

THE PARADOX OF THRIFT: RIP

Clifford F. Thies

Perhaps the single most destructive tenet of Keynesian economics was its denigration of saving. Keynesianism has been used to justify wasteful spending, massive deficits, and one after another scheme to redistribute wealth from those who would save it to those who would spend it.

In keeping with this anti-saving doctrine, during the Christmas selling season of 1991, then President Bush made a big to-do of buying a pair of woolen socks at a suburban shopping mall to try to stimulate consumer spending. And, during his first year in office, President Clinton referred to every increase in spending that he proposed as an “investment.”

But things are changing. The 14th edition of Paul A. Samuelson’s *Economics*, a textbook that popularized Keynesian economics and has been coauthored with William D. Nordhaus since the 12th edition, does not even mention the so-called paradox of thrift. Instead of disparaging saving, this edition contains an extensive discussion of the low U.S. saving rate and a comparison of that rate to the much higher saving rates in Germany and Japan. Probable reasons for the low U.S. saving rate are given as deficit spending, social security, relaxation of restrictions against consumer borrowing, and a decline in the Protestant ethic (Samuelson and Nordhaus 1992: 444–46).

To the extent that Samuelson’s *Economics* chronicles the evolution of mainstream economic opinion, one can say that Keynesianism—and its concern with the paradox of thrift—has now come to an end. At this juncture, it is useful to review what exactly was the Keynesian revolution in economics and why the paradox of thrift is no longer in vogue.

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Keynesian Anti-Thrift Doctrine and the Anti-Thrift Doctrine of Keynes

The paradox of thrift refers to how—in the Keynesian model of the economy—an increase in saving reduces production and employment. This supposedly occurs because a decrease in spending leads to a decrease in employment, which leads to a further decrease in spending, which leads to a further decrease in employment, which leads to a yet further decrease in spending, and so on. Thus, if people try to increase their saving, there will supposedly be a decrease in spending, and a fall in employment and production. Furthermore, as a result of the interaction of what the Keynesians call the “multiplier” and what they call the “accelerator,” an increase of intended saving supposedly may result in a decrease in actual saving.

As Samuelson (1958: 237) writes in an early edition,

It is a paradox because in kindergarten we are all taught that thrift is *always* a good thing. Benjamin Franklin's *Poor Richard's Almanac* never tired of preaching the doctrine of saving. And now comes a new generation of alleged financial experts who seem to be telling us that black is white and white is black, and that the old virtues may be modern sins.

Let us for the moment leave our cherished beliefs to the side, and try to disentangle the paradox in a dispassionate, scientific manner.

This discussion remained more-or-less unchanged through many later editions.

Samuelson's number one textbook rival, Campbell R. McConnell (1960: 261–62), put it much the same way in his first edition:

By attempting to increase its rate of saving, society may create conditions under which the amount it can actually save is reduced. This phenomenon is called the paradox of thrift. . . . [T]hrift, which has always been held in high esteem in our economy, now becomes something of a social vice.

This wording has continued through McConnell's most recent editions.

To be sure, certain textbook writers avoided, or tried to make sense out of the paradox of thrift. George LeLand Bach (1966), whose textbook was somewhat more conservative than Samuelson's, presented the Keynesian multiplier model. But, possibly because “personal saving has been a stable percentage of disposable income in peacetime prosperity” (ibid.: 83), he does not bring up the issue of the paradox. Armen Alchian and William R. Allen (1972: 560), whose textbook was perhaps the most market-oriented of its time, argued: “We may resolve the so-called paradox of thrift by recognizing that

this decreased desire for consumption at all levels of income was associated with an *increased demand to accumulate money holdings*.” That is, in keeping with Say’s (and Walras’) Law, an excess demand for fiat money must correspond to an excess supply of goods and services.

An interesting thing about the paradox is that it is not to be found in Keynes’ *General Theory* (1935). Keynes was indeed opposed to saving. He considered saving to be a social harm, and advocated policies to encourage spending and discourage saving. In particular, he argued that “up to the point where full employment prevails, the growth of capital depends not at all on a low propensity to consume but is, on the contrary, held back by it” (ibid.: 373).

