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Veblen's *Theory of Business Enterprise* and Keynes's Monetary Theory of Production

L. Randall Wray

It has long been recognized that Thorstein Veblen and John Maynard Keynes share a common approach to the nature of “business enterprise” or “monetary production” in the modern capitalist economy (Dillard 1948; Dowd 1964). Keynes’s most explicit treatment was in the early drafts of the *General Theory*, unfortunately the final version dropped some of the clearest statements. Veblen’s best known exposition was in the *Theory of Business Enterprise*. This paper will provide a concise summary of Veblen’s views on the “credit economy,” comparing that with Keynes’s “monetary economy.” While there are many similarities, Veblen’s version is in some important respects more complete, and still relevant for developing an understanding of modern business practice. On one hand, this is not surprising as Keynes had let many of the monetary details “fall into the background.” However, as Matthew Wilson (2006) argues, it is surprising that most followers of Keynes have not mined the *Theory of Business Enterprise* for arguments that nicely complement and extend Keynes’s better known approach.

Veblen and the Distinction between the Money Economy and the Credit Economy

Following “German writers,” Veblen distinguished among the “natural economy,” the “money economy” and the “credit economy.” The first refers to one in which distribution is “in kind” without reliance on markets. The money economy is one in which there is “ubiquitous resort to the market as a vent for products and a source of supply of goods. The characteristic feature of this money economy is the goods market” (Veblen 1958, 75). This is the sort of economy addressed by classical political economy, in which “the welfare of the community at large is accepted as the central

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and tone-giving interest, about which a comprehensive, harmonious order of nature circles and gravitates" (69). The end of production is consumption; the means is "monetary" only in the sense that money is used in markets. While the conventional theory can be criticized for misunderstanding the nature of production even in the money economy, Veblen argues that regardless of the "merits of such a point of view," they "need not detain the inquiry" because "[m]odern business management does not take that point of view"¹ (69). By the 1870s, the money economy already had been displaced by the credit economy.²

Veblen's main purpose in the *Theory of Business Enterprise* was to examine the operations of the credit economy. His distinction between industrial and pecuniary pursuits and his argument that "the motive of business is pecuniary gain" (Veblen 1958, 16) are too well known to require explication. What is more interesting is his argument that in the credit economy, it is not the goods market that dominates, for "[t]he capital market has taken the first place . . . The capital market is the modern economic feature which makes and identifies the higher 'credit economy' as such" (75). By "capital" he means the "capitalized presumptive earning capacity," "comprised of usufruct of whatever credit extension the given business concern's industrial equipment and good-will will support" (65). This is different from "effective industrial capital," the aggregate of the capitalized material items engaged in industrial output, as "business capital" comprises goodwill plus the credit that can be obtained using industrial capital and other nonindustrial property as collateral. The key to his analysis is the divergence between the value of industrial capital and the value of business capital, because this is the basis for credit extension that ultimately generates liquidation crises as well as trust formations.

The "putative earning-capacity" is subject to fluctuation (and, as we will see, manipulation) because it "is the outcome of many surmises with respect to prospective earnings and the like; and these surmises will vary from one man to the next, since they proceed on an imperfect, largely conjectural, knowledge of present earning-capacity and on the still more imperfectly known future course of the goods market and of corporate policy" (Veblen 1958, 77). When presumptive earning capacity rises, this is capitalized in credit and equity markets, with the "[f]unds obtained on credit . . . applied to extend the business"; there is thus "in the nature of things a cumulative character" because "the money value of the collateral is at the same time the capitalized value of the property, computed on the basis of its presumptive earning-capacity"³ (55). In this manner, credit fuels capitalized values, which fuels more credit and further increases the discrepancy between industrial and business capital values.

Management's interest is to maximize this differential, so as to increase capitalized value.⁴ This then encourages concentration of ownership through two processes. First, credit expansion will normally proceed to "abnormal" levels as putative earnings are "over-capitalized." The inflation of the value of the business capital as collateral will rise faster than prospective earnings that ultimately depend on final sales, the majority of which is constituted by sales to consumers (see below) (Veblen 1958, 56). Eventually, the over-capitalization will be recognized, credit will

not be renewed, loans will be called-in, and assets will be sold. Because in a period of “buoyancy” “not only is the capitalization of the industrial property inflated on the basis of expectation, but in the making of contracts the margin of security is less closely looked after,” hence there will be a general reliance on an extensive network of “contracts for future performance” (97). A general liquidation crisis can follow – all it requires is the realization by one large creditor that the earning capacity of some debtor is not as great as the capitalization requires. When credit is cut-off, the debtor is forced to default on contracts and to call-in others, with forced sales of assets following. This snowballs into a general liquidation that allows creditors to accumulate and concentrate industrial capital, however, the nominal value of the business capital must shrink to effect concentration of ownership along these lines.

