

# The Role of Saving in the Process of Income Formation

by  
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## Abstract

The present paper attempts to explain some very serious fallacies contained in the idea of “circular flow of macroeconomic activity”, upon which virtually everything in mainstream macroeconomics is built and which provides a substantial portion of its conceptual framework. The critique proceeds by analyzing the concept of Gross Domestic Product (GDP), which is widely accepted as being “the most comprehensive measure of a nation’s total output of goods and services”, but which actually counts almost exclusively just consumers’ goods, and points out the nature of the consumption illusion of mainstream macroeconomics. The fallacies are clearly seen if set against the alternative approach to problems of aggregate production and aggregate spending as developed by Professor George Reisman. Unlike mainstream economists, who routinely view savings as a “leakage” from the spending stream, a correct account of things points the way to an entirely different understanding of the role savings play in the market process and consequently to an entirely new macroeconomic theory along the lines of the Austrian and Classical schools.

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### 1 Introduction

Contemporary macroeconomics appears to be a vibrant and evolving body of knowledge with a variety of schools, doctrinal traditions and ideological stances. But is there an intellectual core, a common approach that ultimately defines and unites them all?

In this paper I want to show that indeed such a common element exists and that it provides a conceptual framework to every mainstream school of macroeconomic thought today. What unites them is the understanding of the role of consumption and spending in the production process and in the process of income formation. To find the common element we will analyse the widely accepted idea of the “circular flow of macroeconomic activity”, which is implicitly contained in and reinforced by the concept of Gross Domestic Product (GDP). What will be emphasized in the following is that this framework is completely fallacious, and because of that all mainstream schools end up propagating, despite certain disagreements about specific issues, essentially the same fundamentally erroneous understanding of the actual nature of interdependencies between consumer spending, saving and productive expenditure; in short, the process of income formation.

### 2 *Of Fused Entities And Confused Conceptions*

If we want to understand the grave flaws in the very conceptual foundations of contemporary macroeconomics, we have to deal with its basic understanding of aggregate production and aggregate spending in the process of income formation.

The first thing to realize in this connection is the exceptionally large role that consumer spending plays in contemporary macroeconomics. But why this insistence on consumer spending? It is obvious that not only consumers’ goods are produced within a given period. Indeed, if one examines the statistical data on the physical quantities and values of the various kinds of capital goods produced in any given period, one may find the emphasis given to consumer spending particularly puzzling.

What is the rationale for ignoring the obviously much larger amount of spending for capital goods in favor of spending for consumers’ goods? One possible response may be that since providing consumers with goods and services is the objective of all economic activity, the value of the overall spending for consumers’ goods would provide us with at least an approximate measure

of how well people are doing. But isn't greater spending for capital goods indicative for the fact that the economic system is in position to produce more and better consumers' goods in the future? Aren't capital goods of today consumers' goods of tomorrow? Only if one possess large and growing stocks of machinery, trucks, computers in the offices, oil, lumber, steel sheet, iron ore – in short, capital goods, is one able to produce, to sell and to provide consumers with larger quantities and better qualities of consumers' goods in the future.

Indeed, if one sees the matter from this angle, one may conclude that one should pay a much greater attention to the production of capital goods than to the relatively unimportant piece of information contained in the mere observation of how much people spend on consumers' goods. Such an approach would be much more consistent with the experience of probably every individual because as rational human beings we usually want to be prepared to meet our future needs and to take due precautions against such possible risks as poverty, illness, unemployment. Excessive levels of consumption in the present may be potentially detrimental to life and well-being in the future. Individuals, therefore, tend to adjust their action with respect to consumption and provision for the future.

The reason that you actually don't find mainstream economists worrying much about production and availability of capital (intermediate) goods is because they think that those goods are already well accounted for in the value of final goods.

Mainstream macroeconomists reason as follows: since capital goods (intermediate goods) are used in the production of final goods, the prices of final goods must already include or cover the prices of capital goods (intermediate goods) because they are nothing else but costs which must find their remuneration in the value of the final products they help to produce. From this it is concluded, according to the concept of derived demand, that if you keep the demand for final goods steady and undisturbed the capital structure and employment will be maintained as well.

Indeed, such description of things is nothing else than Lord Keynes's concept of "effective demand", which is held to be a description of the aggregate amount of spending in the economic system. Effective demand is defined as the demand for final goods, which, in the aggregate, turns out to be just the sum of consumption spending and net-investment.

The idea of "effective demand", i.e. the amount of aggregate spending, is present in the statistical aggregate commonly known as the Gross Do-

mestic Product (GDP). Indeed, GDP is just the idea of effective demand in numerical form.

Being one of the central building blocks in contemporary macroeconomics, the concept of Gross Domestic Product (GDP) provides a very convenient starting point with the help of which we can begin to understand in very precise terms the fundamental flaw in mainstream thinking concerning what is actually produced and spent.

