

# ***Das Maynard Keynes Problem: Rethinking Rationality***

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## **Abstract**

As with Adam Smith in *Das Adam Smith Problem*, critics have observed that, across the large body of work produced in John Maynard Keynes's lifetime, Keynes displays a shifting or even inconsistent view of rationality. In the *Treatise on Probability*, Keynes argues that economic actors use all available information to make rational decisions. In *The General Theory*, however, Keynes argues that people are irrational and are highly susceptible to psychological forces. This paper seeks to reconcile both views by arguing that, if one allows economic actors to display a range of rationality, Keynes's work is wholly consistent.

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## **I. Introduction**

For any great intellectual who produces an enormous body of work, tracing his philosophical foundations and precise intentions is a valuable but daunting task. For Adam Smith, critics were intrigued by the transformations and inconsistencies in arguments of his two most prominent works. In *The Theory of Moral Sentiments*, Smith was an advocate of sympathy for our fellow human being. In *The Wealth of Nations*, however, he became a strong advocate of self-interest, arguing that it was the primary motive behind economic behavior and the driving force of the economy. This selfless/selfish mismatch has led many economists following in Smith's footsteps to question which stance he truly intended and whether the two can be reconciled. Either reading of his intentions can lead to vastly different interpretations of his theories and his legacy. Such was the nature of *das Adam Smith problem*.

For John Maynard Keynes, interpreters of his work face a similar problem. With *das Maynard Keynes problem*, the dispute centers around Keynes's views on rationality. In the *Treatise on Probability*, Keynes argues that economic actors were essentially rational. People use

all the information available to form accurate probabilities about the world, and thereby make rational decisions. By contrast, in *The General Theory of Employment, Interest, and Money*, Keynes depicts economic actors as fundamentally irrational. Instead of using well-reasoned probabilities, they rely on conventions established by other people to make decisions and are highly susceptible to destabilizing psychological forces. Far from being a trustworthy agent, economic man is apt to be poorly informed, quirky and downright fickle.

This clash over rationality/irrationality strikes at one of the core assumptions of economics as we know it today. Many of our basic, commonly used models assume rationality. However, are people rational actors who unfailingly abide by Benthamite calculus, or do they behave in more unpredictable, irrational ways? Between *Probability* and *General Theory*, Keynes presents models of economic thought processes which point to the two extremes, irrationality and rationality. However, in reconciling these two polarized views, we find that Keynes in fact has taken a more holistic view of how people filter information to make decisions. This approach is seldom highlighted in a study of Keynesian economics but is nonetheless an integral part of the Keynesian understanding of how the economy functions. Far from pigeonholing the economic mind to either extreme, Keynes's models suggest that economic agents respond to circumstances and information available to exhibit a *range* of rationality. *Das Maynard Keynes problem* sheds light on how people can be both more and less rational than is commonly captured in economic theory.

## **II. Rationality in the *Treatise on Probability***

Tracing Keynesian thought back to the *Treatise on Probability*, rationality is a philosophical notion that is closely intertwined with probability. Like G. E. Moore and Bertrand

Russell, Keynes subscribes to a brand of “ontological realism”; he believes that “things and concepts have a real existence.”<sup>1</sup> Probability forms the “philosophical foundations of rational but non-conclusive argument.”<sup>2</sup> Probability essentially is “a logical relation between two propositions”: a set of premises,  $h$ ; and a related conclusion,  $a$ .<sup>3</sup> For instance, the set of propositions,  $h$ , which describe all the relevant information available on a subject, may contain information on the economy’s historical growth rate, how different sectors are currently performing, the state of business expectations, etc. The corresponding conclusion,  $a$ , may deduce from  $h$  that the economy will grow at 6% next year. The probability of  $a$  being true relative to the data set  $h$  is then  $a/h$ , where  $0 < a/h < 1$ . The notation does not imply division per se, but does denote a ratio to convey the degree of rational belief in  $a$  given  $h$ . By extension,  $a/h = 1$  implies a logical deduction tantamount to truth;  $a/h = 0$  implies a logical impossibility (which means that  $-a/h = 1$ , where the minus sign represents “not”).

Based on these concepts, Keynesian probability can be described as an “objective logical relation” that captures the world in absolute terms.<sup>4</sup> These probabilities are unique; they have “the same value for all individuals with the same information.”<sup>5</sup> Subjective probabilities, by contrast, vary depending on the value assigned by each individual. If probabilities are objective, they make a positive statement which should inform each individual’s decision-making process in the same way. Hence, this approach postulates that rational behavior entails people using unique, positive probabilities to draw logical conclusions and finally make decisions. All rational individuals with the same information set should arrive at the same rational conclusion.