Second, credit is used in reorganization through corporate take-over, as industrial capital plus “good-will” created through concentration of ownership serves as collateral for loans.⁵ Further, there is something of a “widow’s cruse” to goodwill, as “it is of a spiritual nature, such that, by virtue of the ubiquity proper to spiritual bodies, the whole of it may undividedly be present in every part of the various structures which it has created” – it is never diminished but rather can augment the capitalized value “of the next corporation into which it enters” (Veblen 1958, 85). The business capital is packaged and sold at a price based on the discrepancy between the putative and actual earning capacity. Increasing this discrepancy is the prime motivation driving the “business interest” of the managers – “not serviceability of the output, nor even vendibility of the output,” but rather “vendibility of corporate capital” (79). They are “able to induce a discrepancy . . . by expedients well known and approved for the purpose. Partial information, as well as misinformation, sagaciously given out at a critical juncture, will go far . . . [i]f they are shrewd business men, as they commonly are . . .” (77-8). Note that like liquidation, trusts achieve concentration, however, they do it without diminishing capitalized values.

Trust formation, in turn, is impelled by rising efficiency of industrial capital, which destroys actual earning capacity of business capital. Technological advance ensures that newer industrial capital will reduce the pecuniary capacity of older industrial capital that is burdened with the credit that was advanced based on the discrepancy between capitalized presumptive earning-capacity and industrial capital – a discrepancy that now cannot be maintained. However, recapitalization based on lower prospective earnings is not possible due to credit obligations – interest must be paid. The only solution is to prevent rising industrial efficiency from lowering price, but so long as competition exists this is not possible. As prices fall, production becomes unprofitable, and chronic depression sets in. Veblen argues that while this is frequently described as a situation of “over-production” or of “under-consumption,” it is really due to a “malady of the affections” – earnings will not cover contracted commitments with net profit that “bears a reasonable relation to the current rate of interest” (Veblen 1958, 114, 105-06).

While a burst of temporary “wasteful” spending (on wars, colonies, and “employment of the courtly, diplomatic, and ecclesiastical personnel,” for example), can maintain sales and prices, waste cannot long keep up with rising industrial

efficiency (Veblen 1958, 122-123). The solution is “a business coalition on such a scale as to regulate the output and eliminate competitive sales and competitive investment . . . to neutralize the cheapening of goods and services effected by current industrial progress” (115-16). Thankfully, “[t]he higher development of the machine process makes competitive business impracticable, but it carries a remedy for its own evils in that it makes coalition practicable” through collateralized credit expansion that can finance trust formation (125).

Comparison with Keynes

Those familiar with the *General Theory* will recognize many similarities with the previous discussion. These include:

- Both make a distinction between historical epochs based on the role played by money. In his preparation of the *General Theory*, Keynes spoke of the “monetary theory of production,” that would deal “with an economy in which money plays a part of its own and affects motives and decisions and is, in short, one of the operative factors in the situation, so that the course of events cannot be predicted, either in the long period or in the short, without a knowledge of the behaviour of money between the first state and the last. And it is this which we ought to mean when we speak of a monetary economy” (Keynes 1973, 408-9). He distinguishes this from a “real-exchange economy” that might use money, but “does not allow it to enter into motives or decisions.” Like Veblen, Keynes insists that in the modern economy, “the firm is dealing throughout in terms of money. It has no object in the world except to end up with more money than it started with” (Keynes 1979, 89). Keynes’s “monetary economy” is thus similar to Veblen’s “credit economy” stage.⁶
- Both emphasize the spending decisions of business, rather than consumer sovereignty. Investment is the critical variable in Keynes’s approach, and as in Veblen’s theory of business enterprise, it is forward-looking, a function of expected future profits. In both approaches expected profits are weighed against “the” current interest rate. Because the future is uncertain, investment fluctuates with changes to confidence or “affections.” In both approaches, new capital competes with old investments. While Veblen focuses on the improved efficiency of the new industrial capital, Keynes emphasizes the importance of different interest rates: if interest rates have fallen, the newer investment goods are satisfied with a lower profit rate – a point Veblen also recognized.⁷
- Finally, both recognized a tendency toward insufficient aggregate demand. Where Veblen attributed this to a tendency for the nominal value of the capitalized firm to rise faster than prospective earnings that depend largely on final sales for consumption, Keynes argued that a “demand gap” opens because the marginal propensity to consume is less than unity. By distinguishing between two kinds of

