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**Working Paper**

## Macroeconomics versus 'Common Sense'

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*Kazimierz Laski*

**Macroeconomics versus ‘Common Sense’**

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'Common Sense'**



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## **Abstract**

*The very basis of macroeconomics is the circular flow of expenditures and incomes. From this follows the conclusion that it is demand which determines supply and not vice versa. The most paradoxical result of this approach is the hypothesis that investment finances itself: by quantity adjustment, if capacity and labour are not fully employed (a typical feature of a capitalist economy) or by price adjustment, i.e. by demand-pull inflation (if capacity and labour force are underemployed).*

**Keywords:** *consumer goods surplus, income and capacity effect of investment, quantity versus price adjustment, two-sector model*

**JEL classification:** *E1, E2, P5*

## Macroeconomics versus 'common sense'\*

### 1 Introduction

The title of this paper does not imply that 'macroeconomics' and 'common sense' contradict each other. It rather intends to suggest that common sense, our true companion in everyday life, may fail if taken as a guide in economic theorizing. However, common sense as it is used in individual private households' and individual private firms' decisions constitutes the very basis of the liberal economic theory. This theory assumes that when every economic agent is directed by – and only by – its individual advantage (the consumer by the maximization of utility, the firm by the maximization of profits) the national economy as a whole would achieve, through the working of the market mechanism, a well-defined optimal efficiency.

The Great Crisis of the 1930s shattered the belief in the power of this miraculous mechanism and gave rise to the school of macroeconomics linked to the name of John Maynard Keynes, the famous Cambridge economist – although the first formulation of this theory (1933) is rather due to the Polish economist Michal Kalecki.<sup>1</sup> Macroeconomics has become a true revolution in economic thinking: it proved, for the first time, that the belief of liberal economics in the perfect functioning of the spontaneous market regulation is baseless. After World War II, up until the mid-1970s, the Keynes-Kalecki macroeconomics prevailed in economic university teaching and also in practical discussions on economic policy matters. However, in the following decade a change took place which Walt Rostow, a well-known US economist and politician, called 'the barbaric counterrevolution' in economic theorizing.<sup>2</sup> Economic liberalism conquered anew not only universities but economic policy as well. One of the reasons why this change of paradigm has been so easily accepted by the public lies in the fact that new-old theory appeals to individual common sense, while Keynes-Kalecki macroeconomics runs very often against it.

### 2 How to increase the utilization of an already existing underutilized railway line?

Michal Kalecki used the following anecdote to explain his theory. Let us assume, he would say, that an already existing railway line is utilized at an unsatisfactory level because unemployment is high and the business climate in the region is bad. What can be done?

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\* Inaugural lecture held at the opening of the academic year 2003/2004 at the Warsaw School of Economic and Social Studies (WSSE), Poland, 2003.

<sup>1</sup> 'Outline of a Theory of the Business Cycle' in: M. Kalecki (1971), *Selected Essays on the Dynamics of the Capitalist Economy*, Cambridge University Press, pp. 1-14.

<sup>2</sup> W. W. Rostow (1983), *The Barbaric Counter-Revolution: Cause and Cure*, University of Texas Press, Austin, TX.



The provocative answer given by Kalecki was: Let us start building a new railway line just parallel to the existing one. The construction of the line would require ordering the production of new rails, new beddings as well as materials for the building industry. The fulfilment of these orders would lead to a higher level of economic activity in the region in which the old underutilized railway line was located. Indeed the steel mills, the factories producing beddings, cement etc. would require additional labour and material inputs which in turn would require additional employment in sectors producing these intermediate inputs. Higher employment in many places would result in higher consumption expenditure, which in turn would require an increase in the production of consumer goods. The increased level of economic activity in the region under consideration would raise the demand for transport services and the utilization of the initially mentioned railway line would improve at last as well.

