Fake Economics: Keynesian Myths Revisited

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INTRODUCTION

Keynesian Macroeconomics failed to predict the stagflation of the 1970s. It failed to predict the economic boom of the 1980s and 1990s. It failed to predict the worst economic recession since the Great Depression, in 2007-2009. It then failed to predict the slowest economic recovery in recorded history. And now Keynesian macroeconomics is in the process of failing to predict the current economic boom. One would think that, with this dismal track record, serious economists would at least question the theoretical underpinnings of Keynesian Macroeconomics.

But we must be careful to distinguish between what Keynes actually said, Keynesian Economics, and what has become of what he said, Neo-Keynesian Economics. For example, Keynes was a staunch anti-inflationist and was absolutely against increasing the money supply. Yet much of Neo-Keynesian policy has to do with monetizing the debt, i.e. printing the money to have government spend it. What Keynes prescribed as a cure for prolonged depression was for government to run a fiscal deficit during a downturn, but then run an offsetting surplus during an upturn. There should be no net accumulation of debt over the course of the business cycle. But now, we have this from Nobel Economist Paul Krugman (the Keynesian's Keynesian), speaking of the Great Recession,

> "*If we discovered that, you know, space aliens were planning to attack and we needed a massive buildup to counter the space alien threat and really inflation and budget deficits took secondary place to that, this slump would be over in 18 months. … There was a Twilight Zone episode like this in which scientists fake an alien threat in order to achieve world peace. Well, this time, we don't need it, we need it in order to get some fiscal stimulus*." (Krugman, 2011)

In this paper we identify and analyze four categories of Keynesian Myths.

(I) Accounting Myth
(II) Philosophic Myth
(III) Praxeological Myth
(IV) Leakage Myth

We do not claim that these Myths are independent categories. Rather, they are interwoven as shown below.

I. The Accounting Myth

GDP = C + I + G + NX: "*Market value of all final goods and services, produced within a country, in a given period of time*" (*Mankiw, 2017*)

C = Consumption purchases
I = Investment purchases
G = Government purchases
X = Net Exports (Exports – Imports)

Let us ignore for now the Austrian critique of Keynes, known as the Aggregation Problem and the Pretense of Knowledge:

> "*We know, of course, with regard to the market and similar social structures, a great many facts which we cannot measure and on which indeed we have only some very imprecise and general information. And because the effects of these facts in any particular instance cannot be confirmed by quantitative evidence, they are simply disregarded by those sworn to admit only what they regard as scientific evidence: they thereupon happily proceed on the fiction that the factors which they can measure are the only ones that are relevant*." (Hayek, 1974)

The construct of Keynesian GDP is merely an accounting definition, i.e. a tautology, with total production of goods and services broken down by category. But Keynes took it to be a causal relationship. He believed that spending creates production. By defining "G" (government purchases of final goods and services) to be part of Aggregate Demand, the accounting math would lead one to believe that increased G must of necessity lead to increased GDP. But look at the definition: There is no market value for most Government purchases, since there is no market for them at all.

What was the market value of the Bridge to Nowhere? It was whatever the government spent on it. Nothing of value was produced, yet it was booked in the National Income and Product Accounts as a government purchase that increased GDP. Indeed, for many government projects the costs <u>are</u> the benefits.

If Keynes was right, then the Soviet economy would have been the strongest in the world since it consisted of 100% government spending. This is clearly false as they could barely feed themselves. Same with N. Korea v S. Korea, and with any number of state-controlled economies v. market economies.

A. The "Prentice Principle" – Government has no money. Any government purchases must by the principle be necessarily subtracted from C through taxes, subtracted from I though taxes on savings and private investment, or subtracted from NX through tariffs and NTB. Government purchases financed by borrowing raises the interest rate and crowds out private sector activity, and government purchases financed by printing money lowers the value of the currency and thus all private sector economic activity in C and I. History has shown over and over again that an economy cannot print its way to prosperity. And Bastiat shows that an economy cannot bomb its way to prosperity (Bastiat, 1846). We can see the result of government projects, but we cannot see the unseen. We need to ask, "*What would have happened otherwise?*", i.e. what are the opportunity costs of the government project? (Hazlitt, 1962)

B. Government purchases, especially military, do not create wealth or economic growth. The best example is pre-WWII Nazi Germany, which had robust GDP growth in the late-30's fueled by the government rearmament program but people still waited in line for food and clothes. Same with the USSR, where consumer goods were rationed (7 years for a car) yet according to official figures GDP grew due to military purchases.

Robert Higgs (1992) found similar data for the U.S. Although the measure of GDP grew during WWII, consumption purchases per capita actually fell. People had access to fewer goods and services, not more. Rubber tires were rationed for automobiles. Meat was rationed. Any consumer product using steel was rationed. It was not until WWII was over, and private consumption and capital investment replaced government purchases, that an actual recovery in the standard of living began. Yet, at that time, Keynesians claimed that the sharp reduction in government purchases after WWII would return the economy to depression. Yet the economy boomed. Private sector activity creates wealth, public sector activity does not.

