General Theory of Employment, Chapters One and Two

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Chapter 1: The General Theory

I have called this book the General Theory of Employment, Interest and Money, placing the emphasis on the prefix general. The object of such a title is to contrast the character of my arguments and conclusions with those of the classical theory of the subject, upon which I was brought up and which dominates the economic thought, both practical and theoretical, of the governing and academic classes of this generation, as it has for a hundred years past. I shall argue that the postulates of the classical theory are applicable to a special case only and not to the general case, the situation which it assumes being a limiting point of the possible positions of equilibrium. Moreover, the characteristics of the special case assumed 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 misleading and disastrous if we attempt to apply it to the facts of experience.

Chapter 2: The Postulates of the Classical Economics

Most treatises on the theory of Value and Production are primarily concerned with the distribution of a given volume of employed resources between different uses and with the conditions which, assuming the employment of this quantity of resources, determine their relative rewards and the relative values of their products. The question, also, of the volume of the available resources, in the sense of the size of the employable population, the extent of natural wealth and the accumulated capital equipment, has often been treated descriptively. But the pure theory of what determines the actual employment of the available resources has seldom been examined in great detail. To say that it has not been examined at all would, of course, be absurd. For every discussion concerning fluctuations of employment, of which there have been many, has been concerned with it. I mean, not that the topic has been overlooked, but that the fundamental underlying it has been deemed so simple and obvious that it has received, at the most, a bare mention.

I

The classical theory of employment—supposedly simple and obvious—has been based, I think, on two fundamental postulates, though practically without discussion, namely:

I. The wage is equal to the marginal product of labour.
That is to say, the wage of an employed person is equal to the value which would be lost if employment were to be reduced by one unit (after deducting any other costs which this reduction of output would avoid); subject, however, to the qualification that the equality may be disturbed, in accordance with certain principles, if competition and markets are imperfect.

II. The utility of the wage when a given volume of labour is employed is equal to the marginal disutility of that amount of employment.
That is to say, the real wage of an employed person is that which is just sufficient (in the estimation of the employed persons themselves) to induce the volume of labour actually employed to be forthcoming; subject to the qualification that the equality for each individual unit of labour may be disturbed by combination between employable units analogous to the imperfections of competition which qualify the first postulate. Disutility must be here understood to cover every kind of reason which might lead a man, or a body of men, to withhold their labour rather than accept a wage which had to them a utility below a certain minimum.

This postulate is compatible with what may be called 'frictional' unemployment. For a realistic interpretation of it legitimately allows for various inexactnesses of adjustment which stand in the way of continuous full employment: for
example, unemployment due to a temporary want of balance between the relative quantities of specialized resources as a result of miscalculation or intermittent demand; or to time-lags consequent on unforeseen changes; or to the fact that the change-over from one employment to another cannot be effected without a certain delay, so that there will always exist in a non-static society a proportion of resources unemployed 'between jobs'. In addition to 'frictional' unemployment, the postulate is also compatible with 'voluntary' unemployment due to the refusal or inability of a unit of labour, as a result of legislation or social practices or of combination for collective bargaining or of slow response to change or of mere human obstinacy, to accept a reward corresponding to the value of the product attributable to its marginal productivity. But these two categories of 'frictional' unemployment and 'voluntary' unemployment are comprehensive. The classical postulates do not admit of the possibility of the third category, which I shall define below as 'involuntary' unemployment.

Subject to these qualifications, the volume of employed resources is duly determined, according to the classical theory, by the two postulates. The first gives us the demand schedule for employment, the second gives us the supply schedule; and the amount of employment is fixed at the point where the utility of the marginal product balances the disutility of the marginal employment.

It would follow from this that there are only four possible means of increasing employment:

(a) An improvement in organisation or in foresight which diminishes 'frictional' unemployment;
(b) a decrease in the marginal disutility of labour, as expressed by the real wage for which additional labour is available, so as to diminish 'voluntary' unemployment;
(c) an increase in the marginal physical productivity of labour in the wage-goods industries (to use Professor Pigou's convenient term for goods upon the price of which the utility of the money-wage depends); or
(d) an increase in the price of non-wage-goods compared with the price of wage-goods, associated with a shift in the expenditure of non-wage-earners from wage-goods to non-wage-goods.

This, to the best of my understanding, is the substance of Professor Pigou's *Theory of Unemployment*—the only detailed account of the classical theory of employment which exists.  

II

Is it true that the above categories are comprehensive in view of the fact that the population generally is seldom doing as much work as it would like to do on the basis of the current wage? For, admittedly, more labour would, as a rule, be forthcoming at the existing money-wage if it were demanded. The classical school reconcile this phenomenon with their second postulate by arguing that, while the demand for labour at the existing money-wage may be satisfied before everyone willing to work at this wage is employed, this situation is due to an open or tacit agreement amongst workers not to work for less, and that if labour as a whole would agree to a reduction of money-wages more employment would be forthcoming. If this is the case, such unemployment, though apparently involuntary, is not strictly so, and ought to be included under the above category of 'voluntary' unemployment due to the effects of collective bargaining, etc.

This calls for two observations, the first of which relates to the actual attitude of workers towards real wages and money-wages respectively and is not theoretically fundamental, but the second of which is fundamental.

