

# ON THE ECONOMICS OF SAY AND KEYNES' INTERPRETATION OF SAY'S LAW

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## INTRODUCTION

A recent paper by Clower [1994] in this *Journal* has demonstrated that Keynes' portrayal of how Ricardian economics differed from his own *General Theory* was at best disingenuous and at worst fraudulent. Moreover, because of Keynes' misdirections and their effects on the subsequent debate "we economists are less close than we might otherwise be to achieving a central aim of Keynes' book; improved understanding of just how economic activities are coordinated in contemporary money economies." [Clower, 1994, 383] A similar argument can also be made about Keynes' equally egregious and serious misrepresentations of Jean-Baptiste Say's and John Stuart Mill's views on recessions and the relationship between the markets for different products.

Keynes' obfuscations, along with the fact that Say advanced a number of separate propositions (which some writers see as contradictory [Schumpeter, 1954, 615-5; Hutt, 1974; Baumol, 1977]) have spawned a debate about which of Say's varied and numerous arguments best depict his true beliefs on the relationship between the markets for different products. Several of Say's postulates, as well as some misrepresentations thereof, have subsequently been given the label "Say's law of markets." Perhaps this very term is a source of some confusion. A better translation of *loi des débouchés* would be either "law of market openings" or "law of vent."

To Say, the law of vent was simply the truism that trade is bilateral — that in successful voluntary reciprocal trade each trading partner must have been able to offer the other one something of value. In other words: "the value we can buy is equal to the value we can produce" [Say, (1821) 1967, 3]. Say's various arguments on markets and the coordination of trades were all based on this observation, and perceived inconsistencies in his arguments arise only when he applies the consequences of this observation to fundamentally different situations. His understanding of the bilateral nature of trade naturally led him to focus first on coordination and then on coordination failures. Indeed, Say was acutely concerned with how to explain commercial crisis. Thus it is jarringly ironic that Say's law is now commonly invoked *first* as the naive notion that "supply creates its own demand," and *second* as the putative justification for classical disavowals of the very existence of gluts.

The well-known naive rendition of Say's law was contrived by Keynes [1936] — although some writers [Baumol, 1977; Thweatt, 1979; 1980] have tried to pin it on James Mill [(1808) 1964; 1826]. Incessant repetitions of it notwithstanding, this version of Say's law has little to do with the actual ideas of the classical economists —

certainly it has nothing at all to do with Say's own views or arguments. As already noted, Say's basic propositions focus on economic coordination. Moreover, Say's arguments are not only valid, they are "crucial for clear understanding of macro-theory" [Clower and Leijonhufvud, (1973) 1981, 80].<sup>1</sup>

Many of Say's contemporaries [Chalmers, (1832) 1968; Malthus, (1836) 1986; Sismondi, (1828) 1991; (1847) 1966] never seemed to grasp the essence of Say's arguments. But most of the modern confusion about the meaning and significance of Say's law is still derived from Keynes' [1936, 18] strawman supply-creates-its-own-demand version of Say's law and from Lange's [1942] most unfortunate "restatement" of the law. As Clower and Leijonhufvud have demonstrated, Lange's arguments and restatement of Say were "(a) logically false and (b) economically nonsensical" and moreover based on "gross historical inaccuracy" [(1973) 1981, 99]. No fair-minded reader of Say's *Letters to Malthus* [Say, (1821) 1967] can possibly infer that Say had in mind anything as garbled as Lange's restatement. Nevertheless, Lange's incoherent ideas and terminology, including his superfluous "Walras' Law," have become fixtures of the economic literature.

As Clower and Leijonhufvud [1973] have explained (and as one may easily verify by reading either Say's [1826; 1828] original words or the outstanding coeval translations of his *Letters to Malthus* or the *Treatise* [Say, (1821) 1967; (1880) 1971]). Say simply postulated that in free trade, no one plans to give up anything of value without obtaining something equally valuable in return. Moreover, Say used this idea as the starting point in explaining the nature of recessions or extensive gluts.

## SAY VS. MALTHUS AND THE LAW OF VENT

In his first letter to Malthus, Say explained his motives as follows:

In the first place my attention is fixed by the inquiry, so important to the present interests of society: What is the cause of the general glut of all the markets in the world, to which merchandize is incessantly carried to be sold at a loss? What is the reason that in the interior of every state, notwithstanding a desire of action adapted to all the developments of industry, there exists universally a difficulty of finding lucrative employments? And when the cause of this chronic disease is found, by what means is it to be remedied? On these questions\* depend the tranquillity [sic] and happiness of nations. [Say, (1821) 1967, 2]

