1. Introduction

Writing this book was an odd experience, since the premise of everything found within the rest of this book is that just about the whole of modern economic theory is perniciously wrong, that other than here and there, such as in its opposition to rent controls, there is virtually nothing useful one can learn from a modern economics text in how to manage an economy.

And while you are reading this introduction first, it was written last. I started the book recognizing how absurd it is to be saying what I say and believing what I believe, yet the further into the book I went, the more it felt accurate and the less I felt I was in the territory of the economically absurd. If I am wrong, it must be for others to explain to me why.

What, then, is the premise of the book? It is that economic theory reached its peak level of understanding with the nineteenth-century classical school, and, in particular, with the economic theory presented in John Stuart Mill’s *Principles of Political Economy*, whose first edition was published in 1848, and whose final statement may be found in the last edition published during his lifetime, the seventh edition, published in 1871.

Almost nothing from Mill’s time remains alive in economics. Virtually all has been purged. The two economic revolutions since that time – the marginal revolution of the 1870s and the Keynesian revolution of the 1930s – have left behind almost nothing that was taught and discussed within the classical school.

Let me emphasize this to the fullest extent. It is J.S. Mill and his contemporaries that I refer to as the proponents of classical economic principles in their final and fullest extent. Others before, such as Adam Smith and David Ricardo, helped lay the groundwork that would finally reach its full flowering with Mill. It is not an argument against anything written in this book to refer to any economist who had written before Mill had published his *Principles*. Mill took from them those elements he had agreed with and reformulated the rest.

The notion that economic theory has gone in such a misguided direction, and has done so since the end of the nineteenth century with little to correct it other than this book written a century and a half later, is, I agree, a very odd idea. Yet, such is as it is. Therefore, a brief summary of all that follows in the rest of the text will give you the reader some guidance on whether to continue or just abandon going further. So, here below is what you will find argued in the coming chapters.
A SUMMARY

Classical economics saw an economy run on the basis of entrepreneurial decision making, where non-value-adding forms of production were rapidly culled to prevent them using up an economy’s resources. It was an entirely supply-side theory of the operation of an economy. The supply side, as represented by entrepreneurs (usually referred to as capitalists) would seek to earn a living by working out what others wished to buy, and those who succeeded in finding profit-making activities would prosper, even while others would enter the market to compete. The theory of value that developed during classical times was based on the costs of production. Although the labour theory of value had had some attraction early on among the very first of the major classical economists – Adam Smith and David Ricardo being the most notable – by the middle of the nineteenth century, a theory of value based on production costs represented the approach that dominated economics. The focus was on the role of relative prices in the adjustment of an economy. Demand and utility had an important place but were seen as peripheral to a full and complete understanding of how an economy functioned.

None of this prevented governments from filling in gaps where the private sector had not produced as much as the market sought or had not produced anything at all. Government regulation and oversight were also recognized as essential for the operation of a market economy. It was also the role of governments to provide welfare where needed. Laissez-faire was in no sense a feature of economic theory. A role for government was absolutely recognized, although strict limits on government intervention were seen as essential. Understanding those limits was also a major aspect of economic theory.

The shift away from the supply-side focus began with the marginal revolution. The reason for placing marginal utility at the core of the theory of value had a number of motivations behind it, with developing a counterargument to the Marxist labour theory of value high on the list. Whatever the reason, the focus on utility redirected attention to the demand side of the economy as the driving force in giving an economy direction, rather than finding the direction through entrepreneurial activity.

And while much of the classical theory of the market was maintained by the early marginalists as part of their unstated presuppositions, over time these faded into the deep background. And with the marginal revolution, certain intrinsic attributes of the classical approach faded, notably the important distinction between productive and unproductive economic actions, as well as the distinction between value in use versus value in exchange. What had been a study of the operation of the economy as a whole was whittled down
to a study of the individual actions of buyers. The macroeconomic perspective shrivelled into a much narrower focus on microeconomic adjustment.

The further effect of the marginal revolution was to shift economic theory from a philosophical study of markets into a mathematical study of equations. Economists had recognized mathematics as a useful background tool for clarifying concepts. The introduction of mathematical models would then, over time, replace the more conceptual approach, turning economic theory into a social scientist’s form of physics.

