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Henry Hazlitt and the Failure of Keynesian Economics

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For four decades, from the mid-1930s to the 1970s, Keynesian economics almost monopolized economic policy in the United States and around the world. The "new economics," as it was called, was going to assure mankind economic stability, full employment, and material prosperity—all through wise government management of monetary and fiscal policy. So dominant was this view that only in 1959 did the first book-length refutation of the ideas of John Maynard Keynes appear: Henry Hazlitt's *The Failure of the "New Economics": An Analysis of the Keynesian Fallacies*.[1]

Keynes (1883–1946)[2] had a acquired an international reputation shortly after World War I, when he published *The Economic Consequences of the Peace*, a biting criticism of the Treaty of Versailles that formally ended the war.[3] In the 1920s he was a leading critic of the gold standard and a vocal proponent of a government-managed currency to maintain full employment. In his 1924 book, *A Tract on Monetary Reform*, Keynes declared that gold was a "barbarous relic" and that governments should use their control over the money supply to maintain a stable domestic price level even if this required abandoning a stable foreign exchange rate between the British pound and the other currencies of the world.[4]

In 1930 Keynes published *A Treatise on Money*, a two-volume work that he expected would establish his reputation as the leading monetary theorist of his time.[5] Instead, the book was savaged by reviewers, including many of the most prominent economists in Great Britain and the United States. The most devastating criticisms were made by a young Austrian economist named Friedrich A. Hayek, who in a lengthy two-part review demonstrated the logical confusions and theoretical misunderstandings that ran through the entire work.[6]

For the next five years Keynes devoted his time to devising a new theory for his argument that a free-market economy was inherently unstable and that only the guiding hand of government could assure full employment in the face of the economic disaster being experienced during the Great Depression of the early 1930s. This work finally appeared in February 1936 under the title *The General Theory of Employment, Interest, and Money*.[7]

Except for some of Keynes's young protégés at Cambridge University, most of the reviewers of the book were highly critical of many of its theoretical "innovations," as well as its inflationary prescriptions for unemployment.[8] Even some economists who later became proponents of Keynes's "new economics" were initially highly critical of his work. For example, Alvin Hansen, who was one of the leading advocates of Keynesian economics in the United States in the 1950s and 1960s, wrote in late 1936 that *The General Theory* "is not a landmark in the sense

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that it lays the foundation for a 'new economics.' . . . The book is more a symptom of economic trends than a foundation stone upon which a science can be built."[9]

Yet within a few years, and most certainly by the end of World War II, Keynes's ideas had virtually pushed aside every other explanation of the causes and cures of economic depressions.[10] Keynes's book became the foundation stone for the new "macroeconomics." His face even appeared on the cover of the December 31, 1965, issue of *Time* magazine. The feature article, titled "We Are All Keynesians Now," stated:

> Today, some 20 years after his death, his theories are a prime influence on the world's free economies, especially America's. . . . Now Keynes and his ideas, though they still make some people nervous, have been so widely accepted that they constitute both the new orthodoxy in the universities and the touchstone of economic management in Washington. . . . Now even businessmen, traditionally hostile to Government's role in the economy, have been won over. . . . They have begun to take for granted that the Government will intervene to head off recession or choke off inflation, [and] no longer think that deficit spending is immoral.[11]

Keynes argued in *The General Theory* that the free-market economy contained no built-in mechanism to assure full employment. The crucial weakness, he said, lies in the relationship between savings and investment. People tend to consume more as their incomes go up, but the increase is not as great as the increase in income. In other words, they also save a portion of their higher income. The problem, he insisted, is that saving is "non-spending" and if people do not spend all the extra income they earn, businessmen may not have the incentive to invest enough to employ all those who want to work at prevailing wages.

As a result, a large portion of the labor force may be left unemployed because the private sector has failed to create enough jobs. The economy, therefore, may be stuck for a prolonged period in what Keynes called an "unemployment equilibrium." Couldn't workers improve their prospects by accepting lower money wages? No, Keynes insisted, because workers suffer from a "money illusion"—even if prices were falling and a cut in wages would make them no worse off in real buying-power terms, workers would refuse to accept less money.

Rather than demand that workers accept lower pay, Keynes favored raising the general level of prices so employers could make profits without cutting wages. In other words, Keynes's solution to unemployment was price inflation.

Deficit Spending

Government deficit spending would provide additional market demand, pushing prices up and stimulating more hiring. Public-works projects would "prime the pump." This policy would continue until "full employment" was attained. But since, in Keynes's view, businessmen were usually shortsighted and irrational in their fears about investment prospects, the private sector would always lag behind in creating jobs. The government would have to be constantly at the monetary and fiscal controls, injecting spending into the economy to prevent it from sinking back into unacceptable levels of unemployment.

