The Demoralizing Trap of Keynesianism

Daniel J. Smith
Troy University
Sean P. Alvarez
Troy University

Classical economists, since the days of Scottish Enlightenment thinkers, held that one of the primary arguments for capitalism, in addition to its superior economic efficiency and its grounding in robust political economy, was its civilizing role. They recognized that commerce channels self-interest into voluntary, mutually beneficial pursuits. The cooperative pursuit of profit thus encourages the development of tolerance, honesty, and manners even among diverse people. Keynesianism, however, can undermine the civilizing role of commerce by promoting widespread government control and direction of the economy. Because big government undermines the market and fosters cronyism, commercial virtues are dampened, and they are often replaced with dishonesty, distrust, and intolerance.

Dangerous human proclivities can be canalised into comparatively harmless channels by the existence of opportunities for money-making and private wealth, which, if they cannot be satisfied in this way, may find their outlet in cruelty, the reckless pursuit of personal power and authority, and other forms of self-aggrandisment. It is better that a man should tyrannise over his bank balance than over his fellow-citizens.

—John Maynard Keynes

Introduction

Most economists today defend a market society with the notion of economic efficiency. In terms of achieving advanced material production, a market society—including the institutions of private property, prices, and profit and loss—
provides the information, incentives, and innovation necessary to outperform centrally planned economies.\(^2\) Empirically, the superiority of market institutions in enhancing prosperity has been proven time and again.\(^3\)

While the defense of capitalism offered by Scottish Enlightenment thinkers, including David Hume and Adam Smith, certainly included a strong appreciation for the productivity of capitalism, their defense of a market economy was not limited to efficiency claims. Scottish Enlightenment thinkers, as well as scholars building on their work, recognized that capitalism was also robust to knowledge and incentive problems.\(^4\) Rather than design centralized political and economic institutions for nonexistent, omniscient, and benevolent philosopher kings, a scenario that has historically led to poor outcomes in a world inhabited by people with severe knowledge and incentive problems, a commercial society provided a uniquely decentralized framework that enabled the flow of information and the structuring of incentives toward socially beneficial outcomes.\(^5\)

An important observation of the Scottish Enlightenment thinkers was that while a strong centralized government encourages distrust, suspicion, and conflict among diverse people, commerce provided a commercial space for people of different cultures and of diverse philosophical and religious views to engage in mutually beneficial exchange.\(^6\) Thus, another important defense of capitalism that they made is that commerce plays a civilizing and moralizing role in society.\(^7\)

The contribution from the Scottish Enlightenment thinkers that commerce plays a civilizing and moralizing role in society has come to be recognized as the doux commerce thesis.\(^8\) Rather than the path to national wealth and prosperity that hinges on using military strength to conquer, subdue, pillage, and all of the concomitant moralities attributed to a society built on such goals, the scholars who advanced the doux commerce thesis realized the path to national wealth was through “peace, easy taxes, and a tolerable administration of justice.”\(^9\) The economics profession has, for the most part, shifted its arguments in favor of capitalism from the doux commerce thesis to an argument that champions capitalism’s efficiency. However, modern scholarship has built upon the preexisting arguments for the doux commerce thesis and has increased their validity.\(^10\)

In the midst of the Great Depression, Keynes ushered in a new theoretical and empirical framework of economic thinking. While Keynes recognized the validity and power of the doux commerce thesis, he advocated curtailing capitalism in order to preserve it.\(^11\) Keynes believed that unless government took action to stimulate the economy and bring about full employment, citizens dismayed with persistent unemployment would turn to the false promises of comprehensive central planning.
Most economists employ efficiency arguments to respond to Keynes. While we believe these are important arguments, we also believe, on the margin, too little emphasis is placed on the moral shortcomings of the middle path ushered in by widespread adoption of Keynesian ideas. The growth of government and the proliferation of private-public partnership carried out under Keynesian auspices has enabled and encouraged cronyism. Rather than honestly competing to serve customers, businesses are increasingly relying on special government privileges. Cronyism turns the positive-sum game of voluntary market exchange into a zero- or even negative-sum game, where businesses compete not to serve customers but to curry the favor of government agents at the expense of taxpayers. The suppression of the market and rise of cronyism has important moral implications. Cronyism, as a substitute for the free market, can dampen and undermine the doux commerce virtues of tolerance, honesty, and kindness.

The first section of this article provides a brief description of the classical defense of capitalism and the doux commerce thesis. The second section details the Keynesian revolution and the adoption of the pursuit of full employment. The third section argues that the Keynesian revolution fostered the wide-scale growth of cronyism, which has undermined the doux commerce virtues of the market. We then offer a concluding summary.

