From Keynesianism to Neoliberalism: Shifting Paradigms in Economics

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The intellectual foundations of neoliberalism

> "(T)he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slave of some defunct economist."
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> John Maynard Keynes, *The General Theory of Employment, Interest and Money* (1936), p.383.

For the last 25 years, economic policy and the public's thinking have been dominated by a conservative economic philosophy known as neoliberalism. The reference to "liberalism" reflects an intellectual lineage that connects with 19th century economic liberalism associated with Manchester, England. The Manchester system was predicated upon *laissez-faire* economics and was closely associated with free trade and the repeal of England's Corn Law, which restricted importation of wheat. Contemporary neoliberalism is principally associated with the Chicago School of Economics, which emphasizes the efficiency of market competition, the role of individuals in determining economic outcomes, and distortions associated with government intervention and regulation of markets.[1]

Two critical tenets of neoliberalism are its theory of income distribution and its theory of aggregate employment determination. With regard to income distribution, neoliberalism asserts that factors of production--labor and capital--get paid what they are worth. This is accomplished through the supply and demand process, whereby payment depends on a factor's relative scarcity (supply) and its productivity, which affects demand. With regard to aggregate employment determination, neoliberalism asserts that free markets will not let valuable factors of production--including labor--go to waste. Instead, prices will adjust to ensure that demand is forthcoming and that all factors are employed. This assertion is at the foundation of Chicago School monetarism, which claims that economies automatically self-adjust to full employment and that the use of monetary and fiscal policy to permanently raise employment merely generates inflation.[2]

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[1] Key figures in the Chicago School are Milton Friedman, George Stigler, Ronald Coase and Gary Becker--all of whom have been awarded the Nobel Prize in economics.
[2] Monetary policy is conducted by central banks, who manage interest rates to affect the level of economic activity. Fiscal policy refers to government management of spending and taxation to affect economic activity.

These two theories have been extraordinarily influential, and they contrast with the thinking that held sway in the period between 1945 and 1980. During this earlier era, the dominant theory of employment determination was Keynesianism, which maintains that the level of economic activity is determined by the level of aggregate demand.[3] Additionally, Keynesians maintain that capitalist economies are subject to periodic weakness in the aggregate demand generation process, resulting in unemployment. Occasionally, this weakness can be severe and produce economic depressions--as exemplified by the Great Depression. In such a world, monetary and fiscal policy can stabilize the demand generation process.

With regard to income distribution, Keynesians have always been divided, and this created a fatal breach that facilitated the triumph of neoliberalism. American Keynesians (known as neo-Keynesians) tend to accept the neoliberal "paid what you are worth" theory of income distribution, while European Keynesians (widely associated with Cambridge, U.K., and known as post-Keynesians) reject it. Instead, post-Keynesians argue that income distribution depends significantly on institutional factors. Thus, not only do a factor's relative scarcity and productivity matter, but so too does its bargaining power, which is impacted by institutional arrangements. This explains the significance of trade unions, laws governing minimum wages, employee rights at work, and systems of social protection such as unemployment insurance. Finally, public understandings of the economy also matter, since a public that views the economy through a bargaining power lens will have greater political sympathies for trade unions and institutions of social protection.

The great reversal: the decline of Keynesianism and the rise of neoliberalism

For the 25 years after World War II (1945-1970), Keynesianism constituted the dominant paradigm for understanding the determination of economic activity. This was the era in which modern tools of monetary policy (control of interest rates) and fiscal policy (control of government spending and taxes) were developed. It was also a period in which union coverage rose to historical highs and "New Deal" style institutions of social protection and regulation were expanded.

However, in the mid-1970s the Keynesian impulse went into reverse, to be replaced by neoliberalism. This reversal piggybacked on the social and economic dislocations associated with the Vietnam War era and the OPEC oil price shocks, which dominated the 1970s. However, these dislocations only provided an entry point. The ultimate spark of neoliberal dynamism is to be found in the intellectual divisions of Keynesianism and its failure to develop public understandings of the economy that could compete with the neoliberal rhetoric of "free markets."

