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Keynes Was Right!

Kenneth G. Dau-Schmidt

Indiana University Maurer School of Law, kdauscm@indiana.edu

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Keynes Was Right!

KENNETH G. DAU-SCHMIDT*

In planning this conference, I chose Professors Golden and Flanagan to discuss the current economic context for American labor and employment law policy because I thought they would give two very different accounts. Both distinguished academics in their own right, Professor Golden hails from a “progressive” economics department and has a strong track record for analyzing and advocating government labor policies, while Professor Flanagan hails from a business school and has had a long and illustrious career analyzing and advocating on behalf of the machinations of the labor market: a “liberal” economist and a “conservative” economist, to use the political vernacular. They did not disappoint.

Yet while our two speakers expressed significant differences on the merit of active labor market policies to reduce unemployment and decrease income inequality, I prefer to focus on what they agreed on. Both speakers agreed that education and training were the best methods to raise employee wages; both agreed that income inequality could most effectively be addressed through tax policy; and, most importantly, both agreed that fiscal policy, including prominently direct government deficit spending on infrastructure, was the best way to address the current crisis we face in unemployment. This last point is vital to the current health of our economy and the futures of our children and students as they venture out to find jobs. Why Republican politicians and sectors of the American public have suddenly become obsessed with balancing state and federal budgets at a time when this will clearly do harm to the recovery, the economy, and our children’s future, after almost a decade of profligate spending on the war in Iraq, is beyond me.¹ Indeed the point has become so politically charged that Alabama Senator Richard Shelby has blocked the appointment of Nobel laureate and unemployment expert, Peter Diamond, for appointment to the Federal Reserve merely because Diamond is a “Keynesian” and has advocated expansionist fiscal policy—even though the Federal Reserve of course has no responsibility for the federal budget.² But, of

* Willard and Margaret Carr Professor of Labor and Employment Law, Indiana University Maurer School of Law; J.D. (1981) University of Michigan—Ann Arbor; Ph.D. (Economics 1984) University of Michigan—Ann Arbor. I dedicate this comment to Frank Stafford, my dissertation advisor at the University of Michigan—Ann Arbor. Frank is a renowned labor economics theorist and econometrician. He doesn’t give a wit about the political implications of his empirical findings, only that they accurately reflect reality.

1. “I do not know which makes a man more conservative—to know nothing but the present, or nothing but the past.” JOHN MAYNARD KEYNES, *THE END OF LAISSEZ-FAIRE* 16 (1926), available at <http://www.panarchy.org/keynes/laissezfaire.1926.html>.

2. Mark Felsenthal & Kristina Cooke, *UPDATE 2: Obama Fed Pick Withdraws, Slams Partisan Politics*, REUTERS (June 5, 2011), <http://www.reuters.com/article/2011/06/06/usa-fed-diamond-idUSN0522942320110606>. “[Conservatism] leads nowhere; it satisfies no ideal; it conforms to no intellectual standard; it is not even safe, or calculated to preserve from spoilers that degree of civilisation which we have already attained.” ROBERT SKIDELSKY, JOHN MAYNARD KEYNES: THE ECONOMIST AS SAVIOUR 231 (1992) (quoting 9 JOHN MAYNARD KEYNES, *Am I a Liberal?*, in *THE COLLECTED WRITINGS OF JOHN MAYNARD KEYNES* 295, 296–97 (1972) (Keynes discussing the Conservative Party).

course, the current economic crisis shows that John Maynard Keynes was right and that his teachings have a lot to offer us in resolving our current problems.

Keynes developed his theories in response to the persistent unemployment during the Great Depression, an economic circumstance eerily similar to the predicament in which we now find ourselves. On “Black Thursday,” October 24, 1929, a speculative bubble in stock market prices burst when stock speculators, many of whom had bought stock on margin, began to panic and sell off their shares, which resulted in a decline in stock prices of twenty-four percent in less than a week.³ Many of the nation’s banks were heavily invested in the market, and the market’s decline forced the banks into default either directly or by undermining people’s confidence in the security of their deposits. These defaults forced the banks to recall loans, restricting the availability of credit and causing a contraction in the money supply. As the nation’s wealth and money supply contracted, aggregate demand for goods and services declined, which depressed prices and wages and caused employers to lay off employees.⁴ For over a decade, the nation’s unemployment rate exceeded ten percent and reached heights estimated at twenty-five to thirty percent.⁵ By 1933, the nation’s gross domestic product had dropped by a third.⁶

