Keynes and Social Democracy

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For decades, Keynesianism was associated with social democratic big-government policies. But John Maynard Keynes's relationship with social democracy is complex. Although he was an architect of core components of social democratic policy – particularly its emphasis on maintaining full employment – he did not subscribe to other key social democratic objectives, such as public ownership or massive expansion of the welfare state.

In *The General Theory of Employment, Wages and Interest*, Keynes ends by summarizing the strengths and weaknesses of the capitalist system. On one hand, capitalism offers the best safeguard of individual freedom, choice, and entrepreneurial initiative. On the other hand, unregulated markets fail to achieve two central goals of any civilized society: "The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes." This suggested an active role for government, which dovetailed with important strands of left-wing thought.

Until *The General Theory* was published in 1936, social democrats did not know how to go about achieving full employment. Their policies were directed at depriving capitalists of the ownership of the means of production. How this was to produce full employment was never worked out.

There was an idea, originally derived from Ricardo and Marx, that the capitalist class needed a "reserve army of the unemployed" to maintain its profit share. If profits were eliminated, the need for that reserve army would disappear. Labor would be paid what it was worth, and everyone willing to work would be able to find a job.

But, apart from the political impossibility of nationalizing the whole economy peacefully, this approach suffered from the fatal flaw of ignoring the role of aggregate demand. It assumed that demand would always be sufficient if profits were eliminated.

Keynes demonstrated that the main cause of bouts of heavy and prolonged unemployment was not worker encroachment on profits, but the fluctuating prospects of private investment in an uncertain world. Nearly all unemployment in a cyclical downturn was the result of the failure of investment demand.

Thus, the important thing was not to nationalize the capital stock, but to socialize investment. Industry could be safely left in private hands, provided the state guaranteed enough spending power in the economy to maintain a full-employment level of investment. This could be achieved by monetary and fiscal policy: low interest rates and large state investment programs.

In short, Keynes aimed to achieve a key social democratic objective without changing the ownership of industry. Nevertheless, he did think that redistribution would help secure full employment. A greater tendency to consume would "serve to increase at the same time the inducement to invest." And the low interest rates needed to maintain full employment would lead in time to the "euthanasia of the rentier" – of those who live off the rents of capital.

Moderate re-distribution was the more politically radical implication of Keynes's economic theory, but the measures outlined above were also the limits of state intervention for him. As long as "the state is able to determine the aggregate amount of resources devoted to augmenting the instruments [i.e., the capital base] and the basic reward to those who own them," there is no "obvious case" for further involvement. The public was never to substitute for the private, but merely to complement it.

Today, ideas about full employment and equality remain at the heart of social democracy. But the political struggle needs to be conducted along new battle lines. Whereas the front used to run between government and the owners of the means of production – the industrialists, the rentiers – now, it runs between governments and finance. Such measures as the efforts by the European Parliament to regulate the derivatives market or the British government's ban on short selling in the wake of the financial crisis or the demand to caps bankers' bonuses are contemporary expressions of the wish to reduce the power of financial speculation to damage the economy.

The new focus on the need to tame the power of finance is largely a consequence of globalization. Capital moves across borders more freely and more quickly than goods or people do. Yet, while large global firms habitually use their high concentration of financial resources to press for further de-regulation ("or we will go somewhere else"), the crisis has turned their size into a liability.

Being too big to fail simply means being too big. Keynes saw that "it is the financial markets' precariousness which creates no small part of our contemporary problem of securing sufficient investment." That rings truer today – more than 70 years later – than in his own day. Rather than securing investment for productive sectors of the economy, the financial industry has become adept at securing investment in itself.

This, once again, calls for an activist government policy. Yet, as Keynes would have argued, it is important that the expansion of government involvement is informed by sound economics rather than political ideology, social democratic or otherwise.

State intervention needs to bridge gaps that the private sector cannot reasonably be expected to do on its own. The current crisis has shown with utmost clarity that private markets are unable to self-regulate; domestic regulation is therefore a key area in which government has a role to play. Similarly, time-inconsistency issues prevent large international firms from compartmentalizing their markets. Re-erecting barriers to capital flows in the form of international taxes, thereby cordoning off crises before they turn global, is therefore another task for government.

Keynes's main contribution to social democracy, however, does not lie in the specifics of policy, but in his insistence that the state as ultimate protector of the public good has a duty to supplement and regulate market forces. If we need markets to stop the state from behaving badly, we need the state to stop markets from behaving badly. Nowadays, that means stopping financial markets from behaving badly. That means limiting their power, and their profits.