Not until the 1930s, however, some 60 years after the marginal revolution began, was there a full flowering of the use of diagrams to explain the operation of an economy. As with the introduction of mathematics, diagrams shifted economic theory even further from the kind of subject matter on which abstract thought would be applied to market adjustment. Instead, economic theory became a subject matter in which the operation of an economy was presented via a string of static two-dimensional diagrams. Possibly the most damaging has been the diagrams showing price determination to occur where marginal revenue is equal to marginal cost. Since no seller ever knows the position and shape of the demand curve for any product being sold, the reality was that economic theory became more detached from an actual representation of market processes led by entrepreneurial decision making since there was no means to calculate marginal revenue.

The next stage in shifting economics into its present dead end was the Keynesian revolution, which began with the publication of John Maynard Keynes’s *General Theory of Employment, Interest and Money* in 1936 (Keynes, *Collected Writings* [1936] 1981, VII). Published after the Great Depression had ended, never actually applied to the circumstances of any economy until the 1960s, Keynesian theory completely stormed the citadels of economic theory, so that by the end of the 1940s it had entirely replaced the classical theory of the business cycle across the academic world, and would therefore soon after replace the framework used by policy makers in dealing with unemployment and recessions.

Keynesian theory was introduced on the premise (now almost entirely forgotten) that economists did not until then even have a theory of recession and mass unemployment. Keynes’s purpose, therefore, was to provide economists with just such a theory, and the theory that was then introduced into economics was the theory of demand failure (or overproduction) as the cause of recession. This remains the central theory adopted by policy makers ever since, which has led to attempts to regenerate growth following a downturn using measures to increase demand, usually with higher levels of public spending and often through lowering interest rates.

One further result of the Keynesian revolution is that virtually no economist any longer knows what the classical theory of the business cycle was. And far
from classical economists having had no such theory, they had had many. But the one aspect of classical theory upon which there was virtual unanimity was that an economic downturn would never be caused by a deficiency of demand. The causes of recession inevitably stemmed from structural dislocations that could occur for any number of reasons but were often caused by some kind of failure within the credit creation system. This was a theory that had been developed over more than a century since the start of the nineteenth century, but which has entirely disappeared from economic discourse and from within the considerations of policy makers.

In relation to unemployment and the level of economic activity, the clearest statement of the conclusions that had been drawn by classical economists was from John Stuart Mill, who wrote in his *Principles*, ‘demand for commodities is not demand for labour’. His meaning was clear during the whole of the classical period, but since then has become almost incomprehensible. His point was that the number of jobs in an economy is unrelated to the level of demand for goods and services. That is the actual meaning of Say’s Law, and it was this proposition that Keynes very successfully displaced. It is a proposition that is, for all that, absolutely correct both in theory and also from the evidence of every attempt to use a stimulus to increase the level of employment.

The arguments developed within this volume are mainly, but not entirely, based on the theoretical writings of John Stuart Mill in the seventh edition of his *Principles of Political Economy* published in 1871, the last edition published before his death. The first edition had been published in 1848, and while there were many changes to the book, which is near 1000 pages in length, had not changed substantially in that time, but had mostly been refined and updated as circumstances had changed. Although other economists are brought into the argument, all are self-identified followers of the economics of John Stuart Mill, many of whom were writing well into the twentieth century.

THE STRUCTURE OF THE BOOK

Let me explain how this book is structured in detail so that the contours of the argument are set out more completely.

Chapter 2 deals with why only I could have written this book but also why I was able to. I was able to write the book because I had independently discovered the actual meaning of Say’s Law on my own, not knowing it was Say’s Law I had discovered, and then found the identical argument I had formulated in Mill’s *Principles*. Having found the argument in Mill, only then did I discover that what I had stumbled across was what we now think of as Say’s Law. Having discovered that Say’s Law – properly understood – is not only valid but essential for understanding the operation of an economy, I proceeded to write my doctoral thesis in an attempt to explain all this to others. The PhD
was then published as *Say’s Law and the Keynesian Revolution* in 1998. As part of my work on Say’s Law, I continued my research into the economics of John Stuart Mill and the entire late classical school, in which I discovered an understanding of the operation of an economy that is not only superior to what is taught today but also an understanding that has completely disappeared from the ways in which economics is taught in the modern world.

