The Place of Keynes in the History of Economic Theory.

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THE PLACE OF KEYNES IN THE HISTORY OF ECONOMIC THEORY

A Dissertation

Submitted to the Graduate Faculty of the Louisiana State University and Agricultural and Mechanical College in partial fulfillment of the requirements for the degree of Doctor of Philosophy in the Department of Economics

by

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# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>CHAPTER</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACKNOWLEDGMENT</td>
<td>11</td>
</tr>
<tr>
<td>ABSTRACT</td>
<td>v</td>
</tr>
<tr>
<td>I. INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>II. SOME PHILOSOPHICAL ASPECTS OF KEYNES' IDEA SYSTEM</td>
<td>5</td>
</tr>
<tr>
<td>A. Logic</td>
<td>16</td>
</tr>
<tr>
<td>B. Epistemology</td>
<td>20</td>
</tr>
<tr>
<td>C. Ethics</td>
<td>28</td>
</tr>
<tr>
<td>III. KEYNES AND THE RECEIVED ECONOMICS</td>
<td>35</td>
</tr>
<tr>
<td>John R. Commons' Theory of Value and Keynes</td>
<td>49</td>
</tr>
<tr>
<td>IV. EVOLUTION OF THE DOCTRINE OF EFFECTIVE DEMAND</td>
<td>56</td>
</tr>
<tr>
<td>Pierre le Pesant de Boisguilbert</td>
<td>57</td>
</tr>
<tr>
<td>Bernard Mandeville</td>
<td>68</td>
</tr>
<tr>
<td>Sir James Steuart</td>
<td>74</td>
</tr>
<tr>
<td>Lord Lauderdale</td>
<td>76</td>
</tr>
<tr>
<td>Thomas Malthus</td>
<td>86</td>
</tr>
<tr>
<td>Jean Charles Sismondi</td>
<td>122</td>
</tr>
<tr>
<td>T. Chalmers, R. S. Moffat, J. A. Hobson</td>
<td>127</td>
</tr>
<tr>
<td>Albert Aftalion</td>
<td>133</td>
</tr>
<tr>
<td>W. T. Foster and Waddill Catchings</td>
<td>138</td>
</tr>
<tr>
<td>V. MONETARY HERESY AND FINANCIAL CAPITALISM</td>
<td>145</td>
</tr>
<tr>
<td>A. Proudhon's Idea System</td>
<td>150</td>
</tr>
<tr>
<td>B. Silvio Gesell's Idea System</td>
<td>161</td>
</tr>
<tr>
<td>C. Similarities of the Idea Systems of Proudhon, Gesell, and Keynes</td>
<td>178</td>
</tr>
</tbody>
</table>
ABSTRACT

The general reference of this study is to the relationships between the economics of John Maynard Keynes and received economics. The term "received economics" refers to the economic theory promulgated before Keynes. The specific problem was to place properly the economics of Keynes in the history of economic theory with specific reference to his more important antecedents.

Within this frame of reference, the following aspects of Keynesian economics were examined: (a) his general demand analysis, (b) his theories of value, (c) his doctrine of effective demand, and (d) his monetary theory. The research took the form of examining the works of those economists who have been largely responsible for the formulation of economic theory from the period of Mercantilism to Keynes. Primarily, this involved the Classical School, Austrian theory, and the thought systems of some of the so-called economic "heretics."

The results of the study strongly indicate that economists may confidently reject the hypothesis that the idea system of Keynes constituted a break from the past and created a new economics. The demand analysis employed by Keynes had its beginning with the Austrians. Insofar as he embraced a labor theory of value, Keynes accepted—at least in part—the value theory of the Classicists. His commanded value theory was derived directly from the Austrians, and his expectation theory of value was virtually identical with John R. Commons'
volitional theory of value. The doctrine of effective demand has a long and interesting history. With reference to this doctrine, Boisguilbert, Lauderdale, Malthus, Sismondi, Aftalion, Hobson, and others were important predecessors of Keynes. Macro-economics was by no means original with Keynes. All business cycle theories run in macroscopic terms. The consumption function has long been a major factor in underconsumption economics. And, of course, it was virtually stated in Engel's Law of Consumption. Keynes' attack on saving and his enthusiasm for spending was a concept which has been present in the literature of economics for at least two centuries. Keynes was a monetary "heretic," but there were important antecedents to his monetary theory and to his distrust of financial capitalism. Finally, the General Theory is full of tendency concepts quite in keeping with classical economics.

The general conclusion is that Keynes took scattered ideas that had long been present in economic thought and formulated an economic theory that was an intellectual response to existing economic conditions. The General Theory of Employment, Interest, and Money marked an important milestone in the development of economic theory; it caused all economists to re-evaluate their fundamental theories. But it cannot properly be referred to as the "Keynesian Revolution." It was simply an important part in the evolution of economic theory.
THE PLACE OF KEYS IN THE HISTORY OF ECONOMIC THEORY
CHAPTER I

INTRODUCTION

There is a significant gap in the literature treating the idea system of the great English economist, John Maynard Keynes. That gap is present because no one has seriously attempted to view the economics of Keynes from the perspective of the history of economic thought; that is, place Keynes in his proper position in the development of economic theory. To be sure, many writers have explained that this or that aspect of Keynes can be found in the writings of earlier economists,¹ but none have searched diligently through the history of economic thought for the precise purpose of discovering whether Keynes' so-called "New Economics" is in fact new or whether it is a brilliant combination of pre-existing economic theories presented at a very opportune time in the development of the capitalistic economic system. Economists, as a group, have been too busy either eulogizing or criticizing the General Theory² to concern themselves with this issue. This study is an

¹For example see: Lawrence R. Klein, The Keynesian Revolution (New York: The Macmillan Co., 1947), Ch. 5; The essays in The New Economics--Keynes' Influence on Theory and Public Policy (New York: Alfred A. Knopf, 1948), by Seymour Harris (Chs. 1, 3, and 6), Joseph Schumpeter (Ch. 9), Paul Samuelson (Ch. 13), Gottfried Haberler (Ch. 14), J. Tinbergen (Ch. 18), Wassily Leontief (Ch. 19), Arthur Smithies (Ch. 39), and R. F. Harrod (Ch. 41).

attempt to bridge this gap in the Keynesian literature.

Obviously, the whole of the history of economic thought cannot be presented in a study of this type. Fortunately, that is not necessary to realize the objectives of the study. Only those parts of the stream of economic theory will be examined which clearly anticipated the major principles contained in the General Theory.

In view of the great body of Keynesian literature, there is no need for still another detailed analysis of the economics of Keynes, and this study does not purport to present such an analysis. Quite the contrary, the assumption is made throughout that the reader is familiar with the General Theory.

Many writers have explained that the appearance of the General Theory in 1936 was in response to the depression that was sweeping the capitalistic world at that time. This explanation has a great degree of validity but it is not the complete story. There is reason to believe that Keynes wrote as he did for more reasons than those prompted by the great depression, reasons which were primarily philosophical and pragmatic in nature. Keynes lived during a period of rather radical change in philosophical thought, and his own thinking in matters of an economic nature was profoundly affected. The objective of Chapter Two is to examine the philosophical environment which surrounded Keynes and to relate this environment to the theoretical approach employed in the General Theory.  

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Keynes believed that his major mission in writing the *General Theory* was to refute classical economic theory, and many economists claim that he accomplished his mission.¹ To be sure, Keynes employs the demand approach in his idea system, while the classicists utilized the supply approach. However, it was not Keynes who brought about this great cleavage in the development of economic theory. The Austrian school was responsible for that change in the direction of economic analysis. Chapter Three is devoted to an examination of Keynes' theory as it relates to the received economics.

Economists generally agree that the doctrine of "effective demand" constitutes the very core of the Keynesian idea system. Was this a new doctrine? Was it of such a nature that economic theory was pushed through a revolutionary metamorphosis and emerged as a completely new theoretical framework upon which a new economics could be constructed? Or was it merely a blooming--under ideal weather conditions--of a kind of century plant, the seeds of which had been planted quite early in the history of modern economic theory and nurtured carefully down through the years by repeated grafts, cuttings, and trimmings? Chapter Four deals with these questions.

Throughout the history of industrial capitalism, and in the face of "refutations" without number at the hands of orthodox economists,

¹ The two basic ideas of classical theory are: (1) the theory of capital formation, which holds that saving is a dynamic factor in capital accumulation; and (2) J. B. Say's Law of Markets, which states that demand can never be deficient. Keynes, with his liquidity-preference theory of interest, his concept that saving was a residual, and his doctrine of effective demand, believed that classical economics had been refuted. See *General Theory*, p. 3 and Chs. 2, 3, 7, and 13.
the doctrines of monetary "heretics" have tenaciously persisted. Their proposals for reform and their accompanying unorthodox principles have been particularly prominent during periods of severe economic crises. In the contemporary controversy over monetary policy and theory, Keynes, as perhaps the most distinguished of the monetary radicals, occupies a focal point. Since the publication of the General Theory in 1936, many of the old "heresies" of general economic thinking have been revived and have assumed prominence in academic discussion. From the point of view of the history of economic thought, the Keynesian controversy represents a revival of the challenge which economic orthodoxy has been unable to extinguish during the past one hundred and fifty years.

Keynes expressed great admiration for Silvio Gesell in the General Theory, and Gesell considered himself a disciple of P. J. Proudhon. Because of this, the assumption may be made that there exist significant similarities among the three economists. Gesell and Proudhon are believed to be important predecessors of Keynes; their thought appears to have presupposed much of Keynes' monetary theory. Chapter Five is a testing of this assumption.

Chapter Six presents some conclusions of the study.

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"Monetary reform" is here used to mean, not a program which treats only incidentally changes in the financial structure, but one which attributes basic economic maladjustments to monetary factors, and places primary emphasis on the altering of financial institutions while leaving intact ownership of property and private industrial enterprise.
CHAPTER II

SOME PHILOSOPHICAL ASPECTS OF KEYNES' IDEA SYSTEM

Anyone acquainted with the progress of philosophical thinking since Charles Darwin published his Origin of Species (1859) cannot but realize the extent to which the frameworks of interpretation into which economists pour their thinking have been influenced by philosophical thinkers. Although it is not the purpose of this study to examine the evolution of philosophical thought, the attempt to assign to Keynes his proper place in the history of economic thought does dictate at least a brief investigation of his philosophical orientation. This is true because there is such a close correlation between modern philosophy and the basic framework of Keynes' idea system. Thus the purpose of this chapter is to demonstrate this correlation and to examine the Keynesian system in terms of "logic," "epistemology," and "ethics."

Before examining the relationship which exists between the

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1By "modern philosophy" the writer means that body of philosophical thought promulgated by such philosophers as James, Whitehead, and Bergson in contrast with the philosophy of such men as Newton, Descartes, and Leibnitz. Keynes' philosophical outlook was clearly based on the thought of the former three men, whereas orthodox economists from Ricardo to Marshall owed their intellectual orientation to the latter three men.

2Keynes was not in any way a specialized student of modern philosophy, his intellectual interests having been absorbed by studies in the fields of mathematics and economics.
economics of Keynes and recent developments in philosophy, it is well to present briefly those major features of modern philosophical thought which have so greatly influenced, not only Keynes, but the thinking in the social sciences in general. These features, which characterize twentieth century philosophy, may be termed: (a) the significance of the whole, (b) the emergent nature of things, and (c) the attempt to be realistic. It is readily seen that these new elements in philosophy are of a methodological nature; that is, the true significance of modern philosophy is to be found in new methods of analysis.

The philosophy of the eighteenth and nineteenth centuries was characterized by an atomistic attitude. According to this method of analysis, one must use the individual unit method of examination. Then, to understand the essential conditions of whatever was being investigated as a whole, one merely added together the component parts of the whole. In short, it was a method of generalizing with reference to the whole from specific findings derived from analyzing the individual parts. The basic assumption, of course, was that the whole was always equal to the sum of its parts. The new philosophy turns this method of analysis upside down, and approaches an investigation with an holistic attitude; that is, it believes the proper method of analysis is one which emphasizes the totality of things. Once the characteristics of the whole are known, then, an examination of the component

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3The major source of information for this discussion of modern philosophy is: Twentieth Century Philosophy, ed. D. D. Runes (New York: Philosophical Library, 1943), especially the following essays: John E. Boodin, "Philosophy of History;" Victor F. Lenzen, "Philosophy of Science;" Alfred N. Whitehead, "Philosophy of Life;" Bertrand Russell, "Philosophy of the 20th Century;" and Herbert Feigl, "Logical Empiricism."
parts is proper. This view is based upon the realization that the whole may be more or less than the sum of its parts. Furthermore, the new philosophy insists that the whole is basically different in character from its separate parts; consequently, one can never understand the nature of the whole by merely inquiring into the characteristics of the component parts.

The second significant feature of modern philosophical thought is the importance it gives to the emergent nature of things. This is closely associated with the holistic method of analysis because the totality of things which interests the modern social scientist is the evolving or emergent whole. Whitehead says, "Existence is activity ever merging into the future." By this, Whitehead means that everything that exists is always in the process "of being made," thus, the universe, the physical world, and social systems have had a past, do have a present, and will have a future. Of course this is the evolutionary or continuous process, and most social scientists are interested in incorporating this concept of change and its consequences into their theoretical systems of thought. Many scholars recognize that in some circumstances the concept of the emergent nature of things is a much more useful tool for analysis than the concept of the mechanism itself.

Modern philosophical thought prides itself in its attempt to be "realistic." This is the third important characteristic of twentieth century philosophy with which this study is concerned. This realistic approach in philosophy bears a close affinity

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"Whitehead, op. cit., p. 144.
to the methodology of the physical sciences. Not only has philosophy adopted their methods, the modern philosopher attempts to formulate his thought in such a manner that it conforms with the conclusions reached in the physical sciences. Whitehead and others explain that it is unnecessary for conflict to exist between philosophical and scientific thought. They point out that it is not sufficient for philosophy to be merely consistent within itself, there must be room in the body of philosophy for the contributions of science. The modern philosopher is especially careful to see to it that he has made a place within his thought system for all generally accepted scientific doctrines.\(^5\) This development in philosophical thinking has brought philosophy and science into a very close relationship during the past half-century. This has not been a case of a reciprocal influence. Quite the contrary, the realism of science has caused philosophy to be much more realistic or inductive in the sense that today's philosopher actually looks for support for his own views among those of the scientists. The modern philosopher is quite willing to re-examine his own position if his opinions differ from those of the scientists. In most instances if a change in opinion is called for, it is the philosopher who shifts his position, not the scientist. It is this willingness to take account of the discoveries of natural science that gives a realistic flavor to much of recent philosophical thought and which sets it off from the more speculative thought of earlier centuries.

\(^5\)See Lenzen, Whitehead, and Russell, \textit{op. cit.}\n
Keynes incorporated these three aspects of modern philosophy into the intellectual structure of his idea system. He embraced the totalistic or aggregative approach to economic analysis to such an extent that the fundamental basis of his over-all idea system is the aggregates of employment, national income, national output, aggregate supply, aggregate demand, total social consumption, total social investment, and total social savings. This is not to say that Keynes completely ignored the individual unit method of analysis; he simply made the individual aspects of the economy—for example, prices and values—subsidiary to the aggregate of employment, income, etc.

In adopting the holistic method of analysis from the philosophers, Keynes abandoned what he described as the "atomic hypothesis." This hypothesis assumed that: (a) the economic system was a static organism consisting of many essentially independent parts; each economic unit functioned as a separate and distinct entity; and the manner in which the entire system functioned was simply the sum of the manner in which the individual parts functioned. This Newtonian attitude toward economic analysis has dominated the theoretical framework of economics since Ricardo. Keynes departed (although he was

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7In his discussion of the "paradox of thrift," Paul Samuelson says, "In economics, we must always be on guard against the logical fallacy of composition. What is good for each person separately need not be good for all; under some circumstances, private prudence may be social folly. Specifically, this means that the attempt of each and every person to increase his saving may...result in a reduction in actual saving by all the people in the community. Note the italicized words 'attempt' and 'actual'; between them there may be a world of difference if people find themselves thrown out of jobs and with
by no means the first to do so) from this atomistic or Newtonian approach to economic studies. "We are faced at every turn," Keynes said, "with the problems of Organic Unity, of Discreteness, of Discontinuity--the whole is not equal to the sum of its parts, comparisons of quality fail us, small changes produce large effects, the assumptions of a uniform and homogeneous continuum are not satisfied." 8

One of Keynes' fundamental concepts was that the modern economy differed greatly from the economic order which Alfred Marshall wrote about in 1879. The economy had changed both in structure and in function. He was convinced that the Marshallian theory, based upon the assumption of a small-scale competitive economy, was inadequate to explain an economy dominated by big business. The corporate form of business organization which resulted in separation between ownership and management had become the rule not the exception. Thus lowered income payments." Paul A. Samuelson, Economics (New York: McGraw-Hill Book Co. Inc., 1948), pp. 270, 271.

Under a sub-head "The Whole And The Part," Samuelson says, "The first lesson in economics is: things are often not what they seem. Some examples chosen at random may illustrate this:
1. If all farmers work hard and nature cooperates in producing a bumper crop, total farm income falls.
2. One man by great ingenuity in hunting a job or by a willingness to work for less may thereby solve his own unemployment problem, but all cannot solve their problems in this way.
3. Higher prices for one industry may benefit its members but, if the prices of everything bought and sold increased in the same proportion, no one would be any better off.
4. It may pay the United States to reduce tariffs charged on goods imported even if other countries refuse to do likewise.
5. What is prudent behavior for an individual or a single business firm may at times be folly for a nation or a state." Ibid., p. 8.

See Ibid., pp. 324, 426, and 452 for other examples of the "fallacy of composition."

8 Essays in Biography, p. 28.
at times "enterprise becomes the bubble on a whirlpool of speculation." 9

In this new economy characterized by a dichotomy of "business" and "industry," the whole was frequently less than the sum of its parts. As early as 1926, Keynes contended that one could not determine community welfare by simply adding together individual welfares. The quantities were unequal, with community welfare usually less than the sum of its individual parts. Individual economic behavior could create advantages for the individual but there was no assurance that this would result in community betterment. 10 It was entirely possible for an individual to exploit others and enrich himself, but by no type of reason or logic could one conclude that this would enrich the economy. Using the individual firm method of analysis, it is entirely logical to hold that a reduction in wages will result in more employment. But when the economy is viewed in macrocosmic terms, it becomes clear that employment cannot increase if all business firms reduce wages. Purchasing power would fall and this would cause business to reduce production. Less employment and not more would result.

On the basis of this philosophical attitude, Keynes developed his macro-economic analysis which deals with "the economic system as a whole and with securing the optimum employment of the system's entire resources." 11 It was not the quantity of resources that was important; it was the employment of them that dominated Keynes'

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9General Theory, pp. 150, 159.


thinking. The quantity was taken as given. Keynes' totalistic attitude toward economic investigation was in keeping with recent developments in philosophy and all the social sciences. The sciences which treat of human behavior were turning more and more toward a more totalistic outlook during the period of Keynes' intellectual development.\textsuperscript{12}

The essence of Keynes' holistic approach to an analysis of the economic system may be grasped by pointing out that the older economists made the general level of economic activity a function of the behavior of the individual firm. When the individual firm was in equilibrium, the whole economy was assumed to be in the same condition. In Keynes' system the reverse is true. The behavior of the individual firm is held to be a function of the behavior of the whole economic system. As the economy rises and falls, it takes the individual firm with it. Private businessmen determine their economic policies in the light of their expectations or forecasts relating to the future behavior of the entire economic system. For this reason the behavior of the individual businessman is in large part nothing but a reflection of the larger behavior pattern of the whole economic community; and to understand the activities of the private firm, one must first have an understanding of the way in which the entire economic system operates.\textsuperscript{13}

By treating the economy as an emerging process, Keynesian economics duplicated another important characteristic of modern philosophy. Keynes was interested with the manner in which the economic systems of western Europe and the United States were evolving. His concern with this continuum is demonstrated in nearly all of his writings. The English economy was plagued with heavy unemployment during the 1920's. In attempting to find causes for this, Keynes studied the economic history of England, and concluded that fundamental changes had occurred.


\textsuperscript{13}\textit{Ibid.}
in English economic life. In the nineteenth century certain dynamic growth factors were present to absorb the savings of wealthy individuals and to maintain virtually full employment of all the productive resources most of the time. These factors were: (1) a rapid increase in population, (2) a heavy and constant flow of inventions and innovations, (3) the settlement and exploitation of new land areas, and (4) frequent wars. These forces operating within a laissez-faire environment created seemingly unlimited private investment opportunities. By the beginning of the twentieth century, however, these growth factors which made "individualistic capitalism" function at high levels of income and employment were losing much of their dynamic effects. Population had begun to grow at a decreased rate, there was a slowing down of technological progress, and there was no longer large land areas available for exploitation. Thus by the close of World War I, the English economy and other industrialized nations, which depended upon private investment for their level of operation, had reached a stage of maturity where private investment was not sufficient to create and maintain full employment of all available productive resources.

Keynes explained his fundamental thesis in the following manner:

When a country is growing in wealth somewhat rapidly, the further progress of this happy state of affairs is liable to be interrupted, in conditions of laissez-faire, by the insufficiency of the inducements to new investments. When investments in new plant and equipment fail to materialize, chronic stagnation and mass unemployment become persisting...
features of economic life. Money ceases to function as a vital factor aiding in the creation of useful material goods; instead, it becomes merely a means of storing wealth. Idle or unspent money means less demand for the products of farm and factory, and hence less employment. Thrift or saving, which was regarded as a private virtue by the orthodox economists, now becomes a public or communal vice since it leads to business stagnation and low levels of employment and national income.\textsuperscript{15}

Thus, "Keynes' fundamental thesis, stripped of all its technicalities, was that we had arrived at a stage in our economic evolution where the tendency to save on the part of the middle and upper classes outstrips the ability of businessmen to absorb private savings through the investment process."\textsuperscript{16} The fact that Keynes does not inquire very far into the past or the future of capitalistic society does not deny the essentially emergent nature of his economic analysis. As early as 1920 he said, "Very few of us realize with conviction the intensely unusual, unstable, complicated, unreliable, temporary nature of the economic organization by which Western Europe has lived for the last half century. We assume some of the most peculiar and temporary of our late advantages as natural, permanent, and to be depended on, and we lay our plans accordingly."\textsuperscript{17}

Much of Keynes' analysis is of the short-run variety and a great deal of his energy was directed toward solving immediate economic problems. Nevertheless, he never lost sight of the importance of historical economic forces and the manner in which they had shaped the modern capitalistic economy. For Keynes, all industrialized

\textsuperscript{15}\textit{Ibid.}, p. 335. \textsuperscript{16}\textit{Gruchy, op. cit.}, p. 239.

\textsuperscript{17}J. M. Keynes, \textit{The Economic Consequences of the Peace} (New York: Harcourt, Brace and Co., 1920), p. 3.
capitalistic countries could correctly hold that "an age is over."  

The third way in which the economics of Keynes duplicated modern philosophical thought was in its claim to be more realistic than the inherited or received economics. Throughout his writings Keynes emphasized the fact that he was dealing with the "complex real world." What concerned him were the "actual practices and institutions of the contemporary world" and "the problems of the real world." Keynes "had no special concern with any simplified pro- paedeutic of his science. He strongly protests against any attempt on the part of economists to reduce their science to an oversimplified model or scheme of general relations which has little connection with the actual world of hard-and-fast facts."  

Keynes was especially critical of the tendency to make economics less a social and more a mathematical science. "Too large a proportion of recent mathematical economics," he said, "are mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentions and unhelpful symbols."

Thus Keynes' idea system reflected the new philosophy of the twentieth century. His analysis emphasized the emergent, the totalistic, and the realistic nature of things. Despite the fact that he never completely abandoned eighteenth-century British empiricism, his intellectual orientation was clearly post-Darwinian rather than

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18Ibid., p. 4.  19General Theory, pp. 264, 266, 293.
Attention may now be turned to the logic, epistemology, and ethics of Keynes' idea system for a closer insight into the philosophical aspects of his system of thought.

A. Logic

What is now generally classified as modern philosophy had its beginning with Bacon. The primary distinguishing characteristic of this type of philosophy is its disregard for the metaphysical search for the "truth" and the "real." Modern philosophy is primarily concerned with two questions: "How do we know?" and "How do we go about finding truth?" In short, modern philosophy has wrought a change in methodology, not merely a shift in emphasis. The concern here, however, is not with philosophical methodology per se; rather the interest lies in the influence which this new method of philosophical examination has had on the study of logic. Everyone will agree that the advance in logic during the last four or five decades has been remarkable, and Keynes, throughout his life, was close to this new development in philosophy. During his years at Cambridge Keynes was a close friend and associate of such great philosophers as Ludwig Wittgenstein, Alfred Whitehead, Bertrand Russell, and Frank Ramsey. These men were primarily responsible for the formulation of the new philosophy. Moreover, Keynes had the training and the background to understand what was occurring in this basic discipline. His father had made significant contributions both to mathematical logic and to methodology in the social sciences. Keynes was a trained mathematician. However, his interest lay, not in pure mathematics, but rather in "the borderland
between mathematics and philosophical problems." Helen Phillips points out that Keynes "was familiar with Principia Mathematica from the time of its publication, remarking in My Early Beliefs that it was a companion volume to Moore's Ethics in that it provided a scientific method capable of analyzing the ethical problems raised by Moore." Keynes was never greatly concerned with formal logic and contributed nothing to the new movement in philosophy. He much preferred the informal analysis of Russell to the more formal logic of Wittgenstein, and his attitude toward logic is to be found only in the area of non-formal logic. This, of course, is what one should expect since Keynes, although he was interested in philosophy, was not engrossed in that discipline. Keynes demonstrated quite clearly his nominalistic position with reference to the problem of universals in his Introduction to Ramsey's The Foundation of Mathematics. In a subsequent essay he once more revealed his position by quoting several passages from Ramsey's book. The material he selected to quote leaves no doubt but that he was basically concerned with the principle that all science must deal with the problem of meaning.

We are driven to philosophise because we do not know clearly what we mean; the question is always "What do I mean by X?" And only very occasionally can we settle this without reflecting on meaning. But it is not only an obstacle, this necessity of dealing with meaning; it is doubtless an essential clue to the truth.


we cannot get clear about these terms and sentences without getting clear about meaning, and we seem to get into the situation that we cannot understand, e.g. what we say about time and the external world without first understanding certainly time and probably the external world which are involved in it. So we have to take our problems as a whole and jump to a simultaneous solution.

Keynes was convinced that human language conventions were not as precise as the older logic implied or as people generally believed. His conviction was based upon his belief that human beings "feel" that they understand a word, but are unable to define it in precise terms.

I feel we may get into the absurd position of the child in the following dialogue: "Say breakfast." "Can't." "What can't you say?" "Can't say breakfast."

I used to worry myself about the nature of philosophy through excessive scholasticism. I could not see how we could understand a word and not be able to recognise whether a proposed definition of it was or was not correct. I did not realise the vagueness of the whole idea of understanding.

It seems to me that in the process of clarifying our thought we come to terms and sentences which we cannot elucidate in the obvious manner by defining their meaning. For instance, theoretical terms we cannot define, but we can explain the way in which they are used.

Keynes believed that words should be considered as useful tools of thought, and he did not accept the idea that there should exist a rigid relationship between word and thing. In short, words were merely "tags" which ought to be used as a means of describing and manipulating the human environment.

I don't think it is necessary to say with Moore that definitions explain what we have hitherto meant by our

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propositions, but rather that they show how we intend to use them in the future. Moore would say they were the same, that philosophy does not change what anyone meant by "This is a table." It seems to me that it might; for meaning is mainly potential.26

The meaning of a sentence is to be defined by reference to the actions to which asserting it would lead, or, more vaguely still, by its possible causes and effects.27

But he remained silent with reference to the word-making activity and to the status of the entities to which words refer. There was a metaphysics in his nominalism, but it was of the type which emphasized the creative role of mental activity for reality. However, this does not justify a general statement to the effect that Keynes was a realist. The truth is that there is not enough evidence in the Keynesian literature to warrant classifying him either as an idealist or as a realist. Perhaps this is of no great importance. What is significant is that he was firmly convinced that man had the power to define words to suit his purpose.

Not only did Keynes believe this, he also practiced it.

The bearing of this view on the task of integrating psychological, ethical, and experiential material into a body of knowledge usable for economics is obvious. Here we find the first trace, the first general principle he employed. Quickly, surely, and successfully, he brought together ideas and facts which were later appreciated as belonging together. Fearless in combining ideas which to others seemed quite unrelated, he was unhampered by conventional terminology and traditional concepts. He used well his conviction that meaning is to some extent within our power to change.28


27Ramsey, quoted in Essays in Biography, p. 299.

28Phillips, op. cit., p. 15.
B. Epistemology

One is probably never completely justified in classifying a scholar either as an empiricist or as a rationalist. In most instances it is impossible to do so for the simple reason that most scholars demonstrate both empirical and rational tendencies. It follows, then, that the most scientific classification is one based on this dichotomy. Both the empiricist and the rationalist search for truth. But the difference between these two epistemologies does not rest in the objective; rather, it lies in the method or the procedure of ascertaining truth. For the rationalist, the truths of reason are all important. He is primarily concerned with formal, conceptual knowledge; his thought ideal is modeled after the type of knowledge found in mathematics. Deductive logic is his tool of analysis. The empiricist, on the other hand, is one who places emphasis on the truths of fact, who wants to find out the relationships between observed matters of fact. Inductive logic is the basic tool of analysis for the empiricist.

Keynes' idea system lies somewhere between the two poles of empiricism and rationalism, but closer to the empirical than the rationalistic. His fondness for the empirical is shown clearly in his conception of the proper business of the economist. Certainly he was thinking in empirical terms when he formulated the methods by which his social goals could be achieved. A policy or program of action designed to influence practical affairs must, by its very nature, flow from an empirical attitude. For Keynes, the major function of the economist was to promulgate policy based upon empirical data. In the Keynesian idea system, the economist makes value judgments. Thus Keynes returned to the nineteenth century conception of
what was the proper business of the economist. It was to describe the economy, predict future economic events, and formulate basic principles of economic policy. Robinson says that Keynes "never devised an economic tool purely for its own sake rather than to solve an immediate practical problem in the application to government of the methods of economic analysis; his absorbing interest in politics and government made Keynes, in the very best sense of those words, a political economist." Robinson contends that in Keynes' work in the India Office, he acquired a basic sympathy with the problems of the public administrator who needs economic analysis in order to make decisions concerning policy. He learned there a great deal about the way the machinery of government operated, and in particular to see the problems of economics from the angle of the administrator, who must make the decisions, as well as from that of the academic, who must discuss the principles that underlie the decisions.

Thus Keynes believed that the political economist must devote a large share of his time to advising those who formulate economic policy for this was the goal and beacon light of analysis. In other words, Keynes designed his program of public policy, which was based upon quite realistic observations and then promulgated his body of theory to justify his program of action.

Further evidence of Keynes' empiricism was the position he took on the Malthus-Ricardo controversy. By supporting Malthus, he renounced all faith in the excessive deductive logic which characterized the Ricardian brand of economics. Keynes' own statements make

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this quite clear:

Malthus is dealing with the monetary economy in which we happen to live; Ricardo with the abstraction of a neutral money economy... If only Malthus, instead of Ricardo, had been the parent stem from which nineteenth-century economics proceeded, what a much wiser and richer place the world would be to-day! We have laboriously to re-discover and force through the obscuring envelopes of our misguided education what should never have ceased to be obvious.31

For Malthus had said:

I certainly am disposed to refer frequently to things as they are, as the only way of making one's writings practically useful to society, and I think also the only way of being secure from falling into the errors of the taylors of Laputa, and by a slight mistake at the outset arrive at conclusions the most distant from the truth... A writer may, to be sure, make any hypothesis he pleases; but if he supposes what is not at all true practically, he precludes himself from drawing any practical inferences from his hypotheses.32

Both Malthus and Keynes gave the empiricist's emphasis to thought and its material usefulness. No one should be greatly surprised to discover that Keynes held Malthus in very high esteem. Their attitudes and economic views were virtually identical.

Keynes demonstrated a keen interest in David Hume and this is still further evidence of his attitude toward empiricism. He shows in his Introduction to Hume's Abstract an appreciation for Hume's work that could only have come from thorough study:

It remains as good a brief introduction to the essence and original genius of the Treatise as can be found. Hume has pointed with infallible finger to those passages which, in the eyes of posterity as well as in those of the author, "shake off the yoke of authority, accustom men to think for themselves, give new hints, which men

31 Essays in Biography, pp. 138, 144.
32 Malthus to Ricardo, January 26, 1817, in Ibid., pp. 139, 140.
of genius may carry further, and by the very opposition, illustrate points, wherein no one before suspected any difficulty."

of the various passages in the Treatise tracing the origin of belief from custom none is more Humeian than the following from the Abstract: "Tis not therefore reason which is the guide of life, but custom. That alone determines the mind, in all instances, to suppose the future conformable to the past. However easy this step may seem, reason would never, to all eternity, be able to make it."33

Not only had Keynes studied Hume, but there is evidence to support the conclusion that he was influenced by the writings of the great philosopher. The fact that Keynes accepted Ramsey's nominalism and utilized it in his theorizing about economic data, and his statement that "Ramsey reminds one of Hume more than of anyone else"34 show that he viewed Hume's analysis of causation and the role of reason in science with a great deal of admiration and sympathy.

The empiricism that Keynes embraced was not in a pure form; that is to say, he allowed at least two modifications and these are very important to his idea system. First, he included in his empiricism the concepts of social change. The contemporary concept of the emergent nature of things—that is, the evolutionary process—perhaps had its intellectual beginning with Darwin and received great impetus by the philosophies of Bergson and Whitehead. The emphasis on evolution was simply a new theory of change which treated change as a


34 Essays in Biography, p. 301. Because Schumpeter, on p. 81 (note 11) of The New Economics, took Keynes' essay on Ramsey to be indicative of Keynes' philosophy as well as of Ramsey's, I have cited both what Keynes said about Ramsey and what he quotes of him as expressing Keynes' own views.
process by which new, unique forms appeared. This differed from the older concept of change which thought of change as the realization of forms already inherent in the nature of things. Now, on the basis of the new theory the philosophers and physical scientists viewed the physical world as being constantly in the process of being made. Keynes applied the same reasoning to the social system; that is, the social system was a dynamism constantly creating new institutions. Whitehead and Keynes were both making use of the new concept of change when Whitehead said that "Existence is activity ever merging into the future," and Keynes said that "We have to invent new wisdom for a new age." Keynes believed that change and its consequences must always be an important aspect of economic analysis. In the area of public policy, for example, he said "There can be no unique policy which the monetary authority will adopt in the long run." Thus Keynes regarded the flow of events as being more important and fundamental than separate or individual happenings, not only for a better interpretation of history, but also as a basis for political economic action.

In my opinion there is now no place...for those whose hearts are set on old-fashioned individualism and laissez-faire in all their rigour—greatly though these contributed to the success of the nineteenth century. I say this, not because I think that these doctrines were wrong in the conditions which gave birth to them...but because they have ceased to be applicable to modern conditions.

I criticise doctrinaire State Socialism, not because it seeks to engage men's altruistic impulses in the service of Society, or because it departs from laissez-faire, or because it takes away from man's natural liberty to make


36The Times (London, November 15, 1932), from a lecture given at Cambridge the previous day.
a million, or because it has courage for bold experiments. All these things I applaud. I criticise it because it misses the significance of what is actually happening.37

The second modification of Keynes' empiricism was his emphasis on the point that there was a basic difference between the whole and the part. He insisted that the very nature of the whole was essentially different from that of the parts which comprised the whole. The importance of this attitude lies in the analytical approach; that is to say, one must examine the whole; that is to say, generalize about the whole rather than investigate its parts. By the time of Keynes, the atomism of the British empirical tradition, according to which the whole was merely the sum of the parts, had been recognized to be largely superficial and faulty, chiefly by the German idealists. To be sure, Lord Lauderdale had refuted this doctrine in a very satisfactory manner at a much earlier date,38 but he, like Malthus, was engulfed in the Ricardian tidal-wave. As was pointed out earlier in this chapter, Keynes adopted this "holistic" point of view in insisting that the proper method of economic analysis was the "aggregate" or "macro" approach. In short, just as one cannot add the happiness of each individual and arrive at the total happiness of the nation, Keynes believed that one could not add the supply curve for each firm in the economy and get an aggregate supply curve for the economy. Keynes' concept of the relationship of the whole to the part permeates all of his mature economic thought. One commentator even considered this "aggregate" approach as being "the sum

38See Infra., p. 82 for a discussion of this.
and substance of Keynes' heresy."39

It would be an error to classify Keynes as a pure empiricist. He had rather strong tendencies toward the rationalistic point of view. First, despite his acceptance and use of the empirical method, he never adopted the irrationalism which is inherent in empiricism. His attitude toward viewing the economy as an emerging process is a case in point. This point of view did not cause him to neglect examining and commenting upon what was occurring in the economy at a given time. Second, Keynes always believed that reason, as well as observation, must be used in economic analysis. Schumpeter saw this in Keynes when he remarked that Keynes' "intellectual affinity with Ricardo merits notice."40 Schumpeter was referring, of course, to the fact that Keynes did employ deductive logic in the manner of Ricardo. Perhaps Schumpeter overstated the similarity in the methods of Keynes and Ricardo; nevertheless, there is much rationalism implicit in the economics of Keynes despite his many explicit statements supporting the empirical method. Finally, Keynes was a theorist; and perhaps it is not assuming too much to say that Keynes would have admitted that all theory depends for its construction upon the use of reason as well as observation. Certainly, reason and observation were used in his idea system.

Perhaps the best evidence that can be found in the works of Keynes to demonstrate his position on the empiricist-rationalist


40Schumpeter, in Ibid., p. 94, (note 30).
tightrope is the following:

It is a great fault of symbolic pseudo-mathematical methods of formalising a system of economic analysis. . .that they expressly assume strict independence between the factors involved and lose all their cogency and authority if this hypothesis is disallowed; whereas, in ordinary discourse, where we are not blindly manipulating but know all the time what we are doing and what the words mean, we can keep "at the back of our heads" the necessary reserves and qualifications and the adjustments which we shall have to make later on, in a way in which we cannot keep complicated partial differentials "at the back" of several pages of algebra which assume that they all vanish.\textsuperscript{41}

Here is found the rationalist's concern for method, but it plays a secondary role to the empiricist's concern for the difficulty of expressing satisfactorily the complexity of experience.