In Keynes's conception of the world, governments guided by his ideas would be wise and farseeing, assuring that the mass unemployment of the 1930s never happened again. Government would manipulate interest rates, the level of prices, and the amount and direction of investment to assure that society had high employment, socially beneficial investment, and general economic stability.

There were critics of Keynesian economics in the 1940s and 1950s, but they were virtually ignored by academic economists and policymakers.[12] Some mainstream macroeconomists also took Keynes to task. But many of their criticisms were couched in terms clearly meant not to antagonize their Keynesian colleagues.

Then in 1959 came Henry Hazlitt's *The Failure of the "New Economics."*[13] What was unique about Hazlitt's exposition was his chapter-by-chapter dissection of the arguments in Keynes's *General Theory*.[14]

Central to Keynes's theory was his insistence that "Say's Law" was wrong in claiming that "supply creates its own demand." Just because people supply goods on the market does not mean they will demand what others are selling. They may abstain from spending by holding idle cash balances. Thus there could be a general glut of goods on the market.

Say's Law

Hazlitt showed that Keynes had misunderstood what the Jean-Baptiste Say and other nineteenth-century economists meant. Goods can virtually always find buyers if prices are sufficiently attractive. The pre-Keynesian "classical" economists never denied that goods can go unsold and labor unemployed if suppliers fail to adjust their prices and wages to match existing market demand.

Furthermore, Hazlitt explained, many of the classical economists, especially John Stuart Mill, understood that individuals could "hoard" money rather than immediately spend it. But this was most frequently due to the temporary uncertainties of an economic crisis, usually caused by a prior, unstable inflationary boom.[15]

The central flaw in Keynes's thinking, Hazlitt insisted, was his unwillingness to acknowledge that the high unemployment in Great Britain in the 1920s and the United States in the 1930s was caused by government intervention, including the empowering of labor unions, that made many prices and wages virtually "rigid." Political and special-interest power prevented markets from competitively re-establishing a balance between supply and demand for various goods. Hence, the market was trapped in wage and price distortions that destroyed employment and production opportunities, resulting in the Great Depression. (Hazlitt did not deny that the contraction of the money supply in the early 1930s increased the degree to which prices and wages had to fall to re-establish full employment.)

Hazlitt considered Keynes's inflationary "fix" crude and dangerous. First, Hazlitt pointed out that Keynes's focus on macroeconomic "aggregates" concealed the microeconomic relationships among a multitude of individual prices and wages. The price level, wage level, total output, aggregate demand, and aggregate supply were all statistical fictions that had no reality in the actual market. Thus the wage level could not be too high relative to the general price level. But in the 1930s many wages for different types of labor were out of balance with the prices of individual goods sold on the market. What was needed to restore full employment was an adjustment of numerous individual wages and resource prices to the lower prices of many consumer goods. The extent to which any individual money wage or resource price might have to adjust downwards depended on the distinct supply and demand conditions in each of the individual markets.

An inflationary policy attempts to bring some individual price-wage relationships back into balance by pushing prices up throughout the economy, Hazlitt explained.

> Because Keynes, with his lump, aggregate thinking, is opposed to restoring employment or equilibrium by small, gradual, piecemeal adjustments . . . we must achieve the same result by inflating the money supply and raising the price level, so everybody's *real* wages are slashed by the same percentage. . . . The Keynesian remedy, in short, is like changing the lock to avoid changing to the right key, or like adjusting the piano to the stool instead of the stool to the piano.[16]

Second, Hazlitt pointed out that workers and labor unions are aware of how rising prices affect the real value of money wages. There is certainly no "money illusion" in an upward direction. An increasing cost of living due to rising prices soon brings worker and union demands for higher pay to make up for lost purchasing power. But if workers and unions demand the same real wages they had before the inflation, then the Keynes solution to unemployment must fail.

Finally, Keynes's macroeconomic approach also concealed the fact that beneath the aggregate rising price level, inflation distorts many of the relative price relationships, including the rate of interest. This inevitably brings about misdirection of resources, capital, and labor across different sectors of the market that will eventually require a reshuffling of supply and demand once the inflation ends. Thus the inflationary "cure" for unemployment brings in its wake an eventual new bout of unemployment when workers have to shift jobs and readjust their wage demands in the post-inflationary period.