Let us assume, for the moment, that labour is not prepared to work for a lower money-wage and that a reduction in the existing level of money-wages would lead, through strikes or otherwise, to a withdrawal from the labour market of labour which is now employed. Does it follow from this that the existing level of real wages accurately measures the marginal disutility of labour? Not necessarily. For, although a reduction in the existing money-wage would lead to a withdrawal of labour, it does not follow that a fall in the value of the existing money-wage in terms of wage-goods would do so, if it were due to a rise in the price of the latter. In other words, it may be the case that within a certain range the demand of labour is for a minimum money-wage and not for a minimum real wage. The classical school have tacitly assumed that this would involve no significant change in their theory. But this is not so. For if the supply of labour is not a function of real wages as its sole variable, their argument breaks down entirely and leaves the question of what the actual employment will be quite indeterminate. They do not seem to have realized that, unless the supply of labour is a function of real wages alone, their supply curve for labour will shift bodily with every movement of prices. Thus their method is tied up with their very special assumptions, and cannot be adapted to deal with the more general case.

Now ordinary experience tells us, beyond doubt, that a situation where labour stipulates (within limits) for a money-wage rather than a real wage, so far from being a mere possibility, is the normal case. Whilst workers will usually resist a reduction of money-wages, it is not their practice to withdraw their labour whenever there is a rise in the price of
wage-goods. It is sometimes said that it would be illogical for labour to resist a reduction of money-wages but not to resist a reduction of real wages. For reasons given below, this might not be so illogical as it appears at first; and, as we shall see later, fortunately so. But, whether logical or illogical, experience shows that this is how labour in fact behaves.

Moreover, the contention that the unemployment which characterizes a depression is due to a refusal by labour to accept a reduction of money-wages is not clearly supported by the facts. It is not very plausible to assert that unemployment in the United States in 1932 was due either to labour obstinately refusing to accept a reduction of money-wages or to its obstinately demanding a real wage beyond what the productivity of the economic machine was capable of furnishing. Wide variations are experienced in the volume of employment without any apparent change either in the minimum real demands of labour or in its productivity. Labour is not more truculent in the depression than in the boom—far from it. Nor is its physical productivity less. These facts from experience are prima facie ground for questioning the adequacy of the classical analysis.

It would be interesting to see the results of a statistical enquiry into the actual relationship between changes in money-wages and changes in real wages. In the case of a change peculiar to a particular industry one would expect the change in real wages to be in the same direction as the change in money-wages. But in the case of changes in the general level of wages, it will be found, I think, that the change in real wages associated with a change in money-wages, so far from being usually in the same direction, is almost always in the opposite direction. When money-wages are rising, that is to say, it will be found that real wages are falling; and when money-wages are falling, real wages are rising. This is because, in the short period, falling money-wages and rising real wages are each, for independent reasons, likely to accompany decreasing employment; labour being readier to accept wage-cuts when employment is falling off, yet real wages inevitably rising in the same circumstances on account of the increasing marginal return to a given capital equipment when output is diminished.

If, indeed, it were true that the existing real wage is a minimum below which more labour than is now employed will not be forthcoming in any circumstances, involuntary unemployment, apart from frictional unemployment, would be non-existent. But to suppose that this is invariably the case would be absurd. For more labour than is at present employed is usually available at the existing money-wage, even though the price of wage-goods is rising and, consequently, the real wage falling. If this is true, the wage-goods equivalent of the existing money-wage is not an accurate indication of the marginal disutility of labour, and the second postulate does not hold good.

But there is a more fundamental objection. The second postulate flows from the idea that the real wages of labour depend on the wage bargains which labour makes with the entrepreneurs. It is admitted, of course, that the bargains are actually made in terms of money, and even that the real wages acceptable to labour are not altogether independent of what the corresponding money-wage happens to be. Nevertheless it is the money-wage thus arrived at which is held to determine the real wage. Thus the classical theory assumes that it is always open to labour to reduce its real wage by accepting a reduction in its money-wage. The postulate that there is a tendency for the real wage to come to equality with the marginal disutility of labour clearly presumes that labour itself is in a position to decide the real wage for which it works, though not the quantity of employment forthcoming at this wage.

The traditional theory maintains, in short, that the wage bargains between the entrepreneurs and the workers determine the real wage; so that, assuming free competition amongst employers and no restrictive combination amongst workers, the latter can, if they wish, bring their real wages into conformity with the marginal disutility of the amount of employment offered by the employers at that wage. If this is not true, then there is no longer any reason to expect a tendency towards equality between the real wage and the marginal disutility of labour.

The classical conclusions are intended, it must be remembered, to apply to the whole body of labour and do not mean merely that a single individual can get employment by accepting a cut in money-wages which his fellows refuse. They are supposed to be equally applicable to a closed system as to an open system, and are not dependent on the characteristics of an open system or on the effects of a reduction of money-wages in a single country on its foreign trade, which lie, of course, entirely outside the field of this discussion. Nor are they based on indirect effects due to a lower wages-bill in terms of money having certain reactions on the banking system and the state of credit. They are based on the belief that in a closed system a reduction in the general level of money-wages will be accompanied, at any rate in the short period and subject only to minor qualifications, by some, though not always a proportionate, reduction in real wages.

