ON THE TRUE MEANING OF SAY'S LAW

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"Men err in their productions, there is no deficiency of demand."

David Ricardo in a letter to T. R. Malthus
commenting on Say's Law
[(1819-1821) 1951-1973, VIII, 277]

The meaning of Say's Law may seem an issue of little relevance to economists today. It would seem, on the face of it, of interest only to historians of economics. Whatever Say's Law might mean, the one thing we economists know, or at least think we know, is that it was comprehensively refuted by John Maynard Keynes in his *General Theory of Employment, Interest and Money*. Knowing the meaning of this ancient economic doctrine would appear a matter of no contemporary importance.[1]

This paper will, however, argue that the disappearance of the guiding principles underlying Say's Law has grievously damaged our understanding of economic processes. The disappearance of Say's Law from amongst the conceptual tools employed by economists is in fact Keynes's most enduring legacy. A startling, and important, example of this legacy was shown in a recent article by Jonsson titled, "On the Economics of Say and Keynes' Interpretation of Say's Law" [1995]. In his article, Jonsson goes much of the way towards bringing out the implications of Say's Law to Say and other classical economists. Jonsson correctly demonstrated that J.-B. Say not only had a theory of the cycle, but that this theory was also, in its basic features, the same as the modern theory of the cycle based on co-ordination failure.

Yet in presenting his argument, Jonsson actually continues the distortion represented by the modern interpretation of Say's Law by writing that Say not only does not deny the possibility of gluts, but "goes on to attribute such gluts to a failure of effective demand" [*ibid.*, 148]. John Stuart Mill, too, is deemed by Jonsson to have accepted the possibility of deficient aggregate demand during recession [ibid., 153]. This claim, that classical economists in general accepted that recession might occur as a result of demand failure, is a serious misunderstanding of the central issue in the classical controversy over the validity of Say's Law.

Indeed, the importance of the law of markets in classical economic theory was precisely that it denied that demand failure might be a cause of recession. Whether expressed by the words "there is no such thing as a general glut" or stated as the proposition that overproduction is impossible, it was this conclusion which was meant. Recessions and the associated high unemployment were never the consequence of demand failure. And it was to this proposition that every major economist, prior to the publication of the *General Theory*, assented. To believe that demand failure might

be responsible for recession was seen as utterly fallacious. No economist would, however, have denied that recessions were entirely possible.

Since the publication of the *General Theory* the meaning of Say's Law has radically shifted. The phrase which has become associated with Say's Law are the words introduced by Keynes, "supply creates its own demand" [1936 (1973), 18]. By this was meant that everything produced would be bought. Therefore, according to Keynes, if Say's Law were true, then recession and high rates of unemployment were theoretically impossible, or if they occurred at all, would be very brief. Thus, the meaning that attached itself to Say's Law related to the very possibility of recession which classical economists were said to have denied.

But the *General Theory* was not a discourse on the history of economics. It had a deadly serious intent, which was to overturn the judgement associated with Say's Law. Where classical economists had denied the possibility of demand failure, Keynes set about trying to demonstrate that demand failure was the single most important cause of recession and unemployment. In this he was wildly successful. The result was that a theory of recession which had been almost universally rejected by economists for more than a century became the mainstream.

Two passages from the *General Theory* capture Keynes's intent. The first, taken from the introduction to the French edition, outlines Keynes's view of the assumption of full employment implicit in Say's Law:

> I believe that economics everywhere up to recent times has been dominated, much more than has been understood, by the doctrines associated with the name of J.-B. Say. It is true that his 'law of markets' has been long abandoned by most economists; but they have not extricated themselves from his basic assumptions and particularly from his fallacy that demand is created by supply. Say was implicitly assuming that the economic system was always operating up to its full capacity, so that a new activity was always in substitution for, and never in addition to, some other activity. Nearly all subsequent economic theory has depended on, in the sense that it has required, this same assumption. Yet a theory so based is clearly incompetent to tackle the problems of unemployment and of the trade cycle. [*ibid.*, xxxv]