However, what is to be done when sooner or later the second railway line gets ready, when orders related to this endeavour are fulfilled, when as a result people start anew losing their jobs and earnings? Then it is necessary – was the answer given by Kalecki – to immediately start building a third railway line next to the two already existing ones. Of course, it does not make great sense to continue building new railway lines next to existing ones just in order to assure their proper utilization. But the anecdote is not to be understood *verbatim*. What matters is the main idea behind: better utilization of existing resources requires their growth just as keeping one's balance on a bike requires the bike to move. The anecdote also shows that the conclusions drawn from common sense in the usual meaning of the word are not very helpful when analysing problems related to the level of economic activity in the case of underutilized capacity.

Besides, this is true not only as regards economics. In many other branches of theorizing as well, common sense based on everyday experience is a poor advisor when scientific conclusions are looked for. A coin thrown from the window would fall to earth more quickly than a feather, however, when we put both in a vacuous tube they would fall at the same speed. This is so because gravity, which causes the fall, does not depend on the mass of the falling object. Similarly, it is the earth which turns around the sun contrary to what our everyday experience, based on the observation of sunrise and sunset, would suggest.

The everyday experience of a private household tells us that our capacity to spend, hence our demand for consumer goods and services, depends in a decisive way upon our incomes. It is impossible – at least in the long run – to spend more than one earns. Thus the hypothesis that our individual income determines our expenditure is indeed well founded. In the economy as a whole, however, this is not the case – as will be proved below: here aggregate expenditures determine aggregate incomes, or it is the aggregate demand which determines the aggregate supply. This is the central hypothesis of Keynes-Kalecki macroeconomics.

### 3 The commodity surplus in the sector producing consumer goods

We start with an extremely abstract example to explain the term 'consumer goods surplus'. Let us assume that the national economy consists of one – and only one – private firm producing bread as a final good. This is, however, a very special firm because – using already existing equipment – it produces for itself all the intermediate inputs (flour, grain, fertilizers, energy etc.) required for the production of the final good. In economics, such a firm is called a vertically integrated firm and (disregarding amortization) the cost of bread, the final commodity, depends on the aggregate wages on all stages of production.

Let us further assume that the full capacity output of our firm in a certain period amounts to 1000 loaves of bread and the price of one loaf is 1 EUR. Thus the value of output may reach 1000 EUR. Let us further assume that aggregated wages at this level of output amount to 800 EUR and that workers spend all their earnings on bread. Thus the owner of the firm could sell 800 loaves of bread to his workers but, disregarding his own consumption, he would be left with 200 loaves of bread which would not be saleable if the firm under consideration is – according to our assumption – the only one in the economy. This is the potential 'consumer goods surplus' because it could not be sold under the given circumstances.

However, is this result due to the initial assumption that our vertically integrated 'bakery' is the only firm in the national economy? No! Let us assume that we have plenty of integrated firms producing final consumer goods (food, garments, furniture, home electronics, cars etc.). For each of these integrated firms our reasoning could be applied in the sense that aggregate wages cannot buy the final product, thus the 'consumer commodity surplus' would still appear. The only difference is that our initial assumption – that workers would buy only, and would live only on, bread – can be dropped. They could buy whatever they find on the market, still they could not buy the 'consumer goods surplus'. The conclusion we arrive at is the following: the multiplicity of firms belonging to the vertically integrated consumer sector does not solve the problem of the 'consumer goods surplus'. The latter simply cannot be sold if the national economy consists of the consumer goods sector only. This is however a major question because for the owners of the firms in this sector, the surplus represents potential profits, the very goal of their activity. They would earn real profits only if this surplus could be sold. As profits do exist in real life, the selling of the 'consumer goods surplus' does take place – which implies the existence in the national economy of a sector that produces final goods being non-consumer goods. This is the direction in which our model must now be extended.

#### 4 The 'income effect of investment'

The most important non-consumer final goods in the economy are investment goods.<sup>3</sup> These are goods that replace or expand worn-out capacities and increase inventories. When we look at investment from this point of view, we describe the 'capacity effect' of investment, its very *raison d'être*. This is of course a very important effect of investments because otherwise they would not be needed. However, in the Kalecki anecdote the 'capacity effect' (the completion of the second railway line) was a nuisance rather than the target. Indeed, a second railway line next to an unsatisfactorily utilized first one does not make much sense. In the centre of the Kalecki anecdote stood, however, the 'income effect' of investment: as long as investment projects are being realized, people directly or indirectly taking part in the process earn wages. Thus incomes are being created while the 'capacity effect' would materialize only after some delay, when the investment project is completed and starts producing goods for the market.