The Doux Commerce Thesis

Adam Smith’s most famous contribution to economics is the recognition that different institutional arrangements can channel individual motivations into productive or unproductive uses. The institutions of the market—private property, contract, and consent—channel entrepreneurial activity and resources toward socially beneficially outcomes as if led by an invisible hand. These insights were formalized as technical arguments that demonstrated the efficiency of market institutions in the First and Second Welfare theorems. These theorems demonstrate that competitive markets lead to efficient outcomes if specified conditions, including strict assumptions of perfect rationality, complete information, well-functioning futures markets, and a large number of buyers and sellers, hold.

Moreover, Smith and his Scottish Enlightenment contemporaries saw the invisible hand propensities of the market as part of a much broader—and perhaps even more important—feature of market institutions: the doux commerce thesis. The doux commerce thesis recognized that market institutions, based on private property, consent, and the rule of law, encourage moral development. With the emergence of business, the Scottish Enlightenment thinkers saw the development of a merchant code of behavior, including tolerance, honesty, and fairness, which
facilitated and encouraged positive social interaction and cooperation among even diverse people. David Hume, for instance, wrote,

No one can doubt, that the convention for the distinction of property, and for the stability of possession, is of all circumstances the most necessary to the establishment of human society, and that after the agreement for the fixing and observing of this rule, there remains little or nothing to be done towards settling a perfect harmony and concord.

Modern philosophical critiques of capitalism have sparked a renewed interest in the doux commerce thesis. Recent work has demonstrated the historical importance of market institutions in facilitating the formation of civil society and economic prosperity. Experimental evidence is providing additional support for the doux commerce thesis. For instance, Henrich et al. find that the exposure to market institutions of exchange actually reduces selfish behavior in small-scale societies. Al-Ubaydli et al. find that priming laboratory subjects for market exchange and trade resulted in increased subjects’ willingness to trust strangers. Development economists have taken notice and are also beginning to realize the empirical importance of the doux commerce thesis. Given this, it is not surprising that some economists are returning to supplementing efficiency arguments for capitalism with the doux commerce thesis.

The Keynesian Revolution

The publication of John M. Keynes’s *The General Theory of Employment, Interest, and Money* started a revolution that rapidly transformed academic economics and public policy. At the heart of Keynes’s criticisms of laissez-faire economics was his belief that markets had no tendency toward full employment equilibrium. This was particularly harmful because disequilibrium might mean high unemployment, unsold goods, and unused resources. The persistence of such conditions, without government action, could threaten and undermine the support for capitalism and potentially lead to popular support for full-scale socialism. Keynes favored a middle way that could address the perceived shortcomings of markets while preserving the essential features of capitalism. According to Keynes, that middle-way required government to

exercise a guiding influence on the propensity to consume partly through its scheme of taxation, partly by fixing the rate of interest, and partly, perhaps, in other ways. Furthermore, it seems unlikely that the influence of banking policy on the rate of interest will be sufficient by itself to determine an optimum rate of
investment. I conceive, therefore, that a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment; though this need not exclude all manner of compromises and of devices by which public authority will co-operate with private initiative.28

The need for government socialization of investment was derived from Keynes’s belief that savings were a leakage from the economy. Investment was unpredictable and often below the optimal level required for full employment due to the sometimes dominating influence that human psychology had on investment, a phenomena that Keynes described as “animal spirits.”29 For instance, Keynes writes, “In estimating the prospects of investment, we must have regard, therefore, to the nerves and hysteria and even the digestions and reactions to the weather of those upon whose spontaneous activity it largely depends.”30 Consumer spending has the potential to create jobs. In Keynes’s view, however, aggregate spending was reduced when consumers saved, because they did not lend those savings freely to firms that might put them to good use due to the “fickle and highly unstable marginal efficiency of capital.”31 This in turn reduced output and employment. Thus, government had a role to play in encouraging investment to stabilize the economy at the full employment equilibrium.32 Government-led investment would then encourage consumption.33 This was so vital, especially during downturns, that Keynes held that it justified breaking away from the tradition of balanced-budgets to engage in deficit-spending. Keynes envisioned that government would need to influence two-thirds to three-fourths of private investment.34

Keynes held that these modifications of capitalism were necessary in order to preserve it from the growing threat of socialism. Thus, the fate of “efficiency and freedom” hinged on the adoption of Keynesian remedies.35 The widespread adoption of Keynesianism forged a heavily followed middle path between the extremes of capitalism and communism.36 According to Skidelsky, under Keynesian influence, “capitalism was evolving new forms of public-private partnership that blurred the traditional separation of state and market.”37

Keynes’s ideas took hold, especially where they concerned public policy. Government deficit spending has become the new norm and has widely replaced concerns for balanced budgets.38 Government direction of investment, including private-public partnerships, have also increasingly become more ubiquitous. These investments have taken several different forms, including government-sponsored enterprises with bailout guarantees (implicit or explicit), tax privileges, subsidies, regulation, and protectionism.
Keynesianism, Big Government, and the Decline of Market Morality

The widespread adoption of Keynesian ideas in public policy has enabled the tremendous growth of government. This has led to the growth of cronyism for two reasons. Primarily, the growing size of government crowds out private-sector investment, business opportunity, and entrepreneurship. This means that businesses have to increasingly rely on special privileges, such as tax breaks, just to stay in business. Secondarily, the growth of government inherently brings about a subculture of lobbying.

