Keynes on the Stages of Development of the Capitalist Economy: The Institutional Foundation of Keynes's Methodology

James R. Crotty: 1990 *

Most economists assume that Keynes's theory of the capitalist macroeconomy is adequately represented by the standard set of "Keynesian" aggregate supply and demand curves. The generally accepted interpretation of The General Theory, pioneered and popularized by Paul Samuelson, suggests that the consumption, marginal efficiency of capital, liquidity preference, and labor supply functions constitute the scientific core of the book; the comments, observations and asides that surround this core, it is assumed, have little scientific value. These core behavioral equations of mainstream Keynesianism are derived from the optimizing decisions of typical neoclassical economic agents who are fully specified through their endowment bundles and preference orderings. Indeed, the fact that modern Keynesian theory is logically founded on such starkly defined, isolated agents is the reason it is granted scientific status.

This essay is concerned with the following important implication of the standard interpretation of Keynes's theory. If mainstream Keynesian theory is indeed an adequate reflection of Keynes's approach to macroeconomic analysis, then his theory must be ahistorical and institutionally nonspecific, and The General Theory must be a model of capitalism-in-general, equally applicable in all times and in all places where the capitalist system dominates economic activity. I argue to the contrary that such a characterization of Keynes's theory is profoundly mistaken. The central thesis of this article is that Keynes's theory is - as it ought to be-institutionally specific and historically contingent. In The General Theory and elsewhere Keynes made evident his belief that no all-purpose, institutionally abstract macromodel can adequately capture the processes and outcomes of distinct phases or stages of capitalist development: qualitative change in institutions, in class structure or in agent constitution or motivation requires a qualitatively distinct version of his theory.1

If Keynes's macrotheory is indeed historically contingent, then he should have developed different versions of his theory to describe and analyze institutionally distinct historical stages of capitalism. I argue that Keynes provided the outlines of a theory of the evolution of two distinct stages of capitalist development (and anticipated the transition toward a third) in which each stage is assumed to possess unique institutions and agent practices that differentiate its processes and outcomes from the other. Specifically, Keynes argues that nineteenth-century capitalism differed in institutional and class structure as well as in agent behavior patterns from post World War I capitalism. Because of these institutional differences, nineteenth-century capitalism exhibited impressive economic growth and stability, whereas twentieth-century capitalism was

---

* The author is Professor of Economics at the University of Massachusetts, Amherst campus. He would like to thank Randall Bausor, Don Goldstein, Jon Goldstein, Craig Freedman, Ilene Grabel, Martha Olney, Douglas Vickers, Sam Bowles, and especially Carol Heim for helpful criticism and suggestions.

1 Keynes's belief that abstract mathematical macromodels are inherently incapable of capturing the historical and institutional contingency of macro-theory comes through strongly in his criticism of Jan Tinbergen's early work. (See Keynes [1073, pp. 299-320]).
prone to stagnation-depression as well as to bouts of extreme instability.

Clearly, these sets of profoundly different outcomes cannot be comfortably generated by a single Keynesian theory of something called competitive-capitalism-in-the-abstract. This being the case, the question naturally arises as to precisely what The General Theory is a theory of, and in what sense it is general.

In the sections to follow I address this question and explain and defend the proposition that Keynes's theory is institutionally and historically contingent.

**Keynes's Methodology and The General Theory**

The institutional foundation of Keynes's methodology can be seen most clearly if we understand his macrotheory to be the integration of *two distinct levels of analysis* – a relatively *abstract* level (which we label Level I) and a more *institutionally concrete* level (Level II). Keynes's Level I analysis would then incorporate the defining characteristics of the capitalist economy as well as those assumptions required to construct the skeletal properties of the supply and demand schedules of textbook Keynesianism (but not their position or pattern of movement through time). A Level II analysis adds to the theory the assumptions that specify the concrete institutions, classes, and agent motivations peculiar to each particular stage of economic development and develops the theoretical and behavioral implications of this institutional assumption set.²

Standing alone, Keynes's Level I analysis is incapable of generating the characteristic patterns of outcomes associated with a particular stage of development or of explaining why distinct stages exhibit contrasting patterns because Level I theory has underdeveloped institutional and behavioral concreteness. Conversely, without the guidance and direction of Keynes's Level I analysis, a uniquely Keynesian Level II theory of any specific stage is not possible. Level I concepts and categories are designed to guide the institutional research that informs Level II theory: they tell the theorist which institutions and which behavior patterns to study.³

Looked at from this perspective, The General Theory can be said to be general because it contains Keynes's Level I analysis of the capitalist macroeconomy at the most abstract level. But its concrete object of investigation is the institutionally specific form of capitalism found in Britain (or the United States) in the interwar period. Thus, neither the theoretical nor the policy conclusions of The General Theory are directly applicable to earlier to later stages of development.