Throughout the period of Keynesian dominance, there remained deep conservative opposition within the United States, providing a base from which to launch a neoliberal assault. This opposition had been present during the New Deal period, as manifested in conservative resistance to the creation of the Social Security retirement

[3] Aggregate demand is the total level of demand for goods and services in an economy. Keynesians believe that firms produce on the basis of their expectations of the level of aggregate demand and that the level of aggregate demand thus determines the overall level of economic activity.

income system. And the antagonism continued after World War II, as illustrated by the conservative-sponsored Taft-Hartley Act (1947), which sowed the seeds that eventually eviscerated the rights of American workers to form unions by undermining union power and the ability to organize.

The appeal of neoliberalism was also enhanced by economic and cultural factors. At the economic level, the success of New Deal Keynesianism may have contributed to its own undoing. Rising prosperity, built upon Keynesian policies and the postwar social contract between business and labor, may have engendered beliefs that the core economic problems of income distribution and mass unemployment had finally been solved. As a result, U.S. citizens may gradually have come to view as dispensable the very policies and institutions--such as unions--that had brought about their now-presupposed prosperity.

At the cultural level, America has always celebrated radical individualism, as epitomized in the frontiersman image. This radical individualism was further promoted by the ideological conflict embedded in the Cold War, which fostered antipathy to notions of collective economic action and denial of the limitations of market capitalism. In particular, collective economic action was tarred by identification with the communist approach to economic management. The Cold War, therefore, provided fertile ground for popularizing an economic rhetoric that spoke of "natural" free markets independent of governments and in which government regulation reduces well-being.[4]

Yet, as important as political and cultural factors were in explaining the appeal of neoliberalism, Keynesianism also suffered from internal intellectual divisions that made for weakness. One source of division was the theory of income distribution. Keynes was a believer in the marginal product theory of income distribution, whereby workers get paid what they are worth to the company. This gives little justification for trade unions and other forms of labor market intervention, all of which can be painted as market distortions rather than corrections of market failure associated with unequal bargaining power. In effect, whereas Keynesians contributed greatly to understanding the factors of aggregate demand and its role in determining employment outcomes, they developed no matching analysis of production conditions and their interactions with and impacts on aggregate demand.[5]

A second Keynesian weakness was the belief that downward price and (especially) nominal wage rigidity were responsible for unemployment. This position emerged in the 1940s, a decade after the publication of Keynes' 1936 book, "The General Theory of Employment, Interest and Money." The argument was that lower nominal wages would lower prices, thereby increasing the real value of money holdings, which in turn would stimulate consumption spending and aggregate demand. In addition, lower prices would increase the real money supply, thereby lowering interest rates and stimulating investment spending. In this fashion, lower nominal wages and prices could solve the problem of unemployment.

This neo-Keynesian view of price and wage flexibility was adopted especially strongly by American economists. In effect, it stated that economic rigidities were responsible for unemployment and that these rigidities included such factors as trade

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[4] See Palley, *Plenty of Nothing*, pp.31-38.
[5] This theme is developed in Palley, *Plenty of Nothing*.

unions and minimum wage laws. In a sense, the American neo-Keynesian position was implicitly a forerunner of today's neoliberal labor market flexibility agenda. This neo-Keynesian view contrasts sharply with post-Keynesian analysis, which holds that unemployment results from demand shortages caused by weak business confidence and uncertainty about the future. In a monetary economy, spending can dry up if people decide to hold onto money, and price flexibility can make the demand problem worse on account of debt. Thus, lower prices and nominal wages increase the interest payment burden of debtors, causing them to cut back on spending and possibly to default.[6] The post-Keynesian bottom line is that money-based contracting yields great economic efficiency by lowering transacting costs, but it also makes economic adjustment through price and nominal wage flexibility highly problematic.