Robert Barro, one of the leading macro-theorists in the Neo-Classical camp, defines GDP as “the market value of an economy’s domestically produced goods and services over a specified period of time.”<sup>1</sup> Notice in particular that GDP is explicitly employed as a measure of the value of all domestically produced goods and services. In other words, GDP is understood as a measure that takes into account all goods and services produced over one period of time: all kinds of consumers’ goods and all kinds of capital goods. In short, no item produced over a specified period of time is left out, unaccounted for.

If we break up GDP into its constituent parts, in order to get a sense of the relative weights of each of its constituent parts, we would discover that the share of personal consumption expenditure typically varies around 65-70%, government expenditure (consumption and gross investment) revolves around the 20% figure, and gross private domestic investment is in the range of 10-15%.<sup>2</sup>

And as to assure us that GDP really does measure the value of all goods and services produced, Barro, speaking for the immense majority of macroeconomists, particularly emphasizes avoiding the error of adding the value of intermediate goods to the GDP because it would constitute “*double-counting*”. It is important to clearly realize the exact meaning of the term double counting.<sup>3</sup> Logically considered, one can be guilty of having a thing double counted only if one already has counted this thing once. Indeed, if the intermediate goods were really counted in the value of final goods, a separate counting of them would have certainly represented “double-counting”.

But, the truth about GDP is that it does not count intermediate goods at all! GDP is most definitely not a measure of the overall economic activity, but actually revolves almost exclusively around the consumers’ goods alone,

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<sup>1</sup>Cf. Barro(1997, p. 52.).

<sup>2</sup>Cf. Ibid., pp. 38-40.

<sup>3</sup>Cf. Ibid., p. 41.

as the numbers above confirm, with private and government consumption accounting for 85-90% of GDP. What is “missed” in GDP is the overwhelming portion of spending for precisely those intermediate goods, and wage payments besides, which it claims to cover. GDP actually offers us a severely truncated picture of overall economic activity, not in any sense “the most comprehensive measure of a nation’s total output of goods and services” as Professors Paul Samuelson and William Nordhaus want us to think.<sup>4</sup> And as such it is absolutely unsuitable for analysing such major macroeconomic problems as business cycles or unemployment.

But what does it mean to say that GDP does not count intermediate goods, an attentive reader might ask? Doesn’t the production process involve many intermediate steps using goods and services which cost money, thereby influencing the value of goods consumers buy? Is it not true that, for example, the price of bread costing \$10 at retail is derived from the same bread costing, say, \$9 at wholesale and that the value (price) of the latter is determined by the price of flour the baker pays to the miller and the price of the wheat the miller pays to the farmer?

Prices of consumers’ goods definitely do have a connection with their costs of production, but it should also be clear that by being merely aware of this connection does not entitle us to leap to the conclusion that the entire produce of an economy is fully contained just in the value of aggregate consumption spending. Furthermore, and more importantly, this fact certainly does not entitle us to draw the conclusion that consumption spending is the most important source of revenue and that it is consumption spending that pays all wages and somehow also pays for capital (intermediate) goods.

But exactly such view is expressed most clearly in the well-known idea of the so-called “circular flow of macroeconomic activity” (CFMA). This idea allegedly incorporates all one needs to know about the so-called “short-run” process of income formation: consumers spend their money on consumers’ goods and provide thereby simultaneously and instantaneously the financial means to pay wages, land rents, to buy intermediate goods, and to make all conceivable kinds of payments. Thus, if one accepts the idea of CFMA, then one must think that consumers perform two, three, indeed multiple actions at once – namely, that consumers not only buy the consumers’ goods in question but also acquire with the same purchase all sorts of things just mentioned. No other logical inference is possible from such an idea, because

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<sup>4</sup>Cf. Samuelson/Nordhaus(2004, p. 424.).

the only sort of spending allowed for in the system is consumption spending. Indeed, it is even explicitly argued that what is saved, i.e. not consumed, simply disappears from the spending stream and into cash hoardings.

Exactly the same confusion of things is present in the so-called Multiplier Model, which still dominates major portions of university education and public policy thinking. This model is a logical offshoot of the CFMA, because it explicitly argues that an increase in consumption spending triggered, for example, by government purchases raises output and creates additional employment and incomes, which in turn, according to the marginal propensity to consume, fuels successive rounds of consumption spending, higher output, additional incomes, and so on.

What is most crucial here is the role of savings in this model. Put simply, saving plays at best a marginal role, when viewed at its share in the GDP, and at worst a positively destructive role. Saving does have a function to perform, but it is largely understood as the saving out of income of *private households* (who are mostly wage earners). These savings, it is believed, go to finance additional capital investment, thus contributing to economic growth.

Everything allegedly goes well as long as *planned* savings equal *planned* investment. Problems start to emerge if the demand for investment goods displays erratic fluctuations, for whatever reason, and suddenly falls short of the available savings. Under these circumstances, one portion of savings simply does not enter the circular flow of spending, and thus, presumably, disappears in cash hoardings of private households. In this way the circular flow of macroeconomic activity gets disturbed with the consequence that production is cut back, forcing business firms to layoff personnel, declining workers' incomes, causing consumption spending to fall and so on until the amount of savings is low enough to accommodate the most basic demand for investment.