² I do not mean to argue that Keynes self-consciously utilized the *formal* distinction between the analytical levels discussed here. I use this logical partition solely to clarify my own thesis that Keynes's method of analysis *in fact* incorporated both general and stage-specific theoretical and empirical assumptions.

³ By implication at least, a Level I analysis also tells the theorist what not to study. For example, in The General Theory Keynes shows no interest in the human aspects of production (or the labor process) and deemphasizes the significance of the structure, organization, and attitudes of the working class in determining economic outcomes. The stark contrast between Keynes's Level I analysis and Marx's analysis of "capital-in-general" is quite instructive in this regard.
The "general" analytical level of *The General Theory* incorporates many of the ideas typically associated with Keynesian economics. For example, it includes the attack on the classical thesis that wage and price flexibility guarantee market clearing in competitive capitalism, as well as the thesis that the behavior of aggregate demand is the key to macrodynamics. Keynes's arguments that consumption and savings patterns are complexly determined but relatively stable in the short-to-intermediate run, and that investment is the active element (and consumption the passive element) in capitalist macrodynamics are made primarily at Level I. Indeed, the main conclusion of Level I theory is that the key to understanding the characteristic behavior of the economy in any particular stage is a concrete theoretical analysis of three clusters of institutions and agent practices that determine the behavior of capital accumulation in that stage: (1) the strength and stability of the desire of enterprises to accumulate physical capital (financing considerations aside); (2) the proportion of income saved; and (3) the character of the relation between the entrepreneurial class and the class of savers and wealth-holders.

Since much of *The General Theory* is devoted to a Level II analysis of interwar capitalism, a brief review of Keynes's specification of the institutions and behaviors that molded the pattern of capital accumulation in the 1920s and 1930s will help clarify major differences between Keynes's theories of the macrodynamics of nineteenth- and twentieth-century capitalism.

In *The General Theory* Keynes discussed two related problems with investment demand in the modern era. First, he argued, investment is potentially extremely unstable. Second, investment has a tendency to stagnate at a level well below full-employment savings.

The stagnationist perspective is easiest to deal with. Keynes argued that rising household wealth and the satiation of basic consumption needs would generate a high average propensity to save. Investment spending, on the other hand, would be held down by the assumed low consumption growth rate, a relatively completed infrastructure, the absence of significant technical change (it played no role in *The General Theory*), a stable population (which implied a secular rise in capital per worker), and a not insignificant lower bound on interest rates. In addition, the potential instability of investment would, by making investment risky, lower the incentive to invest.

Keynes's vision of an extremely unstable modern capitalism has more complex roots. His theory of investment instability focused on the behavior of enterprise managers and wealthy rentiers and stressed the separation of ownership from management. Enterprise managers have to construct a "marginal efficiency of capital" or MEC schedule that associates an *expected* marginal rate of profit with each prospective level of investment. As expected long-term profit maximizers, managers should undertake every potential investment project whose MEC exceed the appropriate risk-adjusted cost of financial capital.

Rentiers in turn must decide upon the composition of their portfolios, a decision that turns upon both their attitudes toward risk versus return and the risk-return characteristics they associate in their *expectations* with different financial assets. Changes in either rentier attitudes or expectations will change the cost of capital.

Because of this particular institutional structure of the investment decision, Keynes
rooted his theory of the instability of modern capitalism in the unknowability of the future. 4 The fundamental determinants of both the MEC schedule and the long-term interest rate are the expectations of entrepreneurs and rentiers about prospective future yields on real and financial assets, the degree of confidence they place in the reliability of their expectations, and their attitudes toward risk. The central tenet of Keynes's theory of instability is that these future returns are in principle knowable; they cannot be adequately represented by stable subjective probability distributions. "The outstanding fact" about the investment decision, Keynes wrote in The General Theory:

is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made. Our knowledge of the factors which govern the yield of an investment some years hence is usually very slight and often negligible. [It]...amounts to little and sometimes to nothing [Keynes 1964, pp. 149-50].

In other words, Keynes placed the two classes of agents responsible for the investment decision in the following irreducible epistemological dilemma. They must make investment and portfolio selection decisions, for these decisions are crucial to their reproduction as economic agents, yet it is impossible for them to obtain the information required to make these decisions in a safe, rational manner. Keynes put this conundrum rather nicely: “About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know. Nevertheless, the necessity for action and for decision compels us as practical men to overlook this awkward fact” [Keynes 1937, p. 214].