Keynes did not, however, connect underemployment to *shifts in consumption spending*. He connected underemployment to a *low level of consumption spending* via the “secular stagnation” hypothesis. Supposedly, because of past economic growth there came to be a chronic excess of what planned saving would be at full employment over what investment would be at full employment. This hypothesis was massively contradicted by the post-World War II economic expansion, and has been long abandoned by Keynesian economists.

Keynes considered the consumption function to be relatively stable. Under normal conditions, shifts in “the propensity to consume out of a given income” were not considered to be of more than secondary importance (ibid.: 110). This point is made by Alvin H. Hansen (1953: 84), one of Keynes’ most loyal followers. So why did the early Samuelson and other textbook writers make such a big deal out of the paradox of thrift?

Several reasons can be cited, first among them being rejection of the past. According to Harry G. Johnson (1978: 189), part of the appeal of Keynesianism was that it was “an intellectual realm in which youthful iconoclasm could quickly earn its just reward (in its own eyes at least) by the demolition of the intellectual pretensions of its academic seniors.”

A second reason the paradox of thrift made its way into the textbooks is the elastic nature of Keynesianism. *The General Theory* is widely acknowledged to be wrong in many of its most important assertions, as well as being disorganized, confusing, and self-contradicting. As to “how did it happen that a book so full of obscurities, contradictions, confusions, and misstatements was hailed as one of the great works of the Twentieth Century,” Henry Hazlitt (1960: 9–10)—a critic of Keynes—put it bluntly: “as with the works of Hegel and Marx, the very mystification added to the book’s prestige. Unintelligibility was assumed to be a mark of profundity.” Samuelson (1964: 316)—an admirer of Keynes—writes:

It is a badly written book, poorly organized; any layman who, beguiled by the author's previous reputation, bought the book was cheated of his five shillings. It is not well suited for classroom use. It is arrogant, bad tempered, polemical and not overly generous in its acknowledgements. It abounds in mares' nests and confusions. . . In short, it is a work of genius.

Because *The General Theory* is such a poorly written book, "there is," according to Axel Leijonhufvud (1968: 35), "room. . .for differing interpretations of Keynes." Indeed, Leijonhufvud argues that if his interpretation is not what Keynes meant to say, it's ". . .what he should have said." Samuelson (1964: 316) writes that "there is reason to believe that Keynes himself did not truly understand his own analysis."

The methodology of Keynesian economics is hardly restrictive. With minor additions and adjustments, its typical equations can be used as the basis of a classical, a monetarist, or a supply-side model. Robert Clower and Leijonhufvud (1975: 183) argue that there is no end to "the Keynesian model's capacity for mischief." Thus, Keynesian economics evolves over time, easily discarding whatever it is that Keynes said, and whatever it is that passed for Keynesian economics at one time or another.

A third reason for incorporation of the paradox of thrift into the textbooks was mathematical sophistry. Keynesian economists are known to love mathematical models that impress their audiences and that allow them—like a magician pulling a rabbit out of a hat—to produce from their models amazing "facts" challenging their audiences' prior beliefs.

In economics, mathematical models are usually justified not so much because they are realistic, but because of their efficiency in illustrating something considered to be important. That is, a trade-off is often involved between the realism lost and the clarity gained in the simplifications made when designing mathematical models. As a result, mathematical models that do a good job of illustrating something of importance might be silent or even misleading about other things.

But Keynesian economists tend to treat their mathematical models as objects to be studied in their own right; either believing their models to actually be realistic, or being more interested in teaching their methodology than in teaching economics. Quirks such as the paradox of thrift are given center stage in Keynesian textbooks because only someone trained in the cabala of Keynesian economics would know that an increase in saving would decrease production and employment.

Mr. Keynes and Wage Rigidity

It was John R. Hicks (1937) who put Keynes' economics into mathematical form in his famous article "Mr. Keynes and the Classics." He developed the "IS-LM" model showing how, in the Keynesian system, fluctuations in aggregate demand effect national income and employment. Hicks' formulation revealed that Keynesian economics rested fundamentally on the inflexibility of certain wages and prices, which he referred to as "fixprices" (also see Modigliani 1944). Keynes did not break with classical economics in identifying monopoly power as a source of macroeconomic instability—for classical economists also accepted that doctrine. Classical economists argued against the corn laws that protected domestic agriculture, grants of monopoly power to industry, and prohibitions against workers freely entering into unions. Keynes broke with classical economics, however, in arguing that the government *should accommodate* prices and wages that were high due to monopoly power, rather than resist monopolization of the economy.

