse for expanded public spending.

A third area that attracts little or no attention from Keynes is the extensive New Deal drive toward cartelization of industries, which may well have had a parallel impulse in Great Britain. American industrial cartelization was no modest endeavor. In the eighteen months between August 1933 and February 1935, FDR’s administrative agencies churned out some 546 Codes and 185 Supplemental Codes, pursuant to which they issued over eleven thousand administrative orders in the relentless pursuit of “fair” competition.²⁰ The National Industrial Recovery Act (NIRA) was of course opposed to using these industrial codes to promote monopoly.²¹ But that spurt of generosity arose only because the Roosevelt political agenda organized cartels instead, which did not “oppress small enterprises [or] operate to discriminate against them.”²² These codes set minimum prices or, alternatively, requirements that goods be sold only above cost, generously defined, which is an indirect way to impose price floors. The social losses resulting from cartels are well established in economic theory and flow to the bottom line no matter what fiscal or monetary policies are in place. Their removal should have been a top priority of the very Roosevelt Administration that established them. The same

20. See LOUIS L. JAFFE & NATHANIEL L. NATHANSON, *ADMINISTRATIVE LAW, CASES AND MATERIALS* 52 (4th ed. 1976).

21. See National Industrial Recovery Act, Pub. L. No. 73-67, § 3, 48 Stat. 195, 196 (1933).

22. *Id.*

can be said about the continued use of the various agricultural marketing orders that have similar effects today.²³

The New Deal efforts on this score were not limited to product markets. Before the first round of codes was struck down on grounds of improper delegation in *A.L.A. Schechter Poultry Corp. v. United States*,²⁴ the New Dealers included a minimum wage and maximum hours standard, intended to cartelize labor markets. This was no accidental adjunct to the Roosevelt program. It was yet another manifestation of the relentless progressive agenda to substitute cartels for competition whenever possible. Indeed, the NIRA interventions did not die with the invalidation of the statute that created them. Because *Schechter Poultry* was decided on broad nondelegation grounds, the entire issue resurfaced in a statute with greater particularity, the Fair Labor Standards Act of 1938 (FLSA),²⁵ which was sustained with great fanfare in *United States v. Darby*.²⁶ The FLSA provided a solid statutory foundation for regulations of the minimum wage, maximum hours, and overtime that have expanded in scope relentlessly from the time of its initial passage.²⁷

Nor were NIRA and FLSA the only misguided efforts to cartelize labor markets. Many of the low points of the Great Depression involved misguided labor statutes that had an adverse impact on unemployment. The year 1931 saw the adoption of the Davis-Bacon Act,²⁸ which required wages on government contracts to be set at the “prevailing” level within the local community.²⁹ There is some dispute as to whether the legislation was passed with an explicit intent to keep African-American workers from the South from competing with white laborers from the North.³⁰ But even if

23. For the origins of this agricultural policy, see the Agricultural Adjustment Act of 1938, Pub. L. No. 75-430, 52 Stat. 31, which replaced the Agricultural Adjustment Act of 1933, Pub. L. No. 73-10, 48 Stat. 31 (introducing quotas and crop supports).

24. 295 U.S. 495 (1935).

25. Pub. L. No. 75-718, 52 Stat. 1060 (codified as amended at 29 U.S.C. §§ 201–219 (2006)).

26. 312 U.S. 100 (1941).

27. See, e.g., *Christensen v. Harris County*, 529 U.S. 576 (2000) (exploring its application to overtime wages for public sheriffs).

28. Pub. L. No. 71-798, 46 Stat. 1494 (1931) (codified as amended at 40 U.S.C. §§ 3141–3148 (2006)).

29. *Id.* §1, 46 Stat. at 1494.

30. See, e.g., David Bernstein, *The Davis-Bacon Act: Vestige of Jim Crow*, 13 NAT'L BLACK L.J. 276 (1994).

the statute had no racist element, its protectionist origins against interstate competition cannot be disputed. Nor is it possible to deny the consequences of shielding incumbent workers from external competition: small local gains at the expense of larger national losses. Davis-Bacon is hardly a winning strategy to beef up national labor markets in times of high unemployment. Its repeal is seventy-nine years overdue.