To "save our faces as rational economic men" in this contradictory situation, Keynes noted, we act - at least in non-crisis periods - as if the information available to us was in fact an adequate basis on which to make real and financial investment decisions. Specifically, we pretend that the past and present are a more adequate guide to the future than they can possibly be and make ourselves believe that, though individual judgments about the future are worthless, the collective and "conventional" judgment of the business community is much better informed. Unfortunately,

a practical theory of the future based on these principles has certain marked characteristics. In particular, being based on so flimsy a foundation, it is subject to sudden and violent changes. At all times the vague panic fears and equally vague and unreasoned hopes are not really lulled, and lie but a little way below the surface [Keynes 1937, p. 215].

Given these core institutions and practices of modern capitalism, the assumption that the future is unknowable constitutes an adequate foundation for a theory of instability. But in the absence of additional institutional detail, the degree of instability associated with modern capitalism would have been limited by Keynes's belief that British entrepreneurs were knowledgeable professionals who habitually adopted a long-term perspective and tended, unless convinced otherwise, to provide their firms with the capital required to survive and prosper over the long haul.

But Keynes removed even this modest limitation on the instability of modern capitalism

---

4 The central role played by the unknowability of the future in Keynes's theory of instability has been stressed by G. L. S. Shackle, among others, and is an important component of Post Keynesian analysis.
by arguing, especially in Chapter 12 of *The General Theory*, that entrepreneurs are forced to substitute the stock market's more volatile, short-term assessment of the expected profitability of capital expansion, implicit in the price of the firm's shares, for their own more sober and longer-term MEC calculations.\(^5\) He stated, for example, that investment is "governed by the average expectation of those who deal on the Stock Exchange as revealed in the price of shares, rather than by the genuine expectations of the professional entrepreneur" [Keynes 1964, p. 151].

Since Keynes pictured twentieth-century rentiers as notoriously fickle and short-sighted, the degree of instability associated in *The General Theory* with the unknowability of the future is potentially severe. Volatile rentier expectations will, from time to time, violently unhinge investment demand. With "no strong roots to hold [them] steady," Keynes argued, the expectational determinants of investment will fluctuate substantially in the face of "waves of optimistic and pessimistic sentiment, which are unreasoning and yet in a sense legitimate where no solid basis exists for rational calculation" [Keynes 1964, p. 154].

This, in brief, is Keynes's theory of the instability of interwar capitalism.\(^6\) My central thesis implies that Keynes did not intend this to be a theory of the instability of capitalism in general or in every stage of development. I turn now to his Level II analysis of nineteenth-century capitalism to provide support for this thesis.

**Pre-World War I Britain: Keynes's First Stage of Capitalist Development**

Note first that Keynes clearly distinguished two historical stages of capitalist development: pre-World War I or "nineteenth-century" capitalism (which I label Stage One), and post-World War I or modern or twentieth-century capitalism (which I label Stage Two). He argued that these stages had qualitatively different economic outcomes because they had qualitatively distinct institutions and agent practices.

In a number of writings, Keynes asserted that while freedom of trade and of capital flows brought peace and prosperity in the nineteenth century, the same international system produced imperialism, war, and depression in the twentieth century (a point to which I return). In a similar vein, Keynes often observed that Britain's domestic nineteenth-century capitalism was characterized by reasonably steady growth, price stability, adequate employment and rising living standards, all produced by a strong and relatively steady pace of capital accumulation. In

\(^5\) For a richer discussion of Keynes's treatment of manager-stockholder relations or of what is known as the principal-agent problem in the theory of the firm, see Crotty [1990].

\(^6\) In this discussion I have focused on Keynes's treatment of those institutions, agents, and practices that directly affect the investment decision. However, the investment decision is not the only subject that receives an institutional analysis in *The General Theory*. Keynes's critique of classical labor market theory and his reconstruction of the labor supply function in Chapters 2 and 19 depend crucially on the absence of national or centralized process of wage determination. See, for example, Keynes [1964, pp. 268, 269 and 333]. And Keynes discussed the institutional foundation of the consumption-savings decision in Chapters 8, 9, and 10.

Paradoxically, Keynes's decision *not* to investigate the institutions and practices of the labor process but rather to accept the purely technical and abstract classical theory of capital-labor relations created one of the major flaws or blindspots in his theory.
The General Theory Keynes made the point as follows. "During the nineteenth century," there existed:

a schedule of the marginal efficiency of capital which allowed a reasonably satisfactory average level of employment to be compatible with a rate of interest high enough to be psychologically acceptable to wealth-owners. There is evidence that for a period of almost one hundred and fifty years ...rates of interest were modest enough to encourage a rate of investment consistent with a rate of employment which was not intolerably low [Keynes 1964, pp. 307-8].

Later in the book he commented on "the exuberance of the greatest age of the inducement to invest" in nineteenth-century England [Keynes 1964, p. 353]. And in the Economic Consequences of the Peace he argued that before World War I, "Europe was so organized socially and economically as to secure the maximum of capital accumulation [with] some continuous improvement in the daily conditions of life of the mass of the population" [Keynes 1920, p. 18].