Turning back to our isolated bakery firm, let us assume that wages related to the fulfilment of some investment project amount to 200 EUR and are being spent on consumer goods. In this case the 'consumer goods surplus' consisting of 200 loaves of bread can be sold and profits in the consumer goods sector – arising from the production of 1000 loaves of bread – can be transformed from just potential into real ones.

The difference between the 'income effect' and the 'capacity effect' of a given investment project plays a decisive role in understanding the way in which the 'consumer goods surplus' may find a market. *Ex definitione* the two effects cannot occur simultaneously. When the 'income effect' manifests itself, the 'capacity effect' does not yet exist because the investment project is still not completed. When, on the other hand, the 'capacity effect' manifests itself, the 'income effect' is already gone because the investment project has been completed. The difference between the two aspects of investment helps us to understand how the 'consumer goods surplus' can be sold. Wages arising from the completion of investment projects create demand for the 'consumer goods surplus' (without influencing its potential volume). In this – and only this – way they make possible the selling of the 'consumer goods surplus' and its transformation into real profits. A capitalist economy could function smoothly only if the 'income' and 'capacity' effects were adjusted to each other in time to assure a constant degree of utilization of resources. This is possible *in abstracto*, but impossible in real life because it would require investment to increase continuously at a special rate adjusted to existing parameters, a condition which cannot be fulfilled spontaneously in a market economy.

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<sup>3</sup> There are other non-consumer final goods, namely goods demanded by the Government and by the rest of the world. These goods are ignored here.

## **5 Investment – an unsteady phenomenon**

Investment is a rather fickle occurrence because it is always linked to risk. No one undertaking an investment has a guarantee to be successful, to get back the means invested plus a satisfactory profit, and when exactly this would happen. This is so because investments are oriented towards a more or less distant future which *ex definitione* is unknown. The investor does not know the future costs and the future prices of his produce, the future competition internal and external, the future taxation and the future political situation.

Kalecki was the first economist to introduce the important distinction between investment decisions and investment proper. Investments cannot be compared to, e.g., accidentally buying a new pair of shoes. They require as a rule own financial resources and bank credits which are not always easy to get. Therefore they are not made under some short-lived stimulus but are preceded by detailed analysis, and thorough calculations. Only after this preparatory work is done an investment decision can be made. Further, there exists a necessary delay between the investment decision and the completion of investment. Very often the equipment for an investment project must be individually ordered and produced. Building activities require time as well and do not start immediately even if the investment decision has already been made. For all these reasons investment completed during a period result mostly from decisions made in the preceding period. For the sake of simplicity one can assume that investments of this year result from investment decisions made already last year, and investment decisions made this year will materialize as investment only next year.

The variability of investment over time is the main reason why the consumer goods sector cannot simply produce at its full capacity level. Indeed, if concurrently investment were relatively low, firms in the consumer goods sector would not be able to find satisfactory markets for the 'consumer goods surplus', would earn lower profits than expected or even make losses. Hence they would be well advised to produce at a rate corresponding to the level of actual demand coming from the investment sector in the form of its 'income effect', i.e. according to what the market would absorb, rather than according to what they are able to produce.

## **6 Quantity versus price adjustment**

Let us assume that this year investment is larger than it was last year and consequently wages in the investment sector are 10 EUR higher than they were last year. Of course the 'consumer goods surplus' that can be sold this year would increase by 10 EUR as well. Is this the end of the story? No, because the very production of the additional 'consumer goods surplus' would require more workers and more wages, which in turn would further

increase the demand for consumer goods etc. This process of additional spending and earning inside the consumer goods sector would continue until a point at which the total 'consumer goods surplus' would reach some 'proper' relation to the total output of the consumer good sector. Let us assume that, at the prevailing level of wages and prices, the 'proper' relation is 20%, meaning that profits constitute 20% of the value of the output of the consumer goods sector. (This was the case in our initial example with the vertically integrated bakery: 200 against 1000 loaves of bread.) At this profit share, additional output in the consumer goods sector would amount to 50 EUR, i.e. it would be 5  $[=1/(0.2)]$  times larger than 10 EUR, the initial increase in wages in the investment sector. Indeed at this level of additional output, the additional demand for consumer goods coming from 'outside' (10 EUR) and from inside (40 EUR) would be satisfied.