Next on the list is the Norris-LaGuardia Act of 1932,³¹ which sharply limited the use of labor injunctions in trade disputes. Most importantly, it followed the pattern of the English Trade Disputes Act of 1906³² by refusing to issue injunctions when labor unions tried to induce workers to unionize secretly in violation of their terms of employment. Previously the employer had been able to stop the offending union in its tracks by obtaining injunctive relief, a right of action that the Supreme Court upheld in *Hitchman Coal & Coke Co. v. Lewis*.³³ The statute thus strengthened the hands of unions in ways that once again pushed wages for labor further from the competitive equilibrium, with a consequent loss in social welfare.

That statute was followed by an elaborate effort to organize collective bargaining arrangements under the NIRA. That act was struck down in *Schechter Poultry*,³⁴ only to reappear in much more institutionalized form in the National Labor Relations Act of 1935,³⁵ which created a new enforcement mechanism in the National Labor Relations Board. So a statute intended to usher in an era of labor peace brought in its wake labor instability that certainly failed to draw capital into labor intensive industries.

It is easy to understand the sense of desperation that led to the passage of these acts, but it is impossible to ignore the role that they played in keeping levels of unemployment high. Here, again, it hardly matters whether Keynes, Krugman, or Posner (especially the last two) supports these statutes or not. If they support or ignore these statutes, they have allowed macroeconomic concerns to blind them. If they oppose these statutes, they do so for microeconomic reasons that have nothing to do with the grand Keynesian synthesis. But either way, it is hard to defend the position that

31. Pub. L. No. 72-65, 47 Stat. 70 (1932).

32. Trade Disputes Act, 1906, 6 Edw. 7, c. 47 (Eng.).

33. 245 U.S. 229 (1917).

34. 295 U.S. 495 (1935).

35. Pub. L. No. 74-198, 49 Stat. 449 (1935).

these midlevel changes do not matter, and harder still today to think that the situation would not get worse with the passage of the Employee Free Choice Act, against which I have argued at every possible opportunity.³⁶ Posner himself is opposed to passage of the statute but thinks that its effect will be moderated by the global nature of labor markets.³⁷ That perception is at odds with the perception of the American business community, which recoils at the prospect of a card-check device for selecting unions followed by a mandatory arbitration of the substantive term of the labor contract. This latter requirement is a real job killer if anything is.³⁸ Put otherwise, the favor that the Obama Administration shows to organized labor is a real disincentive to economic recovery in employment markets. One does not have to be a Keynesian to explain why unemployment rates now stubbornly persist at around ten percent, with no decline in sight. The threat of more labor and environmental legislation acts as a real deterrent to new jobs. And the recent passage of ObamaCare will roil labor markets for years to come.

Last, there is the question about the stability and operation of financial markets, and here too the case for some Keynesian explanation for the failure of these markets looks to be vanishingly thin. As before, there are some conventional explanations that Keynesians may embrace, but these are hardly distinguishable from the more traditional Chicago-style explanations. Thus, the obvious culprits are the easy money policies of the Federal Reserve and the unwise guarantee policies of both Fannie Mae and Freddie Mac. Proving we have not learned our

36. See, e.g., Richard A. Epstein, *The Case Against the Employee Free Choice Act* (Chi. John M. Olin Law & Econ., Working Paper No. 452, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1337185.

37. See Posting of Richard Posner to The Becker-Posner Blog, <http://www.becker-posner-blog.com> (Jan. 25, 2009, 21:49 EST).

38. See Anne Layne-Farrar, *An Empirical Assessment of the Employee Free Choice Act: The Economic Implications* (Law & Econ. Consulting Group, Working Paper No. 452, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1353305 (estimating on assumptions favorable to the proposed legislation an increase of unemployment from between 0.30% of 0.35% jobs for each 1% increase in unionization levels). Anne Layne-Farrar has been roundly attacked by a group of pro-labor economists on a variety of methodological grounds. For representative examples, see the essays in Volume 15 of *Just Labor: A Canadian Journal of Work and Society*. It is worth noting that the title of the journal contains an unambiguous affirmation of its political allegiances and that the articles offer no theoretical explanation of how the creation of monopoly unionization could enhance overall social productivity.

