A Study in Caricatures: Keynes and the Classics at the 1931-1932 Harris Foundation Meetings

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At times, sharp distinctions are made between pre-1936 “classical economics” and post-1936 “Keynesian economics.” Most of these distinctions are derived from putative “classical” theory. Once the putative “classical” macroeconomic system is stated, it is shown to differ sharply with the post-1936 “Keynesian” tradition, particularly with respect to depression policy. Specifically, the common conclusion is that “classical” economists were wedded to the deflationary policies of annually balanced budgets and wage reductions as depression policies.

It is doubtful that any one economist ever held all of the ideas attributed to the putative “classical” tradition, much more incredible that all economists once held all such ideas. Nevertheless, inferences about economists in general often are drawn from this putative “classical” theory rather than from historical evidence. On the other hand, a descriptive indicator of U.S. economists and their policy responses to the Great Depression can be found in the 1931-1932 Round Tables of the Harris Foundation. [1, 2] These Round Tables are noteworthy on a number of grounds. First, in the presence of John Maynard Keynes, U.S. economists, *i.e.*, the “Classics,” discussed at length the question of wage cuts as a remedy for unemployment. Second, in the presence of U.S. economists, *i.e.*, the “Classics,” Keynes himself discussed at length his own remedy for unemployment. Third, U.S. economists, *i.e.*, the “Classics,” argued the preference of fiscal policy over monetary policy, whereas Keynes argued the preference of monetary policy over fiscal policy. Given the caricatures of Keynes versus the Classics, the Round Tables stage a series of role reversals.

Through the view provided by hindsight, transcribed proceedings of the Round Tables are a kind of revisionist history. U.S. economists, *i.e.*, the “Classics,” argued against wage cuts as a remedy for unemployment because of the adverse effect that wage cuts would have on aggregate demand. Keynes agreed with the “Classics” on wage policy. However, Keynes insisted that the means to full employment equilibrium in the United States should be concentrated on the rate of interest rather than, say, a regime of public works. A University of Chicago economist, *i.e.*, one of the “Classics,” tried but failed to convince

Keynes that the means to full employment equilibrium in the United States should be concentrated on expansionary fiscal policy.

Is Wage Cutting The Way Out?

On 26 June 1931, Henry Schultz (University of Chicago) and Carter Goodrich (Columbia University) presented a paper, “Are Wage Cuts a Remedy for Unemployment?” Their disquisition was significant because John Maynard Keynes attended. Introduced as “*a hard-boiled classicist,*” Henry Schultz opened the Friday afternoon session by suggesting the fundamental alternative remedies for depression were attacking the problem on the *demand* side and on the *supply* side. His task, Schultz said, was to consider *cost* policy, *i.e.*, attacking depression on the *supply* side.

Schultz noted that the depression was characterized by an inordinate frequency of firms for which marginal cost exceeded price. *If* wages were cut, Schultz posited, and marginal costs were reduced correspondingly, would production increase? Schultz emphasized that the answer to this question depended on, among other factors, the price elasticity of demand for the product and the relationship between the price elasticity of demand and aggregate output. He seems to have had in mind brand-level or firm-level price elasticity of demand and industry-level or market-level price elasticity of demand. He was contemplating a nexus of production, employment, income, and spending. Schultz’s point, therefore, was that the *ultimate* effect of wage or cost policy depended on the *demand* side. *If* cutting wages increased demand, the ultimate effect was potentially favorable to recovery.

Carter Goodrich followed Schultz with two questions. First, if other prices fall, must wages also fall? Second, If unemployment is widespread, must wages fall? With full consent of Schultz, Goodrich concluded that neither question could be given a single answer for all business conditions. In cases of prolonged depression of one industry or one group of industries while the rest of industry is flourishing, Goodrich admitted that the argument for wage reduction in the depressed industry or industries was strong. However, Goodrich was not suggesting a policy of wage reductions but rather a case for allowing wages to fall as the result of market forces. If wages were allowed to fall, wages simply would be performing their function of directing labor away from what appears to be an inefficient use. The only case to be made for wage reduction, Goodrich concluded, was under conditions in which a reduction in wages served as a market signal to labor to relocate elsewhere in flourishing industries.

