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The General Theory after Sixty Years: History or Economic Laws?

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2.1 Introduction

My attempt to evaluate the significance of *The General Theory of employment interest and money* will focus on the concept of effective demand beginning with a set of considerations vis à vis Classical and Marxian political economy. Indeed the principle of effective demand can be much more directly related to this body of thought rather than to Marginalist inspired doctrines. Furthermore Marginalism in its modern form has become so much devoid of conceptual content as to be challenged on methodological grounds by some of its most qualified practitioners (Clower, 1994; Malinvaud, 1995). In the process of the discussion it will be shown that Keynes was not wrong in dubbing all his predecessors as Classical. Finally, I will argue that during the long boom the level of aggregate investment has been determined in the main by external - non economic factors, thereby confirming Kalecki's and Keynes's sceptical views about the existence of endogenously created long-run propulsive forces.

2.2 The Classics: Marx

I have chosen to take Marx as the Classical reference with which to compare Keynes's notion of effective demand since the author of *The General Theory* himself in a famous letter to Bernard Shaw—reprinted on the back cover of the Macmillan paperback editions of the book—stated that his work will knock away the Ricardian foundations of Marxism. In reality, however, it was Kalecki who—proceeding from the Marxism elaborated in Central Europe—departed from Marx's framework (Halevi, 1992). I will therefore discuss both Keynes's and Kalecki's contributions.

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Marx addressed the questions of a fully industrialized economy and, in this context, he brought Classical thought to its peak. In particular, Marx, by breaking with Malthusian naturalism, invented the first, and still the most logically robust, theory of the business cycle. One of the several achievements of the first volume of *Das Kapital* lies in making the process of investment and accumulation completely endogenous to the capitalist system. This is obtained through the well known mechanism of the Reserve Army of Labor, which, in turn, is based on the Classical hypothesis of the inverse relationship between the wage rate and the rate of profits. A simple set of accounting identities will clarify the point.

Consider X to be total corn output, K the corn stock of capital, d its rate of depreciation, a the output capital coefficient, w the corn wage rate and n the number of workers operating one unit of the corn stock of capital. The accounting relation for total net corn profits P is then:

(1) $P = X - W - dK$ where $d = 1$ with circulating capital at full capacity

(2) $X = aK$

(3) $W = wnK$ where nK = Employment E, $W = wE$

Substituting equations (2) and (3) into (1) and dividing by K we obtain the expression for the rate of profit:

(4) $r = [a - wn - d]$ where: $d = 1$ at full capacity

From equation (4) we see that the rate of profits is always inversely related to the wage rate, positively related to the output coefficient a and positively related to any decline in the labor capital coefficient n induced by technical progress. If we leave aside the special case of a falling rate of profit in the long run, due to a fall in a not matched by a greater fall in n, Marx's theory of the business cycle is entirely captured by equation (4). Capitalists, pushed by competition strive to invest all the surplus or most of it. Hence:

(5) $sP = I = dK$ where s is the propensity to save out of profits and it is very near 1.

(6) $g = sr$ where g is the rate of accumulation.

In accounting terms (6) is similar to the Cambridge equation of distribution which in a Kaldor-Pasinetti model operates ex hypothesis in a fully employed economy with steady growth. Yet in Marx the behavior of accumulation is based on a strong cyclical variation in the share of profits over output and in the rate of profit, both positively related to each other. In *Das Kapital*, the productive powers unleashed by modern capitalism—always strongly associated with machine production—cannot allow accumulation

to be limited by the natural increase in population. Thus, as capitalism initially develops from a small industrial core, it draws from the surplus population emanating from the hitherto non-capitalistic branches of the economy. Furthermore, greater productivity brings about a ruination of the petty commodity producer, which, along with the dispossession of the people living by natural right on the land, causes a systemic surplus population available for capitalistic exploitation.

As a consequence, having nothing but only their labor power to sell, these people will drive down the real wage rate. On the basis of equation (4) the fall in the wage rate is ipso facto transformed into a higher rate of profit, into a higher share of profit over national income and into a higher share of investment over total output. It follows that the presence of a surplus population speeds up the rate of accumulation and growth through the rise it induces in r (see equation 6). This is the inescapable conclusion stemming from Marx's own discussion of the law of capital accumulation presented in chapter 25 of the first volume of *Capital*. Subsequently, the quickening of the pace of accumulation will eventually bring about a dwindling of the Reserve Army of Labor. Wage rates rise and the rate and share of profits fall as prescribed by (4). Remember now that Marx adhered strictly to the Classical notion of competition, so that in the face of rising wages induced by a decline in the Reserve Army, firms can only react by changing the technological structure of production. In other words Marx's phrase according to which competition "compels [the individual capitalist] to constantly extend his capital in order to preserve it, but extend it he cannot except by means of progressive accumulation" (Marx, 1977 I, p.555), means that firms keep investing most of their surplus no matter how meagre it has become. Yet they will do so by demanding labor saving capital goods which is the only way firms can face up to the profit squeeze generated by the dwindling of the Reserve Army. Such a type of technical change will reduce the quantity of labor—n—needed to operate each unit of machinery, resulting in technological unemployment compounded by the slow intake of workers into production due to the profit/investment squeeze. The formation of large scale unemployment will expand the Reserve Army and the wage rate will fall setting the stage for the cyclical upturn as predicted by equation (4). Through technical change the expansion of capitalist accumulation does not have to rely on surplus labor from pre-capitalist sector. The systemic fall in the labor coefficient n induced by the profit squeeze, will ensure an internal surplus population totally functional to the requirements of accumulation.