lesson, the Federal Housing Administration (FHA) is now replicating these policies and has begun to specialize in making risky loans on a 3.5% down payment.³⁹ In addition, it looks as though it will commit yet another \$50 billion to salvage homeowners who are in default or whose properties are worth less than the mortgages on them.⁴⁰ Once again, it does not take a Keynesian to note that the low rates of interest will generate a bubble, which will surely burst once there are no greater fools to step into the gap. Nor does it take a Keynesian to examine the role, if any, that mark-to-market accounting had in spurring the downward cycle in asset values as private banking houses had to sell off asset after asset to make back their margins.⁴¹

There is some debate about the extent to which these policies are attributable to securities regulation or to private covenants. The right answer is some mixture of both, which suggests that both public and private parties did not perform ideally in the financial meltdown. But that observation hardly makes the case for more extensive governmental control over lending markets. Rather, the key question is who learns more quickly from their mistakes. There are only two choices: government bureaucrats who are systematically immunized from the consequences of their decisions or private lenders who (even with imperfect employment contracts) are not. No private bank will lend on the terms that the FHA is prepared to supply. The reasons are too evident to require extended discussion.

The situation only gets worse when we look at the rules in place once mortgages go into default. From the outset I have taken the uncompromising position that the only person who

39. See David Streitfeld, *Housing Agency, Cash Dwindling, Tightens Rules*, N.Y. TIMES, Nov. 13, 2009, at A1. The FHA Down Payment Guidelines note that "FHA loans do not have a zero down payment mortgage but the down payment can be as little as 3.5%. Here is the exciting part, . . . those funds (3.5%) can be a Gift and come from a family member, charity, or your employer." FHA, *FHA Down Payment Guidelines*, http://www.fha-mortgageunderwriters.com/fha_down_payment_guidelines.htm (last visited Feb. 24, 2010). Why not do without the excitement? Note that "excitement" is an open invitation to bad underwriting. If the borrower cannot come up with the down payment on his own, chances of default probably rise.

40. See David Streitfeld, *A Bold U.S. Plan to Help Struggling Homeowners*, N.Y. TIMES, Mar. 26, 2010, at B1. Streitfeld questions whether the plan will work. The answer is no.

41. See Richard A. Epstein & M. Todd Henderson, *Marking to Market: Can Accounting Rules Shake the Foundations of Capitalism?* (Chi. John M. Olin Law & Econ., Working Paper No. 458, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1385382.

should be entitled to renegotiate loans or waive foreclosure is the bank or syndicate that holds the paper.⁴² The current policy reintroduces the worst features of the Depression strategy that sought delayed foreclosures in ways that only prolonged the agony for the individual parties and prevented the restabilization of the market. Everyone should have some sympathy for the plight of borrowers in the 1930s, given that the major deflation forced them to pay back loans with more expensive dollars than those they borrowed. But that problem can only be cured by keeping currencies stable—which is harder to do with one, or more, large stimulus programs waiting in the wings.

Today, we do not have deflation to justify government intervention, and the various programs of forced delay have done exactly what one would have predicted. Very few of the borrowers who were in arrears brought their payments current during the foreclosure moratorium.⁴³ The common result was eventual foreclosure at additional expense, at which time the underlying properties were worth less than before. The systematic effect of debtor relief is to keep these units out of the resale market, to keep prices artificially high, and to put obstacles in the path of new home buyers who were guilty of no indiscretions of their own. It does not take a Keynesian to realize that the insecurity of all forward transactions saps the confidence that governments should build in markets. Even people who have excellent “animal spirits”⁴⁴ will be loathe to invest in a market in which neither politicians nor courts give credence to “stable expectations.”⁴⁵ Animal spirits lurk in all individuals who take joy in their work. The question is whether that private satisfaction from productive labor is enough to offset the additional burdens and uncertainty of oppressive regulation.

42. See Richard A. Epstein, *The Subprime Crisis: Why One Bad Turn Leads to Another*, 2 J. BUS. ENTREPRENEURSHIP & L. 198 (2008).

43. EDWARD VINCENT MURPHY, CONG. RESEARCH SERV., ECONOMIC ANALYSIS OF A MORTGAGE FORECLOSURE MORATORIUM (2008).

44. See GEORGE A. AKERLOF & ROBERT J. SHILLER, ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM (2009). No one denies that psychology matters, but it matters far more for personal interactions than large global phenomena.

