The Economic Consequences of John Maynard Keynes

MANY EMINENT men have in their day accepted the Malthusian principle of population as a scientific revelation. Among them is the naturalist Charles Darwin, the distinguished economist Alfred Marshall and, of course, Lord Keynes himself.

It was left to Henry George to inveigh against the so-called principle with its plausible explanation of poverty and unemployment among people dependent upon incomes at subsistence level.

John Maynard Keynes, the centenary of whose birth falls this year, had a most favourable view of these theories and the propositions that flow from them. After reading the volume of letters that passed between Thomas Mathus, Professor of Political Economy at Haileybury, and the stockbroker David Ricardo, Keynes gave this opinion in his *Essays in Biography:*

> **"One cannot rise from a perusal of this correspondence without a feeling that the almost complete obliteration of Malthus's line of approach and the complete domination of Ricardo's for a period of a hundred years has been a disaster for the progress of economics ... 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 today."[1]**

To Keynes's great regret, the Malthusian doctrine that employment is regulated by the laws of supply and demand for labour appeared to be swamped by the weight of Ricardian reasoning. But this cannot be quite right because Ricardo not only did not dissent from the Malthusian view of wages, he also voiced his admiration for the *Essay on Population*. "I am persuaded" he wrote, "that its just reputation will spread with the cultivation of that science of which it is so eminent an ornament."[2]

Ricardo's differences with Malthus were over a quite different aspect of economic science – the principles of rent. Here the Ricardian view has not triumphed. To quote Henry George:

> **"This accepted (sic) law of rent, which John Stuart Mill denominates the *pons asinorum* of political economy, is sometimes called 'Ricardo's law of rent' from the fact that, although not the first to announce it, he first brought it prominently into notice. It is: 'The rent of land is determined by the excess of its produce over that which the same application can secure from the least productive land in use'."[3]**

As Henry George comments, the mere statement of this proposition should be sufficient to demonstrate its self-evident character. It may well be that economists have agreed over the principle or formulation of the law of rent. But the Malthusian interpretation of its action is totally different from that of Ricardo and there is no doubt whatever that the Malthusian view of the law of rent has prevailed.

This interpretation, as expounded by John Stuart Mill and most leading economists since then, is that because a greater effort is required to raise the same produce from inferior land, labour and capital is confronted by the law of diminishing return.

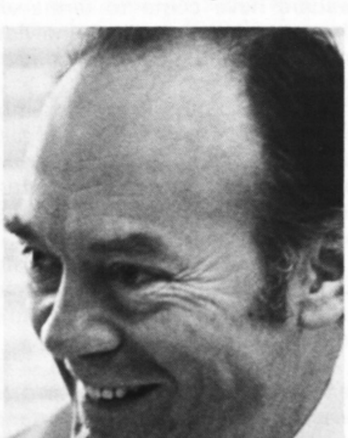
To cite John Stuart Mill, it is the law of production from the land that an increase in labour inputs does not increase the output of produce by an equal degree; or to express the same thing in other words, every increase of produce is obtained by a more than proportional increase in the application of labour.

MILL SAYS that this general law is the most important proposition in political economy.[4]

Not surprisingly, other economists have followed him down this road, culminating at the end of the 19th century with the theory of marginal productivity as propounded by Marshall and others.

This centres on the proposition that the wages of every class of labour tend to be equal to the net product of the marginal labourer. This principle is Malthus all over and Keynes draws heavily on it in his writings.

An analysis



by John D. Allen

This kind of thinking, where wages are subject to the law of diminishing return, is at the basis of Keynesian economics and indeed the orthodox economics of the preceding century.

In his preface to the German edition of the *General Theory of Employment, Interest and Money,* Keynes says that Alfred Marshall, on whose principles of economics all contemporary English economists have been brought up, was at particular pains to emphasise the continuity of his work with Ricardo's.

According to Keynes, the important contribution made by Marshall was grafting the marginal principle on to the Ricardian tradition.

This in itself is rather strange for it was Ricardo who first drew attention to the marginal principle as the regulator of all economic phenomena. However, if Marshall followed the Ricardian tradition, it is not evident from his writings. Plainly from his own testimony, he was an ardent Malthusian. There was no need for Keynes to wring his hands over Marshall's deviationist tendencies.

Malthus, he stated, by careful study of the facts, proves that every people has been so prolific that the growth of their numbers would have been rapid and continuous if they had not been checked either by a scarcity of the necessaries of life or some other cause, that is by disease, by war, by infanticide or, lastly, by a voluntary restraint.