Beyond that, working in a political environment as the chief economist of Australia’s national employers’ association, I had endless opportunities to put classical economic theory to a real-world test. (Let me also mention parenthetically that I do find it interesting that for 24 years I was the economist for the Australian Chamber of Commerce in the same way that Ludwig von Mises had been the economist for the Austrian Chamber of Commerce, and also for 24 years.) In my work for the Chamber, I found that applying classical theory to modern economic circumstances never failed me on any occasion to make sense of economic events and allowed me to forecast what would follow the applications of particular policies. The economics of Mill in particular, and the classics in general, always and inevitably provided the correct judgement in every instance. Since everything I have written and said on the economy since that time is on public record, and this goes back to 1982 when I discovered Say’s Law and Mill, it can all be verified, including from my work in industry as well as my published academic work, which includes books and articles. There are also any number of submissions and news commentaries that will also demonstrate the accuracy of my economic judgements made since that time. Much of this is discussed in Chapter 2. How to substantiate beyond that the accuracy of classical theory I do not know, other than for others to recognize how badly served we have all been by the application of Keynesian policies since that time. The invitation I offer in the writing of this book is for others to apply classical theory in making sense of the economic events they come across themselves.

Chapter 3 outlines the shifts in economic theory that have occurred since classical times, with an emphasis on the disappearance of the classical theory of the business cycle and its replacement with Keynesian macro. Crucial to understanding the economics of another time are the presuppositions that saturate all attempts to discuss economic management. At any moment there are belief systems and beliefs in general that dominate virtually all discourse on any philosophical and political topic. There is a surrounding world in which things are done in particular ways. An important part of the value in using the economics of John Stuart Mill as the standard for classical theory is that Mill was more than just an economic theorist, but was also possibly the most important political philosopher of his time. His *On Liberty* was a core text in outlining the political philosophy of his time, with the focus on individualism and personal responsibility. While Mill self-identified as a ‘socialist’, the meaning
The chapter goes to some length in discussing the advent of Keynesian theory, which was summarized by Paul Krugman in his introduction to the 2006 edition of *The General Theory*, 70 years after Keynes’s original publication in 1936:

Stripped down, the conclusions of *The General Theory* might be expressed as four bullet points:

1. Economies can and often do suffer from an overall lack of demand, which leads to involuntary unemployment
2. The economy’s automatic tendency to correct shortfalls in demand, if it exists at all, operates slowly and painfully
3. Government policies to increase demand, by contrast, can reduce unemployment quickly
4. Sometimes increasing the money supply will not be enough to persuade the private sector to spend more, and government spending must step into the breach

To a modern practitioner of economic policy, none of this – except, possibly, the last point – sounds startling or even especially controversial. But these ideas weren’t just radical when Keynes proposed them; they were very nearly unthinkable. And the great achievement of *The General Theory* was precisely to make them thinkable. (Reprinted from DeLong, 2006)

There is no question that Keynes did indeed make each of these more than just thinkable. He was able to turn these propositions into the mainstream where virtually every economist has accepted them ever since. It is classical economic theory that has now become unthinkable. The result of the Keynesian revolution has left things such that the classical alternative is not just no longer contemplated by anyone within the mainstream of economic theory, but that no one within the mainstream even knows what that alternative is.

Chapter 4 introduces classical economic theory in contrast to modern macroeconomics. Modern macro is, for all practical purposes, entirely a descendant of the Keynesian economics that followed from the publication of *The General Theory* in 1936. Keynesian theory has not in any significant way been transcended, although much has been added since that time. The central division between classical and modern remains whether economies can and do go into recession because of a lack of demand, and following from that, whether a demand stimulus is capable of bringing an economy into recovery. Classical economists denied that recessions, which were frequent, were ever caused by oversaving and a lack of demand and that increased public spending could hasten a recovery. Modern economic theory and policy since 1936 has emphasized demand deficiency as the major, if not the sole cause of recessions,
and that an increase in public spending not only can, but is also necessary to generate recovery, as specifically noted by Krugman.