We may conclude this section by observing that Marx's system is very predictable once the Classical mechanism of the formation of a general rate of profit is combined with the specific interaction between the Reserve Army of Labor, the profit squeeze and the labor-saving process caused by the latter. Investment is virtually identical to surplus creation and the ratio of investment to the stock of capital approximates the rate of profits. This ratio will rise or fall according to whether or not the Reserve Army is large (or small)

enough to allow for a wage or a profit squeeze. It follows that investment is endogenously determined and so is the dynamics of technical change.

2.3 Effective Demand: The End of Marxian Laws

In Marx the cyclical variation in the rate of profits and in the distribution of income, constitute, with the long-run theory of the falling rate of profits, the General Law of capital accumulation. The Law leaves very little room for the working of the principle of effective demand. According to the Law unemployment brings down the wage rate and, with it, effective demand for consumption goods. At the same time the lower real wage restores the rate of profits and, through the endogenous creation of investment, it contributes to the next upswing. If we now think in terms of a two sector system, it will become apparent the problem of effective demand will tame Marx's optimistic views about the immanent dynamism of capitalist accumulation.

The endogenous expansion of the Reserve Army of Labor, by means of labor saving investments, will curtail effective demand for consumption goods thereby creating unused capacity in the consumption goods sector. If such a rise in unemployment leads also to a decline in the real wage rate, further unused capacity will emerge in the consumption goods industries. Under these circumstances, the level of investment demand stemming from the consumption goods sector is likely to suffer causing unwanted unused capacity in the investment goods industries. As a consequence, the system instead of moving onto a higher rate of accumulation, as prescribed by Marx's theory of cyclical growth, will plunge into a state of chronic depression with structural unused capacity. In other words, the Reserve Army will not be used to restart the process of growth. It follows that Marx's reliance on the competitive tendency to a uniform rate of profits in order to force the capitalist to constantly extend his capital by means of progressive accumulation, was excessive.

The introduction of effective demand considerations into Marx's own framework has actually derailed the working of the fundamental Law of capital accumulation, while reducing, at the same time, the importance ascribed to the formation of a general and uniform rate of profits. Not only is the system no longer able to implement its compulsion to accumulate but, with the emergence of unused capacity as a structural phenomenon, the rate of profits need not be systematically inversely related to the wage rate. Hence:

(7) $p = u(a - wn - d)$ where p is the new rate of profits when the rate of capacity utilization – u – is less than unity.

Differentiation of p in relation to both u and w, shows that the rate of profits will not be, in general, inversely related to the wage rate because of the capacity utilization factor u. Such a factor cannot be taken as stable or as adjusting to a desired value u*. For u* to exist as a meaningful target, even

as an attractor, the process of accumulation should have a built-in tendency towards a steady state, an event that modern growth theory has shown to be extremely remote (Halevi and Kriesler, 1991).

As a consequence, the formation of unused capacity is not just an occurrence at the bottom of the crisis which will be weeded out by bankruptcies—due to price deflation—thereby leaving a clean terrain for the subsequent recovery. The principle of effective demand makes the rate of capacity utilization emerge as a persistent feature in the working of a capitalist economy. In other words, as Pasinetti has pointed out, the difference between actual and potential output is a central characteristic of an industrial system (Pasinetti, 1974).

In terms of the example given above, the upshot of the discussion is that if wages fall as prescribed by the conditions of recovery in the Marxian trade cycle, the system instead of reaching out towards the higher notional rates of profits and growth, is likely to move to a lower rate of capacity utilization in both the consumption and the capital goods industries. In this context, the unemployed cease to function as a Reserve Army of Labor and their role is no longer that of regulating the cyclical expansion of capitalist production. Unemployment is the product of the failure to invest as correctly understood by Keynes. Let us note that once the regular or normal pattern of classical accumulation is broken, workers can claim for higher wages also under conditions of mass unemployment.