Indeed, in a series of chapters, Hazlitt clearly showed that Keynes was confused about the actual relationships among savings, investment, and the rate of interest. The core of his theory was founded on a bundle of errors and mistakes. This resulted in Keynes's failure to comprehend that saving, investment, and capital formation—not government-stimulated increases in aggregate consumer demand—are the foundations of sustainable employment and rising standards of living.[17]

Hazlitt also took Keynes to task for advocating increasing government control and direction of investment decision-making. Keynes clearly believed, Hazlitt sarcastically observed, "that there exists a class of people (perhaps economists very much resembling Lord Keynes) who are completely informed, rational, balanced, wise, who have means of knowing at all times exactly how much investment is needed and in exactly what amounts it should be allocated to exactly which industries and projects, and that these managers are above corruption and above any interest in the outcome of the next election."[18]

If *The General Theory* had so many fundamental flaws, how did it become, in the words of one of his most enthusiastic followers, "the Keynesian bible"?[19] Hazlitt offered some possible reasons in his introduction to his edited volume, *The Critics of Keynesian Economics*, which appeared a year after his own book. He suggested that Keynes's theories rationalized the politics of special-interest groups that desired to reap the benefits of an inflation. Also, while much of *The General Theory* is written in difficult language, Keynes could dazzle the reader with literary imagery and wit that hid his central logical flaws. Keynes used the "technique of obscure arguments followed by clear and triumphant conclusions," Hazlitt said. And finally, Hazlitt conjectured that the success of the book may have had a lot to do with its appearing to overthrow the existing orthodoxy in favor of radical and fashionable ideas about social engineering. "But whatever the full explanation of the Keynesian cult," Hazlitt concluded, "its existence is one of the great intellectual scandals of our age."[20]

The monolithic domination that Keynesian economics once had over all macroeconomic policy has been broken for more than two decades. While too many of Keynes's misconceptions still underlie how economists think about inflation, recession, and unemployment, the original and primitive Keynesian thinking has been more or less overthrown. To a great extent this is because of the thorough and brilliant demolition that Henry Hazlitt performed more than 40 years ago. □

1. Henry Hazlitt, *The Failure of the "New Economics": An Analysis of the Keynesian Fallacies* (Princeton: D. Van Nostrand, 1959), reprinted by the Foundation for Economic Education in 1995.

2. The most comprehensive biography of Keynes is Robert Skidelsky, *John Maynard Keynes: Hopes Betrayed, 1883–1920* (London: Macmillan, 1983), *John Maynard Keynes: The Economist as Saviour, 1920–1937* (London: Macmillan, 1992), and *John Maynard Keynes: Fighting for Britain, 1937–1946* (London: Macmillan, 2000); in addition, see, Roy H. Harrod, *The Life of John Maynard Keynes* (London: Macmillan, 1951), and D. E. Moggridge, *Maynard Keynes: An Economist's Biography* (London: Routledge, 1992). All of them are highly sympathetic to Keynes as an economist and policy advocate.

3. John Maynard Keynes, *The Economic Consequences of the Peace* (New York: Harcourt, Brace, 1920); see the critical analysis of Keynes's arguments about the peace treaty by Etienne Mantoux, *The Carthaginian Peace, or The Economic Consequences of Mr. Keynes* (New York: Charles Scribner's Sons, 1952).

4. John Maynard Keynes, *A Tract on Monetary Reform* (New York: Harcourt, Brace, 1924); see the critical analysis of Keynes's arguments by Benjamin M. Anderson, "The Gold Standard vs. 'A Managed Currency,'" *Chase Economic Bulletin*, March 23, 1925, p. 39.

5. John Maynard Keynes, *A Treatise on Money*, 2 vols. (New York: Harcourt Brace, 1930).

6. Friedrich A. Hayek, "Reflections on the Pure Theory of Money of Mr. J. M. Keynes," *Economica*, August 1931, pp. 270–95, and February 1932, pp. 22–44; reprinted in Bruce Caldwell, ed., *The Collected Works of F. A. Hayek*, vol. 9: *Contra Keynes and Cambridge: Essays, Correspondence* (Chicago: University of Chicago Press, 1995), pp. 121–97, which also includes Keynes's reply after the appearance of part I of Hayek's review and Hayek's rejoinder.

7. John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York Harcourt, Brace, 1936); he earlier presented an outline of his prescriptions for an "activist" government policy in *The Means to Prosperity* (London: Macmillan, 1933).

8. Some of these reviews, especially those by Frank Knight and Jacob Viner, were published together many years later in Henry Hazlitt, ed., *The Critics of Keynesian Economics* (Princeton: D. Van Nostrand, 1960); there were many others not included in this excellent anthology, especially the reviews and essays by Henry Simons, Joseph Schumpeter, Dennis Robertson, Arthur C. Pigou, Bertil Ohlin, Erik Lindahl, and Carl Landauer, which were highly critical and insightful about fundamental errors in Keynes's ideas.