The chapter further discusses how Keynes stitched together his arguments. Discussed, in particular, are the origins of the term ‘Say’s Law’ and the phrase, ‘supply creates its own demand’. Their origins are virtually unknown among economists, given how discrediting to the Keynesian mythology they are. ‘Say’s Law’ was a term invented by the American economist, Fred Manville Taylor, and is entirely twentieth century in origin. It became part of the discourse among economists with the official publication of Taylor’s introductory text in 1921, having originally been used as in-house university publication since 1911. The phrase ‘supply creates its own demand’ was formulated by another American economist, Harlan Linneus McCracken, in a book published in 1933, and is thus also twentieth century in origin. There are other elements in the creation myth of how Keynes came to write *The General Theory* that are utterly unknown and can be found only in this text, as well as in other books and articles I have previously published. The mythology on the steps taken between his *Treatise on Money* and *The General Theory* is bogus.

Chapter 5 provides the essential guide if one is to understand how economists became cut off from their classical past. There have been so many changes in terminology and definitions that it is impossible for a modern economist to read a classical text and follow its meaning. There are many, many such changes, with perhaps the most insidious being the definitions of capital and saving. The classical definitions are more fruitful if one is to understand how economies operate, but in the end, definitions are only definitions. If one is to follow modern theory, then only the definitions used within modern theory can be applied if one is to make coherent sense of what is being said. The same must apply to making sense of classical theory. What is important, however, is that if one applies modern terminology when reading a classical text, it becomes impossible to understand properly what is being said. To follow a classical text, the terms used must be understood in the sense they are being applied. This chapter explains the terminology of classical theory so that the classical perspective can be brought to the surface.

Beyond that, it is important to appreciate the changed presuppositions between those that existed during the classical period and those that existed in the 1930s. During classical times, the emergence out of the poverty of the entire human past and into a sudden burst of wealth was everywhere to be seen. The incredible growth in personal and communal wealth occurred before their eyes, since this was the generation that had lived through the astonishing transformation of the world’s economy that followed the Industrial Revolution. This was in sharp contrast with the presuppositions that surrounded discussions of the economy in the 1930s, which were taking place well after the secret of economic growth and prosperity had been unlocked. Economic
growth was by then an old story. The result was that by the 1930s, the general presumption, even among economists, was that, as far as the economy was concerned, everything would only keep getting better. This is only the first of the changes made in the state of mind between individuals who lived in the two eras. The aim of this chapter is to allow a modern economist to make sense of a classical text in the way it was meant to be understood.

Chapter 6 discusses the classical theory of value and, in addition, Mill’s conception of the steady state. It has not just the classical theory of the business cycle that has been overturned. The micro side of classical theory has completely disappeared as well. To follow these shifts, however, it is necessary to return to the marginal revolution and examine the displacement of the classical theory of value to see the effects this has caused. Everyone assumes that marginal analysis replaced the labour theory of value (LTV). Certainly, the LTV had been at the core of Adam Smith’s and David Ricardo’s theory of value. The LTV had, however, disappeared from classical theory by the mid-nineteenth century. Mill had a list of 17 elements in his theory of value, of which the second of the 17 was how prices are in the first instance determined by supply and demand. Beyond that is a more sophisticated depiction of the forces that affect the price level and encompass every possible combination of circumstances that might be imagined. There is, no doubt, more to it than can be presented in a single chapter, as Mill acknowledged, but marginal cost equals marginal revenue was not the missing element. The LTV was not embodied in Mill’s theory of value, although the cost of labour quite rightly was one part, but only one part of total production costs.

The steady state, as envisaged by Mill, was not a theory of secular stagnation. In 1848, in the long, long run, it was conceivable that the economy would eventually settle into a steady-state equilibrium, which far from any notion of a period of stagnation, was one in which everyone had more than enough of worldly goods to settle into a period of idyllic contentment. That rapid growth and unimaginable levels of innovation would occur instead was recognized as an ongoing possibility, but the extent to which it would and did occur was only dimly seen as a living possibility. We no longer think of the steady state as a realistic potential, but this possibility should be distinguished from the recessionary state that occurs from time to time in every economy.