To state the relationships involved in terms of familiar equations, assume a closed economic system without government, then we have

$$(1) \quad Y = C + I$$

where  $Y$  represents gross output (GDP) and national income at the same time,  $C$  is consumption spending and  $I$  gross investment. The national income will be either consumed or saved to satisfy the equality

$$(2) \quad Y = C + S$$

( $S$  denotes saving)

At first glance it may appear that savings are always equal to investment spending. Substituting  $C + I$  from the first equation for  $Y$  in the second, and we obtain the equality

$$(3) \quad C + I = C + S \Rightarrow I = S$$

But, the equality holds only ex-post, mainstream macroeconomists claim; what by no means follows from this is that investment demand will always match the available savings. Note that excessive savings are thought to be the only potential source of unemployment and idle resources in general. An excessive investment demand can be at worst the source of a demand-pull inflation. Investment is always regarded as something positive and is eagerly desired and which, unfortunately, is lacking more often than not. What can in no way occur in the world described by the simple model above is the coupling of excessive investment demand with unemployment and idle resources. But excessive savings are routinely viewed as the source of trouble and as inherently possessing the *potential* to depress overall economic activity. The problem is to find investment outlays for all the savings out there.

This is the basic theory concerning which all currents in today's mainstream macroeconomics stand in substantial agreement. They disagree over how the individual elements in the system interact with each other under the constraints set by the basic model. Viewed from the most general angle, they disagree over subtleties. Since my objections in this paper concern the very foundation not the subtleties, I will confine myself to the discussion of the foundation. Nevertheless, it may be useful to briefly review the subtleties.

What are the subtleties? The “very old” Keynesians (Keynes himself and particularly his disciple Alvin Hansen) hold that the problem of capitalism is of a twofold character. First, as output expands, income rises, which in turn implies that absolute saving out of income will increase as well (marginal propensity to consume is less than unity). Second and closely related, profitable investment opportunities tend inadvertently to disappear as more and more capital is accumulated because of the operation of diminishing returns to capital (a well known property of every neoclassical production function). And as the gap between the availability of real savings and investment opportunities widens, the average rate of profit (rate of interest) must fall too, reaching eventually such a low level at which people simply do not like to make investments because of a too low rate of return to investment to “part” with their object of fetish – cash, regardless of how much cash they might have accumulated or how rapidly the purchasing power is eroded through “banking policy” (meaning inflation of money supply) of the government. The free-market economies were projected to remain forever in the “liquidity trap” unless a doctor and master and commander - the government comes to rescue the economic system from the excessive savings by means of the so-called fiscal policy, meaning in effect siphoning off private savings and channelling them into increased government “investment”, thereby steering the economic system toward full-employment and maximum production. The thesis of secular stagnation and the dawn of the new age of post-scarcity under the auspices of extensive government planning was an important theme of the *General Theory*.

Then came the self-styled “old” Keynesians whose distinguished mark was Paul Samuelson’s “synthesis” and the division between the short- and long runs. They disagreed with the “very old” Keynesians over the secular stagnation thesis because of the remarkable revival of the Western economies after the World War II. But the essential theoretical core was retained. Occasional short-run deficiencies in aggregate demand were still thought to be curable through the increases in investment spending by the government and injections of new and additional money. Even the end of business cycles was proclaimed. But then suddenly came stagflation. That was a really disturbing event for the economics profession.

The disillusionment with Keynesianism has brought about the doctrines of New-Classicism and New-Keynesianism on the economics profession. The distinctive feature of these new schools are the almost obsessive worries about rational and irrational expectations, market clearing, stickiness of prices,

wages and interest rates due to asymmetrical information, efficiency wages, supply shock and the like.

Now, what is crucial for our present discussion is not so much the degree of stickiness of prices and wages or asymmetry of information. No one denies that you cannot fool all people all the time and that there is some stickiness and that information is asymmetrically distributed. But all that is simply irrelevant in light of the fundamental agreement that exists between the mainstream schools over the respective roles of consumption and saving in the process of income formation. It is simply irrelevant how rational private households are in allocating their consumption between present and future consumption; it is simply irrelevant whether capital markets and the financial system react instantaneously or not so. As long as the basic conception of the “circular flow of macroeconomic activity” is held to be true, as long as the GDP is generally conceived to be “the most comprehensive measure of a nation’s total output of goods and services” and as long as separate counting of capital (intermediate) goods is thought to constitute double-counting, precisely that long all the subtleties that explicitly or implicitly build upon them will remain irrelevant. This is because, as I will show, it is the utterly fallacious understanding on the part of mainstream macroeconomics of the actual nature of aggregate production and aggregate spending that calls for a complete reconsideration of virtually everything in contemporary macroeconomic theory.

In order to show the utterly confused nature of the concept of “circular flow of macroeconomic activity” and to point the way to a correct analysis, I shall proceed in two steps. In the first step I will briefly examine that if using purely physical quantities involving capital goods and consumers’ goods, common sense and simple logic literally force us to include capital goods (intermediate goods) as well as consumers’ goods into the gross product. By analysing physical quantities it will become quite obvious that no double-counting is present if intermediate goods are counted in addition to the consumers’ goods despite of the fact that those intermediate goods are destined to be productively consumed in the subsequent stages of production. The second step will extend the analysis using monetary spending.