Nor did Keynes minimize the importance of statistical method for the interpretation of economic data. So highly did he regard the contribution of statistics that he formulated his theories in such a way that the possibility of applying statistics to the results of deduction was substantially increased; he gave great impetus to the statistical approach to economics.

This examination of Keynes' epistemology shows that he developed his idea system within a definite framework of methodological principles. The basic principle was empiricism, but it was of such a nature that it contained the new idea of change and the new attitude toward the relationship of the whole to the part. And the principle was broad enough to be friendly to a certain amount of rationalism. Having acquired all of this from the new philosophy, Keynes never wavered in his belief that it was the proper method for political

\textsuperscript{41}General Theory, pp. 297, 298.
C. Ethics

In presenting his fundamental ethical principles, Keynes revealed quite clearly his philosophy of life and thought. With reference to his concept of human nature and of right and wrong, his writing indicates that he was basically pre-Freudian and pre-Marxian. The ethical principles of Freud and Marx failed utterly to impress Keynes, although the modern world has yet to recover completely from the shock of those principles. Keynes, who was ultramodern in his economic views, held tenaciously to the ethical beliefs of an older period. Or better yet, perhaps, in attempting to enrich and modify the old beliefs, he succeeded only in reaffirming them.

Keynes attempted to explain in My Early Beliefs why he and some of his friends had "preserved the faith," why they had not succumbed to the wave of irrationalism, uncertainty, and pessimism which followed the Victorian period. This essay was read a few months before his death to the members of the club at Cambridge which had been in existence since his undergraduate days. And its content shows that he did not embrace the irrationalism of Freud and Marx. He said:

I see no reason to shift from the fundamental intuitions of the Principia Ethica; though they are much too few and too narrow to fit actual experience, which provides a richer and more various content...the ways in which states of mind can be valuable are more various and also much richer than we allowed for.

...There was a thinness, a superficiality, both of judgement and of feelings...we ignored certain powerful and valuable springs of feeling...It seems to me looking back that this religion of ours was a very good one to grow up under. It remains nearer the truth than any other I know, with less irrelevant, extraneous matter and nothing to be ashamed of...It was a purer, sweeter air by far
than Freud cum Marx. It is still my religion under the
surface.\textsuperscript{42}

It is true, as Keynes stated, that no one today reads Moore. His
Principia has joined that great body of literature which is read,
and then only upon occasion, by the savant lost in the paths of
serendipity. Moore's work, while it impressed the world of philoso-
phy to some degree at the time of its production, is hardly appli-
cable to any world but that of the late Edwardian and Victorian
cultures.

Preaching a lucid brand of philosophical and moral anarchy,
Moore's philosophy held the usual views of the anarchist: that men
were, in and of themselves, of such a nature that they naturally
behave as rational, moral, beauty-seeking individuals. The action
of the individual, and the individual alone, was extolled by Moore.
The highest action to which individuals could aspire was the con-
templation of beauty.\textsuperscript{43}

To those souls most capable of seeing beauty, the greatest
good could and should accrue. To those lesser mortals, to whom beau-
ty was dimmed for whatever cause, the superior individual should act
in such a way as to reveal beauty. This one duty, to behave accord-
ing to a general Utilitarian rule-of-beauty-contemplation, Moore
discussed in one chapter.\textsuperscript{44} The rest of the book is a plea for the
purest form of anarchy: the individual contemplation of states of

\textsuperscript{42}My Early Beliefs, pp. 91, 92.

\textsuperscript{43}George Edward Moore, Principia Ethica (Cambridge: Cambridge
University Press, 1903), pp. 5-33, 183-198.

\textsuperscript{44}Ibid., pp. 142-178.
beauty. This action was definitionally "good," and the only "good"
which Moore's philosophy admits. This was Keynes' religion.

Keynes' attitude toward life was primarily anthropomorphic.

Where I seem to differ from some of my friends is in
attaching little importance to physical size. I don't
feel the least humble before the vastness of the heavens.
The stars may be large, but they cannot think or love;
and these are qualities which impress me far more than
size does... My picture of the world is drawn in per-
spective and not like a model to scale. The foreground
is occupied by human beings and the stars are all as small
as threepenny bits... Humanity, which fills the foreground
of my picture, I find interesting and on the whole admirable.45

Here is found clear evidence for what was perhaps his most basic ethi-
cal assumption: human problems are important and demand attention.
Keynes was concerned with man and man's problems; he was concerned
with nature only so far as it aided in satisfying human needs.

The Keynesian group believed that man was essentially rational
and good. In discussing the group, Keynes said:

We were the last upholders of the eighteenth-century
heresy of progress... by virtue of which the human
race already consists of reliable, rational, decent
people, influenced by truth and objective standards,
who can be released from outward restraints of con-
vention and traditional standards and left to their
own sensible devices, pure motives, and reliable in-
tuitions of the good.46

This identification of virtue with knowledge was one of Keynes' guid-
ing lights. His faith was never shaken in the belief that all men
had the capacity of acquiring knowledge and thus to be virtuous. It

45 Ramsey, quoted in Essays in Biography, pp. 310, 311. See
note 34, above, for justification of this statement as indicative of
Keynes' own views.

46 My Early Beliefs, p. 89.
was modified only when he felt obligated to explain social injustice as being a result of the failure of the rational faculty to develop properly because of the blindness of the wealthy and the unequal economic opportunity afforded the poor.

Keynes' club had found in Moore a prophet and savior. They adopted his ethical intuition, according to which states of mind are the only entities relevant to ethics, with great enthusiasm.

The goodness of states of mind was known by direct inspection, about which it was useless and impossible to argue. Disagreement might arise. . .the two parties might not be talking about the same thing, not bringing their intuition to bear on precisely the same object, and by virtue of the principle of organic unity, a very small difference in the object might make a large difference in the result. . .or it might be that some people had an acuter sense of judgement, just as some people can judge a vintage port and others cannot. . .Broadly speaking, though, we all knew for certain what were good states of mind. . .they consisted in communion with objects of love, beauty, and truth. Our apprehension of good was exactly the same as our apprehension of green and we purported to handle it with the same logical and analytical technique which was appropriate to the latter.47

The third trace of Keynes' basic philosophy is found in the ethical principles in the light of which he surveyed the contemporary scene. The bases of his judgment of social and individual behavior were his belief in the supreme importance of man in the scheme of things, his belief in the essential goodness of man's states of mind, and his belief in man's individuality and uniqueness. Because he had faith in reason as the helper of knowledge and because he believed in the capacity of men to be guided by rational formulation, he

47 Ibid., p. 86.
emphasized the importance of the role of ideas in history:

...the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas...soon or late, it is ideas, not vested interests, which are dangerous for good or evil.48

Keynes insisted that unemployment and the sharp division between rich and poor were the chief social evils of the time:

Many of the greatest economic evils of our time are the fruits of risk, uncertainty, and ignorance. It is because particular individuals, fortunate in situation or in abilities, are able to take advantage of uncertainty and ignorance, and also because for the same reason big business is often a lottery, that great inequalities of wealth come about; and these same factors are also the cause of the Unemployment of Labour, or the disappointment of reasonable business expectations, and of the impairment of efficiency and production.49

Because he believed the ends of life were spiritual and not material, he loathed the overcalculation of utilitarianism and modern capitalism:

I do now regard the Benthamite tradition as the worm which has been gnawing at the insides of modern civilisation and is responsible for the present moral decay.50

...modern capitalism is absolutely irreligious, without internal union, without much public spirit. ..51

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50 My Early Beliefs, p. 72. 51 Essays in Persuasion, p. 306.
Perhaps above all, he hated the Puritan ethics of rejecting present enjoyment for the sake of a never-realized greater future enjoyment:

If mankind solves its economic problem, for the first time since his creation man will be faced with his real, his permanent problem—how to use his freedom from pressing economic cares, how to occupy the leisure which science and compound interest will have won for him, to live wisely and agreeably and well.

The strenuous purposeful money-makers may carry all of us along with them into the lap of economic abundance. But it will be those peoples, who can... cultivate into a fuller perfection, the art of life itself and do not sell themselves for the means of life, who will be able to enjoy the abundance when it comes...we have been trained too long to strive and not to enjoy...The love of money as a possession—as distinguished from the love of money as a means to the enjoyments and realities of life—will be recognized for what it is, a somewhat disgusting morbidity, one of those semi-criminal, semi-pathological propensities which one hands over with a shudder to the specialists in mental disease. All kinds of social customs and economic practices, affecting the distribution of wealth and of economic rewards and penalties, which we now maintain at all costs, however distasteful and unjust they may be in themselves, because they are tremendously useful in promoting the accumulation of capital, we shall then be free, at last, to discard.

I see us free, therefore, to return to some of the most sure and certain principles of religion and traditional virtue—that avarice is a vice, that the exaction of usury is a misdemeanor, and the love of money is detestable, that those walk most truly in the paths of virtue and sound wisdom who take least thought for the morrow. We shall once more value ends above means and prefer the good to the useful. We shall honour those who can teach us how to pluck the hour and the day virtuously and well, the delightful people who are capable of taking direct enjoyment in things, the lilies of the field who toil not, neither do they spin.52

This was the goal, and Keynes believed it would be achieved. For he said, "I still hope and believe that the day is not far off when the Economic Problem will take the back seat where it belongs, and

that the arena of the heart and head will be occupied, or re-occupied, by our real problems—the problems of life and of human relations, of creation and behavior and religion."53
CHAPTER III

KEYNES AND THE RECEIVED ECONOMICS

Since the time of Adam Smith there has been but one great cleavage in the fundamental method of economic analysis. That "break" with received economics was accomplished by the architects of the Austrian School of economics, Carl Menger, Friedrich von Wieser, and Eugen von Böhm-Bawerk.¹ Indeed, the cleavage was so wide and so deep that it is quite proper to refer to the Austrian school as the "New Economics."

By the time of Keynes, the two most important systems of economic analysis were the "Classical," as developed primarily by Adam Smith and David Ricardo and the "Austrian," as promulgated by the economists named above. Keynes "received" these two bodies of economic thought. John R. Commons was also an important anticipator of one of Keynes' value theories.²

The most important economic problem at the beginning of the nineteenth century was one of production or how to make available

¹According to Lewis H. Haney, "The members of this school, for better or for worse, were deeply influenced by German economic literature, and that literature was rich in criticism of objective exchange value theories and in psychological analysis." Lewis H. Haney, History of Economic Thought (New York: The Macmillan Co., Revised ed., 1933), p. 543.

²There are three theories of value in Keynes' works.
a larger supply of goods. In short, the problem was one of economic scarcity. And this formed the basis for the classical method of analysis. To support this contention one needs only to recall Adam Smith's great concern with production, J. B. Say's Law of Markets, the Malthusian theory of population, and David Ricardo's rent theory. The Classicists assumed demand to be given and formulated their analyses around the issue of supply.\(^3\)

Later classical economics, especially in its central and most controversial features, was an attempt to solve the problem of distribution, from the point of view of production. This analysis led to generalizations of great practical usefulness for a certain period. But as time went on the peculiar conditions, the specific proportion of economic factors that perhaps justified the classical analysis, were passing away. Ricardian economics declined from the position of authority it had held for nearly half a century. The successors of the classical economists following J. S. Mill abandoned the wages fund theory. The labor value theory of Ricardo was adopted by Karl Marx in support of radical socialism. A destructive attack was made on English classical economics by the German historical school. Shortly after the age of Ricardo the rent of English farms declined. After 1870, with the opening up of the agricultural lands in the Mississippi Valley and in Canada the rent of English farms fell still lower. The birth-rate in the more advanced countries of the west

\(^3\)For Malthus, this applies only to his theory of population. His principles of economics were formulated in terms of demand analysis. This is discussed at length in Ch. IV.
steadily declined. Population in France became stationary. In Ireland it actually decreased. Thus Ricardo's law of industrial progress as a universally valid formula was proved to be false. Wages rose and labor organizations grew in power in spite of the demonstrations of their futility by the classical economists. In the latter part of the nineteenth century English prosperity began to decline, even under a period of free trade. Large-scale industry began to develop in Germany and the United States. English industrialists began to feel the force of foreign competition. Production began to catch up with the world's demand for manufacture; and competition developed for foreign markets. The English manufacturers could no longer look forward to an unsatisfied demand for their products. With the rise of capitalism in other countries there developed a supply of capital from the United States, Germany, and France, so that capital accumulation on the part of the English enterpriser could no longer be assumed as inevitably an inhibitory factor. So there was a need for a new economic theory.

The Austrian economics was the answer to this obvious need for a reorientation of economic theory. The members of this school approached the subject of value and distribution from the point of view of consumption, of wants and feeling rather than from the point of view of the cost of production. In short, the emphasis in economic analysis shifted from "supply" to "demand." Their subjective theory of value was really the first complete break away from the objective valuation theory of the classicalists. According to Haney, "The 'Austrian

\[1\] See Haney, op. cit., pp. 528-530 for a rather long list of anticipators of the Austrian School.
School's so analyzes utility as to base a comprehensive theory of economic values upon subjective elements.\textsuperscript{5}

For the classical economists, cost of production determined value, with labor cost predominating in the total cost of producing a commodity. A commodity sold in the market at a price based on the costs incurred in producing it. The utility of a commodity to the user was recognized but it was taken for granted. Thus it is perfectly clear that the problem of valuation was approached from the supply side of the exchange transaction. The demand side of the equation was always considered to be sufficient and, therefore, demand was also taken for granted. All of this, of course, was in keeping with the great emphasis which the early classical economists placed upon the problem of supply or scarcity, and also, it was in accordance with Say's Law of Markets.

For the Austrians, however, human wants or needs are the origin of economic value. These wants or needs are in the human mind; they are subjective judgments of individuals. Value arises when people attach importance to limited quantities of things. Value comes at the margin—the utility to people of a little more or a little less. That is the central core of the Austrian marginal utility analysis. Value is measured by the least important use of any one unit.

Wieser's emphasis on maldistribution of wealth and income as a powerful factor causing a misdirected employment of productive resources is of great importance to the student of economic theory.

\textsuperscript{5}Ibid., p. 543.
and its history. This alone sets the Austrian school completely apart from Ricardian economics. It fits most snugly into that stream of economic thought that includes the commanded value theory of Malthus, the underconsumption theory from Lauderdale to H. Gordon Hayes, the institutional economics of Veblen and Commons, and particularly, the economics of Keynes. It was in Wieser that the Austrian school reached its apex in the new demand approach to economic analysis. Demand, particularly as it relates to value and production, has ever since been the focal point of economics.

It is true that the Austrians did not make a complete "break" with received economics. The Austrians followed the classical tradition in several ways. Their methodology included deductive reasoning. There was little attempt at statistical verification or critical analysis of postulates. The basic assumptions of classical economics were largely accepted by the Austrians—static conditions, freedom of industry, great mobility of capital and labor, a *laissez-faire* individualistic order, profit motivation, gain through adjusting production to a market price, hedonistic human nature, and the entrepreneur as the pivotal factor in industry and the class chiefly responsible for industrial progress.  

Austrian economics thus developed into a static analysis of the problem of value and distribution. The assumption that the

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entrepreneurial function was the most expandible factor was one in which the Austrians were in agreement with the later classicists. This implied several other assumptions, which seem to have been the actual conditions of the time—an individual economy, capital accumulation based on individual savings, invention proceeding faster than the accumulation of loanable funds, and production in the field of manufactures not yet adequate to the world demand for manufactured products. This again implied—that which was actually existent—vast unexploited natural resources, such as those of North and South America, South Africa, Australia, and Siberia; a growing world population or mass of labor to be organized (the population of the world doubled during the nineteenth century); and finally, an expandible or buoyant market for machinery or producer’s capital.

The chief point of departure from classicism was the attempt of the Austrians to explain value by states of feeling or consciousness rather than from the point of view of objective physical commodities. They approached the subject of value and distribution from the point of view of consumption, of wants and feeling rather than from the point of view of the cost of production. But it was a fundamental departure and quite sufficient to form a new economics.

In what broad and general ways is the economics of Keynes related to the Classical and Austrian idea systems? There is no intent on the part of the writer to labor this point. Consequently many of the apparent similarities between what is referred to in this chapter as "received" economics and the economics of Keynes will not be discussed. The concern is with only those broad contours of thought which are important to the systems under examination, and
which, to a large extent, have either been ignored or denied by many writers in the area of economic theory and its history. The few writers who have concerned themselves with this subject have invariably used terms such as "orthodox" or "traditional" to classify all economic thought before Keynes. That is to say, in their attempts to show what parts of the received economics influenced Keynes, they simply refer to orthodox or traditional economics. Using the terms in this fashion, it is impossible to know to what they have reference. In short, it is a grave error to refer to all economics from Smith to Keynes as orthodox or traditional economics. To "lump" together Classical, Austrian, and the later Marginal Utility economics is to misconceive the development of economic theory. Hence, in this attempt to assign to Keynes his proper position in the history of economic theory, care is taken to indicate throughout the discussion just what part of the received economics is under analysis.

Did Keynes make a major break with received economics when he refused to assume that the automatic functioning of the economy would result in full employment? As is well known, one of the more important lessons to be learned from the General Theory is that underemployment equilibrium is not only possible but characteristic of the capitalistic economy. It has generally been held that received economics assumed full employment, allowing only for frictional unemployment.

Schumpeter says, "...I repeat that the arguments that Keynes set forth against what he conceived to be the classical theory (in his sense) are entirely irrelevant against any correct statement of the full-employment equilibrium theory and that his indictment that the
classical theory knows no unemployment except a frictional one is true only if the term frictional is defined so widely as to rob the indictment of all significance.\(^8\)

Many reflections have been made on the "classical assumption" of full employment. In the most recent statements of this view, no quotation or reference is given in support of it; it has become a conventional remark, which gives to the Keynesian "New Economics" the advantage of another supposed contrast with the past. Keynes' view is strengthened when it is shown to be a fuller perception of ideas which were growing into their maturity, rather than when it is required to depend on the dangerous appeal to a new revelation. For example, the statement that "the point of departure (in the economics of Keynes) is that the level of employment can be effectively raised by changes in taxation, in the spending power of the government, or by other means,"\(^9\) should not be contrasted with, but related to, Mill's proposition that "governments can create additional industry by laying on taxes and employing the amount productively," and that "public loans are justified if otherwise capital would not have been saved or would have been used wastefully."\(^{10}\) There is, however, a longer history than that of the antecedents out of which the doctrine of full employment has grown.

Much of what is said in Chapter Five concerning the evolution of the

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doctrine of effective demand is relevant here also, but more special references have to be made at this point.

More justice should be done to Sir J. Steuart, a writer who came between the Physiocrats and Smith. He is not usually included among the classical economists, although Say quoted him several times, and Marshall believed that he made important additions to economic theory. Chapter Five indicates how Steuart anticipated Malthus with respect to the principle of effective demand.

Steuart was perhaps the first among modern writers in the field of economics to regard the provision of full employment as a duty of the State. While Smith gave only subsistence and public revenue as the right objects of political economy, as the "science of a statesman," Steuart had held that the object of an economy was to provide for the nourishment, the other wants, and the employment of every individual. That number of inhabitants is best which is compatible with the full employment of every one of them. Of what consequence is it to know how many people are in a country when the employment of them does not enter into the inquiry? A free and perfect society implies full employment for reciprocal and proportioned services between all who compose it. Whenever therefore anyone is found upon whom nobody depends, and who depends upon every one, as is the case with him who is willing to work for his bread, but who can find no employment, that is a breach of the social contract and an abuse.

Steuart then moved quickly to a program of action. He said:

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There is a vibration of work and demand; either may fail to support the other. The case may arise when work augments, and no more demand can be procured; it may then be expedient to diminish hands, by making soldiers of them, by employing them on public works or by emigration. Whenever the competition stands too long upon either side, the statesman must endeavour to load the lighter scale. That is to say, he must act either on demand for goods, or on provision of work. From this principle flows the authority vested in all governments to load the country with taxes in order to advance the prosperity of the State, and this object can be nowise better obtained than by applying the amount of them to the keeping of an even balance between work and demand, that is by the imposition of taxes and the right employment of them to retard or promote the consumption of every branch of industry. Under a frugal reign, numbers will diminish if the statesman does not open every channel which may carry off the superfluous products of industry. Here is the reason; a diminution of expense at home is a diminution of employment.\(^1\)

It goes without saying that Malthus is not among the classicalists who can be charged with an assumption of full employment, and the long final chapter of his *Principles* is referred to by Keynes. There is nothing on the subject, between Steuart and Mill, which bears on this question. There is a good deal of reference to the fact of unemployment in Smith, Senior, Lloyd, and Merrivale, but the observations are casual. At that time, it was population and production, not employment, which was the prior concern. There is no argument, in this period, of a relation of wage-rates to full employment. Smith based the wealth of a nation on capital accumulation. There are passages in Smith which may be interpreted to mean that he did not believe that the accumulation of capital was automatic. If capital did not in fact accumulate at a proper rate, unemployment would result.\(^2\)


Thus, we come to Mill. It is a quotation from Mill which is often called Say's Law. In his *Principles*, Mill stated a general proposition that the means of payment for commodities is other commodities, and that "all sellers are inevitably and *ex vi termini* buyers." If production were doubled "everybody would be able to buy twice as much because everyone would have twice as much to offer in exchange."\(^\text{16}\) He applied his limitation of this general case to the question of full employment in another place where he made it plain that the general rule can fail because of the division of labor. "Periods of brisk demand," he said, "are also the periods of greatest production; the national capital is never called into full employment but at these periods. The annual produce of a country is never anything approaching in magnitude to what it might be if all the capital were in full employment. This perpetual non-employment of a large proportion of Capital is the price we pay for the division of labour."\(^\text{17}\)

There is another line of thought in Mill, when he says that "it would be possible for the State to guarantee employment at ample wages to all who are born," but only if it could control the birth-rate.\(^\text{18}\) Otherwise, he believed, the individual product may, by sheer force of numbers, fall below the necessary subsistence wage, and there would be unemployment. Here again full employment fails for an essential reason, the laws of population and diminishing returns. But

\(^\text{16}\) Mill, op. cit., p. 558.


even if population could be controlled, the possibility of full em-
ployment was made to depend by Mill on an action of the State which
could create "additional industry" by laying on taxes and employing
the amount of money secured in a productive manner. 19

It is therefore impossible to ascribe to Mill the opinion
that full employment was a result of the free operation of the eco-

nomic system. It is not unusual, in any analysis, to indicate the
limiting case, where conditions are ideal, and to introduce qualifi-
cations. The ideal must also be allowed for in the Keynesian analy-
sis; there, full employment will result from the government's policy
only if its proposals work ideally, if all the estimates of invest-
ment are correct, all the statistics faultless, and there are no dis-
turbances or interferences.

Surely no one can read the statements written by Wieser con-
cerning distribution of wealth and maintain that the Austrians assumed
full employment. Wieser said:

. . . Production is ordered not only according to simple want,
but also according to wealth. Instead of things which would
have the greatest utility, those things are produced for
which the most will be paid. The greater the differences in
wealth, the more striking will be the anomalies of production.
It will furnish luxuries for the wanton and the glutton, while
it is deaf to the wants of the miserable and the poor. It is
therefore the distribution of wealth which decides how pro-
duction is set to work, and induces consumption of the most
uneconomic kind: a consumption which wastes upon unnecessary
and culpable enjoyment what might have served to heal the
wounds of poverty. 20

Anyone concerned with healing "the wounds of poverty" could not assume
full employment.

19 Ibid. 20 Wieser, op. cit., p. 58.
Thus, professional economic thought since before Smith has not supported a policy of public inaction regarding unemployment nor has it assumed full employment. But the Keynesian analysis gains rather than loses authority if it recognizes, instead of depreciating, the growth of its ideas in the work of earlier writers.

Smith's contention that capital accumulation determined the wealth of a nation may be viewed in a different matrix. Throughout the history of capitalism, capital (goods) has been formed and accumulated by and through the investment process; that is, the expenditure of capital (funds) for the purpose of creating goods other than consumption goods. Thus, what Smith was in effect saying was that the welfare of the economy depended upon investment. And Keynes, in making investment, along with the consumption function, the determinant of effective demand, came to exactly the same conclusion as did Smith. For Keynes, employment could not increase unless investment increased. For Smith, the wealth of a nation could not increase; production could not increase; employment could not increase unless the quantity of capital goods increased.

Many writers contend that Keynes embraced a labor theory of value. The writer agrees, with the qualification that Keynes also had an "expectation" theory of value, which is discussed later in the present chapter, and a "commanded" theory of value, which is examined in Chapter Five. As to Keynes' labor theory of value:

It is much preferable to speak of capital as having a yield over the course of its life in excess of its original cost, than as being productive. For the only reason why an asset offers a prospect of yielding during its life services having an aggregate value greater than its initial supply price is because it is scarce; and it is kept scarce because
of the competition of the rate of interest on money. If capital becomes less scarce, the excess yield will diminish, without its having become less productive—at least in the physical sense.

I sympathise, therefore, with the pre-classical doctrine that everything is produced by labour, aided by what used to be called art and is now called technique, by natural resources which are free or cost a rent according to their scarcity or abundance, and by the results of past labour, embodied in assets, which also command a price according to their scarcity or abundance. It is preferable to regard labour, including, of course, the personal services of the entrepreneur and his assistants, as the sole factor of production, operating in a given environment of technique, natural resources, capital equipment and effective demand. This partly explains why we have been able to take the unit of labour as the sole physical unit which we require in our economic system, apart from units of money and of time.21

One might view this as a revolutionary doctrine were it not for the fact that Adam Smith and Ricardo and practically all their contemporaries looked at the economic process in much the same manner.

The elimination of the scarcity of capital assets along with the advocacy of socialized investment led in quite logical fashion to Keynes' conclusion that labor was the sole factor of production. Keynes' labor theory of value had something in common with Marx's value theory as well as with the value theories of Smith and Ricardo. But this is more or less irrelevant for the purpose of this study. The significant factor is to recognize that Keynes did not "break new ground" when he embraced the labor theory of value. This is but another way in which the economics of Keynes is related to the classical tradition.

This acceptance of a labor theory of value did not, however, cause Keynes—as it had the classicists—to employ a "supply" approach

to economics. His idea system throughout embraces and uses the "demand" approach formulated so well by the Austrians. Even his emphasis on investment is a demand and not a supply concept. Consumption, human want, and human need were not taken for granted by Keynes just as they had not been assumed by the Austrians. Quite the contrary, it was the supply function that was taken as given by Keynes; then, he formulated his entire analysis around the demand function. As all economists know, even the marginal concepts—marginal efficiency of capital and marginal propensity to consume—are quite in keeping with the Austrian marginal utility concept.

Thus, with reference to assigning Keynes to his proper position in the history of economic theory, his idea system flows from the Austrian method of analysis and not the classical. This was Keynes' "break" from classical economics, but the "break" was effected more than half-a-century before the appearance of the General Theory.

John R. Commons' Theory of Value and Keynes

The final task of this chapter is to show the relationship between the "volitional" theory of value of John R. Commons and the "expectation" theory of value of Keynes. 22

For the classical economists, value had its origin in labor, its time was in the past, and its source was supply. For the Austrians, value had its origin in the mind, its time was the present, and its

source was demand. For the Volitional Theory of John R. Commons, value had its origin in the transaction, its time was the future, and its source was also the transaction.

Commons' theory of value was similar to the Austrians but it was not Hedonistic. Evaluation was an individual phenomenon in the Hedonic theory. But for Commons, evaluation involved collective action. He believed that the objective of economic study was the collective behavior of man-made institutions as they functioned around the institution of private property, codified laws, and court decisions. The very first sentence in his, Institutional Economics reads, "My point of view is based on my participation in collective activities, from which I here derive a theory of the part played by collective action in control of individual action."²³ The problem of economic study was "not to create a different kind of economics--'institutional' economics--divorced from preceding schools, but how to give to collective action, in all its varieties, its due place throughout economic theory. In my judgment this collective control of individual transactions is the contribution of institutional economics to the whole of a rounded-out theory of Political Economy."²⁴

Commons was critical of the value theory of classical economics because it failed to recognize the importance of collective action as determinants of value and price. Neither did the theory see and understand the importance of private property or the impact of courts of


²⁴Ibid., pp. 5, 6.
law as enforcing agencies of collective action. It was these faults in received value theory with which he grappled. And the result was a new theory of value.

For Commons, transactions took place in an institutional environment. Institutional conditions such as the open shop, labor unions, the closed shop, monopoly, etc. prevailed in the real world, and Commons refused to ignore these in the formulation of his value theory. He was a pragmatist, a realist; he believed that it was high time for economists to stop being so "pure" and start being more "functional." All of this is reflected in his theory of value. Basically, Commons was concerned with "reasonable value;" that is, how could reasonable value be arrived at through the transaction process. By this type of value, he meant a value that would be fair and equitable to everyone concerned in the transaction.

It will be recalled that Smith's niggardliness of nature, Ricardo's diminishing returns and rent theory, and Malthus' theory of population made scarcity the most important problem in economics. This, of course, evolved into Say's Law of Markets. According to the classical thought, anyone who attempted to create scarcity, primarily by monopoly, should be eliminated. In the United States, this way of thinking led to the passage of the Sherman Anti-Trust Act and other anti-trust legislation.

Commons would have none of this type of thinking in relation to valuation problems. He believed that since transactions occurred between collective groups, those groups should have about equal bargaining strength. If they did not, then, some institutional force must make it so or more nearly so. If the strength of the bargaining
groups were about the same, the result would be just about as it should; that is, reasonable value for all concerned would be realized. For Commons, the government should be the institutional force making for this equality of bargaining power or strength. The government must formulate the rules governing the transactions and then act as umpire in the exchange process to see to it that the rules were followed. Commons was not interested in equilibrium price because that price could be an exploitative one; that is, not a reasonable price.

Commons recognized that there were people who attempted to gain riches by increasing supply, but there were others who strived to enrich themselves by creating scarcity. It was the latter group that concerned Commons because scarcity, itself, created value; and the transaction was largely between those who controlled the supply, that is, the scarcity. It was this recognition of the real world that caused Commons to insist that, if necessary, the government must act to equalize bargaining power. Governmental legislative and umpiring activities were Commons' program of action to protect the weak in the bargaining processes. This is what he meant by individual control by collective action. Thus, Commons would not attack the problem of unequal bargaining power, monopoly, and scarcity with anti-trust legislation. He would not destroy the groups that tried to obtain wealth by creating scarcity, but he would try to equalize the bargaining processes. This would be his working rules of social action.

However, once the rules are established, reasonable value may still not be realized because of the slope of the demand curve. Suppose the demand curve is a highly elastic one but production is
in the nature of a monopoly. Now assume that prices are increased by 10 per cent. Demand would fall sharply as consumers shifted their expenditure to substitutes. Thus, there is no need to worry a great deal about consumers if the demand is highly elastic and there are substitutes for the commodity available. Now assume high inelastic demand. Under this condition, sellers tend to raise prices higher and higher. Demand would not change much. It was under these circumstances that Commons insisted on some new rules which would insure reasonable value. Perhaps these prices should be set as are the prices charged by public utilities. This demonstrates quite clearly that Commons' theory of value and his ideas concerning economic policy were inseparable.

McCracken sums up Commons' theory of value very neatly in the following words: "For Commons, man was not a hedonistic creature arriving at vital conclusions with respect to value on the monetary sensations of pleasure and pain. But rather, man was a rational, calculating being, forcing himself by a volitional act of the will to make appraisals and evaluations, yet appraisals and evaluations designed to discover the present worth of future expectations. Value is a mental appraisal in the present of expected future uses or incomes." These appear to be the basic principles around which Commons constructed his idea system, particularly his theory of value. Thus, Commons' "futuristic"-"transactions" theory of value was a "break" of great importance with received economics.

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It has been shown that by the very nature of his analysis, Keynes embraced a labor theory of value. But perhaps his idea system was too broad and general, after the fashion of the Wealth of Nations, to be contained in only one value theory. In any event, as was indicated earlier, Keynes had three theories of value. In his Chapter, "Expectation as Determining Output and Employment," Keynes expressed the same concept of value that Commons had formulated some fifteen years earlier. It was the "futuristic" idea; Keynes referred to it as "expectations."

All production is for the purpose of ultimately satisfying a consumer. Time usually elapses, however—and sometimes much time—between the incurring of costs by the producer (with the consumer in view) and the purchase of the output by the ultimate consumer. Meanwhile the entrepreneur (including both the producer and the investor in this description) has to form the best expectations he can as to what the consumers will be prepared to pay when he is ready to supply them (directly or indirectly) after the elapse of what may be a lengthy period; and he has no choice but to be guided by these expectations, if he is to produce at all by processes which occupy time.

These expectations upon which business decisions depend, fall into two groups, certain individuals or firms being specialised in the business of framing the first type of expectation and others in the business of framing the second. The first type is concerned with the price which a manufacturer can expect to get for his "finished" output at the time when he commits himself to starting the process which will produce it; output being "finished" (from the point of view of the manufacturer) when it is ready to be used or to be sold to a second party. The second type is concerned with what the entrepreneur can hope to earn in the shape of future returns if he purchases (or, perhaps, manufactures) "finished" output as an addition to his capital equipment. We may call the former short-run expectation and the latter long-term expectation.

Thus the behaviour of each individual firm in deciding its daily output will be determined by its short-term expectations—expectations as to the cost of output on various possible scales and expectations as to the sale-proceeds of this output; though, in the case of additions to capital equipment and even of sales to distributors, these short-term expectations will largely
depend on the long-term (or medium-term) expectations of other parties.26

Thus, for Keynes, the expectations of the enterprisers determine value, not only for consumers' goods but for capital goods as well. It falls again to McCracken to neatly sum up Keynes' expectation theory of value.

According to him (Keynes), the present value of anything is the discounted present worth of all expected future annuities. It matters not whether one is thinking of a 3 per cent government bond maturing in 20 years, or an office building in a metropolitan area. It matters not what historical costs may have been according to an accounting statement or what the incomes have been in previous years—except to the extent that past incomes may supply a rational basis for future expectations. Any basic change in technology or permanent shift in demand automatically divorces future expectations from past experience and present values are adjusted accordingly.27

Then, McCracken says, "Many young economists have given Keynes credit for this novel and modern idea. However, it was my privilege to be exposed to this idea as long ago as 1921 while pursuing graduate work at the University of Wisconsin in the 'value and valuation' seminar of John R. Commons. At that time he was working out a system of economic thought which he chose to call the 'volitional theory of value.'"28

26General Theory, pp. 46, 47.
27McCracken, Economic Contradictions, pp. 345, 346. See General Theory, Ch. 5.
28Ibid., p. 346.
CHAPTER IV

EVOLUTION OF THE DOCTRINE OF EFFECTIVE DEMAND

The doctrine of effective demand is not a "new-comer" in the history of economic theory. Quite the contrary is true. This principle that demand cannot be assumed or taken as given, and that a deficiency of demand can and does lead to terrible economic consequences has been present in the stream of economic theory since at least the very beginning of the eighteenth century.

The purpose of this chapter is to examine this doctrine that has characterized the social thought of the economic "underworld" for more than two hundred and fifty years from the perspective of its historical development. The names most closely associated with the doctrine of effective demand during this period are: Boisguilbert, Mandeville, Steuart, Lauderdale, Malthus, Sismondi, Aftalion, Hobson, and Foster and Catchings. These are the men we shall examine. These are the men who nurtured the doctrine for more than two centuries until a "Keynes" appeared and caused it to burst into full bloom.

Keynes, of course, recognized that the principle of effective demand had long been a part of economic theory. He expressed this when he wrote, "It is no new thing, however, to ascribe the evils of unemployment to the insufficiency of the propensity to consume. But this explanation of the economic evils of the day... played a small part in sixteenth and seventeenth-century thinking and has
only gathered force in comparatively recent times. He then pointed out that Laffemas, Petty, von Schrotter, Barbon, and Cary had emphasized consumption, or effective demand, as early as the seventeenth century. He also paid tribute to Mandeville, Hobson, and of course, Malthus. Keynes' treatment of these three men is presented in connection with the discussion of them.

Pierre le Pesant de Boisguilbert

The study of the evolution of the doctrine of effective demand may properly begin with Pierre le Pesant de Boisguilbert, a writer who has been largely ignored by historians of economic thought. Those writers who have not completely neglected Boisguilbert have associated him with anti-mercantilism, free trade, and agricultural primacy. There is no mention of Boisguilbert in the General Theory, although, in Chapter 23, Keynes mentions Laffemas, Petty, von Schrotter, Barbon, Cary, and Mandeville as men who made consumption or "effective demand" an important part of their idea systems. Boisguilbert appeared between Cary and Mandeville, and anyone who has studied his writings must conclude that he emphasized mass consumption as the fundamental source of national economic well-being to a far greater degree than did any of the writers mentioned by Keynes. In fact, one authority on Boisguilbert wrote, "No modern writer adhering to the belief that economic ills spring

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1 General Theory, p. 358.
2 See Ibid., pp. 358, 359 for a brief statement by each of these men as quoted by Keynes.
in large part from underconsumption has put the case more strongly than Boisguilbert.\(^4\)

As has been true with so many economists, the economics of Boisguilbert reflected the great economic and social problems present in France during the latter quarter of the seventeenth century. The major economic problem in France during this period was what would now be referred to as secular stagnation. From roughly 1665 to 1700, the economy of France had grown progressively weaker. Commerce and trade had declined greatly. Agriculture had become more and more depressed; population had declined until the rural areas were almost deserted and many villages abandoned; and people were starving to death, not only because they did not have sufficient purchasing power but also because there was an absolute shortage of food. France was nothing more than a great poorhouse, desolate and without provision.\(^5\) Vauban estimated in 1707 that one-tenth of the French population actually begged, while five-tenths were "reduced almost to that unhappy condition."\(^6\)

Between 1695 and 1707, Boisguilbert published five short books and treatises, each of which was an attempt to explain to the public this terrible economic wretchedness that had befallen France. In addition, his writings contained programs of action designed to cure

\(^4\)This statement is quoted by McDonald, op. cit., p. 401, and he cites "Hazel V. Roberts, Boisguilbert, Economist of the Reign of Louis XIV, p. 287."