45. See, e.g., *Usery v. Turner Elkorn Mining Co.*, 428 U.S. 1, 16 (1976) (“[O]ur cases are clear that legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations.”). The “solely” overturns thousands of years of sound thinking on property rights. As to what should be added, Justice Marshall never offered a coherent answer.

The motivations of individuals are, of course, not amenable to public intervention, but the rules that either shackle or encourage innovation are. Figuring out what these are, and how they relate to the current malaise is difficult because some of the policies to which I refer have been in effect for a long time, and others are of much more recent vintage. But even older policies may have greater salience as time marches on. One need only look to the ever greater threats to solvency in Medicare, Medicaid, and Social Security to realize that incremental changes and adjustments can produce long-term effects. The same can be said about the accumulated public pension liabilities that are now the norm in states like New York and California, owing to the enormous strength of their public unions. My own sense, therefore, is that we must start dismantling these programs if we as a nation are to get out of the long-term stagflation (or inflation?) that is our due. The Keynesians have little distinct to say about this dilemma. Nor, in the end, do they have much useful to say about the issues of employment, consumption, investment, and savings that lie at the core of their theory.

II. KEYNESIAN THOUGHT ON ITS OWN TURF

In this Part, I shall examine the power of Keynesian theory in those areas where it purports to differ from the standard Chicago-type economics of thinkers such as Milton Friedman and Robert Lucas. I start with the proposition, urged by Richard Posner, that the linchpin of the Keynesian synthesis is the push toward consumption, which is said to justify the adoption of stimulus programs to spur additional immediate economic activity. Posner stresses the point that, under the Keynesian model, "consumption is the 'sole end and object of all economic activity,'"⁴⁶ which, as Posner insists, is true "because all productive activity is designed to satisfy consumer demand either in the present or in the future."⁴⁷ But the last qualification about future consumption reduces the grand proposition to a truism that deprives the Keynesian approach of all utility. Keynes's *General Theory* sets income less consumption equal to savings, which in turn equals investment. But note that "consumption" covers only present consump-

46. Posner, *supra* note 3, at 36.

47. *Id.*

tion, not all consumption. And it also refers only to private consumption, not the indirect consumption that comes from public infrastructure investment. The statement, therefore, that the sole function of all human activity is consumption does not tell us when to prefer each form of consumption. It is only a bland observation that investments fall into a class of intermediate goods that are desired solely because of the consumption that they eventually facilitate. The grand Keynesian statement looks to be no more and no less informative than a general statement that people act to maximize their utility, or that the purpose of a social welfare function is to maximize human satisfaction, which we now know equates with consumption.

The key question, therefore, is how to make the various allocations. Let us start with the temporal dimension and, to keep matters simple for the moment, focus on a single isolated individual whose only choices are to consume now or to defer consumption of some existing stock of goods. This question involves the decision whether to forgo leisure today to create something of value tomorrow. The individual's range of choices is highly complex because the choices are not just consumption now or consumption later. It is possible to create depreciable assets, for example, that are consumed through use and over time.

In dealing with this particular problem, we start with the brutal truth that production and consumption do not move in lock-step progression over time. In the agricultural realm, the common insight is that the individual must decide what portion of the crop to consume today, what to save and to consume in winter, and what to keep as seed corn to plant for the next year's crop. "Do not eat your seed corn" has a descriptive as well as metaphorical meaning. Essentially the individual makes the choice in terms of discounted present value, which inclines one weakly toward present consumption. But the desire to equalize consumption in all states of the world pushes strongly toward savings and investment. At this point the individual problem looks like the one that Milton Friedman addressed in dealing with his permanent income hypothesis in the absence of trade.⁴⁸ In periods of slack production, the individual will consume some of his store of savings; in periods of abundant production, he will replenish the stores. The objective is to even out con-

48. MILTON FRIEDMAN, *A THEORY OF THE CONSUMPTION FUNCTION* 20–37 (1957).

sumption in the face of variable production. I see nothing in the Keynesian concern with consumption that alters this analysis. It only says what has been known since Aristotle: Consumption, not investment, is the final cause of all human activity.