However, Schultz and Goodrich agreed that the "traditional" answer to the question of unemployment was, in their words, "If labor is unemployed, it is therefore overvalued; reduce its price, and more will be taken off the market." [1, p. 191] By "traditional," they did not mean the foundations, interests, and limitations of contemporary economic theory. Throughout their disquisition, Schultz and Goodrich claimed that contemporary economic theory rested on a much sounder logical basis than that of a century earlier. As Schultz said, there was "a far cry between the economic theory of Ricardo's day and our own." [1, p. 192] Furthermore, even the "traditional" solution for unemployment was intended only for cases in which reductions in the wage rate were signals. The "traditional" solution was not intended for cases of unemployment during the depression phase of a business cycle when wage reductions were useless as signals and were vehicles carrying perverse influences that impede recovery.

Goodrich argued strongly against wage reduction under conditions of the depression phase of a business cycle. Suppose, he said, that presently employed workers had their wages cut by ten percent. What would be the effect? The immediate effect, Goodrich concluded, would be a ten percent reduction in the incomes of employed workers, which in turn would reduce aggregate demand, especially for consumer goods. In his own words, "The first effect, or one of the first effects, at least, is to reduce by that 10 percent the purchasing power of those particular workers who are now employed, leading therefore to a reduction in the demand for workmen's commodities, at least, and therefore, probably to a reduction in the total demand for consumers' goods as compared to the total demand for producers' goods." [1, p. 201]

By reducing the cost of labor, perhaps business firms would hire more labor and thus pay out more rather than less in total wages. Goodrich wondered rhetorically if this circumstance would materialize. He doubted it. Goodrich pointed out that business firms are governed by expectations, and these business firms might see no market at any price for more volume of output. Schultz and Goodrich concluded that wage cutting was no general remedy. Goodrich warned against committing a logical error of composition. Wage cutting "may be dubious in its effects on business in general, even when it is highly advisable from the point of view of the individual business. [1, p. 201]

When Schultz and Goodrich completed their argument against wage cutting, there was widespread agreement among the leading economists in attendance. Both Alvin Hansen (University of Minnesota) and Sumner Slichter (Harvard) agreed openly. Then, in the light of interpretations of his *General Theory* [5] as an assault on the "Classics" only a scant five years later, a rather dramatic moment arrived when John Maynard Keynes responded to the Schultz and Goodrich analysis of wage cutting. Keynes was extravagant in his agreement.

> I think that this analysis which Mr. Schultz and Mr. Goodrich have given us is extraordinarily good and most helpful. I have never seen it put quite so before. This division seems to be vital in the discussion of this. I have very little to add to the actual scope of this, or to criticize.... [1, p. 212]

Actually, Keynes did want to add some thoughts on the depression phase of the business cycle, but he attributed the analysis to the young English economist, R.F. Kahn. This attribution to Kahn's recently published article [4] was somewhat strange because the framework Keynes then developed was in terms of the saving-investment nexus, which Keynes had discussed at length in his *Treatise on Money* [5]. Basically, Keynes suggested a saving-investment framework that could serve as a test of whether or not a wage cut would increase employment. In this framework, the effect of wage reductions was a function of the direction of movement in the saving-investment disparity. Keynes asserted that a favorable influence, *i.e.*, a movement toward investment, was unlikely as "over-capacity" generalized in every direction.

"[A]t the beginning of a slump," Keynes said, "there might be more to be hoped for from wage cuts than later in the slump." [1, pp. 212-215] Keynes then openly admitted that the net result of wage cuts "depends upon quantities which we are not in a position to measure," presumably elasticities of demand, effect on the saving-investment disparity, *etc*., and that "there is a great deal which is indeterminate on both sides." [1, pp. 215-216]

Schultz, Goodrich, and Keynes then engaged in a cordial discourse that indicated complete agreement among the three. Schultz demonstrated that Keynes was merely repeating his "Cournot-Amoroso" analysis. The Cournot-Amoroso formula suggested that, for each firm, the difference between price and marginal cost, when expressed as a ratio to price, is directly proportional to the ratio of the quantity produced by the firm to total production by all firms and is inversely proportional to the price elasticity of demand. Keynes agreed that, if Schultz's Cournot-Amoroso formula was aggregated, "you get a formula by which you can relate the excess of saving to the volume of investment." [1, pp. 217-218] Keynes was suggesting that the difference between total business receipts and the total costs of output is related to the difference between what he called "savings" and what he called "investment."

In a subsequent interchange with Sumner Slichter, Keynes again showed his affinity with the Schultz and Goodrich analysis. When Slichter asked Keynes directly if he would favor wage cuts in the construction industry, Keynes replied, "whether it might help depends on whether the demand for housing were very elastic." [1, p. 222]

If a slugfest between "hard-boiled" Classics who would be cutting every wage in sight and a "sentimental Laborite" who would be echoing John L. Lewis's slogan of "no backward step" was expected, the faint evidence of combat was startling. This 1931 exchange between Keynes and the Classics shows that, in the United States, economists were unconvinced that wage cutting would augment employment, production, income or any other relevant aggregate, and they certainly were opposed to wage cutting as a policy remedy for what ails the economy during the depression phase of the business cycle.