spending, one (mostly, consumption) a function of income and the other (mostly, investment) autonomous, Keynes created the possibility that aggregate demand (D curve) would not rise as fast as aggregate supply (Z curve). The “special properties” of money are then invoked in Keynes’s argument that investment will not normally be at the level required to generate the point of effective demand at full employment (Wray 2006). Both blame unemployment of productive resources on the profit-seeking behavior of entrepreneurs. Further, both find a temporary expedient in “wasteful spending” to prop up demand. In spite of the tendency of “Keynesians” to present Keynes’s theory as “fine-tuning,” Keynes was as skeptical as Veblen concerning the use of wasteful spending to resolve problems of effective demand.⁸

Let us turn to an assessment of the areas in which Veblen’s analysis provides more insight into the operation of the modern capitalist economy.

- Because Keynes was most concerned with demonstrating the determination of the point of effective demand, he primarily focused on the demand-side (or, multiplier) effects of investment and ignored the supply-side (or, capacity) effects. This led, of course, to the extensions by Roy Harrod and Evsey Domar, which then spurred growth theory – unfortunately, mostly down a neoclassical synthesis path – and the Cambridge/capital theory debates. Harold Vatter and John Walker (1983; 1997) show how accounting for the capacity effects of investment leads to an explanation for the chronic stagnation that grips modern capitalism: capital-saving technological advance causes the capacity effects of investment to continually outstrip multiplier effects on demand, generating excess capacity that depresses investment and growth. This is closely related to the argument made by Veblen that technological advance affects *all* production, increasing capacity faster than potential pecuniary earnings, thus “chronic depression, more or less pronounced, is normal to business under the fully developed regime of the machine industry” (Veblen 1958, 112). Again, Veblen is pessimistic that increasing “unproductive consumption,” including that by a deficit-spending government, will allow demand to keep pace with growth of industrial efficiency (122-3).
- Veblen’s discussion of the role played by credit in financing growth of capitalized values not only provides insight into the important distinction between industrial capital and business capital (less important in Keynes and the extensions made by Vatter and Walker), but it is also critical to his description of the business cycle and the crisis phase that leads to liquidation. While Keynes provides a chapter titled “notes on the trade cycle,” the *General Theory* does not really provide a theory of the cycle. By contrast, Veblen ties his theory of the business enterprise to the theory of the cycle, and links this to his theory of growing concentration of ownership. Keynes does address the distinction between ownership and control of the production process, arguing that the modern corporation’s owners know

little about operations, forcing management to focus on the short-run out of fear of possible adverse impacts on stock prices.⁹ However, unlike Veblen, Keynes is not wholly critical of the increasing corporatization of the economy. Indeed, his call for increased “socialization of investment” (explicitly in Chapter 24 of the *General Theory*, and less directly in his earlier essay on “The End of Laissez-Faire”) could be interpreted as a call for greater concentration of corporate decision-making that would allow concern with long run and social interests to play a bigger role.

- Chapter 12 of *General Theory* is famous for its discussion of “whirlwinds of optimism and pessimism,” speculation, and uncertainty, and for its criticism of the operation of the stock market, likened to a game of “Old Maid, of Musical Chairs,” or in which “each competitor has to pick, not those faces which he himself finds prettiest . . . nor even those which average opinion genuinely thinks the prettiest . . . [but rather] what average opinion expects the average opinion to be”¹⁰ (Keynes 1964, 156). While Veblen agrees that there is uncertainty and speculation involved in business enterprise, he emphasizes pecuniary initiative in manipulating stock values to increase differential valuation between industrial and business capital. He even denies that the trust-maker devoted to enhancing the vendibility of business faces much uncertainty, indeed, “the certainty of gain, though perhaps not the relative amount of it, seems rather more assured in the large-scale manipulation of vendible capital than in business management with a view to a vendible product” (Veblen 1958, 82). While the manipulation does carry risk, it is “not so much to the manipulators as such, as to the corporations . . . [and to] the business men who are not immediately concerned in this traffic” (82-3). Veblen’s preference for an explanation based on “capitalization” over “speculation” would seem to apply much more readily to the dealings of the Milkens and Enrons. While Keynes’s description might have captured the experience of many who were duped by the NASDAQ “buoyancy,” those who actually *produced* the discrepancy between putative earnings on an imaginary scale versus actual earnings capacity in mostly negative territory did quite well, thank you.