The next stage in the model asks what happens when we introduce the possibility of trade. At this point speaking about money as a means of exchange makes sense, and the question is how any group of individuals exploits the prospects for gains from trade. The answer, straight from Adam Smith, is through specialization. The decision to put money into a savings account or a debt instrument represents the choice to take a low but secure rate of return. Not all individuals will prefer that option, which in turn creates the opportunity for additional gains from trade by having those banks that receive their deposits lend money out to others for a higher rate of interest that compensates for the additional risk. The bank then seeks to minimize this risk by a range of good practices that include due diligence at the one end and the receipt of appropriate real security or personal guarantees at the other.

This division of labor seems desirable. Yet Posner has his doubts. Consider this striking sentence: "If you buy common stocks, you are investing, but the contribution of your investment to the productive capital employed in building a factory is attenuated."⁴⁹ Attenuated? What an odd choice of words. It makes it appear as though the individual holder of capital has somehow defaulted on his obligation to be a trader whose "animal spirits" lead him into the fray. But a far better way to describe the situation is that the passive individual investor is willing to risk his capital with those whom he trusts under a regime of corporate law that offers sufficient protection against the expropriation of his investment by either public or private parties. Indeed, in many cases, savers do not make their own decisions about which stock to buy, but hire financial advisors, invest in mutual funds, or do both. There is no mysterious downward cycle in this process. And the distinction between people who make "passive investments" and those who make "active investments" does not represent some hidden pathology. It is a sign that all is well with the economy, not that there will be some hitherto unidentified market failure.

49. Posner, *supra* note 3, at 36.

Nor is there any reason to worry that this investment will reduce aggregate consumption below the appropriate level any more than there is reason to fear that it will raise it above the appropriate level. In the case of the individual who has to deploy his assets over time, there is no one formula that indicates how much he should consume in the first period or save for each future period. A lot depends on present and future labor skills, levels of accumulated capital, and estimation of future personal needs and social conditions. Similarly, on the trade front, there is no reason to fret if some individuals decide to save more and consume less, and others do the opposite. In an article in the *New York Times*, Roger Lowenstein hits the nail on the head when he notes this nation's long-standing ambivalence toward saving.⁵⁰ On Mondays, Wednesdays, and Fridays, we lament collectively that a consumerist society takes in too much today and thus promises to short change the next generation by leaving it with a mountain of debt. Yet on Tuesdays, Thursdays, and Saturdays, we take the opposite view and deplore the "hoarding" that Keynes and Posner fear will deprive the nation of the productive juices it needs. In the end this equivocation reflects a sensible uncertainty about trade-offs between present and future consumption. But I think that Lowenstein misdiagnoses the problem when he asserts that setting the trade-off between current and future consumption is a task "that the private sector [has] thoroughly botched."⁵¹ At the very least it had a lot of help from the cheap money policies on the public side.

The urgent question, however, is not where to point fingers for past sins. It is to chart the correct future policy. Here is one simple suggestion. For heuristic purposes, put savings (investment) on the y-axis and current consumption on the x-axis. Then draw the usual hyperbolic indifference curve. Underlying today's debates over consumption versus savings is an attempt to figure out where on this curve the optimal ratio of savings to current consumption is. Obviously it is somewhere in the middle. But no one knows precisely where. In the face of that limited knowledge, the vital mission is to move the entire curve northeast by developing sound institutional practices that re-

50. Roger Lowenstein, *U.S. Savings Bind: Save money to rescue the economy! Spend money to rescue the economy!*, N.Y. TIMES, Oct. 18, 2009 (Magazine), at 15.

51. *Id.* at 16.

verse the foolish practices set out above and encourage both savings and consumption in greater quantities.

In dealing with this question, the wrong approach is to buy into the Keynesian emphasis on “aggregates,” whether for consumption, savings, investment, or anything else. This collective obsession is sure to take us down the road to national industrial policy in which we think that we can name some form of collective decision about which sectors and which firms should receive government largesse. It is once again critical to remind ourselves of Nozick’s powerful critique of patterned principles.⁵² It was just such a political maneuver to set targets for the appropriate level of home ownership in the United States—aggregately and for individual groups—that induced the public lending policies that left us with a subprime crisis with reverberations beyond the collapse of the housing markets. The same is true here. What is there to fear if governments do not seek to tweak these aggregates, but just let each individual decide for himself how much to save and how much to spend? As people will all be at different stages of their own life cycles, we should expect these decisions to be all over the lot. And the disparity will only increase when we take into account the real possibility of wealth transfers within families, including transfers across generations.

