

## KEYNES AND COASE

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### INTRODUCTION

I am sure that Ronald will not like my bracketing him with Keynes, as I am about to do. But if he is patient, he will hear me modify criticisms of his approach to economics that I made in an essay I wrote many years ago—sixteen to be exact—for the *Journal of Economic Perspectives*.<sup>2</sup>

At first glance Keynes and Coase have nothing in common except that they were great English economists who loved ballet and attacked Pigou (a colleague of Keynes's at Cambridge—the professor of economics, Keynes being merely a fellow)—but attacked different parts of Pigou: his theory of unemployment, in the case of Keynes, and his theory of externalities, in the case of Coase.<sup>3</sup> That is not much to build a comparison on. Keynes was liberal, Coase is conservative. Keynes was a macroeconomist, Coase is a microeconomist. Keynes was upper class, a celebrity, a

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<sup>1</sup> This paper was prepared for a conference on “Markets, Firms and Property Rights: A Celebration of the Research of Ronald Coase” held at the University of Chicago Law School on December 4–5, 2009. My discussion of Keynes draws on my article “How I Became a Keynesian,” *New Republic*, Sept. 23, 2009, p. 34, and on chapters 8 and 9 of my forthcoming book *The Crisis of Capitalist Democracy*.

<sup>2</sup> Richard A. Posner, “Ronald Coase and Methodology,” *Journal of Economic Perspectives*, Fall 1993, p. 197.

<sup>3</sup> Pigou was a conservative in macroeconomic matters, strongly hostile to Keynes's *General Theory*, but a liberal in microeconomic matters, and hence a natural target for Coase, a microeconomist, especially since conservatives have traditionally decried the Cambridge economics tradition as liberal. For an interesting discussion, see Roger E. Backhouse and Steven G. Medema, “Economists and the Analysis of Government Failure: How Cambridge Did and Did Not Anticipate Chicago and Virginia” (University of Birmingham and University of Colorado Denver, Nov. 16, 2009).

great public figure, a baron, a man of the world, a speculator, in his youth a homosexual (what we who study such things call an “opportunistic homosexual”), a brilliant writer on diverse subjects, a best seller—a man of Eton, Cambridge, the Apostles, Bloomsbury. Ronald is none of these things. And he is an expatriate—almost an American. Keynes didn’t much like Americans.

But these differences are superficial from the standpoint of how one approaches economics. Keynes and Coase shared an approach to economics that was once dominant, that fell into disfavor, but that is undergoing a revival as a result of the worldwide financial crash of September 2008, which took the economic profession by surprise and created profound doubts about the profession’s understanding of the economy. It was shortly after the crash that I read Keynes’s masterpiece, *The General Theory of Employment, Interest and Money*, published in 1936, for the first time. I found Keynes’s approach at once unfamiliar and convincing. I sensed the affinity to Coase and it sent me back to my 1993 article about Coase’s methodology.<sup>4</sup>

#### THEIR METHODOLOGIES COMPARED

What I said descriptively about Coase’s methodology in the article still seems to me correct, and I will start there. I said that he had “declared war on modern economics.”<sup>5</sup> I quoted such statements of his as “when economists find that they are unable to analyze what is happening in the real world, they invent an imaginary world which they are capable of handling.”<sup>6</sup> He has written that the rational model central to modern economics is “unnecessary and misleading” because “there is no reason to suppose that most human beings are engaged in maximizing anything unless it

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<sup>4</sup> I published a revised version of the article as chapter 21 of my book *Overcoming Law* (1995), and it is on the revised version that I draw in this paper.

<sup>5</sup> *Id.* at 409.