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<sup>1</sup> Bradley Bateman, “Das Maynard Keynes Problem,” *Cambridge Journal of Economics*, 15 (1991): 104.

<sup>2</sup> R. M. O’Donnell, *Keynes As Philosopher-Economist* (New York: St. Martin’s Press, 1989), 5.

<sup>3</sup> Bateman, “Das Maynard Keynes Problem,” 104.

<sup>4</sup> Ibid.

<sup>5</sup> Bradley Bateman, *Keynes’s Uncertain Revolution* (Ann Arbor: The University of Michigan Press, 1996), 50.

The beauty of this approach lies in the fact that it suggests that the economy possesses a predictable stability. Each economic actor can arrive at a rational conclusion, which he can reason that every other economic actor will share. Hence, all economic actors will have a perfect understanding of the aggregate outcome, and with some application of game theory, they can bring the system to equilibrium. Barring any further shocks to the system, this equilibrium is self-sustaining because of the collective rationality embedded in the system. In the event of shocks, rational economic agents will simply assimilate the new information, form new probabilities, make decisions, and make the necessary adjustments to bring the economy to its new equilibrium. Rationality seems to act as a self-correcting force of inertia to provide the system with right nudges towards equilibrium and, by implication, often optimality as well. To that end, the *Treatise On Probability* strongly defines one end of the rationality spectrum: people will act in accordance with strict rationality if given complete information.

### **III. Dealing With Uncertainty: Irrationality in *The General Theory***

However, people rarely find themselves at that end of the spectrum. Too often, they lack sufficient information to calculate probabilities in any meaningful way. Perfect information is merely the assuming economist's wishful ideal. Rationality as described by the *Probability* model is unrealistic, because people in reality are overwhelmed by uncertainty on many fronts. Keynes writes,

“By ‘uncertain’ knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is merely probable... The sense in which I am using the term is that in which the price of copper and the rate of interest twenty years hence... are uncertain. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know.”<sup>6</sup>

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<sup>6</sup> John Maynard Keynes, “The General Theory of Employment,” *The Quarterly Journal of Economics*, 51, No. 2, (1937 Feb), 209-223.

With probabilities rendered void by pervasive uncertainty, people must address decision-making problems in other ways. Rather than feeling completely powerless in the face of the unknown, people employ several different techniques to inform and influence their decisions. These techniques are addressed in *The General Theory*.

Most frequently and most easily, people assume (like all good economists) that the present is the best available predictor of the future. Without better information to suggest otherwise, “our usual practice [is] to take the existing situation and to project it to the future, modified only to the extent that we have more or less indefinite reasons for expecting a change.”<sup>7</sup> We allow for the possibility of change simply because we cannot rule it out, but we lack the knowledge to predict which direction it will take. Hence, we generally ignore its effects, fall back on the present, and allow “facts of the existing situation [to] enter, in a sense disproportionately, into the formation of our long-term expectations.”<sup>8</sup> We develop a bias towards current information to fill in the gaps regarding the future. The overall effect of emphasizing the present but allowing for unexpected change in the future hints at what is now commonly known as the random walk hypothesis. Today’s result is the best guess for tomorrow’s, but tomorrow’s will almost certainly be different from today’s, except that it is impossible to know how it will be different, because if we had that information, we would incorporate that into today’s result.

In tandem with our predilection for the present, we also look to the present faced by those around us and form some notion of an aggregate present, which amounts to social convention. We follow social convention. In Keynes’s words, “In practice, we have tacitly agreed, as a rule,

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<sup>7</sup> John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York: Prometheus Books, 1997), 148.

<sup>8</sup> *Ibid.*

to fall back on what is, in truth, a *convention*... We are assuming, in effect, that the existing market valuation, however arrived at, is uniquely *correct* in relation to our existing knowledge of the facts.”<sup>9</sup> We trust the judgment of the rest of the world, and resort to a “psychology of individuals each of whom is endeavoring to copy the others to what we may strictly term a conventional judgment.”<sup>10</sup>

This psychology carries several implications. The result of conventional judgment need not be efficient or optimal by any measure, economic or otherwise. It may not even be the result produced if individuals had disregarded social conventions completely. Instead, economic actors, especially investors in capital markets, engage in a “third degree” analysis of social conventions. As described in the famous analogy made by Keynes between stock market and newspaper beauty contests, “we devote our intelligences to anticipating what average opinion expects the average opinion to be.”<sup>11</sup> More significantly, this market outcome based on everyone obeying what they deem to be conventional judgment is inherently unstable. Conventions can be produced randomly and lack a self-stabilizing force. We can trust the results produced by following conventions “so long as we can rely on the maintenance of the convention”, which Keynes would argue is not for very long.<sup>12</sup>

Keynes would be more inclined to argue that people are susceptible to psychological factors. The opinions of the herd are “liable to change violently as the result of a sudden fluctuation of opinion”. Especially under abnormal circumstances, “the market will be subject to waves of optimistic and pessimistic sentiment, which are unreasoning and yet in a sense

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<sup>9</sup> Keynes, *General Theory*, 152.