Now the assumption that the general level of real wages depends on the money-wage bargains between the employers and the workers is not obviously true. Indeed it is strange that so little attempt should have been made to
prove or to refute it. For it is far from being consistent with the general tenor of the classical theory, which has taught us to believe that prices are governed by marginal prime cost in terms of money and that money-wages largely govern marginal prime cost. Thus if money-wages change, one would have expected the classical school to argue that prices would change in almost the same proportion, leaving the real wage and the level of unemployment practically the same as before, any small gain or loss to labour being at the expense or profit of other elements of marginal cost which have been left unaltered. They seem, however, to have been diverted from this line of thought partly by the settled conviction that labour is in a position to determine its own real wage and partly, perhaps, by preoccupation with the idea that prices depend on the quantity of money. And the belief in the proposition that labour is always in a position to determine its own real wage, once adopted, has been maintained by its being confused with the proposition that labour is always in a position to determine what real wage shall correspond to full employment, i.e., the maximum quantity of employment which is compatible with a given real wage.

To sum up: there are two objections to the second postulate of the classical theory. The first relates to the actual behaviour of labour. A fall in real wages due to a rise in prices, with money-wages unaltered, does not, as a rule, cause the supply of available labour on offer at the current wage to fall below the amount actually employed prior to the rise of prices. To suppose that it does is to suppose that all those who are now unemployed though willing to work at current wage will withdraw the offer of their labour in the event of even a small rise in the cost of living. Yet this strange supposition apparently underlies Professor Pigou's Theory of Unemployment, and it is what all members of the orthodox school are tacitly assuming.

But the other, more fundamental, objection, which we shall develop in the ensuing chapters, flows from our disputing the assumption that the general level of real wages is directly determined by the character of the wage bargain. In assuming that the wage bargain determines the real wage the classical school have slipped in an illicit assumption. For there may be no method available to labour as a whole whereby it can bring the wage-goods equivalent of the general level of money-wages into conformity with the marginal distiluity of the current volume of employment. There may exist no expedient by which labour as a whole can reduce its real wage to a given figure by making revised money bargains with the entrepreneurs. This will be our contention. We shall endeavour to show that primarily it is certain other forces which determine the general level of real wages. The attempt to elucidate this problem will be one of our main themes. We shall argue that there has been a fundamental misunderstanding of how in this respect the economy in which we live actually works.

III

Though the struggle over money-wages between individuals and groups is often believed to determine the general level of real wages, it is, in fact, concerned with a different object. Since there is imperfect mobility of labour, and wages do not tend to an exact equality of net advantage in different occupations, any individual or group of individuals, who consent to a reduction of money-wages relatively to others, will suffer a relative reduction in real wages, which is a sufficient justification for them to resist it. On the other hand it would be impracticable to resist every reduction of real wages, due to a change in the purchasing-power of money which affects all workers alike; and in fact reductions of real wages arising in this way are not, as a rule, resisted unless they proceed to an extreme degree. Moreover, a resistance to reductions in money-wages applying to particular industries does not raise the same insuperable bar to an increase in aggregate employment which would result from a similar resistance to every reduction in real wages.

In other words, the struggle about money-wages primarily affects the distribution of the aggregate real wage between different labour-groups, and not its average amount per unit of employment, which depends, as we shall see, on a different set of forces. The effect of combination on the part of a group of workers is to protect their relative real wage. The general level of real wages depends on the other forces of the economic system.

Thus it is fortunate that the workers, though unconsciously, are instinctively more reasonable economists than the classical school, inasmuch as they resist reductions of money-wages, which are seldom or never of an all-round character, even though the existing real equivalent of these wages exceeds the marginal distiluity of the existing employment; whereas they do not resist reductions of real wages, which are associated with increases in aggregate employment and leave relative money-wages unchanged, unless the reduction proceeds so far as to threaten a reduction of the real wage below the marginal distility of the existing volume of employment. Every trade union will put up some resistance to a cut in money-wages, however small. But since no trade union would dream of striking on every occasion of a rise in the cost of living, they do not raise the obstacle to any increase in aggregate employment which is attributed to them by the classical school.
IV

We must now define the third category of unemployment, namely 'involuntary' unemployment in the strict sense, the possibility of which the classical theory does not admit. Clearly we do not mean by 'involuntary' unemployment the mere existence of an unexhausted capacity to work. An eight-hour day does not constitute unemployment because it is not beyond human capacity to work ten hours. Nor should we regard as 'involuntary' unemployment the withdrawal of their labour by a body of workers because they do not choose to work for less than a certain real reward. Furthermore, it will be convenient to exclude 'frictional' unemployment from our definition of 'involuntary' unemployment. My definition is, therefore, as follows: Men are involuntarily unemployed if, in the event of a small rise in the price of wage-goods relatively to the money-wage, both the aggregate supply of labour willing to work for the current money-wage and the aggregate demand for it at that wage would be greater than the existing volume of employment.