Chapter 7 discusses the way in which Keynesian theory overran the classics. The Keynesian revolution is a phenomenon unique within the sciences, even from within the social sciences. The General Theory was published in 1936 and within a decade had entirely conquered the economics profession. That is not to say that those who had been educated within the classical tradition were converted to Keynesian macro. There were, in fact, virtually no converts whatsoever. What did happen, however, was that so overwhelming was the Keynesian tide that no other approach to economic issues could stand in its
way. By war’s end in 1946, if there were still non-Keynesians left in teaching roles, they kept their views to themselves. New modern Keynesian textbooks replaced the old. There may have been a few sporadic skirmishes here and there, but as far as the profession was concerned, the battles, to the extent there had even been any battles, had all come to an end.

The chapter therefore goes through the main staging posts in the step-by-step progress from the publication of a book that many had looked forward to in anticipation, but which virtually no one could make coherent sense of when it was finally published, through to the publication of the first Keynesian introductory texts and the disappearance of virtually all dissenting voices. The result is that while there has been elaboration of the Keynesian IS–LM (investment-saving–liquidity preference-money supply) model developed by Hicks, or the Samuelson $I = S$ (investment = saving) and aggregate demand 45-degree-line diagrams, these remain completely orthodox in both the teaching of economic theory and in the development of policy. The equilibrium between aggregate supply and aggregate demand carries on this tradition.

Chapter 8 delves more deeply into the reasons for Keynes’s success. Keynes was certainly the best-known economist in the world in his time, and amongst the most well-known public intellectuals. His early fame came from the publication of *The Economic Consequences of the Peace* (Keynes, *Collected Writings* [1919] 1981, II), an international bestseller in which he had attacked the Treaty of Versailles that followed World War I. He was also internationally recognized because of his frequent media commentaries and his various books, some professional and others more popular, that made him very well known. In addition, he was the editor of *The Economic Journal*, at the time the most prestigious economics journal in the world, where he was able to publish articles that dealt with *The General Theory* and in which he was able to post his own replies to others, adding to his ability to control the debate.

Beyond his own fame and respectability, there were the various channels in which economic discussion was conducted in the period after 1936. Of crucial importance was the complete dominance of the ‘neoclassical synthesis’, which was the name given to the ways in which Keynesian theory was expanded outwards in the post-war economies. Keynesian terms and forms of analysis dominated the way theory was discussed and policy options were analysed. The national accounts were structured along the lines of Keynesian theory. Not only were the data being collected in conformity with the primitive classroom models that had been developed following the theories outlined in Keynesian texts, these primitive models were expanded into massive econometric models that were fitted to the data sets that were being simultaneously developed. Public sector and university economics departments found it relatively easy to design programmes to test the various Keynesian propositions being developed by a more mathematically oriented economics community.
The simplicity of the Keynesian model also made it easy both for policy makers and the community to fathom, or to believe they had fathomed, the intricacies of economic theory and policy. Fiscal expansion seemed to make sense. An absence of demand had always been the first port of call for anyone observing a recession. There had to be a reason in a world of scarcity for the failure of everything being offered for sale not to find buyers. The simplistic answers had turned to demand-side failures for an answer. Keynesian theory provided just that answer, and not just answers from anywhere, but from within Cambridge University, possibly the most prestigious university of its time. And with any critical response to this apparently obvious argument needing to be much more complex, and in need of a major effort to comprehend, it became an answer that easily fitted the public mood and allowed governments to undertake public sector expansions with less regard for concerns about the potential for inflation that would have accompanied such fiscal policies in pre-Keynesian times. This was all the more the case since it could be argued that the world’s economies had been brought out of the Great Depression by the increases in demand that had occurred during the war when unemployment reached low levels that had not by then been experienced for many years.

Chapter 9 is a response to the common belief that classical economic theory was in essence *laissez-faire*, that among the major shifts that followed the Keynesian revolution was a more robust effort to use the resources of governments to assist individuals to deal with the fallout from adverse economic conditions. Such government actions, whether specific to themselves – such as in providing assistance during periods of unemployment – or more general – such as in providing education and healthcare to the entire community – were seen as opening up new possibilities for enlightened public policy. The fact that there were fewer resources available to governments during the nineteenth and early twentieth centuries was seldom recognized as the impediment it had been. But more important was the belief that what had changed was the willingness of economists to argue that a greater role for government was appropriate, and that these beliefs were in contrast to the beliefs that were common within the classical school. The recognition among economists that there was a significant role for government involvement in economic matters had existed throughout classical times, and in particular is absolutely spelled out in John Stuart Mill’s *Principles*.