### *2.1 Example Involving Physical Quantities*

Imagine a group of people living on an island. Their economy is not very advanced but they possess enough skills to allow some division of labor and to

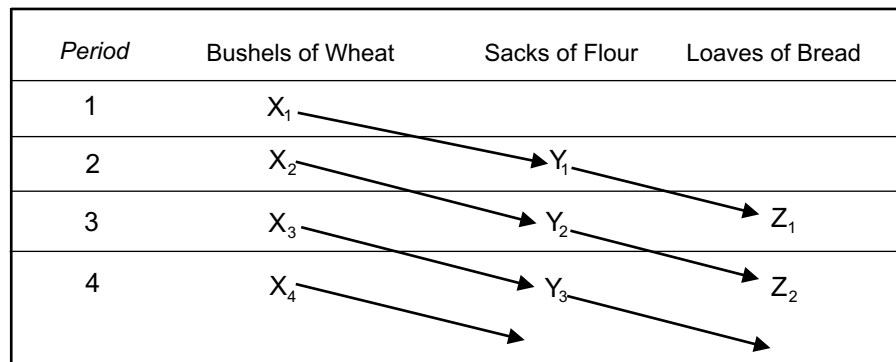


Figure 1: Gross Product and Productive Consumption

produce some capital goods with the help of which they produce a consumer good, say, bread. In order to be able to plan for the future, they decide to keep track of everything produced within a given period of time. Since bread cannot be created out of thin air, steady supplies of capital goods in the form of wheat and flour must be constantly available for an undisturbed and continuous production of bread.

In order to produce bread, of course, one needs to grow wheat first. Assume this takes up one period. After the wheat is grown, it can be made into flour. Making flour takes up another period. Finally, baking the bread takes up the third period. Now, this succession of periods is important because we have to realize that a production process takes time, and that before you can have flour you must grow wheat first, and that before you can bake bread you have to have a sufficient quantity of flour available. In other words, the production process of all of the intermediate goods involves more or less significant time as well as labor.

For the purpose of a better illustration of the processes involved, consider Figure 1.<sup>5</sup> Observe particularly that from the third *Period* on, the economy produces in every year some quantities of wheat, flour and bread simultaneously. So, we are certainly entitled to say that the total (gross) product of the third period consists of  $X_3$  wheat,  $Y_2$  of flour and  $Z_1$  of bread. And what about the net-product? Why we are interested in it? Precisely because we want to know whether the present production of capital goods will enable the economy to produce the same quantity of consumers' good in the future,

<sup>5</sup>This figure is an exact replica of the Figure 15-1 in Reisman(1996, p. 625.).

or a larger or smaller quantity. If the present production of capital goods exceeds the quantity of capital goods consumed in the present period, then the economy will be able to produce more consumers' goods in the next period. If it is less, then it will be possible to produce only correspondingly less consumers' goods in the next period. We can calculate the net-product in *Period 3* by subtracting the amount of capital goods productively consumed ( $X_2 + Y_1$ ) from the total (gross) product ( $X_3 + Y_2 + Z_1$ ). Now, the quantities  $X_2$  of wheat and  $Y_1$  of flour, which were produced in *Period 2*, are productively consumed in *Period 3*. They are productively consumed in the production of  $Y_2$  of flour and  $Z_1$  of bread, respectively. The entire produce of *Period 3* which consists of  $X_3$  of wheat and  $Y_2$  of flour and  $Z_1$  of bread goes in the case of  $X_3$  of wheat and  $Y_2$  of flour into further production, and in the case of  $Z_1$  is passed over to consumers.

Now, in regard to the process of production of bread and consumption of bread, this exercise makes unmistakably clear that in order to consume a certain quantity of bread one has to extend substantial material resources to the production of capital goods - wheat and flour. Furthermore, the gross product of any given period consists of capital goods and consumers' goods produced in that period. In order to calculate the net-product, one needs to subtract capital goods which have been productively consumed in the process of producing the  $Z_1$  of bread. In addition, as this example should make abundantly clear, by just counting the final product, bread, one does not count anything else besides bread itself.<sup>6</sup> It follows that counting the intermediate goods (wheat and flour) separately can never ever represent "double-counting" despite of the fact that capital goods eventually go down in the production of bread, i.e. which will eventually be productively consumed.

### 3 *Introducing Money*

The only escape-route for mainstream economics from the embarrassing situation it places itself every time it propounds the nonsensical notion that "final goods already include all intermediate goods used in their production" and denounces it as "double-counting" when one attempts to count intermediate goods separately and in addition to the final goods, is to argue that

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<sup>6</sup>In the interest of accuracy, I must point out that the final product (the net-product), is the sum of bread, a *consumer* good, plus more the excess or deficiency of capital goods produced in the period under consideration compared with the capital goods productively consumed in the process, which excess or deficiency can be called *net-investment*.

everything must change once money and monetary calculations are introduced. If it were true that the presence of money and monetary calculation makes it somehow possible that by buying final goods one also simultaneously buys intermediate goods, pays wages, and declares dividends throughout all stages of production, then, indeed, a separate counting of intermediate goods would constitute “double-counting”. But, of course, none of these is true. By buying consumers’ goods one does one and only thing, namely, one buys the consumer good in question; one neither buys intermediate goods, nor pays wages, nor declares dividends nor does anything but buys the consumers’ good.