It follows from this definition that the equality of the real wage to the marginal disutility of employment presupposed by the second postulate, realistically interpreted, corresponds to the absence of 'involuntary' unemployment. This state of affairs we shall describe as 'full' employment, both 'frictional' and 'voluntary' unemployment being consistent with 'full' employment thus defined. This fits in, we shall find, with other characteristics of the classical theory, which is best regarded as a theory of distribution in conditions of full employment. So long as the classical postulates hold good, unemployment, which is in the above sense involuntary, cannot occur. Apparent unemployment must, therefore, be the result either of temporary loss of work of the 'between jobs' type or of intermittent demand for highly specialized resources or of the effect of a trade union 'closed shop' on the employment of free labour. Thus writers in the classical tradition, overlooking the special assumption underlying their theory, have been driven inevitably to the conclusion, perfectly logical on their assumption, that apparent unemployment (apart from the admitted exceptions) must be due at bottom to a refusal by the unemployed factors to accept a reward which corresponds to their marginal productivity. A classical economist may sympathize with labour in refusing to accept a cut in its money-wage, and he will admit that it may not be wise to make it to meet conditions which are temporary; but scientific integrity forces him to declare that this refusal is, nevertheless, at the bottom of the trouble.

Obviously, however, if the classical theory is only applicable to the case of full employment, it is fallacious to apply it to the problems of involuntary unemployment—if there be such a thing (and who will deny it?). The classical theorists resemble Euclidean geometries in a non-Euclidean world who, discovering that in experience straight lines apparently parallel often meet, rebuke the lines for not keeping straight—as the only remedy for the unfortunate collisions which are occurring. Yet, in truth, there is no remedy except to throw over the axiom of parallels and to work out a non-Euclidean geometry. Something similar is required today in economics. We need to throw over the second postulate of the classical doctrine and to work out the behaviour of a system in which involuntary unemployment in the strict sense is possible.

V

In emphasising our point of departure from the classical system, we must not overlook an important point of agreement. For we shall maintain the first postulate as heretofore, subject only to the same qualifications as in the classical theory; and we must pause for a moment, to consider what this involves.

It means that, with a given organization, equipment and technique, real wages and the volume of output (and hence of employment) are uniquely correlated, so that, in general, an increase in employment can only occur to the accompaniment of a definite in the rate of real wages. Thus I am not disputing this vital fact which the classical economists have (rightly) asserted as indefeasible. In a given state of organization, equipment and technique, the real wage earned by a unit of labour has a unique (inverse) correlation with the volume of employment. Thus if employment increases, then, in the short period, the reward per unit of labour in terms of wage-goods must, in general, decline and profits increase. This is simply the obverse of the familiar proposition that industry is normally working subject to decreasing returns in the short period during which equipment etc. is assumed to be constant; so that the marginal product in the wage-good industries (which governs real wages) necessarily diminishes as employment is increased. So long, indeed, as this proposition holds, any means increasing employment must lead at the same time to a diminution of the marginal product and hence of the rate of wages measured in terms of this product.

But when we have thrown over the second postulate, a decline in employment, although necessarily associated with labour's receiving a wage equal in value to a larger quantity of wage-goods, is not necessarily due to labour's demanding a larger quantity of wage-goods; and a willingness on the part of labour to accept lower money-wages is not necessarily a remedy for unemployment. The Theory of Wages in relation to employment, to which we are here leading up, cannot be fully elucidated, however, until Chapter 19 and its appendix have been reached.
VI

From the time of Say and Ricardo the classical economists have taught that supply creates its own demand—meaning by this in some significant, but not clearly defined, sense that the whole of the costs of production must necessarily be spent in the aggregate, directly or indirectly, on purchasing the product.

In J.S. Mill's *Principles of Political Economy* the doctrine is expressly set forth:

What constitutes the means of payment for commodities is simply commodities. Each person's means of paying for the productions of other people consist of those which he himself possesses. All sellers are inevitably, and by the meaning of the word, buyers. Could we suddenly double the productive powers of the country, we should double the supply of commodities in every market; but we should, by the same stroke, double the purchasing power. Everybody would bring a double demand as well as supply; everybody would be able to buy twice as much, because every one would have twice as much to offer in exchange.

As a corollary of the same doctrine, it has been supposed that any individual act of abstaining from consumption necessarily leads to, and amounts to the same thing as, causing the labour and commodities thus released from supplying consumption to be invested in the production of capital wealth. The following passage from Marshall's *Pure Theory of Domestic Values* illustrates the traditional approach:

The whole of a man's income is expended in the purchase of services and of commodities. It is indeed commonly said that a man spends some portion of his income and saves another. But it is a familiar economic axiom that a man purchases labour and commodities with that portion of his income which he saves just as much as he does with that he is said to spend. He is said to spend when he seeks to obtain present enjoyment from the services and commodities which he purchases. He is said to save when he causes the labour and the commodities which he purchases to be devoted to the production of wealth from which he expects to derive the means of enjoyment in the future.

