Going for the Juglar: Keynes, Schumpeter and the Theoretical Crisis of Economics

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Abstract: this paper was presented in the session on 'Long Waves in Political Economy' organised by Ingo Schmidt at the Congress of the Humanities and Social Sciences, Ottawa, June 1-4 2015. It discusses the 'theoretical turn' towards state intervention in the last Great Depression and the need for clarity about the underlying views of Keynes and Schumpeter – two of the major opposed players in that theoretical turn. It argues that primary function of economics as an esoteric discipline disguises the essence of these underlying theoretical positions. Thus in order to make a rational and evidence-based connection between theory and policy, attention both to interpretation and to assertive pluralism is indispensable.

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Alan Freeman, Ottawa, June 3 2015

In this paper, I will look at 'Long Movements' in economics through the prism of a theoretical crisis that it underwent in the last Great Depression of 1929-42. In this way, I hope to shed light on the kind of developments we might expect in the theoretical crisis through which the discipline is now entering, under the impact of the Great Depression which began in 2008.

I start with a paradox. On the policy questions at issue in the battles of the 1930s, Keynes and Schumpeter stood on opposite sides. Schumpeter was a trenchant defender of the Austrian *Laissez-Faire* policy position; Keynes called not just for demand management but for the 'socialization of investment' and the 'euthanasia of the rentier'.

If we focus only the economic content of these policies, and if we refer to what these authors actually proposed (instead of what is merely attributed to them by their detractors and supporters) Keynes is clearly closer to Marx especially on the critical question of state's role in production. It is not unfair, indeed, to say that the principal policy difference is that of agency; to achieve the 'despotic inroads on the rights of property' of which the Manifesto speaks, Marx's requirement is to 'raise the proletariat to the position of ruling class to win the battle of democracy,' whilst the fairly despotic measures which Keynes proposes above are (presumably) to be performed within the structures of the existing state and system of legal rights.

This proximity on the field of policy appears at first sight to be inverted on the terrain of theory. Schumpeter lauds Marx as the co-discoverer of economic cycles, while Keynes hardly mentions him and even excludes this most consistent 19th Century critic of Say's Law from the list of its prescient opponents which opens the *General Theory.*

In summary as regards the policies that Marx is associated with, Keynes's conclusions are surprisingly close to Marx whereas Schumpeter's are the polar opposite. But as regards the theoretical positions on the basic laws governing the long-term tendencies of the capitalist system – which ought, in principle, to be the rational basis for policy – these two writers present the matter as if the opposite were the case.

There thus appears to be, at least at the superficial level, a contradiction between the policy stances taken on the one hand, and the theoretical principles underlying them on the other. After all, if policy is not rationally deduced from theory, what is the point of the theory?

I will argue that this paradox is not an accident but is typical of the 'form of appearance' of disputes in economics are treated particularly at times of what I term *Theoretical Crisis*, which occur during profound, long and politically disruptive depressions such as the present one, and that of 1929-1942. For this reason, if we want to understand how economics, as a discipline, reacts to the stress of major event which call its principal precepts into question – such as the current Great Depression – we cannot expect a transparent or self-evident mapping between theories as they are publicly expressed and policies as they are rationally required. We must instead conduct significant *exegetical* or *interpretative* work, to uncover theoretical presuppositions that are often concealed, when new theoretical interventions make their appearance. The proven ability to conduct such study in an evidence-based manner, I then argue, should be part of the assertive pluralist competence of an economist (Freeman 2010).

I have dealt with some of the detail of the interpretative questions elsewhere (Freeman 2015a-d), so here in the spirit of the title of this session, I want to focus on the essential character of the problem rather than providing chapter and verse concerning the theoretical positions of the protagonists. I will supply sufficient textual and exegetical material to make clear the point at issue.

I will attempt therefore to express the dispute in its purest possible theoretical form. Schumpeter articulates the idea that *capitalism can restore itself unaided* whereas Keynes, and Marx, articulate the directly contrary idea that *capitalism generates contradictions it cannot solve on its own*. That is the central point of this presentation. It is, I will argue, the central contradiction of economic thought and therefore the key to its long-term oscillations and to the turning points in those oscillations, its theoretical crises.

Let's begin with Schumpeter. Here is what he writes about Marx:

> He [Marx] aptly says that 'the superficiality of Political Economy shows itself in the fact that it looks upon expansion and contraction of credit, which is a mere symptom of the periodic changes of the industrial cycle, as their cause.' … We find practically all the elements that ever entered into any serious analysis of business cycles, and on the whole very little error. Moreover, it must not be forgotten that the mere perception of the existence of cyclical movements was a great achievement of the time. Many economists who went before him had an inkling of it. In the main, however, they focussed their attention on the spectacular breakdowns that came to be referred to as 'crises'. *And these crises they failed to see in their true light, that is today, in the light of the cyclical processes of which they are mere incidents (*Schumpeter 1965:41; emphasis added).