Like most great theoretical economists, Boisguilbert was concerned with the wealth of the nation and the forces which determined it. He refused, as Adam Smith was to do nearly a century later, to accept the mercantilistic idea that bullion was wealth. For Boisguilbert, wealth was economic goods such as, "food and clothing" and "bread, wine, meat, or other commodities." He was very clear in his definition of true wealth. It consisted of "a complete enjoyment, not only of the needs of life, but even of all the superfluities and of all that can give pleasure to the sensuality, concerning which the corruption of the heart invents and refines forever." But more quantity of goods and productive powers could not measure true national wealth. The important factors were the utilization of a nation's powers of production and, even more important, the consumption of the goods. It was not enough that a nation have a large quantity of all of the means of production. Consumption was the key to the creation of wealth. Consumption set the means of production into motion and determined their employment. "All the most exquisite fruits of the earth and the most precious commodities

7 See McDonald, op. cit., p. 403, for a very brief summary of the books and treatises. These five works are reprinted in Daire, op. cit., and all references to Boisguilbert's writings in this dissertation are to this edition.


are only manure when they are not consumed." Boisguilbert took an equally positive position with reference to money. It was only a medium of exchange.

Gold and silver are not and never have been wealth in themselves, having value only relatively, and insofar as they can procure the necessary things of life, with regard to which they serve only as a pledge and a measure. It is a matter of indifference whether there is more or less (of money), provided it can produce the same results.

Concerning wealth, money is only the means and the method, while the commodities useful to life are the end and the aim.

Boisguilbert argued that the quantity of money presented no problem. Its velocity of circulation was important but this was a function of the demand for goods. This functional relationship created an effective elasticity to the supply of money. If the demand for goods increased, the increase in the velocity of circulation of the medium of exchange would create purchasing power despite the scarcity of gold or silver. Here again, he stressed consumption.

Money is uniquely the slave of consumption, following step by step its destiny, and moving or stopping with it, an ecu passing a hundred times in a day, when there are many sales and resales, and remaining for entire months in a single place when consumption is ruined.

And,

It is consumption which leads the march; money stops,

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13 Ibid., p. 198.

14 *Factum*, p. 320.
dislodges, and runs along with consumption. Thus when there is very much consumption, a little silver, on account of its frequent appearances, passes for a great quantity of specie; consumption diminishing, silver stops immediately and causes it to be said that there is no more of it.\textsuperscript{15}

Even if the velocity of circulation of the medium of exchange were insufficient to facilitate trade and commerce, there was no reason for great concern. There was always the bill of exchange to supplement and/or replace coin. According to Borsguilbert, much of the trading that occurred in a market was carried on with bills of exchange.\textsuperscript{16}

It is not a question of there being much silver, but that it should march and circulate always, and of what this celerity consists, and what causes it. When this speed of movement of silver does not suffice for the number of masters it is obliged to serve, it produces an infinity of children, whom it clothes with all its authority. These are bills of exchange, or paper money, that is to say, inexhaustible matter provided there be enough workmen to coin it. These workmen are the merchants or courtiers of consumption.\textsuperscript{17}

Thus it appears clear that Borsguilbert's concept of money and wealth was not merely an attempt to refute the mercantilistic theory of wealth as so many writers have concluded. More important was the relationship between this concept and Borsguilbert's major argument that only by a program designed to create and maintain mass purchasing power at high levels could the people of France enjoy a higher standard of living. The basic theme which runs through all of

\textsuperscript{15}Letter to Chamillart of July 1, 1704, cited by Roberts, op. cit., p. 212.

\textsuperscript{16}Dissertation, p. 377.

\textsuperscript{17}Letter to Chamillart of July 19, 1704, quoted by Roberts, op. cit., pp. 47, 48. (Roberts' translation).
his works was that effective demand, and not money nor its quantity, was the key to national and individual economic welfare. Economic stagnation and poverty resulted from a deficiency of effective demand. If effective demand failed, any supply of money would be totally ineffective in preventing economic depression.

Having defined wealth as he did, Boisguilbert was quick to see a relationship between wealth and total demand. Aggregate money expenditure determined the income of a nation. Or better still, total consumption expenditure determined the wealth of a nation. 18 "It may be established as a principle," he said, "that consumption and income are one and the same thing; and that the ruin of consumption is the ruin of income." 19

Boisguilbert placed great emphasis upon the distribution of income; in fact, it was this that determined the level of consumption. He argued that the "little" people must have purchasing power to create a level of income comparable to full employment. These people spent their money and thereby created income and employment. On the other hand, much of the money which flowed into the pockets of the rich was hoarded. There was no necessity for them to spend all of it to satisfy their needs and desires. Boisguilbert expressed the "Keynesian" concepts of the "propensity to consume" and the "propensity to save" in the following manner:

18 Boisguilbert did not always explain what he meant by the word "expenditure." In general, however, he used it to mean consumer spending. The French word "consommation," which he used, may be translated literally as "consumption" or "expenditure."

19 Ibid., p. 183.
An eau with a poor man or a very small merchant has a hundred times more effect, or rather, causes more income, than with a rich man, because of the continual daily turnover that this modest sum experiences with the former. This does not happen with regard to the other, in the coffers of which considerably greater quantities of money remain for months and entire years idle, and consequently useless, whether due to corruption of heart blinded by avarice, or to the waiting for a better market.

But, from this saving, the king and the body of the nation obtain no utility, and this amounts to so much theft from both.

But this sum, such as a thousand ecus, distributed among a thousand people of small means, would pass one hundred thousand hands in less time than it occupied the coffers of this rich person, which would not be able to happen without consequently causing one hundred thousand ecus of consumption expenditures.\(^{20}\)

Boisguilbert understood that investment spending created income and employment. But he also realized that all saving did not flow immediately into investment. With reference to saving and not investing during a period of deflation, he said:

And what is said of the merchant is equally true of all persons who live on their (property) incomes, should it be from landed estates or invested funds. Receiving their returns, they are not able to reinvest them for lack of security, because the most ordinary affectations being over the lands, the product of them diminishes every day before our eyes, due to the destruction of consumption. Also, they would rather lose the interest than risk the capital, retrenching to incur less expense, which is an increase of disaster for the body of the republic.\(^{21}\)

Even during better times, the rich, "dealing only in large affairs, wait long periods of time for their sum to be furnished... before sending forth their money, which is always prejudicial to the state. ... All of which shows what an interest a country has that its inhabitants should not be in an obligation to spend less money than they

\(^{20}\)Dissertation, pp. 401, 402.

\(^{21}\)Détail, p. 199.
In this manner, Boisguilbert promulgated a theory of income determination in terms of money flows. And thus in the broad contours of the development of the history of economic thought, he anticipated Keynes in great detail with reference to the doctrine of effective demand.

For Boisguilbert, both recurring crises and secular stagnation, which had plagued France for so long, were the result of a failure of consumption. His explanation of the business cycle was not only unique but also ingenious at the time it was formulated. The theory appears in his *Traité des grains* and briefly runs as follows:

The farmer, because of strong competitive price forces, must sell his wheat on the market at whatever price it would demand. In years of good crops, the price would be low because of the great supply. It was common for the price to be so low that the ordinary costs of production; that is, the costs of maintaining his family and paying his rent, could not be covered. This, of course, resulted in definite losses for the farmer. The immediate effect of this was a reduction in consumption on the part of the farm family. But that was not all. His expenditures for such items as seed, fertilizer, and labor would decline. Under these conditions the farmer had two avenues open to him. First, he could leave the farm and seek employment elsewhere. Second, he could try to get his landlord to postpone the rent payments or to waive them entirely. Which course the farmer selects to follow is more or less immaterial. The significant factor is that the landlord

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experiences a decrease in his income regardless of what course the farmer takes. This causes the landlord to reduce his demand for goods of all types. However, his expenditures for luxury items will decline first. The effect of this is to reduce the income of the men who produce these goods. Then, they buy less of everything, particularly consumer goods. The final effect is that all those engaged in supplying consumer goods will suffer a decline in money income and this will be reflected by a drop in demand all around the place. There is a general reduction in purchasing power throughout the economy. Of course, the decline in consumption has an adverse effect on investment. And this further reduces national income.

Thus, from low grain prices there stems "the ruin of the farmers of the lands, which entrains that of their masters and of their creditors, by a gradation that extends infinitely, and which owes all its principle to the cessation of consumption." This may be classified as an agricultural-underconsumption theory. The crisis originates in agriculture and spreads throughout the economy through the factor of consumption.

The depression continues until grain prices start rising. This inflation of farm prices results from a diminished supply. Because of the depressed prices of grain farmers abandon the land in large numbers. Furthermore, those who remain on the land are forced to use poor cultivation methods such as eliminating manure and tillage. Finally, supply will fall below demand at current prices, particularly

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23 Boisguilbert, Traité des grains, pp. 333, 334.

24 Détail, p. 191.
if a drought or plant disease causes output to be far below normal. The rising prices will encourage reentry into farming and improved cultivation methods. Thus the cycle starts over again.25

Boisguilbert had a positive program which he believed would eliminate the business cycle. His basic contention was that grain prices must be stabilized. To accomplish this, he designed a program which called for the abolition of the mercantilistic policy of prohibiting the export of grains. He was convinced that grain prices and production could be partly stabilized by following a policy of free export of grains. And this stabilization would cause an increase in the production of grains and a better distribution of income. This second effect would increase mass consumption. But he did not place complete reliance upon the free export policy. His program also called for government price supports on grains, "to sustain the price which grain has once contracted."26

But Boisguilbert's major reform was directed at secular stagnation. As we should now expect, he found the cause of the secular decline in national income to be the result of a deficiency in effective (consumer) demand. This failure of demand resulted directly from the French tax system. Certain types of taxes prohibited consumption, while others made consumption impossible.

Consumption has ceased because it has become absolutely prohibited and absolutely impossible. It is prohibited by the uncertainty of the Taille, which, being entirely arbitrary, has no more certain incidence than to be paid

26Ibid., p. 369.
higher the more one is poor, and the more value is assigned to property owned by defenseless persons... Finally, consumption has become impossible by reason of the Aides and the Douanes on the exports and internal movements of the kingdom, which have put all the commodities at a point that not only are they transported outside no more than a quarter of what they were before, but they perish in the very places where they are produced, while in other places quite nearby they are valued at an exorbitant price.27

Boisguilbert's program called for a tax system that would not seriously reduce the nation's power to consume. He believed that taxes should be certain and not arbitrary and that they should be easy to collect.28 He also argued that taxes should be universal and levied in proportion to ability to pay.29

He argued that no person should be left off the tax rolls for any reason. Nobles, clergy, officials, and other influential people must pay their share of the tax burden. "And when God commanded to pay tributes to the princes," he said, "He pretended to speak to everyone, and not to the wretched and defenseless only, who would be unable to exempt themselves from them."30 Moreover, taxes should be levied on the principle of ability to pay. "For tributes, like all sorts of debts, draw their quality of excessiveness or moderateness, not from the absolute amount of the sums demanded, but from the value of the property from which they are exacted."31

Boisguilbert did not discuss taxation in terms of progressive rates, but he certainly did imply that progressive taxation would aid in the economic welfare of France. For example, he said, "It is

27 Détail, p. 172.
28 Ibid., p. 212. 29 Ibid., p. 208. 30 Ibid.
31 Supplément, p. 246.
certain that an individual who pays 100 francs of Taille on a farm of 1,000 livres, would be far less charged in paying 200, if the farm could return 2,000 livres." He also pointed out that, "If then the rich understood their interests, they would entirely discharge the wretched of their taxes, which would form immediately so many opulent people; and this, being impossible without a great increase in consumption, which spreads over all the mass of a state, would repay the rich three times their first advances."  

These were the general principles of Boisguilbert's reform program. He hoped to prevent recurring crises by stabilizing grain prices and he believed that the secular decline in the national income of France could be halted by abolishing certain sections of the tax system and reforming others. Underlying the entire program was his firm conviction that the purchasing power of the "little" people of France had to be protected in the interest of national economic welfare.

For Boisguilbert, just as it was to be for Keynes over two hundred years later, effective demand was the dynamic factor in determining the level of national income and employment.

**Bernard Mandeville**

Bernard Mandeville, a Dutch immigrant to England, was neither an economist nor a philosopher but a doctor with considerable philosophical talent. There seems to be no exact certainty about the date of his birth, but most writers estimate it to have been in 1670;

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32 *Détaillé*, p. 206.

33 *Dissertation*, p. 402.
he died in 1731.

Many writers in the area of economic theory and its history refer to Mandeville as a precursor of Adam Smith. They point out that the *Fable of the Bees*, published in 1714, has pointed suggestions regarding self-interest and division of labor. It is true that Mandeville did clearly express the concept of division of labor and illustrated the idea by showing how watches and clocks were produced. According to Haney, Mandeville was perhaps the first to use the words "divided" and "division" in this connection.  

But the concern with Mandeville here is not in relation to Smith. He is examined in terms of his contribution to the doctrine of effective demand. Mandeville's work at first consisted of a poem of 400 lines entitled "The Grumbling Hive: or Knaves Turn'd Honest," which was published as a pamphlet in 1705. In 1714 the poem was reprinted and accompanying it was a much greater amount of prose than appeared in the first edition. The 1714 product was called *The Fable of the Bees: or Private Vices, Public Benefits; with an Essay on Charity and Charity Schools and a Search into the Nature of Society*. Finally in 1729, Mandeville added a second part, nearly as large as the first, which consisted of a dialogue on the subject. The "grumbling hive," which was in reality a characterization of a human society, was described in the poem as prospering greatly so long as it was full of vice:

> The worst of all the multitude

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Did something for the common good.
This was the state's craft, that maintain'd
The whole, of which each part complain'd:
This, as in music harmony,
Made jarrings in the main agree;
Parties directly opposite,
Assist each oth'r, as 'twere for spight;
And temp'rance with sobriety
Serve drunkenness and gluttony.
The root of evil, avarice,
That damn'd ill-natur'd baneful vice,
Was slave prodigality,
That noble sin; whilst luxury
Employ'd a million of the poor,
And odious pride a million more:
Envy itself and vanity
Were ministers of industry;
Their darling folly, fickleness
In diet, furniture, and dress,
That strange ridic'lous vice, was made
The very wheel that turn'd the trade.
Their laws and cloaths were equally
Objects of mutability;
For what was well done for a time,
In half a year became a crime;
Yet whilst they altered thus their laws,
Still finding and correcting flaws,
They mended by inconstancy
Faults which no prudence could forsee.
Thus vice nursed ingenuity,
Which join'd with time and industry,
Had carry'd life's conveniencies,
It's real pleasures, comforts, ease,
To such a height, the very poor
Lived better than the rich before;
And nothing could be added
more.

The bees, however, were not happy living under these conditions
and grumbled so much that Jove abolished fraud from the hive. The bee
community became honest, frugal, and virtuous. The result was a great
reduction in expenditure which ruined trade and commerce. In his
"search into the Nature of Society," Mandeville concluded:

35 Quoted in Adam Smith, Wealth of Nations (New York: Random
House, 1937), Editors Introduction, pp. lii, liii, cited from Fable
of the Bees, pp. 11, 13 in the ed. of 1705.
After this I flatter myself to have demonstrated that neither the friendly qualities and kind affections that are natural to man, nor the real virtues he is capable of acquiring by reason and self-denial, are the foundation of society: but that what we call evil in the world, moral as well as natural, is the grand principle that makes us sociable creatures, the solid basis, the life and support of all trades and employments without exception: that there we must look for the true origin of all arts and sciences, and that the moment evil ceases the society must be spoiled, if not totally dissolved.36

In a letter dated August 10, 1723, to the London Journal, Mandeville said, "That on the multiplicity of those wants depended all those mutual services which the individual members of a society pay to each other: and that consequently, the greater variety there was of wants, the larger number of individuals might find their private interest in labouring for the good of others, and united together, compose one body."37 In this one statement one finds expressed the principles of aggregate demand, self-interest, division of labor, and the idea that one person's spending is another person's income.

Keynes believed that it was Mandeville's work more than any other that popularized the idea that spending was a virtue and frugality was a vice. He refers to the Fable of the Bees as a work "which stands out in the history of the moral sciences for its scandalous reputation," and mentions the fact that the book was "convicted as a nuisance by the grand jury of Middlesex in 1723."38

According to Keynes, "The text of the Fable of the Bees is an


37Quoted in Ibid., pp. liii, liv, cited from Ibid., p. 465 in ed. of 1724.

38General Theory, p. 359.
allegorical poem—'The Grumbling Hive, or Knaves turned honest,' in which is set forth the appalling plight of a prosperous community in which all the citizens suddenly take it into their heads to abandon luxurious living, and the State to cut down armaments, in the interests of Saving." Then he quoted the following parts of the poem:

No Honour now could be content,
To live and owe for what was spent,
Liv'ries in Broker's shops are hung;
They part with Coaches for a song;
Sell stately Horses by whole sets;
And Country-Houses to pay debts.
Vain cost is shunn'd as moral Fraud;
They have no Forces kept Abroad;
Laugh at th' Esteem of Foreigners,
And empty Glory got by Wars;
They fight, but for their Country's sake,
When Right or Liberty's at Stake.

"The haughty Chloe"

Contracts th' expensive Bill of Fare,
And wears her strong Suit a whole Year.

"And what is the result?—"

Now mind the glorious Hive, and see
How Honesty and Trade agree:
The Shew is gone, it thins apace;
And looks with quite another Face,
For 'twas not only they that went,
By whom vast sums were yearly spent;
But Multitudes that lived on them,
Were daily forc'd to do the same.
In vain to other Trades they'd fly;
All were o'er-stocked accordingly.
The price of Land and Houses falls;
Mirac'rous Palaces whose Walls,
Like those of Thebes, were rais'd by Play
Are to be let. . .
The Building Trade is quite destroy'd
Artificers are not employ'd;
No Limner for his Art is fam'd,
Stone-cutters, Carvers are not nam'd.

39 Ibid., p. 360.
"So 'The Moral' is:"

Bare Virtue can't make Nations live
In Splendour. They that would revive
A Golden Age, must be as free,
For Acorns as for Honesty.\(^0\)

In Keynes' view, "Two extracts from the commentary which follows the allegory will show that the above was not without a theoretical basis:"\(^1\) He quotes from Mandeville:

As this prudent economy, which some people call Saving, is in private families the most certain method to increase an estate, so some imagine that, whether a country be barren or fruitful, the same method if generally pursued (which they think practicable) will have the same effect upon a whole nation, and that, for example, the English might be much richer than they are, if they would be as frugal as some of their neighbors. This, I think, is an error.\(^2\)

"On the contrary, Mandeville concludes:"

The great art to make a nation happy, and what we call flourishing, consists in giving everybody an opportunity of being employed; which to compass, let a Government's first care be to promote as great a variety of Manufactures, Arts and Handicrafts as human wit can invent; and the second to encourage Agriculture and Fishery in all their branches, that the whole Earth may be forced to exert itself as well as Man. It is from this Policy and not from the trifling regulations of Lavishness and Frugality that the greatness and felicity of Nations must be expected; for let the value of Gold and Silver rise or fall, the enjoyment of all Societies will ever depend upon the Fruits of the Earth and the Labour of the People; both which joined together are a more certain, a more inexhaustible and a more real Treasure than the Gold of Brazil or the Silver of Potosi.\(^3\)

One could probably pursue the whole of economic literature from Mandeville to the present and not find a more exact expression of Keynes' theory of spending and his concept of the role the government should play in maintaining full employment.

\(^0\) Ibid., pp. 360, 361.  \(^1\) Ibid., p. 361.  \(^2\) Ibid.
\(^3\) Ibid., pp. 361, 362.
After paying tribute to the several writers who had concerned themselves with the problem of effective demand, Keynes said:

No wonder that such wicked sentiments called down the opprobrium of two centuries of moralists and economists who felt much more virtuous in possession of their austere doctrine that no sound remedy was discoverable except in the utmost of thrift and economy both by the individual and by the state. Petty's "entertainments, magnificent shews, triumphal arches, etc." gave place to the pennywisdom of Gladstonian finance and to a state system which "could not afford" hospitals, open spaces, noble buildings, even the preservation of its ancient monuments, far less the splendours of music and the drama, all of which were consigned to the private charity or magnanimity of improvident individuals.44

According to Keynes, "the doctrine did not reappear in respectable circles for another century, until in the later phase of Malthus the notion of the insufficiency of effective demand takes a definite place as a scientific explanation of unemployment."45 Keynes did not mention Sir James Steuart or Lord Lauderdale.

Sir James Steuart

The relationship of the economics of Keynes to the Mercantilistic thought of the sixteenth to the eighteenth centuries is well known. Keynes himself pointed to it.46 He said much in praise and in defense of mercantilistic theory and policy and against arguments presented by its classical critics.

However, it would not advance the purpose of this study to investigate in detail the relationship between the Mercantilistic-

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46 Ibid., p. 333 ff. For Keynes' formulation of the main conclusion of the Mercantilists, see Ibid., pp. 336, 338, 340. Keynes seemed to assume that Mercantilism can be used to support his ideas, especially regarding the stimulation of business activity.
Keynesian theories of employment. But it is necessary to show that the theory of Mercantilism—at least in the writing of one who embraced that doctrine—contained the concept of effective demand.

Sir James Steuart (1712-1780) is generally regarded as the "last of the mercantilists." He was not only the last but possibly the ablest of the eighteenth century writers before Smith. His two-volume work, An Inquiry into the Principles of Political Economy, published in 1767, was a systematic study, but it attracted little attention. Although the book appeared only nine years before the Wealth of Nations, Smith ignored it.

Steuart clearly anticipated Malthus in the significance as well as in the statement of effective demand. His thought is contained in the following statements:

It is the effectual demand, as I may call it, which makes the husbandman labour for the sake of the equivalent. The demander must have an equivalent to give; it is this equivalent which is the spring of the whole machine. Every transition of money from hand to hand for a valuable consideration implies some service done, something wrought by man, or some consumption of something produced by his labour. The quicker, therefore, the circulation of money is in any country, the more strongly may it be inferred that its inhabitants are laborious.

This doctrine of the equivalent was the central theme in his Inquiry.

My principal point in view is, to find out a method for enabling those to buy who at present cannot, because they can give no equivalent.

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49 Ibid., p. 8.
And he held it to be the duty of the statesman to maintain the circulation of money if it appeared liable to stagnate, when the "propensity of the rich to consume" was not in proportion to the "disposition of the poor to be industrious." These were his only direct statements concerning effective demand. However, he treated the subject matter of the five books which made up his Inquiry—Population and Agriculture; Trade and Industry; Money and Coin; Credits and Debts; and Taxes—in terms of the importance of maintaining effective demand.

Since Steuart's public policy has already been discussed, it is sufficient to simply mention here that he endorsed the traditional mercantilistic policy that the government should develop a grand scheme of economic mobilization and frame the necessary laws and regulations to compel the citizens of the country to do those things which the government believed to be conducive to national economic prosperity. There is little, if any, difference between Steuart's program of action and Keynes' program of socialized investment and public manipulation of the interest rate. They both would involve a tremendous amount of governmental interference in the economy.

Lord Lauderdale

Lord Lauderdale (1759-1838) has been recognized by many authors as having been one of the great minds in the history of economic theory. For example, Haney says, "Lauderdale's emphasis of consumption and demand, and his shrewd observations on the effects of varying distribution

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50 Ibid., p. 301.

51 See Supra, pp. 43, 44.
of wealth, are remarkable. He was far in advance of his contemporaries in these matters. In his discussion of accumulation and consumption, he may be dubbed the father of the overproduction idea."^2

Although the emphasis in this chapter is upon the doctrine of effective demand and how it has developed, it would be doing Lauderdale a great injustice if his theory of the nature and origin of public wealth were not examined in some detail. Primarily, this involves a presentation of his value theory which so clearly anticipated the commanded theory of Malthus, the Austrians, and Keynes. In other words, the commanded theory of value is an integral part of the doctrine of effective demand.

Lauderdale treats the subject of value and its measurement in Chapter One of his book.53 He begins by simply stating a refutation of Smith's embodied labor theory of value.54 "The term Value," he said, "whatever might have been its original sense, as it is used in common language, does not express a quality inherent in any commodity. There is nothing which possesses a real, intrinsic, or invariable value. The possession of no quality, however important to the welfare of man, can confer value; for water, the most necessary of all things, seldom possesses it."55 Thus, for Lauderdale, no embodied concept could explain

52Haney, op. cit., p. 350.


54Since the first edition of his book appeared in 1804, which antedated the works of Ricardo and Mill, Lauderdale aimed his criticisms directly at Smith. Of course, Lauderdale's argument may be used equally as well against Ricardo and Mill.

55Lauderdale, op. cit., pp. 10, 11.
For an item to have value, it must be "demanded" and it must be "scarce" relative to the demand. In Lauderdale's words, "To confer value, therefore, two things appear requisite: 1. That the commodity, as being useful or delightful to man, should be an object of his desire; 2. That it should exist in a degree of scarcity."\(^{56}\)

Concerning the manner by which the value of goods could vary, Lauderdale said:

> With respect to the variations in value, of which every thing valuable is susceptible, if we could for a moment suppose that any substance possessed intrinsic and fixed value, so as to render an assumed quantity of it constantly, under all circumstances, of equal value; then the degree of value of all things, ascertained by such a fixed standard, would vary according to the proportion betwixt the quantity of them and the demand for them, and every commodity would, of course, be subject to a variation in its value from four different circumstances.

1. It would be subject to an increase of its value, from a diminution of its quantity.
2. To a diminution of its value, from an augmentation of its quantity.
3. It might suffer an augmentation in its value, from the circumstances of an increased demand.
4. Its value might be diminished, by a failure of demand.\(^{57}\)

But for Lauderdale, no good could possess fixed and intrinsic value; hence, there was no commodity that could be used to measure the value of economic goods. Thus, not only is value determined by demand and supply, but also its measurement is calculated in the same manner. The four circumstances involving increases and decreases in demand and supply express and measure the value of any given commodity.\(^{58}\)

Thus he said:

> The value of every thing is so completely dependent upon

\(^{56}\text{Ibid.}, \text{p. } 11.\) \(^{57}\text{Ibid.}, \text{pp. } 11, 12.\) \(^{58}\text{Ibid.}, \text{p. } 13.\)
the proportion betwixt the demand for it and the quantity of it, that the possession of no quality, whatever excellence it might add to a commodity, could produce any material alteration in its value, if it did not affect either the demand for it, or the quantity of it.\(^59\)

And after giving several illustrations of this thesis:

Thus we may perceive, that the existence of value is perfectly independent of any inherent characteristic in the commodity itself; that there is no such thing as intrinsic value; and that alterations in the degrees of value are not dependent upon any change of quality, but always on some change of proportion betwixt the quantity and the demand for a commodity;--a sure proof of which is, that we cannot express value, or a variation of value, without a comparison of two commodities; and every variation in the expression of value, must depend upon some alteration in the proportion betwixt the quantity of and demand for, one or other of the commodities compared.

For example, if the price of grain is to be expressed in silver, it might vary, in consequence of the circumstance of the alteration of the proportion betwixt the quantity of the grain and the demand for it; it might also alter, in consequence of the variation betwixt the proportion of silver and the demand for it. It may happen, too, that alterations might take place in both those proportions; which must likewise generally produce a variation in the expression of value. For though it is possible that there should exist alterations in both, and that the relative proportion betwixt the quantity and demand for each should still be preserved, yet it is highly improbable, that, under such circumstances, this equilibrium should be maintained.\(^60\)

Lauderdale made a direct attack on Smith's labor theory of value. He believed that Smith had "struggled most" to formulate the concept that labor was the source of value. According to Lauderdale, Smith made the mistake of believing that labor was a constant value and hence could be used to measure the value of all commodities. But, for Lauderdale, nothing had a constant value, least of all labor.

\(^{59}\)Ibid., pp. 15, 16. \(^{60}\)Ibid., pp. 19, 20.
To those who understand any thing of the nature of value, or on what its variations depend, the existence of a perfect measure of value must at once appear impossible: for as nothing can be a real measure of magnitude and quantity, which is subject to variations in its own dimensions, so nothing can be a real measure of the value of other commodities, which is constantly varying in its own value. But as there is nothing which is not subject to variations, both in its quantity and in the demand for it, there can be nothing which is not subject to alteration in value.  

Lauderdale accused Smith of not using "reasoning" with reference to Smith's statement that labor was the only commodity that did not vary in value, and considered this as being "extraordinary because labour is the thing most subject to variation in its value, and is, of course, of all others that could have been selected, the worst calculated to perform that duty."  

In support of this statement, Lauderdale used Smith's own arguments concerning the variation in the value of labor. Lauderdale argued that Smith demonstrated that labor was not only subject to all the forces causing a good to vary in value, but also that labor was the only commodity which possessed the "characteristic of varying (in value) at the same time and place."  

Then he quotes at great length from Smith to show that Smith had held that the value of labor could vary during the same year, during periods longer than a year, in different countries, and in different parts of the same country.  

But Lauderdale was not through. He said:  

It is, indeed, most extraordinary, that the author of the Wealth of Nations should ever have considered labour as an accurate measure of value; for in Book II. Chap. iii. of his work, he treats of productive and unproductive labour, and therein announces an opinion, which forms one of the

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61 Ibid., pp. 24, 25. 62 Ibid., p. 25. 63 Ibid., p. 27. 64 Ibid., see pp. 27-33 and 35.
most striking features of his theory, that a great portion or description of labour is totally unproductive: yet it is evident, that a proposition, holding forth a mathematical point as a measure of dimension, would not be more absurd than proposing any thing unproductive as a measure of value. 65

And he concluded this chapter of his book with the following remarks:

Great, therefore, as the authorities are who have regarded labour as a measure of value, and who by so doing have contradicted that view of the nature of value which has been here given, it does not appear that labour forms any exception to the general rule, that nothing possesses real, fixed or intrinsic value; or that there is any solid reason for doubting the two general principles we have endeavoured to establish:--

1. That things are alone valuable in consequence of their uniting qualities, which make them the objects of man's desire, with the circumstance of existing in a certain degree of scarcity.
2. That the degree of value which every commodity possesses, depends upon the proportion between the quantity of it and the demand for it. 66

This was the beginning of the true commanded theory of value. Malthus was to make it the core of his Principles. According to McCracken, "...Malthus and Lauderdale stood quite together on the problem of effective demand, because they thought in terms of commanded value instead of embodied value and feared the short-run evils which might come from maladjusted production and consumption." 67

Lauderdale protested most vigorously against the received doctrine of his day that wealth and money were synonymous and that the wealth of a nation was the sum total of the wealth of the individuals in the nation. He said:

The terms we use, in talking of the wealth of a nation, or of the riches of individuals, are in all languages exactly the same. They denote, that private riches are

65 Ibid., pp. 33, 34. 66 Ibid., pp. 35, 36.

universally considered in no other light than as a portion of national wealth. The sum total of the riches of those who form the community, is thus regarded as necessarily conveying an accurate statement of the wealth of a nation; and this idea has become so universally prevalent, that, even by philosophers, exchangeable value has been announced as the basis of wealth.\(^\text{68}\)

That public wealth, however, ought not to be considered as merely representing the sum of individual riches, is undoubted; and that much of obscurity, and even of error, has existed in economical reasoning from confounding them, will be made apparent.\(^\text{69}\)

Later he says, "it is, however, impossible to subscribe to the idea, that the sum-total of individual riches forms an accurate statement of public wealth. Though the opinion has been universally prevalent, it must be deemed false and unfounded by every man who considers the subject, after having formed, and familiarized himself to, an accurate and distinct opinion of the nature of value."\(^\text{70}\)

Lauderdale made a distinction between public wealth and private riches. The former he defined as "to consist of all that man desires, as useful or delightful to him,"\(^\text{71}\) and individual riches "to consist of all that man desires as useful or delightful to him; which exists in a degree of scarcity."\(^\text{72}\) Thus, scarcity was the factor which created a distinction between the two types of wealth. Scarcity was a fundamental characteristic of private wealth and essential to value, which was the measure of private wealth.

He contended that private wealth or riches changed as their demand and supply relationships changed, but public wealth was

\(^\text{68}\) Lauderdale, \textit{op. cit.}, p. 6. \(^\text{69}\) \textit{Ibid.}, pp. 7, 8.

\(^\text{70}\) \textit{Ibid.}, p. 41. See also pp. 41-52. \(^\text{71}\) \textit{Ibid.}, p. 57.

\(^\text{72}\) \textit{Ibid.}, p. 58.
dependent solely on its supply. And the relationship between public
and private wealth was inverse: "in proportion as the riches of
individuals are increased by an augmentation of the value of any
commodity, the wealth of the society is generally diminished; and
in proportion as the mass of individual riches is diminished, by
the diminution of the value of any commodity, its opulence is gen-
erally increased."73

Lauderdale was utterly convinced that Smith had made a grave
error in assuming that parsimony or individual savings was the chief
means of increasing the wealth of a nation.74 This, for Lauderdale,
was a fallacy which, "if persisted in, must infallibly ruin the
country that adopts or preserves it."75 Quite the contrary, "a sud-
den demand for any consumable commodity, by increasing its value,
encourages an augmented production, and tends, therefore, to in-
crease wealth..."76 He contended that parsimony "does not augment
opulence; it only changes the direction in which the labor of a com-


unity is exerted."77 But, parsimony in reality meant that a forgoing
of consumption by the consumer, in turn, had its bad effects on so-
ciety. Thus, "the wealth of a society never can be increased by a
system of continual parsimony, this abstinence from expenditure in
consumable commodities, and consequent accumulation, may evidently
be highly injurious to its progress."78

73Ibid., p. 49.
74See Wealth of Nations, pp. 321, 322, 324, 578, 632.
75Lauderdale, op. cit., p. 201. 76Ibid., p. 213.
Lauderdale was firm in his argument that the needs of the country should dictate the supply of capital. His main argument against parsimony was not against saving per se; it was against too much saving, because that would lead to an overproduction of capital. He held that labor and capital supplemented one another in the productive process, and the real problem was to find new uses for both labor and capital which would result in the production of wealth. The concept of too much saving has been a major principle in the underconsumption theory since Lauderdale. Furthermore, Lauderdale saw no logic in the argument that saving would result in more consumption in the future by virtue of an increase in the quantity of capital. He was primarily concerned with the short-run and said:

...If the abstraction from expenditure of a sum equal to what is added to the capital of the community, causes a diminution of production to that extent; parsimony must be considered as a means of creating capital, at the expense of sacrificing a revenue as great as the capital created; and it does not appear, that a more ruinous operation in all its bearings can be devised, than that of disposing of an annual income, (for example, of a million,) for the purpose of acquiring a capital to the same amount.

If, indeed, the mercantile system of political economy has justly been deemed objectionable, and is now universally exploded, because it exclusively regarded money as wealth, the system that holds parsimony to be the great means of increasing wealth, seems equally objectionable, because it exclusively considers capital as wealth. The former system could alone be maintained by its followers teaching mankind, in estimating the benefit derived from trade, to overlook, as a matter of indifference, the goods sacrificed to obtain money; whilst the latter can alone be maintained by its adherents habituating mankind to show a similar indifference for revenue, by disregarding that diminution in the production of consumable commodities, which parsimony must inevitably create. 79

Here Lauderdale expresses Keynes' concept that investment and

79Ibid., pp. 217, 218. See also pp. 346-349.
consumption are complementary activities and not in opposition with each other.

Finally, Lauderdale was quite aware of the relationship which existed between the distribution and the production of goods.

...The distribution of wealth in all societies must ultimately regenerate the formation of wealth...The distribution of wealth not only regulates and decides the channels in which the industry of every country is embarked, and, of course, the articles of production of which it excels; but a proper distribution of wealth insures the increase of opulence, by sustaining a regular progressive demand in the home market, and still more effectively, by affording to those whose habits are likely to create a desire of supplanting labour, the power of executing it.80

With reference to the function of the government in relation to the wealth of the country, Lauderdale believed that the surest way to increase national wealth was to make public expenditures, and the quickest way to decrease it was to accumulate a large sinking fund.81

Thus, Lauderdale had the overproduction-underconsumption theory in every detail. Since capital accumulated, consumption had to be maintained, else there would be an overproduction because of underconsumption. This called for the maintenance of a proper balance between saving and consumption.82

One cannot fail to wonder what the course of economic theory and economic history would have been had the teachings of Lauderdale been followed. But, as is so well known, he, along with Malthus, was buried underneath the Ricardian avalanche. The commanded theory of


value with its emphasis on demand lay virtually dormant until the 
Austrians breathed new life into it.

Thomas Malthus

Thomas Malthus (1766-1834) was one of the first to challenge 
the doctrine that production automatically financed consumption; that 
with adequate supply, demand would care for itself. Again, as with 
Lauderdale, the treatment of Malthus is confined to his theory of 
value and his concepts relating to the doctrine of effective demand.

Since the discussion to follow is in some respects a com­
parison between Malthus and Ricardo, it perhaps is important to note 
one general and major difference between the theories of these two 
economists. Ricardo centered his attention primarily on long-run 
trends and long-run phenomena. Malthus, on the other hand, concen­
trated his analysis on the short-run period. By the short run Malthus 
meant a time period approximately the length of an ordinary business 
cycle. Malthus did not deny the existence of long-run trends, but 
he minimized their significance. He was of the opinion that what 
was likely to occur in the long run was of no particular significance 
because that time never arrived. In short, Malthus' position was 
that man lived in these short-run periods. It is interesting to note 
that Keynes, a century later, expressed the same idea when he said, 
"this long run is a misleading guide to current affairs. In the long 
run we are all dead. Economists set for themselves too easy, too 
useless a task if in tempestuous seasons they can only tell us that
when the storm is long past the ocean is flat again."

Of course the great difference between Malthus and Ricardo and Smith with which we are primarily concerned was Malthus' substitution of the demand and supply principles for the cost (primarily labor) principles both in the analysis of value determination and in the explanation of the distributive shares. Ricardo and Smith distinguished between market and natural price, with market price determined by the forces of supply and demand, and natural price determined by costs of production, primarily labor cost. In general, that was also true of their explanation of the distributive shares. As a consequence, Ricardo, particularly, gave very little attention to demand. Malthus, on the other hand, held that costs of production affected value only as they affected supply and that demand was an equally active factor with supply in determining prices. Malthus always expressed the relationship between demand, supply, and price in very clear terms. For example, "When prices are said to be determined by demand and supply, it is not meant that they are determined either by the demand alone, or by the supply alone, but by their relation to each other." And in more emphatic terms, he said, "If the terms demand and supply be understood...there is no case of price, whether temporary or permanent, which they will not determine; and in every instance of bargain and sale, it will be perfectly correct to say, that the prices of commodities will depend upon the relation


of the demand to the supply; or will vary as the demand (that is, the money ready to be offered) directly, and the supply inversely."