It is true that it would not be easy to quote comparable passages from Marshall's later work or from Edgeworth or Professor Pigou. The doctrine is never stated today in this crude form. Nevertheless it still underlies the whole classical theory, which would collapse without it. Contemporary economists, who might hesitate to agree with Mill, do not hesitate to accept conclusions which require Mill's doctrine as their premise. The conviction, which runs, for example, through almost all Professor Pigou's work, that money makes no real difference except frictionally and that the theory of production and employment can be worked out (like Mill's) as being based on 'real' exchanges with money introduced perfunctorily in a later chapter, is the modern version of the classical tradition. Contemporary thought is still deeply steeped in the notion that if people do not spend their money in one way they will spend it in another. Post-war economists seldom, indeed, succeed in maintaining this standpoint consistently; for their thought today is too much permeated with the contrary tendency and with facts of experience too obviously inconsistent with their former view. But they have not drawn sufficiently far-reaching consequences, and have not revised their fundamental theory.

In the first instance, these conclusions may have been applied to the kind of economy in which we actually live by false analogy from some kind of non-exchange Robinson Crusoe economy, in which the income which individuals consume or retain as a result of their productive activity is, actually and exclusively, the output in specie of that activity. But, apart from this, the conclusion that the *cost* of output are always covered in the aggregate by the sale-proceeds resulting from demand, has great plausibility, because it is difficult to distinguish it from another, similar-looking proposition which is indubitable, namely that the income derived in the aggregate by all the elements in the community concerned in a productive activity necessarily has a value exactly equal to the value of the output.

Similarly it is natural to suppose that the act of an individual, by which he enriches himself without apparently taking anything from anyone else, must also enrich the community as a whole; so that (as in the passage just quoted from Marshall) an act of individual saving inevitably leads to a parallel act of investment. For, once more, it is indubitable that the sum of the net increments of the wealth of individuals must be exactly equal to the aggregate net increment of the wealth of the community.

Those who think in this way are deceived, nevertheless, by an optical illusion, which makes two essentially different activities appear to be the same. They are fallaciously supposing that there is a nexus which unites decisions to abstain from present consumption with decisions to provide for future consumption; whereas the motives which determine the latter are not linked in any simple way with the motives which determine the former.
It is, then, the assumption of equality between the
demand price of output as a whole and its supply price which
is to be regarded as the classical theory's 'axiom of parallels'.
Granted this, all the rest follows—the social advantages of
private and national thrift, the traditional attitude towards
the rate of interest, the classical theory of unemployment,
the quantity theory of money, the unqualified advantages of
laissez-faire in respect of foreign trade and much else which
we shall have to question.

VII

At different points in this chapter we have made the classical
theory to depend in succession on the assumptions:

(1) that the real wage is equal to the marginal disutility of
the existing employment;

(2) that there is no such thing as involuntary unemploy-
ment in the strict sense; and

(3) that supply creates its own demand in the sense that the
aggregate demand price is equal to the aggregate supply
price for all levels of output and employment.

These three assumptions, however, all amount to the same
thing in the sense that they all stand and fall together, any one
of them logically involving the other two.

Chapter 24: Concluding Notes on the Social Philosophy Towards
Which the General Theory Might Lead

I

The outstanding faults of the economic society in which
we live are its failure to provide for full employment and its
arbitrary and inequitable distribution of wealth and incomes.
The bearing of the foregoing theory on the first of these is
obvious. But there are also two important respects in which
it is relevant to the second.

Since the end of the nineteenth century significant
progress towards the removal of very great disparities of
wealth and income has been achieved through the instru-
ment of direct taxation—income tax and surtax and death
duties—especially in Great Britain. Many people would
wish to see this process carried much further, but they are
deterred by two considerations; partly by the fear of making
skillful evasions too much worth while and also of dimin-
ishing unduly the motive towards risk-taking; but mainly, I
think, by the belief that the growth of capital depends upon
the strength of the motive towards individual saving and that
for a large proportion of this growth we are dependent on
the savings of the rich out of their superfluity. Our argu-
ment does not affect the first of these considerations. But it
may considerably modify our attitude towards the second.
For we have seen that, up to the point where full employ-
ment prevails, the growth of capital depends not at all on a
low propensity to consume, but is, on the contrary, held back
by it; and only in conditions of full employment is a low
propensity to consume conducive to the growth of capital.
Moreover, experience suggests that in existing conditions
saving by institutions and through sinking funds is more than
adequate, and that measures, for the redistribution of incomes
in a way likely to raise the propensity to consume may prove
positively favourable to the growth of capital.

The existing confusion of the public mind on the matter
is well illustrated by the very common belief that the death
duties are responsible for a reduction in the capital wealth
of the country. Assuming that the State applies the proceeds
of these duties to its ordinary outgoings so that taxes on
incomes and consumption are correspondingly reduced or
avoided, it is, of course, true that a fiscal policy of heavy death
duties has the effect of increasing the community's propen-
sity to consume. But inasmuch as an increase in the habitual
propensity to consume will in general (i.e., except in condi-
tions of full employment) serve to increase at the same time
the inducement to invest, the inference commonly drawn is
the exact opposite of the truth.

Thus our argument leads towards the conclusion that in
contemporary conditions the growth of wealth, so far from
being dependent on the abstinence of the rich as is com-
monly supposed, is more likely to be impeded by it. One of
the chief social justifications of great inequality of wealth is,
therefore, removed. I am not saying that there are no other
reasons, unaffected by our theory, capable of justifying some
measure of inequality in some circumstances. But it does dis-
pose of the most important of the reasons why hitherto we
have thought it prudent to move carefully. This particularly
affects our attitude towards death duties; for there are certain
justifications for inequality of incomes which do not apply
equally to inequality of inheritances.