The second passage extends this concept to the problem of demand deficiency which Keynes rightly points out had been a settled question since the start of the nineteenth century:

> The idea that we can safely neglect the aggregate demand function is fundamental to the Ricardian economics, which underlie what we have been taught for more than a century. Malthus, indeed, had vehemently opposed Ricardo's doctrine that it was impossible for effective demand to be deficient; but vainly. For, since Malthus was unable to explain clearly (apart from an appeal to the facts of common observation) how and why effective demand could be deficient or excessive, he failed to furnish an alternative construction; and Ricardo conquered England as completely as the Holy Inquisition conquered Spain. Not only was his theory accepted by the city, by statesmen and by the academic world. But controversy ceased; the other point of view completely disappeared; it ceased to be discussed. The great puzzle of effective demand with which Malthus had wrestled vanished from the economic literature. [*ibid.*, 32]

Although Keynes describes the impossibility of demand failure as "Ricardo's doctrine," this was in fact Say's Law. And with the publication of a single book by a master polemicist, the law of markets disappeared. While debate raged on almost every aspect of the *General Theory*, none of it revolved around the question of the validity of Say's Law. Say's Law simply vanished. In its place arose the universal acceptance that variation in demand was the major source of economic instability. Raising demand became the central policy solution offered by economists during recession.

OSKAR LANGE

The meaning of Say's Law was then further distorted in a 1942 paper by Oskar Lange, "Say's Law: a Restatement and Criticism". Lange took the same position as Keynes, but curiously only referred to the *General Theory* in passing. It is an article that, to all appearances, could have been written whether the *General Theory* had been published or not.[2]

Keynes had defined Say's Law as "supply creates its own demand", meaning that every addition to supply would be bought. It is from this standpoint that Lange also begins. His opening words are, "Say's law is the proposition that there can be no excess of total supply of commodities (general oversupply) because the total supply of all commodities is *identically* equal to the total demand for all commodities" (Lange [1942] 1970: 149). In other words, everything produced will be sold. Both Keynes and Lange agreed that recession and involuntary unemployment are ruled out by Say's Law because total demand is always equal to total supply.

According to Lange, the central issue surrounding Say's Law was the demand for money:

> Say's law implies a peculiar nature of the demand for money, namely, that the individuals in our system, taken together, are always satisfied with the existing amount of money and never wish to hold either more or less. There is never a desire to change the total cash balances otherwise than to adapt them to changes in the amount of money available. Under these circumstances, purchases of commodities are

> never financed from cash balances nor do sales of commodities serve to increase cash balances. [*ibid.*, 153]

Lange concluded that Say's Law could only apply in a barter economy. Money had no role other than as a worthless medium of exchange, which was never held for its own sake. The price level was therefore indeterminate, although relative prices could be determined. As Lange wrote, "Say's Law precludes any monetary theory. The theory of money must, therefore, start with a rejection of Say's Law" [*ibid.*, 167].

Thus, according to Lange, acceptance of Say's Law meant firstly, the existence of unemployment and recession and secondly, the development of a coherent monetary theory were both logically impossible. This was the foundation from which the modern interpretation of Say's Law was to evolve.

BECKER AND BAUMOL

The most significant aspect of Lange's paper was that it touched off a decade-long discussion which was finally brought to an end by a classic paper written by Gary Becker and William Baumol and published in 1952. The paper was appropriately titled, "The Classical Economic Theory: The Outcome of the Discussion." It was this paper which crystallised the modern interpretation of Say's Law.

But in summing up, the unimportance of Keynes and the *General Theory* in generating this debate is unmistakable. Becker and Baumol state that they "consider the attack on the earlier writers to have been opened by Lange" [Becker and Baumol 1952, 355]. The views of Keynes are not even given passing mention as a stimulant to the debate.