Money serves important functions: it makes possible to calculate, to compare production alternatives, to provide for a smooth and steady flow of economic activity, but it certainly cannot eliminate either the multiplicity of separate stages of production, which involve employment of labor and capital goods, or the time element in the production process. Nor is it possible to perform the miraculous task and buy intermediate goods and pay wages in the very act by buying consumers’ goods. Just as physical units of every intermediate good must be produced, and every single working hour must be worked, so each of these transactions is accompanied by separately existing financial transactions.

Since money enters the analysis as a new element, a couple of distinctive features of the monetary economy must be closely observed. The law of identity and the requirements of internal coherency require us to keep the various spending flows involved strictly separated from each other. It means that demand for consumers’ goods is only and exclusively demand for consumers’ goods and which, therefore, stands in direct competition with the demands for capital goods and labor services. All three alternatives on which to spend money are mutually exclusive. This fact must always be kept in mind. Here J.S. Mill’s proposition that demand for commodities is not demand for labor comes into its full force and actual meaning. Alternatively formulated, neither demand for consumers’ goods, nor demand for capital goods constitutes demand for labor. Similarly, strictly speaking, demand for labor constitutes neither demand for capital goods, nor demand for consumers’ goods.<sup>7</sup>

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<sup>7</sup>Again, it should not be implied from this that demand for labor does not have any connection whatsoever to the production and sale of goods, either capital or consumers’ goods. It certainly does, but it is nevertheless true that we have to acknowledge the separateness and mutual exclusiveness of each of the events: spending for consumers’ goods, capital goods, and labor services. But just because a connection exists, of which

*3.1 The Role and Significance of Saving in the Production Process*

Before we come to a full appreciation of the position of consumption spending within the wider network of production and spending, we have to make some general observations concerning the role of saving in economic life. This is desperately needed in the light of very the peculiar, and completely erroneous, understanding on the part of mainstream economics of what saving is, from whence it comes, where it goes, and what significance it has for the production process. This understanding leads directly and inevitably to the conclusions that equate saving with hoarding, thus advancing the view that saving, i.e. not spending on consumers' goods, has potentially depressing effects.

If we define saving as money outlays not spent on consumers' goods<sup>8</sup>, simple logic and a little reflection on the actual facts of economic life would quickly lead us to recognize what an enormous role saved funds play in economic life. Even if we were to confine our case merely to such big ticket consumer items as major household appliances, personal automobiles, houses, etc., whose purchases cannot be financed out of current incomes because they exceed them more or less considerably, it would quickly become obvious that an important part of expenditures must come from individuals who save, i.e. who do not themselves spend their entire incomes and cash balances on consumers' goods.<sup>9</sup>

Indeed, an important portion of the savings of the wage-earners is made precisely for the purpose of buying homes, automobiles, flat-screen television sets and the like. It is nothing else than the fallacy of composition to argue that what is not spent on consumers' goods simply lands in cash balances, i.e. is being hoarded. What I save now for the purpose of buying a home in 10 years is presently used, for example, by a young couple to buy a house or automobile. When my time comes, I will be able to use the cash and buy a house myself.

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more below, it should not detract us from the elementary observation that demand for goods cannot simultaneously constitute demand for labor etc.

<sup>8</sup>Keynes himself defined it in the clearest terms: "Expenditure on consumption during any period must mean the value of goods sold to consumers during that period, which throws us back to the question what is meant by a consumer-purchaser. Any reasonable definition of the line between consumer-purchaser and investor-purchaser will serve us equally well, provided that it is consistently applied". Cf. Keynes(1936, p. 61.).

<sup>9</sup>The only other source that can provide the needed financial funds is the creation of new and additional money.

