What are the principles of Keynesianism policies?
Why did governments of the 1970's reject them?

Keynesian economics were the second major breakthrough of the 1930's, many of the theories such as income determination were primarily the work of one man, John Maynard Keynes. He was interested in the level of national income and the volume of employment rather than the equilibrium of the firm or the allocation of resources. This was still a problem of supply and demand, but demand here means the total lev el of effective demand in the economy, and supply means the nations capacity to produce. When effective demand falls short of productive capacity unemployment and depression occurs. If demand exceeds the capacity to produce, inflation is caused.

The heart of Keynesian economics consists of an analysis of the determinants of effective demand. If one ignores foreign trade, effective demand consists essentially of three spending streams, those being, consumption expenditures, investment expenditures, and gov ernment expenditures, each of which is independently determined. Keynes attempted to show that the level of effective demand may well exceed or fall short of the physical capacity to produce goods and services and that there is no automatic tendency to pro duce at a level that results in the full employment of all available men and machines. This theory came as a shock to traditional economists who had assumed that economic systems tend automatically to full employment. By keeping his attention focused on macroeconomic aggregates, like total consumption, total investment, and by a deliberate simplification of the relations between these economic variables, Keynes achieved a powerful model that could be applied to a wide range of practical problems. This model was used effectively by governments in the UK up until the 1970's when governments started to reject it. Instead they were using microeconomics such as monetary policy and fiscal policy. One reason for this was because they were being asked to do more in providing higher education, building motorways, protecting countryside, and supporting regions of Britain which had lower rates of growth, lower wage rates and higher rates of unemployment than the rest of the country. Instead of using Keynes' method of de aling with all of the problems at the same time they decided to deal with one at a time, therefore steering away from macroeconomics.

Keynesian economics was entirely static and did not involve time as an important variable. This applied to all of Keynesian policies. Keynesian economics had many principles, many were thought up by Keynes himself. Keynes economics specifically believed in government intervention and thought that the government or public was needed for the ownership of the means of production as it was believed that the government should own resources and property so they could make decisions in monopolistic businesses on wages, selling prices and expansion. Keynes believed this was the best way for companies to work as it meant deep down the government could control them. During the 1970's this theory was rejected as the governments then decided to sell the public monopolies so they could become private. By selling it meant the companies could sell shares and gain capital from shareholders. The government at this time believed that if the companies became private new firms could enter the market, thus creating competition and a free and healthy market.

Keynes was critical of inequalities in income and wealth but argued that some inequality was necessary to provide incentive to entrepreneurs to undertake investment. He believed this built up the economy by increasing morale and also more businesses meant more jobs. In the 1970's governments had different ways with dealing with inequalities in income. Whereas Keynes had seen it as a motive for the unemployed to work, Prime ministers such as Harold Wilson of the labour party, saw that some people will not work and so gave out benefits. These benefits were enough for the unemployed to live on, and in some cases were more than what some workers were getting for a weeks work after tax. Therefore this discouraged some people to work and the government was left with the problem of how to lower unemployment levels. They could either lower the benefits, or lower tax. Whichever they were still left with high unemployment levels, higher than those when the Keynes theory was used, yet still this theory was rejected as there were too many unemployed to stop benefits altogether in order to encourage people to work.

As mentioned earlier Keynes believed in government intervention. He rejected the Adam/Smith classical economics belief, which was that a laissez-fairre government led to a strong economy. Keynes was convinced that market based economies do not produce full employment automatically. He argued that under a laissez-fairre government there would be unemployment and depression. In his view, government action was essential to stabilise an unstable economy. It was necessary for the

government to intervene in the economy, by running demand management policies, these were to counter trends in the trade cycle, therefore to speed it up when there is little and to slow it down when there is excess.

Another Keynesian principle is the anti-thrift doctrine. This paradox of thrift refers to how an increase in saving reduces production and employment. This supposedly works because a decrease in spending leads to a decrease in employment, as firms will not be selling as much therefore will have to make some workers redundant. With more people unemployed, there will be a decrease in spending as the people out of work will have less money, and again less spending will lead to more unemployment and so on. However as a result of what the Keynesians call the multiplier and accelerator effect, an increase in intended saving may result in a decrease in actual saving. Keynes was indeed opposed to saving. He considered saving to be of social harm, and advocated policies to encourage spending. In particular he argued that "up to the point where full employment prevails, the growth of capital depends not at all on a low prosperity to consume but is, on the contrary, held back by it"
Keynes - General theory (1935)

Keynes believed that to increase spending you had to increase government spending. However in order to do this the government spending would have to be increased through borrowing, rather than raising finance through tax increases, otherwise because of the increased tax, consumer spending would fall. For governments to spend to encourage consumer spending, Keynes believed it need not be wasteful, although Keynes thought that even wasteful government expenditure was better than none at all. Public investment in infrastructure or housing could offset declines in private investment spending and provide society with useful assets. Therefore this would encourage people to spend rather than save.