The consensus among Keynes and the Classics can be seen first in the emphasis that Schultz and Goodrich placed on the aggregate effects of wage policy. Particularly, they argued that wage reduction was favorable only *if* the wage reduction augmented aggregate demand. When Keynes's Foreword to the German edition of the *General Theory* [8] is considered, it seems that Keynes did not intend the purview of his comments on the Classics to include leading U.S. economists, only certain English economists. There, Keynes made clear that his *General Theory* was meant as a reaction to and a disengagement from the classical *English* tradition. He admitted that his deviations from recognized doctrine were extremely controversial in certain *English* circles. Nevertheless, Keynes asked, how could someone who was educated in the *English* economic orthodoxy and who was even a priest of the faith avoid controversial emphasis when he became a protestant for the first time?

Wage Cuts Revisited

Following a paper by E.J. Phelan (International Labor Office) on "International Mechanisms and Unemployment," wage policy was discussed once again. Phelan pointed out that there appeared to be no mechanism through which wage cuts could be executed. Henry Schultz was the first to agree. Even if an international body of experts agreed that a reduction of wages would be desirable, Schultz emphasized, there did not seem to be any possibility of bringing wage reductions into practice. Thinking primarily of the United States, Schultz concluded that labor would not agree to wage reductions. If employment opportunities could not be enhanced by wage reductions, which was the consensus, why should labor accept wage reductions? Five years later, Keynes made the same point. In his *General Theory*, Keynes asked why unemployment should be considered voluntary in cases where workers refuse to accept lower money wages. His caustic reply was that "it is unfortunate that the workers...are instinctively more reasonable economists than the classical school.... [7, p. 11] Once again, he must have had in mind certain English economists who adhered to some version of "classical" orthodoxy. He certainly could not have been referring to the U.S. economists with whom he participated at the Harris Foundation Round Tables in 1931.

Finally, Sumner Slichter seems to have spoken for all participants when he said the question of wage reductions was a dead issue. In his own words,

> From the standpoint of the United States,...I wonder if the wage issue...isn't becoming pretty academic.... I think it is practically a dead issue in this depression. [1, pp. 544-545]

No disagreement whatsoever was expressed. No Keynes versus the Classics was evidenced. Keynes and the Classics were as one on the issue of wage reductions.

Public Works Construction and Unemployment

On 30 June 1931, Otto Nathan led a discussion of public works and unemployment. Nathan's paper, "Public Works Construction and Unemployment," was seriously limited by an initial assumption, based on historical grounds, that a countercyclical public works program would be too small. Consequently, he seemed to favor waiting until the depression had established an unemployment equilibrium before executing the public works program. Nonetheless, Nathan unequivocally supported floating loans in times of depression to defray the costs of public works and government accumulation of reserves during expansion and disposal of reserves during contraction. The latter notion was tantamount to balancing the budget over the business cycle. Pursuant to discussion regarding when to execute public works and how much spending was necessary, Keynes rightly pointed out that Nathan's paper was rooted fundamentally in the assumption that government has very little "ammunition." The test of "adequacy," Keynes suggested, depended on how much private investment fell below "normal." If total construction in 1928 was $10 billion and fell to $7 billion in 1930, Keynes argued, then $3 billion was the measure of how much would be needed. Keynes credited this idea to Sidney and Beatrice Webb, who were influential in the early years of the "Fabians." Undoubtedly, Keynes must have been referring to the Minority Report of the Royal Commission on the Poor Laws and Relief of Distress (1909). Interestingly, Keynes makes no use of the multiplier in the rudimentary form found in *Can Lloyd George Do It?* [5] or the more modern version found in Kahn's seminal article. [4]

Only moments later, however, Keynes weakened his recommendation considerably when he shifted his attention directly to the United States. He made clear that the case for public works for the United States was much weaker than for Great Britain. He also emphasized that the task of getting back to "a state of equilibrium" should rest with monetary policy and not fiscal policy. In Keynes's words,