Of crucial importance, Becker and Baumol deny that classical economists had held views which ruled out the possibility of recession and unemployment or that their views on monetary theory were incoherent. Their conclusion, stated in the introductory section, is that:

> It will be argued through re-examination of some of the classical writings that most of the group probably never held views like those ascribed to them. . . . Many of the members of that group, among them some of those specifically accused, have passages in their writings which explicitly contradict the charges against them. . . . In most cases where the problem was considered *explicitly*, it was analysed in a manner which is at least formally valid. [*ibid.*, 355-56]

But in terms of the modern understanding of Say's Law, the major contribution made by Becker and Baumol was to distinguish between what they called "Walras' Law", "Say's Identity" and "Say's Equality." "Walras' Law" as they defined it meant that total demand, including the demand for money, is equal to total supply, including the supply of money. This is merely a definition and has no economic implications. "Say's Identity" referred to the proposition that the total demand for goods is always equal to the total supply of goods. Therefore, variations in the demand for money do not affect the level of economic activity. It is this proposition which came to be seen as the meaning of Say's Law contained in the *General Theory*. Finally, they introduced the term "Say's Equality" which they defined to mean that while the demand for goods may move out of equilibrium with the supply of goods, the processes of the economy will rapidly bring the two back into equilibrium. This proposition became generally accepted as the meaning of Say's Law held by classical economists.[3]

Say's Law was in this way incorporated into monetary theory so that it could then be rejected. It was seen as a statement about the demand for money. Say's Identity assumed no variations in the demand for money which in turn meant no variations in the demand for goods and services. Recessions in this setting were therefore impossible. Say's Equality assumed there could be brief periods during which monetary disequilibrium could occur, so that there could be brief periods of recession.

This interpretation was further reinforced by Baumol's 1977 article, "Say's (At Least) Eight Laws, or What Say and James Mill May Really Have Meant," which was his second venture into the area and in which he recognised that there was more to Say's Law than had been previously recognised. While indeed recognising that there was far more to Say's Law than had been captured in his earlier article, his conclusion was that Say's Law meant Say's Equality:

> Thus the eighth (and for our purposes the last) of Say's eight propositions is Say's Law itself. Apparently this takes the form of a type of Say's equality, i.e., supply and demand are always equated by a rapid and powerful equilibration mechanism. [1977, 159]

That is, the actual meaning of Say's Law is that "supply and demand are always equated by a rapid and powerful equilibrating mechanism." This is the textbook conclusion on Say's Law found today. Recessions can occur, but they will be brief because of this powerful equilibrating mechanism.

The wash up is that classical economists have been absolved of being the fools that Keynes made them out to be without actually having to say that Keynes was especially wrong. The compromise has been that Keynes argued that classical economists had accepted Say's Identity (no changes ever in the demand for money) but that they had in fact accepted Say's Equality (the possibility of a short period of disequilibrium). But it was all history anyway so what difference did it really make?

CLOWER, LEIJONHUFVUD AND "SAY'S PRINCIPLE"

There is one additional facet in the modern interpretation of Say's Law. This is Robert Clower's and Axel Leijonhufvud's introduction into the literature of the concept they term "Say's Principle." In their work, they see themselves as providing a proper interpretation of Keynes. But rather than properly interpreting Keynes, they have instead gone a long way toward re-discovering the law of markets. The basic operating principle of Say's Law is that demand is constituted by supply: one makes

purchases with the receipts from one's sales. The "Say's Principle" variant of Say's Law is defined as follows:

> No transactor consciously *plans* to purchase units of any commodity without at the same time *planning* to finance the purchase either from profit receipts or from the sale units of some other commodity. [Clower 1984a, 47]

What Clower appears to have in mind is a process in which goods buy goods through the mediating role of money, the fundamental concept underlying Say's Law. Clower was undoubtedly aware of his parallels with classical economic theory when he wrote:

> *Money buys goods and goods buy money; but goods do not buy goods.* This restriction is —or ought to be—the central theme of the theory of a money economy. [1984b, 86]