<sup>10</sup> Keynes, “General Theory of Employment.”

<sup>11</sup> Keynes, *General Theory*, 156.

<sup>12</sup> Keynes, *General Theory*, 152.

legitimate where no solid basis exists for a reasonable calculation.”<sup>13</sup> People may succumb to the impulses of psychological factors, which may seem irrational but may not be entirely unreasonable, as they lack information that instructs them otherwise. When surrounded by uncertainty, it may not be unreasonable to behave in uncertain ways.

To suggest the extent of the instability embedded in the system, Keynes writes, “At all times the vague panic fears and equally vague and unreasoned hopes are not really lulled and lie but a little way below the surface.”<sup>14</sup> This ominous description runs counter to notions of strong rationality espoused by Classical economic theory. However, this is precisely Keynes’s point. He critically writes, “I accuse the Classical economic theory of being itself one of those pretty, polite techniques which tries to deal with the present by abstracting from the fact that we know very little about the future.”<sup>15</sup> His insistence on uncertain knowledge paints economic man as a highly irrational creature. This version may strike Classical economists as discomforting, difficult to deal with in modeling, and even offensive to their rational sensibilities, but this version poses a Keynesian challenge for economists to address the uncertainty facing economic decision-makers and incorporate irrationality into their models and theories.

Lest one mistake Keynes’s emphasis on irrationality for an extremist claim that people are always irrational and wholly unpredictable, Keynes cautions us to exercise moderation in interpreting his theories. “We should not conclude from this that everything depends on waves of irrational psychology... We are merely reminding ourselves that human decisions... cannot depend on strict mathematical expectations, since the basis for making such calculations does not exist...”<sup>16</sup> He does acknowledge that we are driven by rational impulses and will perform

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<sup>13</sup> Keynes, *General Theory*, 154.

<sup>14</sup> Keynes, “General Theory of Employment.”

<sup>15</sup> Ibid.

<sup>16</sup> Keynes, *General Theory*, 162.

calculations where it is reasonable: “Our rational selves [choose] between the alternatives as best we are able, calculating where we can.” Failing those instances, however, decisions are necessarily left open to “whim or sentiment or chance.”<sup>17</sup>

#### **IV. Rethinking Rationality**

By allowing for the economic mind to be capable of both irrationality and rationality, Keynes may seem inconsistent in his theorizing, but in fact he has opened up the possibilities for rethinking our conceptions of rationality. The conflicting impressions of rationality presented by Keynes essentially turn on the point that we often do not have sufficient information but still form expectations and must make decisions all the same. Rationality is often viewed using the Neoclassical framework, which forces economic agents into a false dichotomy. “Either Keynes’s agents are always rational in some strong sense, or they are regarded as irrational.”<sup>18</sup> In its place, we should consider a “multi-domained perspective”, where “agents take account of both expectations and confidence, and they exhibit different forms of rationality, depending on the context.”<sup>19</sup> In *The General Theory*, Keynes stresses the relevance and indeed prevalence of “weak rationality”, which still involves a degree of rational thinking but occurs under conditions of radical uncertainty. Most decisions in the real world arguably exist in this subtle domain.

While operating in this domain, social conventions serve as useful instruments that impose a rational framework on irrational elements. If everyone is adhering to social conventions and is using them to form expectations, the rational individual must take into account this fact. Arbitrary and unstable as social conventions may be, because the use of social conventions is a reality, the individual’s optimal and rational course of action requires him to respond to the

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<sup>17</sup> Ibid.

<sup>18</sup> O’Donnell, *Philosopher-Economist*, 40.

<sup>19</sup> Ibid.



information provided by social conventions. Rationality in the domain of a high degree of uncertainty is when individuals are “acting in accord with correctly identified social conventions.”<sup>20</sup> It is rational to use social conventions.