In analyzing the way in which cost of production affected value in regulating the supply of commodities, he recognized that labor cost had an effect upon price, yet at the time that exchange actually occurred "no circumstance affects it but the relation of the supply to the demand." Since "all objects of human desire are obtained by the instrumentality of human exertion" it was necessary that labor be so remunerated in the value of objects given in exchange that the supply of the goods would be adequate, that goods would be supplied continually, and that there must be adequate materials as well as food for the laborer. These conditions must be met by every society in order that the greater number of its wants may be satisfied. The price of the commodities entering into exchange is therefore made up of "that which pays the labourer employed in its production; that which pays the profits of capital...and that which pays the rent of land...the price of each of these component parts being determined exactly by the same causes as those which determine the price of the whole." Adam Smith called this the "natural price," but Malthus chose to call it the "necessary price" because it more nearly expressed the importance of supply. He added, "It will be the price necessary, in the actual circumstances of society, to bring the commodity regularly to the market." This, of course, was very similar to Alfred Marshall's "supply price" concept.

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85 Ibid., p. 70. 86 Ibid., p. 83. 87 Ibid.
Ricardo defined demand in such a way that it could not have an effect on the equilibrium level of prices. For Ricardo, demand was the quantity of a commodity purchased with no reference to price. Thus, demand increased as a greater quantity of a commodity was offered for sale irrespective of price. Malthus, on the other hand, defined demand in terms of the intensity of demand. By this he meant the will of the purchasers to purchase plus their ability to purchase. His definition of demand corresponds quite closely with most definitions found in elementary textbooks today. After presenting his concept of demand, Malthus compares Ricardo's definition with his own:

Demand in this sense is obviously quite different from the sense in which Mr. Ricardo had before used the term. The one (Ricardo) is a demand in regard to extent, the increase of which implies a greater quantity of the commodity purchased; the other (Malthus) is demand in regard to intensity, the increase of which implies the will and power to make a greater sacrifice in order to obtain the object wanted. It is in the latter sense, I think that the term is most frequently applied; at any rate, it is in this latter sense alone that demand raises prices.®®

In a footnote to this statement Malthus pointed out that, "Of course it must often happen that an increased intensity of demand, and an increased extent of demand go together. In fact, an increased intensity of demand, when not occasioned by an increased difficulty of production, is the greatest encouragement to an increase of produce and consumption."®® Thus for Malthus, an increase in demand meant an increase in the intensity of demand and would be evidenced by an


®®Ibid. All future references are to this edition unless otherwise indicated.
increased quantity demanded at the same price. Ricardo would say that demand had increased when the quantity demanded had increased. Malthus would say, however, that demand had remained the same. An increase in demand for Malthus would be represented by a complete shift in the demand curve. And such an increase in demand would raise the price.

As to the determinants of the supply, Malthus held that supply was determined by the entrepreneur's costs of production. He included all costs of production plus a normal return on investment. Price, then, was determined by the forces of demand and supply at the point of equilibrium.

In summary form, then, according to Malthus, the determinants of demand were: (1) the number of demanders, and (2) the number of wants they had plus purchasing power. Costs of production determined supply. The forces of demand and supply determined both market and natural price. There must be a change in the relation of the demand to the supply to bring about a change in price, either natural or market price.90

Malthus' theory avoided all the pitfalls that Ricardo encountered in his labor cost theory. For example, Malthus was able to explain the value of all commodities with only one theory, whereas Ricardo was forced to distinguish between two different types of commodities. More important perhaps was the fact that Malthus' theory eliminated the problem of the varying organic composition of capital with which Ricardo grappled without much success. Furthermore, his theory enabled Malthus to give a much more realistic explanation of

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90 Ibid., see pp. 70-73.
profits, and the distributive shares in general, than Ricardo was able to accomplish with his embodied labor theory of value.

It may be stated once more that for Ricardo, the value of a good was derived from the labor required to produce it. Thus, if more labor were used to produce a commodity its value would increase, but riches would not. An increase in value generally meant a decrease in riches, i.e., if more and more labor were required to produce a commodity its value increased, but the riches produced by the labor remained the same. In short, Ricardo concluded that in general value and riches varied inversely. Malthus contended that the wealth of a nation consisted of the want-satisfying powers of its production; that is, the use values of the commodities produced in the country. Thus, Malthus differed from Ricardo's analysis of value and riches for two reasons. First, Malthus had a different concept of use value; and second, he had a different theory of value determination and value measurement.

With reference to use value, Malthus anticipated later theories because he had a psychological concept of utility; that is, the utility (use value) arose out of a relationship between the goods and human wants. And he had the concept of diminishing utility. The use value of a commodity per unit becomes less as its quantity increases. Therefore, for Malthus, if wealth consisted of the want-satisfying powers of the production of the nation, value could not increase in proportion to the increase in physical output but in less than proportion. Malthus carried the analysis further. He pointed out that if goods should be produced in such quantities as to satisfy all wants for them, then, they would cease to have use value. Hence, Malthus disagreed with
Ricardo that an increase in the physical quantity of goods was synonymous with an increase in use value.\(^1\)

Malthus also disagreed with Ricardo as to the measure of value. For Ricardo, value was measured by the quantity of embodied labor in the product. For Malthus, value was measured by the quantity of labor the commodity could command in exchange. "The labour which a commodity will command is not the cause of its value, but it will appear in the next chapter to be the measure of it."\(^2\) Hence, the value of a commodity increased if it commanded a greater quantity of labor in exchange irrespective of the quantity of labor required to produce it. How much labor a good would command in exchange depended upon the wages of labor. Taking the standard-of-living theory of wages, any given quantity of wage goods would always command in exchange the same quantity of labor and hence would have the same value. That meant that an increased quantity would command in exchange more labor and would have as a consequence more exchange and use value. Thus, Malthus concluded that in fact use and exchange value generally varied directly rather than inversely as Ricardo maintained.

Ricardo contended that wealth increased if the quantity of goods were increased. Malthus pointed out that it was impossible to determine when this occurred or to measure by how much wealth had increased in terms of output itself because the goods were

\(^1\)Ibid. See pp. 299-308 for Malthus' distinction between value and wealth.

\(^2\)Ibid., p. 83 note.
incommensurable in physical terms. For Malthus, the goods in a country at a given time were of such an infinite variety that summing them up was an impossibility. He believed the only way one could measure the wealth of a nation was by reducing all of the commodities to a common denominator. Thus, Malthus used the labor command theory of value as a common denominator as a means of wealth measurement. He maintained that there was a very close connection between value and wealth because it was value alone that stimulated the production of wealth. The existence of wealth was absolutely dependent upon the existence of value in the commodities that constituted wealth. Thus, if one asserted that the wealth of a nation had increased, one could only mean that the value of the commodities that constituted the wealth had increased.

With this discussion of Malthus' theory of value as a basis, attention may now be directed to his ideas directly related to the doctrine of effective demand. This primarily takes the form of Malthus' criticism of the classical theory of capital formation.

All the classical economists prior to Malthus had made economic progress depend exclusively upon capital accumulation. Smith had written that the nature and cause of a nation's wealth depended upon capital accumulation and the rate of the increase of wealth to depend upon the rate of accumulation. Although he did not state it as explicitly, Ricardo reached the same conclusion. This meant that the level of output and the level of real income depended upon the productive capacity of the nation; that is upon conditions of supply. Productive capacity, in turn, as Smith noted, depended upon the number in and the efficiency of the labor force; hence upon population
which itself depended upon the quantity of capital accumulated because it was capital that set labor in motion, and natural resources. Any increase in the quantity or efficiency of any one of these factors would result in an increase in output, an increase in total absolute real income, and an increase in the nation's wealth. But since natural resources were given, economic progress depended fundamentally upon capital accumulation. An increase in employment could result only from an increase in capital; hence, economic progress had depended upon an increase in the quantity and/or the efficiency of the factors of production and ultimately upon the capital accumulated; that is to say, upon conditions of supply, not upon the extent of the market for output and not upon the extent of demand.

For Ricardo, as for the other classical economists, there could never be a deficiency of markets in which output could be sold at profitable prices. This, of course, followed from Say's Law of markets. Hence, markets expanded along with supply; in fact, the expansion of markets was dependent upon an increase in the supply. Demand was dependent upon and was determined by supply.

It was precisely this principle that Malthus attacked in Book II of his Principles. He raised exactly the same question that had concerned Smith. What were the causes of the wealth of a nation? But he arrived at a different answer from that of Smith and Ricardo. He labeled the book "On the Progress of Wealth" and opened Chapter One, "There is scarcely any inquiry more curious, or, from its importance, more worthy of attention, than that which traces the causes which practically check the progress of wealth in different countries,
and stop it, or make it proceed very slowly, while the power of pro-
duction remains comparatively undiminished, or at least would furnish
the means of a great and abundant increase of produce and population."

In this statement he made quite clear that he did not agree that the
wealth of a nation depended on supply, on production. He considered,
one after the other, the various causes of the wealth of a nation which
his predecessors had listed.

Malthus raised the question: Does an increase in population
in itself cause an increase in the wealth of a nation? He said,
"Many writers have been of the opinion that an increase of population
is the sole stimulus necessary to the increase of wealth, because
population, being the great source of consumption, must in their
opinion necessarily keep up the demand for an increase of produce,
which will naturally be followed by a continued increase of supply." To this position, Malthus countered:

That a continued increase of population is a powerful and
necessary element of increasing demand, will be most readily
allowed; but that the increase of population alone, or, more
properly speaking, the pressure of the population hard against
the limits of subsistence, does not furnish an effective
stimulus to the continued increase of wealth, is not only
evident in theory, but is confirmed by universal experi-
ence. . .

But those who are acquainted with the nature of effec-
tual demand, will be fully aware that, where the right of
private property is established, and the wants of society
are supplied by industry and barter, the desire of any
individual to possess the necessaries, conveniences and
luxuries of life, however intense, will avail nothing
towards their production, if there be no where a recipro-
cal demand for something which he possesses. A man whose
only possession is his labour has, or has not, an effective
demand for produce according as his labour is, or is not,
in demand by those who have the disposal of produce. . .

\[^93\textit{ibid.}, \text{p. 309.} \ 94\textit{ibid.}, \text{p. 311.} \ 95\textit{ibid.}, \text{pp. 311, 312.} \]
And then:

To suppose a great and continued increase of population is to beg the question. We may as well suppose at once an increase of wealth; because such an increase of population cannot take place without a proportionate or nearly proportionate increase of wealth. The question really is, whether encouragements to population, or even the natural tendency of population to increase beyond the funds destined for its maintenance, will, or will not, alone furnish an adequate stimulus to the increase of wealth. And this question, Spain, Portugal, Poland, Hungary, Turkey, and many other countries in Europe, together with nearly the whole of Asia and Africa, and the greatest part of America, distinctly answer in the negative.

Malthus believed that the wealth of a nation depended upon effective demand. One must not only have the will to consume but also the power. Entrepreneurs were induced to produce not because people wanted goods but because they were able to pay for them. People were not born with purchasing power.

Having disposed of the concept that population was responsible for the wealth of a nation, Malthus turned his attention to an investigation of the relationship between saving and capital accumulation with reference to increasing the wealth of the nation. Because he always kept uppermost in his mind the issue of effective demand, Malthus wondered how all goods could be sold if production exceeded consumption and the difference was saved. For Malthus, this situation would in fact be a failure of demand, commodities would fall in value compared with labor, profits would decline, production would be reduced, and the result would be a general glut of the market. Malthus explained:

It has been thought by some very able writers, that although there may easily be a glut of particular

96 Ibid., pp. 313, 314.
commodities, there cannot possibly be a glut of commodities in general; because, according to their view of the subject, commodities being always exchanged for commodities one half will furnish a market for the other half, and production being thus the sole source of demand, an excess in the supply of one article merely proves a deficiency in the supply of some other, and a general excess is impossible. 97

Malthus denied the validity of this view:

This doctrine, however, as generally applied, appears to me to be utterly unfounded, and completely to contradict the great principles which regulate supply and demand.

It is by no means true, as a matter of fact, that commodities are always exchanged for commodities. An immense mass of commodities is exchanged directly, either for productive labour, or personal services: and it is quite obvious, that this mass of commodities, compared with the labour with which it is to be exchanged, may fall in value from a glut just as any one commodity falls in value from an excess of supply, compared either with labour or money. 98

Malthus believed that Say, Ricardo, and Mill, in formulating the principle that "supply created its own demand," had made three fundamental errors. "In the first place," Malthus said, "they have considered commodities as if they were so many mathematical figures, or arithmetical characters, the relations of which were to be compared, instead of articles of consumption, which must of course be referred to the numbers and wants of the consumers." 99 For Malthus, this was neither logical nor realistic. He contended that:

If commodities were only to be compared and exchanged with each other, then indeed it would be true that, if they were all increased in their proper proportions to any extent, they would continue to bear among themselves the same relative value; but, if we compare them, as we certainly ought to do, with the means of producing them, and with the numbers and wants of the consumers, then a great increase of produce with comparatively stationary numbers or with wants diminished by parsimony, must necessarily occasion a great fall of value estimated in labour, so that the same

97 Ibid., p. 315. 98 Ibid., pp. 315, 316. 99 Ibid., pp. 316, 317.
produce, though it might have cost the same quantity of labour as before, would no longer command the same quantity; and both the power of accumulation and the motive to accumulate would be strongly checked.100

As a general principle, Ricardo held that it was impossible for capital to be redundant. He allowed only one exception—and that a temporary one—to this principle. He admitted the possibility of general overproduction in one paragraph in his chapter on the effects of accumulation of capital on profits. If every capitalist should decide that there was no reason why he should live any better (consume more) than the laborer, and if all capitalists should reduce their consumption to the level of the laboring class, then, demand would be so narrowly restricted that the output could not be purchased. A general glut would result. "If men ceased to consume, they would cease to produce. This admission does not impugn the general principle."101 Malthus quoted this paragraph from Ricardo and replied rather sharply:

It appears to me most completely to impugn the general principle. Even if we suppose with Mr. Ricardo, what is not true, than an increase of population would certainly remedy the evil; yet as from the nature of a population, an increase of labourers cannot be brought into the market, in consequence of a particular demand, till after the lapse of sixteen or eighteen years, and the conversion of revenue into capital by saving, may take place much more rapidly; a country is always liable to an increase in the quantity of the funds for the maintenance of labour faster than the increase of population. But if, whenever this occurs, there may be an universal glut of commodities, how can it be maintained, as a general position, that capital is never redundant; and that because commodities may retain the same relative values,

100Ibid., p. 317.

a glut can only be partial, not general?

The central core of his argument here seems to be that whether the supply of a commodity creates the demand for another commodity depended on whether or not the consumer wanted the good. If it is not wanted, the mere production of it would not create a demand for any other good.

The principle that supply creates its own demand involved the assumption that no one withholds goods or money from the market. On this point, Malthus held that the process of saving reduced the demand for consumer goods; it reduced the ability of a given quantity of consumer goods to command other goods in exchange. If the income that has been saved were invested it was indeed a demand for capital goods, but the increased quantity of capital goods further increased the supply of consumer goods. Thus, increased productive capacity as a result of capital accumulation may make it impossible to use that capacity in production because the demand for the goods produced by that capacity may not be large enough to clear the markets. He also was of the opinion that Say's law was weak because people could hoard money. Money had functions other than its ability to serve as a medium of exchange. Since it could be hoarded, it was also a store of value. If individuals sought to make provision for future contingencies, there was no way to accomplish this more effectively than to hold money. In this, Malthus was stating what Keynes was to later call the "precautionary motive for liquidity."

The second error Malthus found in the theory of Say, Ricardo,

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102Malthus, op. cit., pp. 319, 320.
and Mill was their assumption that human wants were insatiable. They did not take "into consideration the influence of so general and important a principle in human nature, as indolence or love of ease." Malthus contended that human wants were quite limited. Individuals would generally prefer more leisure than more goods beyond a certain level. Thus, beyond that level of consumption there would be no further demand for goods. This, of course, was a crude statement of the law of diminishing utility, and also it was an anticipation of the movement of the propensity to consume with changing levels of income. Demand, then, could be deficient for lack of desires. Malthus said:

It has...been said, that there is never an indisposition to consume, that the indisposition is to produce. Yet, what is the disposition of those master manufacturers, and merchants who produce very largely and consume sparingly? Is their will to purchase commodities for their consumption proportioned to their power? Does not the use which they make of their capital clearly show that their will is to produce, not to consume?  

The third error in the doctrine of capital accumulation, according to Malthus, was the assumption that all of that part of income that was saved would be invested; that is, saving was automatically followed by investment. Malthus contended that this was a pointless and hence an impossible procedure, for in order that it be true, capitalists would have to be willing to invest at zero profits, or that the demand for output coming from the laborers who were employed in the process of investment would have to be sufficient to induce the investment to be made, and this would require that their wages be sufficient to enable them to buy the output that was produced by the

103Ibid., p. 320. 104Ibid., p. 322.
investment. This, of course, was impossible. If they received the total value of the output there would be no profits. Malthus believed this to be "practically the most important of the three" errors. In his words the error "consists in supposing that accumulation ensures demand; or that the consumption of the labourers employed by those whose object is to save, will create such an effectual demand for commodities as to encourage a continued increase of produce." He explained:

If, in the process of saving, all that was lost by the capitalist was gained by the labourer, the check to the progress of wealth would be but temporary, as stated by Mr. Ricardo; and the consequences need not be apprehended. But if the conversion of revenue into capital pushed beyond a certain point must, by diminishing the effectual demand for produce, throw the labouring classes out of employment, it is obvious that the adoption of parsimonious habits beyond a certain point, may be accompanied by the most distressing effects at first, and by a marked depression of wealth and population afterwards.

He went on to state:

What is wanted... prior to the increase of capital and population, is an effectual demand for commodities, that is, a demand by those who are able and willing to pay an adequate price for them...

And he concluded:

Though it may be allowed therefore that the laws which regulate the increase of capital are not quite so distinct as those which regulate the increase of population, yet they are certainly just of the same kind; and it is equally vain, with a view to the permanent increase of wealth, to continue converting revenue into capital, when there is no adequate demand for the products of such capital, as to continue encouraging marriage and the birth of children without a demand for labour and an increase of the funds for its maintenance.

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In brief, then, Malthus refuted the classical theory of capital accumulation by demonstrating the invalidity of Say's Law of Markets, and by destroying the classical assumptions that human wants were insatiable and that savings were automatically invested.

Malthus' exact concept of the role of saving and how it could be accomplished without causing a reduction in value and wealth has been considered by many economists—particularly since Keynes—as a major contribution to economic theory. Malthus, as Keynes was to write a century later, held that savings must derive from an increase in production if the nation were to avoid a decline in value and wealth. It was perhaps at this point that Malthus reached the apex of his general aggregative approach in his analysis, and it was his concept of saving as related to capital formation that will forever link his economics to the idea system of Keynes. To be sure, there are other important similarities between the two idea systems, but the same concept of saving held by both economists is perhaps the most dramatic because it is so contrary to general economic orthodoxy. For Malthus, saving almost always occurred:

...in consequence of a previous increase in the value of the national revenue, in which case a saving may be effected, not only without any diminution of demand and consumption, but under an actual increase of demand, consumption and value during every part of the process. And it is in fact this previous increase in the value of the national revenue which both gives the great stimulus to accumulation, and makes that accumulation effective in the continued production of wealth.  

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And,

The fortune of a country, though necessarily made more slow,

is made in the same way as the fortunes of individuals in trade are generally made, --by savings, certainly; but by savings which are furnished from increased gains, and by no means involve a diminished expenditure on objects of luxury and enjoyment.\footnote{\textit{Ibid.}, p. 367.}

In these statements, one finds perfectly expressed Keynes' concept that saving was a residual; that is, a function of the national income and that it is production that creates savings rather than vice versa.

It is necessary now to consider what Malthus believed to be the real causes of economic progress. Of course, supply was a basic prerequisite for wealth, and "the three great causes most favourable to production are, accumulation of capital, fertility of soil, and inventions to save labour."\footnote{\textit{Ibid.}, p. 360.}

When Malthus' view on accumulation of capital was examined it was learned that effective demand was the pivot upon which capital formation turned. With reference to fertility of the soil, his argument was identical. The fertility of the soil created a potential for an increase in wealth, but whether or not that potentiality would be used depended upon the existence of adequate demand. Malthus' argument throughout was that mere productive capacity did not insure that the capacity would be used. Whether or not it would be depended upon effective demand. Productivity itself did not increase the effective demand. Here, of course, is Keynes' "under-employment" equilibrium concept developed to a very high degree. For Keynes, it was characteristic of capitalism that the economy functioned at a level below full employment because of a deficiency of effective demand. According to
Malthus: "Though the land might be rich, it might not suit the production of the materials most wanted." He examined the conditions of poverty in Ireland and New Spain, despite the great fertility of the soil in those countries, and concluded the section on fertility of the soil with the following observations:

- ...the power of employing labour on the part of landholders may often exist to a much greater extent than the will;
- ...the necessity on the part of labourers of employing only a small portion of time in producing food does not always occasion the employment of a greater portion of time in procuring conveniences and luxuries;
- ...the deficiency of wealth in a fertile country may be more owing to want of demand than to want of capital;
- ...in general... the fertility of the soil alone is not an adequate stimulus to the permanent increase of wealth.

In his discussion of inventions or technological progress, Malthus held firmly to his idea of effective demand. To be sure, he had the greatest respect for inventions of new machinery, but he said:

In the actual state of things... there are great advantages to be looked forward to, and little reason to apprehend any permanent evil from the increase of machinery. The presumption always is, that it will lead to a great extension both of wealth and value. But still we must allow that the preeminent advantages derived from the substitution of machinery for manual labour, depended upon the extension of the market for the commodities produced, and the increased stimulus given to consumption; and that, without this extension of market and increase of consumption, they must be in a considerable degree diminished. Like the fertility of land, the invention of good machinery confers a prodigious power of production. But neither of these great powers can be called fully into action, if the situation and circumstances, or the habits and tastes of the society prevent the opening of a sufficient market, and an adequate increase of consumption.

There were two points, however, in his analysis of inventions with

113 Ibid., p. 333. 114 Ibid., p. 351. 115 Ibid., p. 360
reference to wealth creation, that deserve mention. Malthus' explanation of technological improvements in relation to production contained the concepts of elastic and inelastic demand. To the knowledge of the writer, Malthus was the first to use the concept of elasticity. The effect a technological improvement would have depended upon the elasticity of the demand for the product. Malthus pointed out that the effect on aggregate employment and wealth depended upon whether the demand for the commodity was elastic or inelastic. If the demand were elastic; that is, if the quantity demanded increased more than proportionately to the decrease in price, then it would be true that after the introduction of the improvement the aggregate value of the output would be greater. This, for Malthus, would be an increase in wealth and the volume of employment may be greater than it was before. He used the cotton industry as an illustration. Technological improvements brought about a great reduction in the price of cotton products, and since the demand for the products was elastic, the aggregate employment and the aggregate value of the products increased. This would not occur, however, in the case of a product for which the demand was inelastic. The improvement would reduce its cost and its price, but the price would fall more than proportionately to the increase in the quantity demanded so that the aggregate value of the output would be less than it was before.116

For Malthus, these three forces of production "all act in the same direction; and as they all tend to facilitate supply, without

reference to demand, it is not probable that they should either separately or conjointly afford an adequate stimulus to the continued increase of wealth."\textsuperscript{117} It was necessary that there be "a union of the powers of production with the means of distribution in order to ensure a continued increase of wealth."\textsuperscript{118} Malthus said:

We have seen that the powers of production, to whatever extent they may exist, are not alone sufficient to secure the creation of a proportionate degree of wealth. Something else seems to be necessary in order to call these powers fully into action. This is an effectual and unchecked demand for all that is produced. And what appears to contribute most to the attainment of this object, is, such a distribution of produce, and such an adaptation of this produce to the wants of those who are to consume it, as constantly to increase the exchangeable value of the whole mass.

In individual cases, the power of producing particular commodities is called into action, in proportion to the intensity of effectual demand for them; and the greatest stimulus to their increase, independent of improved facilities of production, is a high market price, or an increase of their exchangeable value, before a greater value of capital has been employed upon them.

In the same manner, the greatest stimulus to the continued production of commodities, taken altogether, is an increase in the exchangeable value of the whole mass, before a greater value of capital has been employed upon them.\textsuperscript{119}

Always and everywhere, for Malthus, "General wealth, like particular portions of it, will. . .follow effectual demand."\textsuperscript{120}

What precisely did Malthus mean by distribution? He said, "It is that which effects the best adaptation of the supplies of produce, both in quantity and quality, to the actual tastes and wants of the consumers, and creates new tastes and wants by means of greater facilities of intercourse."\textsuperscript{121} Malthus concerned himself with three

\begin{itemize}
\item \textsuperscript{117}Ibid., p. 360.
\item \textsuperscript{118}Ibid., p. 361.
\item \textsuperscript{119}Ibid.
\item \textsuperscript{120}Ibid., p. 363.
\item \textsuperscript{121}Ibid., p. 371.
\end{itemize}
distributive factors: (1) Division of landed property, (2) Internal and external commerce, and (3) The maintenance of unproductive consumers. These were the factors, which in connection with the factors of production, determined the wealth of a nation.

Production and distribution are the two grand elements of wealth, which, combined in their due proportions, are capable of carrying the riches and population of the earth in no great length of time to the utmost limits of its possible resources; but which taken separately, or combined in undue proportions, produce only, after the lapse of many thousand years, the scanty riches and scanty population, which are at present scattered over the face of the globe. 122

Let us examine briefly Malthus' three distributive factors. Malthus' belief that a high concentration of ownership of land was deterrent to the wealth of a nation was based directly on his concept of effective demand. He noted that the consuming power of the landed gentry in England was restricted somewhat because of the relatively high degree of concentration of land ownership, and he carefully pointed out that a wider distribution of landed property would increase the consuming power of the class of landed proprietors. According to Malthus, "A very large proprietor, surrounded by very poor peasants, presents a distribution of property most unfavourable to effectual demand. Thirty or forty proprietors, with incomes answering to between one thousand and five thousand a year, would create a much more effectual demand for the necessaries, conveniences, and luxuries of life, than a single proprietor possessing a hundred thousand a year." 123 And he continued this underconsumption thesis by saying, "Practically it has always been found that the excessive wealth

122 Ibid. 123 Ibid., pp. 373, 374.
of the few is in no respect equivalent, with regard to effectual demand, to the more moderate wealth of the many."\textsuperscript{124}

In the final analysis, however, economic progress was a matter of proportions. "It will be found, I believe, true that all the great results in political economy, respecting wealth, depend upon proportions."\textsuperscript{125} He explained this in the following statements:

But though it be true that the division of landed property, and the diffusion of manufacturing and mercantile capital to a certain extent, are of the utmost importance to the increase of wealth; yet it is equally true that, beyond a certain extent, they would impede the progress of wealth as much as they had before accelerated it. There is a certain elevation at which the projectile will go the farthest: but if it be directed either higher or lower, it will fall short. With a comparatively small proportion of rich proprietors, who would prefer menial servants, retainers and territorial influence to an excessive quantity of manufactured and mercantile products, the power among capitalists of supplying the results of productive labour would be much greater than the will to consume them, and the progress of wealth would be checked by the want of effectual demand. With an excessive proportion of small proprietors both of land and of capital, all great improvements on the land, all great enterprises in commerce and manufactures, and most of the wonders described by Adam Smith, as resulting from the division of labour, would be at an end; and the progress of wealth would be checked by a failure in the powers of supply.

...there is no part of the whole subject, (political economy) where the efficacy of proportions in the production of wealth is so strikingly exemplified, as in the division of landed and other property; and where it is so very obvious that a division to a certain extent must be beneficial, and beyond a certain extent prejudicial to the increase of wealth.\textsuperscript{126}

The second method of maintaining effective demand in relation to supply and thereby causing value and wealth to increase was through the extension of both internal and external commerce. Malthus' argument here was based upon his idea or assumption that human wants were

\textsuperscript{124}\textit{Ibid.}, p. 375. \textsuperscript{125}\textit{Ibid.}, p. 376. \textsuperscript{126}\textit{Ibid.}, pp. 375, 376.
satiatable. For Malthus, commerce or trade always increased value because that good received in exchange must have greater value than the good surrendered in the exchange. If this were not true; that is, if both parties to an exchange did not gain, no trade would occur. Here again Malthus had a utility concept.

In the case of external commerce, he explained that if a nation did not secure from abroad certain goods, they would not be produced internally because the costs of production would be too great. Thus, less would be spent on consumption because of the satiation of human wants if a nation's population was entirely dependent on home production.

With reference to his utility concept, Malthus said:

> Every exchange which takes place in a country, effects a distribution of its produce better adapted to the wants of the society. It is with regard to both parties concerned, an exchange of what is wanted less for what is wanted more, and must therefore raise the value of both the products.

> If indeed it did not tend to increase the value of the national produce, it would not be carried on. It is out of this increase that the merchants concerned are paid; and if some London goods are not more valued in Glasgow than in London, and some Glasgow goods more valued in London than in Glasgow, the merchants who exchange the articles in which these towns trade, would neither be doing themselves any good, nor any one else...The giving one article for another has nothing to do with effectual demand, unless the commodity received so far exceeds in value the labour employed on the commodity parted with, as to yield adequate profits to the capitalists concerned, and to give them both the power and the will to set fresh labour to work in the same trade.\(^{127}\)

Malthus saw a direct relationship between capital formation and a widening of the market. He stated in very emphatic terms:

\(^{127}\) Ibid., pp. 382, 383, 384.
No country with a very confined market, internal as well as external, has ever been able to accumulate a large capital, because such a market prevents the formation of those wants and tastes, and that desire to consume, which are absolutely necessary to keep up the market prices of commodities, and prevent the fall of profits. The distribution of commodities occasioned by internal trade is the first step towards any considerable increase of wealth and capital.\(^{128}\)

The same conditions in a capitalistic economy that caused internal trade to be necessary in order that a proper balance could be achieved and maintained between supply and effective demand, or production and consumption, also dictated that a nation engaged in external trade. Thus:

The motives which urge individuals to engage in foreign commerce are precisely the same as those which lead to the interchange of goods between the more distant parts of the same country, namely, a desire to increase or keep up the market prices of the local products; and the increase of profits thus made by the individual, or the prevention of that fall of profits which would have taken place if the capital had been employed at home, must be considered as a comparative increase in the value of the national produce.\(^{129}\)

Malthus was particularly eager for the reader to understand that foreign commerce increased exchange value. He said:

It will readily be allowed that an increase in the quantity of commodities is one of the most desirable effects of foreign commerce; but I wish particularly to press on the attention of the reader that in almost all cases, another most important effect accompanies it, namely, an increase in the amount of exchangeable value. And that this latter effect is so necessary, in order to create a continued stimulus to productive industry, and keep up an abundant supply of commodities, that in the few cases in which it does not take place, a stagnation in the demand for labour is immediately perceptible, and the progress of wealth is checked.\(^{130}\)

Malthus' third and final method of increasing the value and wealth of a nation, and at the same time maintaining a proper balance

\(^{128}\)Ibid., p. 388. \(^{129}\)Ibid., pp. 388, 389. \(^{130}\)Ibid., p. 393.
between production and consumption, was the maintenance of consumers who were unproductive. It is important here to state Malthus' definition of wealth. He says, "I should define wealth to be the material objects, necessary, useful, or agreeable to man, which are voluntarily appropriated by individuals or nations." Production, then, was the creation of material goods for sale in the market. Those persons who produced personal services were unproductive.

Malthus believed that in a country which had great powers of production, there was a need for the existence of a group of consumers who did not participate in the productive process. This need was based primarily upon the fact that the productive groups in the economy did not appreciably increase their consumption, particularly during those periods when they were increasing their savings in order to form capital. But the matter of creating the proper proportion between productive and unproductive laborers presented a problem that political economy could not solve. The correct proportion depended upon many circumstances, "particularly upon the fertility of the soil and the progress of invention in machinery. A fertile soil and an ingenious people can not only support without injury a considerable proportion of consumers not directly productive of material wealth, but may absolutely require such a body of demanders, in order to give effect to the powers of production. While, with a poor soil and a people of little ingenuity, an attempt to support such a body would throw land out of cultivation, and lead infallibly to impoverishment and ruin."

Another important factor which caused difficulty in arriving

131 Ibid., p. 33. 132 Ibid., p. 399.
at a proper proportion between productive and unproductive workers, "is the difference in the degree of consumption which may prevail among the producers themselves." 133

Perhaps it will be said that there can be no occasion for unproductive consumers, if a consumption sufficient to keep up the value of the produce takes place among those who are engaged in production.

With regard to the capitalists who are so engaged, they have certainly the power of consuming their profits, or the revenue which they make by the employment of their capitals; and if they were to consume it, with the exception of what could be beneficially added to their capitals, so as to provide in the best way both for an increased production and increased consumption, there might be little occasion for unproductive consumers. But such consumption is not consistent with the actual habits of the generality of capitalists. The great object of their lives is to save a fortune, both because it is their duty to make a provision for their families, and because they cannot spend an income with so much comfort to themselves, while they are obliged perhaps to attend a counting-house for seven or eight hours a day. 134

Malthus contended that there were three factors necessary to make demand effective, namely, desire, purchasing power, and an inclination to use it. If any one of these were absent from a given market at a given time, effective demand would not be present. For Malthus, then, the situation was clear. Many capitalists and master producers desired to save more than they desired to spend for consumption purposes. They had the power but not the will to maintain effective demand. On the other hand, the mass of the population desired to spend for consumption rather than save. These people had the will but not the power to maintain effective demand. This situation caused supply and effective demand to become improperly balanced. The result was general overproduction and a decline in value and wealth.

133 Ibid. 134 Ibid., pp. 399, 400.
Thus, economic progress was hampered by the fact that the rich voluntarily refused to consume and the poor involuntarily refused to consume. It was this situation that Malthus' unproductive consumers was supposed to remedy.

There must therefore be a considerable class of persons who have both the will and power to consume more material wealth than they produce, or the mercantile classes could not continue profitably to produce so much more than they consume. In this class the landlords no doubt stand pre-eminent. . .135

To the class Malthus would add menial servants, and public servants such as statesmen, soldiers, judges, lawyers, clergymen, teachers, etc.

Malthus believed that workers should be well paid because this was not only important to the wealth of the nation, but also because well-paid workmen created happiness for the mass of society. But he sounded a warning. "But as a great increase of consumption among the working classes must greatly increase the cost of production, it must lower profits, and diminish or destroy the motive to accumulate."136

On the other hand, unproductive workers "are paid from revenue, not from capital. They have no tendency to increase cost and lower profits. On the contrary, while they leave the cost of production, as far as regards the quantities of labour required to obtain any particular commodities the same as before, they increase profits by occasioning a more brisk demand for material products, as compared with the supply of them."137

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135 Ibid., p. 400. See also p. 401. 136 Ibid., p. 405.
137 Ibid., pp. 408, 409.
Malthus had positive ideas concerning public policy. With reference to a national public debt, he believed that a slow retirement of it would be more beneficial to the country than paying it off quickly. He was a strong advocate of public works to rid the economy of unemployment. His tax program was closely related to his government sponsored work for the unemployed. Taxation should create a public fund to finance the public works. "In our endeavours," he said, "to assist the working classes in a period like the present (depression), it is desirable to employ them in unproductive labor, or at least in labor, the results of which do not come for sale into the market, such as roads and public works." To the knowledge of the writer, Malthus was the first to state this idea in economic literature.

Malthus was never very specific concerning his attitude toward taxation. However, he did indicate strongly that heavy taxation might be necessary to maintain prosperity; that is to say, he was willing that a goodly portion of the national income be spent by the government to support effective demand sufficiently high to enhance economic progress.

Let us briefly summarize Malthus' major points. The productivity of labor on the land set an ultimate limit to the increase of wealth. Wealth and value depended upon the extent of effective demand and not on the productivity of labor. A nation of fertile soil might still be a country of little wealth because of lack of markets for the output that could be produced on that fertile land. Population and technological improvements were important to supply but had little

relationship to effective demand. Proper distribution was necessary to create and maintain economic progress. Malthus argued that it was true that the laborers worked in order to make a living, but it was not true that capitalists invested for the sole purpose of making a living. The capitalists wanted more exchange values, not more use values. They wanted more capital and profits, not more goods for consumption. The disposition of the capitalist was not to consume, but to invest. Thus, whether they would invest or employ labor depended upon the prospects of making profits and forming capital. Profits could be realized only if there were markets in which goods could be sold at prices that exceeded the entrepreneur's costs of production; that is, only if the extent of the effective demand for output was such that it would maintain prices above costs. If effective demand were not sufficient to accomplish this, the productive process ceased for lack of a motive. No matter how great the need for a good—poverty in the midst of plenty—the need itself did not constitute effective demand, and hence would not result in increased production.

It was very important to Malthus, in terms of effective demand, to understand the distribution of goods and money. Because producers had the power to consume but not the will; laborers had the will but not the power.