For my own part, I believe that there is social and psych-
ological justification for significant inequalities of incomes
and wealth, but not for such large disparities as exist today.
There are valuable human activities which require the
motive of money-making and the environment of private
wealth-ownership for their full fruition. Moreover, dangerous human proclivities can be channeled into comparatively harmless channels by the existence of opportunities for money-making and private wealth, which, if they cannot be satisfied in this way, may find their outlet in cruelty, the reckless pursuit of personal power and authority, and other forms of self-aggrandizement. It is better that a man should tyrannize over his bank balance than over his fellow citizens; and whilst the former is sometimes denounced as being but a means to the latter, sometimes at least it is an alternative. But it is not necessary for the stimulation of these activities and the satisfaction of these proclivities that the game should be played for such high stakes as at present. Much lower stakes will serve the purpose equally well, as soon as the players are accustomed to them. The task of transmuting human nature must not be confused with the task of managing it. Though in the ideal commonwealth men may have been taught or bred to take no interest in the stakes, it may still be wise and prudent statesmanship to allow the game to be played, subject to rules and limitations, so long as the average man, or even a significant section of the community, is in fact strongly addicted to the money-making passion.

II

There is, however, a second, much more fundamental inference from our argument which has a bearing on the future of inequalities of wealth, namely, our theory of the rate of interest. The justification for a moderately high rate of interest has been found hitherto in the necessity of providing a sufficient inducement to save. But we have shown that the extent of effective saving is necessarily determined by the scale of investment and that the scale of investment is promoted by a low rate of interest, provided that we do not attempt to stimulate it in this way beyond the point which corresponds to full employment. Thus it is to our best advantage to reduce the rate of interest to that point relatively to the schedule of the marginal efficiency of capital at which there is full employment.

There can be no doubt that this criterion will lead to a much lower rate of interest than has ruled hitherto; and, so far as one can guess at the schedules of the marginal efficiency of capital corresponding to increasing amounts of capital, the rate of interest is likely to fall steadily, if it should be practicable to maintain conditions of more or less continuous full employment—unless, indeed, there is an excessive change in the aggregate propensity to consume (including the State). 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. This would not mean that the use of capital instruments would cost almost nothing, but only that the return from them would have to cover little more than their exhaustion by wastage and obsolescence together with some margin to cover risk and the exercise of skill and judgment. In short, the aggregate return from durable goods in the course of their life would, as in the case of short-lived goods, just cover their labour costs of production plus an allowance for risk and the costs of skill and supervision.

Now, though this state of affairs would be quite compatible with some measure of individualism, yet it would mean the euthanasia of the rentier, and, consequently, the euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity-value of capital. Interest today rewards no genuine sacrifice, any more than does the rent of land. The owner of capital can obtain interest because capital is scarce, just as the owner of land can obtain rent because land is scarce. But whilst there may be intrinsic reasons for the scarcity of land, there are no intrinsic reasons for the scarcity of capital. An intrinsic reason for such scarcity, in the sense of a genuine sacrifice which could only be called forth by the offer of a reward in the shape of interest, would not exist, in the long run, except in the event of the individual propensity to consume proving to be of such a character that net saving in conditions of full employment comes to an end before capital has become sufficiently abundant. But even so, it will still be possible for communal saving through the agency of the State to be maintained at a level which will allow the growth of capital up to the point where it ceases to be scarce.

I see, therefore, the rentier aspect of capitalism as a transitional phase which will disappear when it has done its work. And with the disappearance of its rentier aspect much else in it besides will suffer a sea-change. It will be, moreover, a great advantage of the order of events which I am advocating, that the euthanasia of the rentier, of the functionless investor, will be nothing sudden, merely a gradual but prolonged continuance of what we have seen recently in Great Britain, and will need no revolution.

Thus we might aim in practice (there being nothing in this which is unattainable) at an increase in the volume of capital until it ceases to be scarce, so that the functionless investor will no longer receive a bonus; and at a scheme of direct taxation which allows the intelligence and determination and executive skill of the financier, the entrepreneur et hoc genus omne (who are certainly so fond of their craft that their labour could be obtained much cheaper than at present), to be harnessed to the service of the community on reasonable terms of reward.
At the same time we must recognize that only experience can show how far the common will, embodied in the policy of the State, ought to be directed to increasing and supplementing the inducement to invest; and how far it is safe to stimulate the average propensity to consume, without forgoing our aim of depriving capital of its scarcity-value within one or two generations. It may turn out that the propensity to consume will be so easily strengthened by the effects of a falling rate of interest, that full employment can be reached with a rate of accumulation little greater than at present. In this event a scheme for the higher taxation of large incomes and inheritances might be open to the objection that it would lead to full employment with a rate of accumulation which was reduced considerably below the current level. I must not be supposed to deny the possibility, or, even the probability, of this outcome. For in such matters it is rash to predict how the average man will react to a changed environment. If, however, it should prove easy to secure an approximation to full employment with a rate of accumulation not much greater than at present, an outstanding problem will at least have been solved. And it would remain for separate decision on what scale and by what means it is right and reasonable to call on the living generation to restrict their consumption, so as to establish, in course of time, a state of full investment for their successors.