What Clower has done is impose an equilibrium condition in which everyone is able to finance all of their planned purchases [1984a, 48] and then consider the implications when reality differs from expectation. He finds that such miscalculations lead to involuntary under-consumption which is his counterpart to involuntary unemployment [*ibid.,* 51]. By structuring the argument in this way, Clower has brought economic theory full circle. His theory of the cycle is in all its essentials classical theory, based on Say's Law, which is built from the understanding that demand is constituted by supply. And the irony of it is that he and Leijonhufvud describe their argument as what Keynes really meant in the *General Theory.*

THE MEANING OF SAY'S LAW IN CLASSICAL ECONOMICS

To understand the actual meaning of Say's Law, and why its disappearance has made the most profound difference to economic theory, the best place to start is with the controversy out of which Say's Law grew. Although the law of markets is now generally referred to as *Say's* Law, Say was not in fact the originator of the essential proposition denying the possibility of demand deficiency. The actual originator of Say's Law was James Mill who was responding to an 1807 pamphlet written by William Spence. Spence had argued that it was demand which was at the heart of the wealth creation process:

> It is clear, then, that expenditure, not parsimony, is the province of the class of land proprietors, and, that it is on the due performance of this duty, by the class in question, that the production of national wealth depends. And not only does the production of national wealth depend upon the expenditure of the class of land proprietors, but, for the due increase of this wealth, and for the constantly progressive maintenance of the prosperity of the community, it is absolutely requisite, that this class should go on progressively increasing its expenditure. [1807, 33]

It is spending which causes wealth to grow, not saving. And Spence makes no bones about it as this example shows:

> The *prosperity* of the country would be as much promoted, if an owner of an estate of 10,000l. a year, were to expend this sum in employing 500 men to blow glass bubbles, to be broken as soon as made, as if he employed the same number in building a splendid palace. . . . The 500 glass blowers would require as much wealth to be brought into existence from the soil, would consume as much food, and would consequently be as prosperous, as the 500 palace builders. [*ibid.,* 36]

Spence owns that it would be better to build palaces since this would add to the capital stock of the nation. But even so, the creation of no value at all would have the same economic effect on the level of prosperity as the building of a palace. There is no substantive difference between this and Keynes in the *General Theory.*

> Pyramid-building, earthquakes, even wars may serve to increase wealth, if the education of our statesmen on the principles of the classical economics stands in the way of anything better. . . .
>
> If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coalmines which are then filled up to the surface with town rubbish, and leave it to private enterprise on well-tried principles of *laissez-faire* to dig the notes up again . . . there need be no more unemployment and, with the help of the repercussions, the real income of the community, and its capital wealth also, would probably become a great deal greater than it actually is. [*op.cit.,* 129]

Keynes too stated that it would be better to build something useful, but argued that even completely unproductive spending would add to wealth. And for both Keynes and Spence, it was the restrictions in demand caused by saving which was at the heart of the problem [see Spence, 1807, 31-32].

It was to this kind of argument in Spence that James Mill replied. And this is why the argument moves in the way it does from demand deficiency to the causes of recession. Mill finds it beyond comprehension that someone should recommend wasteful expenditure as a means of generating wealth. Spending is a depletion of wealth while saving adds to it. The idea of spending one's way to prosperity was the worst sort of nonsense to Mill as it was to the entire classical school.

But while denying that demand deficiency was possible, Mill did not argue that everything produced would find a market at cost covering prices. He made the point

which was made by every classical economist which was that the goods produced had to be the goods that would be demanded. Mill puts the qualification in this way:

> All that here can ever be requisite is that *the goods should be adapted to one another*; that is to say, that every man who has goods to dispose of should always find all those different sorts of goods with which he wishes to supply himself in return. [*op. cit.*, 136, italics added]

And it was from this that the theory of recession built on misdirected production grew. Recessions were not due to insufficient demand but to the wrong goods and services having been produced.