Malthus' general position was precisely the argument put forth by Keynes. They were in perfect agreement with reference to effective demand. They also agreed that the capitalistic economy operated in such a manner that it tended to make effective demand insufficient.
They both refuted Say's Law of Markets and the classical theory of capital formation. These have always been the two major pillars of the classical system. Had Malthus' teachings been followed, the classical tradition perhaps would have ended more than a century before Keynes attacked it. Both Malthus and Keynes held that money was more than a medium of exchange; it could be used as a store of value. Although Keynes developed more fully the concept of expectations as one of the motivating forces for investment, this principle was definitely a part of Malthus' idea system. Malthus contended that the savings of the capitalist would be invested if the rate of profit were sufficiently attractive. Thus, over-saving was possible for Malthus just as with Keynes. Finally, they both embraced the commanded theory of value. On this point, McCracken says, "Without formal commitment or verbal definition Keynes consistently utilizes the commanded value concept. Even the purchasing power of gold is determined, not by cost of production or labor embodied, but, to some extent at least, by central banking policies. The embodied value theory of Ricardo cannot be fitted into his system of economic thought." Of course, this was the Keynes of A Treatise on Money. But Keynes indicated no change from this in his later writings, including the General Theory. Thus it appears that Keynes was a true descendant of Malthus. "With respect to the importance of the 'short-run forces', we observe that Keynes joins the swelling ranks of those economists who insist that major attention, in the face of business instability, should be given to those short-run forces to

139 McCracken, Value Theory and Business Cycles, p. 177.
which Malthus alluded a century ago. 140

There is, of course, one major difference in the works of Malthus and Keynes. Keynes' criticism of the underconsumption theory, of which Malthus was a representative, was that it assumed that consumption expenditures were an autonomous factor independent of the level of income and determining the level of income. Keynes' idea of consumption ran precisely to the contrary. For Keynes, consumption was a dependent variable, depending on the level of income and not determining it; that is, the effect of income, not a cause. The propensity to consume was a cause, for it determined how much income would be spent on consumption out of a given level of income. Thus, a variation in the propensity to consume would cause a variation in income. Consumption would vary when and if income varied. 141 This however, is perhaps not of great importance when the complete idea systems of both men are considered. For example, Keynes said, "Thus our argument leads towards the conclusion that in contemporary

140 Ibid.

141 If, in fact, the level of employment and income depended upon the current level of consumption, then any saving would be depressing on the economy, because whatever the current level of consumption may be, the economy obviously is equipped to produce that output and no additional capital goods are required. If out of current income any portion should be saved— not spent for consumption—demand would be inadequate to absorb current output of consumers' goods at current prices, and losses would be incurred by producers. The underconsumption theory, then, must necessarily find that any saving whatsoever is depressive on the economy unless some external factor can be found to offset the effect of saving. This was exactly the function performed by Malthus' unproductive consumers. Later underconsumptionists who have been unwilling to accept the concept of unproductive consumers have been forced to look for some other way out of this dilemma. For example, H. Gordon Hayes uses extraneous factors—opening of new territories and markets, new inventions, etc.
conditions the growth of wealth, so far from being dependent on the abstinence of the rich, as is commonly supposed, is more likely to be impaired by it. One of the chief social justifications of great inequality of wealth is therefore, removed.\(^{142}\) This statement could have very well appeared in Malthus' *Principles*. It embodies the major principles of the doctrine of effective demand to which both men held so tenaciously. If the two idea systems are considered from this broad point of view, the fact that Malthus made consumption the dynamic factor of effective demand, whereas Keynes made new investment the dynamic factor of effective demand is of little importance. In the final analysis, what is significant is that they both assumed a capitalistic economy in their respective analyses. This was actually the fundamental "break" from Ricardian economics. Ricardo assumed a self-subsistence economy. Anyone who assumes the basic nature of the capitalistic process, must, if he is logical in his argument, arrive at much the same theoretical conclusions as did Malthus and Keynes. Perhaps it is this assumption that has set the "heretics" apart from the orthodox tradition for more than two hundred years. This is the link which has served to connect the "effective demand" theorists from Boisguilbert to Keynes. In short, the doctrine of effective demand based upon a true realization of the capitalistic process has been and continues to be the common denominator for these theorists.

In concluding the discussion of Malthus, it is proper to note the tribute paid to him by Keynes. He pointed out in the *General Theory* that Malthus used a deficiency of effective demand "as a

\(^{142}\) *General Theory*, p. 373.
scientific explanation of unemployment.\textsuperscript{143} Then he quotes passages from two letters which Malthus wrote to Ricardo to support his statement. Perhaps there is no better way to show the relationship between Malthus and Keynes than to quote these passages:

\begin{quote}
We see in almost every part of the world vast powers of production which are not put into action, and I explain this phenomenon by saying that from the want of a proper distribution of the actual produce adequate motives are not furnished to continue production. . . I distinctly maintain that an attempt to accumulate very rapidly, which necessarily implies a considerable diminution of unproductive consumption, by greatly impairing the usual motives to production must prematurely check the progress of wealth. . . But if it be true that an attempt to accumulate very rapidly will occasion such a division between labour and profits as almost to destroy both the motive and the power of future accumulation and consequently the power of maintaining and employing an increasing population, must it not be acknowledged that such an attempt to accumulate, or that saving too much, may be really prejudicial to a country?\textsuperscript{144}

The question is whether this stagnation of capital, and subsequent stagnation in the demand for labour arising from increased production without an adequate proportion of unproductive consumption on the part of the landlords and capitalists, could take place without prejudice to the country, without occasioning a less degree both of happiness and wealth than would have occurred if the unproductive consumption of the landlords and capitalists had been so proportioned to the natural surplus of the society as to have continued uninterrupted the motives to production, and prevented first an unnatural demand for labour and then a necessary and sudden diminution of such demand. But if this be so, how can it be said with truth that parsimony, though it may be prejudicial to the producers, cannot be prejudicial to the state; or that an increase of unproductive consumption among landlords and capitalists may not sometimes be the proper remedy for a state of things in which the motives to production fail.\textsuperscript{145}
\end{quote}

\textsuperscript{143}\textit{Ibid.}, p. 362.


Of course Keynes said nothing about unproductive consumers in his theory, but one must assume that he supported the doctrine in principle. Furthermore, could it be that Keynes' "make-work" programs was a twentieth century expression of Malthus' unproductive consumers?

More to the point perhaps was the fact that Keynes quoted the following passages from Malthus' Principles:

Adam Smith has stated that capitals are increased by parsimony, that every frugal man is a public benefactor, and that the increase of wealth depends upon the balance of produce above consumption. That these propositions are true to a great extent is perfectly unquestionable. But it is quite obvious that they are not true to an indefinite extent, and that the principles of saving, pushed to excess, would destroy the motive to production.

Of all the opinions advanced by able and ingenious men, which I have ever met with, the opinion of M. Say, which states that, un produit consommé ou détruit est un débouché fermé (I. i. ch. 15), appears to me to be the most directly opposed to just theory, and the most uniformly contradicted by experience. Yet it directly follows from the new doctrine, that commodities are to be considered only in their relation to each other, not to the consumers. What, I would ask, would become of the demand for commodities, if all consumption except bread and water were suspended for the next half-year? What an accumulation of commodities! Quels débouchés! What a prodigious market would this event occasion!

One could not find better evidence to demonstrate the close relationship between the theories of Malthus and Keynes. Perhaps H. Gordon Hayas, a current underconsumptionist, was guilty of a slight exaggeration when he wrote, "Keynes was the first academic economist of

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high professional repute since Malthus to attack the doctrine that the economic forces of a private-property economy tend to bring about the employment of all who wish to work at the prevailing wage rates.\textsuperscript{148}

Nevertheless, the statement is to the point discussed in this chapter and shows again the relationship between Malthus and Keynes. And it seems perfectly safe to state that Keynes believed it was he who rescued Malthus' doctrine of effective demand from the economic "underworld."\textsuperscript{149}

Perhaps he did, but there were others who concerned themselves with effective demand at the time of or after Malthus and before Keynes.

The writers remaining to be examined with reference to effective demand are Sismondi, Chalmers, Moffat, Hobson, Aftalion, and Foster and Catchings. It will not be necessary to examine these authors as extensively as Malthus was treated. It was Malthus, following the rather faint trail left by Boisguilbert, Mandeville, Stuwart, and Lauderdale, who elevated the doctrine of effective demand to a high pinnacle. The writers to be discussed kept it there until a "Keynes" appeared to send it soaring even higher. To be sure, these economists based their idea systems upon the concept of effective demand, but the idea did not dominate their thought as it did Malthus' theory. In fact, it is quite easy to demonstrate the attitude of these writers toward effective demand and its importance to economic activity by carefully selecting and quoting a few passages from each.


\textsuperscript{149}One should read the essay on Malthus by Keynes in his Essays in Biography (London: Macmillan and Co., Ltd., 1933), pp. 95-150. On page 144 Keynes clearly shows that he thought Chapter I in Book II of Malthus' Principles was a neglected basis of what might have been a better development of economic thought than what actually took place.
This, the writer believes, is sufficient to show that there was a continuous development in the effective demand principle from Malthus to Keynes. This, along with the fact that each of these authors has been quite adequately examined by other writers, justifies the brief treatment of them here.

Jean Charles Sismondi

Sismondi (1773-1842) was a contemporary of Malthus. In fact, two of his more important works appeared before 1820, which was the publication date of the first edition of Malthus' Principles. One of Sismondi's first books, De la richesse commerciale, was published in 1803. His two-volume work, Nouveaux principes d'économie politique, ou de la richesse dans ses rapports avec la population, first appeared in 1819, and it came forth in a second edition in 1827. One of his latest works, Études sur l'Économie politique, was published in 1838.

According to Schumpeter, "Sismondi's reputation as an economist rests on his Nouveaux Principes d'économie politique, which appeared in 1819. But we know that the essentials of this work had actually been written by 1815 for an article that Sismondi contributed to Brewster's Edinburgh Encyclopaedia, though this article was not published until after the Nouveaux Principes. By then--at the latest--he was in possession of all the elements of doctrine that are associated with his name. His later works, such as his Études sur l'Économie politique, emphasized and developed the main points--and his claims--but do not add anything essentially new." 150

Although Sismondi has been justly criticized by many able writers for his theory of economic crises, his reputation in the history of economic thought rests upon his concept of economic instability. And this idea was based upon his thinking along the lines of overproduction as a result of underconsumption or inadequate demand. Sismondi first developed a theory of partial overproduction and then formulated his thesis of a general economic glut. Sismondi's theory of markets was his theory of crises. The cause of the crisis in economic activity was the direct result of inadequate consumption, which was the result of the poverty of the masses. The mass market simply could not absorb the output of modern industry when it operated at full capacity. This was the central theme of Sismondi's theory, and it characterizes all underconsumption theory.

Sismondi looked with nostalgic eyes back to the days when society was organized along rather primitive lines with each family regulating its own economic needs. In such a society, progress was retarded but "wherever are found peasant proprietors are also found that ease, that security, that independence, that confidence in the future, which assure at the same time happiness and virtue. The

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peasant who, with his children, does all the work on his little inheritance. who neither pays rent to anyone above him, nor wages to anyone below him, who regulates his production by his consumption. . . cares little about knowing the price of the market; for he has little to sell and little to buy and is never ruined by the revolutions of commerce. . ." But the Industrial Revolution had brought to an end this happy and stable society. The result of machine-capitalism was that:

The proletarion are cut off from all the benefits of civilization; their food, their dwellings, their clothes are insalubrious; no relaxation, no pleasures except occasional excesses, interrupt their monotonous labours; the introduction of the wonders of mechanics into the arts, far from abridging their hours of labour, has prolonged them; no time is left for their own instruction or for the education of their children; no enjoyment is secured to them in those family ties which reflect their suffering; it is almost wise in them to degrade and brutalize themselves to escape from the feeling of their misery; and that social order which threatens them with a worse condition for the future, is regarded by them as an enemy to combat and destroy. This is not all; whilst their own distress is increasing, they see society overcome, as it were, by the weight of its material opulence; they are in want of everything, and on all sides their eyes are struck with what is everywhere superabounding.153

The new industrial economy had greatly enhanced output, but the great mass of the workers did not share in this increase in productivity. The capitalist received income in surplus amounts; the laborer received just enough for subsistence. The result of this


inequality in income distribution was that the mass of the population could not bring into the market effective demand above the absolute necessities of life. There was room in Sismondi's system for reasonable profits, but not for exaggerated profits. In short, a proper balance between profits and wages in order to maintain effective demand for the output of industry was Sismondi's solution to the problem.

In his attack on Say's Law that supply created its own demand, Sismondi held that demand was independent of production and was a function of the needs of the buyers, and the means by which they had to pay for goods. He virtually dismissed the concept of human needs as a determinant of demand and concentrated his argument on the lack of purchasing power on the part of the workers. This was the cause of overproduction and underconsumption. Sismondi believed that most of the men engaged in production were not able to exchange the products which their labor created for those goods which they desired. The workers received only a small portion of the selling price in exchange for their labor—a portion all too small to permit them to absorb the entire supply of merchandise. The manufacturers compete with each other in placing upon the market a constantly increasing quantity of products. But the ability of the workers—who constitute the great bulk of the population—to buy is diminished. Demand contracts to the degree that supply expands.

This raised an issue with which economists have wrestled throughout the history of modern capitalism. This issue has been and still is: Does it really make any difference how purchasing power is apportioned so long as enough is distributed to take off
the market all the goods produced? The manner in which an economist answers this question identifies him either on the side of Say's Law and Ricardian economics or on the side of commanded value and "heretical" economics. Needless to say, the writers being examined in this chapter placed themselves on the side of the latter. Of course, this would also be true of the Austrians. Perhaps it has been this attitude, as much or more than anything else, that links together the "heretics" from Boisguilbert to Keynes.

Sismondi's position with reference to this issue was very clear. In his analysis, overproduction could not be avoided, because the objects of prime necessity, the chief objects of manufacture, are consumed to a very limited degree by the wealthy. The rich desire those expensive and rare things which single them out from among the crowd, i.e., objects of conspicuous consumption and conspicuous waste. They encourage the industries de luxe, the industries which do not have a wide market and appeal to a restricted clientele. As soon as any article is produced in abundance and is found to be consumed by the vulgar, it is no longer dignified for them. Therefore the rich will not permit an excess of supply from the industries de luxe, industries which they call exceptional. Hence, labor is always concentrated in those factories which create necessities for the masses, and overproduction results.

By an inherent contradiction in modern economic conditions, while their great wealth push the wealthy to build vast factories, their riches also exclude the products of these very great factories from the consumption of the rich. Those who receive the selling price of the merchandise, those who benefit from fabrication, are not the same as those who consume them. The production thus goes on accumulating while consumption is restrained. Overproduction is a fatal effect of contemporaneous economic organization.155

Thus for Sismondi, economic crises were inevitable. They were a direct result of the Industrial Revolution and the capitalistic system.

The three men primarily responsible for keeping alive the doctrine of effective demand for the remainder of the nineteenth century were Thomas Chalmers, whose *Political Economy* was published in 1832; R. S. Moffat, who published *The Economy of Consumption* in 1878; and J. A. Hobson, whose *Physiology of Industry* appeared in 1889. Of these three, Keynes noticed only Hobson, but they fashioned important links in the argument of the importance of effective demand.

Chalmers distinguished between capitalistic accumulation and consumers' accumulation. "It is true of every single capitalist," he said, "that he is all the richer by saving than by spending. But it is not true that capitalists collectively will become richer by saving than by spending." This was true, Chalmers believed, because the rate of profits was reduced by over-investment. But consumers' accumulation by not spending accentuated the losses of capitalists. If consumers saved and did not buy, capitalists could not sell and make profits. Thus, savings resulted in a loss of effective demand, which caused production to fail. Chalmers basic thought was that, "Spending and trading must be in due relation to each other, or there will be general glut and depression. Those who say that this cannot happen are called the 'new economists'." Chalmers was referring here, of course, to the new Ricardian school of economics.

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Moffat's argument was that consumption had not been given its due place, and that the distribution and habits of consumption were as important as the volume of production was to Smith. It was a fallacy to generalize saving as a way of increasing wealth; one person may profitably save, but not all. "A general increase of parsimony would evidently diminish the demand for commodities, lessen the need for production, and reduce the amount of capital which could be held in organic relation to industry. The hoarding of the community is limited; the hoarding of the individual is practically not limited."\(^{158}\)

For Moffat, capital accumulation was not made by saving out of consumption. Industry itself formed capital on the basis of consumer buying; that is, it was consumer buying and not consumer saving that stimulated industry to accumulate capital. "Effective demand is the demand rendered effective by industry itself. Abstinence itself gives no reward; the critical word is investment. In order that the profit motive may not gorge markets by over-investment, the buying power of labour must be maintained, in relation to its producing power."\(^{159}\)

According to Hansen, "After reading Lauderdale and Malthus, one gains relatively little from Hobson's work. Hobson does indeed make clearer than his predecessors the role of growth--changes in technique and increase in population--in opening investment outlets. But with respect to consumption, his treatment is less penetrating than that of Malthus."\(^{160}\)


\(^{159}\)Ibid. \(^{160}\)Hansen, op. cit., p. 255.
Hobson repeated the proposition of Chalmers and Moffat that separate persons might save too much, while a community, or a Crusoe, would regulate saving. Every increase in saving and capital, in order to be effective, required a corresponding increase in immediately future consumption. An increase in production did not force an increase in consumption because people wished to save as well as to consume. "The desire to save may lead them to increase their production independently beyond the desire for present or immediately future consumption." There was enough income, according to Hobson, to buy all the product, and replace the capital, if all the final product were consumed soon after production. But "depression and excessive thrift describe phases of the same phenomenon." Insufficient demand falls especially, "by backward incidence, on the requisite of production which is, in any country, the limiting requisite, in least elastic supply. In Britain that requisite is labour, since capital can adjust itself, and the use of land depends on import. So that the East End problem, with its concomitants of vice and misery, is traced to its economic cause, and this economic cause is the most respectable and highly extolled virtue of thrift." According to Hobson, it is sometimes assumed that any proportion of the income of a community can advantageously be saved. But this is not the case. An industrial community cannot usefully save more than a certain proportion of its income: that proportion is


162 Ibid., p. 13. 163 Ibid., p. 17.
never accurately known, and it is always shifting with changes in the arts of production and consumption. It is only by taking the partial standpoint of an individual or a group of individuals, or some other part of the industrial whole, that it seems plausible to hold that there is no limit to efficacious saving.164

Then he concluded,

There exists at the present moment, a right proportion between saving and spending. Industrial progress, or the economical working of the industrial system, consists largely in the ascertainment of this proportion and the adjustment of industry to it. The right proportion of saving to spending at any given time depends upon the present condition of the arts of production and consumption, and the probabilities of such changes in modes of work or living as shall provide social utility for new forms of capital within the near or calculable future. The proportion of its income which could be saved for conversion into new forms of capital must depend upon the state of the industrial arts upon the one hand, and the standards of consumption upon the other. The increased demand for final commodities which a rising consumption of a growing population will create in the calculable future. Beyond these growth requirements, saving would defeat its purpose, creating more forms of capital than were wanted and than would actually be used.165

Hobson foresaw the propensity to consume concept when he wrote,

"A greater equalization of incomes, either by the successful pressure of the workers for a larger share of wealth or by the taxation of 'surplus' for purposes of public expenditure" would increase demand and employment, and so "validate at least as large an absolute quantity of saving as before, though a smaller proportion of saving to spending."166 Hobson had reference here to what would now be called an upward shift in the propensity to consume or consumption function.

As was noted earlier, Keynes paid a great tribute to Hobson.


165 Ibid. 166 Ibid., p. 39.
It bears repeating here. "Theories of under-consumption hibernated until the appearance in 1889 of The Physiology of Industry, the first and most significant of many volumes in which for nearly fifty years Mr. Hobson has flung himself with unflagging, but almost unavailing, ardour and courage against the ranks of orthodoxy. Though it is so completely forgotten to-day, the publication of this book marks, in a sense, an epoch in economic thought." 167

Keynes, in six pages devoted to Hobson, quotes several passages from The Physiology of Industry, and explains what he believes to have been Hobson's major analytical error. Keynes says that, "In this early work Mr. Hobson with his collaborator expressed himself with more direct reference to the classical economics (in which he had been brought up) than in his later writings; and for this reason, as well as because it is the first expression of his theory, I will quote from it to show how significant and well-founded were the authors' criticisms and intuitions. They point out in their preface as follows the nature of the conclusions which they attack:" 168

Saving enriches and spending impoverishes the community along with the individual, and it may be generally defined as an assertion that the effective love of money is the root of all economic good. Not merely does it enrich the thrifty individual himself, but it raises wages, gives work to the unemployed, and scatters blessings on every side. From the daily papers to the latest economic treatise, from the pulpit to the House of Commons, this conclusion is reiterated and re-stated till it appears positively impious to question it. Yet the educated world, supported by the majority of economic thinkers, up to the publication of Ricardo's work strenuously denied this doctrine, and its ultimate acceptance was exclusively due to their inability to meet the now exploded wages-fund doctrine. That the conclusion should have survived the

argument on which it logically stood, can be explained on no other hypothesis than the commanding authority of the great men who asserted it. Economic critics have ventured to attack the theory in detail, but they have shrunk appalled from touching its main conclusions. Our purpose is to show that these conclusions are not tenable, that an undue exercise of the habit of saving is possible, and that such undue exercise impoverishes the community, throws labourers out of work, drives down wages, and spreads that gloom and prostration through the commercial world which is known as Depression in Trade...

The object of production is to provide "utilities and conveniences" for consumers, and the process is a continuous one from the first handling of the raw material to the moment when it is finally consumed as a utility or a convenience. The only use of capital being to aid the production of these utilities and conveniences, the total used will necessarily vary with the total of utilities and conveniences daily or weekly consumed. Now saving, while it increases the existing aggregate of capital, simultaneously reduces the quantity of utilities and conveniences consumed; any undue exercise of this habit must, therefore, cause an accumulation of capital in excess of that which is required for use, and this excess will exist in the form of general over-production.

Keynes' emphasis on investment and his "expectations" theory of value caused him to make the following remarks concerning the above quoted passages from Hobson. "In the last sentence of this passage," Keynes said, "there appears the root of Hobson's mistake, namely, his supposing that it is a case of excessive saving causing the actual accumulation of capital in excess of what is required, which is, in fact, a secondary evil which only occurs through mistakes of foresight; whereas the primary evil is a propensity to save...

169 This concept that the productive process is a continuous one is of great importance for a true understanding of the capitalistic system. It has always been clearly understood by those who approach economic analysis from the demand side that there is no "beginning" or "ending" of the productive process. It is a "belt-like" movement with no "starting" or "stopping" points. Consumption can very well be the "beginning" instead of the "end".

in conditions of full employment more than the equivalent of the capital which is required, thus preventing full employment except when there is a mistake of foresight. A page or two later, however, he puts one half of the matter, as it seems to me, with absolute precision, though still overlooking the possible role of changes in the rate of interest and in the state of business confidence, factors which he presumably takes as given:  

We are thus brought to the conclusion that the basis on which all economic teaching since Adam Smith has stood, viz. that the quantity annually produced is determined by the aggregates of Natural Agents, Capital, and Labour available, is erroneous, and that, on the contrary, the quantity produced, while it can never exceed the limits imposed by these aggregates, may be, and actually is, reduced far below this maximum by the check that undue saving and the consequent accumulation of over-supply exerts on production; i.e. that in the normal state of modern industrial Communities, consumption limits production and not production consumption.  

Although Keynes did not mention many of the names who have contributed heavily to the development of the doctrine of effective demand, his recognition that Hobson was a Keynesian antecedent perhaps demonstrates that he—much more so than some of his ardent followers—knew his "place" in the history of economic thought.  

Albert Aftalion  

Using the subjective value theory and the principle of diminishing utility developed by the Austrians, Aftalion formulated an economic analysis that greatly enhanced the "demand" approach to

171 General Theory, pp. 367, 368.  
172 Ibid., p. 368. Keynes cites "Hobson and Mummery, op. cit., p. ix."  
173 More evidence of this is shown in Chapter Five.
economics. The purpose of this chapter does not dictate, however, that Aftalion be examined in any great detail. The treatment of this economist will be confined here to a few statements concerning his attitude toward consumer wants and diminishing marginal utilities. Aftalion used the principle of diminishing utility to refute Say's Law of Markets.

Aftalion based his analysis upon the dynamics of human wants. He believed it was this element in the economy which determined and caused fluctuations in the rate of investment. Capitalists based their investment decisions upon their expectations of final consumer demand for their products. In short, the value of the final consumer goods determined the value of the capital goods used to produce them. This, of course, was the derived demand concept. Aftalion did not believe that technological progress caused capital to be formed unless the new techniques promised to more fully satisfy consumption wants. Thus, consumption was the end of all production. Fundamental to Aftalion's analysis, then, was the principle that the demand for capital goods could be explained only in terms of those forces which controlled human wants and the demand which resulted from these wants.

For Aftalion, it was an excess of capital goods and not a scarcity of them that brought a period of prosperity to a close. During a boom period capital accumulates quickly. Eventually the output of capital goods exceeds consumer demand as a result of "glutting of wants." When this occurred the inducement to create still more capital goods came to an end.

Hansen explains that Aftalion's principle of diminishing marginal utilities is the result of two factors: (1) as the stock
of capital goods on hand becomes larger and larger, the possibility of substituting capital for the other productive factors diminishes, and (2) the value of consumers' goods—relative to the cost of capital—diminishes as they become more abundant. The construction of houses is a case in point. During a period of prosperity, net investment in houses increases. As a result, the rate of return (marginal utility) on each new house constructed declines. The immediate result of this is a reduction of rents and a fall in the value of houses relative to the cost of construction. The end result is a decline in the demand for new houses, and the construction of new houses falls sharply.

As consumers' goods become more abundant, their marginal utilities decline. Producers of consumers' goods experience a fall in their prices. As consumers' goods become less valuable, the value of the capital goods used to produce them declines relative to the cost of capital goods. The solution of this problem is an ever-increasing demand for consumers' goods. If this can be achieved, the marginal utilities of consumers' goods will not decline; furthermore, the increasing consumer demand will create new capital investment opportunities. Although caused by somewhat different forces, this position of Aftalion is almost identical with Keynes' concept that the marginal efficiency of capital showed great instability in the long-run. Keynes emphasized the role of interest in determining the rate of investment more than did Aftalion. And for Keynes, it was a low propensity to consume rather than diminishing marginal

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174 Hansen, op. cit., p. 349.
utilities that was a source of difficulty.

This concept of a diminishing intensity of desire to satisfy human wants was the very heart of Aftalion's analysis. Furthermore, he did not believe this to be in conflict with the fact that human wants are insatiable. The whole point is that persons experience a decline in their intensity of desiring goods as they increase their ability to satisfy their lesser needs. Because of this factor, "the decreasing utility of goods is in perfect harmony with the insatiability of human wants." According to Aftalion, then, if human wants or desires are viewed properly, the fact that wants are insatiable does not prevent a general overproduction of economic goods and glutted markets.

In commenting upon Aftalion's use of the principle of diminishing utility, McCracken explains that, "Aftalion definitely rejects the Ricardian theory of embodied value and joins the Malthusian group and Austrian School of 'commanded value.'" In concluding this brief treatment of Aftalion, let us see how he used the principle of diminishing utility to refute Say's Law of Markets. According to McCracken:

Aftalion next directs his attention to the classic doctrine that goods exchange against goods, creating a law of two

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175 Aftalion, "La Réalité des surproductions générales," in Revue d'économie politique, XXIII (1909), pp. 86, 87. This was one of a series of articles. The major elements of his analysis were presented in the March, 1909, issue, pp. 201-229. Aftalion expanded his main thesis in his two volume work, Les Crises périodiques de surproduction (Paris, Marcel Rivere et Cie, 1913).

176 Ibid., p. 87.

177 McCracken, Value Theory and Business Cycles, p. 132
supplies, making impossible a general overproduction. The most that could happen would be maladjusted production or partial overproduction. In reply, Aftalion says it is of little import to say that one's power to acquire increases proportionately with his production. "Intensity of desire for goods is not identified with the power of acquisition. It may be that my ability to buy cloth depends upon how much wheat I produce. But the strength of my desire for cloth is not a function of my wealth of wheat. It diminishes with the increased abundance of cloth, since this abundance will permit only of the satisfaction of a lesser need. Wheat and cloth may be mutually exchangeable but if production is carried to the point where increased consumption satisfies a less intense desire then the value of both will fall. Thus it is with the total ensemble of products. If supplies are increased quite generally, they meet on the demand side a diminished intensity of desire. But as general intensity of desire fies away, so does value. Prices will no longer cover cost of production. We still have general overproduction, even if consumers have the power to clear the market but because of diminished intensity of desire refuse to do so.

It seems quite clear from this analysis that supply could not create its own demand because of a voluntary failure of demand. Aftalion's concept of voluntary failure of demand was of course the same as Malthus' producers who had the power but not the will. This sets Aftalion apart from the "pure" underconsumption theory. The underconsumptionist holds that demand is deficient because of an involuntary failure of purchasing power based upon maldistribution of income. This is the same as Malthus' worker who had the will but not the power to demand goods. Malthus was the fountainhead for both concepts.

Perhaps it is quite correct to give Aftalion credit for demolishing Say's Law of Markets. However, it is perhaps more correct to state that it is the concept of commanded value which destroyed it.

\[^{176}\text{Ibid.}, \text{p. 131.}\]
And many economists, including Malthus and the powerful Austrian trio, embraced this value theory. In short, one cannot give to any one person the credit of completely refuting the principle that supply creates its own demand. Keynes, in his attack on Say's Law, merely added the weight of his prestige to a bitter struggle that had been running for over two centuries.

W. T. Foster and Waddill Catchings

And now the trail of the doctrine of effective demand is brought very close to Keynes in the writings of Foster and Catchings. Here is found the underconsumption theory, based upon the principle of involuntary failure of demand, in full bloom.

These writers believed that the objective of economic activity was to keep the economy operating at full capacity at all times in order that the population could enjoy as high a real income as was possible with existing technology. Their analysis and their public policy were derived directly from this belief.

They pointed out that, "First, that there is no possibility of attaining the economic goal upon which all are agreed unless consumers somehow obtain the money, year in and year out, to buy the goods about as readily as they are produced; second, the present money and profit economy does not enable consumers long to obtain the required money; third, there is consequently no possibility of sustained economic progress, and extreme alternations of prosperity and depression are inevitable." 179 Perhaps no writer has ever expressed the

underconsumption theory with more exactness than this.

For Foster and Catchings, consumption was the regulator of production, "since it is always possible to produce far more than we consume, consumption regulates production." In more emphatic terms, "There could not possibly be a serious setback of business in general if consumption regularly kept pace with production. Sustained business depression accompanied by adequate consumer-demand is no more possible than drought accompanied by heavy rains." They ask an allimportant question, "Why do we ever curtail production in general—reduce crop acreage, bank furnaces, shut down mills, throw men out of work?" And their answer was simple and direct. "Because we cannot get our products consumed, which means that we cannot sell them to the people who want to use them, at prices that make continued production possible." They were firmly convinced that, "The one thing needed above all others to sustain a forward movement of business is adequate consumer purchasing power. Sunshine campaigns may start business, but only consumers' dollars can sustain it." "A willing buyer does not have to wait long, but a willing seller may have to wait forever. Adequate consumer-demand would do more than any other means now within human control towards increasing wealth, abolishing poverty, maintaining employment, solving labor problems, increasing good will among men generally, and maintaining the peace of the world."

181 Ibid.
182 Ibid.
183 Profits, p. 239.
Foster and Catchings were impatient with any analysis which stated that production and consumption would balance in the long-run. "To keep business free from extreme fluctuations, production and consumption must balance within a sufficiently short period of time. Time is the essence of the problem." People are unemployed and factories are idle in the short-run. It was repugnant to these writers to even think of waiting for the long-run to run its course and bring about high economic activity. Their attack against Say's Law of Markets was quite simple. They held that it was obsolete and fallacious in a money and credit economy.

"What a mess we get into!," they said, "We work hard to pile our shelves high with what we most desire, and then we have to stop working because we are unable to take these things off the shelf and enjoy them." The two writers explain that, "production must slacken, and thus render increased consumption impossible, unless products find their way to consumers about as rapidly as they are produced. This condition prevails, obviously as long as there is close and continuous correspondence between the dollar-sales of consumers' goods and the output of these goods measured in dollars at prevailing prices." However, saving by individuals upsets this balance and glutted markets result.

When producers save and invest, "Money that is used once to bring about the production of goods is again used to bring about

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185 Profit, p. 248.
187 Profit, p. 279.
the production of goods, before it is used to bring about the con-
sumption of goods. In other words it is used twice in succession
to create supply."\textsuperscript{188} Again, overproduction is the result. Thus,
a lack of effective demand is a direct result of savings and profits.

The major points in the theory of Foster and Catchings may
be summarized in the following manner. Society does not spend all
its income. Some part of it is bound to be saved. Some of this
saving is carried out by industry itself, for not all the value pro-
duct of industry is distributed in incomes; part is retained to add
to productive equipment. Of that which is distributed in incomes,
some part also is saved. These savings, via banks and security issues,
find their way back to industry where they are invested; that is to
say, they are used to purchase productive equipment, the means to
produce more goods.

On the face of it, this volume of consumer and business
saving would seem to create a deficiency of buying power in respect
to goods offered for sale. It does this in the end, but not im-
mEDIATELY. No deficiency arises immediately, for all the savings
thus apparently taken out of incomes, and therefore out of purchasing
power, are, by the process of investment, being paid out to wage
earners (and other factors of production) engaged in the capital-
producing industries. Hence the total volume of purchasing power
is not affected by savings, since what is given up by one group is
transferred to another.

Yet this situation of adequate purchasing power is temporary

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and short-lived. In due time, the productive facilities on which savings are being spent are ready for operation, and, after the lapse of a further period, the goods they are capable of producing are ready for the market and added to the existing supply. When this finally happens, then purchasing power is inadequate to buy both the original and the additional flow of goods at the existing levels of prices; or, more exactly, it is inadequate to do so unless the total volume of money is increased, either by incoming gold or by the inflationary action of banks.

To suppose that banks can continue to meet this situation is to misconceive the lessons learned from experience. The truth is, they cannot continue to do so; sooner or later, the state of reserves calls a halt or imposes some restriction on the rate of increase of the money supply. When this time comes, the ultimate results of the process of saving can no longer be postponed. The deficiency of purchasing power, put off for a while by an increase in the supply of money through the banking system, is finally here; and the crisis begins. It follows that it is impossible for a society to save without causing crisis and depression. But in a capitalistic society, savings are in fact made. Thus, depressions are inevitable.189

There has been no attempt made in this chapter to include all those writers who have contributed to the doctrine of effective demand. To do so would have been impossible in a work of this type.

189See McCracken, Value Theory and Business Cycles, pp. 147-151, for an appraisal and criticism of Foster and Catchings.
Following the trail as it was blazed by the more important authors was the only concern of this chapter. This was the trail, these were the economists who fashioned it, which led in an unswerving line to the General Theory in 1936. Faced with this picture of the evolution of the doctrine of effective demand, inadequate as it may be, it seems quite clear that the economics of Keynes should never be referred to as "revolutionary" or "the new economics." The writers presented in this chapter were the main stem of the argument on effective demand in relation to saving, which was integrated into a system by Keynes. The system is new, which was no mean accomplishment, but the ideas go far back.

In summary form, these ideas were, first, the incomes of all people depend on the expenditure of other people. Second, if all the incomes are spent in one way or another, the whole income will be maintained, and also the employment which created it, if general prices are steady. Third, money which individuals save must therefore re-enter the circulation by the borrowing and spending of other persons, public or private, failing which the whole income will fall. Fourth, there is a gap between saving and spending, since the saver is not the same person as the spender of borrowed money; this gap should therefore be quickly closed by the investment of savings. Fifth, if savings are invested, they will maintain both the income out of which they have come, and will themselves be exactly maintained so that the investment will in a sense be self-financed. The effective demand of the nation will thus be maintained, but it will require a public intervener to do it, if private enterprise does not rapidly
take up private savings. There must either be public investment, or policies to increase private enterprise or private consumption. Saving must be offset by some kind of spending, in order that full expenditure may maintain full employment, and vice versa. Idle savings limit the income they might have maintained, and clog the whole effective demand. These ideas forged into a system by Keynes constitute the economics of Keynes.
CHAPTER V

MONETARY HERESY AND FINANCIAL CAPITALISM

The significant basis of uniformity in the monetary heresy tradition resides in a common practical attitude which ascribes the existence of unemployed resources to the prevailing financial institutions. According to this system of thought, money and credit represent a monopoly which embodied itself in the financial structure and developed alongside modern industrial enterprise. These financial institutions are viewed as important inhibitions to the on-going capitalistic process. They prevent the full employment of community resources, lead to an inadequacy of effective demand, and result in an artificial scarcity of capital assets. The central argument is that the financial structure of capitalism must be changed in such a manner that will eliminate its undesirable consequences. A distinguishing characteristic of the theoretical argument is the integration of money and credit theory into the general body of economic principles. Criticism of the orthodox point of view centers around the classical theory of interest.

The monetary heretics attribute interest to the private ownership of money held as a store of value, and attack all income derived from the mere ownership of property. Labor cost becomes the sole social cost of production. Income consists of labor income plus
scarcity rents from land and capital. With regard to class structure, a characteristic feature of this attitude is the condemnation of the rentier class because of its non-functional role in production and exchange. Income from private entrepreneurship, as contrasted with income from private ownership, is justified from the social point of view on functional grounds because the entrepreneur is regarded as indispensable to industrial progress and to the exercise of individual initiative.

Keynes' theoretical and policy arguments fit neatly into this system of thought. The general reference of this chapter is to the history of these ever-persistent theories of monetary reform. The specific investigation attempts to trace the monetary aspects of Keynes' General Theory back to two important antecedents, P. J. Proudhon and Silvio Gesell. Why these two men? There are two reasons.

1 That which is called in this study the Keynes-Gesell-Proudhon tradition extends much further into the history of capitalism and is much broader in the contemporary world than the particular thread which is being pursued in this chapter. It was perhaps the most important type of reform in the early history of industrial capitalism prior to the age of mass production, which began approximately in the middle of the nineteenth century. After 1850 there was a shift in emphasis among European social reformers, away from proposals for financial and exchange reforms toward programs calling for the collective ownership of property used in production.

In the early nineteenth century the attack on money and banking institutions was implemented by an appeal to the labor theory of value. Attempts were made, with the sanction of the theory that price should equal cost, to organize systems of exchange which were intended to eliminate interest and middlemen's charges. In England the Ricardian socialists pointed out that since all income is produced by labor, there can be no social justification for the receipt of income by money lenders and land owners.

Robert Owen put such a system into practice when in 1832 he established the National Equitable Labour Exchange, which was an attempt to bring producer and consumer into direct contact through the use of labor-notes or labor-tickets. In this way all non-labor income would be
First, of course, in a study of this type a writer is limited in the material that he can examine. It would be impossible to make a comprehensive analysis of all the antecedents of Keynes' monetary reform proposals. Fortunately, that is not necessary to achieve the general objective of the dissertation, which is to assign Keynes to his proper position in the history of economic thought. Second, and a more important reason, is that Keynes in the *General Theory* expresses sympathy and admiration for both the technical theory and the social premises of Gesell's most important work, *The Natural Economic Order*. Keynes refers to Gesell as "the strange, unduly neglected prophet... whose work contains flashes of deep insight and who only just failed to reach down to the essence of the matter." According to Keynes:

> The purpose of the book (*The Natural Economic Order*) as a whole may be described as the establishment of an anti-Marxian socialism, a reaction against laissez-faire built on theoretical foundations totally unlike those of Marx in being based on a repudiation instead of on an acceptance of the classical hypotheses, and on an unfettering of competition instead of its abolition. I believe that the future will learn more from the spirit of Gesell than from that of Marx.  

 eliminated. The plan operated less than two years. The Ricardian socialists designed similar schemes. And programs of a related nature were attempted in France, Germany, and the United States. The common characteristic of all these programs was a frontal attack on financial and marketing institutions. There was no justification for using gold as money and for the existence of interest. Furthermore, they challenged J. B. Say's law of markets because of the inflexible and monopolistic financial organization which prevented "supply" from creating its own "demand."