"His second position", said Marshall, "relates to the demand for labour. Like the first it is supported by facts, but by a different set of facts. He shows that up to the time at which he wrote, no country (as distinguished from a city, such as Rome or Venice) had been able to obtain an abundant supply of the necessaries of life after its territory had become very thickly peopled. The produce which Nature returns to the work of man is her effective demand for population: and he shows that up to this time a rapid increase in population when already thick had not led to a proportionate increase in this demand."[5]

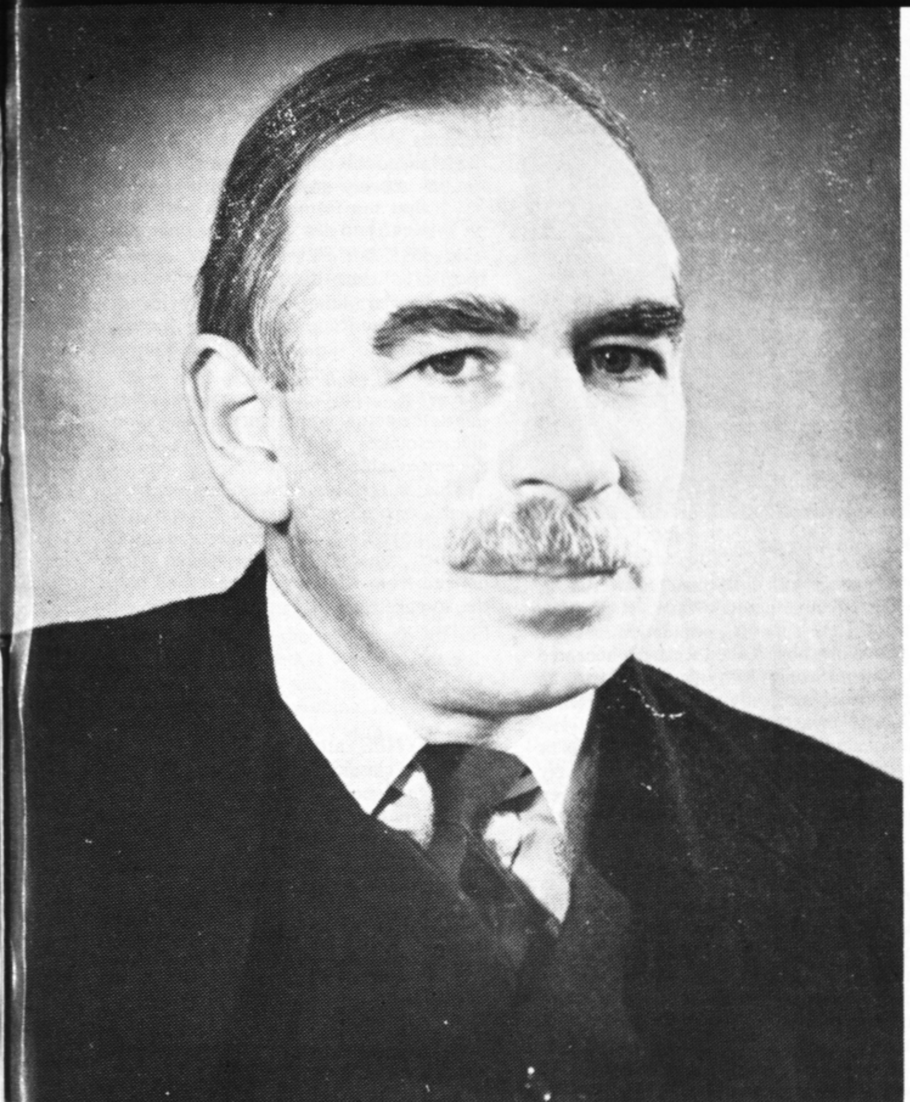
Malthus could hardly have wished for a more able expositor, but those who have read Henry George will know that there are other facts and reasons for this apparent niggardliness of Nature.

Lest it be thought that Marshall was merely summarising Malthus, one more quotation will dispel that:

> **"His position with regard to the supply of the population ... remains substantially valid ... it remains true that unless the checks on the growth of population in force at the end of the nineteenth century are on the whole increased ... it will be impossible for the habits of comfort prevailing in Western Europe to spread themselves over the whole world and maintain themselves for many hundred years."[6]**

The principle of effective demand turns up as one of the key concepts in Keynesian economics.