> "*Per capita growth and the ratio of private investment to GDP are negatively related to the ratio of government consumption expenditure to GDP. An interpretation is that government consumption introduces distortions, such as high tax rates, but does not provide an offsetting stimulus to investment and growth. On the other hand, there is little relation of growth to the quantity of public investment.*" (Barro, 1991)

C. Although Keynes made a clear distinction between government purchases and government spending, this distinction has been lost (*Keynes, 1936*). Purchases of goods and services requires production of goods and services, and the employment that goes along with production. But the vast majority of government spending today – about 75% -- is not on currently-produced goods and services, but on Marxist transfer payments – confiscating income and wealth from one person to redistribute to another (Budget in Brief, 2018)

Consider a person who receives a welfare payment, and stays home to watch Jeopardy reruns. Since it is a transfer payment, there is no addition to GDP. But if a government bureaucrat writes a job description to hire someone to watch Jeopardy reruns, then it is booked as an increase in GDP by the amount of “*one man-day of watching Jeopardy reruns*”.

Now consider a plain plot of level ground. If it remains in that condition, then no production has occurred. Yet if government hires a person to dig a hole, then one dug-hole shows up in the GDP accounts. Then if government hires another person to fill in that same hole, then one filled-in hole shows up in the GDP accounts. GDP shows a double increase, two government jobs have been created, yet no actual production has occurred.

D. According to Jean-Baptiste Say, production generates the income necessary to purchase the product (Say, 1803). This can be rephrased as “*factor payments exhaust the product*”. When General Motors produces a car worth $25,000, it represents payment to the factors of production – land, labor, and capital. Perhaps it consists of $5,000 payment to land, $15,000 payment to labor, and $5,000 payment to capital. It is the act of production that creates the income to buy that production (payment to capital is a residual). Production precedes consumption, not the other way around. Think logically, how can something be consumed unless it first has been produced? Yet Keynesian economics teaches that consumption creates production. It confuses an accounting identity with a causal relationship.

I. The Philosophic Myth

In the Keynesian Definition of GDP, it makes no difference what is produced or on what the income from that production is spent. One dollar of Personal Consumption has the same economic value as one dollar of Government Purchases. This is clearly false as the value and meaning of the economy is vastly different if a consumer purchases something with their income earned by voluntary marketplace labor, v. if government purchases something with money commandeered at gunpoint or threat of gunpoint.

A. The choices a consumer makes reflect rational utility choices on the opportunity cost of any economic decision. This includes the decision to work (earn) in order to obtain income for consumption, as well as the decision to consume or save (MPC and MPS). Because the government does not have to earn its money, it misallocates resources because the opportunity cost is not considered. There is thus no objective measure of value (or utility) of government purchases, which explains why government consistently wastes and misallocates resources.

According to Keynes, government purchases are more expansionary than tax cuts, yet Aesina and Ardagna (2009) found the opposite results:

> "*Our results suggest that tax cuts are more expansionary than spending increases in the cases of fiscal stimulus*."

B. Consider that your own a factory, and that you engage in production by hiring the factors of production through voluntary exchange based on market prices. The very fact of you doing this means that you have achieved the greatest level of your subjective value, based on your resource constraints. If that was not the case, you would be doing something else – obviously. The same is true of the executive team you hire, and of the production workers you hire.

   Now assume that the neighborhood around your factory becomes infested with criminal gangs. You must consume scarce resources to hire protection for your plant and your people. Clearly you must move down to a lower level on your value scale. Further, you now have fewer resources to use for production and hiring. All people associated with your enterprise now have to move down on their value scale.

   Even traditional Microeconomics says that your supply curve shifts to the left due to the increase in cost – you are now able and willing to produce less than before, at each and every price. But if instead of purchasing the private security, you now pay a tax to government to provide the security, it magically ends up in the Keynesian model as an addition to Aggregate Demand which then shifts to the right, when in fact it is a subtraction from Aggregate Supply.

C. Government is the overhead cost of maintaining a free society. Its only legitimate purpose is to protect the pre-existing rights to life, liberty, and property. Therefore government should be limited. Any other activity in which it engages is illegitimate, according to America's founders (Jefferson, 1821). Massive government interference in the economy has more to do with the philosophy of Karl Marx than it does with the philosophy of John Locke or Thomas Jefferson (Locke, 1690).

D. According to the Keynesian model, a dollar spent by a consumer on a pick-up truck has the same GDP value as a dollar spent by a farmer or rancher on the same pick-up truck used in his business. In the first instance, Consumption has increased. In the second instance, Investment has increased. The same item has a vastly different purpose. For the business, it becomes part of the capital stock that is used to generate production – it adds to the resource base to increase not just current GDP, but future GDP as well. It should be thought of as a supply-side variable, not a demand-side one.