Keynes' most loyal followers both agreed and disagreed. Dudley Dillard (1948: 24–26), for example, while admitting that Keynes recognized the need to accommodate union wage-setting, nevertheless argued that Keynes' contribution was more fundamental, dealing with the failure of interest rates to clear the money market, the irrational expectations of business executives, the durability of fixed capital, and the "peculiar aspects" of a monetary economy.

This contradictory doubleness of thought concerning price stickiness continues to this day. Certain "New Keynesians" (e.g., Ball et al. 1988 and Mankiw 1990) have recently developed what they call the microfoundations of price rigidities. Because there are costs involved in setting prices, and because many markets are characterized by monopolistic competition, changes in *nominal* demand can lead to fluctuations in *aggregate* employment and output. And, following a change in nominal demand, some time may be required for entry and entry-deterrence to reestablish something approaching macroeconomic equilibrium.¹

Commenting on this latest twist of Keynesian economics, James Tobin (1993: 48), the doyen of Keynesianism, agrees that Keynes "would have done better to assume imperfect or monopolistic competition throughout the economy." Yet Tobin (ibid.: 26) insists that Keynesian economics "neither asserts nor requires nominal wage and/or price rigidity."

¹This theory hardly seems capable of explaining the Great Depression.

According to Tobin (ibid.: 49), “classical unemployment” occurs when jobs are limited because of excessive real wage rates imposed by government or trade union regulations. Unemployment, says Tobin, would be best dealt with by removing those barriers to competition. “Keynesian unemployment,” on the other hand, is that unemployment that can be eliminated by increased aggregate demand that erodes high real wages through inflation and that increases production and employment. Differentiating one from the other, Tobin admits, “is sometimes difficult.” Exactly!

Not all Keynesians insist on making the mystic distinction between wage-price rigidity and Keynesian economics that Tobin makes. Samuelson (1964: 332) writes,

Had Keynes begun his first few chapters with the simple statement that he found it realistic to assume that modern capitalistic societies had money wage rates that were sticky and resistant to downward movements, most of his insights would have remained just as valid.

Robert Lekachman (1964: ix) is clear enough:

The Keynesian critics who argue that Keynes’ doctrines of underemployment equilibrium depend on assumptions of wage and price rigidity, no doubt score important *theoretical* points. . . . The practical importance of their achievement is small, for every advanced western society is characterized by institutional barriers against declining commodity prices and labor incomes.

Thus, Keynesian economics is based on the premise that *the way to* deal with unemployment is by increasing aggregate demand, rather than by attacking “the institutional barriers” resulting in wage and price rigidity. It rests on the curious idea that those with the political clout necessary to protect their monopoly advantages are not smart enough to figure out the effects of inflation.

Keynesianism and the High Wage Doctrine

It must be pointed that the Keynesian presumption that wages are “sticky downward” melded nicely with the prevailing economic hearsay of the 1930s—i.e., the “high wage doctrine” (see Krooss 1970: 90–91). The high wage doctrine incorrectly identified the high wages that were *the result of* the economic prosperity of the 1920s to have been *the cause of* the prosperity. Thus, at the outbreak of deflationary pressure during the Great Depression, the Hoover administration encouraged the maintenance of high wages; the deflationary pressure took its toll by reducing production and employment rather than by reducing wages and prices.

Given these circumstances, once the recession turned ugly, resort to aggregate demand management may have been the only practical thing to do. Indeed, it is a “myth. . . that Keynes alone among leading economists had advocated public works in the Depression” (Demand 1988: 1). Lionel Robbins and Friedrich Hayek—who, in accord with the Austrian theory of the business cycle, initially advocated allowing deflation and the liquidation of the malinvestment to run their course—both later accepted this course of action.

Even W.H. Hutt and Ludwig von Mises—two of the most severe critics of Keynesian economics—both eventually, but still reluctantly, accepted at least the inevitability of deficit spending. Hutt (1979: 414) referred to Keynesianism as “a theory which provided a justification for what may have been *politically expedient*.” And Mises (1966: 793) wrote:

We may admit that for the British and American governments in the ‘thirties no way was left other than that of currency devaluation, inflation and credit expansion, unbalanced budgets, and deficit spending. Governments cannot free themselves from the pressure of public opinion.