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With respect to governmental intervention and free competitive enterprise, Keynes recorded his approval of Gesell in the following manner:

Thus I agree with Gesell that the result of filling in the gaps in the classical theory is not to dispose of the "Manchester System," but to indicate the nature of the environment which the free play of economic forces requires if it is to realize the full potentialities of production. 6

While expressing disagreement with certain aspects of Gesell's technical analysis, especially with its incompleteness, Keynes was for the most part sympathetic toward his theory. He says, "the idea behind stamped money is sound." 7

Gesell unstintingly acknowledged Proudhon as the only economist prior to himself whose investigations into the theory of capital and interest had suggested a workable solution for the reform of capitalism. 8 The passage from Proudhon which he quotes and paraphrases time and time again is this: "Money is a sentinel posted at the entrance of the markets, with orders to let no one pass. Money, you imagine, is the key that opens the gates of the market (by which term is meant the exchange of products); that is not true--money is the bolt that bars them." 9 The durable (and therefore hoardable) character of money, the monopoly of credit, and the propensity to hoard money, are, for Gesell, Proudhon, and Keynes, respectively, the strategic factors in the explanation of the conflict between wealth and welfare in the

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6 General Theory, p. 379. 7 Ibid., p. 357.
8 Gesell, op. cit., see esp. Money Part, p. 3.
social economy.

To Proudhon's insight into the theory of capital and interest Gesell attributes the former's suggestion for eliminating unearned income without socialization of productive property. Gesell's clearest statement of his relation to Proudhon in this connection is contained in the introduction to the *Natural Economic Order*. He begins with a citation from Proudhon's *What is Property?* and in the course of the introduction he commends Proudhon while castigating Marx in a series of comparisons:

The abolition of unearned income, of so-called surplus value, also called interest and economic rent, is the immediate economic aim of every socialistic movement. The method generally proposed for the attainment of this aim is Communism in the shape of nationalization or socialization of production. I know of only one socialist--Pierre Joseph Proudhon--whose investigations into the nature of capital point to the possibility of another solution of the problem. No one, except Proudhon, was able to conceive that the preponderance now manifestly on the side of property can be shifted to the side of the dispossessed (the workers), simply by the construction of a new house beside every existing house, or a new factory beside every factory already established.

These observations indicate the basis for the contention that Keynes was a follower of Proudhon as well as Gesell. The acknowledgments of Keynes to Gesell and Gesell to Proudhon relate to matters which appear to be fundamental to their social outlooks as well as their technical analyses. Proudhon, Gesell, and Keynes reacted similarly to relatively similar issues, though there were wide

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10Gesell, *op. cit.*, *Money* Part, p. 3.
11Ibid., pp. 3-14.
12Ibid., p. 3.
13Keynes makes no mention of Proudhon in the *General Theory*. 
differences in the chronology and geography of their environments. Proudhon wrote in France during the hectic years of the revolution of 1848. Gesell early in life moved from Europe to Argentina, where he lived during the financial, commercial, and industrial crises of the late 1880's and 1890's. Keynes developed gradually to his position of the General Theory under the influence of such post-war problems as international indebtedness, prolonged economic depression, financial crisis, and mass unemployment.  

First, Proudhon's theories will be investigated; second, Gesell's argument will be examined; and finally, the similarities of the idea systems of Proudhon, Gesell, and Keynes will be reviewed.

A. Proudhon's Idea System

Despite his voluminous writings, Proudhon did not develop a systematic body of economic theory. His central concern and preoccupation was with a system of gratuitous credit. This major interest stimulated him to explore and come to definite conclusions about the theory of interest and capital, and the theory of a specie standard.

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The periodic recurrence of the association of theoretical ideas with a criticism of financial institutions has interesting implications, not only for the nature of economic theory, but also for a study of capitalism as a type of economic organization whose characteristic structure gives rise to similar problems in different times and different places.

\[15\] His most important publications were: Qu'est-ce que la propriété? (1840), Système des contradictions économiques (1846), Organization du crédit et de la circulation et solution du problème social (1848), Résumé de la question sociale, banque d'échange (1848), les Confessions d'un révolutionnaire (1849), Intérêt et principal (1850), De la justice dans la révolution et dans l'église (1858), la Guerre et la paix (1861), and De la capacité politique des classes ouvrières (1865).
This was his method of attacking financial capitalism. Proudhon's idea system will be examined in terms of these major aspects of his economic theory.

Proudhon's theory of interest and capital has been classified as an "exploitation theory," and this classification is justified because he looked upon labor as the sole creator of economic goods and services and thought of capital as being unproductive insofar as it did not contribute anything to net current output. "Capital can be exchanged," he says, "but cannot be a source of income." On the basis of this labor theory of value, interest, for Proudhon, was a monopolistic income which flows to the privileged owners of money-capital and was in sharp contrast with the income received by the owners of legitimate productive wealth, which was quite permissible and logical for the creation and maintenance of individual enterprise.

Proudhon defined capital in a typical socialistic manner. For him capital was "Every settled value, whether in land, machinery, merchandise, provisions, or money, serving or capable of serving in production." And he drew a sharp distinction between what he termed "free" and "engaged" capital. Capital was free when it took the form which "can be regarded as realized or immediately realizable--that is,

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converted into such other product as may be desired; in this case the form that capital most readily assumes is that of money."\textsuperscript{19} And, "capital is said to be engaged...when the value that constitutes it is employed definitely in production; in this case it assumes all possible forms."\textsuperscript{20}

Interest was the payment which was necessary to induce the owners of "free" capital to "engage" it in productive use. Thus by Proudhon's definition and Keynes' terminology, interest was a money reward paid to the owners of liquid-wealth for parting with the liquidity for a given period of time. In Proudhon's words:

Values created by net product are classed as savings and capitalized in the most highly changeable form, the form which is freest and least susceptible of depreciation...the form of specie, the only constituted value. Now if capital leaves this state of freedom and engages itself—that is, takes the form of machines, buildings, etc.,—it will still be susceptible of exchange, but much more exposed than before to the oscillations of supply and demand. Once engaged, it cannot be disengaged, without difficulty;...Exploitation alone is capable of maintaining engaged capital at its nominal value;—interest is the insurance premium paid on the capital.\textsuperscript{21}

Proudhon's many statements on interest and capital theory are sometimes seemingly contradictory and never too clearly formulated, but the statement quoted above was the central emphasis of his argument. It is quite evident that Proudhon believed that interest originated and was possible because of the peculiar characteristics of conventional money. There is virtually no difference between

\textsuperscript{19}\textsuperscript{Tbid.}, p. 143. \textsuperscript{20}\textsuperscript{Tbid.}

this theory of interest and Keynes' view that interest is a payment to money-holders for not hoarding money.

Proudhon did not believe that capital was productive. For him, the concept of "productivity" of capital was sheer fiction. Of course, this attitude toward capital was a part of his labor theory of value. He reasoned that if interest were a non-functional form of money income resulting from a system of private monopolized credit institutions (the Bank of France and its branches), the activity of the money lenders could not be classified as productive because it was not associated with the actual creation of economic goods. He did not deny that labor working with capital was more productive than labor working without capital. He maintained, however, that labor itself was the creator of capital and that this capital was consumed by labor in the process of production. And, he argued, that this was entirely different from the view that capital itself was productive. As a matter of fact, Proudhon did not give to any one factor of production the credit for being the sole productive force. In his First Memoir he was highly critical of some of his predecessors with reference to this issue. He disagreed with Quesnay and earlier economists because they imputed productivity to land; he criticized Smith's and Ricardo's labor theory of value; and he did not believe that J. B. Say and his followers had stated the thesis correctly when they imputed

23Solution of the Social Problem, pp. 123, 146.
24Ibid., p. 149.
productivity to land, labor, and capital. "The truth is," he says, "that neither land nor labor nor capital is productive. Production results from the cooperation of the three equally necessary elements, which, taken separately, are equally sterile." Unfortunately, this argument that production is a function of the total social process was not developed in a rigorous or consistent manner, and the reader is left with an unsatisfied hunger.

In the final analysis, Proudhon argued, interest was not a payment for the use of existing money funds but a monopoly payment made to the banking system to induce it to manufacture bank credit. And since this creation of credit involved no sacrifice to society as a whole, there was no social necessity to charge for this service. The fact that such charges did exist meant that the economy contained a socially unnecessary private monopoly of credit, a monopoly which did not in fact supply additional capital but merely provided the social sanction for the creation of capital.

By attempting to demonstrate historically that the rate of interest had not decreased in France with the accumulation of capital, Proudhon tried to prove his position that interest was a payment for monopoly-created-credit and not a payment for the use of capital. In this attempt, he shows that the discount rate of the Bank of France had remained at four per cent during years in which both the national capital of France and the assets of the Bank itself increased

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25 *What is Property?*, p. 164.

26 *Solution of the Social Problem*, p. 114.
several-fold. 27

His remedy for the unnecessary and illegitimate interest payments was a financial system which would supply gratuitous credit. 28 This procedure would fully recognize the fact that the function of a credit institution was to substitute its well-known credit for the little-known credit of the individual enterpriser. 29 Thus a "mutual" (socialized) credit system was the answer to the problem. 30 In a specific sense, Proudhon's mutual credit system would nullify interest by making it equal for all producers. 31 His position reduced itself to: If I used as much of your capital as you use of mine, the interest which you suppose to derive from the productivity of capital would cancel out leaving a balance of zero. 32 Proudhon insisted that inequality of income distribution existed because of interest and argued that this could be corrected only "by centralizing credit and abolishing interest, in order to equalize facilities, needs, and chances." 33

Proudhon further supported his exploitation theory of interest by contending that there was no analogy between the rate of interest and the price of a commodity. 34 He explained that a "loan" and a "sale" are qualitatively different. When a merchant sells a commodity

27Oeuymes completes, p. 265.
28Solution of the Social Problem, pp. 123, 125.
29Ibid., p. 114.
30This perhaps was also the logical conclusion of Keynes' argument that the interest rate must be pushed down to zero.
31Solution of the Social Problem, p. 125.
32Ibid., p. 117. 33Ibid., p. 124. 34Ibid., pp. 123, 131.
at a given price, the price is the equivalent value of the good, and the seller relinquishes all future claim to the commodity. In this type of activity there is no exploitation (receipt of non-functional income) because the "price" and the "value" of the commodity are quantitatively equal. However, when a capitalist makes a loan of either money or credit, he not only does not relinquish title, but he receives it back and can lend it over and over again. Furthermore, he receives a payment in the form of interest in addition to the repayment of the amount of the loan.\textsuperscript{35} This was exploitation, according to Proudhon, because the lender of money-capital extracts from this exchange process a greater value than he contributes to it.\textsuperscript{36} Thus Proudhon made no distinction between "value" and "price," did distinguish between a "loan" and a "sale," and contended that exploitation occurs only in the payment of interest by borrowers to lenders.

Finally, Proudhon held that it was not the multiplication of capital which decreased the rate of interest, but it was the decrease in the rate of interest which caused capital to multiply.\textsuperscript{37} This position closely approximates Keynes' central thesis that it is the rate of interest which determines the rate of accumulation of capital, and thus the marginal efficiency of capital, and not vice-versa.\textsuperscript{38} Thus both Proudhon and Keynes believed that the monopolistic privilege of interest charging inhibited a nation's attempt to

\textsuperscript{35}\textit{Ibid.}, p. 123. \textsuperscript{36}\textit{Ibid.} \textsuperscript{37}\textit{Ibid.}, p. 134.

accumulate wealth and was contrary to the welfare of society.

In order that his theories and views concerning interest and capital might bear fruit, Proudhon advocated a reorganization of the exchange process. To accomplish this, he proposed that what he called a "bank of exchange" be organized and replace the Bank of France. It was through this new financial institution that Proudhon hoped to achieve a gratuitous credit system, which was the very heart of his reform program. Free credit, he believed, would eliminate the major evils of financial capitalism.

The basic function of the bank of exchange was discounting. A producer who sold a commodity or rendered a service would make out a bill of exchange, have it accepted by the purchaser and then take the bill to the bank to have it discounted. The discounting process consisted of the substitution of a bill of exchange of the bank--called a "bon de circulation"--for the bill of the individual. The "bon de circulation" bearing the signature of the exchange bank, was redeemable at sight in merchandise or services equal to the face value of the "bon." All members of the association were pledged to honor these notes by products or services of the type which they customarily produced.39 The notes, in contrast to those of the Bank of France, were not to be redeemable in specie. According to Proudhon, "Gold is the talisman which congeals life in society, which binds circulation, kills labor and credit, and makes slavery mutual. We must destroy the royalty of gold; we must republicanize specie by making every product of

39See Proudhon, Œuvres complètes, VI, p. 309 for a model of a "bon de circulation."
labor ready money."

The basic principle of the bank was to make the bill of exchange universal and thus overcome the scarcity of money and credit; that is make credit free. In its most complete form the bank would have been essentially a system of national bookkeeping in which the bill of exchange served as the medium of transfer. Every commodity was to be raised to the level of exchangeability; products would exchange directly for products. While Proudhon's reform called for complete abandonment of a relation between gold, or any other type of specie, and legal tender money, it was not his intent to establish a new type of paper money. He asked, "Is this a paper currency?" And he answered, "I answer unhesitatingly, No! It is neither paper money, nor money of paper; it is neither government checks, nor even bank bills; it is not of the nature of anything that has been hitherto invented to make up for the scarcity of specie. It is the bill of exchange generalized." The essence of the idea, in Proudhon's view, was to make every product of labor ready money. The "bon de circulation" was merely a means for facilitating the exchange of commodities for commodities between producers. Bank paper was to be based upon neither specie nor land but upon products of labor. In order to be eligible for discount, bills had to represent "products accepted or sold, products accepted or sold, and sold,

\[\text{specie would have been used only for small change.}\]

\[\text{Proudhon, Oeuvres complètes, VI, p. 116.}\]

\[\text{Solution of the Social Problem, p. 60.}\]

\[\text{Tbid., p. 62.}\]
delivered or immediately deliverable." Such discount credit was to
be unlimited when there was previous acceptance of products by an
actual buyer. The bank would grant credit to borrowers on open ac-
count with the guarantee of two signatures by association members, who
would be jointly and severally liable.

The bank would also make long-term loans on notes secured by
mortgages, and would purchase property on time, consign it to a pro-
nrietor and permit him to repay in installments with no interest. If
a proprietor were unable to repay, the bank would take over the prop-
erty. It would, however, extend to the proprietor the privilege of
continued occupancy as a tenant or manager. These bank loans differed
from ordinary loans only in that they carried no interest charges.

The essential feature of Proudhon's exchange bank was to make
all commodities as exchangeable as money. His argument was that if
labor-time were the true measure of value, then there was no neces-
sity for a second measure of value in the form of money. Furthermore,
if it were the presence of money which caused economic difficulties,
the sensible solution was to abolish gold and silver money and sub-
stitute labor-money. All commodities being the product of labor and
their value measured in labor-time, they would exchange directly for
one another. After the initiation of his bank and the consequent
elimination of interest charges as a corrupting element in the price
structure, the competitive market was to be the process for equating

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45 Ibid., p. 71. 46 Ibid. 47 Ibid., pp. 72, 73.
48 Ibid., p. 73.
Thus it is very obvious that the reform program which Proudhon proposed as a general solution to the social problem was in every respect a financial one. His new financial system would eliminate interest—bank credit would be gratuitous—and every producer would always have a market for his goods; that is, commodities would exchange for commodities. There could not be a lack of effective demand because the bank of exchange would create a market for all the goods that producers were capable of supplying. Thus unemployment could not exist. Proudhon believed that the ideal of a barter economy envisaged in classical economic theory was at long last to be made to function free from monetary inhibitions and aberrations. He was convinced that a revolutionary change in the distribution of property ownership would follow as a consequence of his banking reforms, and that the bureaucratic form of government would be transformed into an anarchistic type of society. Every producer would become a small capitalist, either as an agricultural proprietor, an artisan, or in such instances...

Early in 1849 Proudhon organized the Banque du Peuple, which was modeled after his bank of exchange, but was much less pretentious. Its basic operating principles were: (1) no interest would be charged on loans, (2) circulating notes would be issued based on economic goods, certain types of securities, and outstanding loans on landed property, and (3) buyers and sellers, through the bargaining procedure, would determine commodity prices, and the seller could take the certificate of sale to the bank and have it discounted at par.

Just when Proudhon had secured sufficient subscribers, and adherents to begin operation of the bank, he was sentenced to a three year term in prison for articles against Louis Napoleon, who was at the time (spring of 1849) serving as the first president of the newly established French Republic. Rather than allow his associates to carry on without him, Proudhon dissolved the enterprise and refunded the subscriptions.
as was necessary, an "associate" in an industrial enterprise. This was possible because the bank of exchange would make free credit available to all workers.

3. Silvio Gesell's Idea System

Gesell viewed the capitalistic economy as an interest exploiting system. For him, capitalism was, "an economic condition in which the demand for loan-money and real-capital exceeds its supply and therefore gives rise to interest." It was in terms of this definition that Gesell developed his economic theory and his attack on financial-, rentier-capitalism.

Gesell's attack on financial capitalism centered on interest and rent. These types of income, he believed, were non-functional (unearned) because they derived from monopolies of money and land. His new economic order would be one in which interest and rent would not exist. His program called for a periodic stamping of all currency, which would eliminate the private monopoly of money; and for the nationalization of all natural resources, which would eliminate the private monopoly in land. The stamped currency plan would cause

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51 The Natural Economic Order, Money Part, p. 110.


53 Gesell's land reform program is of no direct interest to the subject matter in this chapter. His Free-Land program was much less important than the Free-Money program in the sense that the former is
interest payments to wither away until income from the mere ownership of capital goods had disappeared. This would be the euthanasia of the rentier class.

Gesell's money program consisted of rigid controls over the quantity and velocity of money. The regulation of the quantity of money was for the purpose of maintaining a stable price level, and by regulating the velocity of money "hoarding" would be prevented. Thus, the prevention of "hoarding" money and the maintenance of a stable price level were the two aspects of Gesell's money program.

He would prevent "hoarding" of money by requiring that all currency be stamped at a rate (rate of demurrage) which would be sufficient to cause people to part with their money. According to Gesell, the issuance of this currency (Free-Money) would eliminate checks, bills of exchange, and all other credit instruments. This Free-Money was to take the form of notes ranging in value from $1.00 to $1,000. Perforated sheets of stamps would serve as a medium of exchange for amounts less than $1.00 and for weekly attachment to the currency notes. Metallic money would not enjoy legal tender privileges, and there would be no redemption of Free-Money in specie.

only a problem in the distribution of a given volume of output, whereas the Free-Money program is essential to the maintenance of the total output at a maximum. The problems of unemployment and economic crises are essentially problems of money and exchange and not of distribution as such, according to those who find the evils of capitalism in its financial aspects. Furthermore, with respect to the objectives of this study, there is no relationship between Gesell's land program and Keynes' policies. Hence, we shall not treat this aspect of Gesell's idea system. For the essence of his land program see, The Natural Economic Order, Land Part, pp. 77, 78.

54 The Natural Economic Order, Money Part, p. 151.
At the time of introduction, no one would be compelled to redeem gold or silver for Free-Money, but after a period of grace, all metal coins and other types of old money would cease to be legal tender.

Gesell believed that a rate of demurrage of 5.2 per cent per year would be sufficient to prevent "hoarding." He would accomplish this by taxing (attaching a stamp) currency bills one-thousandth of their face value each week. In this manner, "hoarded" currency would lose value each week, and if held long enough would cease to have value. This rate of demurrage was to be administered upward or downward--depending upon changing economic conditions--by the National Currency Office, which was the administrative agency that would exercise the State's monopoly power over money. Gesell insisted that this monetary agency of the State must be guided by and base its rate of demurrage decisions on his theoretical principles. Another basic function of the National Currency Office was to issue new money each year in amounts sufficient to offset the annual shrinkage in the total quantity of money; that is to say, enough new money would be issued to equal the total volume of the tax levied on currency.

Gesell was firmly convinced that if his money program were to be successful a stable price level would have to be maintained. This could be accomplished, he believed, by correlating the total quantity of money to the volume of output of economic goods and services. This would be still another function of the National Currency Office since it would have displaced the central bank of issue. This monetary agency

55 These principles are presented in some detail later in this chapter.
of the government would issue and withdraw money in relation to changes in the volume of output.\textsuperscript{56} As the price level, calculated by an index number,\textsuperscript{57} tended to rise or fall, the monetary circulation would be reduced or increased. New money would be injected into the economy through a reduction in taxes. The currency office would pay into the public treasury the necessary amount of new money, and the treasury would reduce the collection of tax money by an equivalent amount. A reduction in the quantity of money would result automatically from the annual depreciation in its value. If a further decrease were required, additional taxes could be levied which would withdraw money from circulation.

The effects which Gesell expected from the introduction of Free-Money indicate the intent of his proposal. He listed the anticipated effects of Free-Money as follows:

"On Commerce:

1. An uninterrupted circulation of money and consequently a steady increase of cash-payments.
2. Unlimited sales of goods.
3. Elimination of the causes which led to the general fall of prices of goods and securities.
4. Elimination of commercial and industrial crises.
5. Cessation of the market fluctuations, of the cycles of general trade activity of depression (alternating periods of rising and falling prices) resulting from changes in the exchange relation of goods to money.

\textsuperscript{56} The Natural Economic Order, Money Part, pp. 141, 142.

\textsuperscript{57} While Gesell was skeptical of the indices of Jevons, Sauerbeck, and Soetbeer, he felt that the determination of proper index numbers was no real obstacle to his program. He proposed a law requiring all producers to furnish data on the amounts of commodities produced and the prices obtained from sales. On a basis of this information, a weighted index would be established for the guidance of the National Currency Office in its injection and withdrawal of money. The Natural Economic Order, Money Part, p. 68.
7. Cessation, to a large extent, of retail commerce in its present form, an increasing number of commercial employees becoming available for productive work.
8. Simplification and cheapening of commerce generally.
9. Reduction of the present high cost of commerce from 30-40% to about 10-15% of production.
10. Abolition of protective tariffs which will no longer be needed, and transition to Free-Trade.
11. Removal of the economic causes of war.
12. Facilitation of international trade through a currency agreement on the basis of common interests.

"On Interest and Wages:

1. Money loses its power of exacting interest and is reduced to the rank of goods and labor.
2. Continuous conversion of all money surpluses into means of production, dwellings, etc., even if such investments yield no profit (interest, "surplus-value").
3. Immediate and permanent cessation of unemployment, entire disappearance of the labor reserve.
4. Gradual decline and, if Free-Money is adopted universally, disappearance of interest.
5. Gradual rise of wages until they completely absorb capital interest with the exception of rent on land, which will be made to accrue to the whole population by our land reform (Free-Land).
6. Facilitation of saving by removal of the present burden of capital interest, by the unfettered development of production and trade, and by the reduction of the cost of commerce."58

It is interesting to view Gesell's expected results from his Free-Money plan in connection with what Proudhon wrote when he proposed his Bank of Exchange. He said:

I no longer hesitate to propose that which speculative study of social economy shows me is most applicable to the situation in which we now find ourselves. Work is at a standstill—it must be resumed. Credit is dead—it must be resuscitated. Circulation is stopped—it must be reestablished. The market is closed—it must be reopened. Taxes never suffice—they must be abolished. Money hides itself—we must dispense with it. Or better still, since we should express ourselves in an absolute manner, for what we are going to do today must serve

58 Ibid., pp. 138, 139.
for all time. Double, triple, augment labor indefinitely, and in consequence the products of labor. Give credit so broad a base that no demand will exhaust it. Create a market that no amount of production can supply. Organize a full, regular circulation, which no accident can disturb. Instead of taxes always increasing and always insufficient abolish all taxes. Let all merchandise become current money and abolish the royalty of gold.59

Thus the problem of full employment for Proudhon was one of organizing exchange (credit) for the purpose of increasing the effective demand for goods. For Gesell, effective demand could be maintained by organizing exchange (money). It is quite obvious that in many ways Gesell's list of expectations bears a close similarity to Proudhon's anticipated effects despite the fact that Gesell's program was a currency reform, while Proudhon's program called for a credit reform.

Gesell did not pretend that the introduction of stamped money would immediately eliminate the necessity for paying interest on loans. The rate of loans would be equal to the rate of return on so-called real capital, and would fall continuously as real capital became more and more abundant. However, interest would never disappear entirely unless Free-Money were adopted universally. The important anticipated effect of the change to demurrage money was that the monetary barrier which impedes production and acts as a brake on accumulation would disappear.

Attention is now directed to a rather brief examination of Gesell's major theoretical principles as they relate to his program for reform. The objective of his theory as a whole was to develop a theory of interest and money which would explain the non-utilization

59Solution of the Social Problem, p. 46.
of resources and the existence of unearned income in terms of the peculiarities of conventional money. The theoretical argument in his program of monetary reform was based upon the principle of assigning to money a rate of interest of its own. He believed this rate was determined independently of the return on assets other than money. He was very explicit on this:

It used to be considered a scientifically proven fact that money bore interest only because the instruments of production bore interest, that the interest-bearing power of money was fundamentally a delegated or borrowed power. And it now seems that the reverse is true.  

There is great similarity between this position of Gesell and Keynes when the latter says: "Instead of the marginal efficiency of capital determining the rate of interest it is truer (though not a full statement of the case) to say that it is the rate of interest which determines the marginal efficiency of capital."  

Throughout the history of economic theory, economists, as a group, whether they were orthodox or unorthodox, have concerned themselves with the issue of economic value. Gesell, however, was unique in this respect. He was intolerant of all value theory, and criticized both orthodox and unorthodox theory for attaching central significance to it. He refers to value theory as "futile theological speculation," "completely sterile," "an illusion," "a fantasy," and "pernicious by its very existence." He acknowledged supply and demand schedules

60The Natural Economic Order, p. 186.
62The Natural Economic Order, pp. 32, 33.
as the "sovereign regulators of prices."\textsuperscript{63}

The practical intent of Gesell's criticism of value theory was to show why metallic money and banking currency should be replaced by money made of paper without any kind of promise of conversion into substance of "intrinsic" value.\textsuperscript{64} "Our gold standard," he said, "is the off-spring of the theory of value."\textsuperscript{65} And Gesell believed that a monetary system which in any way was linked to gold was inherently unstable. It was primarily against the misuse of gold money as a store of value that he directed his attack on financial capitalism. The physical durability of conventional money and its consequent desirability as a form of "hoarded" wealth was, in Gesell's view, the basis for the use of money as an object of speculation. He therefore proposed that money be made unhoardable, and that its quantity be regulated in such a way that industrial activity would not be subjected to a fluctuating level of prices. Gesell's program recognized that money was indispensable to an economy that enjoyed the advantages of the division of labor, but he held that the material from which money was made was of no importance as long as its value periodically decreased. Thus the precious metals were one of the few substances unsuited to serve as a medium of exchange.\textsuperscript{66}

When Gesell argued that the "laws" of demand were different from the "laws" of supply, he meant that those who produced commodities for sale were under compulsion to exchange their products for money, whereas the owners of money were not always willing to exchange

\begin{footnotes}
\item[63] Ibid., p. 92.
\item[64] Ibid., pp. 24, 63.
\item[65] Ibid., p. 100.
\item[66] Compare with General Theory, pp. 235, 236.
\end{footnotes}
their money for products. The owners of commodities had no choice, they had to sell because their products were subject to carrying costs in the form of deterioration, depreciation, storage costs, rust, rot, etc. The inadequacy of effective demand in a money economy was accounted for by the fact that the conventional forms of money did not involve carrying costs similar to those "naturally" incurred in the case of all, or almost all, other assets. Individuals who received income (in the form of money) and did not spend it all would "hoard" unless there was sufficient inducement to offset the advantages which money enjoys as a medium of saving. The premium which was necessary to induce conversion into non-monetary assets, either directly or through an agent, was called "basic-interest."

In a barter economy, according to Gesell, interest could not exist because when real products confront one another in a market, they cancel each other. In a money-economy in which goods exchange for money and money exchange for goods, basic interest would continue to be extorted as long as money could be withheld from circulation without loss to the owner. In order to stimulate the circulation of money and create a continuous demand, basic interest had to be abolished. Its abolition involved placing money under the same handicap which all other commodities were under. In short, money must be perishable and the periodic tax in the form of stamps on the currency was to serve this function. Such was Gesell's theoretical argument for stamped money. By "compelling demand (money) to appear regularly

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67The Natural Economic Order, pp. 88, 95. 68Ibid., p. 263.
in the market," the fluctuating price level and the accompanying variations in employment and output could be eliminated. Gesell refers to his plan as the "revolutionary proposal of compulsory demand," which is all that is needed "to protect the exchange of goods against any conceivable disturbance, to render crises and unemployment impossible, to reduce commercial profits to the rank of a wage, and in a short space of time to drown capital interest in a sea of capital." Gesell proposed to alter the currency system so that the capitalist economy would work as if goods exchange directly for goods. His attack upon Say's law was part of his appeal for a reformed economy in which supply would create its own demand, and in which money would be "neutral." Gesell's theory of interest must be classified as an exploitation theory in much the same sense as Proudhon's. Interest income was non-functional (unearned) income incident to the monopolistic position of money in relation to other commodities. This share of the total social income was a deduction from the social income created by workers. He finds the explanation for the existence of interest

69Ibid., p. 133.  70Ibid., p. 136.  71Ibid., p. 134.

72On pages 266-275 in The Natural Economic Order, Gesell discusses former attempts to explain interest on capital. One by one he discards as unsatisfactory the fructification, productivity, utility, and abstinence theories. In Böhm-Bawerk's history and analysis of interest, he finds nothing satisfactory. It is in terms of the superiority of his own analysis that Gesell rejects the previous theories.

73Despite his "disgust" with value theory, Gesell seems to have embraced a labor theory of value at this point.
income in the hoardable character of money. Gesell states that, "Interest is the byproduct of our traditional form of money and can therefore be scientifically explained only with the help of a theory of money. A theory of interest can only be derived from a theory of money." According to Gesell, "Money is an instrument of exchange and nothing else." The use of money as a medium of saving as well as a medium for facilitating the exchange of commodities and services has been described as an anomaly, a misuse of the medium of exchange. The misuse derives from the durable qualities of the prevailing types of money. "Its material privilege (as a precious metal) and its legal privilege (as legal tender) give gold money an exceptional position among the products which depend upon money for their exchange." The advantages of the durable character of money do not accrue to all members of society, but only to those members who save their money and do not invest it in capital assets which they themselves own. These savers "will not pass their money into circulation again without the promise of interest." In the consumers' market, money does not extract interest because the necessity of existence of the consumer compels him to spend his money. Likewise the producers

74 This is what basically distinguishes Gesell's exploitation theory of interest from the "surplus-value" theory of Marx.

75 The Natural Economic Order, p. 19. 76 Ibid., p. 130.


78 Ibid. 79 Ibid. 80 The Natural Economic Order, p. 225.
cannot postpone sale of their products to the merchant because delay results in increasing losses connected with the storage of products. Thus the fundamental aim of Gesell's theory of interest was to show that interest was a payment to prevent "hoarding" of money. According to his analysis, the great difficulty in economic life arises because the same money which is needed as a medium of exchange is also capable of being used as an instrument of savings. The purpose of stamped money was "a complete separation of the medium of exchange and the medium of saving." Gesell's concept of interest assumed the utmost importance in his theory as a whole because he conceived the fundamental aspects of economics to be "commodities" and "exchange." For him, all economic life resolved itself into a series of exchange transactions. He described terms such as "wages," "labor," and "value" as "superfluous circumlocutions" of the two basic concepts, commodities and exchange.

In order to explain why unemployment, crises, and unearned income have their origins in the dual use of money as a medium of exchange and a medium of saving, and also in order to explain the manner in which stamped money would eliminate these difficulties, Gesell employs a three-fold classification of interest rates: the basic rate (a theoretical rate), the rate of real capital (an estimated rate), and the loan rate (a contractual rate).

Basic interest is a purely monetary phenomenon whose existence has nothing to do with time-preference, waiting, or the productivity of real capital. Instead, it is a payment extracted for the use of

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81 Ibid. 82 The Natural Economic Order, p. 112.
money in exchange. It is a monopoly price which must be paid in order to induce those who save to transfer their savings into a non-monetary form, and it can be charged because historical coincidence has made the most efficient medium of exchange also the most desired store of value. The basic rate is measured by the difference between the efficiency of money and its surrogates:

"Basic interest corresponds to the difference of efficiency between money and the substitutes for money (bills of exchange, barter and primitive production) as media of exchange."  

Gesell refers to the payment made to the owners of assets other than money as "interest" on real capital. This rate depends on the relative scarcity or abundance of instruments of production, though a very important characteristic is the fact that it can never fall below the basic interest rate. As the quantity of instruments is augmented, the rate of return on real capital declines. While Gesell retains the term "interest" in referring to this phenomenon, he says, in contrasting it with basic interest, "We ought to cease designating two so fundamentally different things by the same word, interest,"  

This is the reference of Keynes' statement that Gesell distinguishes clearly between the rate of interest and the marginal efficiency of capital. Of course it is Gesell's basic rate of interest which corresponds to the rate of interest in Keynes' liquidity-preference schedule, and Gesell's rate of interest on real capital is analogous to Keynes' marginal efficiency of capital.

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84 Ibid., p. 263.  85 Ibid.  86 General Theory, p. 355.
The meaning of the distinction between basic interest and the rate of interest on real capital may be seen in relation to Gesell's practical program. The object of stamped money was to eliminate basic interest. The elimination of basic interest meant the elimination of unemployment because persons who otherwise would tend to hold money in order to extract basic interest, would, under stamped money, be willing to part with their money even if they received no return in excess of the loan. With money no longer hoarded, there would be no lack of effective demand and no unemployment. One who received money would create demand directly through the purchase of a consumption good or capital asset, or indirectly through someone else who would invest in a capital asset. According to Gesell's theory, all private income not consumed would be invested. After money had been received from the sale of a service or commodity, it would be immediately passed on. "If money is to fulfill its purpose, purchase must follow step for step on the heels of sale," Gesell insisted that social control was necessary.

Gesell's distinction between basic interest and interest on real capital is also used to contrast the declining rate of return on real capital assets with the constant rate of return on money. In this way he points out that it is the money rate of interest which checks accumulation and impedes production. The accumulation of

87 The Natural Economic Order, p. 115.

88 Gesell cited evidence to show that the basic rate of interest had been relatively constant throughout the ages, or at least since money was first used as the medium of exchange. The figure he gave was about four per cent. Ibid., pp. 284, 285.
capital assets in no way reduces the independently determined money rate of interest. The accumulation of capital assets, on the other hand, does lower the rate of return on real capital, and when the latter tends to fall below the basic rate of interest, accumulation of capital ceases because it is more profitable to hold money for the premium it will bring from those who prefer to have it for use as a medium of exchange, than to invest in industrial enterprise. If it were not that money had a rate of interest of its own (basic interest), accumulation would continue without interruption and the rate of return on real capital would fall and soon become zero. Under a system of stamped money, with basic interest eliminated, the only reason for paying a reward to the owners of instruments of production would be their scarcity.

Gesell did not concern himself with the question of the rate at which the productivity of capital assets would probably fall under the impetus of unrestrained accumulation. He took an optimistic view of the productive powers of the industrial system and held that it would not be long until the payment of scarcity rents would disappear.89 The purpose of his theory was to show that payments for the use of real capital were caused by the special character of money, whereas in an economy employing stamped money, they would depend upon the demand for loans exceeding the supply of loans at a zero loan rate of interest.90

This loan interest is the third aspect of Gesell's complete theory of interest. It is the interest paid to lenders by the borrowers

89 The Natural Economic Order, pp. 261, 262. 90 Ibid., p. 263.
of liquid funds. According to Gesell, the loan rate would always be equal to the rate of return on real capital assets, whether the loan be made in conventional money or Free-Money. It will be recalled that Gesell's Free-Money program would not cause interest on loans to disappear immediately. The explanation of this is found in the distinction between basic interest and loan interest, a distinction which turns on the difference between an exchange and a loan.\textsuperscript{91} Basic interest is not interest on a loan, but the tribute that arises when money is exchanged for other commodities in cases in which the purchaser is in a position to delay the transaction. In saying that basic interest will disappear with the introduction of stamped money, Gesell meant that the consequences which flowed from the use of conventional money would be eliminated, and processes would be set in motion which in time would reduce the loan rate and the real rate to zero. When this had come about, interest income would have disappeared, and with this, rentier-capitalism, the "interest exploiting system," would come to an end.\textsuperscript{92}

Loans contracted in stamped money would bear loan-interest as long as the demand for loan capital and real capital exceeded the supply at a zero loan rate, or, in other words, as long as a scarcity of real capital assets existed.\textsuperscript{93} Since real capital assets would continue to yield a return above cost, and since money could be used to purchase such assets, "anyone seeking a loan of money must pay for it

\textsuperscript{91}\textit{Ibid.}, p. 261.

\textsuperscript{92}See Gesell's definition of capitalism, \textit{Supra}, p. 161.

\textsuperscript{93}\textit{The Natural Economic Order}, p. 262.
the same interest as is yielded by real capital. This is obvious from the laws of competition.\textsuperscript{94} The immediately significant difference arising from the substitution of Free-Money for conventional forms would be that all resources would be continuously employed. Basic interest would not exist as a barrier inhibiting new capital formation. The "natural" forces of competitive production would adjust to a level of output at which all the resources would be fully employed. This is the meaning, in terms of practical consequences, of Gesell's distinction between basic and loan interest.