This was the established view at the end of the 19th century and Keynes carried it forward, though in a novel form



John Maynard Keynes

which caught the attention of his generation.

To give him his due, it was a brilliant attempt to re-formulate the 19th century view. And the predictions of the population principle certainly seem to be borne out by rising unemployment in Europe and the state of things in the Third World.

While endorsing the Malthusian approach with such eloquence (for he was a fine writer), Marshall was slighting in most of his references to Ricardo. He accused him of inexactitude in stating the law of diminishing return, adding somewhat patronisingly: "It is however probable that the inaccuracy was due not to careless thinking but only to careless writing."[7]

These are hardly the words of someone who sought to perpetuate the tradition of Ricardo. Alfred Marshall was very much on the side of Malthus when it came to the law of rent.

Actually Ricardo never formulated any law of diminishing return: this was the work of Malthus and the economists who followed this line of thinking.

WHAT RICARDO stated with tolerable accuracy was the action of the principles of rent, albeit mainly in their agricultural application.

These principles brought out the key importance of the least productive site in use, or the margin of cultivation. Time and again, Ricardo refers to the product of the marginal site as the regulator of wages, prices, profits and rents.

The Ricardian marginal principle is that the product of the least productive land in use is the fund from which wages and return on capital are drawn; any excess above this on more productive land is rent. Since prices are determined by the revenue required by the marginal producer, rent cannot possibly enter into prices because at the margin no rent is paid.

This is quite different from the exposition given by Malthus, who asserted that the main cause of the high price of produce was "that quality of the earth, by which it can be made to yield a greater portion of the necessaries of life than is required for the maintenance of the persons employed on the land."[8]

Here is a fundamental difference between the two men: though he admired Malthus for his diligent application to the principles of economics, Ricardo felt it necessary to refute this and other errors.

This part of his book is one of the most rewarding in economics, due to its close reasoning. In one telling passage he says:

> **"Land possessed of very little fertility can never bear any rent; land of moderate fertility may be made, as population increases, to bear a moderate rent; and land of great fertility a high rent; but it is one thing to be able to bear a high rent, and another thing actually to pay it. Rent may be lower in a country where lands are exceedingly fertile than in a country where they yield a moderate return, it being in proportion rather to relative than absolute fertility – to the value of the produce and not to its abundance."[9]**

Time and again, Ricardo keeps on hammering home that rent is not a question of quantity but of proportion. Its quantity has no influence on wages, costs or prices. The amount of rent on any site is measured by the product on that site (given equal inputs of labour and capital) relative to the product on the marginal site.

This has been completely missed by the advocates of the law of diminishing return, required to give a spurious validity to the Malthusian approach. This assumes, as Keynes expounded it, that the return to labour diminishes with the increase of employment at a given location, so that the pressure of population or demand for jobs exerts a downward force on wages, until they reach the level at which they are just sufficient to call forth the required volume of labour.

Ricardo, on the other hand, said that with increasing population, the tendency was for rents to rise, implying that the community was enriched by the expansion of employment. This is the correct analytical approach and if it were adopted, it would help us to banish unemployment.

But the Malthusian approach won: Keynes described unemployment occurring when the marginal product of labour falls to a level where its utility to the employee is counterbalanced by the disutility of employment as "voluntary unemployment".

In other words, if men withhold their labour because the return isn't worth the effort, that is their affair. In the welfare state, of course, the missing subsistence for labour has to be supplied from public funds, at enormous cost to the taxpayer. The resulting tax pressure has a further adverse action on the margin.

THE SURPRISING aspect of the Keynesian theory is that when men are unwilling to work for the marginal wage (itself determined according to this

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● From P.71

theory by the pressure of numbers) their plight is regarded as "voluntary".

According to Keynes, the state of "involuntary unemployment" occurs when, even though men are willing to work for a lower money wage than the marginal product would justify, there is insufficient demand for their labour.

Such a reduction in the money-wage would be caused by rising prices, i.e. the marginal wage unadjusted for inflation.

This is close to the economic policy followed by Mrs. Thatcher's Conservative Government, whose Chancellor sees pay restraint as the key to improved prospects for employment.

As Keynes saw it, writers in the classical tradition assumed that "unemployment must be due at bottom to a refusal by the unemployed factors to accept a reward which corresponds to their marginal productivity." [10] Such unemployment, he argues, is merely apparent and this corresponds to a state of full employment.