With investment being determined by, and being the determinant of, the level of effective demand and output, the Classical laws of motion lose their thrust. We simply no longer know what the direction and the share of investment will be. To go back to our example of a fall in consumption demand due to the impact of unemployment, we could say that, with the appearance of unused capacity in both sectors, it is impossible to establish in a convincing functional way the level of investment, which therefore may be treated as exogenously determined. Profits, while continuing to be the main objective of capitalist production, do not lead accumulation but depend on the externally given level of investment, as described by Kalecki in the formula (Kalecki, 1971, p. 2):

(8) $P = (B + A)/s$ $\qquad$ B = autonomous capitalists' consumption

Where A is investment (gross accumulation in Kalecki) and s is the propensity to save out of profits. Investment appears as an exogenous factor; its changes are not functionally related to variations in the share of profits over output (Kalecki, 1971). Under these conditions it becomes impossible to map out a regular investment and cyclical pattern of accumulation. In this way, Classical laws, centered on the link between the tendency towards a uniform rate of profits and accumulation, cease to act as gravitational and inertial forces.

Nowhere is such a break with the long-run dynamics portrayed by Marxian political economy as clear as in Kalecki's treatment of wages and class struggle in an effective demand framework. It suffices to compare Kalecki's *Money and real wages* (1939) and *Class struggle and distribution of national income* (1971), with Marx's *Wages Price and Profit* which is based entirely on the theory of cyclical growth summarized earlier. In the first of the two essays Kalecki argued that unemployment and the business cycle exist also in a flex-price system. Hence if money wages are reduced in the presence of unemployment, prices will decline pro-tanto leaving the situation unchanged. By contrast, under conditions of imperfect competition the same fall in money wages will be accompanied by a lesser flexibility in prices which will cut real effective demand for wage goods. As a consequence unemployment is not due to the particular strength of collective bargaining. The same argument is reiterated in a more dynamic form in the 1971 essay where Kalecki assumed an overall increase in money wages. In this case, if prices were to increase exactly by the same proportion the system would be a perfectly competitive one. If prices do not rise as much as wages, markups will shrink and employment will expand under the impact of higher consumption demand. It follows that according to the principle of effective demand, collective bargaining is not the cause of unemployment while its role in an expansionary situation is to cut into the markup of oligopolistic firms thereby ensuring a higher level of demand. This result is made possible by the link between oligopolistic pricing and unused capacity which, according to Kalecki, is always present in the system.

From Marx's point of view, as expressed in *Wages Price and Profit*, the ideas put forward by Kalecki would make little sense. Wages, Marx would say, do not rise and fall independently from the rate of accumulation which determines the size of the Reserve Army of Labor. The dependence of the dynamics of real wages upon the rate of accumulation implies that variations in wages have no impact on the prices of commodities but affect distribution instead. Marx therefore sees the attempts to raise money wages as a response to a rise in the value of labor power measured in terms of the hours socially necessary to produce the basket of wage goods. Such a view stems from the fact that the share of investment is endogenously determined and its long-term function is to restore the conditions of accumulation in an upward, albeit cyclical, direction.

The comparison between Marx and Kalecki, who developed the concept of effective demand better than Keynes, allows us, however, to conclude that Keynes was correct in labelling all the economists before him as *Classical*. Indeed for both Classical and Marginalist economists the act of saving is nothing but a procedure leading to investment. In the Classics, the size of the surplus and level of profits are synonymous, while savings are almost identical to profits. Thus Classical causality runs from Surplus to Profits to Investment to Accumulation and, if all profits are saved, these terms are

just the same expression for the increment in the stock of capital. For the Marginalists the process is more complicated because of the intervening role of the rate of interest to equilibrate the supply for and the demand of capital (saving and Investment) at full employment. Both approaches do assume that a prior pool of savings and profit is the necessary condition for investment to occur. In this respect Marginalist and Classical political economy, although in conflict on the crucial questions of value and distribution are conservative in nature when confronted with the implications of the concept of effective demand. In this context Keynes's view that an act of individual saving is "not a substitution of future consumption demand for present consumption demand", but it is "a net diminution of such demand" can be applicable also to a Classical framework (Keynes, 1936, p. 210). In the latter case instead of referring to an intertemporal consumption preference it would be necessary to specify that an act of saving does not constitute an act of accumulation.

2.4 Dynamics as Short-Period Analysis

It follows that the principle of effective demand frees one's thoughts from the constraints arising from deterministic regularities. The persistent formation of unused capacity without any systemic target rate of capacity utilization, allows both wage rates and profit rates to rise in tandem with increases in the degree of capacity utilization. Under conditions of technical change and rising productivity the positive relation between wage and profit rates becomes notionally the norm.

Therefore Keynes's conceptual framework is liberated from the iron clad laws concerning the link between accumulation and the rate of profits. In Keynes's world there is no reason to wait for the accumulation of profits in order to generate investment. The latter can be financed by credit and profits turn out to be the ex-post accounting saving generated by prior investment. At the same time contradictions do arise but not because of the need to accumulate profits in order to finance investment.