Gesell did not develop a separate theory of crises. Fluctuations in output and employment were viewed as part of the normal behavior of an economy which employed hoardable money as the medium of exchange. For Gesell, the immediate cause of crises was falling prices. Most important among the reasons why prices must sooner or later fall in an economy employing conventional money was the decline in the rate of return on each new unit of real capital produced.\textsuperscript{95} When this rate tended to fall below the basic-rate of interest, money would be withdrawn from circulation, or what amounts to the same thing, the velocity of circulation of money would be reduced. The reduction in the supply of money, which was equivalent to a reduction

\textsuperscript{94}\textit{Ibid.}

\textsuperscript{95}Gesell gave two other reasons why prices fall, "because the conditions under which gold is produced do not allow the supply of money (demand) to be adapted to the supply of wares," and "because with increased production and prosperity money is melted by gold-smiths..." \textit{The Natural Economic Order}, p. 109. It is clear that Gesell's argument was addressed to a gold standard economy.
in the demand for products, caused prices to begin falling. The fall in prices would lead to an expectation of a further fall, developing into a cumulative process of deflation. The merchant would cease buying goods, fearing that the goods he was tempted to buy so cheaply today could be bought still more cheaply tomorrow. "Wares are unsalable because they are too cheap and threaten to become still cheaper. This is the crisis." Recovery from a crisis began with the discovery of gold, the issue of paper money, or any factor which would increase credit, and the velocity of circulation.

Clearly, Gesell's explanation of crises was based upon his theory of interest, the essence of which was that interest on money was independent of the interest on real capital.

C. Similarities of the Idea Systems of Proudhon, Gesell, and Keynes

The purpose of this Section is to make a comparative analysis of the practical attitudes and theoretical positions of Proudhon, Gesell, and Keynes.

The programs of these three men attempted to initiate social controls which, they believed, were justified by the theoretical premise that the competitive market system was not automatically self-adjusting because money had characteristics not possessed by other commodities. These unique qualities of money were linked directly to the existence of restraints imposed upon the activity of the entrepreneur by the cost and difficulty of securing money capital for

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96The Natural Economic Order, p. 100. 97Ibid., p. 101.
98Ibid. 99Ibid. 100Ibid., p. 108.
industrial enterprise. All three men believed they had formulated programs which would result in a rectification and preservation of a system of private enterprise.

In their critical aspect these men were dedicated to a condemnation of financial institutions which seemed to the authors to inhibit the free flow of community resources into the production and satisfaction of community wants. In particular their anti-financial capital orientation was associated with attitudes toward private property, metallic money, speculation, and the rentier. It was in these areas that the practical attitudes of Proudhon, Gesell, and Keynes took form and substance.

With respect to property, the attitudes of Proudhon and Keynes bear an interesting relation to one another. In spite of difference in terminology, they came essentially to the same position on the private ownership of property and money. It was the intention of both that there should be no legal change in the rights to the ownership of property. But both condemned all income from property, and attributed the flow of such income to the artificial scarcity of property caused by the peculiarities of money.

Proudhon's objection to "property"—his name is universally associated with the phrase, "Property is theft"—had much the same meaning as Keynes' objection to interest income, or rentier income in general. Proudhon distinguished between "property" and "possession." By the latter he meant the private ownership of the instruments of production minus the unearned (non-labor) income which usually accrues to such ownership. Keynes said that it was not the ownership (possession)
of property which was important for the state to assume. The state should merely control certain aspects of investment and determine the basic rate of reward to those who own the instruments of production.\(^{101}\) Since interest rewarded no genuine sacrifice any more than did rent from land, the non-functional rentier capitalist would gradually disappear,\(^{102}\) as a result of the inauguration of a rational economic reform program. To be sure, Keynes differs from Proudhon in that he is not directly concerned with the problem of non-functional income from land. He does, however, refer to the income from land as a scarcity rent.\(^{103}\) Insofar as Proudhon believed that free credit would lead to the disappearance of rent as well as interest, his primary preoccupation did not differ from that of Keynes. In both cases it is the money (credit) institutions to which the principal difficulty is attributed.\(^{104}\)

The focal point of the historical attacks on financial capital has always been a criticism of the conventional forms of money. Throughout the writings of Proudhon, Gesell, and Keynes there is a very vigorous condemnation of the practice which makes gold the basis for the money and banking system. Their opposition to metallic money has in common this characteristic. It is associated with an abnormally

\(^{101}\) General Theory, p. 378. \(^{102}\) Ibid., pp. 376, 378.

\(^{103}\) Ibid., p. 376.

\(^{104}\) When an economic theorist combines the view that private property in production is fundamentally sound, with the view that the hoarding, or tendency to hoard, money is the real source of the economic problem, his theoretical analysis is almost certain to center on money and interest. This is the fundamental basis for the similar idea systems of Proudhon, Gesell, and Keynes.
high rate of interest, which acts as a brake on industrial enterprise. Proudhon's bank of exchange called for complete abandonment of the relation between gold and legal tender money. To Proudhon and to his predecessors in England, the Ricardian socialists, gold was the symbol of economic disharmony. The relation which it bore to the rate of interest involved his theory of constituted value and "engaged" capital. In the passage which Gesell so frequently quoted from Proudhon concerning money as the barrier to the exchange of products, "gold" is sometimes substituted for "money" in the paraphrase. To Gesell, stamped currency represented a technique for avoiding the unnatural restraints placed on industrial enterprise by any money such as gold, which is protected by its physical properties against depreciation in substance. He regarded interest as a direct consequence of the durability of precious metals. Keynes was one of the most influential opponents of the gold standard in England. His country's greatest economic ills were ascribed by him to an attempt to protect her foreign balances at the expense of exercising control over the domestic rate of interest. The international gold standard, which necessitated maintenance of foreign balances, limited the degree of monetary autonomy and precluded the possibility of independence in national economic policy. Keynes' advocacy of economic self-sufficiency was largely responsible for his protectionist policies, and was directly related to his view that the international gold standard was

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105 The Natural Economic Order. Compare the quotation on p. 7 with the paraphrases on pp. 182 and 271, 272.
in no small degree responsible for the struggle for foreign markets among nations, and in consequence, to the economic causes of war: Never in history was there a method devised of such efficacy for setting each country's advantage at variance with its neighbours' as the international gold standard. For it made domestic prosperity directly dependent on a competitive pursuit of markets and a competitive appetite for the precious metals.¹⁰⁹

This passage could serve well as the thesis of Gesell's pamphlet on The Foundations of Peace. Much of Keynes' best social satire, intended to illustrate the contradictions in the present economic organization, related directly to the characteristics of gold.¹¹⁰

All three authors condemned the stock exchange, no less than the gold standard, as one of the institutions by which financial capital exerts a perverting influence on industrial capital. Their position may be summed up in this way. The legitimate function of money is to move goods and services through the stages of production to the final consumer. It is important that the volume of money correspond to the needs of such transactions, and particularly important that there should be no sudden shifts in the rate of output. Unfortunately a major source of disturbance was to be found in the buying and selling of shares on the stock exchange. The absorption of money into the financial sphere for speculative purposes impinged on industrial activity by making it difficult for the industrial entrepreneur to secure funds for operating and extending his plant. The exchange also added to the uncertainties of the industrial entrepreneur until he

¹⁰⁹ Ibid., p. 349.
¹¹⁰ General Theory, esp. pp. 130, 131.
was forced either to close down his firm or participate himself, through the anticipation of price changes, in the speculative process. Keynes said, "Business loses its genuine character and becomes no better than a speculation in the exchanges." The businessman became a gambler in a process in which his gains bore no relation to what his activities had contributed to society. The sensitivity of industry to the activities of the exchanges was a major point of emphasis with all three writers. Of course, Keynes made a more direct attack upon the investment market than did either Proudhon or Gesell when he advocated the socialization of investment. This resulted from his skepticism of monetary reform (lowering the interest rate) as an adequate social control for securing a sufficient inducement to invest, and his belief that the incidence on the marginal efficiency of capital of the instability of market estimations made through the stock exchange would be too great to be offset by reductions in the rate of interest. Neither Proudhon nor Gesell called for socialized investment; however, the logical implications of their programs make quite clear the fact that, had their reform plans been adopted, investment would have been socialized.

The fourth aspect of the attack on financial capital relates to the rentier. The finance capitalist and the rentier were the twin results of the separation of management from ownership, a condition associated at the present time with the growth of the corporate

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112 General Theory, p. 164.
form of economic organization, but formerly with absentee land proprietorship as well as the growth of large public debts. The rentier is a passive income receiver, whereas the term "finance-capitalist" refers to the promoter, speculator and banker.\textsuperscript{113}

The most deep-seated change in the social structure involved in the type of reform proposed by Proudhon, Gesell, and Keynes is the passing of the rentier, whose disappearance will occur when the rate of return on capital falls to zero. This implies no necessary ethical judgment prejudicial to the rentier. The attitude toward the rentier is not fully explained until the emphasis on the role of the entrepreneur has been clearly indicated. Disappearance of the non-functional rentier is incidental to a practical program which makes the entrepreneur the initiator of economic activity. Society has no particular stake in the inactive, functionless rentier. On the other hand, anything which dampens the ardor of entrepreneurship is inimical to the welfare of society as a whole. In an economy in which enterprise is carried on with borrowed capital, a reduction in the cost of borrowing is obviously a stimulus to enterprise. The Proudhon-Gesell-Keynes attack on the rentier involves, on the objective level, a matter of fact pronouncement that if the conditions under which enterprise is carried on are not bettered, the community as a whole will suffer in consequence.

In directing attention to a comparative analysis of the theoretical positions of Proudhon, Gesell, and Keynes, the concern is with

\textsuperscript{113}\textsuperscript{113}I. C. Merriam, "Rentier," Encyclopaedia of the Social Sciences, XIII, pp. 296-300, esp. p. 297.
the theories as a whole rather than to matters of specific detail.  

It is necessary to note first that the primary reference of
Proudhon, Gesell, and Keynes was to the sphere of circulation, though
some exceptions must be allowed in the case of Keynes. The three
authors selected from the entire economic process the difficulties
arising from the use of money in making transfers between buyers
and sellers as the special point of emphasis. Proudhon's statement
that the theory of circulation of capital constituted the whole of
economic theory corresponds to Gesell's assertions that the funda-
mental concepts of economics are "exchange" and "commodities." Gesell
represents the social relations between the industrial employer
and the worker as an exchange of the product of the worker for a value-
equivalent. With Keynes the institutional process which links indi-
vidual non-consumption to social accumulation was the particular point
of friction in the economic process.

This "transfer" difficulty was associated with the peculiarity
of exchanges of commodities for money. The preferred qualities of
money were related in a casual way to interest. Thus the theories

114 These writers differed greatly in their preparation for
technical economic analysis. Keynes was the only academically
trained economist in the group. Proudhon was largely self-educated.
Although he wrote prolifically on economic subjects, he was by no
means a master craftsman with the tools of analysis of political
economy. Gesell was even less an academician than Proudhon. His
writings were stimulated by his experience as a business man who
was implicated in situations in which he could scarcely have avoided
pondering the events which affected his affairs daily. For these
reasons, a detailed comparison would not be particularly relevant
under any circumstances.

115 Proudhon, Oeuvres complètes, XIX, p. 218.

of Proudhon, Gesell and Keynes are theories of money and interest considered in relation to the utilization of resources and the accumulation of capital. While interest is purely a monetary phenomenon, money is important in ways not related directly to interest, and insofar as this is significant, this type of theory may better be described as the "theory of a Monetary Economy." The purely monetary theory of interest of Proudhon, Gesell, and Keynes is distinguished by the strategic role which interest plays in relation to the total theoretical construction.

The way in which money, working through the rate of interest, acted as a brake to the growth of real capital assets was singularly significant for this trinity of economic reformers. They all maintained that if the monetary barriers to production were removed, the accumulation of real capital assets would increase so rapidly that the necessity for paying scarcity rents to the owners would disappear in a relatively short time. The integration of money into general economic theory is closely connected with the insight that the failure

117 General Theory, p. 293. Keynes refers to the "complete theory of a Monetary Economy."

118 There have been economists who interpreted interest as essentially a payment for money who cannot be identified with the Proudhon-Keynes type of economic theorizing. For example, both Marx and Schumpeter regarded interest as a purely monetary problem, but in the theoretical systems of Marx and of Schumpeter the rate of interest occupies a somewhat incidental position. See Marx, Capital, III, p. 435, and Schumpeter, "Review of Keynes' General Theory," Journal of the American Statistical Association, New Series, XXXI, (December, 1936), p. 795. Schumpeter said: "I wish to welcome his (Keynes) purely monetary theory of interest which is, as far as I can see, the first to follow upon my own. Unfortunately, I must add that the similarity stops there and that I do not think my argument open to the objections which this one is sure to meet."
to accumulate assets and the continual lack of effective demand for products are attributable to the impediments to continuous production afforded by the behavior of financial capital. It was because Keynes and his predecessors believed that they had discovered in monetary processes the strategic flaw in the capitalist economy that they logically insisted that money could not be abstracted away, even on a preliminary level of analysis.

In the writings of each author there is a particular concept with which the pretended uniqueness of his entire theory is associated. In the case of Keynes, it is "liquidity-preference," in the case of Gesell, "basic-interest," and in the case of Proudhon, "constituted-value." These are parallel concepts in the sense that they are the most important in the views of the theorists. "Basic-interest" and "liquidity-preference" are directly related to the theory of interest, but "constituted-value" is not. Each was rather pretentious concerning his theoretical innovation. Upon a basis of the idea described by the concept, each proclaimed the superiority of his theory over that of any predecessor. The advocacy of practical policy was closely connected with these "scientific discoveries." The meaning

119 By having values "constituted" Proudhon meant having the true, and therefore stable and certain values assigned to commodities. In the existing organization of society, with its particular type of money and credit institutions, the only commodity whose value is constituted is specie (money). It is the uncertain value of other commodities which makes these less readily exchangeable than specie. If this quality of constituted value could be extended to all commodities, they would be raised to a level of exchangeability equal to that of specie, and in this way would serve directly as money. For Proudhon's complete theory of value, see System of Economic Contradictions, pp. 65, 73, 82, 83, 91, 94, 95, 102, 226, 233, 236.
of the proposition that the theories as a whole are theories of
interest may be illustrated by taking these strategic concepts and
showing how they are related to one another and to the ideas about
money.

These theories differ from the orthodox theory in that the
latter assumes in its general principles that all capital is indus­
trial capital. The repudiation of this assumption is the starting
point of the Proudhon-Keynes tradition. It is precisely the presence
of financial capital which causes the disturbances to the movements
of industrial capital in such a way as to lead to the characteristic
difficulties associated with capitalism: unemployment, poverty,
unearned incomes, inequality, and insufficiency of effective demand.
This distinction focuses the analysis on the different behavior of
financial and industrial capital.

Each is agreed that financial capital possesses characteristics
which, because of its strategic place in the mobilization and exchange
of industrial capital, impose profound limitations on the working of
an otherwise sound competitive system. The theoretical systems of
Keynes, Gesell, and Proudhon are most similar in relation to their
theories of interest. Allowing for differences in exposition, all
three might be appropriately described as liquidity-preference theories
of interest. According to each theory, interest is the payment, or
the reward, for parting with liquidity, i.e., with money. Proudhon
says that interest payments are necessary in order to induce the
owner of money to "engage" it. Gesell maintains that interest has
to be paid by those who want money for a medium of exchange to those
who prefer money as a medium of saving. It is preferred as the medium of saving because it does not involve carrying costs. In the case of Keynes, the preference for holding money is explained by the uncertainty of the future rates of interest and the instability of the marginal efficiency of capital.

Proudhon's constituted value becomes coordinate with Keynes' liquidity-preference and Gesell's basic interest in that it attempts to explain how the bank of exchange would overcome, or eliminate, the preference of wealth-owners for money. If the objective of the bank could be realized, there would be no basis for preferring money to any other asset. According to Proudhon, the value of money was the only constituted value. The aim of his bank of exchange was to constitute the value of all commodities. If this condition were realized, there would be an uninterrupted exchange of products for products in proportion to their "true" or constituted values. Gesell believed that stamped money would eliminate the preference for money as a medium of saving. Keynes' central bank control was designed to reduce uncertainty concerning the interest rates which prevail in the future.

Starting from the proposition that reductions in the rate of interest are of fundamental significance in the programs of Gesell and Keynes, the question may be asked how this practical view was related to the use of the concepts basic interest and liquidity-preference and how these concepts were analogous in the analyses of the two theorists. Keynes' description of interest as the reward for not hoarding,

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or alternatively, as the reward for parting with liquidity, fits easily into Gesell's notion of interest. In proposing that currency be taxed by requiring periodic stamping, Gesell's idea was to prevent wealth-owners from hoarding money, or to compel them by pecuniary penalty to part with liquidity. Keynes employs the concept liquidity-preference (due to speculative motive) to denote the resistances which must be overcome before people will part with their money.

The reference of the concept is to the subjective state of mind of wealth-owners, and in this sense liquidity-preference is an independent variable, though of course it is subject to change. Analytically, Keynes represents liquidity-preference in a diagram involving three variables. When the liquidity-preference schedule is held constant, the coordinates are the rate of interest and the quantity of money. Given the state of liquidity-preference and the quantity of money, the rate of interest is determined.

If the liquidity-preference curve is assumed to be given, Gesell's basic rate of interest could be represented as the rate of interest which appears in Keynes' liquidity-preference diagram. If the liquidity-preference schedule were lowered, e.g., following Gesell's stamped money proposal, and assuming a constant volume of money, there would be a point at which the basic rate of interest would fall to zero.

Keynes states that the rate of stamp-taxing should be, in his terminology, approximately equal to "the excess of the money-rate of interest...over the marginal efficiency of capital corresponding to a rate of new investment compatible with full employment."  

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121 Ibid., p. 167. 122 Ibid., p. 171. 123 Ibid., p. 357.
This corresponds in Gesell's terminology to the difference between the basic rate of interest and the rate of return on real capital. It would appear from his analysis that Gesell intended the stamping rate should be equal to the basic rate of interest. In Keynes' system this corresponds to the rate of interest appearing in the liquidity-preference schedule.

Keynes' major criticism of Gesell's theory is that it represented "only half a theory of the rate of interest...because the notion of liquidity-preference escaped him." In his discussion of Gesell, Keynes does not once mention the theory of basic interest, which contains the crux of Gesell's whole position. Keynes' pronouncement was valid only in the sense that Gesell did not develop in explicit fashion a theory of liquidity-preference.

Gesell's argument may be restated as follows. In a barter economy there would be no interest. In a money economy interest exists for two reasons: (1) the carrying costs of money are negligible compared to the carrying costs of other commodities, (2) money is more efficient than bills of exchange and other media for transferring goods. Money is more efficient because it is the unit of account, and no special knowledge is needed to know its value. Moreover, it is easily divisible into fractions for making payments.

Private property includes the right to accumulate on a large scale,

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124 Ibid., p. 356.
125 The Natural Economic Order, pp. 228, 238.
126 Ibid., p. 263.
and accumulation presupposes saving. The function of saving is
divorced from the function of producing goods and services. Interest
is necessary to induce the inactive savers to transfer their wealth
into the control of the active producers. With Gesell, as with Keynes,
interest was a rentier phenomenon, and would disappear with the rentier.
The object of Gesell's explanation of basic interest was to show why
money draws interest. It was not true, as Keynes said, that Gesell
completely overlooked the need of an explanation why the money rate
of interest was positive. Gesell's theory represented a refinement
of his practical insight that money should be forced to circulate by
means of a periodic taxing which would offset the preference of wealth
owners for holding, or "hoarding" money rather than spending it for
some form of productive or consumable wealth. In attempting to refine
and theoretically justify this insight, it should not be surprising
that Gesell, in a sense, anticipated the notion of liquidity-preference.

Gesell's stamped money fits logically into Keynes' general
program, which is otherwise lacking in proposals for lowering the
money rate of interest below the minimum attainable through manipu-

tating the quantity of money. The socialization of investment as such
has nothing to do with reductions in the rate of interest for the
reason that the latter is a monetary phenomenon and is subject to
change only via monetary influences. Some variation of stamped money,
such as a tax on bank deposits, is a logical step toward the attain-
ment of the long-term implications of Keynes' position, i.e.,

127 General Theory, p. 356.
disappearance of a rate of return on accumulated wealth and the con­sequent euthanasia of the rentier. Thus the theoretical problem for both Gesell and Keynes was to develop a theory which would show the way to eliminate the private ownership of money while maintaining the private ownership of other forms of wealth.

The above discussion has been concerned with the similarities between the theories of interest of Gesell and Keynes. Let us now turn to a consideration of Proudhon's theory in this same respect. As has been shown, Proudhon viewed interest as the premium paid for getting capital to "engage itself," and stated that "exploitation alone is capable of maintaining engaged capital at its nominal value." The owner of money was able to extract this premium because of the peculiar nature of money, which was, in Proudhon's language, explained by the fact that money was the only article of exchange whose value had been "constituted." Of course the meaning of Proudhon's constituted value was related to his bank of exchange, which was his method for extending constituted value to all other commodities.

Proudhon's proposal to convert the bill of exchange into the universal medium of exchange may be described in terms of the conditions under which a "debt" in the Keynesian sense can be used as "money." Keynes said that there was no hard and fast division between a "debt" and money: "We can treat as money any command over general purchasing power which the owner has not parted with for a period in excess of...three months, one month, or three days or

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128 Economic Contradictions, I, p. 291.
three hours or any other period; or we can exclude from money whatever is not legal tender on the spot. The use of a "debt," i.e., Proudhon's bill of exchange, directly as money, would be possible in circumstances in which there was no reason for preferring money. If there were no uncertainty about the future value of a "debt," and if it could at any time be converted into general purchasing power without inconvenience to the owner, there would be no preference for holding money. Proudhon believed that his program would create an ideal exchange economy in which production and circulation would be well coordinated, and in which there would exist no uncertainty about the liquidity of bills of exchange (about the debtor's ability and willingness to pay). "Debts," like bank notes, would earn no interest. Under these circumstances the distinction between money and "debts" would have no practical significance. The rate of interest could be zero as Proudhon believed it would be.

Whether such a scheme is realizable under private enterprise production raises an issue of the validity of the program and of the significance of the theory devised in support of such a program. If an investigation of this problem were made, it would probably indicate that the evidence, drawn from the historical development of the private enterprise economy, would be against supposing such a proposal workable. One of the essential implications of the formal principles of a free enterprise economy is that the less efficient forms will be forced out of the market. The competitive process itself produces uncertainty concerning the future exchange "value" of any particular debt and

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affords a basis for preferring cash to "debts." It is likewise difficult to imagine that a system of production based on private enterprise could be coordinated in production, circulation, and consumption after the fashion of an ideal planned economy. The least shock may interrupt the chain of payments by bills of exchange. Goods would depreciate and if the fall in prices gained momentum, a cumulative deflation and crisis would result.

There are, then, fundamental similarities among the concepts liquidity-preference, basic-interest, and constituted value. Each involves the notion that money possesses distinctive qualities which cause it to be preferred, particularly in times of crisis, to all other forms of wealth. When an individual acquires money from the sale of commodities, there is no social control over its subsequent use. The money may be withheld from circulation, thus failing to be exchanged for commodities produced in anticipation of exchanging for money. Again, the money may be used for speculative transaction. The diversion of money away from industrial transactions interferes with the process of production by reducing the money demand for consumption and investment goods. This is the heart of the Proudhon, Gesell, Keynes tradition and to view Keynes' theory of interest and money as a revolutionary contribution to economic thought is to completely ignore this strong tradition.

Arguments for reform which involve an attack on income-receiving groups characteristically take on a theoretical dress which attempts to demonstrate that the group attacked occupies a non-functional position in the creation of output. Keynes, Gesell,
and Proudhon all point to the rentier as non-functional and conclude that the rentier will disappear with the inauguration of a rational program of reform. They all point out that the institutional mechanism which is responsible for rentier income is contrary to the interests of society because it inhibits the activity of the entrepreneur, the initiator of new enterprise and innovations. The community will benefit from a lowering of the rate of interest because it facilitates transferring the use of wealth into the control of the active entrepreneur from the control of the inactive rentier or speculator.

The attack on the rentier involves in each case arguments that the payment of interest is not necessary to induce individual saving, and also that the rate of social accumulation will be accelerated by a low or zero rate of interest. It is not necessary to deny the tendency of individuals to save more out of a given income at a higher rate of interest than at a lower rate. The essence of this position is to regard the rate of interest as the principal deterrent to the creation of income. The functional relationship between the rate of interest and the volume of saving from a given income is of secondary importance. The existence of unemployed resources is the substantial basis which gives validity to the argument that consumption and the accumulation of capital can proceed together. This contrasts with the orthodox view that accumulation can increase only at the expense of consumption, or vice-versa. Thus Proudhon said:

It is not the multiplication of capital which decreases the rate of interest, but the decrease in the rate of
interest which increases capital.\textsuperscript{130}

Gesell said:

The greater the fall in interest, the greater the amount of real capital created. . .If interest is an incentive, it is still more an obstacle to saving.\textsuperscript{131}

Keynes said:

Thus, even if it is the case that a rise in the rate of interest would cause the community to save more out of a given income, we can be quite sure that a rise in the rate of interest. . .will decrease the actual aggregate of savings.\textsuperscript{132}

All three theorists were extreme optimists concerning the rate at which accumulation would proceed if substantial reductions were made in the rate of interest. They believed that within a relatively brief period capital could be deprived of its scarcity value so that the return over the life of an investment would just be equal to its cost. Keynes estimated that in countries as wealthy as the United States and Great Britain, a period of about twenty-five years would be required to reduce the marginal efficiency of capital to zero.\textsuperscript{133} Gesell believed likewise that unimpeded production would soon lead to an "ocean of real capital necessary to drown interest."\textsuperscript{134} He gives no specific indication as to how long this would take but says that interest would have been eliminated long ago, had not production been frustrated by the traditional medium of exchange.\textsuperscript{135}

Proudhon was less clear as to the length of the period requisite

\textsuperscript{130}Deuress completès, XIX, p. 267.
\textsuperscript{131}The Natural Economic Order, pp. 250, 251.
\textsuperscript{132}General Theory, p. 111. \textsuperscript{133}Ibid., p. 324.
\textsuperscript{134}The Natural Economic Order, p. 262. \textsuperscript{135}Ibid., p. 261.
under the bank of exchange plan to abolish interest. The actual proposals which he drew and presented for adoption called for a gradual lowering of the discount rate, though his writings often implied that the interest rate could be reduced forthwith to zero.

The passage from Proudhon which Gesell quotes at the opening of The Natural Economic Order is, however, a significant indication of the similarity in their views. "The surest method of depreciating real capital...is to create and operate additional real capital. By every economic law, increased production of capital increases also the total of the capital supplied to the workers, thus raising wages and finally reducing interest to zero."

Opposition to the so-called productivity and abstinence theories followed logically from this position on interest. The interpretation of interest as a scarcity rent paid for the use of unnecessarily scarce capital assets is not consistent with the view that capital is "productive." All versions of the productivity theory were explicitly rejected by Proudhon, Gesell, and Keynes. If all income is said to be created by labor, including the efforts of entrepreneurs, the income received by the owners of capital is not a consequence of the "productivity" of capital, but a deduction from the income created by labor. In this sense the interest theories of Proudhon, Gesell, and Keynes are "exploitation" theories. The

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136p. 3. Cited by Gesell from Proudhon's What is Property?
138The Natural Economic Order, pp. 268, 269.
139General Theory, pp. 213-217.
exploitation results from the institutional monopoly which centers around the restrictive tendencies of financial capital.

The above comparative analysis indicates that there is a significant theoretical similarity corresponding to the similar practical outlooks of Proudhon, Gesell, and Keynes. Their attack on financial capital directed their emphasis toward money and interest theory, and led to interesting uniformities in some of the special aspects of the respective theories. Thus Keynes' place in the history of economic thought, so far as money and interest theories are concerned, is with the "circulation" reformers, the monetary "heretics." Keynes was completely honest when he said:

Now I range myself with the heretics. I believe their flair and their instinct move them towards the right conclusion. But I was brought up in the citadel. . .A large part of the established body of economic doctrine I cannot but accept as broadly correct. I do not doubt it. For me, therefore, it is impossible to rest satisfied until I can put my finger on that part of the orthodox reasoning that leads me to the conclusions that for various reasons seem to me to be unacceptable. I believe that I am on my way to do so. There is, I am convinced, a fatal flaw in the part of orthodox reasoning that deals with the theory of what determines the level of effective demand and the volume of aggregate employment; the flaw being largely due to the failure of the classical doctrine to develop a satisfactory and realistic theory of the rate of interest.

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CHAPTER VI

CONCLUSIONS

No longer do professional economists debate whether or not the economics of John Maynard Keynes had tremendous influence upon economic theory, inquiry, thinking, and policy. The validity of the many facets of Keynesianism is still a topic for discussion, but it is safe to say that now—after twenty years of the General Theory—all economists agree that economic theory was profoundly affected by J. M. Keynes, the English aristocrat, a scholar of Eton and King's College, Cambridge, a director of the Bank of England, an advisor to the Chancellor of the Exchequer, a peer of the Realm.¹ This is not to say that all economists have become Keynesians or Keynesian economists.² The economics of Keynes has its converts and critics, its friends and foes, and there are those who classify themselves as Keynesians and there are economists who consider themselves to be


²The writer has heard H. L. McCracken, Professor of Economic Theory and Head of the Department of Economics at Louisiana State University, say many times that there is a great difference between a Keynesian and a Keynesian economist. A Keynesian is one who begins and ends his study of economic theory with the General Theory. A Keynesian economist, on the other hand, is one who has been thoroughly trained in the complete history of economic thought, with the General Theory being only a part of his economic education.
non- or anti-Keynesians. But they all agree that Keynes "...stirred the stale economic frog pond to its depth."\\(^3\)

Seymour Harris says, "Keynes' influence, both in theory and practice, has of course been outstanding. It is indeed doubtful whether any other economist ever had so large an influence on policy, and particularly in so short a time."\\(^4\) Harris' final appraisal of the General Theory is that:

...Keynes was undoubtedly the great figure in economics of the twentieth century and may well prove to be the giant of modern economics. ...Certainly, the economic historian interpreting the middle years of the 20th century will characterize the period as the struggle for, and over, full employment. He may well refer to the period as the Keynesian period in the same manner as we now refer to the Mercantilist, the Physiocratic, and the Classical periods. He will point to Keynes' emphasis on the level of employment against the classical concern with the allocation of economic resources; he will stress Keynes' skill in marshalling available weapons and techniques and inventing of new ones for attaining the objective; and he will comment on the persuasive manner in which the message was passed to disciples and policy-makers.\\(^5\)

Alvin H. Hansen, perhaps the most thorough-going Keynesian economist in the United States, does not believe that one should draw a complete line of demarcation dividing pre-Keynesian and Keynesian economics. Nevertheless, "If a stranger from Mars," he says, "should undertake to read the literature of economics from, say, 1700 to the present day, he would be struck, I believe, particularly by the new

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4Seymour Harris, "Keynes' Influence on Public Policy," The New Economics, p. 12.

5Seymour Harris, "About This Book," and "Keynes' Influence on Public Policy," The New Economics, pp. 6, 15.
direction and outlook injected by the publication of (a) Wealth of Nations, (b) the works of Jevons, the Austrians, and Walras, and (c) Keynes' General Theory.\(^6\) Hansen's attitude toward the economics of Keynes may be summarized by quoting the following statements:

> It is evident that a new outlook was injected into economics, both with respect to theory and policy, by the publication of the General Theory. That it was not just "old stuff" is evidenced by the terrific effort it required for economists to readjust their thinking and, indeed, the difficulty they had in understanding what it was all about. Witness, for example, the first reviews (including my own) and the endless controversial articles on concepts which, in retrospect, are rarely a credit to the profession. More and more, even those who professed to see little in Keynes that was new or valid began to reveal that they had experienced a rebirth despite their protestations to the contrary. Add to this the fact that the influence of Keynes permeates all official international gatherings grappling with economic problems and is present wherever internal economic problems are under consideration. . .It is difficult to avoid the conclusion that nothing like it has happened in the whole history of economics. It is too early to say, but it does not now appear an extravagant statement, that Keynes may in the end rival Adam Smith in his influence on the economic thinking and governmental policy of his time and age. . . \(^7\)

Paul Samuelson, probably the most outstanding young Keynesian economist in this country, believes that the doctrines of Keynes have correctly been named "The Keynesian Revolution."\(^8\) Becoming lyrical in his praise for the great English economist, Samuelson says, "To have been born as an economist before 1936 was a boon--yes. But not to have been born too long before! Bliss was it in that dawn to be

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\(^7\)Ibid., pp. 143-144.

alive, But to be young was very heaven!"  

The General Theory caught most economists under the age of 35 with the unexpected virulence of a disease first attacking and decimating an isolated tribe of south sea islanders. Economists beyond fifty turned out to be quite immune to the ailment. With time, most economists in-between began to run the fever, often without knowing or admitting their condition.

With respect to the influence of the General Theory and its importance as a lasting body of thought, Samuelson takes a firm stand:

Fashion always plays an important role in economic science; new concepts become the mode and then are passé. . . In this case, gradually and against heavy resistance, the realization grew that the new analysis of effective demand associated with the General Theory was not to prove such a passing fad, that here indeed was part of "the wave of the future." This impression was confirmed by the rapidity with which English economists, other than those at Cambridge, took up the new Gospel: e.g., Harrod, Meade, and others, at Oxford; and, still more surprisingly, the young blades at the London School, like Kaldor, Lerner, and Hicks, who threw off their Hayekian garments and joined in the swim.

Instead of burning out like a fad, ten years after its birth, the General Theory is still gaining adherents and appears to be in business to stay. Many economists who are most vehement in criticism of the specific Keynesian policies—which must always be carefully distinguished from the scientific analysis associated with his name—will never again be the same after passing through his hands.

Finally, and perhaps most important from the long-run standpoint, the Keynesian analysis has begun to filter down into the elementary text-books; and, as everybody knows, once an idea gets into these, however bad it may be, it becomes practically immortal.

So much for the unswerving admiration of the Keynesian economists for the General Theory. They are disciples of Lord Keynes in the truest meaning of the term. Although Samuelson believes that the "new doctrines" of Keynes are something more than a religion, he refers to Keynes and the General Theory in a religious manner. "True, we find

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9 Ibid., (Italics by Samuelson).
10 Ibid., p. 146.
11 Ibid., pp. 146-147. (Italics by Samuelson).
a Gospel, a Scripture, a Prophet, Disciples, Apostles, Epigoni, and even a Duality; and if there is no Apostolic Succession, there is at least an Apostolic Benediction." And Harris refers to the General Theory as "the Keynesian bible," and says, "Keynes indeed had the Revelation. His disciples are now dividing into groups, each taking sustenance from the Keynesian larder. The struggle for the Apostolic Succession is on."^13

But even the critics have had high praise for Keynes' idea system. In commenting upon Keynes' influence, Joseph Schumpeter says:

A Keynesian school formed itself, not a school in that loose sense in which some historians of economics speak of a French, German, Italian school, but a genuine one which is a sociological entity, namely, a group that professes allegiance to one master and one doctrine, and has its inner circle, its propagandists, its watchwords, its esoteric and its popular doctrine. Nor is this all. Beyond the pale of orthodox Keynesianism there is a broad fringe of sympathizers, and beyond this again are the many who have absorbed, in one form or another, readily or grudgingly, some of the spirit or some of the individual items of Keynesian analysis. There are but two analogous cases in the whole history of economics--the Physiocrats and the Marxists.^14

And Paul Sweezy, a Marxist and hence an anti-Keynesian, has characterized Keynes as "one of the most brilliant and versatile geniuses of our time. . .the most important and illustrious product of the neo-classical school. . .whose mission was to reform neo-classical economics, to bring it back into contact with the real world." Sweezy has said that he has no doubt that "Keynes is the greatest British

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^12 Ibid., p. 147.

^13 Seymour Harris, "About This Book," The New Economics, pp. 5, 9.

(or American) economist since Ricardo," and that he thinks "his school sheds a flood of light on the functioning of the capitalist economy."\(^{15}\)

Thus economists are in agreement that the Keynesian idea system was a phenomenal development in the history of economic theory. No one now denies the fact that Keynes' equilibrium analysis has had tremendous influence on economic policy. According to the best authorities the economics of Keynes has forced all economists to subject their thinking to a rather rigid re-examination, and has had the effect of compelling many to revise and reformulate their basic theoretical framework.

Of course it comes as no great surprise to anyone to learn that the Keynesian economists account for the great popularity and influence of the General Theory on the basis that contained within the Keynesian idea system are very important and everlasting contributions to economic science. It is claimed that Keynes manufactured new analytical tools by the use of which the economic problems of the present day can be solved. "Keynes contributed importantly to the solution of the following problems: reparations, exchange rates, international equilibrium, appropriate rates of interest, central banking policy, inflation, deflation and wastage of economic resources, and employment. These problems are, of course, interrelated; they are not, and perhaps never will be, solved satisfactorily; nevertheless, by removing underbrush, building foundations, and illuminating the signposts, Keynes

prepared the road to full employment and stability."\(^{16}\)

Lawrence R. Klein wrote *The Keynesian Revolution* in 1947, a book which was based on his doctoral thesis written in 1944 at the Massachusetts Institute of Technology under the guidance and inspiration of Paul Samuelson. In the Foreword, Klein says, "The Keynesian theory is viewed in the following pages as a revolutionary doctrine in the sense that it produces theoretical results entirely different from the body of economic thought existing at the time of its development. The 'Revolution' discussed here is a revolution in thought, not in the economic policies of government."\(^{17}\) According to Klein, once Keynes realized that orthodox interest theory did not conform to the facts of the real world and what was needed was a theory of income determination to replace traditional interest rate theory, "a revolution occurred in economic theory."\(^{18}\) Klein also maintained that Keynes' refusal to accept the standard theory of flexible wage rates as a cure for unemployment rendered the Keynesian system revolutionary.\(^{19}\)

Klein asked "what has been Keynes' revolutionary contribution?" And he answers the question in a quite precise manner:

\[\ldots\] the revolution was solely the development of a theory of effective demand; i.e., a theory of the determination of the level of output as a whole.

There are two major economic problems--the problem of achieving full employment, and the problem of allocating resources in a full-employment economy. Keynes has shown how the level of employment gets determined, and thus has provided a theory with which to attack the first problem.

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\(^{18}\)Ibid., p. 37.