This statement, with its fulsome endorsement, contains a poison pill. Marx, we learn, discovered the cause of crisis: the business cycle. But he failed to make the final correction: since cycles are the cause of the spectacular breakdowns, he failed to see these spectacular breakdowns in their true light. Schumpeter, that is to say, uses Marx against Marx. His true objective is to show that all crises are merely a manifestation of capitalism's inherent self-correcting tendencies, which consist in an oscillation around equilibrium. The apparent endorsement disguises its opposite.

Now let us turn to Keynes. A somewhat Ozymandian slide offers the classic 'pre-neoliberal' reading of Keynesian, from its chief apostle, Samuelson.

> The United States has experienced numerous cyclical ups and downs. At the same time, we have avoided depressions – the prolonged, cumulative slumps like those of the 1870s, 1890s, or 1930s. What has changed in the last 50 years? Primarily, developments in macroeconomics now allow governments to take monetary and fiscal steps to prevent recessions from snowballing into a persistent and profound slump. If Marxists wait for capitalism to collapse in a final cataclysmic crisis, they wait in vain. The wild business cycle that ravaged mature capitalism during its early years has been tamed. (Samuelson and Nordhaus 1992:371-372)

Perhaps if we want to truly understand the scale of the mess that economics is in today, we must first realise that the majority of practicing Anglophone economists were introduced to economics by the textbook cited above.

The entire debate about today's Great Depression revolves around two alternative propositions. The first says that essentially Samuelson was right, one upon a time we fixed the business cycle, and the cause of the present crisis is the reversion to *laissez-faire* or neoliberalism.

A more sanguine view, far closer to Marx but also more consonant with the evidence, argues that crisis expresses a deeper unresolved failure of capitalism, specifically its failure to maintain *investment*. This in turn is produced by capitalism itself; it is the outcome of accumulation, the cause of the fall in the profit rate. Where does Keynes stand on this? His theory of investment revolves around the Marginal Efficiency of Capital (MEC), his key explanator for investment behaviour.

> The ordinary theory of distribution, where it is assumed that capital is getting *now* its marginal productivity (in some sense or other), is *only valid in a stationary state*. … the extent of investment in any direction will depend on a *comparison between the rate of return over cost and the rate of interest*. (Keynes 1971:139-140. The second emphasis is mine)
>
> The demand for capital is strictly limited in the sense that *it would not be difficult to increase the stock of capital up to a point where its marginal efficiency had fallen to a very low figure*… The return from [new means of production] would have to cover little more than their exhaustion by wastage and obsolescence together with some margin to cover risk and the exercise of skill and judgment (*idem,* emphasis mine)

The opportunities for productive investment are capitalised over their expected lifetime and discounted by the expected rate of interest; only those are undertaken whose expected discounted return is above zero. It is the difference – Marx's surplus profit – between the return on productive investment, and that on financial hoarding or accumulation, which determines the level of investment.

But the rate of return on productive investment is none other than the rate of profit. What then determines its progress? Precisely that advanced by Marx, that is, accumulation. 'It will not be very difficult to increase the stock of capital' is just a cautious way of saying that this is very likely to happen. Moreover, we argue in Kliman et al (2015), Marx's 'Law of the Tendency of the Rate of Profit to Fall' must be understood as an *explanation of what is observed* not a *prediction of what must inevitably happen.* As explanations for the falling profit rate, and as statements of the great difficulties that a falling average rate will produce for capitalism, the two theories are really far closer together than widely recognised (more detail is provided, dealing in particular with the question of expectations, the conception of the profit rate as a distribution, and the crucial importance of financial or speculative usage as an alternative claim on capital investment, see Freeman 2014a)

The theoretical relation between Marx and Keynes is thus the mirror image of the theoretical relation between Schumpeter and Marx. The apparent opposition between Keynes and Marx turns out on examination to be an identity.

With the paradox now properly stated, we can ask where it comes from. It arises, I will argue, from the unique role of economics whose material function is essentially religious. It provides the *language of political decisions*. the rationale for what governments do: most obviously for how they spend their money, but more broadly, everything which affects the production and realization of value. This is discussed at some length in Freeman (2015e).

It therefore manifests two aspects which alternate, coming to the fore at different periods of capitalist history. These I term esoteric and exoteric, following Marx's own usage of these terms.

The exoteric function of a theory is to explain the facts we observe; economics is rarely employed in this way because as the fate of Marxist economics demonstrates, it is simply too dangerous to present the true facts of the capitalist system. Economics, simply put, is a body of esoteric doctrine. Its function is not to explain the facts but to justify them.