III

In some other respects the foregoing theory is moderately conservative in its implications. For whilst it indicates the vital importance of establishing certain central controls in matters which are now left in the main to individual initiative, there are wide fields of activity which are unaffected. The State will have to exercise a guiding influence on the propensity to consume partly through its scheme of taxation, partly by fixing the rate of interest, and partly, perhaps, in other ways. Furthermore, it seems unlikely that the influence of banking policy on the rate of interest will be sufficient by itself to determine an optimum rate of investment. I conceive, therefore, that a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment, though this need not exclude all manner of compromises and of devices by which public authority will co-operate with private initiative. But beyond this no obvious case is made out for a system of State Socialism which would embrace most of the economic life of the community. It is not the ownership of the instruments of production which it is important for the State to assume. 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, it will have accomplished all that is necessary. Moreover, the necessary measures of socialization can be introduced gradually and without a break in the general traditions of society.

Our criticism of the accepted classical theory of economics has consisted not so much in finding logical flaws in its analysis as in pointing out that its tacit assumptions are seldom or never satisfied, with the result that it cannot solve the economic problems of the actual world. But if our central controls succeed in establishing an aggregate volume of output corresponding to full employment as nearly as is practicable, the classical theory comes into its own again from this point onwards. If we suppose the volume of output to be given, i.e., to be determined by forces outside the classical scheme of thought, then there is no objection to be raised against the classical analysis of the manner in which private self-interest will determine what in particular is produced, in what proportions the factors of production will be combined to produce it, and how the value of the final product will be distributed between them. Again, if we have dealt otherwise with the problem of thrift, there is no objection to be raised against the modern classical theory as to the degree of consilience between private and public advantage in conditions of perfect and imperfect competition respectively. Thus, apart from the necessity of central controls to bring about an adjustment between the propensity to consume and the inducement to invest, there is no more reason to socialize economic life than there was before.

To put the point concretely, I see no reason to suppose that the existing system seriously misemploys the factors of production which are in use. There are, of course, errors of foresight; but these would not be avoided by centralizing decisions. When 9,000,000 men are employed out of 10,000,000 willing and able to work, there is no evidence that the labour of these 9,000,000 men is misdirected. The complaint against the present system is not that these 9,000,000 men ought to be employed on different tasks, but that tasks should be available for the remaining 1,000,000 men. It is in determining the volume, not the direction, of actual employment that the existing system has broken down.

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. The central controls necessary to ensure full employment will, of course, involve a large extension of the traditional functions of government. Furthermore, the modern classical theory has itself
called attention to various conditions in which the free play of economic forces may need to be curbed or guided. But there will still remain a wide field for the exercise of private initiative and responsibility. Within this field the traditional advantages of individualism will still hold good.

Let us stop for a moment to remind ourselves what these advantages are. They are partly advantages of efficiency—the advantages of decentralization and of the play of self-interest. The advantage to efficiency of the decentralization of decisions and of individual responsibility is even greater, perhaps, than the nineteenth century supposed; and the reaction against the appeal to self-interest may have gone too far. But, above all, individualism, if it can be purged of its defects and its abuses, is the best safeguard of personal liberty in the sense that, compared with any other system, it greatly widens the field for the exercise of personal choice. It is also the best safeguard of the variety of life, which emerges precisely from this extended field of personal choice, and the loss of which is the greatest of all the losses of the homogeneous or totalitarian state. For this variety preserves the traditions which embody the most secure and successful choices of former generations; it colours the present with the diversification of its fancy; and, being the handmaid of experiment as well as of tradition and of fancy, it is the most powerful instrument to better the future.

Whilst, therefore, the enlargement of the functions of government involved in the task of adjusting to one another the propensities to consume and the inducement to invest, would seem to a nineteenth-century publicist or to a contemporary American financier to be a terrific encroachment on individualism, I defend it, on the contrary, both as the only practicable means of avoiding the destruction of existing economic forms in their entirety and as the condition of the successful functioning of individual initiative.

For if effective demand is deficient, not only is the public scandal of wasted resources intolerable, but the individual enterpriser who seeks to bring these resources into action is operating with the odds loaded against him. The game of hazard which he plays is furnished with many zeros, so that the players as a whole will lose if they have the energy and hope to deal all the cards. Hitherto the increment of the world's wealth has fallen short of the aggregate of positive individual savings; and the difference has been made up by the losses of those whose courage and initiative have not been supplemented by exceptional skill or unusual good fortune. But if effective demand is adequate, average skill and average good fortune will be enough.

The authoritarian state systems of today seem to solve the problem of unemployment at the expense of efficiency and of freedom. It is certain that the world will not much longer tolerate the unemployment which, apart from brief intervals of excitement, is associated—and, in my opinion, inevitably associated—with present-day capitalistic individualism. But it may be possible by a right analysis of the problem to cure the disease whilst preserving efficiency and freedom.

IV

I have mentioned in passing that the new system might be more favourable to peace than the old has been. It is worth while to repeat and emphasize that aspect.