> I think the argument for public works in this country is much weaker than it is for Great Britain. I have for a long time past agitated very strongly for a public works program, and my argument has been that we cannot operate on the rate of interest, because if we tried to force the rate of interest down, there is too much lending, and we lose our gold. The advantage of a government program in Great Britain is that the government can borrow at whatever the world rate of interest is, regardless of whether the investment yields that.
>
> In this country you haven't a problem of that kind. Here you can function as though you were a closed system, and I think all your argument hitherto has been rather based on the closed system assumption. For such a system I would use as my first method operating on the long term rate of interest....
>
> I think in this country deliberate public works should be regarded much more as a tonic to change of business conditions, but the means of getting back to a state of equilibrium should be concentrated on the rate of interest. That condition not being so in Great Britain, one had to lay great stress on public programs, but in this country I should operate on the rate of interest. [1, p. 285]

Three salient points emerge from Keynes's comments here and elsewhere during the round tables. One, Keynes assumed that there was only one equilibrium, that the equilibrium was at full employment. None of his comments acknowledged the possibility of unemployment equilibrium or unemployment equilibria. The Classics, on the other hand, argued that there were many possible unemployment equilibria. The only exception among those who spoke up was Alvin Hansen, later known as the "American Keynes," who, by assuming perfect competition, argued that there was not more than one equilibrium. [1, p. 285] Two, Keynes was clearly wedded to the "pump-priming" rationale for fiscal policy, counting on monetary policy to prevent a return to the old level of income and employment. He apparently believed that temporary injections of government spending would get the economy out of unemployment disequilibrium and to a "state of equilibrium," where the private sector and monetary policy could carry the economy along. By 1933-1934, Keynes would abandon this naive rationale for fiscal policy based on one-time pump-priming, becoming an advocate of recurrent pump-priming rather than compensatory public spending closely associated the Chicago economists. Three, although Keynes explicitly distinguished between closed and open economies, he clearly expected too much of the rate of interest.

Keynes and Central Banks Revisited

On 1 July 1931, Keynes himself was scheduled to discuss governmental and central bank action regarding unemployment. Keynes concentrated on central bank action. Speaking only briefly, Keynes left matters largely to subsequent discussion. Actually, Keynes already had discussed his theories of the interest rate and of central banking. A few days earlier, for example, he had argued that excessive interest rates were to be blamed for falling prices and that he preferred central bank action to cure such problems. Insofar as recovery was concerned, Keynes continued to insist that he "should like to try the central bank method first," to argue that "central bank action as being on the whole rather more important than government action," and to attribute "importance to government action in the short run, and to central bank action in the long run." [1, p. 501-502]

In the discussion that followed Keynes's paper, Lloyd Mints (University of Chicago) tried to get him to focus on fiscal policy rather than monetary policy. Keynes admitted he was counting on the interest rate to equilibrate saving and investment. Mints wanted Keynes to agree that fiscal policy, primarily through its influence on investment spending, was more reliable. In their words,

> MR. MINTS: I should like to revert for a moment to the question of the relative importance of lowering the interest rate and public works. As I understand your argument, you want to reduce the interest rate in order to bring about an equivalence between saving and investment. As a matter of fact, won't public works bring about precisely the same results, not through decreasing the rate of interest, but increasing the rate of return for business firms, thereby increasing the rate of investment, even at current rates of interest.
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> MR. KEYNES: Certainly, therefore I am in favor of an admixture of public works.... I should use the public works program to fill in the interregnum while I was getting the interest rate down. The public works program would in itself increase business profits, and therefore relieve people from that exceptional unwillingness to borrow.
>
> I should be afraid of that as a sole remedy. I should be afraid it would work itself out, come to an end, and then we should be back where we were unless we decided on a very definite further action. [1, pp. 493-494]

Once again, Keynes implies a policy of pump-priming and then monetary policy to keep the economy at a higher level of production, employment, and income. Keynes's paper and its subsequent discussion were rather uninspiring and disappointing. He persisted in championing monetary policy, particularly manipulation of the interest rate as the key to recovery. Until the interest rate could be reduced to a level consistent with equilibrium between saving and investment, Keynes would count on fiscal policy only as a transitory tonic.

Why Not Public Works?

Only six months later in January 1932, leading U.S. economists again gathered in Chicago for Harris Foundation lectures and round tables. Almost immediately, disillusion was expressed in monetary policy, particularly open market operations. Harold Moulton (Brookings Institution) was one of the first to argue that open market operations failed to augment spending. Moulton suggested that the federal government should borrow from the Federal Reserve and spend the money on public works, unemployment relief, and so forth.