But while this early skirmish touched on the central issues of Say's Law the real battle commenced with the publication, in 1820, of Malthus's *Principles of Political Economy*. Malthus was extraordinarily well known as a result of the publication of a previous work.[4] The enormous prestige of Malthus's *Principles of Population* meant that more than normal attention would be drawn to his views on economic issues. And what profoundly differentiated Malthus from virtually every other economic writer of his time was his belief that demand deficiency could cause recession.

The reaction to Malthus was swift and furious. Within a few years, a series of books and pamphlets were published in which an attack on Malthus's views formed a major component. Works were written by James Mill, J.R. McCulloch, Robert Torrens and J.-B. Say. The fourth edition of Say's *Treatise*, which was the most recent edition at the time, was translated into English. David Ricardo wrote a series of notes on Malthus's *Principles* which were not, however, published in his own lifetime. There was also an on-going correspondence between Ricardo and Malthus on the possibility of demand deficiency. This controversy was what became known as the "general glut" debate, and according to Sowell, continued for almost three decades until the publication of John Stuart Mill's *Principles* in 1848 [Sowell, 1972, 14]. But when the dust had finally settled, the consensus amongst economists was that demand deficiency (a general glut) was impossible.

SAY'S LAW AND THE THEORY OF RECESSION

Say's Law denied the possibility of demand failure. What then caused recession? It is in explaining the generation of the business cycle that classical theory overlaps with the modern theory of recession. What modern theory refers to as co-ordination failure classical theory described as miscalculation or "disproportionality." Recessions were due to cumulative errors in the production process.

McCulloch was extraordinarily clear on this, tying in the law of markets with the process of recession.

> Setting apart for the moment the influence of sudden changes in the value of money, and of political regulations,[5] if the market be encumbered and a difficulty be experienced in effecting sales, we may be satisfied that the fault is not in producing too much, but in producing articles which do not suit the tastes of buyers, or which we cannot ourselves consume. . . . We may increase the power of production ten or twenty times, and be as free of all excess as if we diminished it in the same proportion. *A glut never originates in an increase of production; but is, in every case, a consequence of the misapplication of the ability to produce*, that is, of the producers not properly adapting their means to their ends. Let this error be rectified, and the glut will disappear. [(1864) 1965, 155-56, italics added]

That McCulloch believed he was doing no more than stating the very essence of Say's Law is shown by the footnote placed at the end of this discussion:

> Say was the first who showed, in a full and satisfactory manner, that effective demand depends upon production (see his chapter *de Débouchés*); and that gluts are the result of the misapplication, and not of the increase, of productive power. [*ibid.*, 156n]

What McCulloch was saying was that output could never outpace demand. Demand deficiency would therefore never be the cause of recession. When recessions occurred, they were due to errors in production, not to failure of demand. And all of this was part and parcel of the law of markets.

Where the concept of Say's Law and the theory of recession were brought together was through the recognition that demand was constituted by supply ("effective demand depends upon production"). The point was that one made purchases with the money received from the sale of one's own productions. If saleable goods were produced, then an income with which to buy other goods was earned. Such a situation could continue indefinitely.

But once errors were made in the production process, so that what producers had produced did not correspond to what buyers wished to buy, then some goods, in what was referred to as a "partial glut," would remain unsold. Incomes would then fall below expectations, employment numbers would be reduced and the demand for other products would decrease. The consequences of partial glut in some parts of the economy could thus reverberate through the economy as a whole and would often end in recession. Recessions were thus conceived as structural. It was not the level of demand which mattered, but the structure of demand relative to the structure of supply.

That this theory of recession, based on Say's Law, remained a constant amongst the mainstream of the economics profession may be seen in the following extract taken from Taussig's introductory text on economic theory. In it he denied the possibility of overproduction in the sense of demand deficiency in a way which perfectly captured classical reasoning:

> Some of the phenomena connected with crises, and especially the course of events during a period of depression, have been ascribed to overproduction. During times of depression, it would seem, more is