War has several causes. Dictators and others, to whom war offers, in expectation at least, a pleasurable excitement, find it easy to work on the natural bellicosity of their peoples. But, over and above this, facilitating their task of fanning the popular flame, are the economic causes of war, namely, the pressure of population and the competitive struggle for markets. It is the second factor, which probably played a predominant part in the nineteenth century, and might again, that is germane to this discussion.

I have pointed out in the preceding chapters that, under the system of domestic laissez-faire and an international gold standard such as was orthodox in the latter half of the nineteenth century, there was no means open to a government whereby to mitigate economic distress at home except through the competitive struggle for markets. For all measures helpful to a state of chronic or intermittent under-employment were ruled out, except measures to improve the balance of trade on income account.

Thus, whilst economists were accustomed to applaud the prevailing international system as furnishing the fruits of the international division of labour and harmonizing at the same time the interests of different nations, there lay concealed a less benign influence; and those statesmen were moved by common sense and a correct apprehension of the true course of events, who believed that if a rich, old country were to neglect the struggle for markets its prosperity would droop and fall. But if nations can learn to provide themselves with full employment by their domestic policy (and, we must add, if they can also attain equilibrium in the trend of their population), there need be no important economic forces calculated to set the interest of one country against that of its neighbours. There would still be room for the international division of labour and for international lending in appropriate conditions. But there would no longer be a pressing motive why one country need force its wares on another or repulse the offerings of its neighbour, not because
this was necessary to enable it to pay for what it wished to purchase, but with the express object of upsetting the equilibrium of payments so as to develop a balance of trade in its own favour. International trade would cease to be what it is, namely, a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbour which is worsted in the struggle, but a willing and unimpeded exchange of goods and services in conditions of mutual advantage.

V

Is the fulfilment of these ideas a visionary hope? Have they insufficient roots in the motives which govern the evolution of political society? Are the interests which they will thwart stronger and more obvious than those which they will serve?

I do not attempt an answer in this place. It would need a volume of a different character from this one to indicate even in outline the practical measures in which they might be gradually clothed. But if the ideas are correct—a hypothesis on which the author himself must necessarily base what he writes—it would be a mistake, I predict, to dispute their potency over a period of time. At the present moment people are unusually expectant of a more fundamental diagnosis; more particularly ready to receive it; eager to try it out, if it should be even plausible. But apart from this contemporary mood, 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. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil.

Notes

1 The 'classical economists' was a name invented by Marx to cover Ricardo and James Mill and their predecessors, that is to say for the founders of the theory which culminated in the Ricardian economics. I have become accustomed, perhaps perpetrating a selection, to include in the classical school the followers of Ricardo, those, that is to say, who adopted and perfected the theory of the Ricardian economics, including (for example) J.S. Mill, Marshall, Edgeworth, and Prof. Pigou.

2 This is in the Ricardian tradition. For Ricardo expressly repudiated any interest in the amount of the national dividend, as distinct from its distribution. In this he was assessing correctly the character of his own theory. But his successors, less clear-sighted, have used the classical theory in discussions concerning the causes of wealth. Vide Ricardo's letter to Malthus of October 9, 1820: 'Political Economy you think is an enquiry into the nature and causes of wealth I think it should be called an enquiry into the laws which determine the division of the produce of industry amongst the classes who concur in its formation. No law can be laid down respecting quantity, but a tolerably correct one can be laid down respecting proportions. Every day I am more satisfied that the former inquiry is vain and delusive, and the latter only the true objects of the science.'

3 For example, Prof. Pigou in the Economics of Welfare (fourth ed. p. 127) writes (my italics): 'Throughout this discussion, except when the contrary is expressly stated, the fact that some resources are generally unemployed against the will of the owners is ignored. This does not affect the substance of the argument, while it simplifies its exposition.' Thus, whilst Ricardo expressly disclaimed any attempt to deal with the amount of the national dividend as a whole, Prof. Pigou, in a book which is specifically directed to the problem of the national dividend, maintains that the same theory holds good when there is some involuntary unemployment as in the case of full employment.

4 Prof. Pigou's Theory of Unemployment is examined in more detail in the Appendix to Chapter 19 below.

5 Cf. the quotation from Prof. Pigou above, p. 5, footnote.

6 This point is dealt with in detail in the Appendix to Chapter 19.

7 This argument would, indeed, contain, to my thinking, a large element of truth, though the complete results of a change in money-wages are more complex, as we shall show in Chapter 19.

8 Cf. Chapter 19, Appendix.

9 The argument runs as follows: if men are employed, the nth man adds a bushel a day to the harvest, and wages have a buying power of a bushel a day. The (n+1)th man, however, would only add a half bushel a day, and employment cannot, therefore, rise to (n+1) men unless the price of corn rises relatively to wages until daily wages have a buying power of a half bushel. Aggregate wages would then amount to 9/10 (n + 1) bushels as compared with n bushels previously. Thus the employment of an additional man will, if it occurs, necessarily involve a transfer of income from those previously in work to the entrepreneurs.


11 p. 34

12 Mr. J.A. Hobson, after quoting in his Physiology of Industry (p. 102) the above passage from Mill, points out that Marshall commented as follows on this passage as early as his Economics of Industry, p. 154: 'But though men have the power to purchase, they may not choose to use