We have shown how expenditures of the investment sector determine the level of the 'consumer goods surplus' which can find a market and consequently the output level of the consumer goods sector. This is what we mean by saying that expenditures determine incomes or that it is aggregate demand which determines aggregate supply, not *vice versa*.

We have tacitly assumed that there exists some unemployment and that the consumer goods sector has idle capacity, hence may respond to increased demand by an increased supply. This reaction of the consumer goods sector may be called 'quantity adjustment'. We have also tacitly assumed that prices are constant. This implies that unit labour costs are constant as well if one assumes that the relation between nominal wages and labour productivity does not change.

Quantity adjustment does not necessarily require prices to remain constant. If nominal wages increase faster than labour productivity then unit labour costs increase and so do prices. If the price increase adjusts the increase in real wages to the growth of labour productivity, we are still faced with pure quantity adjustment although linked with price inflation. However, in this case at least two provisions must be made. First, we have to assume that investment decisions are made in real rather than in nominal terms; second, we disregard the influence which price inflation may have on nominally determined assets and the resulting changes in aggregate demand.

We can also have quantity adjustment mixed with price adjustment. This will be the case if the profit (wage) share in the consumer goods sector were allowed to change. More specifically, when capacity utilization in the consumer goods sector approaches its limit, prices may increase in relation to labour unit costs in such a way that real wages would grow more slowly than does labour productivity. When the profit share in the consumer goods sector increases, the quantity reaction in this sector provoked by an increase in wages in the investment sector is smaller than would be the case under the initial profit

share. For instance, at a profit share of 25% – higher than the 20% assumed previously – additional output in the consumer goods sector would amount to 40 EUR, i.e. it would be 4  $[=1/(0.25)]$  times larger than 10 EUR, the initial increase in wages in the investment sector.

We can have at last pure price adjustment if the production in the consumer goods sector is capacity-constrained while investment is still increasing. In that case only consumer goods prices and the ‘consumer goods surplus’ would increase at a given level of consumer goods output and the real wage must decline compared with the situation at which investment does not increase.

We have assumed in the last case that production is capacity-constrained in the consumer goods sector but employment can still increase in the investment sector. If full employment prevails in the whole economy together with full utilization of capacity in the consumer goods sector, the price adjustment provoked by an increase in investment becomes a fuzzy concept. Indeed the increase in investment, hence employment in this sector would require under full employment the reduction of employment in the consumer goods sector. Investor would have to attract workers from the consumer goods sector by higher nominal wages – but there is no reason why firms in the consumer goods sector would not try to keep their labour fore by offering higher nominal wages as well. This may result in price inflation *pari passu* with unit labour cost inflation without any increase in the investment outlays to the detriment of consumer goods supply.

## 7 A two-sector model

We shall assume, for the sake of simplicity, that the Government can be ignored and the closed economy can be divided into two vertically integrated sectors producing I (gross) investment goods (sector 1) and C consumer goods (sector 2), respectively. In each sector (gross) value added is distributed into wages  $W$ , which are fully spent on consumer goods, and (gross) profits  $R$ , which are fully saved.

sector 1	$W_1 + R_1 = I$
sector 2	$W_2 + R_2 = C$
national economy	$W + R = Y$

where lower-case numbers at  $W$  and  $R$  denote the respective sector and where  $Y$  denotes GDP.