None of this is meant to be a critique of Keynes’s *General Theory*. Keynes’s purpose there was narrower – to present an alternative to the neoclassical theory of the determination of the point of equilibrium. Further, Keynes wanted to provide an “internal” critique, exploding neoclassical theory from within by adopting, where possible, some of the neoclassical assumptions. By contrast, Veblen was the eternal outsider, attacking “on several fronts at once: nationalism, the business system, war, *de facto* political oligarchy, a corrupted educational system, and, most generally, irrationality” (Dowd 1964, xii; see also Dowd 2000).

The purpose of this paper has been to draw out some of the similarities between Keynes and Veblen and to point the way toward improving our understanding of what Keynes called the monetary production economy and what

Veblen termed the credit economy. More importantly, the purpose is to recommend to Keynes scholars the insights in *Theory of Business Enterprise*.

Notes

1. He argues that “[l]ooking at the process of economic life as a whole . . . [as if it were] a collective endeavor to purvey goods and services for the needs of collective humanity . . . need neither be defended nor refuted here, since it does not seriously touch the facts of modern business” (Veblen 1958, 196 note 11).
2. Of course, orthodoxy remains fixated on developing theory for the hypothesized economy dominated by the sovereign consumer and “in which all things should work together for the welfare of mankind” (Veblen 1958, 69) – a theory that was not even appropriate to nineteenth century capitalism.
3. He goes on: “competing business men bid up the material items of industrial equipment by the use of funds so obtained . . . the aggregate of values employed in a given undertaking increases . . . but since an advance of credit rests on the collateral as expressed in terms of value, an enhanced value of the property affords a basis for a further extension of credit . . .” (Veblen 1958, 55). See also Raines and Leathers (1996), and Wilson (2006) for discussions of use of collateral to support credit.
4. This is where the divergent interests of owners and managers become important, because “the business interest of the managers demands, not serviceability of the output, nor even vendibility of the output, but an advantageous discrepancy in the price of the capital which they manage” (Veblen 1958, 79).
5. This goodwill includes “[v]arious items, of very diverse character . . . the items included have this much in common that they are ‘immaterial wealth,’ ‘intangible assets’; which . . . are not serviceable to the community, but only to their owners” – precisely because it can be collateralized and thereby increase the divergence between the values of industrial and business capital (Veblen 1958, 70). Also, see Wilson (2006) for a discussion of market evaluation of goodwill.
6. Interestingly, both Keynes and Veblen addressed the stability of the purchasing power of money. For Keynes, relatively stable value of money (especially in terms of the nominal wage) is essential to maintaining its liquidity (Keynes 1964, 270, 240-1). For Veblen, the presumption of stability of nominal values is important for business practice (as opposed to industrial pursuits): “Capitalization as well as contracts are made in its terms, and the plans of the business men who control industry look to the money unit as the stable ground of all of their transactions,” even though they know “the value of money has varied incontinently throughout the course of history” (Veblen 1958, 45).
7. “[A] low or declining rate of interest is effective in the way of depressing the business situation. . . . What gives effect to this drawback for the business enterprises which have such fixed interest charges to meet is the fact that the new investments . . . come into competition with the old. These new or rejuvenated concerns are not committed to a scale of fixed charges carried over from a higher interest level . . .” (Veblen 1958, 107). Further, as Vining (1939) emphasizes, in both Veblen and Keynes interest is eminently a pecuniary or monetary phenomenon.
8. For a discussion of similarities in Veblen and Keynes on this score, see Vining (1939). However, it is undoubtedly true that Keynes’s *General Theory* Chapter 24 policy recommendations are more optimistic than Veblen’s *Theory of Business Enterprise* Chapter 10 prognosis of the “natural decay of business enterprise.”
9. As “human nature desires quick results . . . remoter gains are discounted by the average man at a very high rate” (Keynes 1964, 157).
10. “And there are some, I believe, who practise the fourth, fifth and higher degrees” (Keynes 1964, 156).

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