But who cares about the supposed social implications of these private acts? If I decide to save everything I have above subsistence level, it does not mean that overall savings levels will go up. The amount that I invest may lower the overall rate of return on investment, which could easily encourage others to shift toward consumptive activity. In addition, my dollars when invested get paid out to other individuals, for example, workmen in construction, who then make their own decisions as to how much to consume or to save. We cannot, therefore, draw any inference as to the total level of savings by just watching the herky-jerky movements of any one individual. We have to look at them all.

Should we be concerned with these choices because of the supposed multiplier effect gained from present consumption? Not really. The decision to save counts as deferred consumption, which has its own multiplier effect. Here it is best to drop

52. See *supra* text accompanying note 5.

the term and just substitute for multiplier effect the traditional concern with gains from trade through voluntary transactions, which typically have positive external effects by creating additional opportunities for others. As one person saves the other invests in long term projects with borrowed capital. The key point is that stable expectations require enforceable contracts and steady and predictable price levels. So long as each person makes informed trades, each of these contracts over time should be a positive sum. Reduce the transaction costs in good Coasean style by supporting stable property relationships and the temporal consumption issue will take care of itself in the same way that all such allocations take care of themselves. People make choices and are bound by their consequences. The conclusion is hardly novel, for the same thing happens when we remove the intertemporal element from the equation. The choice of one consumer good over another is only possible for persons who can articulate and act on a set of stable preferences.

The puzzle is still not complete, however, because we have to worry about the creation of bona fide public goods that markets cannot generate. For that task we need to have a set of taxes that, ideally, create the fewest possible distortions in private behavior. We could think of general revenue taxes, special assessments, tolls, or other user fees as a way to support public projects. But the correct mix of public and private should not be determined by deciding to honor or override our animal spirits. What is really needed is a good estimation as to whether the next dollar on some public improvement is worth as much as or more than the next dollar in private hands. That question does not prejudge the further issue of whether the public funds should be spent on immediate consumption, such as rescue operations in a flood, or on long-term benefits, such as building the right superhighways. These trade-offs are governed by the same rules applicable to the private side.

But the one point that is clear is that there is no gain from stimulus programs that waste money and squander resources. In any sensible evaluative scheme we do not praise current expenditures that produce goods of no long-term value. It is for that reason that Keynes seemed loopy when he approved Roosevelt's decision to destroy excess crops, which were stored at government expense solely because of the agricultural adjustment acts that kept output down to keep prices up. We might as well burn down buildings to create new jobs in construction,

dig for oil with teaspoons in order to stimulate labor, or provide large subsidies to buy clunkers in August 2009, only to see new car sales plummet in September.⁵³ The simple objection to Keynesian pump priming in a first-best world is that we are priming the wrong pump when public control over general investment (sound infrastructure aside) yields less usable output than the private investment itself.

CONCLUSION

In the end, I can see nothing distinctive in Keynesian theory that advances our understanding of economics. Consumption becomes a nice substitute for utility that conceals the trade-offs between current consumption and investment and between public and private investment and consumption. The real task is to figure out the right set of property rights that will give individuals incentives to make the right personal choices. Sound institutions will boost confidence across the board and encourage investment so long as no one has to factor into the equation the huge levels of gratuitous uncertainty that stem from useless government intervention. We have to accept that external circumstances will create good and bad times. No economic theory can ward off hurricanes, disease, or war, even if sound social institutions can contain some of their adverse effects. But the purpose of government is not to eliminate all the uncertainties of nature and politics. It is to not add to the confusion by creating baroque structures of taxation, regulation, and government spending that add fresh layers of uncertainty through mechanisms that expend real resources in order to reduce social output. One does not have to be a Keynesian to know that the sum of three negatives (administrative cost, allocative distortions, and unneeded uncertainty) is always negative, no matter what their relative proportions. Getting out of the gimmick business will do more good than all the bogus short-term stimulus packages that muddle-headed or devious politicians can generate. We do not want government to do nothing, but we do not want it to do something stupid either. The presumption remains: Government intervention is bad until shown to be good. For that reason I am not, nor will I ever be, a Keynesian.

53. See Nick Bunkley, *After Clunkers Program, Sales Are Slow Again*, N.Y. TIMES, Oct. 2, 2009, at B3.