Initial government reactions to the Great Depression were minimal or even counterproductive. President Hoover argued that the nation’s problems could be solved through “belt-tightening.”⁷ He reasoned that in such a time of uncertainty, the government should be stable—balancing its budget and shoring up its currency. Unfortunately, these measures further contracted the money supply and decreased aggregate demand, further increasing the unemployment rate.⁸ There were also those in Hoover’s administration who believed that the pain people were enduring would have a therapeutic effect on the economy. Secretary of the Treasury Andrew Mellon argued, “Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. . . . [That] will purge the rottenness out of the system. . . . People will work harder, live a more moral life. . . . and enterprising people will pick up the wrecks from less competent people.”⁹

3. KENNETH G. DAU-SCHMIDT, MARTIN H. MALIN, ROBERTO L. CORRADA, CHRISTOPHER DAVID RUIZ CAMERON & CATHERINE L. FISK, *LABOR LAW IN THE CONTEMPORARY WORKPLACE* 43 (2009).

4. *Id.*

5. *Id.*

6. JOHN KENNETH GALBRAITH, *THE AGE OF UNCERTAINTY* 209–11 (1977) [hereinafter GALBRAITH, *UNCERTAINTY*]. See generally JOHN KENNETH GALBRAITH, *THE GREAT CRASH: 1929* (1997). “But to-day we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand. The result is that our possibilities of wealth may run to waste for a time—perhaps for a long time.” JOHN MAYNARD KEYNES, *The Great Slump of 1930*, in *ESSAYS IN PERSUASION* 135, 136 (1930) (referring to economics and the Great Depression).

7. GALBRAITH, *UNCERTAINTY*, *supra* note 6, at 211–13.

8. GALBRAITH, *UNCERTAINTY*, *supra* note 6, at 213.

9. HERBERT HOOVER, *THE MEMOIRS OF HERBERT HOOVER: THE GREAT DEPRESSION: 1929–1941*, at 30 (1953).

Keynes hypothesized that, in order to escape the Great Depression, the government should actively stimulate aggregate demand to increase employment and consumer spending and thus encourage the economy to spiral upward, not downward.¹⁰ This should be done, according to Keynes, by expanding the money supply, or by direct government deficit spending to increase demand for goods and investment in capital.¹¹ Although merely adjusting the money supply might be adequate to combat small recessions, Keynes argued that direct government deficit spending would be the most effective tool in combating unemployment when interest rates had dropped to the point that further increases in the money supply did not increase aggregate demand. Keynes referred to this situation as “the liquidity trap” because, at a low enough interest rate, businesses and consumers became indifferent between holding cash (liquidity) and making investments, and thus further increases in the money supply would not increase aggregate demand or employment.¹² Franklin Delano Roosevelt adopted Keynes’s theories as a basis for the New Deal and undertook an aggressive policy of deficit spending on infrastructure to employ people and put money in their hands for consumption and improvement of the economy.¹³ This policy significantly improved the economy, which fully recovered with the massive deficit spending required for World War II.¹⁴ As a result of the economic recovery, people had jobs and government coffers were filled, so that in the long run the direct government deficit spending improved both the lives of Americans and the government’s balance sheet.¹⁵

We now find ourselves in a very similar predicament in which investment speculation has resulted in the failure of financial institutions and a significant decline in the money supply, aggregate demand, and employment.¹⁶ The Federal Reserve has valiantly and appropriately combated the recession by expanding the money supply, but with interest rates to banks basically at zero, interest rates have fallen to the point where there is no more room for purely monetary policy to

10. GALBRAITH, *UNCERTAINTY*, *supra* note 6, at 213–17.

11. EDMUND S. PHELPS, *POLITICAL ECONOMY: AN INTRODUCTORY TEXT* 504–36 (1985). *See generally* JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY* (1936) [hereinafter *KEYNES, GENERAL THEORY*].