There has always been a need to ensure that such assistance is affordable, or that expenditure programmes do not defeat their own purpose by reducing the willingness of members of the community from undertaking productive work. Within these constraints, there were no limitations on the perceived role of governments in assisting the community. The last 200 pages of Mill’s 1000-page *Principles* – the entire Book V, ‘On the Influence of Government’ – outlines both the proper means for governments to raise revenue and the various roles...
the government should take upon itself in undertaking these efforts. Classical economists were not characterized by an automatic laissez-faire attitude to the role of government in managing an economy.

Chapter 10 examines Austrian economic theory and its differences from the classical theory out of which it emerged, with the crucial difference being the demand-side approach that would become indelibly embedded within Austrian theory because of its focus on utility and marginal analysis. This focus on utility has obscured the classical presuppositions that were silently embedded within Austrian theory. Austrian economists to a large extent assume the whole of the classical supply-side understanding of the operation of a market economy without explicitly drawing out its implications. They are just there, understated and often unstated, with Say’s Law almost universally ignored.

Among the problems in such an examination are the different historical roots of Austrian theory, which are continental in their background and scope, different from the classical school that was the province of the English-speaking nations – in particular, the United States and Great Britain. The particular differences that will be examined are, first, the theory of value, which in Austrian theory focuses on utility – a demand-side concept – while in classical theory the focus was on cost of production, obviously supply-side in its orientation. The Austrian tradition in many respects denies even the existence of a macroeconomic sphere, where the entire economy is looked at as a single unit. ‘Methodological individualism’ is the term often applied to the Austrian approach. From this perspective, economic outcomes are often left unexamined in relation to various economic aggregates, such as employment as a whole.

In many ways, the Austrian school took for granted the presuppositions of the classical school and assumed these would always be there as the background. In addition, and possibly for this reason, there was no anti-Keynesian attack on The General Theory when it was published, which has unfortunately remained the Austrian attitude ever since. There is no lack of criticisms from Austrian theorists of mainstream macroeconomics, but such criticisms are not frontal assaults and have seldom made an attack on Keynes’s version of Say’s Law a core element.

The second difference relates to the emphasis on an active role for governments that was embedded within classical economic theory and policy. Classical theory saw an important role for governments. Indeed, much of the reason for the development of economic theory was to determine the kinds of policies that would benefit the community in general, but also to identify the kinds of policies that would do more harm than good. There may have been cautions that needed to be observed, but there was nothing within classical theory that attempted to deny a key role for government involvement. In contrast, among Austrian economists, there has been a tradition where government
efforts to involve itself with economic outcomes are either left unsupported or are instead often criticized in principle. No effort is made in this chapter to settle these differences, but there is a need to recognize that these differences exist.

Finally, the Austrian theory of the business cycle needs to be seen as merely one version of the classical theory of the business cycle, which explained the downturn in the cycle as due to disharmonies in the structure of production that were often, but not necessarily, brought on by upheavals in the credit creation process.

Chapter 11 presents a very brief overview of classical economic theory and outlines in modern terms not only why classical economists had reached the conclusions they had, but also why they had been right to reach those conclusions.

The chapter will focus on the consequences of the two revolutionary periods in economic theory, the marginal revolution and the Keynesian revolution, and the ways in which these first obscured and then finally all but obliterated the classical perspective on virtually every issue of consequence. The marginal revolution took the focus away from aggregates and the economy in general and reduced the perspective to the individual as the core decision maker. Marginal utility is the perspective of a sole individual, which was the foundation for a demand-side microeconomic perspective. The Keynesian revolution then furthered this demand-side perspective by introducing a macroeconomics that was based on aggregate demand. These individually and together almost entirely removed the supply side of the economy from economic analysis.