The governments in the 1970's however, used different policies to deal with consumer saving. To encourage spending they used the Fiscal policy as this was seen as more effective as it meant they didn't have to borrow any more money to spend on public goods and services. Instead they would expand the economy by keeping government spending at its normal levels and instead cutting taxes. this would leave consumers with

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Keynes - General theory (1935)

more purchasing power and thus, increase consumption spending.

One problem with this though is that taxes would have to be increased once the economy returned to full employment.

This policy not only worked to help raise employment but was also used to lower inflation levels. If inflation were high then the government would use contractionary fiscal policy rather than expansionary fiscal policy. This means taxes can be increased, directly reducing consumer demand. The government of the 1970's could use this policy effectively as

they would usually only have to deal with one issue at a time, either inflation or unemployment, as when one of them is high the other is usually low (Phillips curve).

Keynes ideas on money were similar to those of French economist, Say. Say's law was that money was simply a medium of exchange and that 'products are paid for with products'. Keynes agreed with this, however reminded economists that money was also a store of value. Money allows an indefinite period of time to lapse between a sale and a purchase. The capitalist might sell goods and services at a profit then wait for business conditions to improve before purchasing more labour and raw materials. Keynes pointed out, it was precisely during these times of economic uncertainty that business people might prefer to remain liquid (keep cash flowing), rather than invest in new plant and equipment or hire more workers in order to increase output. This was Keynes' theory of how to manage demand of goods and services.

Demand could also be managed through monetary policy which is what was used in the 1970's a lot. Through the monetary policy the central bank of England could allow money supply to grow at a faster rate. This could bring down interest rates and encourage more of the type of spending that is sensitive to interest rates - spending on new factories, new houses and new cars. Alternatively, the central bank could slow the growth of money supply, therefore lowering the inflation rate. By slowing the growth, interest rates will be raised, reducing demand for new factories, houses and cars.

Many Keynesians were sceptical of the usefulness of monetary policy in a depression or deep recession. Keynes believed lower interest rates would not usually encourage a firm to undertake new investment if

it already has considerable idle production capacity. However governments

in the 1970's adopted the monetary policy as it meant they could control the rate of interest, thus to an extent controlling spending and saving.

Demand can also be managed through trade policy. Imports and exports can be encouraged or discouraged through altering the exchange rate, or blocking imports with tariffs and quotas, such as taxes and red tape. This policy was used during the governments of the 1970's. They wanted to export as much as possible to spur on economic growth, and also wanted to import to create healthy competition in the market. However they didn't want to import too much otherwise the balance of payments would be unstable. Therefore tariffs and quotas were used. Trade policy had to be used cautiously though so as not to cause retaliation by trading partners. However Keynes believed in free international trade without restrictions. Therefore the governments in the 1970's rejected his free trade policy, as they wanted to control the balance of payments.

The Keynesian revolution was about overthrowing the doctrines of balanced budgets and sound money, and laissez-fairre economics, which became the principles and policies used in the 1970's by Edward Heath, Harold Wilson and Callaghan. Instead the doctrines of deficit spending, inflation and managed economy were the principles of Keynes. Keynesian economics starts with an understanding of the limitations of neoclassical economics, which is based on examining only one thing at a time. Keynesian economics attempts to understand an economy in which everything happens at once. During the 1970's the governments turned more towards neoclassical now known as microeconomics, because there were a lot of issues to deal with such as inflation, unemployment, international trade, and entering the European union. Therefore contrasting with the macroeconomics of Keynesianism they dealt with one problem at a time and applied new policies to deal with the issues. Another small reason why they rejected Keynesian policies may have been because some of the policies were not clear. " He should have explained more clearly what he wanted to say.... There is reason to believe that Keynes himself did not truly understand his own analysis."[Quote - Samualson (1964)] Therefore if many of his policies were not

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Quote - Samualson (1964)

clear there is reason for the governments to reject them and use their own policies.