<sup>6</sup> *Id.* at 409 n. 14, quoting, Coase, “The Nature of the Firm: Meaning,” 4 *Journal of Law, Economics, and Organization* 19, 24 (1988).

be unhappiness, and even this with incomplete success.”<sup>7</sup> He wants economists to “study man as he is.”<sup>8</sup> He proposes to abandon the assumption “that an individual’s choices are consistent.”<sup>9</sup> He seems not to regard equilibrium as a useful concept in economics.<sup>10</sup> Skeptical not only about abstraction but about the empirical methods—heavily statistical—used in modern economics (he prefers the case study), he rejects the influential methodological principle that a theory should be tested not by the realism of its assumptions but by the accuracy of its predictions.<sup>11</sup>

My article on Coase’s methodology pointed out that there are two conceptions of economics as a field. The older one conceived of economics as the study of the economic system with whatever tools come to hand; the newer conceives of it as the application of the model of rational choice to any domain of human behavior in which the use of the model might prove fruitful. Coase is steadfast in his adherence to the older conception. He has gone so far as to say that there has been little progress in economics since Adam Smith—indeed he thinks there may have been regress.<sup>12</sup>

Two further claims made by Coase bear on his methodological affinity to Keynes. In arguing that his work will one day “bring about a complete change in the structure of economic theory,” he quickly added: “at least in what is called price theory or

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<sup>7</sup> Ronald Coase, *The Firm, the Market, and the Law: Essays on the Institutional Structure of Production* 4 (1988). He has called the rational model of human behavior “meaningless.” R. H. Coase, “Coase on Posner on Coase,” 149 *Journal of Institutional and Theoretical Economics*, 96, 97 (1993).

<sup>8</sup> R. H. Coase, “The New Institutional Economics,” 140 *Journal of Institutional and Theoretical Economics* 229, 231 (1984).

<sup>9</sup> R. H. Coase, “Duncan Black,” in Coase, *Essays on Economics and Economists* 185, 190 (1994).

<sup>10</sup> Posner, note 4 above, at 419.

<sup>11</sup> R. H. Coase, “How Should Economists Choose?” (American Enterprise Institute 1982); Posner, “The New Institutional Economics Meets Law and Economics,” in *Overcoming Law*, note 4 above, at 426, 430.

<sup>12</sup> R. H. Coase, “The Wealth of Nations,” 15 *Economic Inquiry* 309, 325 (1977).

microeconomics.”<sup>13</sup> And he claims not to have been significantly influenced by any American economist other than Frank Knight.<sup>14</sup> Paradoxically, it is in macroeconomics rather than microeconomics that the approach that Coase shares with Keynes holds the greatest promise. And Knight is an economist who agreed with Keynes on a critical point rejected by most modern economists.

Keynes’s methodology is shown to best advantage in his masterpiece, the *General Theory*. Yet in 1992 Gregory Mankiw, then as now a prominent macroeconomist at Harvard, stated that “after fifty years of additional progress in economic science, *The General Theory* is an outdated book...We are in a much better position than Keynes was to figure out how the economy works.”<sup>15</sup> And Keynes’s biographer goes so far as to say that Keynes “was not an economist at all” (though this is intended as a compliment by the author, who is not an economist)—that he “put on the mask of an economist to gain authority, just as he put on dark suits and homburgs for life in the City [London’s Wall Street].”<sup>16</sup>

What is true is that the *General Theory* is a hard slog, though not for the reason that so much modern economics writing is a hard slog; for the book is not mathematical. There is some math, but not much and it is simple (high-school algebra and a bit of differential calculus) and mostly incidental to Keynes’s arguments. The book is a work of elegant prose. It sparkles with aphorisms (such as “it is better that a man should tyrannise over his bank balance than over his fellow-citizens”<sup>17</sup>) and rhetorical flights—most famously, “madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few

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<sup>13</sup> R. H. Coase, “The Institutional Structure of Production,” in *Essays on Economics and Economists*, note 13 above, at 3.

<sup>14</sup> Posner, note 4 above, at 417 and n. 34.

<sup>15</sup> Gregory Mankiw, “The Reincarnation of Keynesian Economics,” 36 *European Economic Review* 561 (1992).

<sup>16</sup> Robert Skidelsky, *Keynes: The Return of the Master* 59 (2009).