Classical theory was almost in its entirety based on a supply-side perspective that revolved around the role of the entrepreneur. That entrepreneurial activity was based on seeking to produce what others will buy, at prices that covered all their costs of production, was the core of classical thought. But, entrenched within theory was the recognition that everyone, in attempting to meet the demands of others, could only work their way forward in almost complete blindness to what others would really buy, and in almost complete ignorance of what others would attempt to supply in competition with what they were producing themselves. We now use the word ‘uncertainty’ to describe what is in reality and inevitably an almost complete lack of knowledge about the future.

Within this, it was recognized that the economic system would only work productively if individual entrepreneurs were almost entirely left to make their own decisions without being overburdened by government regulations, onerous taxation and high levels of non-productive publicly subsidized expenditures that did not repay their costs in an increased volume of goods and services. In these kinds of circumstances, entrepreneurs would be more cautious and, therefore, would also be more likely to make productive decisions, since to do otherwise would come at great personal cost. In addition, the price
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system had to be left on its own to determine relative prices, not only of final goods and services, but of all the inputs that went into the production process. An analysis of the business cycle was also an integral feature of classical theory. The Keynesian mythology that The General Theory introduced the first such theory into economics is absurd, and should be recognized as absurd. What was absolutely true, however, was that among all the many different explanations for recession, the one that was universally rejected was any theory that attributed an economic downturn to an absence of demand. Ultimately, but not until the start of the twentieth century, was this principle given a name: ‘Say’s Law’. It stated that demand deficiency did not cause recessions and that public spending could not bring a recession to an end. This principle is not, it should be emphasized, J.-B. Say’s loi des débouchés. We will come back to this issue in much greater detail, but, in short, the sequence of events leading to the origins of the term ‘Say’s Law’ and its coming into common usage across the economics profession is described in Box 1.1. Crucially, Say’s Law is fundamentally different in meaning and implications from the nineteenth century’s loi des débouchés, which is properly attributed to Say.

BOX 1.1 SAY’S LOI VERSUS SAY’S LAW

1. In 1803, J.-B. Say published the first edition of his Treatise, in which he argued that recessions are not due to a shortage of money. His argument was that demand is constituted by supply. A shortage of money is never the cause of a lack of demand. The demand for goods and services in total is made up of the goods and services supplied to the market in total. A shortage of money, according to Say, had nothing to do with the totality of the amounts exchanged. This is Say’s loi des débouchés.

2. In 1808, James Mill used Say’s argument to help demonstrate that an economy can never suffer from a lack of overall demand. This principle ultimately became known as “Say’s Law” but not for more than 100 years. Until then, although unnamed, this principle became the orthodox position across economic theory.

3. This principle had become particularly important after the ‘General Glut’ debate that followed the publication of Robert Malthus’s Principles in 1820. Malthus had argued that recessions were caused by too much saving, which led to overproduction and demand deficiency. James Mill in the early 1820s had, among many others, written books and papers to argue that Malthus was completely wrong on this.

4. At the conclusion of the General Glut debate, an absolute denial of the proposition that demand deficiency of goods and services in total across
an entire economy was even possible became the universally accepted proposition. This remained accepted across the whole of mainstream economic theory, especially in the English-speaking world, through until the publication of The General Theory.

5. J.-B. Say wrote in agreement with Mill – first when he revised the second edition of his Treatise in 1812, in which he revised his entire chapter on the loi des débouchés to bring it into conformity with Mill’s argument, and then in more detail when he wrote his book-length reply to Malthus, published in French in 1820 and in English in 1821. But, the principle denying the possibility of deficient total demand was first stated by James Mill and not Say. Importantly, this principle, having been stated and adopted across the whole of economic theory, had no specific name associated with this consensus position until the start of the twentieth century.

6. First in a brief paper published in 1909, then in a textbook used only by his own students at the University of Michigan as an in-house text published in 1911, and then, in his more broadly distributed textbook first published in 1921, the economist Fred Taylor noted that the principle denying the possibility of overproduction and demand deficiency did not have a name. To emphasize its importance, he supplied that name, calling it ‘Say’s Law’ after J.-B. Say. ‘Say’s Law’ is, however, not Say’s loi des débouchés.

7. Following the wider publication of Taylor’s text in 1921, ‘Say’s Law’ becomes somewhat controversial in the United States in regard to the nature of the business cycle. The question raised was whether the denial of overproduction across the whole of an economy was a valid argument.