The ‘consumer goods surplus’, represented by  $R_2$ , cannot find a market inside sector 2 because profits are saved. On the other hand,  $W_1$  – wages in sector 1 – cannot find consumer goods inside sector 1 because the latter produces only investment goods. Hence the market for consumer goods would be cleared if – and only if – the condition

$$\begin{array}{c} \rightarrow \\ W_1 = R_2 \end{array} \quad (1)$$

is fulfilled. The arrow above (1) plays a decisive role because it reminds us that expenditure coming from sector 1, i.e.  $W_1$ , determine the saleable 'consumer goods surplus' and not *vice versa*. By adding the term  $R_1$  to both sides we get

$$\begin{array}{c} W_1 + R_1 = R_1 + R_2 \\ \rightarrow \\ I = R \end{array} \quad (2)$$

According to (2) profits, hence savings, are determined by – but do not determine – investment. Kalecki explained this as 'investment financing itself'. Of course this relation holds for the economy as a whole: an individual capitalist who invests has accumulated a debt equal to his investment (if the financing was credited by the banking system) but the capitalist class *in toto* gets profits which are equal to this investment. In this sense 'investment finances itself' because it creates savings equal to investment.

Thus savings are not a prerequisite of investment but its result. This does not mean that savings do not play an important role in investment. Savings of a firm increase its own capital and this capital is needed for financing a part of the investment project and – what is still more important – for the access to the credit market. Aggregate investments of a given year may be larger than the previous year's savings if firms increase their indebtedness vis-à-vis the banking system; they can also be smaller if firms decrease their indebtedness vis-à-vis the banking system. Of course it may happen that they are equal. The assumption, however, that in a given year firms always invest what they have saved the previous year leads to a logical difficulty if investments are allowed to change over time. Indeed, let us assume that savings of the preceding year denoted  $S(t-1)$  *via* investment decisions made the same year determine investment in the following year  $I(t)$ . Hence

$$S(t-1) = I(t) \quad (3)$$

According to (2), however, we have

$$S(t-1) = I(t-1) \quad (2')$$

From (3) and (2') we get

$$I(t) = I(t-1)$$

i.e. the constancy of investment over time if previous-year savings were to directly determine the current year's investment. As investment does change over time, the hypothesis that savings of last year may exactly determine investment of the current year must be rejected.

## **8 The supply and demand constraint systems**

It is interesting to compare the capitalist economy and the centrally planned economy as practised in the past in the Soviet Union and its satellites from the viewpoint of making investment decisions. The centrally planned economy was a supply-constrained economic system because the investment hunger of the state-owned firms was not limited by any economic factors. It was a consequence of the 'soft budget constraint' (Kornai). Investment was always advantageous for firms and implied no risk for the investor. The only method of limiting the investment hunger were administrative methods – and they were completely ineffective. Hence investment was as a rule high and the derived  $W_1$  was too high with respect to the potential 'consumer goods surplus'. Of course, some remedy could be an increase in prices of consumer goods and the resulting increase of the profit share in the consumer goods sector. But the Government used prices as a propaganda tool rather than as a means to assure the equilibrium on the consumer goods market. As a result, in the socialist economy we were confronted with a seller's market. The seller was in a privileged position while buyers have to queue in search of commodities being in short supply. Also the labour market was a seller's market in the sense that employers looked for workers more often than the other way round. Under these conditions full employment and full utilization of capacity was the rule, however, their efficiency was low. Creativity suffered as well. Of course the intensity of the discussed features of the centrally planned economy depended on the economic policy pursued: the more ambitious the plans, the greater the shortages and *vice versa*. Nevertheless, the term 'shortage economy' (Kornai) describes quite precisely the main weakness of central planning.

Against this background it is easier to discuss the advantages and disadvantages of a capitalist economy. This is a demand-determined system, the main reason being the fact that the propensity to invest is checked by the risk related to investment decisions. Every entrepreneur would weight the expected returns against the possible loss of his own and borrowed capital; he wants to make a gain and is afraid of suffering losses. This is the main reason – at the given profit share in the consumer goods sector – that in the capitalist system the buyer's market prevails: there are commodities of all kinds which 'queue' for buyers. This is also the case for the labour market, where workers 'queue' for jobs. Thus unemployment is not an accidental phenomenon due to labour market inflexibility but a constitutive feature of a capitalist economy linked to the propensity to invest which is very often not intensive enough. The capitalist economy tends towards underemployment of labour force and underutilization of existing capacities at a high efficiency of the utilized



production factors. It also creates conditions for high creativity because the winners in the competitive market are those who offer new products or better ways to produce 'old' goods.