\(^{19}\)Ibid., p. 47.
He did not presume to advance a solution of the second problem, except in so far as the first must necessarily be cleared away before thinking about the second can start.20

Samuelson is in basic agreement with Klein concerning the significance of Keynes' work when he says, "I myself believe the broad significance of the General Theory to be in the fact that it provides a relatively realistic, complete system for analyzing the level of effective demand and its fluctuations."21 In a more restricted or specific sense:

I conceive the heart of its contribution to be in that subset of its equations which relate to the propensity to consume and to saving in relation to offsets-to-saving. In addition to linking saving explicitly to income, there is an equally important denial of the implicit "classical axiom that motivated investment is indefinitely expansible or contractable, so that whatever people try to save will always be fully invested.22

Harris thinks the great contribution of the General Theory to be its adaptation of economics, to the changing institutional structure of modern society. Economics had failed to keep pace with the developments of science, of government, of changes in the market-place, of organization by groups, and in general with institutional developments. Up to 1936, when the General Theory was first published, accepted economics in general belonged much more to the vanished age of competition, of capital deficiencies, of full employment or transitional unemployment, and the like, than to the twentieth-century economy which tolerated and, to some extent encouraged, monopolies, rigidities, excessive savings, deficiency of demand, and unemployment. To make up for the growing lag, Keynes sailed boldly and vigorously

20Ibid., p. 56.


into uncharted waters. Hansen is very specific concerning what he believes to be Keynes' greatest contribution in the General Theory. "It has been my conviction for many years," he says, "that the great contribution of Keynes' General Theory was the clear and specific formulation of the consumption function. This is an epoch-making contribution to the tools of economic analysis, analogous to, but even more important than, Marshall's discovery of the demand function." In more general terms, Hansen says, "The effect of variations in income upon all manner of economic variables has, since Keynes, become an important field for research and analysis. Income analysis at long last occupies a place equally as important as price analysis."

Dudley Dillard sees a very close relationship between the theoretical and the policy concepts of the General Theory. First, "Keynes' major purpose may be characterized as an attempt to buttress political liberalism with a new economic program and to fortify this economic program with a new political economy." Second, "The historic significance of Keynes' new political economy is that it furnishes the theoretical basis for a new liberalism, which, unlike classical liberalism, rejects laissez-faire." And finally, "The

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23Seymour Harris, "About This Book," The New Economics, p. 4.
27Ibid., p. 325.
ultimate significance of the theory...resides in the program of action with which it is associated.”

Schumpeter and Haberler, perhaps the two leading critics of Keynes in this country, concede a victory for the General Theory but for somewhat different reasons than those given by the disciples of Keynes. Haberler attributes, as a partial cause,

...the brilliance of Keynes' style, the versatility, incredible quickness, and fecundity of his mind, the many-sidedness of his intellectual interests, the sharpness of his wit, in one word the fullness of his personality. (These, he says, were) bound to fascinate scores of people in and outside the economic profession. Only a dullard or narrow-minded fanatic could fail to be moved to admiration by Keynes' genius.

He further notes:

The tremendous appeal of the General Theory to theoretically-minded economists has been attributed by many to the (alleged) fact that it uses for the first time in the history of economic thought a general equilibrium approach in easily manageable macroscopic (aggregative) terms.

Yet in Haberler's opinion neither the brilliance of Keynes' style and wit nor the attractiveness of macroscopic general equilibrium analysis is the major cause of the sweeping success of the General Theory. On the contrary, "we can safely assume," he says, "that the concrete content and the policy recommendations which Keynes and others deduced from his system had even more to do with its persuasiveness (even for his theoretically-minded followers) than its theoretical beauty and simplicity."

With respect to the thesis of this study, it is

28Ibid., p. 326.
30Ibid., p. 162. 31Ibid.
interesting to note Haberler's attitude towards Keynes' aggregative approach. "The use of aggregative systems of general equilibrium is by no means new. All business-cycle theories run in macroscopic terms."\textsuperscript{32}

Schumpeter in an even more straightforward manner attributes the appeal of the \textit{General Theory} to the fact that it once more reduces economics, which over the past decades "had been growing increasingly complex and increasingly incapable of giving straightforward answers to straightforward questions...to simplicity," and enables "the economist once more to give simple advice that everybody can understand." Yet, Schumpeter continues, "exactly as in the case of Ricardian economics there was enough to attract, to inspire even, the sophisticated. The same system that linked up so well with the notions of the untutored mind proved satisfactory to the best brains of the rising generation of theorists."\textsuperscript{33}

This reminds one of Keynes' answer in the \textit{General Theory} to a similar question pertaining to David Ricardo's \textit{Principles}, viz., what accounts for the victory of Ricardian economics over the Malthusian doctrine of inadequacy of general demand? According to Keynes, "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. . ."\textsuperscript{34}

\textsuperscript{32}Ibid.

\textsuperscript{33}Joseph Schumpeter, "Keynes, the Economist," \textit{The New Economics}, pp. 99, 100.

\textsuperscript{34}\textit{General Theory}, p. 32.
The completeness of the Ricardian victory is something of a curiosity and a mystery. It must have been due to a complex of suitabilities in the doctrine to the environment into which it was projected. That it reached conclusions quite different from what the ordinary uninstructed person would expect, added, I suppose, to its intellectual prestige. That its teaching, translated into practice, was austere and often unpalatable, lent it virtue. That it was adapted to carry a vast and consistent logical superstructure, gave it beauty. That it could explain much social injustice and apparent cruelty as an inevitable incident in the scheme of progress, and the attempt to change such things as likely on the whole to do more harm than good, commended it to authority. That it afforded a measure of justification to the free activities of the individual capitalist, attracted to it the support of the dominant social force behind authority.\textsuperscript{35}

Like Ricardo's \textit{Principles}, the \textit{General Theory} also was highly suited to the environment into which it was projected—the breakdown of capitalism in the great depression of the nineteen thirties. Like Ricardian theory, the \textit{General Theory} reached "conclusions quite different from what the ordinary uninstructed person might expect." It may be noted, among others, the conclusions that employment and real income are independent of the price level and money wage rates, that saving is a residual and is determined by the level of investment, that thrift is generally an economic vice and spending an economic virtue, that boondoggling in a depression increases income and the wealth of the nation. The \textit{General Theory}, like Ricardo's \textit{Principles}, is "adapted to carry a vast and consistent logical superstructure."

Here, though, the similarity ends.

Keynes' teaching translated into practice is not, like Ricardo's, austere and unpalatable. Quite the contrary. It calls for higher

\textsuperscript{35}\textit{Ibid.}, pp. 32, 33.
living, more consumption, and more leisure. It explains social injustice and apparent cruelty not as an inevitable incident in the scheme of progress, but as a result of stupidity and ignorance which prevent the formulation of policies and the use of controls already at hand to establish and maintain full employment and maximum income. Since these policies, though, call for a rather severe redistribution of income and a vast deal of government interference in the activities of businessmen, the General Theory is damned by authority and by the dominant social force that stands behind authority.

Undoubtedly all the opinions noted above as to the significance of the General Theory to economic theory and public policy are important. The writer should like to submit, however, the idea that the above list does not include one important and significant point of the General Theory. Schumpeter hints at this idea, but his analysis does not include the essential point. He notes that in economics such enthusiasm—and correspondingly strong aversions—as greeted the General Theory "never flare up unless the cold steel of analysis derives a temperature not naturally its own from the real or putative political implications of the analyst's message." 36 A survey of the development of economic thought will reveal the fact that economic theory at any given time is an intellectual reaction to particularly pressing economic issues and problems of the time. Major problems demand solutions; major issues demand resolution. The great shifts in economic theory (for example, from Mercantilism to Classical doctrine) have been

36 Joseph Schumpeter, "Keynes, the Economist," The New Economics, p. 98.
intellectual responses to the changes in economic conditions; that is to say, the great systems of economic thought originally were developed in an attempt to solve problems and resolve issues. The economic theorists who have contributed most to economic thought have been the great thinkers who were deeply concerned with the issues that concerned their generations. Their theories were attempts to deal scientifically with those problems. Thus economic theory does not develop in a vacuum; it is an intellectual response to economic problems, issues, conditions, and circumstances of the time. In consequence perhaps each of the great systems of economic thought in its time derived "a temperature not naturally its own" from the political implications of its message.

Several examples supporting the above thesis may be given. Adam Smith lived during a period that witnessed a gradual disintegration of mercantilistic theory and a very rapid integration of the policy of individual initiative in economic affairs. This rise of individual initiative was hampered by the multitudinous regulations of economic activity which the government exerted under its scheme of economic planning. Smith was a philosopher. He lived at a time when economics was just beginning to separate itself clearly from other disciplines and interests. Reflecting on existing conditions, he became convinced that the policy of economic planning inhibited the progress of the nation. So he propounded the idea that progress would be greater if the government interfered less. He was concerned with the wealth of nations and the policy that would allow a nation to most fully achieve its potentialities. This was the issue he raised and it is still one that men are debating. Smith centered
economic theory on the problem of the production of wealth and how best to encourage this production. That was the problem of economics as he saw it. Thus, Smith was interested in something highly practical. In fact, he was dealing with the overwhelming issue of his age, and he came to quite definite conclusions as to what should be the best policy for the English government to follow. In addition, he did not hesitate to say what he thought.

Another example is Thomas Malthus and his theory of population. Malthus lived at a time when the industrial revolution was beginning to produce its marked effects on the increased population. Population was increasing at its most rapid rate in history, and this was particularly true in England. In addition, the French Revolution had drastically disrupted foreign trade channels, and later the continental blockade by Napoleon cut England off from her food supply just when she had ceased to be self-supporting. Malthus reflected on these practical issues and his conclusions were set forth in his theory of population.

David Ricardo presents another example. Adam Smith centered his economics around the problem of how to increase the wealth of nations. Ricardo changed the perspective of economic theory to the problem of distribution of wealth. He believed that the job of economics was to search out and analyze the determinants of the distribution of income among the three great classes that composed society: capitalists, landowners, and laborers. He differed from Smith on the fundamental problem with which economics should be concerned. This difference was because of the economic conditions that
existed in Ricardo's time. The great problem in government was the issue posed by the Corn Laws. These laws imposed import duties upon the importation of the staple food products of the British people. Everybody believed that these laws would mean an increase in the price of food. Economic theory of the time related money wages with the cost of living; hence, high food prices would mean high wages. This would mean higher costs of production for the entrepreneur, which would place British merchants at a disadvantage in competing with other countries for both foreign and domestic markets. The rising class of manufacturers and merchants were greatly concerned with these Corn Laws lest they should decrease their profits. On the other hand, the landowners favored the Corn Laws as protecting their rents. The Laws kept up the price of agricultural foods thereby keeping up rent. So the issue was clearly drawn. The issue was the distribution of income between landowners and the capitalists. It was generally believed that the Corn Laws increased rents and reduced profits. That was the issue which was largely responsible for Ricardian economics. It was because of him that the issue of distribution became the central theme of economics for the following one hundred years. Clearly, Ricardo attempted to solve a practical problem of the day.

Many such examples could be given. One final one will have to suffice, however. John Stuart Mill lived during the period when England was reaching maturity industrially and the evils of the industrial revolution were becoming apparent to everybody. Crowded living conditions and extremely low wages were prevalent. British capitalists were growing wealthier and wealthier, while the laborers
were becoming poorer and poorer. What should be done about this condition was a major issue of the time. Economists had long since adopted the theory that economic laws were natural laws about which nothing could be done. Mill was a logician and a humanitarian, and he was deeply concerned with existing economic conditions. He disagreed with the economists' concept of natural laws and drew a distinction between the laws of production and the laws of distribution. In other words, he distinguished between the wealth of a nation and the distribution of that wealth. He said the laws of production were natural, but those of distribution were not. The laws of distribution resulted from the institutions of the society. Hence, they were man made—man had made them; man could change them. He explained that the laws of distribution were different in different societies, and that, he believed, proved his position. Mill believed that to a very great degree, the future welfare of the nation depended upon what alterations were made in the methods of distribution of income. Thus, Mill was concerned with the practical issue of his day and his theory reflects this interest.

And so it was with the economics of J. M. Keynes. The General Theory was an intellectual response to the momentous economic problems and issues created when capitalism ceased to function throughout the Western world between 1929 and 1936. For everyone, the events of this period were terrifying. The most direful predictions of Karl

To be sure, the depression continued for another four or five years, but its most terrible phase was between 1929 and 1936, particularly between 1929 and 1933.
Marx seemed to have a better than even chance of coming true. In the United States, the wealthiest and strongest of the capitalist countries, capitalism appeared to be in its death throes with something like fifteen million people walking the streets searching for any kind of work and the great American industrial system—the envy of the world—operating at less than fifteen per cent capacity. The Gross National Product declined from 103.8 billion dollars in 1929 to 55.8 billion dollars in 1933, the low point of the depression. Personal income fell from 85.1 billion dollars to 46.6 billion dollars during the same period. Personal savings were 3.7 billion dollars in 1929 and a negative 1.2 billion dollars in 1933. It is interesting to note what happened to personal consumption expenditures and private domestic investment, the two most important economic indicators in the Keynesian system, during this same period. Personal consumption expenditures declined from 78.8 billion dollars to 46.3 billion dollars. Private domestic investment decreased from 15.8 billion dollars to 1.3 billion dollars. Something had to be done, but what?

To provide a theory adequate to diagnose the illness of capitalism in the Great Depression and thus to indicate what was required to be done to restore that system to health and vigor was the task Keynes set himself in the General Theory. For Keynes was convinced that the postulates of the classical theory were applicable only to a special case, and "the characteristics of the special case assumed

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by the classical theory happen not to be those of the economic society
in which we actually live, with the result that its teaching is mis-
leading and disastrous if we attempt to apply it to the facts of ex-
perience. 39

Keynes was not a socialist, radical or otherwise. He did not
claim to be a member of the Proletariat; he had nothing but scorn for
Marxian economics, and certainly there is no adherence in the General
Theory to Marx' "class-struggle" theory of history. Keynes promulgated
his ideas concerning Marxism and the economic system of Soviet Russia
after visiting that country in the early part of the nineteen twenties.

Writing in 1925, Keynes says, "Marxian Socialism must always remain a
portent to the historians of Opinion--how a doctrine so illogical and
so dull can have exercised so powerful and enduring an influence over
the minds of men, and, through them, the events of history. How can
I accept a doctrine which sets up as its bible, above and beyond criti-
cism, an obsolete economic textbook which I know to be not only scien-
tically erroneous but without interest or application for the modern
world." 40

Keynes concluded that perhaps communism had a future, but it
would be as a new religion and not as a more efficient form of economic
organization. And he was quite impressed with the economic inefficiency
of the Soviet Union:

On the economic side I cannot perceive that Russian

39 General Theory, p. 3.

40 John Maynard Keynes, Laissez-Faire and Communism (New York:
Communism has made any contribution to our economic problems of intellectual interest or scientific value. I do not think that it contains, or is likely to contain, any piece of useful economic technique which we could not apply, if we chose, with equal or greater success in a society which retained all the marks... of British bourgeois ideals.\footnote{1}

As to aligning himself on one side or the other in case the class struggle materialized, Keynes refused to become a member of the Labour party in England, desiring to be associated with the bourgeoisie and not the "boorish proletariat." Keynes listed his reasons for not joining the Labour party in quite precise terms:

To begin with, it is a class party, and the class is not my class. If I am going to pursue sectional interests at all, I shall pursue my own. When it comes to the class struggle as such, my local and personal patriotism, ... are attached to my own surroundings. I can be influenced by what seems to me to be Justice and good sense; but the Class war will find me on the side of the educated bourgeoisie.\footnote{2}

Although these philosophical, economic, and political ideas were expressed in 1925—long before he started writing the \textit{General Theory}—there is no evidence in his published works after 1925 to indicate that he changed his basic thinking in these areas. In point of fact, on pages 380 and 381 of the \textit{General Theory} and on pages 7, 53, and 55 of \textit{How to Pay for the War}, there is positive evidence which indicates a continuation of his earlier views.

However, there are similarities between Keynes and Marx. The \textit{General Theory}, like \textit{Das Kapital}, teaches that unemployment and depression are the norms to which the capitalist economy tends. Both

\footnote{1}{\textit{Ibid.}, p. 130.}

Keynes and Marx were aware of deficient demand and oversaving, of the declining profit rate resulting from limited investment opportunities, of the unwisdom of capital exportation. But Keynes was an ardent believer in and defender of the virtues of industrial capitalism. That system, he was convinced, possessed great values and advantages, values and advantages that must be preserved in the interest of economic efficiency and of human dignity and freedom.

This, however, did not blind him to what he thought were the major faults of capitalism. For him, the illness of capitalism was manifested in the form of periodic depressions that had tormented industrial capitalism throughout its lifetime. Keynes believed that the most obvious faults of capitalism were its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and income. These faults, in his opinion, were linked as cause and effect. But Keynes was sufficiently sophisticated to realize that no economic system is perfect. And he was convinced that these faults of industrial capitalism could be eliminated by measures that would not impair the basic institutions of the system or injure any of its vital organs. Keynes has nothing but praise for industrial capital; the villain in the plot is financial capital. It is the presence and operation of financial capital that causes capitalism to function by a series of "spurts and stalls." The source of the periodic sicknesses (depressions) of the system is financial capital.

Keynes reserved his most vehement remarks for the rentier, the idle and functionless receiver of property income, and the speculator, who, he says, has made the capital development of the country
a "by-product of the activities of a casino." In the Keynesian system the rentier would be eliminated by reducing the rate of interest to zero. Such a measure not only would mean the "euthanasia of the rentier," as he puts it, but would also cause investment to increase to the point at which the marginal efficiency of capital, the expected return over cost, would fall to zero; that is to say, capital goods would cease to be scarce. He would make up for deficiency of private investment and eliminate the speculator as the guiding force in investment by what he calls the "socialization of investment." He never explains precisely what he means by socialized investment, but perhaps he means a wide expansion of public investment to augment private investment and some public control of private investment.

These measures, together with progressive taxation and regressive expenditures to raise the propensity to consume, constitute the major means proposed by Keynes for correcting the faults of capitalism and making it function effectively at high levels of employment, output, and income. Collective ownership of the means of production, he insisted, was unnecessary. "If the State is able to determine the aggregate amount of resources devoted to augmenting the instruments and the basic rate of reward to those who own them," he says, "then it will have accomplished all that is necessary." He admits that the controls required to insure full employment involve a large extension of the traditional functions of government, but contends that "there will still remain a wide field for the exercise of private

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43 General Theory, Ch. 24. 44 Ibid. 45 Ibid. 46 Ibid., p. 378.
initiative and responsibility. "By right analysis," he concludes, "it is possible...to cure the disease whilst preserving efficiency and freedom." 47

Many economists insist that the Keynesian analysis is a static one. For example, John H. Williams says:

Assuming, as Keynes did, constant technique, and confining himself to short-period analysis, with no analysis at all of economic processes--how we get from one state of static equilibrium to another--Keynes' theory has always seemed to me peculiarly inapt as a starting point for an analysis of growth and change, and in this regard inferior to the classical theory it was intended to supplant. 48

According to E. E. Hale:

He (Keynes) assumes that the technology of production is constant and the amount of fixed capital unchanged throughout the periods which his analysis treats. He makes the highly traditional assumption that perfect competition exists throughout the economy. No where in the General Theory is there reference made to monopoly or monopolistic competition. He assumes increasing costs and diminishing returns in all industry as production increases. Of course this is necessary because of the assumption of constant techniques. Finally, he assumes a closed economy. Indeed, Keynes yielded to no person in making unrealistic assumptions. The technique that flows from these assumptions is one of static equilibrium analysis in the tradition of Ricardo and Marshall and of classical economists generally. 49

And Arthur Smithies states:

The General Theory is static and consequently does not take into account the fact that economic events at one point of time are not independent of what went before and will

47 Ibid., pp. 380, 381.


not fail to influence what will occur subsequently.\textsuperscript{50}

If the economics of Keynes is static, then, the following interpretation of the General Theory may be made.\textsuperscript{51}

In a capitalist economy the rate of interest could not be reduced to zero without completely nationalizing or socializing the banking system, and the banking or credit system is the very heart of capitalism. With a zero rate of interest, Keynes assumes that investment would be pushed to the point at which the marginal efficiency of capital equals the rate of interest; that is to say, a zero rate of interest would be the motivating force causing the marginal efficiency of capital to fall to zero. No one can possibly predict all the effects of this drastic measure on the free enterprise system, but one result is quite obvious. Property income as it is recognized in the capitalistic system would disappear, and the desire to acquire and hold property would undergo change. After all, it is not the mere satisfaction of owning something that induces people to acquire property; it is the income which property yields to its owner that makes the acquisition of property significant. If the income producing power of property is eliminated, it is impossible for any rational person to argue that the desirability of owning property would remain unaltered.

Keynes concludes that when the marginal efficiency of capital has fallen to zero, the rentier will have disappeared.\textsuperscript{52} There is


\textsuperscript{51}See Hale, \textit{op. cit.} \textsuperscript{52}General Theory, p. 221.
something of a hiatus in his argument at this point. The euthanasia of the rentier requires a zero rate of interest rather than a zero marginal efficiency of capital. In his own analysis, Keynes admits that the interest rate could not be reduced to zero in the absence of measures which are not suggested in his program. Indeed, that is the case. As suggested above, it would be necessary to completely socialize the banking and credit system of the economy to achieve a zero rate of interest. That is what is not included in his program. Socialized investment is the instrument which will reduce the rate of interest and the marginal efficiency of capital to a value of zero. But if socialized investment, either of a self-liquidating or non-self-liquidating type, does not compete with private enterprise, it will not lower the marginal efficiency of private industrial capital. On this basis, the socialization of investment would be irrelevant to its purported aim of lowering the marginal efficiency of capital, and would be useful only as a means for increasing employment through the medium of "make-work" projects. If it does compete with private enterprise, it will lower the marginal efficiency of private capital and weaken the inducement to invest. If carried to the extent necessary to reduce the marginal efficiency of capital to zero, the inducement to invest would be destroyed. In the absence of some additional measure to reduce the preference for liquidity, private wealth holders will shift their holdings from industrial securities to money assets on an ever increasing scale. Thus Keynes' socialization of investment can mean nothing less than a transition (perhaps gradual) to what he deemed to be unnecessary, namely, government ownership of the means of
production. In the "social philosophy" of the General Theory, the rentier must be eliminated, and also "the cumulative oppressive power of the capitalist to exploit the scarcity value of capital."53

Keynes said there was no way to maintain sufficient private investment to fill the "gap" left between a full-employment income level and the amount of that income spent by consumers on consumption. The purpose of public investment is to absorb this difference, and in so doing, maintain full employment which would serve as a strong inducement to private investment. This is not a simple "pump-priming" proposition to be used until "things economic get better," but a permanent procedure to follow for the purpose of maintaining prosperity. For Keynes, prosperity was not the normal condition of capitalism; quite the contrary, a less than full-employment equilibrium characterized the capitalistic system. Consequently, a constant and permanent injection of public expenditures was necessary. Hence, it is perfectly obvious that Keynes believed he was merely advocating that public investment be used only to compensate for the deficiency of private investment. What form would this public investment take? Well, the government could spend money on a host of investment projects; for example, a modern highway system could be constructed, parks and playgrounds could be built all over the country, school houses could be made to materialize wherever needed, and floodways, dams, etc. could be built. In short, the government would invest heavily in those areas where private capital is reluctant to enter. So far so good. But after all these areas have been completely

53 Ibid., p. 376.
developed, what then? This is a permanent program and thus the government would have to move into those areas which are considered to be for private investment only—starting perhaps with heavy industry and moving through the whole industrial system. And this is the manner by which industrial capital would become socialized. If this is added to the method of reducing the rate of interest to zero (socializing the banking and credit system), only one conclusion is possible. The entire economy becomes socialized.

But there is more. There can be no question but that Keynes was thinking in terms of a full investment economy when he said, "I feel sure that the demand for capital is strictly limited in the sense that it would not be difficult to increase the stock of capital up to a point where its marginal efficiency had fallen to a very low figure." At another point he guesses "that a properly run community equipped with modern technical resources, of which the population is not increasing rapidly, ought to be able to bring down the marginal efficiency of capital in equilibrium approximately to zero within a single generation." This, according to Keynes, would rid capitalism of many of its objectionable features. Perhaps it would rid the system of all its faults and weaknesses because it would eliminate capitalism itself.

Keynes recognized that a full investment economy would result in a quasi stationary community where change and progress would result only from changes in technique, taste, population, and institutions, with the products of capital selling at a price proportioned to the labor embodied in them. He realized that enormous social changes would

\[5^h \text{Ibid., p. 375.} \quad 55^h \text{Ibid., p. 220.}\]
result from a gradual disappearance of a rate of return on accumulated wealth. He is perfectly willing, in fact urges, that the rentier should pass from the scene. But he refuses to recognize the most significant aspect of his program. Not only would the rentier disappear, he would take with him capitalism itself. This is true because in a full investment economy the entire amount of net income produced each year would necessarily have to be spent on consumption goods. There could be no net addition to investment, by definition, and therefore, if any given level of income were to be maintained, 100 per cent of it would have to be consumed. Anything less than 100 per cent would result in a decline in national income. In other words, under conditions of full investment consumer spending is the only contribution to the national income; they are identical in amounts. This certainly would not resemble capitalism, a system which is characterized by profit making and capital accumulation. Profits are made through investment and not from consumption, and capital is accumulated by continued investment and not from 100 per cent consumption. A capitalistic economy cannot consume all that it produces and remain capitalistic because there would be no profits from net investment and no accumulation of capital, the two characteristics of capitalism which distinguishes it from a collective economy. A zero-investment economy with 100 per cent consumption would be the antithesis of an economy in which capitalists engage in enterprise to make profits, not merely to make a living, and to acquire investment goods, not consumer goods.

Hale contends, "Keynes could maintain that his program of action would create and maintain a stronger capitalism only because he
excludes from his analysis all phenomena that really dominate the capitalist processes." The classical economists taught that capitalism evolves into a stationary state characterized by full employment and maximum wealth and income. For Marx, the capitalistic evolution eventually results in complete breakdown. Keynes viewed capitalism as a system that constantly threatened to break down and is prevented from doing so by the state. But the amount of government activity that the Keynesian program calls for would destroy capitalism. No matter how one feels on this issue, the fact is that capitalism is an economy operated by free private enterprise and not one operated from Washington by a government bureaucracy. Hale concludes:

Thus Keynes attacked the major citadels of capitalism, private property and investment profits, and smashed them to dust. This is the logical conclusion of his program. This is the significance of his idea system. This, if one is so inclined, is the "new economics." To search for something new elsewhere in Keynes' idea system is futile.

While the above analysis is logical, it is not necessarily true. One may accept the idea that the General Theory contains static elements without drawing the above conclusions.

In analyzing Keynes' concepts of a zero rate of interest and a zero level for the marginal efficiency of capital, one must keep in mind that Keynes was well steeped in the "equilibrium" and "tendency" aspects of classical and neo-classical economics.

Reducing the interest rate toward zero by monetary measures could make feasible the development of more and more investment

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56Hale, op. cit., p. 15. 57Ibid., p. 15. 58Ibid., p. 17.
opportunities with lower and lower marginal efficiencies. A tendency for the interest rate to move downward would stimulate private investment as long as economically efficient investment opportunities existed. It is not logical to assume that private investment would decrease merely because the marginal efficiency of capital indicated a tendency to decline. Furthermore, there is no need to assume that the banking system would have to be socialized under conditions of a zero rate of interest. Banking income—much of which now comes from bank ownership of public debt—could be supplemented by service charges. This was done during the depression of the 1930's and has been continued since.

With reference to the rate of interest, attention must be called to the fact that the government does in effect determine the private rate of interest in today's world. It does so by the interest rate it pays on the public debt and by the particular monetary policy it follows.

Because the federal government is so large a borrower, and because the public debt is greater than the private, the rates of interest paid on government securities set the rates paid on private borrowing. If the Treasury secures an easy money policy, the rates of interest in the private area of the economy decline. If the Federal Reserve System secures a hard money policy, there tends to be an increase in interest rates on private borrowing.59

The long-run point of view regarding the size of the public debt is that it will remain large. Hence, the government will continue to determine the private rates of interest, and it is unrealistic to assume that the government will adopt a policy calling for zero rates of interest.

Even if it is true that there are forces at work in the economy to cause interest rates and the marginal efficiency of capital to fall to zero, this can be interpreted as a tendency in the tradition of classical equilibrium. The Classicists taught that there was a tendency for profits to disappear, but they did not say this position would be achieved. If Keynes is to be charged with advocating the end of capitalism because of his belief that capital assets would not be a source of income once they ceased to be scarce, then, the same charge must be made against the classical economists. Capitalism could not exist without the presence of profits.

Keynes did not say in the General Theory that the rates of interest and marginal efficiencies would fall to zero. It was a tendency concept, and this tendency toward zero rates can very well be an ultimate which the system ever approaches but never reaches. The American economy is not static, it is not a closed system, and the arts are not in a constant state. The zero rate concepts, viewed as goals to approach but not to attain (as in the case of classical equilibrium), are not inconsistent with capitalism, technological progress, and rising standards of living.

With reference to the above argument, the following is significant:

In my last talk with Keynes, a few months before his death, it was clear that he had got far away from his 'euthanasia of the rentier.' He complained that the easy money policy was being pushed too far, both in England and here, and emphasized interest as an element of income, and its basic importance in the structure and functioning of private capitalism.60

60 Williams, op. cit., p. 60.
Of the two interpretations of Keynesian economics presented above, the latter one appears to be more tenable. It is true that there are static elements in the General Theory. But it is equally true that there are dynamic tendency elements.

The exact skeleton of Keynes' system belongs... to macrostatics, not to macrodynamics. In part this limitation must be attributed to those who formulated his teaching rather than to his teaching itself which contains several dynamic elements, expectations in particular. Keynes' national income formula, his concept that the consumption function may change, his ex-ante and ex-post analyses of the equality of savings and investment, his attitude toward varying supplies of money, his concern with shifting values of the multiplier, his expectation theory of value, and his tendency analysis of zero rates of interest and marginal efficiencies are evidence that the Keynesian system is one largely composed of dynamic tendencies. It appears that this characteristic far outweighs the static aspects.

The proposition that Keynes embraced a dynamic philosophy was explored in some detail in Chapter Two. There it was shown that Keynes did accept the concept of an emerging society and viewed the economy in a quite realistic manner. For too long now segments of the Keynesian system have been examined in isolation from other parts of the system. This has been a grave error and has perhaps postponed a proper understanding of the General Theory. The system must be considered as a whole—no one part is logical without the support of all the other parts—to be clearly understood and appreciated. And when it is so

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61Schumpeter, "Keynes, the Economist," The New Economics, pp. 92, 93.
considered, the dynamic tendency characteristic becomes clear. Furthermore, perhaps it is time that economists abandon the old arguments about dynamic and static economics and substitute the word "evolutionary" for the word "dynamic" when they find it necessary to treat qualitative changes. For quantitative changes, economists perhaps would profit by doing what many physicists do, namely, consider statics as including dynamics.

Both in terms of quantitative and qualitative factors, the economics of Keynes measures up to the dynamic requirements. His concepts involving movement toward and oscillations around an underemployment equilibrium level are clearly in the nature of quantitative dynamics. And the forces which cause the movement and oscillations are the dynamic factors. His concepts of changes or reforms--primarily in the financial and monetary areas--take on the characteristics of qualitative dynamics. The fact that Keynes' evolutionary dynamics is teleological rather than scientific is of no great importance. Those persons who treat qualitative or evolutionary dynamics in a teleological manner see change as tending toward some end or ideal, which of course they assume that they know. Those who believe that their evolutionary dynamics is scientific attempt to think of evolution in terms of survival, free from any presumptions as to the first cause or ultimate goal. Keynes clearly had "ends" in mind when he developed his ideas concerning the euthanasia of the rentier, the socialization of investment, and zero rates of interest and marginal efficiencies. Some familiarity with the thought of those who mean by dynamics a particular kind of qualitative change, seems to warrant the observation
that they are seldom free from teleological assumptions. After all, they are dealing with qualitative values, and if they are frankly teleological, they must make some choice among ends; while if they reason in terms of survival, the question is, Who are the "fittest" to survive? Also it is difficult to escape the question as to whether the results of the survival test are "best."

The logical content of Keynesianism involves the consumption function, the marginal efficiency of capital, liquidity preference, the wage-unit and the labor-unit concepts, a "labor-expectation" theory of value, and the assumption of a given quantity of money. These are the factors which, according to Keynes, govern and determine the level of income and employment. In brief, the welfare of the economy is dependent upon these factors and the relationships between them. But surely no one will any longer claim that these are new factors in the body of economic theory. Schumpeter announces, "What a cordon bleu to make such a sauce out of such scanty material."

Mention has already been made of Haberler's view towards the belief held by some that Keynes was the first to use a macroscopic analysis of general equilibrium.

The use of aggregative systems of general equilibrium is by no means new. All business-cycle theories run in macroscopic terms. It is true that most of the earlier business-cycle theories are incompletely stated, the number of explicitly stated relations is frequently not equal to the number of unknowns, the structure of the system is such that it is unstable (or does not oscillate, which is bad for a business-cycle theory). But even before the appearance of Keynes' General Theory, the work of econometricians, notably Frisch and Tinbergen, had done much to clarify
these issues and had set higher standards of formal completeness and precision. In fact, these early models, or models of models, were superior to Keynes' system in scientific workmanship because they made a clear distinction between static and dynamics, while Keynes' system is entirely static.

As to the logical content of Keynes' idea system:

We thus reach the conclusion that, as far as the logical content of Keynes' theory goes, i.e., apart from his judgment of the typical shape of the various functions and of concrete situations and apart from policy recommendations, no revolution has taken place; the General Theory marks a milestone, albeit a conspicuous one, but not a break or a new beginning in the development of economic theory.

As has been shown, Hansen argues that Keynes' consumption function was the new contribution to economic theory. It is quite true that Keynes honed this analytical tool to a very fine edge, but he did not originate it. The consumption function is a major factor in the entire analysis and argument of the underconsumption economists. Surely no one will deny that Boisguilbert, Malthus, Sismondi, Marx, Hobson, and many others were quite aware of the importance of consumption to the welfare of an economy. Perhaps even more important to a proper chronology of economic thought is the fact that the consumption function is a major factor in the subjective

63 The quickest way to learn how far aggregative analysis had progressed before the publication of the General Theory is to read Tinbergen, "Suggestions on Quantitative Business Cycle Theory," Econometrica, July, 1935. Haberler cites this source.

64 Haberler, op. cit., p. 162.

65 Ibid., p. 176. The writer is of the opinion that Haberler minimizes certain differences between the Keynesian and the Classical systems and is in error in holding generally that where they differ, as for example, in the theory of interest or the relation between money wages and employment, the classical theory is more realistic and useful. However, the quotation above is certainly accurate.
value theory and demand analysis of the Austrian school of economics. The consumption function is virtually stated in Engel's Law of Consumption.

Many economists have claimed that the significant and new factor in the General Theory was Keynes' frontal attack on saving and his enthusiasm for spending. Schumpeter says:

Many of the men who entered the field of teaching or research in the twenties and thirties had renounced allegiance to the bourgeois scheme of life, the bourgeois scheme of values. Many of them sneered at the profit motive and at the element of personal performance in the capitalist process. But so far as they did not embrace straight socialism, they still had to pay respect to saving—under penalty of losing caste in their own eyes and ranging themselves with what Keynes so tellingly called the economist's "underworld." But Keynes broke their fetters: here, at last, was theoretical doctrine that not only obliterated the personal element and was, if not mechanistic itself, at least mechanizable, but also smashed the pillar into dust; a doctrine that may not actually say but can easily be made to say both that who tries to save destroys real capital and that, via saving, the unequal distribution of income is the ultimate cause of unemployment. This is what the Keynesian Revolution amounts to.66

The greatness of Schumpeter as a student and scholar of economic theory and its history is accepted, but it is submitted that he must have forgotten some of his history of economic thought as he wrote the above statements. For the doctrine that saving is essential to capital formation and capital formation is the sine qua non of economic progress has been subjected to many attacks for at least two hundred years. One of the earliest and most devastating blows against saving was delivered by Bernard de Mandeville in his

Fable of the Bees published in 1705. And the underconsumptionists from Lord Lauderdale and Malthus to John Hobson and H. Gordon Hayes have engaged in spirited, and sometimes bitter, attacks on this doctrine. Keynes appeared about two centuries too late to be credited with this "radical" move against economic orthodoxy. To be sure, Keynes lent prestige and respectability to this long fight against the idea that "saving is a virtue and spending is a sin" and completely endorsed the concept that "saving is a sin and spending is a virtue," and that was perhaps an important contribution, but it can hardly be classified as a revolution in economic theory. Keynes himself took no credit for originality in all this. He frankly states that his concepts regarding saving and spending had been living in a furtive manner in the underworld of economics, espoused by such unorthodox characters as Malthus, Hobson, Marx, and Gesell.

This study has demonstrated that there was no "Keynesian Revolution" and that the idea system of Keynes cannot logically be considered as a "New Economics." How, then, can one account for the place of the economics of Keynes in the history of economic theory? It is quite simple. First, Keynes accepted and utilized the major parts of the new philosophy. He recognized the evolutionary process as applied to society and its institutions. He formulated his theory in terms of the "totality" of things. And he looked at the capitalistic economy from a more realistic point of view than had some of his predecessors. Second, Keynes took many of the unorthodox concepts which had long been present in the "underworld" of economic theory and molded them into a system. This was a major contribution, but it
did not constitute a revolution. These concepts all revolved around the doctrine of effective demand, and it is this doctrine upon which hangs the entire Keynesian idea system. And third, the General Theory appeared at an opportune time in the history of capitalism. Every industrial nation was deep in the throes of a depression. The economics of Keynes appeared to be able to point the way out, to relieve human misery, to answer burning economic questions and resolve social issues.

These three factors in combination created a bench-mark in the history of economic theory, but the General Theory did not constitute a break or create a new beginning in the history of economic thought. It was simply an important part in the evolution of economic theory.
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VITA

Leon F. Lee was born in Sentinel, Oklahoma, December 16, 1914. He was graduated from the Beaver High School, Beaver, Oklahoma, in 1933. He received his B. A. degree from the University of Oklahoma in 1940.

He accepted a position to teach economics, sociology, and government in the Muskogee, Oklahoma High School and Junior College in the fall of 1942. He moved to the Guthrie, Oklahoma High School in the fall of 1944, where for two years he taught biology and coached junior high school football and basketball.

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In 1935, he married the former Miss Ruby Reola Foster of Beaver, Oklahoma.
EXAMINATION AND THESIS REPORT

Candidate: Leon F. Lee

Major Field: Economics

Title of Thesis: The Place of Keynes in the History of Economic Theory

Approved:

[Signatures]

Major Professor and Chairman

Dean of the Graduate School

EXAMINING COMMITTEE:

[Signatures]

Date of Examination: March 14, 1956