Etceteras . . .

Animal Spirits and Regime Uncertainty

J. Robert Subrick

Can John Maynard Keynes's ideas explain why expansionary fiscal policy does not in some cases spur economic recovery? The surprising answer is yes. In a famous passage in *The General Theory of Employment, Interest, and Money,* Keynes explains the importance of irrational action in overcoming rational indifference. I refer, of course, to his well-known notion of "animal spirits." He writes:

> Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. 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. ([1936] 1953, 161)

Animal spirits are spontaneous urges to act that have no basis in rational calculation. People act on "whim or sentiment or chance"; they do not calculate expected values (Keynes [1936]1953, 163). Rationality alone would prevent action from taking place in some instances. People sometimes do not know the likelihood of various outcomes. There are unknown unknowns. If one has no probabilities to assign to alternative courses of action, how does one make a decision? In these cases, rational

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calculation would lead to the plight of Buridan's Ass, which died rather than make a decision with no clear rational basis. Animal spirits overcome the dilemma. They cause people to act in the presence of uncertainty. When animal spirits disappear, however, actions cease, and problems arise. Keynes explains: "Thus if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die;—though fears of loss may have a basis no more reasonable than hopes of profit had before" ([1936] 1953, 162).

The demise of animal spirits leads to economic contraction. Without "spontaneous optimism," people stop spending. They hoard money. Consumption and investment decline. People lose their jobs, and unemployment rises. Gross domestic product decreases, and recession ensues. In extreme cases, depression occurs and persists.

Keynesian policymakers advocate expansionary fiscal policy to counteract the decline in private-sector activity. The government becomes the spender of last resort. The increase in government spending offsets the decrease in private-sector purchases. But government spending requires that individuals form expectations about the magnitude, length, and distribution of public-sector activities. In some cases, no meaningful probabilities can be assigned to various courses of government action. Joseph Schumpeter recognized the role of public policy in undermining the calculation of probabilities during the 1930s in the United States.

> The subnormal recovery to 1935, the subnormal prosperity to 1937 and the slump after that are easily accounted for by the difficulties incident to the adaptation to a new fiscal policy, new labor legislation and a general change in the attitude of government to private enterprise all of which can . . . be distinguished from the working of the productive apparatus as such. . . . [S]o extensive and rapid a change of the social scene naturally affects productive performance for a time, and so much the most ardent New Dealer must *and also can* admit. ([1942] 1962, 64–65, emphasis in original)

Businesspeople could not form reliable expectations about public policy. Laws and regulations came and went in quick succession. The Supreme Court deemed some New Deal legislation unconstitutional. The basis for pubic-policy decisions seemed unpredictable. As a result, public policy created "regime uncertainty" (Higgs 1997). Besides increasing regime uncertainty, can public policies dim animal spirits?

Keynes argued that they can. That is, government actions may dim the spontaneous urge to act. Public-sector decisions not only affect the probable consequences of various courses of action but also influence animal spirits. Two paragraphs after the passage describing animal spirits, Keynes writes about the potential adverse effect of public policy: "This means, unfortunately, not only that slumps and depressions are exaggerated in degree, but that economic prosperity is excessively dependent on a political and social atmosphere which is congenial to the average business man. *If the fear of a Labour Government or a New Deal depresses enterprise, this need not be the result either of a reasonable calculation or of a plot with political intent;—it is the mere consequence of upsetting the delicate balance of spontaneous optimism*" ([1936] 1953, 162, emphasis added).

Animal spirits have unsound foundations. Once they are cracked, it takes time to repair them. Simply having the public sector "do something" does not always fix the problem. Public policy's smothering of the urge to act may make matters worse by stifling spontaneous optimism. It sometimes fails to create "a political and social atmosphere which is congenial to the average business man" and thus gives rise to a hostile business environment.

Fear created by government policies can depress aggregate demand. Mathematical expectations about the likely effects of policy may be uncertain, but private-sector trepidation can also arise when governments attempt to increase economic activity in a haphazard manner. After all, animal spirits do not reflect rational calculation. Businesses that are prone to form unreasonable beliefs and fail to act because of market uncertainties are the same businesses that respond to government actions and rhetoric with inaction. Private firms may react to public spending by further reducing their expenditures. Firms may save the money they might have used to increase their spending. Banks may not lend but instead build up reserves.

Keynes recognized that regime uncertainty complements the dimming of animal spirits. Businesspeople's inability to form expectations about public policy is one problem. Decisions made in the presence of genuine uncertainty lack a rational foundation. But the government's actions may also reduce private actors' spontaneous urge to act. Weakness of animal spirits does not necessarily justify expansionary fiscal policy because it does not always foster increased optimism.

N. Gregory Mankiw assesses the relevance of Keynes's ideas for understanding the modern world. He identifies a number of dubious claims regarding Keynesian economics. The first is that "learning how the economy works is best achieved by a careful reading of Keynes's *General Theory*" (1992, 560). Fair enough. But a close reading of Keynes would itself remind economists that animal spirits cannot necessarily be invigorated simply by the government's spending more money.

References

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