Second, note Keynes's belief in the need for a theory that could explain the evolution of qualitatively distinct stages of economic development. He aligned himself with Commons's view that economic theory had to reflect the existence of "three epochs, three economic orders, upon the third of which we are entering." The first, according to Keynes, was a precapitalist "Era of Scarcity with a maximum of communistic, feudalistic or governmental coercion," which was dominant through the sixteenth century and survived to some degree into the eighteenth century. Then came the "Era of Abundance" with "the maximization of individual liberty, the minimum of coercive control through government, and individual bargaining. ...[In] the nineteenth century this epoch culminated gloriously in the victories of laissez-faire and historic liberalism" [Keynes 1963, p. 334].

But, Keynes continued, we are now passing through a period of turbulence into a new stage of capitalism, an "Era of Stabilization" in which societal or governmental controls will replace laissez-faire. The coming era will require a "transition from economic anarchy to a regime which deliberately aims at controlling and directing economic forces in the interests of social justice and social stability" [Keynes 1963, p. 335]. Having established Keynes's belief in the qualitative difference in performance between nineteenth- and twentieth-century capitalism and in the need for a theory of stages of capitalist development to explain these differences, I ask: What is Keynes's explanation of why the stability and growth of nineteenth -century laissez-faire was replaced by the instability and stagnation of the interwar years?

My interpretation of Keynes's method suggests that the Level I analysis of The General Theory is the guide to the construction of the institutionally concrete Level II models used to theoretically compare and contrast the two stages. Keynes's Level I model suggests that the Level II theory should focus on the three clusters of institutions and practices that determine the character of capital accumulation in the period. I examine Keynes's view of Stage One capitalism with respect to each in turn.

The agent motivation and behavior that characterized the decision to accumulate capital in the Level II analysis of The General Theory is not applicable to Stage One, Keynes tells us. Stage One entrepreneurs were not nervous managers unsure of whether the accumulation of physical capital or of liquid financial assets would best satisfy the whimsical desires of their stockholders. In Chapter 12, Keynes contrasted the investment-determining process of this
period with that of modern capitalism.

In former times, when enterprises were mainly owned by those who undertook them or by their friends and associates, investment depended on a sufficient supply of individuals of sanguine temperament and constructive impulses who embarked on business as a way of life, not relying on a precise calculation of prospective profit. The affair was partly a lottery ... But even after the event no one would know whether the average results in terms of the sums invested had exceeded, equaled or fallen short of the prevailing rate of interest. ... Decisions to invest in private business of the old-fashioned type were, however, decisions largely irrevocable, not only for the community as whole, but also for the individual [Keynes 1964, p. 150, emphasis added].

Thus, Keynes saw the Stage One entrepreneur investing not as the result of a careful monetary cost-benefit analysis but rather as a way of life, plowing back his profits (and the savings of his family and business associates) without much regard to whether the expected rate of profit exceeded some interest rate. This characterization of the "heroic" nineteenth-century entrepreneur - "the active and constructive element in the whole of capitalist society... he of all men and classes most respectable, praiseworthy and necessary" [Keynes 1963, pp. 87, 94] - was central to his understanding of why Stage One was "the greatest age of the inducement to invest."

Not only was the desire to accumulate capital strong in Stage One, the propensity to save was high as well. Savings were more than adequate to finance both domestic and foreign investment at low interest rates. The high savings rate was in turn created by two historically specific aspects of nineteenth-century British class structure: a very unequal distribution of income that funneled a disproportionate income share to the emerging strata of industrialists and merchants, to the professions, and to the landed aristocracy, and a high propensity to save among the upper classes.

Before World War I, Keynes tells us:

Society was so framed as to throw a great part of the increased income into the control of the class least likely to consume it. The new rich of the nineteenth century were not brought up to large expenditures, and preferred the power which investment gave them to the pleasures of immediate consumption. In fact, it was precisely the inequality of the distribution of wealth which made possible those vast accumulations of fixed wealth and of capital improvements which distinguished that age from all others [Keynes 1920, p. 18].

He went on to argue (in 1920, at the line of demarcation between Stages One and Two) that this class structure, with its particular class motivations and behavioral conventions, was transitory. "I seek only to point out that the principle of accumulation based on inequality... depended on unstable psychological conditions, which it may be impossible to recreate" [Keynes 1920, p. 21].