We realize that the capitalist economy has two built-in tendencies. The negative one is the tendency towards underemployment of existing resources, first of all of the labour force. The positive one is its flexibility and ability to innovate and adjust the size and structure of production to the changes in demand. The existence of these two tendencies requires a conscious policy which should support the propensity to invest, the main weakness of the capitalist economy, and limit the losses and sufferings provoked by unemployment. This is not easy because the contradictions of the capitalist economy have a common basis in the form of the private property of the means of production. This contradiction cannot be solved but it can be attenuated. This is the proper goal of a successful economic policy.

## **9 The level of wages and unemployment**

At the end of this introduction to the theory of effective demand, let us briefly look at an important topic, namely, whether lowering real wages may help in reducing unemployment. This is a standard postulate of mainstream economics, which sees the source of unemployment in the price of labour, i.e. wages, being too high. That postulate treats the labour market like any other commodity market: If at a given price the supply of a good or service is greater than the demand for it, this price should decline. At a lower price the supply is expected to decline and the demand to increase until that price is found at which supply and demand are equal to each other. This approach may work and does work, e.g. at the horse market. If they are no longer needed in agriculture or as a means of transport, their supply would indeed decline and be adjusted to the demand for horses used in sport activities etc. But workers are not commodities that are produced (or not) in order to be sold and make a gain – although their services, labour, is a special commodity in a capitalist society.

According to mainstream theory, under perfect competition firms maximize profit by expanding production to the level at which marginal cost reaches the price determined by the market. This is tantamount to postulating that the nominal wage rate should be equal to the value of the marginal product of labour or that the marginal product of labour should be equal to the real wage. Thus, if there is unemployment, it is caused by real wages being too high in relation to the (physical) marginal product of labour, which is assumed to be a decreasing function of employment at a given capital stock. By lowering the real wages, conditions are allegedly created for firms to hire more labour with (physical) marginal product declining *pari passu* with increasing employment. Unemployment, according to this approach, is mainly due to real wages being higher than the (physical) marginal product of labour which unemployed workers could produce if employed.

The theory of effective demand does not approve of this theory. It is true that by lowering nominal wages at given labour productivity unit labour costs would decline and, at given price level (or prices falling but less than unit labour costs) the profit share would increase to the detriment of the wage share. However, the expected increase in employment would only materialize if, immediately after the cut in nominal wages, investment were to increase. This is, however, not very likely because today's investments are the result of yesterday's investment decisions. Hence the result of the cut in nominal wages – let us assume, for the sake of simplicity, in the consumer goods sector only – would depend on whether or not investment decisions would be positively influenced by this measure. It seems that this would certainly not be the case. The increase of the profit share would *prima facie* increase the potential 'consumer goods surplus' in relation to output in the consumer goods sector. However, at given investment and wages coming from the investment sector, the saleable 'consumer goods surplus' remains unchanged. Hence the increase of the profit share in the consumer goods sector requires the latter's output and employment to decline rather than increase.

Thus the immediate consequence of lowering nominal wages would be lower employment and lower output in the consumer goods sector. Although the profit per unit of output in the consumer goods sector would increase, total profit would not change. We can prove this point by using formula (2), according to which profits (identical to savings in our model) are equal to investment. At given investment profits do not change either. This means that the increase in profits per unit of output in the consumer goods sector would be exactly compensated by the decline of units of output in this sector. The volume of profits remaining at the same level at which it was before the nominal wage reduction does not create stimuli for more investment decisions. Still worse, the capacity utilization in the consumer goods sector would deteriorate, hence investment decisions would be influenced even negatively.<sup>4</sup> We finally come to the conclusion that lowering nominal wages at given labour productivity (or leaving the real wage growth behind labour productivity growth) would not only miss the goal of increasing employment but would rather increase unemployment. Sometimes this way out of severe unemployment is criticized as socially not acceptable. The problem is, however, more serious: it is not a way out of unemployment at all.

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<sup>4</sup> If the economy is open and if prices of consumer goods decline (although less than nominal wages) then under certain conditions the country would be able to expand exports and compensate to some degree the loss of markets caused by the decline of real wages. This factor would only under very special conditions change the conclusions we have arrived at in a closed model.

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