The divergent theories regarding the determination of income distribution and the role of downward nominal wage rigidity in creating unemployment created deep internal divisions among Keynesians. At the policy level, this rift opened the way for neoliberals to characterize the labor market innovations of the New Deal as market distortions rather than corrections of market failure. As such, these innovations lacked an economic efficiency rationale and could only be justified for reasons of equity.

Additionally, the theoretical divisions opened the way for an attack on Keynesian full-employment monetary and fiscal policies. American neo-Keynesians supported such policies on the pragmatic grounds that prices and wages were downwardly rigid in practice; for this reason they endorsed government policy interventions. Thus, it was not the theoretical benefits of flexibility that neo-Keynesians contested but rather the empirical possibility of price and nominal wage flexibility. Intellectually, this was a bastardization of Keynes' message, and it provided a public policy opening for neoliberal economists to argue that economic policy should abandon targeting full employment and instead make wage flexibility a reality.

Neoliberal policy in practice

As noted above, neoliberalism can be understood in terms of its theories of income distribution and employment determination. According to the former, the market ensures that factors of production are paid what they are worth, obviating the need for institutions of social protection and trade unions. Indeed, institutions of social protection can lower social well-being and cause unemployment by interfering with the market process.

Regarding the work force, neoliberals insist that price adjustment ensures an automatic tendency toward full employment. Within this framework, policy interventions to increase employment either cause inflation or raise unemployment by destabilizing the market process. This was Milton Friedman's claim regarding the Great Depression, which he argued was caused by mistaken monetary tightening by the Federal Reserve. The relevant implication is that macroeconomic policy-makers should discard Keynesian prescriptions of activist demand management aimed at full employment. Instead, they

[6] For a formal analysis of the destabilizing possibilities of price and nominal wage reduction see Palley, *Post Keynesian Economics*, Chapter 4.

should adopt transparent rules that take the discretion out of policy decisions, thereby avoiding mistakes and letting market forces solve the problem.[7]

In practice, the application of neoliberal policy in the United States has often seen a slip between the cup and the lip--that is, pragmatism has forced neoliberal policy-makers to depart from theory. Regarding income distribution, neoliberal policy has consistently sought to promote the cause of labor market deregulation. This has taken the form of allowing the real value of the minimum wage to fall, undermining unions, and generally creating a labor market climate of employment insecurity. In this, neoliberal policy has been true to its theory, which maintains that employment protections and wage rigidities are not needed. The result has been widening wage and income inequality.[8] For neoliberals, this is because the market is now paying people what they are worth; for post-Keynesians, it is because the balance of power in labor markets has tilted in favor of business.

With regard to macroeconomic policy, neoliberalism has been applied inconsistently and opportunistically and has departed from its theoretical rhetoric. In the early 1980s, neoliberal policy-makers sought to apply Chicago School monetarist prescriptions that abandoned Keynesian interest-rate fine tuning in favor of money supply targeting. The result was massive layoffs in developed countries, pushing unemployment rates to their highest levels since the Great Depression, precipitating a sharp rise in global real interest rates, and inducing significant financial market volatility. This, in turn, forced an abandonment of the monetarist experiment and a return to interest-rate based policy.

Despite this return to the use of interest rate targeting and activist Keynesian stabilization, the policy goal was changed. The concept of full employment was replaced with the notion of a “natural rate of unemployment.”[9] This natural rate is unobservable and is supposedly determined by the forces of demand and supply in labor markets. The adoption of natural rate rhetoric has served two purposes. First, it has provided political cover for higher average rates of unemployment, which have undermined the bargaining position of workers. Second, it has offered a rationale for keeping real interest rates at a higher level, benefiting wealthy individuals and the financial sector. Thus, even though interest rates have been adjusted countercyclically to mitigate the business cycle, they have remained higher than average. Likewise, fiscal policy has also been adjusted countercyclically to rectify the business cycle, but it too has been used to favor elites and

[7] Friedman’s rules-based policy argument has been supplemented by a second-generation Chicago School political economy theory contending that politicians are motivated by self-interest and actively engage in deceiving the public and working against its interests. According to second-generation Chicago School economists, the remedy for this situation is independent policy institutions free of political control. The problem with this remedy is that removing political accountability does not remove the self-interest of those who remain in control (Palley, *The Institutionalization of Deflationary Policy Bias*).