Finally, I turn to Keynes's characterization of the relation between the saving and investing classes. He identified two different saver-investor relations. The first referred to the owner-managed firms discussed in the "in former times" quote cited above. Capital accumulation in such firms was financed through retained profits and the savings of close friends and business associates. Here, in sharp contrast with the Level II analysis of The General Theory, saving and investment was done by the same people motivated by the same objective – the growth of the enterprise.
The second relation involved the emergence of the Victorian rentier class. The key behavioral characteristic of this class, in Keynes's view, was that it invested primarily in bonds and preferred stock - not in equity - and that it sought long-term income rather than short-term capital gains. Though the rentier class did purchase financial assets issued by domestic enterprises in the latter part of Stage One, the money was provided on a long-term, non-ownership basis. In contrast to modern capitalism, there was no separation of ownership from control in Stage One. In Keynes's words:

Thus there grew up in the nineteenth century a large, powerful, and greatly respected class of persons, well-to-do individually and very wealthy in the aggregate, who owned neither buildings, nor land, nor business, nor precious metals, but titles to an annual income in legal tender money. In particular, that peculiar creation and pride of the nineteenth century, the savings of the middle class, had been mainly thus embarked [Keynes 1963, p. 90].

With nineteenth-century rentiers treating their investments as relatively illiquid assets, capital accumulation during the period was not burdened by the unstable liquidity preference schedule of Stage Two. The cost of financial capital was on average low and stable. Keynes argued that there was a harmony of interest between the rentier and entrepreneurial classes that is in stark contrast with the domination of the entrepreneur by the fickle rentier pictured in the Level II analysis of The General Theory. He described this relation as follows:

Contracts to receive fixed sums of money at future dates ... must have existed as long as money has been lent and borrowed. ...But during the nineteenth century they developed a new and increased importance, and had, by the beginning of the twentieth, divided the propertied classes into two groups - the "business men" and the "investors" - with partly divergent interests. ...

By this system the active business class could call to the aid of their enterprises not only their own wealth but the savings of the whole community; and the professional and propertied classes, on the other hand, could find an employment for their resources, which involved them in little trouble, no responsibility, and (it was believed) small risk.

For a hundred years the system worked throughout Europe with an extraordinary success and facilitated the growth of wealth on an unprecedented scale. To save and invest became at once the duty and the delight of a large class. The savings were seldom drawn on. ...

The atmosphere thus created well harmonized the demands of expanding business... with the growth of a comfortable non-business class. ... Investments spread and multiplied, until, for the middle classes of the world, the gilt-edged bond came to typify all that was most permanent and secure [Keynes 1963, pp. 83-85; emphasis added].

Keynes's theoretical message here is clear. A large rentier class that holds its wealth in the form of long-term bonds almost "as a way of life" and an entrepreneurial class that both owns and controls business enterprises can, if institutional conditions are right, coexist in harmony, generating secular growth and stability for the community. Though Stage One had some of the same institutional and class categories as The General Theory, its concrete Level II structure was qualitatively different. As a result, it had neither the processes nor the outcomes of Stage Two.
Keynes's Empirical Assumptions and the Historical Record: A Digression

Since this essay is about Keynes's methodology rather than his credentials as an economic historian, the accuracy of his characterization of the institutions and agent practices of the nineteenth century is not directly relevant to its main thesis. Nonetheless, since the issue is pertinent to an assessment of the usefulness of his method of analysis, a brief look at the historical record is warranted.7

I first evaluate Keynes's assertion that capital accumulation was more a "way of life" and less the result of a careful present-value calculation in Stage One. Consider that the major supports of nineteenth century capital accumulation in Britain were the construction of the railroad system and the growth of the export market. They provided the demand that drove the expansion of the core industries of the industrial revolution - capital goods, textiles, iron and steel, and mining. It is not unreasonable to argue that both sectors were themselves driven by forces and motives not adequately captured by standard theories of profit maximization, including the one used by Keynes in *The General Theory*

Eric Hobsbawm, for example, has argued that the railroad boom:

> ...[M]uch of [the capital invested in railroads] was rashly, stupidly, some of it insanely invested. Britons with surpluses, encouraged by projectors, contractors and others whose profits were made not by running railroads but by planning or building them were undeterred by the extraordinary swollen costs of railways. ...Much of this capital was attracted less by rational calculations of profit and loss than by the romantic appeal of technological revolution [Hobsbawm 1968, p. 113].

A similar argument can be made for the export market. Geopolitical motivations associated with "nation-building" and colonialism were obviously of considerable significance in sustaining export demand.

Moreover, there is support for Keynes's characterization of the nineteenth-century owner-entrepreneur. First, until late in the century most industrial enterprises did rely almost exclusively on retained profits and the savings of people closely associated with the firm. Through at least the mid-1870s the combination of strong market growth, limited competitive pressure and a weak labor force generated a profit rate more than high enough to finance investment.