This most characteristic tool of esoteric economics, first appearing as Say's Law, is equilibrium; economics was reconstructed by Marshall as the 'science of equilibrium', overturning even the conventional Marginalist reasoning of the day. Equilibrium mathematically formalises the notion that we must first suppose capitalism works perfectly and on this basis develop all other theory.

This makes it the perfect esoteric candidate. It *axiomatises* the notion that capitalism is without contradiction. It reconstructs all and any economic theory on the assumption that the market is perfect. Contradiction then cannot then be 're-inserted' – mathematically, you cannot deduce crisis from a theory which presupposes it to be impossible. When a real crises occurs, it must be therefore ascribed to a malign external influence.

Second, it is ecumenical or 'supra-theoretical'. E*very* school of thought whether Marxist, Keynesian, Institutionalist or Marginalist is converted into an equilibrium form and no other is permitted; just as Monotheist religions may fight to the death over how to worship God, but all agree that the worst apostasy of all is to deny he exists.

The esoteric *'theoretical practice'* of economics consists in re-packaging all new insights and empirical discoveries, so as to render them harmless by fitting them into the equilibrium framework. Hence the Sweezy-Morishima-Steedman version of Marx which now dominates academia; ISLM bastard 'Keynesianism', Rational Expectations, Real Business Cycle theory, Harrodian development theory, Factor-Price theory – the list does not end, because the real business of economics is to repackage every genuinely innovative insight in equilibrium form.

When a mere recession occurs it can be shaken off as an adjustment. But in a Great Depression, of sufficient depth and length, and above all with sufficient social effects as to lead entire governments to abandon economic convention, economics is left unable to explain it. A burst of 'invention' follows; its peculiar specific form is that it begins by restating what economics once already knew, repackaged as a discovery. Keynes could not have acknowledge his relation to Marx and retained a respectable relation with the body of the economic mainstream which would have resulted in his work being taken seriously.

Long movements in economic therefore consists of an alternation of long *esoteric* stages when this 'repackaging' dominates, with moments of Theoretical Crisis such as we are experiencing now in which exoteric considerations impose themselves in the guise of discoveries.

Economics is stuck in a kind of permanent pre-larval state, alternating between a short and somewhat brutish early life as a greedy but innocent fact-devouring caterpillar and a cocoon stage whose only function is to stamp out butterflies.

This is precisely why economics is so antagonistic both to studying the history of thought, and to any idea that interpretation – the study of the real theoretical content of a given author's work – is a legitimate area of discourse or research.

I well remember a charged meeting just after the Crash, staged by a left-leaning Keynesian think tank to provide Robert Schiller with access to a couple of ministers. Radhika had the temerity to point out Keynes case for the socialization of investment and the euthanasia of the rentier. Some very anxious and harassed denials followed focussed not on whether these were sensible policies but of *whether Keynes advocated them.*

This is why, in the July 2014 issue of CJE*,* eight of us argued that the key confrontations in economics today take place around interpretation rather than theory itself. It is on the terrain of hermeneutics – exegesis, interpretation – that the true debates in economics lie disguised.

The second consequence is that the policy debates of today are replayed as the farce of a battle for authority instead of the tragedy of a struggle for truth. The editorial board of *Monthly Review,* weigh into the discussion on crisis not in the form of a simple, direct and scientific intervention about what its causes are, but in the form of an article by Heinrich explaining at great length that Marx himself had no coherent theory of crisis.

The point of the exegesis above is to establish in a new way – not by examining the 'true' theory of Marx but by asking what is the 'true' theoretical position of his *interlocutors,* that is not possible to walk away from this disguised form of engagement by pretending that economics can do without interpretation. The problem is to set the discussion 'on its feet' by undertaking interpretation in a scientific, evidence-based manner, using the hermeneutic methods that as Kliman (2007) has explained, are in widespread use in the other social sciences and in the humanities, to lay bare the true content of the debate.

The task is not therefore neither to line up like a prize-fighter in favour of or against one or other 'correct' position nor to substitute oneself, as a new prize-fighter, by simply declaring one's own interpretation into existence on the basis of pure popularity, as do so many 'Marx interpreters'. The task is to take interpretation seriously. It is to determine what each real debate really is, so that present and future generations may decide for themselves which of the various theoretically coherent positions is most borne out by the facts.

Perhaps the most basic capacity that is required of a socially useful economist is to provide a rational foundation for policy by demonstrating the logical connection between the theoretical analysis of causes, and the deduction of actions which anticipate correctly how those actions will change the course of events, on the basis of the knowledge of causes. This is a fundamental principle of science, first enunciated by Bacon, and of rational decision-making in general.

I hope I have showed, the capacity to detach and bring to light the underlying theoretical issues at stake in economic disputes – including those that are undoubtedly yet to come – is an indispensable element in the formation of the assertive pluralist 'Economist of Tomorrow'.

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