[8] Mishel, et al., *The State of Working America*; Palley, *Plenty of Nothing*.

[9] This concept is also known as the “non-accelerating inflation rate of unemployment” and is supposed to be an unemployment rate at which inflation shows no tendency to accelerate or decelerate.

special political interests. This is most clearly evident in tax cuts targeted toward upper-income groups.

The neoliberal cooption of stabilization policy raises two issues. First, whereas stabilization policy is the correct response, neoliberal policy-makers have employed it in a suboptimal manner, as illustrated by recent U.S. tax policy. The Bush administration used the 2001 recession opportunistically to cut taxes, but these tax cuts were directed predominantly toward wealthy individuals, thereby yielding less economic bang per buck, and were structured to be permanent, though fighting recession called only for temporary tax cuts. Second, the need for recourse to stabilization policy speaks to the inadequacy of the neoliberal theoretical account of the economy. After all, according to the neoliberal model, market economies are supposed to automatically and rapidly self-adjust to full employment.

Putting the pieces together, the challenge confronting post-Keynesians is to advance the debate at two levels. First, there is a need to challenge the particulars of neoliberal stabilization policy, which has been suboptimal. Second, there is a need to challenge the underlying neoliberal conceptual framework. This twin task is difficult, since debating policy particulars risks a public perception of mere differences of degree rather than fundamental clashes in economic conception.

The economic record under neoliberalism

The elections of Margaret Thatcher in 1979 and Ronald Reagan in 1980 can be viewed as inaugurating the formal period of neoliberal economic policy dominance. The last quarter century has seen an expanding application of neoliberal ideas within both industrialized and developing-country economies. Compared to the 1945-80 era, this recent period has seen substantially slower economic growth and widening income inequality, both within and between countries.[10]

Within industrialized countries, the economic agenda has been dominated by policies associated with the “U.S. model.” These include deregulation of financial markets, privatization, weakening of institutions of social protection, weakening of labor unions and labor market protections, shrinking of government, cutting of top tax rates, opening of international goods and capital markets, and abandonment of full employment goals, all under the guise of the natural rate. International economic policy has been dominated by the “Washington Consensus,” which advocates privatization, free trade, export-led growth, financial capital mobility, deregulated labor markets, and policies of macroeconomic austerity.

The failure of the Washington Consensus to deliver faster growth in developing countries--it has actually delivered slower growth--has contributed to a backlash that has significantly discredited it. There is now widespread recognition that: international financial markets can be prone to instability, export-led growth is not sufficient for domestic development and can promote global deflation and a “race to the bottom,” democracy and institutions promoting social inclusiveness are needed for development, and labor market protections are needed to prevent exploitation. However, though much progress has been made in countering the Washington Consensus, little progress has been

[10] Mishel, et al., *The State of Working America*; Weisbrot, et al., “The Scorecard.”

made in combating the "U.S. model." This poses a danger, since the U.S. model is the source of neoliberal policy, including the Washington Consensus.

Within public debate, the United States is presented as a model economy and contrasted with European economies, which are labeled as sclerotic and inflexible. However, the facts are more complex and indicate that both models have strengths and weaknesses. The strengths of the U.S. neoliberal model are a lower average rate of unemployment, a higher employment-to-population ratio, and faster output growth (in part, driven by population growth caused by legal and illegal immigration). Its weaknesses relative to the European model are higher and worsened income inequality (exemplified by the explosion of CEO pay in the United States), higher poverty rates, lower productivity growth (until the mid-1990s), longer working hours, and wage stagnation for those in the bottom half of the wage distribution. Research by Blanchflower and Oswald into the economics of happiness shows that happiness in the United States has been trending down, while happiness in the United Kingdom has not changed. Of all the world's markets, these two economies have pursued the neoliberal path most aggressively, but it has not translated into more happiness for their citizens.