II. The Praxeological Myth

Austrian economists emphasize the key role of subjective value in what Ludwig von Mises called Praxeology – the science of Human Action. People rank-order their values, and use their scarce means to achieve their highest ends. These values are necessarily subjective, individualistic, and changeable depending on time and circumstance.

A. Say you come to a bar intending to spend $8 on beer and $2 on chips – for $10 of Consumption. But then government commandeers a 20% tax, so that you can only spend $8 on beer and $0 on chips. That puts you automatically down lower on your subjective value scale. But Keynesian economists say that the economic effect is the same. To them, if you spend $8 on beer and $2 on chips it is no different from you spending $8 on beer and government spending $2 on its values. This is clearly false.

B. Government is not the only destroyer of subjective value. Any theft has the same effect. If, on your way to the bar, a robber takes that $2 you were going to spend on chips and spends it on his values instead, the Keynesian model shows the same GDP. The fact that the robber has moved up on his subjective value scale does not, indeed cannot, make up for your loss by moving down on your scale. Since inter-personal comparisons of utility are not possible, there is no way to measure the net loss of value – we only know that, by the act of coercion, value has been destroyed.

   In this respect how is government any different from a normal thief? (Jefferson, 1821). Yet according to the Keynesian model, if government confiscates the income of 50.1% of earners in an economy and redistributes it to the remaining 49.9% by hiring them to produce bridges to nowhere, this will boost GDP.

C. Incentives matter. If anything, this is a prime directive of all economics (Hayek, 1944; Mises, 1946; Mankiw, 2017). To say that people respond to incentives is a self-evident truth, a Praxiological Axiom. Yet in the Keynesian model, when government confiscates income from productive people and uses it to hire unproductive people, then GDP increases. Yet production is dis-incentivized at the same time that sloth is incentivized. Keynesian economics runs counter to the basic economic logic of Human Action.

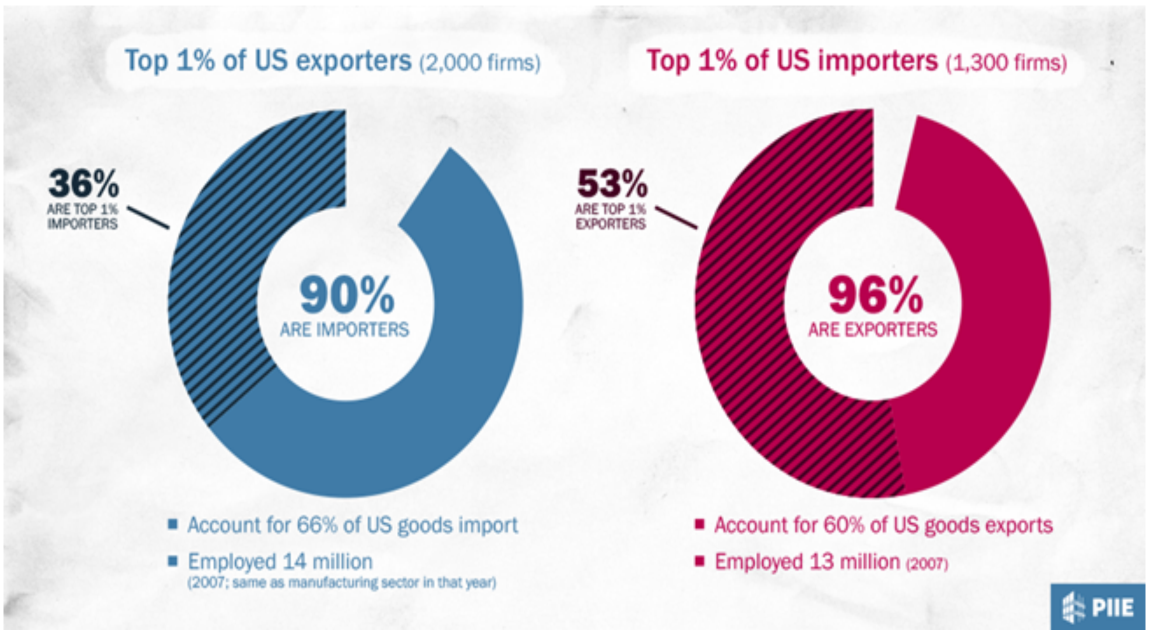
III. The Leakage Myth

According to Keynes, there are two sources of leakage from the spending stream of aggregate demand: (A) Imports, which are said to subtract from GDP; and (B) Savings, which are likewise said to subtract from GDP.