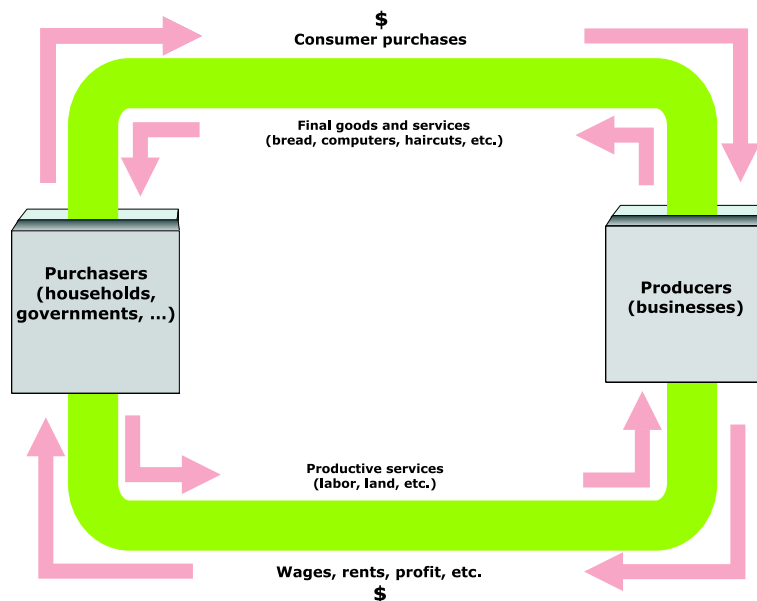


Figure 2: Circular Flow of Macroeconomic Activity

Apart from that, savings have a much wider and a much more fundamental significance. Gross savings of businessmen and capitalists out of sales revenues (out of sales revenues in the consumers' and capital goods industries) constitute the financial means for the demand for factors of production, namely, capital goods and labor services. Demand for capital goods, i.e. so-called intermediate goods, depends on saved funds. Indeed, the fact that the much greater proportion of existing factors of production are employed in the capital goods industries is what signifies the superiority of capitalistic, round-about methods of production. The same applies, of course, to the wages of wage earners as well. To wit, consumption of wage earners, which constitutes the greater bulk of the overall consumption spending in the economic system, has itself a very definite cause, namely, productive expenditure made by businessmen and capitalists explicitly on account of labor.

Now, if we get back to our discussion of the "flow of macroeconomic activity" we must notice the following radical points of disagreement, indeed outright intellectual hostility, between the mainstream understanding of the process of income formation and that of Reisman. Consider the following two

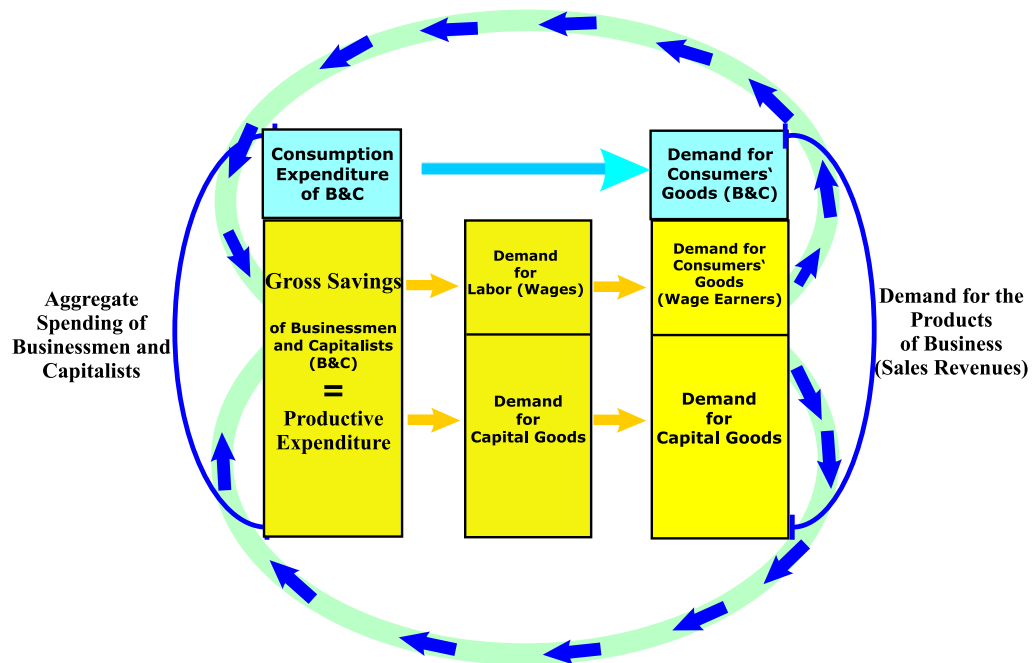


Figure 3: Structure of Aggregate Spending

figures to see clearly what is wrong with the mainstream view.<sup>10</sup> In Figure 2 we clearly see that the only spending stream that is taken into account here is the spending for final goods and services (shown as consumer purchases in the upper-loop). An illusion is created thereby that consumers not only purchase final goods but also at the very same time purchase intermediate goods, pay wages, land rents and distribute profits with the very same money they are supposed to spend on those consumers' goods. No other inference is possible. Indeed, introduce "unwanted" savings into the system and the flow "**Consumer purchases**" is diminished and with it naturally the demand for factors of production as well.

Now compare Figures 2 and 3 with each other. Figure 3 indicates in very precise terms how incomes are created and distributed, what goods are bought, and what is the precise relation between savings, productive expenditure and consumption expenditure. With the help of Figure 3 one is able to clearly recognize that consumption expenditure of wage earners indirectly depend on the demand for labor by businessmen and capitalists

<sup>10</sup>The Figure 2 is taken over from Samuelson/Nordhaus (2004, p. 425.).

because their wages are paid out of *saved funds*.