The absence of deterministic and mechanical tendencies implies that the fundamental conflict lies not in the rate of profits versus the wage rate but in the internal composition of the capitalist classes.

A monetary economy cannot be conceived without the existence of financial markets. These markets do not act just as intermediaries facilitating investment. In a sophisticated economy they generate alternative means in which wealth can be held. In so doing financial markets give rise to very strong constraints on firms' plans and on banks' credit (Parguez, 1996a) To satisfy the constraints imposed by the financial sector, industrial firms—which in a monetary economy tend to operate on a debt basis—have to generate a certain rate of return which includes the interest to be paid on their debts. Now, as pointed out by Parguez (1996b, 1994), positive

expectations about the future capital value of firms determine productive decisions. Firms' debts are held by traders in the financial markets which include the banks themselves. If these anticipate a fall in the future capital values of firms relatively to firms' demand for credit, private financial institutions would impose credit rationing on firms' expenditure plans. Firms must convince financial markets of their profitability being thereby pushed to increase their rate of return at the expense of wages *prior* to an expansion in output which—by increasing the rate of capacity utilization—would have accommodated both a higher rate of profits and a higher wage rate.

The conflict between long-term investment and the alternative ways in which savings can be held in a monetary economy, was expressed by Keynes in chapter 12 of *The General theory*, titled the "State of Long-Term Expectation". The chief lesson from reading that chapter is that long-term expectations, which sustain the investment process, cannot be anchored to any robust and predictable behavioral pattern, unless institutions and State policies are brought in explicitly. In other words, a pure theory of investment is impossible. Thus, any discussion about the macroeconomic impact of investment cannot be but placed in its specific historical and political setting and cannot be derived from models where virtually all the variables are economic ones in the most abstract sense of the word. Indeed, this is according to me the main reason why Kalecki's post war attempts to build a theory of investment have failed. It is not a coincidence that Kalecki's work is remembered in relation to mark up pricing as well as for the connection between effective demand and reproduction schemes. Yet his approach to the determinants of investment is hardly mentioned. Indeed, if the economy—that is the society—is portrayed by the level of output as a whole which is made to depend on the level of aggregate investment, then the latter is inseparable from the socio-political circumstances in which it occurs. It is much better to treat it as an exogenous variable.

2.5 Politics as the Source of Exogenous Impulses

The idea that the determinants of investment can only partly be found within the spectrum of the decisions taken by individual firms, introduces a conceptual break in the historical reading of the process of economic evolution. I will now give some examples of the different perspective that emerges form looking at investment not as resulting from endogenous accumulation but as determined by ad hoc historical and political circumstances. I will concentrate on certain aspects of East Asian industrialization.

A great deal of to day's Japanese brand names are companies whose industrial strength emerged during the 1930s, that is during a period of world depression. In Japan the same decade marked the phase of heavy and chemical industrialization. The source of the process was not at all endogenous. It originated in the political response to the crisis that hit Japan with the

onset of the Great Depression in the United States. In 1931, Japan embarked on a renewed imperialist expansion towards China and the militarization imposed upon the economy was the single most important factor in the process of heavy and chemical industrial growth and of technological change (Johnson, 1982).

Imperial expansion while industrializing the economy could not solve Japan's balance of payments problems since the yen area did not create enough surpluses with the rest of the world to finance Japan's deficits (Nakamura, 1983). The more Japan expanded into China, the more it encroached upon American interests, eventually leading to a global conflict. After the WWII the essential phases of Japanese reconstruction and capital accumulation were also determined by ad hoc circumstances rather than by immanent long-period forces. The only long-period force is the determination to industrialize which has guided and united institutions with the private Zaibatsu system (Calder, 1993). By itself this orientation was not sufficient to guarantee long-term accumulation. As shown by the outcome of the military expansion of the 1930s such a volition can encounter insurmountable barriers, which are first and foremost political in character such as the specific interests of the United States at the time.

After 1945 even the integration of Japan into the American system as a key factor in countering the emergence of the movements of national independence in Asia and of the People's Republic of China, did not provide sufficient momentum for the Zaibatsus to regain confidence and animal spirits. What really brought accumulation back was the Korean war and the subsequent financial and diplomatic measures undertaken by the USA to wrap Japan in a highly protected environment, made even safer by the long wave of Washington's public expenditure in Asia engendered by the Vietnam war (Schaller, 1985).

In conclusion, if capitalism's dynamics does not depend on endogenous systemic laws governing accumulation, it is quite legitimate to invert the Marxian concern with the economic base and to consider socio-political and power relations as the main determinants of the pattern of economic activity. Keynes's ultimate indeterminacy as to the forces leading investment decisions tells us just that.

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