Say then goes on to attribute such gluts to a failure of effective demand — except, unlike Malthus [(1836) 1986, 419-23], he does not naively attribute effective demand failures to the desire to save too much or to overproduction (given some absolute limit to the willingness to consume). Say specifically and explicitly recognizes that effective demand deficiencies are the consequence of coordination failures. Say's arguments have much the same relationship to Malthus', as the coordination arguments

of today's "new Keynesians" have to the Keynesian-cross. To recap Say's point, gluts are created when buyers and sellers do not have uniquely congruent trading plans:

I have advanced that whenever there is a glut, a superabundance, of several sorts of merchandize, it is because other articles are not produced in sufficient quantities to be exchanged for the former; and if those who produce the latter could provide more of them, or of other goods, the former would then find the vent which they required: in short, that the superabundance of goods of one description arises from the deficiency of goods of another description. [ibid., 5]

In other words, trade is bilateral and coordination failures are possible — in order for us to trade with others they must have had something worthwhile to trade with us and *vice versa*. It is when we fail to produce value for others that we no longer have the means to buy their products. Say was emphatic in pointing out that production does not automatically create revenues that can be used to buy other goods, since "the existence of these revenues depends on the production having *exchangeable* value, which it can only have in consequence of the want which there is for such production in the actual state of society" [ibid., 13, italics in original]. The entrepreneur (or "speculator" in production) often takes risks that do not bear fruit, and while "the *exchangeable value* of things is the foundation of all riches" [ibid., 20], some efforts yield no exchangeable value. If the entrepreneur "evinces inexperience in his affairs, he may gain nothing; he may very probably be a loser. All the risks attach to the speculator" [ibid., 14]. This means that gluts are generated in the short run by "the ignorance of producers or traders on the nature and extent of the demand in the places to which goods have been consigned" [ibid., 59]. The central issue is therefore the want of "*Data ... to serve as the foundation of good calculations*" [ibid.].

Combine the two arguments emphasized over and over by Say, *first*, that in trade people "exchange the utility which they produce for that which is produced by others" and *second* that it "is in this sense that we should understand the influence of *demand and supply*" [ibid., 20], and we have a theory that focuses on economic coordination and coordination failures. Say fully recognized how coordination failures, even those created by productivity increases due to technical innovation [ibid., 63-70], could lead to epidemic gluts.

Consider Say's description of what may happen to a collapsing economy with stagnating or declining productivity — ultimately, we may find

the value of the product is less than the charges of its production; no productive exertion is properly rewarded; profits and wages decrease; the employment of capital becomes less advantageous and more hazardous; it is consumed piecemeal, not through extravagance, but through necessity, and because the sources of profit are dried up. The laboring classes experience a want of work; families before in tolerable circumstances are more cramped and confined; and those before

in difficulties are left altogether destitute. Depopulation, misery, and returning barbarism, occupy the place of abundance and happiness. [Say, (1880) 1971, 140]

Going from coordination failures to widespread gluts requires a sense of the fact that markets are interdependent. Say understood very clearly that mistakes by suppliers, i.e. failures to produce something for which others wanted to trade, would inevitably affect the rest of the economy. It is not possible for "one branch of industry [to] suffer without affecting the rest" [*ibid.*, 140 in a footnote].<sup>2</sup>

It should also be noted that Say considered the effect of coordination failures in the context of what almost sounds like a modern view of the circular flow of income.<sup>3</sup> For example, he made "no distinction between the circulation of goods and money, because there really is none" [*ibid.*, 142]. Moreover, in refuting Malthus' distinctions between supposedly productive and unproductive consumption activities he noted:

The master devotes to the workman's labor a part of his capital. Having purchased it, he consumes it; and the workman consumes, on his part, the value which he has obtained in exchange for his labour. Wherever there is exchange, there are two values created and bartered one for the other; and wherever two values are created, there must be, and there are, in effect, two consumptions. [Say, (1821) 1967, 18]

In responding to Malthus' arguments to the effect that some commodities are exchanged for labor and not other commodities he also said, "I go farther than you: I say they are all purchased with labour, extending that expression to the services rendered by capital and land. I say that they cannot be purchased by any other means; that the value and utility of things in all cases are produced by such services" [*ibid.*, 16].

He also understood that the speed of the circular flow (or, equivalently, the velocity of money) depends on the timing of actual trades:

The activity of circulation is at the utmost pitch to which it can be carried with advantage, when the product passes into the hands of a new productive agent the instant it is fit to receive a new modification, and is ultimately handed over to the consumer, the instant it has received the last finish. All kind of activity and bustle not tending to this end, far from giving additional activity to circulation, is an impediment to the course of production—an obstacle to circulation by all means to be avoided. [Say, (1880) 1971, 142]

The point is, Say believed that coordination failures could cause a serious slowdown of the circulation of money and goods, and that this was the cause of depressions. In particular, he cited the following causes of a flagging circulation:

It flags in times of alarm and uncertainty, when social order is threatened, and all undertakings are hazardous. It flags, too, under the general dread of arbitrary exactions, when every one tries to conceal the extent of his ability. Finally it flags in times of jobbing and speculation, when sudden fluctuations, caused by gambling in produce, make people look for a profit from every variation of mere relative price: goods are then held back in expectation of a rise, and money in the prospect of a fall; and in the interim, both these capitals remain inactive and useless to production. Under such circumstances, there is no circulation, but of such products as cannot be kept without danger of deterioration. [ibid., 142]

Malthus, it seems, never truly understood Say's arguments. Thus, he tried to rebut them by noting that if "society were greatly and generally to slacken their consumption, and add to their capitals, there cannot be the least doubt, on the principle of demand and supply, that the profits of capitalists would soon be reduced ... and the population would be thrown out of work and would be starving" [Malthus, 1836, 419]. This attempted riposte is wide off the mark. Yes, an unwillingness by consumers (and investors in real goods) to buy the goods of capitalists will indeed lower the capitalists' income, and this in turn will affect their hiring of labor etc. But this obvious point had already been made by Say himself [Say, (1821) 1967, 31-2]. The more fundamental question is what causes consumers not to want to buy the capitalists' goods in the first place. And Say's answer is a coordination failure, a failure by capitalists to produce the exact mix of goods that consumers want to buy.

Say acknowledged and tried to explain general gluts (in which inventories remain unsold and unemployment and entrepreneurial losses are widespread), but he understood quite well that it is simply logically impossible that this could happen to "all commodities at once" [ibid., 24]. There must, by the rules of logic, always be at least one item or service (possibly money) for which there is no excess supply, since the very attempt to supply anything is also an attempt to get something else. Moreover, as explained in his second letter to Malthus [ibid.], dépressions generate deflationary pressures which ultimately help bring the economy out of the doldrums as "the general wealth is increased by the low price of commodities and productions of all sort" [ibid., 29]. And this would not happen if recessions were created by some absolute limit on people's willingness to consume.

### ON KEYNES' INTERPRETATION OF SAY'S LAW AND J. S. MILL

Several people read early drafts of Keynes' *General Theory*. Of those, both Harrod and Robinson commented on Keynes' interpretation of Say's law [Keynes, 1973, XIII, 543, 639], and neither of them objected. Keynes' interpretation of Say thus seems to have been generally accepted by his closest colleagues. Keynes' thinking [Keynes, 1936, 364-71] on these issues was in turn influenced by Hobson and Mummery

[(1889) 1992, Chapter 4] and possibly Hobson [(1896) 1992]. But similar notions could also have been derived from Chalmers [(1832) 1992, Chapter 5], who somehow had convinced himself that Say and Ricardo did not believe in the possibility of widespread gluts — or from Senior [(1836) 1965, 29] who did indeed reject the possibility of pandemic gluts.

Whatever the genealogy of his ideas, Keynes was the one who defined Say's law as the proposition "that supply creates its own demand" [Keynes, 1936, 18]. He then went on to say, "The doctrine is never stated to-day in its crude form. Nevertheless it still underlies the whole classical theory, which would collapse without it" [Keynes, 1936, 19]. In order to bring the point home, Keynes then quoted John Stuart Mill's *Principles of Political Economy*:

What constitutes the means of payment for commodities is simply commodities. Each person's means of paying for the productions of others consists of those which he himself possesses. All sellers are inevitably, and by the meaning of the word, buyers. Could we suddenly double the productive powers of the country, we should double the supply of commodities in every market; but we should, by the same stroke, double the purchasing power. Everybody would bring a double demand as well as supply; everybody would be able to buy twice as much, because every one would have twice as much to offer in exchange. [J.S. Mill, as quoted by Keynes, 1936, 18]

This quote is taken brazenly out of context. Mill is simply making the obvious point that increased production capacity will increase consumption possibilities. But let us first consider how Keynes' misinterpretation of the above quote came about — its lineage can easily be traced.

Originally, Marshall and Marshall [1879, 154] quoted the above passage, quite properly and in context. Specifically, they first discussed commercial crisis and noted that "it really is nothing but a state of commercial disorganization; and that the remedy for it is a revival of confidence" [Marshall and Marshall, 1879, 154]. Next they quoted the passage from Mill and then continued Mill's arguments by noting (without specifically quoting Mill again for this) that "though men have the power to purchase they may not choose to use it. For when confidence has been shaken by failures, capital cannot be got to start new companies or extend old ones" [ibid.]

Next, Hobson and Mummery [(1889) 1992, 102 in a footnote] followed the Marshalls by quoting the exact same passage from Mill, but then they went on to quote the Marshalls' explication as an insufficiently strong criticism, rather than as an elaboration and reiteration of Mill's original argument. In the words of Hobson and Mummery: "To this Prof. Marshall alone amongst economists, takes exception, and pertinently remarks: 'But though men have the power to purchase they may not choose to use it' ... But he fails to grasp the critical importance of this fact and appears to limit its actions to periods of 'crisis'" [(1889) 1992, 102 in a footnote].