Second, the growth of the family enterprise and the economic and social status of the family were inextricably intertwined: capital accumulation was, to some extent, a way of life. Charles Kindleberger described this period in British history as follows:

> Capital to start most enterprises came from an individual, his family, friends, neighbors, in very informal ways. ...Growth came usually from retained profits. Middle-class entrepreneurs in small firms were reluctant to get involved with outside funds for fear that the family's ownership might be diluted and even lost. The argument being

---

7 Two caveats should be noted, however. First, to my knowledge Keynes did not address the historical questions at issue here in depth and detail: his historical observations are quite sketchy. Second, he was not above selecting only those fragments of economic history that suited his theoretical purpose.
maximized in the objective function, to use economic jargon, was not profit but family survival [Kindleberger 1984, pp. 192-93].

After 1880 external funds became important to the growth of domestic industry for the first time (though much less important than they would become in Stage Two). Technical change and increased economies of scale, along with marketing and distribution demands and the merger movement, necessitated larger plant and firm size even as heightened competition, slower growth and a stronger labor force squeezed internal funds. However, as Keynes stressed, long-term bonds and preferred stock totally dominated public offerings. Ownership and management remained united.

Turning to the saving side of the saving-investment relation, it seems clear that Keynes's assumptions of a very unequal distribution of income and wealth, a high savings rate and a relatively low interest rate are consistent with the historical record. There is a discussion of "capital glut" in most treatments of the period. His characterization of the rentier class seems reasonable as well. P. L. Cottrell notes that the rather scattered data on financial markets prior to 1885 "depict a capital market which was highly localized and dependent mainly upon subscriptions from three social groups, the unoccupied, trade and the professions" [Cottrell 1980, p. 95].

In the first half of the nineteenth century, government and railroad bonds were the assets of choice - "the favorite of couples about to marry, the last resort of Trustees...the cynosure of the old fashioned school of investor" [Kindleberger 1984, p. 201]. Then foreign loans, especially for railroad construction, became a rentier favorite. Finally, toward the end of the century, large-scale issues of domestic industrial and commercial bonds and preference shares became popular. They were:

suited both to the "outside" investor and the management group behind the public company. The investor gained by having a guaranteed return. ...[The] management group of a converted company gained an advantage because they could continue to control it in an unfettered way [Cottrell 1980, p. 164].

With lengthening maturities, industrial "debentures came to be ranked alongside other long dated or perpetual fixed stock such as Consols, but especially colonial government bonds and domestic local authority stock" in Victorian portfolios [Cottrell 1980, p. 165].

Thus, the historical record suggests that the Stage One rentier class received a large share of British income and saved a large share of it. Early on they financed infrastructural development and the export sector and in so doing indirectly financed the growth of domestic industry. Toward the end of the era they directly financed that portion of capital accumulation that could no longer be internally funded. They held long-term debt and preferred stock and they held it for the long term. There was little separation of ownership from control and capital accumulation was not the by-product of a casino. Keynes's stylized facts seem reasonably consistent with historical scholarship.

---

8 This discussion of external finance and the evolution of financial markets relies heavily on Cottrell [1980] and Thomas [1978].
The Transition From Stage One to Modern Capitalism

Many factors contributed to the collapse of the institutional foundation of Stage One. Keynes stressed those associated with the separation of ownership from control, the change in character of the rentier class, and the domination of the entrepreneurial class by rentiers.

In Keynes's view, reasonable price stability was a condition of existence of the Victorian rentier class. "Amidst the general enjoyment of ease and progress" in the nineteenth century, he observed "the extent to which the system depended on the stability of the money to which the investing classes had committed their fortunes was generally overlooked; and an unquestioning confidence was apparently felt that this matter would look after itself" [Keynes 1963, p. 85]. "The remarkable feature of this long period," he continued, "was the relative stability of the price level" [Keynes 1963, p. 88].

Of course, Keynes's Stage One rentier class could not have coexisted with recurring bouts of severe inflation and the capital losses and low real rates of return that usually accompany them. The inflation that was triggered by World War I and accelerated in the social conflict of its aftermath sounded the death knell of the Victorian rentier class, and thus of Stage One capitalism as well. "Through-out the Continent," Keynes wrote, "the pre-war savings of the middle class, so far as they were invested in bonds, mortgages, or bank deposits, have been largely or entirely wiped out" [Keynes 1963, p. 91]. With long-term bond prices and real interest rates now unpredictable, with confidence in the security of gilt-edged bonds broken, with the disappearance of the class that lent their savings to corporations long-term at low fixed interest rates, financial markets had to undergo a profound transformation.

The new rentier class constituted after World War I was qualitatively different from the old one. Diminished inequality meant that the rich were no longer able to personally finance industry. Small savers, whose bank accounts had grown during the war, were increasingly drawn to postwar financial markets, both directly and through the growing institutionalization of savings associated with investment trusts, insurance companies and pension funds. Moreover, from World War I to the 1929 crash, financial assets were increasingly purchased for speculation rather than long-term income - "prices of shares were hopelessly inflated and based on grossly optimistic expected earnings" [Thomas 1978, p. 28] - and were increasingly financed by bank borrowing rather than saving.