9. Alvin H. Hansen, "Mr. Keynes on Underemployment Equilibrium," *Journal of Political Economy* (October 1936), p. 686. Hansen later wrote one of the most widely read popular expositions of Keynes's ideas; see his *A Guide to Keynes* (New York: McGraw-Hill, 1953).

10. For a detailed exposition of the alternative "Austrian" analysis of the causes and cures for the Great Depression compared to the Keynesian perspective, see Richard M. Ebeling, "The Austrian Economists and the Keynesian Revolution: The Great Depression and the Economics of the Short-Run" in Richard M. Ebeling, ed., *Human Action: A 50-Year Tribute* (Hillsdale, Mich.: Hillsdale College Press, 2000), pp. 15–110.

11. "We Are All Keynesians Now," *Time*, December 31, 1965, pp. 64–67B. The quotations are from pp. 64–65. Four years later, Milton Friedman appeared on the cover of *Time* (December 19, 1969, pp. 66–72), with the magazine now saying that "Friedman, a 57-year-old economics professor at the University of Chicago . . . has reached the scholar's pinnacle: leadership of a whole school of economic thought. It is called the 'Chicago School,' and its growing band of followers argues that the money supply is by far the most important and fastest-acting of the economic regulators at the Government's disposal. . . . [M]ost economists now consider themselves . . . hybrid . . . 'Friedmanesque Keynesians' " (p. 66).

12. Among the strongly anti-Keynesian critics who took his ideas to task in some detail were W. H. Hutt, *The Theory of Idle Resources* (London: Jonathan Cape, 1939); Arthur W. Marget, *The Theory of Prices: A Re-Examination of the Central Problems of Monetary Theory*, 2 vols. (New York: Augustus M. Kelley, 1966 [1938 and 1942]); Benjamin M. Anderson, "The Road Back to Full Employment" in Paul T. Homan and Fritz Machlup, eds., *Financing American Prosperity: A Symposium of Economists* (New York: Twentieth Century Fund, 1945), pp. 9–70; L. Albert Hahn, *The Economics of Illusion: A Critical Analysis of Contemporary Economic Theory and Policy* (New York: Squier Publishing, 1949), and *Common Sense Economics* (London/New York: Abeland-Schuman Ltd., 1956); Philip Cortney, *The Economic Munich* (New York: Philosophical Library, 1949); and Hans Mayer, "John Maynard Keynes' 'Neubegründung' der Wirtschaftstheorie" ["John Maynard Keynes's 'New Foundation' for Economic Theory"] in E. Lagler and J. Messner, eds., *Wirtschaftsliche Entwicklung und soziale Ordnung* [*Economic Development and Social Order*] (Wien: 1952), pp. 39–55.

13. Four years later another detailed critical study of Keynesian economics appeared: W. H. Hutt, *Keynesianism: Retrospect and Prospect: A Critical Restatement of Basic Economic Principles* (Chicago: Henry Regnery, 1963); it later appeared in a revised edition under the title *The Keynesian Episode: A Reassessment* (Indianapolis: Liberty Press, 1979); see also W. H. Hutt, *A Rehabilitation of Say's Law* (Athens: Ohio University Press, 1974).

14. Hazlitt, *The Failure of the "New Economics,"* p. 4: "I know of no single work that devotes itself to a critical chapter-by-chapter or theorem-by-theorem analysis of [*The General Theory*]. It is this task that I am undertaking here."

15. Ibid., pp. 361–71; see John Stuart Mill, "Of the Influence of Consumption on Production" [1844] in Hazlitt, ed., *The Critics of Keynesian Economics*, pp. 24–45.

16. *The Failure of the "New Economics,"* pp. 280–81; on the degree to which inflexible money wages relative to the prices for finished consumer goods raised the real cost of employing workers in the early 1930s, and therefore resulted in rising unemployment, see Richard K. Vedder and Lowell Gallaway, *Out of Work: Unemployment and Government in Twentieth-Century America* (New York/London: Holmes & Meier, 1993), pp. 79–95.

17. See also Henry Hazlitt, *The Conquest of Poverty* (New Rochelle, N.Y.: Arlington House, 1973), pp. 217–28.

18. *The Failure of the "New Economics,"* p. 324; on the arrogance in Keynes's thinking about an elite who are wise and good enough to macro-manage the economy, and the harmful real world consequences, see also James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977).

19. Seymour E. Harris, "About this Book," in Seymour E. Harris, ed., *The New Economics: Keynes' Influence on Theory and Public Policy* (New York: Alfred A. Knopf, 1948), p. 9.

20. Hazlitt, "Introduction" in *The Critics of Keynesian Economics*, pp. 9–10.