8. Keynes in the early 1930s comes across both the name ‘Say’s Law’ and also the arguments over the possibility of demand deficiency as a cause of recession. At the same time, he came across the definition of Say’s Law in the writings of another American economist, Harlan McCracken: ‘supply creates its own demand.’ As a result, Say’s Law becomes the core of Keynes’s General Theory in which he rejects the conclusions that follow from Say’s Law in Taylor’s sense, arguing that demand deficiency is not only possible, but the single most important cause of recession and unemployment. Keynes also adopted McCracken’s phrase as the definition of Say’s Law.

9. The rejection of Say’s Law has remained the single most important element in modern macroeconomic theory, differentiating modern macroeconomics from classical theory, with its emphasis on demand deficiency as the cause of recession, with demand stimulation remain-
The actual cause of recessions was a dislocation in the structure of production. For some reason, the capital structure that had been built up through entrepreneurial decisions turned out to have been misdirected because the world did not turn out to be the world that had been expected to come into existence when these investment decisions had been made. The only effective solution to such misdirected production decisions was to allow the economy to readjust by allowing entrepreneurs to find new forms of production that would pay their way in the world of demand as it actually was. Public spending to ‘create jobs’ would only divert productive activity into areas in which the capital that was put in place would not repay their costs of production.

The core element in the theory of employment stated, as found in Mill, that ‘the demand for commodities is not the demand for labour’. Producing goods and services would not lead to the creation of a higher number of jobs. As an expression of the classical perspective delivered as late as 1929, there is a discussion of Winston Churchill’s budget speech as UK treasurer in May 1929, delivered well before the Great Depression began that October. It is clear that Churchill was surprised to find that orthodox theory correctly understood how an economy worked, but surprised or not, discovered that their forecast of no effect of public spending on employment had been accurate:

Churchill pointed to recent government expenditure on public works such as housing, roads, telephones, electricity supply, and agricultural development, and concluded that, although expenditure for these purposes had been justified:

for the purposes of curing unemployment the results have certainly been disappointing. They are, in fact, so meagre as to lend considerable colour to the orthodox Treasury doctrine which has been steadfastly held that, whatever might be the political or social advantages, very little additional employment and no permanent additional employment can in fact and as a general rule be created by State borrowing and State expenditure. (Peden, 1996, pp. 69–70)

This entire passage in relation to Churchill and his surprise in finding that the ‘Treasury View’ had turned out to be an accurate summary of the effects
of public spending on employment will be repeated in full later on in the book and more than once, in both Chapters 8 and 9. Mill and classical economists had not just observed that this classical conclusion was borne out in reality, but more importantly had also explained the reason. By 1929, it was more than 80 years since Mill had discussed why the demand for commodities was not the demand for labour, a conclusion that to Churchill, as well as to Keynes a few years later, seemed inexplicable, in just the same way that this conclusion is inexplicable to virtually every economist today, although not to the British Treasury back then. What makes Churchill’s observation so especially notable is that the government to which he had belonged had attempted to encourage employment through a series of public works, every one of which appears highly productive, and yet discovered that these expenditures had not led to an increase in employment. He was thus more than an unbiased observer. The government he was a member of had tried to lower unemployment through public spending and had undoubtedly hoped the policy would work. He had nothing to gain by admitting that the policy of encouraging higher employment through increased public spending had been a failure.

The most important reverse example of the lack of any connection between the level of public spending and the level of national employment occurred at the end of World War II in 1945 when the Truman administration in the United States immediately balanced the budget, less than a decade since the Great Depression had come to an end. This was in the face of the tens of millions of Americans who had suddenly become ‘unemployed’, having lost their ‘jobs’, both in the armed forces and throughout the armaments industries that had shut down across the country. Yet, this massive cut to public spending and the elimination of the huge deficits that had continued throughout the war began the greatest period of expansion in world history, which continued with virtually no let up until the 1970s.

The insights into the operation of an economy that were discovered by classical economists and thoroughly discussed by Mill and his contemporaries have now disappeared. It is the aim of this book to bring the classical understanding of the operation of an economy to a wider audience. Economists know nothing whatsoever about the analytical depth of the classical economists, among whom John Stuart Mill was the greatest of them all, and who is arguably the greatest who has ever lived.