Furthermore, the idea that unpredictable psychological factors enter into decision-making suggests that rationality may be more accurately described as subjective, rather than objective (as Keynes theorized in *Probability*). Even if presented with an information set identical to that available to every other economic agent, the frame of mind of an individual may influence him to interpret the information in unique ways and lead him to make unique decisions. Because the psychology of the individual is personal and cannot be shared with others but does enter into the decision-making process, perhaps rationality can only be judged from each individual’s perspective. Alternatively, “subjective rationality” may be a contradiction in terms that really means “irrationality”.

## **V. Rationality and Economic Policy**

Keynes’s conception of rationality carries several implications for his prescriptions on public policy. Most significantly, the blend of rationality/irrationality leads to the potential for the “socialization of investment”.<sup>21</sup> In order to stabilize the economy, the government should not pursue nationalization or attempt state control of the industries. Rather, it should aim to exert a “guiding influence” on investment levels and on the propensity to consume “partly through its scheme of taxation, partly by fixing the rate of interest, and partly, perhaps, in other ways.”<sup>22</sup> Interestingly, the list of economic policy tools that Keynes recommends includes typical

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<sup>20</sup> Bateman, “Das Maynard Keynes Problem,” 107.

<sup>21</sup> John Maynard Keynes, *JMK*, vii, 377-8; quoted in John Davis, *The State of Interpretation of Keynes* (Massachusetts: Kluwer Academic Publishers, 1994), 107.

<sup>22</sup> Keynes, *General Theory*, 378.

Keynesian fiscal policy tools (taxation), but it also includes the interest rate, which is traditionally regarded as a monetary policy tool. In fact, Keynes himself discourages direct government expenditure, arguably the most Keynesian of all policy tools!

Instead, interpreters of Keynes's work argue that he favors subtle "maneuver of public opinion" and recommends that the state "adjust the conventional opinions underlying these [economic] phenomena."<sup>23</sup> For instance, Carabelli postulates that when investment is low and liquidity is high, Keynes would assert that, "the primary option of the state... is the control of public opinion."<sup>24</sup> In contrast with the Neoclassical model of rational expectations, which argues that such manipulations are futile, the Keynesian view argues that the degree of success that a state has with its economic policy depends precisely on its ability to convince its people.

In essence, conducting economic policy requires the monitoring and control of disobedient public psychology. "No mechanical formula or easy state directive [can] accomplish this task, and Keynes had no intention of offering one."<sup>25</sup> Governments must carefully utilize an appropriate combination of explicit targets, signaling, and other instruments to communicate its intentions to the market, and must be tuned in to the market's response. Indeed, managing economic policy is more art than science.

Keynes goes so far as to suggest that public expectations can even be managed to achieve ambitious economic goals, such as that of full employment. In his *White Paper on Employment Policy*, Keynes contends that if a state declares that "the maintenance of employment and national income was now an avowed and deliberate aim of financial and economic policy", it could "greatly increase confidence that the Full Employment policy is intended seriously."<sup>26</sup> If

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<sup>23</sup> Bateman, "Das Maynard Keynes Problem," 107.

<sup>24</sup> *Ibid.*

<sup>25</sup> Davis, *State of Interpretation*, 115.

<sup>26</sup> John Maynard Keynes, *JMK*, xxvii, 413; quoted in Davis, *State of Interpretation*, 115-116.

the state can instill a new social convention that expects the economy to run at full tilt, then the new conventions will be a self-fulfilling success.<sup>27</sup> Perhaps the potential for conventions-based (ir)rationality to be harnessed to desirable economic ends should not be underestimated.

## **VI. The Bloomsbury Influence on Rationality**

This attempt to address public policy issues is but one of many Bloomsbury elements to *das Maynard Keynes problem*. Indeed, the very fact that the conundrum deals with duality and prescribes a kind of middle-way moderation between the rational and irrational extremes is very typical of the Bloomsbury Group. Moreover, the attempts to draw from psychology and philosophy to further economic theory reflect the rejection of strict categories and the promotion of interdisciplinary work that is characteristic of the Bloomsburies. Finally, the careful examination of each individual's private conduct and the corresponding link to public affairs captures the deep level of engagement which the Bloomsburies sought at all levels of human interaction.

## **VII. Conclusion**

This paper posits that *das Maynard Keynes problem* can be reconciled by allowing for a range of rationality, but the issue is far from resolved. With the rise in interest in behavioral economics and the contributions of rational choice theory, *das Maynard Keynes problem* has found a new relevance to economics and continues to be widely debated today. The conundrum represents the challenge of gaining a better understanding of human decision-making behavior and being able to capture it in more accurate terms. For a man who participated in an intellectual

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<sup>27</sup> Davis, *State of Interpretation*, 116.

circle that was deeply interested in all manner of human affairs, understanding human rationality surely was a worthy goal.

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