> produced than can be readily sold or than can be sold at a profit: is there not general overproduction?
>
> These phenomena, however, result from the breakdown of the machinery of exchange. They are not due to permanent or deep-seated difficulties of finding an extensible or profitable market. They are due to the fact that confidence has been shaken, credit disturbed, the usual course of production and sale subjected to shock. . . . *They are little related to those supposed limitations of demand* and those possibilities of permanent overinvestment, which are urged by the persons who maintain that there is danger of general overproduction. . . . These things correct themselves in time. The mechanism of exchange is restored to its normal working, and the maladjustment in production is set right. [1927, ii, 60-61, italics added]

That is, demand deficiency is not the cause of recession. Demand would never fall short of properly proportioned supply. Recessions are due to "maladjustment in production", or in more modern terms, co-ordination failure. This is a line of argument which can be traced back to the earliest classical writers, and it is this which is based on the principles which lie behind Say's Law.

CONCLUSION

The very essence of the Keynesian revolution was that it introduced the concept of deficient aggregate demand into mainstream economic theory. This had been the subject of the most intense debate amongst economists during the opening decades of the nineteenth century and which was settled in favour of those who denied demand failure as a cause of recession. Keynes was absolutely right in categorising the issue which divided Malthus from Ricardo as being over whether the aggregate demand function "could be safely neglected." The conclusion accepted by virtually all economists up until 1936 was that demand failure is an irrelevancy in terms of the generation of economic fluctuations and unemployment. It was this conclusion that constituted Say's Law.

What followed from this conclusion was the need for a theory of recession not built on demand failure. The theory which emerged fit seamlessly into the concepts underlying Say's Law. According to the Law, demand was constituted by supply. Therefore, what might appear to be failure of demand was in fact a mismatch between supply and demand. Some form of business miscalculation was the fundamental cause, or in more modern terms, recessions were due to co-ordination failure. To suggest that classical economists would have conceived recessions in terms of demand failure ascribes to them the position taken by Keynes in the *General Theory* and portrays classical economists as having accepted conclusions they would have instead rejected out of hand.

It was the publication of the *General Theory* which was the crucial turning point. The further contributions of Lange and then Becker and Baumol helped to obscure

the original meaning of the law of markets but it was Keynes's initial influence which was crucial.

Economists, due to the enormous influence of the *General Theory*, have been in the theoretical wilderness for the past sixty years. They have lost the guiding influence of one of the most important economic principles ever developed. They have instead taken on board the possibility of demand deficiency and, it is safe to say, virtually all undergraduates since the end of the second World War have been taught macroeconomic theory in terms of fluctuations in aggregate demand. For more than a century, until the publication of the *General Theory*, acceptance of the possibility of demand deficiency was recognised as a fallacy which made a proper understanding of economic issues almost impossible. A return to an economic theory guided by Say's Law would mean a return to theory which denied the possibility of demand failure and accounted for recession and unemployment by other means.

NOTES

1. It is something of a solecism to employ the words "Say's Law." Classical economists would speak of the law of markets or vent, or would refer to *des débouchés* which was the title of the relevant chapter in Say's *Treatise*. The term "Say's Law" was first used by F.M. Taylor in 1921 although not in a sense entirely consistent with classical usage [Kates, 1995]. Keynes's use of the phrase "Say's Law" in 1936 would set in stone the modern form of words to describe what had until then been generally referred to in other ways.
2. There are only two references to Keynes and the *General Theory* in the article, and both are in footnotes. The first [Lange (1942) 1970, 155n] occurs six pages into the article and deals with Keynes' distinction between user costs and supplementary costs. Seven pages later, Lange distinguishes the excess supply of primary factors from the Keynesian definition of involuntary unemployment. One would not know from this article that Keynes had ever employed Say's Law in any of his written work, still less that he had devoted the *General Theory* to its refutation.
3. A particularly thorough discussion of these concepts may be found in Blaug [1985, 149-60].
4. Keynes was in a similar position, having become world famous through the publication of *The Economic Consequences of the Peace* [1919].
5. McCulloch was not, of course, attempting to deny that changes in the value of money and political regulation could cause recession. He understood perfectly well that both could cause recession and often did.

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