This is analagous to Malthus's view that rising prices are due "to the increasing number of people demanding subsistence, and ready to offer their services in any way in which they can be useful."[11]

As previously observed, Ricardo accepted the Malthusian view of wages determination but at the same time lamented the distress of the poor whom Keynes might have regarded as voluntarily unemployed.

However, Ricardo did suggest an easing of unemployment and low wages through accumulation of capital at a faster rate than the growth of population.[12] Here were the seeds of a different possibility, unfortunately killed by the 19th century insistence that industry is limited by capital, and wages are subject to iron laws.

Yet in his *General Theory* Keynes said:

> **"The idea that we can safely neglect the aggregate demand function is fundamental to the Ricardian economics, which underlie what we have been taught for a century. Malthus, indeed, had vehemently opposed Ricardo's doctrine that it was impossible for effective demand to be deficient; but vainly.**
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> **For since Malthus was unable to explain clearly (apart from an appeal to the facts of common observation) how and why effective demand could be deficient or excessive, he failed to furnish an alternative construction, and Ricardo conquered England as completely as the Holy Inquisition conquered Spain.**
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> **Not only was his theory accepted by the city, by statesmen and by the academic world. But controversy ceased; the other point of view completely disappeared; it ceased to be discussed. The great puzzle of effective demand with which Malthus had wrestled vanished from economic literature."[13]**

If the question of effective demand vanished, it must have been because succeeding economists felt that the

● **David Ricardo**

Malthusian principle had answered it; when effective demand failed, it was due to the pressure of population on the means of subsistence. Ricardo accepted it, John Stuart Mill elevated it to an economic law; only the voice of Henry George was raised against it. His advocacy of the taxation of land values as a cure for unemployment is obliquely dismissed by Marshall and not even mentioned by Keynes.

ONE OF the great puzzles of Keynesian economics is its total failure to grapple with questions of taxation, notwithstanding the enormous importance of taxation in the modern economy, both in Europe and the United States.

It seems strange that the principles of taxation laid down by Adam Smith, applauded by Ricardo and endorsed by Henry George, should be so completely ignored. They are hardly mentioned by Marshall and, needless to say, by no economist since his time.

Modern taxation is therefore guided by no principle whatever except that of exaction and impost. This, too, is part of the heritage of Keynes.

The completeness of the Ricardian victory is something of a curiosity and a mystery, according to Keynes. But an even greater curiosity and mystery is why the triumph of Malthusian principles should be laid at the door of Ricardo.

There is a big misunderstanding here.

Take, for example, the postulates on which Keynes founds his *General Theory*. He calls it a general theory to distinguish it from what he calls the special case to which classical postulates are applicable. By "classical", Keynes means the views of all who preceded him including Marshall, Edgeworth and Pigou, those whom he claims perfected the theory of the Ricardian economics.[14]

Keynes evidently meant by the theory of Ricardian economics the proposition as enunciated by Ricardo – that what matters in economics are the laws which determine the division of the product of industry. No law, said Ricardo, could be laid down respecting quantity but a tolerably correct one can be laid down respecting proportions.

This is exactly the principle on which the whole of Ricardian economics depends.

He added this telling comment:

> **"Every day I am more satisfied that the former is vain and delusive, and the latter the only true objects of science."[15]**

If this is what Keynes meant by the Ricardian tradition, he was evidently undeterred by Ricardo's warning that any other kind of inquiry (such as that of Malthus) is vain and delusive.

Keynes's question was: what determines the actual employment of the available resources, which includes the size of the employable population?

This is the quantitative approach so much deplored by Ricardo. He spoke of laws governing distribution of the product, whereas the Keynesian view derived from Malthus is concerned with the so-called laws of supply and demand for labour.

KEYNES attempted to summarise the classical theory of employment in two fundamental postulates.

The first of this is brilliantly simple, the second almost obscure.

1. The wage is equal to the marginal product of labour.
2. The utility of the wage when a given volume of labour is employed is equal to the marginal disutility of that amount of employment.[16]

The first statement is a splendid formulation of the law of wages which classical writers such as Adam Smith sought to express. The marginal product, following the doctrine of *The Wealth of Nations* and echoed by Henry George in *Progress and Poverty*, is the product of labour at the margin of cultivation.

As Henry George put it, the wages which an employer must pay will be measured by the lowest point of natural productiveness to which production extends, and wages will rise or fall as this point rises or falls.