The differences between U.S. and European economic outcomes can be understood using Figure 1.[11] Macroeconomic policy determines the overall rate of unemployment, while microeconomic policies concerning labor market and social protection institutions determine patterns of income inequality. Expansionary macro policy lowers unemployment, while contractionary macro policy increases unemployment. Eroding institutions of social protection increases income inequality, while maintaining protections holds income inequality constant. A pure neoliberal policy configuration would aim at eroding protections, since these are a form of market distortion, and would abandon full-employment countercyclical policy as unnecessary.

In practice, policy has not been applied as pure neoliberal theory would suggest. The United States has pursued a path of expansionary macro policy built on large budget deficits, countercyclical interest rates, and the erosion of social protections. The result has been relatively full employment and worsening income distribution. Contrastingly, Europe has pursued contractionary macro policies centered on high interest rates and fiscal austerity while maintaining its institutions of social protection. The result has been high unemployment and only modest progress in alleviating income inequality.

Finally, Figure 1 can also be used to understand the policy configuration recommended by a post-Keynesian perspective. At the microeconomic level, there is a need for institutions of social and labor market protection to ensure an appropriate distribution of income. At the macroeconomic level, policy should have an expansionary tilt in order to ensure full employment. This policy configuration fits with the underlying Keynesian theoretical framework, which holds that income distribution is significantly impacted by social and institutional forces and that full employment requires management of the level of aggregate demand. The challenge is to ensure that institutions of social protection are designed such that markets retain the appropriate incentives for the provision of labor effort and entrepreneurship, while corporations have an adequate level of flexibility. Precisely calibrated, macroeconomic policy must provide adequate aggregate demand but not so much that it generates unacceptably high inflation.

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[11] The analysis here is drawn from Palley, *Restoring Prosperity*.

The above analysis, in terms of macro-micro policy, also yields important political lessons. Both the U.S. and European models are flawed in important ways. Yet, politically, the U.S. model--with its lower rate of unemployment--has been hard to dent, while the European model has been under pressure to weaken its institutions of labor-market and social protection. This suggests that low-unemployment concerns trump fairer income-distribution desires among electorates. Such a conclusion is supported by the research on the economics of happiness, which reports that unemployment carries a very high unhappiness cost. People are concerned with fairness, but that goal is not strong enough to be politically decisive. This prioritizing means that a successful economic model must address the problem of unemployment, and it explains why the European social model is being sabotaged by the continent's macroeconomic policies.

Reinventing government in economic discourse

In addition to reconfiguring the macro-micro policy mix, there is also a need to reconfigure public understanding of the economic role of government. The traditional liberal explanation for government economic involvement has focused on "market failure" related to problems of monopoly, natural monopoly, public goods and externalities.[12] The basic idea is that market failure leads to suboptimal provision (there may be too little or too much production), calling for government intervention--through regulation, taxes and subsidies, or outright government control of production--to remedy the problem.

The concept of market failure has proved extremely powerful, but it has in turn generated a neoliberal counterargument framed in terms of government failure. The claim is that, though markets may fail, having government remedy market failures may be even worse, owing to bureaucratic inefficiencies and lack of market-styled incentives.

The government failure argument has had great resonance in the United States, given the culture of radical individualism. However, the role of government in a market economy runs far deeper, and its contribution is inadequately understood. Government not only plays a critical role in remedying market failure, it also provides essential services related to education and health. In addition, government is pivotal in stabilizing the business cycle through fiscal and monetary policy. Deeper yet, government is integral to the workings of private markets through its provision of a legal system that supports the use of contracts. Absent the ability to contract, the benefits of a market economy would be enormously diminished.