Nevertheless, Mises argued that office-holders should resign rather than implement such policies.

William Röpke (1963: 222) granted that “it can happen. . . , that all efforts to put a quick end to unemployment prove useless, so that recourse must be had to an increase of ‘effective demand’.” Yet he was very critical of Keynes’ justification of deficit-spending and inflationism as a general rule. Even worse than fueling the demagoguery of politicians, he criticized the intellectual arrogance of Keynesianism: “We find in the teachings of Keynes the social philosophy of a man who, proud of his alleged modernity and progressiveness, believed himself capable of ‘making over’ society and the economy” (ibid.: 227).

This assessment of what was essential about Keynesian economics is shared even by some of Keynes’ admirers. Alan Coddington (1983: 1) wrote, “At the most fundamental level, what distinguishes Keynesian policies is that they take a utilitarian view of the public finances.” Keynesianism denies “the idea that there may be precepts of ‘sound finance,’ or financial ‘propriety,’ ‘rectitude,’ ‘responsibility,’ and so on” (ibid.: 3).

The paradox of thrift simply took Keynesian economics to its illogical conclusion. If governments should increase their spending during recessions, why should not households? If there were no principles of “sound finance” for public finance, from where would such principles come for family finance? Eat, drink and be merry, for in the long-run we are all dead.

The Keynesian revolution was about overthrowing the doctrines of balanced budgets and sound money, free international trade, and laissez-faire economics, and adopting instead the doctrines of deficit spending, inflation, and the managed economy. Adherence to the tried and true was to be replaced by trust in the new, self-confident generation of macroeconomists, who were not to be constrained by old-fashioned precepts, but who were to be free to do as they knew best.

According to Keynes (1935: 371), underconsumptionists prior to him, such as Thomas R. Malthus, "preferred to see the truth obscurely and imperfectly rather than to maintain error." In this one sentence, Keynes implied both that his intellectual opponents—the classical economists—preferred to maintain error and that he saw the truth clearly and perfectly. This kind of arrogance made Keynes famous; he wrote in the self-confident style of the demigods of the modern era.

Concerning Keynes and the textbooks, Samuelson (1964: 316) wrote, "Finally, . . . the Keynesian analysis has begun to filter down into the elementary textbooks; and, as everybody knows, once an idea gets into these, however bad it may be, it becomes practically immortal." If true, the *removal* of the paradox of thrift from Samuelson's 14th edition of *Economics* offers an estimate of the "practical immortality" of Keynesianism.

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ERROR AND BIAS IN BENEFIT-COST ANALYSIS: HUD'S CASE FOR THE WIND RULE

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In July 1994, the U.S. Department of Housing and Urban Development (HUD) put into effect new regulations—the “wind rule”—that set stricter wind resistance standards for the construction of manufactured housing (HUD 1994a).¹ HUD presented the economic rationale for the wind rule in its *Regulatory Impact Analysis of Improved Wind Standards for Manufactured Housing* (RIA), which claimed that asymmetric information and externalities had resulted in market failure (HUD 1994b: 21). According to HUD, the wind rule would yield annual benefits of \$83.8 million at annual costs of \$51.7 million (*ibid.*: 1); the RIA estimates that the cost of an average single-section manufactured house, which sold for \$20,877 before the wind rule, would increase by \$1,492 in Wind Zone II and \$2,119 in Wind Zone III, and that 56 percent of the increase would be passed on to consumers through higher prices.

The RIA is deeply flawed by errors of omission and commission. First, HUD fails to offer any evidence that asymmetric information affects adversely consumers' choices² or that externalities exist; it also

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¹The wind rule amends the National Manufactured Housing Construction and Safety Standards Act of 1974. The new regulations follow closely the standards proposed by the American Society of Civil Engineers in ASCE 7-88 (ASCE 1990). Manufactured houses are the direct descendants, usually larger and without wheels, of mobile homes.

²Consumers may not fully understand the technical characteristics of competing products and yet, as *they* see it, have enough information—including information about the reputation of firms along the production-distribution chain—for making choices. Moreover, although producers may have more information about their products, buyers have more information about how they are going to use them.