The corollary is that wages can never exceed the marginal product which sets the standard of earnings for the rest of the economy. So, on the face of things, the Keynesian formulation is one that could have come straight from the pages of *The Wealth of Nations*. For as Adam Smith said, the produce of labour constitutes the natural recompense or wages of labour.[17]

But this is not what Keynes meant by the marginal product. He had in mind wages being determined by the law of diminishing return and the theory of marginal productivity. Hence the next postulate, bringing in the concept of marginal utility.

As Keynes himself explained, the argument runs as follows: *n* men are employed, and *n*th man adds a bushel a day to the harvest, and wages have a buying power of a bushel a day. That is the marginal product.[18]

Another man, it is argued, could not raise the product by so much; it must be less, say, 0.9 of a bushel.

Thus the marginal product of labour has fallen due to an increase of employment, and this marginal product sets the standard for everyone employed.

Not only that, it will cause a shift in the balance of distribution between labour and employers.

As Keynes puts it, the employment of an additional man will necessarily involve a transfer of income from those previously in work to the entrepreneurs.

What about that for the pressure of population?

This may well have been the view of Marshall; indeed, he advances something of the kind in his own writings.

In reality it is the law of diminishing return and it is straight from the Malthusian tradition of economics. It owes nothing to Ricardo, who merely adopted the prevailing view of the day on wages that the natural level was subsistence of the labourers.

This is Keynes's version of subsistence, for he says that the real wage of an employed person is that which is just sufficient to induce the labour actually employed to be forthcoming. So we arrive at the Keynesian conclusion that the amount of employment is fixed at the point where the utility of the marginal product balances the disutility of the marginal employment.

● Henry George

In its way, this is a brilliant formulation of economic laws at work, except that it means in the minds of today's economists something quite different from what it would have meant to Adam Smith and David Ricardo.

Where the volume of employment is contracting, it should surely be the job of the economist to see how the utility of the marginal product can be improved.

Under today's conditions this effort is weighed down by the huge pressure of taxation on employment, both income tax and national insurance charges.

It means that the price of the marginal product has to be inflated to meet taxation: putting it another way, the cost of the marginal labour becomes too high and the margin is forced out of use.

The Henry George tradition would require easing the burden of taxation on labour and capital by shifting it on to that excess product yielded by more productive sites that the classical economists called rent.[19] This releasing of taxation at the margin has the advantage of relieving taxation on wages and profits, thus reducing the marginal cost of labour to the employer. It also provides an enormous incentive to productive effort.

KEYNESIAN theory has no answer to the problems of rising unemployment and inflation. It cannot produce these answers because it has no theory of taxation. It does not recognise taxation as a factor in the equation, probably because taxation is not a factor of production.

Despite what Keynes said, what is needed now is a return to the Ricardian tradition of measuring marginal productivity, together with a better formulation of the laws that govern wages. Keynes's own formulation, that the wage is equal to the marginal product of labour, would be a good starting point if only the marginal product of labour were equal to the wage. This can only occur if it is freed of taxation.

Adam Smith gave the elements of the law of wages; Ricardo gave the elements of the law of rent. Henry George appreciated the force of both these laws and struggled to reconcile them with the return to capital.

In fact, there is nothing difficult about the return to capital. It is simply that part of the marginal product which the employer takes in providing the means of enhancing the marginal product.

But it must never be forgotten that labour generates the marginal product and must be allowed to take its full share.

Taxation can be met in proportion to the better resources of industries better placed. This needs a concept of taxable capacity, measured by reference to rental values.

This would satisfy the first of Adam Smith's rules of taxation, that the taxpayers should contribute to the support of the Government as nearly as possible in proportion to their respective abilities.[20]

Adam Smith was right when he spoke in favour of liberal wages. "The liberal reward of labour, therefore," he said, "as it is the effect of increasing wealth, so it is the cause of increasing population. To complain of it is to lament over the necessary effect and cause of the greatest public prosperity."[21]

This was the approach with which the classical school began, the liberal approach that has been overthrown by slavish adherence to the doctrines of Malthus.

Keynes is only the latest exponent of these ideas and the price being exacted is the decline of the industrial economies of the Western world.

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20. *Op. cit.*, Vol. II, Book V, p.307.
21. *Ibid.*, Vol. I, Book I, p.72.

● **THE AUTHOR is one of Britain's leading industrial journalists. He has begun a re-examination of the teachings of the masters of economics in the search for a solution to current economic problems. In his view, the works of David Ricardo, the 19th century classical economist, are of crucial importance to an appreciation of the global crisis.**