<sup>17</sup> John Maynard Keynes, *The General Theory of Employment, Interest and Money* 343 (1936).

years back.”<sup>18</sup> But it also bristles with unfamiliar terms and brims over with digressions, afterthoughts, and stray observations, such as “the two most delightful occupations open to those who do not have to earn their living [are] authorship and experimental farming.”<sup>19</sup>

The *General Theory* is an especially difficult read for some present-day academic economists, whose conception of economics is remote from Keynes’s. That is what made the book seem “outdated” to Mankiw and led Robert Lucas, writing a few years after Mankiw, to characterize the *General Theory* as “an ideological event” rather than a contribution to economic theory.<sup>20</sup> The tendency of today’s economists is, as I noted earlier, to take their field to be the study of rational choice. Keynes like Coase adhered to the older view that economics is the study of the economy, employing whatever assumptions seem realistic and whatever analytical methods come to hand. There was a strong presumption that business firms tried to maximize profits and individuals utility, but how well they succeeded was left open. Keynes wanted to be realistic about decision-making rather than explore how far an economist could get by assuming that people base decisions on a close approximation to cost-benefit analysis.

The *General Theory* is full of interesting psychological observations—the word “psychological” is ubiquitous—as when Keynes notes that “during a boom the popular estimation of [risk] is apt to become unusually and imprudently low,” while during a bust the “animal spirits” of entrepreneurs droop.<sup>21</sup> He uses such insights without trying to fit them to a model of rational decision-making.

Such an approach to economic behavior came naturally to Keynes because he was not an *academic* economist in the twenty-

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<sup>18</sup> Id. at 351.

<sup>19</sup> Id. at 322.

<sup>20</sup> Robert E. Lucas, Jr., Review [of first two volumes of Robert Skidelsky’s biography of Keynes], 67 *Journal of Modern History* 914, 916 (1995).

<sup>21</sup> Keynes, note 17 above, at 130.

first century understanding of the term. He had no degree in economics, wrote extensively in other fields (such as probability theory—on which he wrote a treatise that does not mention economics), combined a fellowship at Cambridge with extensive government service as an adviser and high-level civil servant, and was a speculator, polemicist, and journalist. He was an *eclectic* economist, a distinguished breed (think of Malthus, Mill, Schumpeter) that has since become extinct.

Keynes and Coase illustrate the contribution to economics that can be made by economists who are not mathematicians (Keynes started out as one, but as I said there is little math in the *General Theory* and he invites the reader to skip most of it). I think the difference is that Coase could have written in the idiom of modern economics because his analytical framework is classical price theory though he eschews formal models and econometrics, but concepts central to the *General Theory* cannot be fitted to the formal models that economists are comfortable with or subjected to the kind of empirical analysis that economists do well. Economists *still* cannot agree on the causes of the Great Depression 70 years after it ended. The interrelations of money, interest rates, savings, investment, employment, public finance, and production that shape the business cycle are too complex to be modeled fruitfully or their individual effects determined. Modern economists are not comfortable with disequilibrium but the business cycle is a disequilibrium phenomenon characterized by adverse feedback effects that are difficult to integrate into models of the macroeconomy. Finance theorists and macroeconomists alike, with only a few exceptions, failed to anticipate the financial crash of September 2008 and the ensuing deep downturn in the nonfinancial economy. In the wake of the collapse a contrite Gregory Mankiw wrote: “If you were going to turn to only one economist to understand the problems facing the economy, there is little doubt that the economist would be John Maynard Keynes. Although Keynes died more than a half-century ago, his diagnosis of recessions and

depressions remains the foundation of modern macroeconomics. His insights go a long way toward explaining the challenges we now confront.”<sup>22</sup>

It turns out that Keynes’s informal, unrigorous, largely unmathematized analysis of the macroeconomy has provided greater insight into our current economic situation than 75 years of increasingly formal, rigorous, mathematized analysis. When the leading economic student of the Great Depression—Ben Bernanke, the chairman of the Federal Reserve—is blindsided by a repetition of the circumstances that gave rise to that depression (a credit binge, overleveraged banks, “new era” thinking), one begins to suspect that the dismal performance of the economics profession in the present crisis is due to forgetfulness of Keynes.