On the other side of the market one observes that domestic industry funded accumulation externally in a major way for the first time. New firms relied on capital markets for start-up funds and old firms floated stocks and bonds to finance expansion. "The day of the small unit is over," Keynes noted, "partly for technical, even more for marketing reasons" [Keynes 1981, p. 601]. By the late 1920s the speculative boom provided such cheap access to external funds that even well-established and well-capitalized firms felt compelled to enter the market. The situation was described in The Economist in these terms:

Before the war, the small industrial undertaking obtained a large proportion of its finance without making a general appeal to the public. From choice or necessity, industrialists now deem it worth their while, in the periods when the market is active, to turn family businesses into public companies with widely diffused shareholdings. The public for its own part is prepared to buy and hold equities in the undertakings about which shareholders know comparatively little and in whose management they cannot hope to have any decisive influence [Thomas 1978, p. 25].
Thus, the institutions and practices that Keynes described in the Level II analysis of *The General Theory* had emerged to replace those of Stage One: not surprisingly, the macrodynamic properties of Keynes's model underwent qualitative change as well. The accumulation process was now directly dependent upon financial markets that Keynes accurately described as gambling casinos. The investment decision of domestic industry was now hostage to the whims of an unstable, speculative rentier class. Management was now separate from but dependent on owners who "have no special knowledge of the circumstances, either actual or prospective, of the business in question" [Keynes 1964, p. 153]. The "heroic" entrepreneurial class of Stage One had been stripped of effective control of the pace and direction of capital accumulation: it could no longer invest for the long run, more or less as "a way of life." The Victorian rentier class was dead: "Investment based on genuine long-term expectation is so difficult today as to be scarcely practicable" [Keynes 1964, p. 157]. The "harmony" between the great strata of the nineteenth-century capitalist class was replaced by conflict, contradiction, and rentier dominance in the twentieth century. It is little wonder, then, that in the last chapter of *The General Theory* Keynes called for "the euthanasia of the rentier and, consequently, the cumulative oppressive power of the capitalist to exploit the scarcity-value of capital" [Keynes 1964 p. 376].

**Keynes's Stages of Development Theory and the International Economic System**

While an extensive analysis of Keynes's views on the changes that occurred in the international economy in the twentieth century is beyond the scope of this article, it would be appropriate to comment on the similarity between Keynes's stages-of-development approach to both the domestic and international economic systems.

Through the early 1920s, Keynes had been an ardent supporter of free trade, free capital flows and laissez-faire policy as the foundation for peace and prosperity in the international economy. Of course, the fact that Britain had been the main beneficiary of the international division of labor in the nineteenth century no doubt colored his thinking on this issue. The horrors of World War I stimulated Keynes to completely rethink his position on international economics. After 1923 he became a harsh critic of the free-trade system.

Keynes wrote voluminously about international economic problems, but the best example of his thinking on this particular issue is his 1933 essay, "National Self-Sufficiency." The opening paragraph of this essay stressed Keynes's unconditional belief in the free-trade doctrine prior to World War I and its aftermath. "I was brought up," he said, "like most Englishmen, to respect free trade not only as an economic doctrine which a rational and instructed person could

---

9 In the spirit of Keynes's analysis, one could argue that at least two qualitative shifts in investor-saver relations have taken place since *The General Theory* was written. In the 1950s and 1960s, top managers of U.S. Corporations - Keynes's entrepreneurs - were in control of the investment decision-making process. Financial markets were relatively stable, real interest rates were modest, and stockholders, bondholders and bankers played no major role in corporate policy-making. Entrepreneur-rentier relations were characterized by the "harmony" Keynes ascribed to them in Stage One. Since the mid-1970s, however, financial markets have once again become unstable and highly speculative. Meanwhile, in the face of leveraged buyouts, hostile takeovers, and rising debt-equity ratios, corporation managers can no longer make the investment decisions they believe to be in the long-run interest of the enterprise: rather, they are forced to bow to the whims of an increasingly short-horizoned stock market. See Crotty [1990] for a discussion of the current state of entrepreneur-rentier relations.
not doubt, but almost as a part of moral law" [Keynes 1933, p. 755]. Indeed, he argued, this
dctrine was adequate to describe and analyze the processes and outcomes of the Stage One
international economic system: in his view both economic growth and the cause of world peace
were facilitated by free trade in the nineteenth century.

But the twentieth century wrought dramatic changes in the structure of the international
economy and thus in the effects of free trade. The following comment captures well the totality
of Keynes's rejection of free trade doctrine.