12. FRED R. GLAHE, *MACROECONOMICS: THEORY AND POLICY* 191, 210–12 (2d ed. 1977). “Education: the inculcation of the incomprehensible into the indifferent by the incompetent.” LEO ROSTEN, *INFINITE RICHES: GEMS FROM A LIFETIME OF READING* 165 (1979) (quoting John Maynard Keynes).

13. *See* GALBRAITH, *UNCERTAINTY*, *supra* note 6, at 218; RONALD EDSFORTH, *THE NEW DEAL: AMERICA’S RESPONSE TO THE GREAT DEPRESSION* (2000).

14. *See* GALBRAITH, *UNCERTAINTY*, *supra* note 6, at 221.

15. *Id.*

16. Kenneth G. Dau-Schmidt, *Promoting Employee Voice in the American Economy: A Call for Comprehensive Reform*, 94 MARQ. L. REV. 765, 784–87 (2011). “It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges.” KEYNES, *GENERAL THEORY*, *supra* note 11, at 159. “Markets can remain irrational longer than you and can remain solvent.” Robert A. Jaeger, *The Elusiveness of Investment Skill*, in *INVESTMENT MANAGEMENT: MEETING THE NOBLE CHALLENGES OF FUNDING PENSIONS, DEFICITS, AND GROWTH* 175 (Wayne H. Wagner & Ralph A. Rieves eds., 2009) (citing John Maynard Keynes).

stimulate the economy.¹⁷ Balancing state or the federal budgets at this time would merely repeat the errors of the Hoover administration, decreasing aggregate demand and killing, or even reversing, the recovery.¹⁸ Although deficit spending increases future commitments on debt maintenance, well-designed deficit spending now will shorten the recession, improve our children's and student's job prospects, increase employment and tax revenues, and lessen the long-run government budget deficit. General tax cuts for businesses and the wealthy—the “job creators” as the Republicans like to call them—would be a very ineffective way to stimulate aggregate demand because not all of these tax cuts would be spent on consumption,¹⁹ and much of what was spent on consumption would just be spent on more crap from China—benefiting Chinese workers but not American workers.²⁰ Direct government deficit spending on the infrastructure ensures that that money is spent on jobs in the United States and that the money purchases something that will benefit our children who will be left with any debt load.²¹

Keynes himself once said, “Ideas shape the course of history.”²² On the vital issue of determining the appropriate policy to increase employment and get us out of the Great Recession, it is imperative that wiser minds like that of Professors Golden and Flanagan prevail.²³ Regardless of your normative or political beliefs, balancing the state and federal budgets now will decrease aggregate demand and employment while direct government deficit spending will increase aggregate demand and employment. Although we should not undertake additional government debt lightly, under the current circumstances further fiscal stimulus will shorten the Great Recession and increase the gross domestic product enjoyed by Americans and tax revenues.

17. *Turning Japanese: America's Fed Funds Rate Is, in Effect, Almost at Zero*, ECONOMIST, Nov. 15, 2008, at 88, available at <http://www.economist.com/node/12607243>.

18. It is estimated that as many as 175,000 teachers lost their jobs in the most recent round of budget balancing. David Coates, *Not Working in America: People and Public Policy*, HUFFINGTON POST (June 15, 2011), http://www.huffingtonpost.com/david-coates/not-working-in-america-pe_b_877413.html.

19. On this count, tax cuts to the poor and working class would make more sense than tax cuts to the rich because the poor spend a higher share of their budget on consumption. The real “job providers” in the United States have always been the low- and medium-wage consumers who increase demand for goods to the point where businesses decide to increase production and employ more workers. “All production is for the purpose of ultimately satisfying a consumer.” KEYNES, GENERAL THEORY, *supra* note 11, at 46.

20. “Words ought to be a little wild, for they are the assault of thoughts upon the unthinking.” John Maynard Keynes, *National Self-Sufficiency*, THE NEW STATESMAN AND NATION, July 15, 1933, at 66. However, a targeted tax break for businesses that actually create more jobs by employing more people at decent hours and wages might be money well spent.

21. “The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes.” KEYNES, GENERAL THEORY, *supra* note 11, at 372.

22. KEYNES, *supra* note 6, at 97.

23. “The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds.” KEYNES, GENERAL THEORY, *supra* note 11, at viii.