In regard to wages and the standard of living, one can infer, for example, the following. The demand for labor and capital goods are inversely related to the consumption expenditure of businessmen and capitalists. The higher the consumption of the latter, the less funds they will have to pay wages and to purchase capital goods. Similarly, the lower is the consumption of businessmen and capitalists, the more funds they will use for buying capital goods and labor services. It means, for example, that every tax on corporation profits, inheritances, distributed dividends etc. does directly cause the demand for capital goods and labor to fall.

Indeed, we can imagine an economic system where absolutely all sales revenues are consumed by the businessmen and capitalists (average propensity to consume of 1). It is simply not true, as some economists contend, that exactly the same portion of sales revenues will still be invested as before. Production process and capital structure do not maintain themselves; they are dependent on purposeful action of people who make the relevant business decisions, i.e. businessmen and capitalists.

What would be the result of a total withdrawal of productive expenditures? In such an economy there would be virtually no wages, no production of intermediate goods; the economic system would revert to the most primitive stage of societal organization, an economic system without division-of-labor. But apart from this extreme case, any increase in consumption expenditure (decline in savings and productive expenditure) operates to diminish exactly to the same extent the demand for factors of production: capital goods and labor services. If seen from this angle, it becomes crystal clear, for example, that increased government expenditure (fiscal policy), without a parallel increase in the money supply, can never create a single additional job. Indeed, by its very nature it deprives the businessmen and capitalists of the very means to demand additional labor and actually decreases demand for labor.

But the mainstream is apparently completely unaware of all these considerations. In its extremely narrow understanding of things, spending for final goods, of which consumption amounts to almost 90% (government spending must be counted as consumption as well), allegedly purchases capital (intermediate) goods and pays all incomes in the economic system - wages, profits, interest etc. as well as purchases final goods in question. This is the conclusion stated explicitly not only in the Figure 2 but also in the very method

with which they establish the equality.<sup>11</sup> This is the world of contemporary economics, “economics”, as Professor Reisman observed, “fully geared to the Keynesian fantasy world in which one not only can eat one’s cake and have it too, but in which one bakes one’s cake in the very act of eating it.”

### *3.2 Consumption as the Ultimate Purpose of All Economic Activity*

It may be that despite everything said, many people will still remain unconvinced. In the way I’ve presented things it may appear that consumption is at best relegated to a secondary position in economic life and at worst that it must be viewed as a virtual enemy of prosperity and full-employment (in diametrical opposition to the Keynesian understanding of things).

Some further clarifications on my part are in order. People are generally correct when they say that it is ultimately consumers who, by demonstrating their subjective preferences in their buying and abstention from buying, determine what goods will be produced and in what quantities. The pattern of consumer demand can be conceived as structured in descending order of importance for the consuming public. The existence of the most urgent needs is then communicated to the producers through the relative fractions of the incomes devoted to the demand for consumers’ goods destined for the satisfaction of those needs. Consumers’ goods for which consumers are willing to spend relatively more money will almost certainly catch the attention of businessmen and capitalists searching for profitable opportunities to invest. It is precisely the relative demands for various consumers’ goods that constitute the most important piece of information to potential producers. The structure of production is adjusted to the structure of consumer demand. It is important to realize that it is not the absolute level of the demand for consumers’ goods that is crucial here, but the relative composition of the aggregate consumer demand.

From the correct observation that consumption is the ultimate purpose of all economic activity, however, people draw the mistaken conclusion that an

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<sup>11</sup>It should come of no surprise, therefore, that the methodology of arriving at GDP using the so-called “value-added” approach – which provides the analytical basis for the claim that the value of consumers’ goods includes or covers the value of the intermediate goods – itself suffers from grave logical inconsistencies and is utterly contradictory. I abstain from dealing with these problems here. However, any interested reader, in particular a serious student of economics, is strongly advised to study very carefully the devastating critique originally provided in Reisman(1996, pp. 674–699), and applied in his recent article Reisman(2004).

increase in overall consumption spending will increase the aggregate demand for factors of production. Such thinking, which is implicitly present in Figure 2, is a clear instance of the famous fallacy of composition, namely, the fallacy of disregarding important consequences that will occur if some key elements of the system are modified. It is true that an increase in the demand for a particular good will probably cause reallocation of existing factors of production away from the industries now rendered less profitably to the industry or firm experiencing greater demand for its product. The change will be accompanied by a shift of capital funds (productive expenditure coming from the savings of businessmen and capitalists) from the industries and firms which were previously employing those funds in maintaining their operations, and which consumers have now chosen to patronize less. Thus, released capital funds will constitute the financial means to purchase labor services and to buy capital goods. What a firm or industry gains in the form of additional capital funds, all others must necessarily lose because at the same time the rest of the economic system will be experiencing a fall in the demand for their products.

To sum up the role of consumers, consumption spending and saving in the market process, I would like to quote John Stuart Mill, one of the most eminent classical economists, on the subject:

What supports and employs productive labor, is the capital expended in setting it to work, and not the demand of purchasers for the produce of the labour when completed. Demand for commodities is not demand for labour. The demand for commodities determines in what particular branch of production the labour and capital shall be employed; it determines the direction of the labour; but not the more or less of the labour itself, or of the maintenance or payment of the labour. These depend on the amount of the capital, or other funds directly devoted to the sustenance and remuneration of labour . . .