Particularly poorly understood is the role of government in preventing destructive competition, in which market incentives lure agents to engage in actions that generate a suboptimal equilibrium, but the market is unable to generate counterincentives that restore a socially optimal equilibrium. This type of situation is illustrated by the bribery

[12] Monopoly may result from private actions or from the nature of technology. In both cases it precludes the benefits of competition. Public goods refer to such activities as provision of defense and street lighting. Markets underprovide public goods because private producers cannot prevent agents from freely consuming the good. Externalities refer to actions of one agent that impact the well-being of others. The costs and benefits of these impacts are not taken into account by individuals when deciding on their actions, resulting in suboptimal outcomes.

problem. Bribery is economically destructive, because it allocates business on the basis of bribe-paying rather than economic efficiency. For this reason, societies should aim to avoid bribery. However, unregulated markets tend to produce bribery. If one agent bribes while others do not, that agent thrives while others suffer. As a result, all agents have an incentive to bribe. Left to itself, the market therefore generates a "bad" equilibrium in which all agents pay bribes. The "good" equilibrium in which none pay bribes can only be induced and maintained by laws imposing penalties that deter bribery. This illustrates how government action may be needed to support optimally efficient outcomes. The real world is afflicted by situations generating destructive competition--examples include bribery, excessive advertising expenditures, tax competition between jurisdictions to attract business investment, and the global race to the bottom, in which countries ratchet down labor standards to attract business. Remedies for all of these situations require government intervention.

Post-Keynesianism versus the Third Way: similarities and differences

In closing, it is worth comparing the above post-Keynesian construction with the Third Way approach of U.K. Prime Minister Tony Blair.[13] The Third Way is an alternative attempt to topple neoliberal domination of public policy. It seeks to articulate a humane path between the first way of *laissez-faire* capitalism and the second way of centrally planned state economies. In this, it has some resonance with the mixed economy approach of the 1960s, which argued for a combination of privately owned and nationalized industries.

However, though the Third Way seeks to humanize the market, it is fundamentally different from a post-Keynesian perspective, because it basically accepts the major theoretical tenets of neoliberalism regarding income distribution and the stability of capitalist economies. Viewed in this light, the Third Way represents an updating of the earlier market failure approach, and it also aims to counter the neoliberal government failure argument. Thus, the Third Way emphasizes how market failure can result from imperfect information. This imperfect information argument is a variation of market failure that has gained theoretical recognition over the last 20 years. Rather than prescribing that government take over production through nationalized industries and risk government failure, the Third Way emphasizes taxation and regulation as the preferred means of changing private sector behavior. Similarly, regarding provision of essential services such as health and education--which markets underprovide--the Third Way is comfortable having government contract with the private sector for their procurement.

Although these Third Way innovations are in principle consistent with the post-Keynesian approach, unlike the Third Way, post-Keynesianism rejects both the neoliberal approach to income distribution and its claims of an automatic tendency to full employment. Post-Keynesians contend that labor is not automatically paid what it is worth by an anonymous neutral market process. Rather, the pattern of income distribution is impacted by labor market institutions, and institutional interventions are needed, because markets have a tendency to favor capital over labor. Furthermore, capitalist economies are subject to fluctuations in aggregate demand, which give rise to

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[13] Arestis and Sawyer (2001) provide a survey of the economics of the Third Way, as applied around the world by governments that have adhered to this path.

unnecessary unemployment. Downward price and wage flexibility cannot resolve this problem; in fact, they often aggravate it. This calls for monetary and fiscal policy interventions to correct the problem of deficient demand, and institutions that prevent generalized declines in prices and nominal wages are highly desirable to avoid debt deflations. These analytical differences fundamentally differentiate post-Keynesianism from the Third Way, and they explain the policy disagreements that delineate old from new Laborites in the United Kingdom and old from new Democrats in the United States.

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		Macro Policy Options	
		Contraction	*Expansion*
Micro Policy Options	*Erode Protections*	Pure neoliberalism	U.S.
	Maintain Protections	EUROPE	Post-Keynesianism

Figure 1. Differences in economic policy both between neoliberalism and post-Keynesianism and between the United States and Europe.