Finally, we get Keynes' [1936, 18] quote of the passage from Mill, except now, to illustrate Mill's ostensible belief in the naive version of Say's law and his supposed denial of the possibility of recessions. After thus quoting Mill, Keynes then outdid himself by repeating Hobson and Mummery's account of Marshalls supposedly insufficient criticism of the quote, which Keynes considered "fair comment ... in the light of Marshall's later work" [Keynes 1936, 19 in a footnote].

It is beyond irony that Keynes' flawed interpretation of this stuff has now become the received depiction. The passage from Mill is now ubiquitously cited as an illustration of the naiveté of the classical economists [Trevithick, 1992, 5]. This, in spite of the fact that Mill makes it crystal clear a few pages later, in the very section quoted by Marshall and Marshall [1879], Hobson and Mummery [1889], Keynes [1936], and Trevithick [1992], that not only did he *not* believe that any law postulated by Say prevented aggregate excess supply, he actually relied on Say to explain the nature of commercial crisis.

To Mill, Say's arguments described what we now think as of the circular flow of money and goods. And as for Mill's supposed belief in the naive version of Say's Law, Mill states quite clearly that "it is perfectly possible that the demand may be for one thing, and the supply may unfortunately consist of another" [1909, 559-60]. Moreover, rather than denying the existence of commercial crisis, he describes it as follows:

At such times there is really an excess of all commodities .... From the sudden annihilation of a great mass of credit, every one dislikes to part with ready money, and many are anxious to procure it at any sacrifice. Almost everybody therefore is a seller, and there are scarcely any buyers; so that there may really be, though only while the crisis lasts, an extreme depression of general prices, from what may be indiscriminately called a glut of commodities or a dearth of money. [ibid., 561]

It is true that Mill [ibid.] forcefully rejected the arguments of Chalmers [(1832) 1968], Malthus [(1836) 1986], and Sismondi [(1828) 1991; (1847) 1966] to the effect that overproduction in and of itself could cause commercial crisis or recessions—Mill believed, quite correctly, that deficient aggregate demand during recessions was due to mistakes, self-fulfilling expectations, etc., but he rejected the notion that the very attempts to produce more were the cause of the crisis.

It is also true that Mill believed that the economy would ultimately recover from recessions. Indeed, he makes the rather subtle point that commercial crisis "is an evil only because it is temporary" [1909, 561]. The point here is, of course, that if recessions were due to absolute limits on people's willingness to consume, or to overproduction as postulated by Sismondi and Malthus, then we would not observe business fluctuations since an economy in a slump would never recover—that is, just as in the naive Keynesian-cross model (as long as MPC does not change) recessions will last forever. This is why Mill states that it is "a great error to suppose, with

Sismondi, that a commercial crisis is the effect of a general excess of production" [1909, 561].

In short, rather than believing in Keynes' naive version of Say's law, Say and Mill anticipated Knight's [(1933) 1967] belief that specialization and trade lead to interdependence and thus to potential coordination failures. As Knight later put it "this interdependence manifests itself acutely in the ebb and flow of prosperity, particularly the recurrence of business crisis bringing widespread distress" [(1933) 1967, 22]. And if we trace this further, we perceive that Say was in fact a precursor of the new Keynesians, who believe that recessions "result from the inability of agents to coordinate their actions successfully in a many person decentralized economy" [Cooper and John, 1988, 441].

### NOTES

I would like to thank Robert W. Clower, Harold M. Hochman, and Raymond E. Lombra for insightful observations and helpful comments on earlier versions of this paper, and Belvia Williams for her help in translating, verifying, and making sense of Say's original French prose.

1. Clower and Leijonhufvud [(1973) 1981] use the term *Say's principle* for the concept that *ex ante facto* the net value of an individual's trading plan is zero. In the aggregate this suggests that the planned demand for all goods people intend to buy is equal to the planned supply of the things people intend to sell (including money). If we assume that all individuals expect *quid pro quo* in their trades then Say's principle is a logical corollary to the law of vent.
2. Book 2, Part III, Chapter II, of Say's *Cours Complete d'Économie Pratique* [Say, 1828] is also very clear on this point: "Quand une branche d'industrie souffre, d'autres souffrent également" [Say, 1828, Book 2, 284].
3. Patinkin [1981], after reviewing the works of many early economists, concluded that the modern view of the circular flow of income really originated in Frank Knight's [(1933) 1967] *Economic Organization*. Of course, Say never drew a circular flow diagram of the type introduced by Knight. And yet, Say's descriptions of the circular flow, while not as detailed, are still basically the same as Knight's.

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