Frank Knight, in 1921,<sup>23</sup> and Keynes in his treatise on probability published the same year,<sup>24</sup> had distinguished (Knight more clearly than Keynes) between calculable risk—risk to which a numerical probability can be assigned, and of which the likelihood, direction, and magnitude by which actual outcomes may deviate from the estimated (mean) risk can also be estimated—and uncertainty, to which a numerical probability and distribution cannot be assigned with any confidence that it is correct. The risk within the next five years of another major terrorist attack on the United States, or of abrupt global warming, cannot be assigned a quantitative probability that has any objective basis; there just isn’t enough information, or a sufficiently exact theory, to enable such a calculation.

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<sup>22</sup> Gregory Mankiw, “What Would Keynes Have Done?” *New York Times*, Nov. 28, 2008, [www.nytimes.com/2008/11/30/business/economy/30view.html?\\_r=1&partner=permalink&exprod=permalink](http://www.nytimes.com/2008/11/30/business/economy/30view.html?_r=1&partner=permalink&exprod=permalink) (visited Nov. 2, 2009).

<sup>23</sup> Frank H. Knight, *Risk, Uncertainty, and Profit* (1921). See especially pp. 19–20 and ch. 7.

<sup>24</sup> John Maynard Keynes, *A Treatise on Probability*, ch. 3 (1921). Keynes, unlike Knight, does not discuss the economic implications of uncertainty in the treatise.

Keynes explained uncertainty in this sense more clearly in an essay published the year after the *General Theory* than he had done in that book or in his treatise on probability:

By “uncertain” knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty...The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention, or the position of private wealth-owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know. Nevertheless, the necessity for action and for decision compels us as practical men to do our best to overlook this awkward fact and to behave exactly as we should if we had behind us a good Benthamite calculation of a series of prospective advantages and disadvantages, each multiplied by its appropriate probability, waiting to be summed.<sup>25</sup>

Keynes argued plausibly (as did Knight) that investment decisions are often made in a setting of uncertainty because by the time the investment begins to yield a return the conditions determining its profitability may have changed. Some unanticipated changes can be hedged by contract, insurance, derivative securities, or other means. But rarely can all unanticipated changes be hedged, especially those that are uncertain to occur, because then it is difficult or impossible for an insurer (whether an insurance company or an informal insurer, such as the issuer of a credit-default swap) to calculate a premium. Still, businessmen do make investments in the face of uncertainty and were doing so before there were any theories of probability.

Is it rational to make an investment when one's estimate of the expected net benefit is little better than a stab in the dark? The

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<sup>25</sup> J. M. Keynes, “The General Theory of Employment,” 51 *Quarterly Journal of Economics* 209, 214 (1937).

usual concept of rational decision making assumed in economic analysis is some form of cost-benefit analysis, which presupposes that any risk that affects expected costs or benefits is calculable within a reasonable range. Modern economists are extremely uncomfortable with Knightian-Keynesian uncertainty because it cannot be readily assimilated to cost-benefit analysis, the standard model of rational decision making. But the question of rationality didn't arise for Keynes. His analysis did not depend on any very definite assumptions about human behavior. He simply had observed businessmen taking noncalculable risks. Were there no people willing to do so—people who had an “urge to action”—a capitalist economy would not function. Business is a field of activity attractive to such people—call them the bold. Timid people of equal intelligence to the bold become civil servants, middle managers, or professors, instead of entrepreneurs. There is empirical evidence that economic growth is indeed, as Keynes conjectured, positively correlated with tolerance for uncertainty (low uncertainty aversion), and, a closely related point, that entrepreneurs are less averse to uncertainty than other persons.

In a famous passage in the *General Theory*, Keynes wrote that

most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits—of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities...Thus if the animal spirits are dimmed and the spontaneous optimism fades, enterprise will fade and die...It is our innate urge to activity which makes the wheels go round, our rational selves choosing between the alternatives as best we are able, calculating where we can, but often falling back for our motive on whim or sentiment or chance.<sup>26</sup>

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<sup>26</sup> Keynes, note 17 above, at 144.