A. With respect to Imports, Keynes alleges that they subtract from GDP since they have a minus sign in the accounting tautology. But this is clearly false. If I buy a car imported from Japan, it shows up as 1 car purchased as a positive under the

Consumption category, and as 1 car imported as a negative under the Imports category – no net effect on GDP. Furthermore, I would only chose to import a car if I subjectively valued that purchase more than my next alternative.

The largest importers are a significant portion of the largest exporters (*see chart**). Imports of intermediate goods lead to exports of finished good. Imported finished goods are applied to the country of assembly in today's globalized world, which is not necessarily the country of manufacture. Example iPhone, assembled in China from components from over 60 nations. In many cases "imports" have a high percent of US parts (*example: cars from Mexico and Canada*).



If the U.S. did not import goods and services, foreign purchasers would not have the necessary dollars to purchase our exports. In fact, every dollar of imports into the U.S. economy must come back either as exports or as a capital investment. The dollars do not disappear; they either show up in the current account or in the capital account. There is no Keynesian leakage.

B. With respect to Savings, Keynes (1936) alleges that it subtracts from GDP because it is omitted from the accounting tautology. If a household saves, it consumes less, therefore subtracting from GDP. But it is that very savings that provides the financial capital for the Investment category. Again, the Keynesian perspective is clearly false. The price that helps us make the economic calculation of current v. future consumption is the interest rate, which can be thought of as the price of time itself – the social rate of time preference.

Savings is used for investment, which increases the capital stock and leads to future economic growth. Savings is deferred consumption. By manipulating the interest rate the government changes the relative price of savings vs. consumption and causes a misallocation of resources. Indeed, by manipulating interest rates government changes the social rate of time preference and alters the very fabric of a free society. In particular, with artificially-low interest rates people can be fooled into thinking they can consume more without the necessity of saving for the future (Hayek, 1944).

In the Keynesian model, the economy would be stronger if there was no Savings, But if there was no Savings, there would be no Investment. And if there was no Investment, there would be no capital stock. And if there was no capital stock, humanity would be stuck in caves living as hunter-gatherers, surviving from day-to-day with a life-expectancy of about 35 years.

Keynes believed that savings were a leakage based on the false assumption that savings would (presumably) be placed in a mattress – ignoring the fact that saving in banks are promptly lent to investors. But even Keynes realized that:

> "*Public investment should consist of those projects that provide a real return over time, either in cash returns such as public enterprises, or indirect returns such as school buildings*." (Brown-Collier and Collier, 1995)

C. Interest rates are determined as the price of capital in a market for loanable funds. When government interferes in this market through a Central Bank and lowers the interest rate, it fosters malinvestment. When government manipulates the rate of interest below its natural market rate, then projects get undertaken that could not be justified by the market rate. Capital flows into these longer-term projects, lured by low interest rates. But eventually, market rates must reassert themselves.

Those longer-term projects eventually go bust. Reality has an inconvenient way of overturning the best-laid central plan. The heart of the Austrian theory of the Business Cycle explains the repeated booms-and-busts in the U.S. housing market. It also explains why the U.S. economy has been building too many houses and too few factories. Using scarce real capital (real savings) to build a house provides a few one-time jobs during the building. But using that same scarce real capital to build a factory not only creates the one-time jobs during the building, it then leads to on-going jobs in that factory.

> How does an economy know how and where to allocate its scarce resources? It is either through a central plan created by government authority, or it is through no plan at all based on private property and real market prices for both inputs and outputs. History shows over and over again that the latter creates not just more prosperity, it also leads to a free and peaceful society.

CONCLUSION

We have shown the false logic of Keynesian economics. An important question remains, "*Why then do the vast majority of academic economists prefer Keynes over Hayek?*"

Perhaps it is time to get back to reality economics. At a minimum, we believe that universities should teach both schools of thought, Keynesian and Austrian, and let the best ideas win the battle. The next phase of research should be an investigation by political scientists as well as by economists (political economists?) into answering that "Why".

We suspect the answer is ideological rather than scientific. Keynes and the Statist central planners that sprang up from his ideas simply believe, against all historical evidence and against all economic logic, than government can guide an economy to better outcomes than can a market economy. Indeed, the following quote is taken directly from the German edition of The General Theory:

> "*The theory of aggregated production, which is the point of the following book, nevertheless can be much easier adapted to the conditions of a totalitarian state [eines totalen Staates] than the theory of production and distribution of a given production put forth under conditions of free competition and a large degree of laissez-faire*." – (Hazlitt, 1959)

And consider this, in a letter from Keynes to Hayek following the publication of Hayek's "The Road to Serfdom":

> "*I should say that what we want is not no planning, or even less planning, indeed I should say that we almost certainly want more*." – (*Keynes, 1944*)

Keynes provided a great intellectual excuse for the Progressive Era, to move an economy away from free markets, private property, and limited government, toward an economy dominated and controlled by government.

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