It is, to common apprehension, a paradox; and even among political economists of reputation, I can hardly point to any, except Mr. Ricardo and M. Say, who have kept it constantly and steadily in view. Almost all others occasionally express themselves as if a person who buys commodities, the produce of labour, was an employer of labour, and created a demand for it as really, and in the same sense, as if he had bought the labour itself directly,

by the payment of wages. It is no wonder that political economy advances slowly, when such a question as this still remains open at its very threshold. I apprehend, that if by demand for labour be meant the demand by which wages are raised, or the number of labourers in employment increased, demand for commodities does not constitute demand for labour. I conceive that a person who buys commodities and consumes them himself, does no good to the labouring classes; and that it is only by what he abstains from consuming, and expends in direct payments to labourers in exchange for labour, that he benefits the labouring classes, or adds any thing to the amount of their employment.<sup>12</sup>

#### 4 Conclusion

In this article I've attempted to show the deadly fallacies contained in the notion of "circular flow of macroeconomic activity" which provides the very conceptual framework for virtually all mainstream macroeconomic schools. The critique of the concept of Gross Domestic Product (GDP), which is widely accepted as being "the most comprehensive measure of a nation's total output of goods and services" but which actually counts almost exclusively just consumers' goods, has served to point out the consumption illusion of mainstream macroeconomics. Another objective of the article has been to show, using Professor Reisman's ideas, the enormous role played by the gross savings of businessmen and capitalists. Unlike mainstream economists who routinely view savings as possessing depressing potential on the economic activity, a correct account of things points the way to an entirely different understanding of the role savings play in the market process, and consequently to an entirely new macroeconomic theory along the lines of the Austrian and Classical schools.

Viewed from this new perspective, one may perhaps begin to understand the strange state of existence of mainstream macroeconomics. The world of contemporary economics is indeed a very strange one. But its strangeness is not a sign of unappreciated and evolving creativity or aesthetics but rather of its utter contradictory character and virtual intellectual bankruptcy. In practically all undergraduate economics courses around the world Keynesianism continues to be taught in the form of the basic IS/LM-model and its numer-

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<sup>12</sup>Quoted in Reisman(1996, pp. 683–684.).

ous extensions. The allegedly more “advanced” intermediate and graduate courses are reserved for the various versions of Neo-Keynesianism and New-Classicism. The old Keynesianism has been repeatedly proclaimed to be dead – meaning that it is an academically outdated model of macroeconomics. One often hears that “Keynes is dead” or that “no one is a Keynesian anymore” or similar statements. Neo-Keynesianism and New-Classicism represent the “sophisticated” macroeconomic theorizing of today.

But why this contradictory division? If Keynesianism is dead, then why is it still being taught at the universities and is propounded in news reports, business commentaries, and political speeches with vigor and apparently honest conviction? No one upholds the Ptolemaic model of celestial mechanics in astronomy anymore because it clearly fails to provide a theoretically coherent and non-contradictory account of many observable phenomena. Why is economics different? The usual analogy and reply is the following: the IS/LM-model may be not very accurate but it is still useful just as Newtonian mechanics still is despite the fact that, strictly speaking, Einstein’s model is far more coherent and provides a more general picture. Just so IS/LM-model allegedly provides a pretty accurate account of the basic macroeconomic relationships in the short run. In other words, it is allegedly nothing more than a handy tool to analyze and understand everyday economic relationships. However, the analogy is misplaced. Keynesianism is an economic variant of Ptolemaicism. It is utterly and completely contradictory, thus intellectually useless and potentially a dangerous tissue of fallacies.

The actual reason why old Keynesianism is retained is because it really provides the very foundation for all other currents in contemporary macroeconomics. If one accepts this basic set-up one is already in all essentials a full-bloodied Keynesian. Any possible disagreements about such subtleties as the speed with which markets clear, stickiness of wages and prices, rational expectations, animal spirits, the role of interest rate in equilibrating savings and investment etc. amount to nothing if the very basis upon which all that is built is utterly and completely fallacious. And it is this Keynesian framework that underlies virtually everything in contemporary macroeconomics. It is this framework that must be completely jettisoned because it advances a completely erroneous understanding of the most fundamental facts of the economic process. It is this tacit acknowledgment contained in “We all are Keynesians” made by no other than Milton Friedman that places him and all other self-styled Non-Keynesians in the same corner with the all species

of Keynesians.<sup>13</sup> They may feel uneasy in this alliance but it nevertheless remains a fact. It naturally follows that any theory which is built upon the Keynesian conceptual framework must be judged as utterly erroneous and contradictory as the framework itself.

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<sup>13</sup>His exact words were: "Some years ago, I remarked to a journalist from Time magazine, 'We are all Keynesians now; no one is any longer a Keynesian.' In regrettable journalist fashion, Time quoted the first half of what I still believe to be the truth, omitting the second half. We all use Keynesian terminology; we all use many of the analytical details of the General Theory; we all accept at least a large part of the changed agenda for analysis and research that the General Theory introduced." Cf. Friedman(1998).

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