The growth of government inspired by Keynesianism has fostered a system of crony capitalism. As Holcombe writes, “government intervention in the economy to benefit business firms lays the foundation for crony capitalism.” Keynesian taxation, spending, and investment policies undermine the reward for productive entrepreneurship and create rewards for unproductive or even destructive entrepreneurship.

Under capitalism, businesses compete to cooperate with consumers by offering them the best value for goods and services. When government intervenes in the economy, they face both knowledge and incentive problems. Keynes cast aside this issue by suggesting that governments could simply avoid these problems by deferring to economic experts. In reality, governments have not been successful at overcoming knowledge or incentive problems. This is true even of the Federal Reserve, which should arguably be the most expertly handled and independent function of government.

Under crony capitalism, businesses—whether potential or existing—pursue legal methods to secure favors that disproportionately benefit their own business (or industry) or to place obstacles in the way of their competitors. These favors can take many forms including but not limited to, tax breaks, subsidies, antitrust legislation against competitors, bailouts, protectionism, and loan guarantees. To receive said benefits, firms will typically employ advertising, make political donations, promise future jobs to regulators and policy makers (the revolving door), and foster political connections through lobbying. Not only does cronyism undermine market efficiency, but rent-seeking for political favors pulls resources away from productive uses.

There is a strong empirical consensus that increasing the size or scope of government increases the amount of lobbying. Such lobbying tends to pay off in terms of receiving political rents. Even businesses that want to remain out of politics are often forced to play the political game to stay in business.
This emergence of cronyism on the tails of Keynesianism, can—and has—eroded the morality of markets. As we rely increasingly on government intervention in the economy, rather than market competition, we can expect the increasing reliance on government to erode away virtue and tolerance.51 Markets are—and have always been—positive-sum games that encourage mutually beneficial cooperation, while government rent-seeking creates a zero- or negative-sum game.52 Ergo, the erosion of the market and its accompanying virtues will usher in the morality of a zero- or negative-sum world of rent-seeking.

This decline in the virtues of the market can ultimately result in a demoralizing trap from which it is difficult to escape. The more times government intervenes in the market economy and distorts—and corrupts—business, the more the general population will believe that business is responsible and will make more calls for increased government intervention in the market economy.53 Examples of this can be readily seen in health care, finance, and education. These are all highly regulated sectors of the economy that have resulted in massive inefficiencies, bad outcomes, and corruption. While these can all be traced back to government interventions into these sectors, it is commonly perceived that these outcomes are the result of the market process and thus are in need of further regulation or even socialization.54 Regulation and governmental oversight are the cause of the problem, so adding additional regulations and control will only exacerbate the problem further.55

Conclusion

The doux commerce thesis, that markets play a civilizing and moralizing role in society, was part of the original defense of capitalism by the Scottish Enlightenment thinkers. This defense, however, was gradually lost as the economics profession turned to strictly technical efficiency defenses of capitalism. Thus, when Keynes took the profession by storm, it is no surprise that economists did not consider the moral consequences of Keynesianism.

We provided a sketch of one of the moral consequences of Keynesianism here. Keynesian-inspired growth in government control of investment has resulted in a rise in cronyism. Political connections are increasingly becoming important in the business world. As businesses rely more on the political process and less on actually serving customers in the marketplace, it can threaten the civilizing and moralizing tendencies of capitalism.
Notes


8. This originates from the word *douceur*, meaning calmness and gentleness. See Albert Hirschman, *The Passions and the Interests*, 59.


34. It is important to note that Keynes did not favor government ownership of investment, just controlling the allocation of the majority of investment. See Meltzer, “Keyne’s *General Theory*,” 41.


43. See Mark Pennington, *Robust Political Economy: Classical Liberalism and the Future of Public Policy*.

44. See Pennington, *Robust Political Economy*; Smith and Sutter, *Gauging the Perception of Cronyism*.


52. See Robert D. Tollison, “Rent-Seeking: A Survey.”


55. Holcombe, “Crony Capitalism: By-Product of Big Government.”