The decadent international but individualistic capitalism, in the hands of which we found
ourselves after the war, is not a success. It is not intelligent, it is not beautiful, it is not
just, it is not virtuous-and it doesn't deliver the goods. In short, we dislike it, and we are
beginning to despise it [Keynes 1933, p. 761].

We turn first to Keynes's views on the question of peace:

…it does not now seem obvious that a great concentration of national effort on the
capture of foreign trade, that the penetration of a country's economic structure by the resources
and influence of foreign capitalists, and , that a close dependence of our own economic life on
the fluctuating economic policies of foreign countries are safeguards and assurances of
international peace. It is easier, in the light of experience and foresight, to argue quite the
contrary [Keynes 1933, p. 757].

Keynes's argument about the relation between free trade and prosperity was as follows. In
the nineteenth-century, Britain was much more economically advanced than most of the rest of
the world. Under such conditions, it made sense for Britain to export capital goods and skilled
labor and for the importing countries to borrow the money needed to pay for these goods from
the more-than-adequate savings of the British rentier class. In these circumstances "the
advantages of a high degree of international specialization were very considerable" [Keynes
1933, p. 759].

By Stage Two the situation had changed dramatically. For one thing, "the economic
advantages of the international division of labor today are [not] at all comparable with what they
were" [Keynes 1933, p. 760]. More important, financial flows were no longer primarily
generated by the need to import specific capital goods: international financial flows became
increasingly speculative. Money flowed from capital markets all over the globe to capital
markets all over the globe in search of the highest possible short-term rewards. And financial
blocks from powerful countries began to seek control over the economies of weaker ones.

Keynes did not hesitate to label this situation imperialism, and he again identified the
institutional changes leading to the separation of ownership and control of economic life as the
main source of the problem. When the principle of the "divorce between ownership and the real
responsibility of management" is

applied internationally, it is, in times of stress, intolerable - I am irresponsible toward
what I own and those who operate what I own are irresponsible towards me. ...But
experience is accumulating that remoteness between ownership and operation is an evil in
the relation among men, likely or certain in the long run to set up strains and enmities
which will bring to naught the financial calculation [of international investors] [Keynes
1933, pp. 757-58].

Keynes ended this essay with a call for the radical restructuring of Britain's international
economic relations. In brief, he supported strict state controls over the international movement of goods and money. The details of his proposals need not concern us here. The important point for our purposes is that Keynes clearly identified two different stages of development of the international economic system. And just as clearly, Keynes believed that no institutionally abstract theory of capitalist world markets was adequate to describe or analyze the processes and outcomes of both stages.

Conclusion

The central issues addressed in this article, strictly speaking, concern the history of economic thought. It is important to note, however, that they are equally relevant to current debates over macrotheory and macropolicy. Keynes was right and mainstream Keynesians (and "disequilibrium" Keynesians and Walrasians) wrong about how theory can best help us understand and influence the processes and typical outcomes of any historically specific capitalist economic system - including our own. The main policy advantage of a macrotheory, such as Keynes's, that is grounded in the concrete institutional structure of the economy is that it generates a richer set of policy options than a theory such as mainstream Keynesianism that is built on Walrasian agents and an abstract concept of markets. Keynes's theory facilitates a consideration of institutional change as an integral part of the policy decision-making process.10

Thus, we should not be surprised that Keynes drew policy conclusions from his historically contingent, institutionally based approach to theory that are qualitatively different from those associated with mainstream Keynesianism. His most significant and controversial regulatory proposals called for substantial changes in economic and political institutions and in agent practices. He supported public control of the investment process or the "socialization of investment" as well as a substantial redistribution of income. He proposed a new international financial system centered around his International Clearing Union, a system radically different from both the gold standard and the Bretton Woods system. He argued that control by governments over the movement of goods and, especially, money across their borders was a necessary condition for stable full-employment growth.11

Whether or not this particular set of institutional, regulatory proposals would help us better achieve our own economic and political objectives is not the issue here. The point is that qualitatively different theoretical methodologies produce qualitatively different explanations of important economic events as well as qualitatively different policy proposals for the achievement of economic objectives. The implicit debate over macroeconomic theory that is the subject of this article has implications that reach far beyond the discipline of the history of economic thought. We are more likely to understand and control the dynamics of the late twentieth-century capitalism in which we live if we take our lead from Keynes rather than from Paul Samuelson in

10 In this discussion of differences among economic theories I have focused on the question of institutional concreteness. However, this is certainly not the only thing that distinguishes Keynes from Samuelson or, for that matter, from Marx. There are, in addition, central questions concerning which institutions and agents to theorize and how to theorize them.

11 See Crotty [1983] for a discussion of Keynes's proposals for institutional reform in both the domestic and the international sectors.
this debate.
References