Jacob Viner (University of Chicago) agreed and criticized the poor way in which public works had been used as a depression remedy. "What you probably need," Viner suggested, "is a means whereby the banks can take up the increased government indebtedness through a relaxation of eligibility rules and other things, and the funds getting to the consumers through public expenditures." [2, pp. 228-229] Viner complained that the trouble with past public works was the failure to be associated with any procedure for increasing the net supply of credit. Only Hansen, later known as the "American Keynes" seemed unconvinced of the efficacy of public works as an effective recovery measure. Hansen apparently believed that public works were, among other things, wasteful. In his words,

> I have a feeling that public works has been accepted around the Round Table rather too easily tonight. Isn't it true that in the history of Great Britain and Germany they have after all devoted a great deal of attention to the question of public works, and never found public works any sort of remedy for the situation. There are a good many arguments against public works as an emergency measure.... You can't put public works suddenly into motion without an enormous waste, and you have to pay for them eventually, and they do react upon the private economy. [2, pp. 245-245]

Jacob Viner delivered a stinging rebuttal to Hansen's nervousness regarding public works. In the first place, Viner argued, public works in the past had been trivial, and none was connected with a program of currency expansion. In the second place, Viner argued, public works would have an altogether favorable reaction on business. Finally, Viner pointed out that "so far as wasting is concerned, assume that there was thirty, forty, or fifty percent wastage, it would be thirty, forty, or fifty percent of the wastage involved now in the idle capital resources and the idle labor resources that are available and not being used." [2, p. 245] The Viner rebuttal must have influenced Hansen because, only a few days later, he joined twenty-three others who signed a telegram to President Hoover urging him to finance with deficits a fairly large program of public works.

On 30 January 1932, Viner was instrumental in forming a committee of six to draft a statement of recommendations to President Hoover. The six were Viner himself, Charles O. Hardy (Brookings Institution), Henry Schultz (University of Chicago), John H. Williams (Harvard University), Irving Fisher (Yale University), and Alvin Hansen (University of Minnesota). The gang of six agreed on six recommendations: (1) cover for Federal Reserve notes should be liberalized to include both federal government securities and commercial paper; (2) open market operations should be pursued systematically both to facilitate government financing and to increase bank liquidity; (3) the Reconstruction Finance Corporation should make loans to banks on assets ineligible for rediscount with Federal Reserve banks; (4) the federal government should maintain its expenditures at a level not lower than that of 1930-31; (5) intergovernmental debts should be reduced or cancelled; and (6) tariffs and other barriers to world trade should be negotiated with other countries. [3]

Despite lengthy discussion in a special session, the committee's report remained essentially unchanged. Twenty-four of the participants agreed to sign their names to a telegram to President Hoover urging him to act favorably on each of them. Their recommendations received widespread attention, and this group of Classics may have helped to persuade the Hoover Administration to adopt its meager inflationary measures, *viz.*, what later became the Glass-Steagall Act, open market purchases, Reconstruction Finance Corporation aid to banks with ineligible assets, public works programs financed by deficits, and federal unemployment relief.

Some Concluding Remarks

The strong suit of U.S. economists was microeconomics, but an emerging macroeconomics was in evidence in 1931-1932. If there is a criticism of this emerging macroeconomics, it was the failure to articulate the various elements of the theory. This failure resulted in an inordinate amount of measurement without theory, a tradition that was quite stultifying. The macroeconomics found in the Round Table proceedings is nonetheless rooted in the notion that total spending, private and public, should be great enough to take off markets an overall volume of output associated with full employment of labor and capital. Given this fundamental macroeconomic idea, the Classics were opposed to any policy, *e.g.*, wage reductions, that would impair total spending. With this focus, the Harris Foundation participants were cool to monetary policy, except to facilitate an expansionary fiscal policy. The only unobjectionable role that they saw for wage reductions was as a "signal" to labor in declining industries that it was in inferior employment.

Keynes broached his recommendations with careful distinctions between open and closed economies. His robust role for the long term interest rate and his somewhat timid role for fiscal policy were surprising and more conservative than the Classics. Keynes counted on the interest rate to bring the saving-investment nexus into line, whereas the Classics counted on public expenditures to bring the total spending-output-employment-income nexus into line.

Caricatures of Keynes versus the Classics do not square well with the descriptive, historical references evidenced by the Harris Foundation Round Tables of 1931 and 1932. Perhaps all of us are guilty of falsifying history because of a tendency to simplify the process of intellectual change in disciplines governed by paradigms. Rather than consisting in a series of swift transitions from less to more satisfactory paradigms, the process of development often is characterized by lengthy periods of dilemma, search, trial, and anomaly, involving most members of the discipline. From these periods eventually emerges one paradigm more satisfactory than others, embodying nevertheless the interactions of many minds.

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