In a depression, such as we are now undergoing (for this is no ordinary recession), the dimming of the “animal spirits” leads both businesses and consumers to reduce spending out of fear of the unknown. Instead of being spent, money is hoarded, with the result that consumption falls and with it production and employment. An important advance by Keynes over classical macroeconomics was recognition that people want money as a reserve against uncertainty, rather than just for spending or investing; and the greater the uncertainty, the more money they will want to hold in reserve and so the slower the economic wheels will turn.

It is remarkable that almost 75 years after Keynes published the *General Theory*, his pre-modern (as it once seemed to Mankiw and Lucas and other present-day economists) theory of business cycles should receive the encomia it did from Mankiw. It is equally remarkable that Coase’s immense reputation, which places him with Keynes in the pantheon of twentieth-century English economists, should be based on articles that use even fewer of the techniques of modern economics than Keynes did. Keynes unlike Coase made extensive use of the concept of equilibrium—indeed he was more interested in the equilibrium conditions for involuntary unemployment, which when he wrote had plagued England for almost two decades, than in the cyclical unemployment associated with depressions.

Despite all their political and cultural differences, methodologically Keynes and Coase are similar. Both have a sure command of, and deploy, the most basic tools of economics but are disdainful of math and, more interestingly, of the rational model of human behavior. They believe that generally people act in their self-interest, but they are not interested in rigorous specification of what that means. They are inclined to take people as they are, rather than to construct a “rational man.” They do not consider the realism of their assumptions irrelevant or seek to test theory by the accuracy of its predictions. They have no interest in econometrics.

## A PUZZLE

But now here is a question for Coase. Keynes was a liberal, and his liberalism was consistent with his approach to economics. He didn't consider markets self-regulating; he thought as I said that involuntary unemployment could be an equilibrium; he thought and advocated extensive government intervention to keep the economy from running off the rails. There is a utopian streak in the *General Theory*, as when it predicts that within a century people's material wants would be satiated and when that happened the demand for capital (to finance consumption) would plummet and rentiers (people who live on income from passive investments, such as stocks or bonds, and thus are hoarders) would be wiped out—a prospect that delighted Keynes, who looked forward to “the euthanasia of the rentier,”<sup>27</sup> though fortunately he didn't mean that literally.

Coase's extreme hostility to government regulation, reflected everywhere in his work, such as the passage in “The Problem of Social Cost” in which he appears to be suggesting that government is the cause of all pollution,<sup>28</sup> does not seem to me to sort well with his skepticism about equilibrium and rational maximization. If people are busy maximizing their unhappiness and markets are never in equilibrium, one might suppose that there was a lot of work for government to do. In particular, since a central implication of his theory of social cost is that transaction costs may prevent private contracting—the free market—from internalizing social costs, one might have thought that he would have some sympathy for government regulation of pollution.

His hostility to government regulation does not have the analytical basis that one finds in Hayek and other members of the Austrian school of economics, or in Milton Friedman, Mancur Ol-

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<sup>27</sup> Id. at 345.

<sup>28</sup> R. H. Coase, “The Problem of Social Cost,” 3 *Journal of Law and Economics* 1, 26 (1960). See also Posner, note 4 above, at 409–414.

son, or George Stigler. It seems to be purely empirical: he has studied the British Post Office, the Federal Communications Commission, and the private ownership of lighthouses, and in all these and other economic settings that he has studied he has found either that regulation does badly or that (in the lighthouse example) the private market does well despite circumstances that theory suggests should cause the market to fail. Presumably, though, he picks his case studies with an eye to probable government failure; if there are government successes, he is not interested in them. The firmness of his conclusions does not appear to be based on a theory of government, but instead appears to reflect the confidence with which he rejects formal theory and formal empirical methods in favor of a stubborn adherence to the illustrious tradition of what might be called commonsense economics, which is the economics of Adam Smith, of John Maynard Keynes, and of Ronald Coase—economic geniuses all, and to which our current economic troubles invite renewed respect.