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Economic Transition and the Future of Capitalism:
Lessons Learned from Poland's Success in Economically Turbulent Times

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From neo-liberal Capitalism to Social Liberalism on the basis of Classical-Keynesian Political Economy

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Let me say that I am very greatly honoured by this invitation, and it is with great pleasure that I came to the United States and specifically to Washington.

The subject I am dealing with is not very familiar, and, therefore, I should like to present the first two sections of a little paper at this round table: *From neo-liberal Capitalism to Social Liberalism on the basis of Classical-Keynesian Political Economy*. I first deal with some basic features of Classical-Keynesian Political Economy, which is the social liberal alternative to neoclassical economics, the economic theory of Liberalism, realised, in turn, through Capitalism. In the second place, I allude to some general policy implications and a few policy implications for Poland and other transition economies.

In any case, to clarify very broadly the theoretical situation seems absolutely necessary in view of the immensely complex problems on the agenda this evening.

1. On Classical-Keynesian Political Economy and the Underlying Socio-Political Philosophy of Social Liberalism

Taking up a phrase out of the presentation of this Evening Conference I do „believe the current crisis was created by the existing free-market system and now seek to highlight alternative approaches to create a new economic regime for the 21st century." I indeed think that, by way of fundamental reform, we should move from neo-liberal Capitalism in the direction of Social Liberalism, the social philosophy implied in Maynard Keynes's overall work; in Keynes' view, Social Liberalism is Liberalism on a social, fair distribution and full employment, basis (Bortis 1997/2006, chapters 2-4; here, *Social Liberalism* still appears under the name of *Humanism* or *Comprehensive Humanism*). Ideally, this social basis would enable the orderly living together of the social individuals in conditions of freedom.

To set up a reasonably good society, in line with the capacities of fallible human beings, requires a very solid economic theory. Robust theory is also required to criticise capitalism, while recognising the immense merits of this social system in the domains of science and technology, and to make suggestions on the transition to a social liberal state of affairs, which is social, but maintains the fundamental positive attributes of a free-market economy, freedom of enterprise most importantly. In our view, this theory can only be *classical-Keynesian political economy,* which pictures a monetary production economy.

Classical-Keynesian political economy is conceived of as a synthesis of classical (Ricardian) and Keynesian political economy. With Ricardo, income distribution is *the* fundamental problem of political economy. Basically, distribution is a *social and political* problem, not a market problem; the fundamental prices are not market prices, but the prices of production, determined by the normal costs of production and the normal profits, both governed by institutions and technology. Keynesian political economy is concerned with the scale of economic activity governed by effective demand: as a rule, involuntary unemployment may permanently exist; in principle, unemployment increases if the income distribution becomes more unequal and if the autonomous variables, government expenditures and exports, decline; this follows from the classical-Keynesian supermultiplier-relation (Bortis 1997/2006 and 2003), [which is related to the functioning of the socio-economic and political system. [Due to the investment behaviour of entreprises] output and employment fluctuate in the course of business cycles [Kondratiev and Juglar cycles]: the income effect of investment, the post-Keynesian interaction between profits and investment, governs upswings and downswings, the capacity effect of investment determines the turning points (Bortis 1997/2006, pp. 204-220). Given all this, political economy pictures the economic aspects of the functioning of the institutional system within which the behaviour of individuals is embedded. Hence the equilibrium governed by effective demand is a *system-equilibrium,* not a market equilibrium. The economy considered is, primarily, neither a market nor a planned economy, but, rather, a monetary production economy. Given this, *money is of crucial importance;* in fact, endogenous finance is transformed into money in the social process of production where values are created. Within the process of circulation of money and goods, money acts as a representative of value. Subsequently, in a Keynesian *Treatise on Money (1930)* vein, the real and the financial sector interact (Bortis 2009a and 2009b). On this interaction, Keynes's biographer, Robert Skidelsky, writes rather dramatically: «Depressions arise, Keynes wrote in his Treatise on Money [1930], when money is shifted from the 'industrial circulation' into the 'financial circulation'. This emphasis Keynes placed on the function of money as a store of wealth, as an escape from commitment, was one of his original contributions to economics» (Skidelsky 1992, p. xxiv).

A fundamentally important feature of a monetary production economy is that there is no tendency towards a full employment equilibrium at all, even if there are competitive conditions. On the contrary, unfettered Capitalism may lead on to growing disequilibria through processes of cumulative causation as have been pictured by Nicholas Kaldor and Gunnar Myrdal: growing involuntary unemployment, increasing disparities in income distribution, widening wealth gaps between countries and regions; in a classical-Keynesian world competition may become a struggle for survival and may result in destructive socio-economic consequences; social entities, even the small family, may break up; crime and corruption may increase.

The crucially important relationship between unequal distribution and involuntary unemployment represents, according to Schumpeter, the essence of the Keynesian revolution: "[The Keynesian doctrine] can easily be made to say both that 'who tries to save destroys real capital' and that, via saving, 'the unequal distribution of income is the ultimate cause of unemployment.' *This* is what the Keynesian Revolution amounts to" (Schumpeter 1946, p. 517). [Indeed, Keynes held that the "outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes. [Up] to the point where full employment prevails, the growth of capital depends not at all on a low propensity to consume but is, on the contrary, held back by it [and] measures for the redistribution of incomes in a way likely to raise the propensity to consume may prove positively favourable to the growth of capital" (Keynes 1936, pp. 372-73).]

Given this, the role of the state in Social Liberalism is, on the one hand, a very important one: creating as much social harmony as possible and reduce system-caused alienation, involuntary unemployment above all, as far as is humanly possible (Bortis 1997, chapter 6). On the other hand, the citizens should hardly realise that there is a state. Indeed, government activity must, in the first place, be directed towards organising the social system, i.e. towards setting up, or encouraging the coming into being, of appropriate institutions. This can only be done properly if there is a very solid economic theory from which appropriate policy conceptions may be derived, and, much more important, underlying theory, there must be vision of the society to be aimed at, and a vision implies values, most fundamentally, the good state and the good life of the social individuals on the basis of a sense of life; the pursuit of truth in the natural, social and human sciences; the realisation of beauty in all spheres. Ideally, with alienation (mainly involuntary unemployment and the social problems resulting therefrom) reduced to a minimum, the state would be almost imperceptible. Contrariwise, with heavy alienation - unemployment and social unrest, in the main - the state would have to be a law and order state, interfering heavily with the behaviour of individuals, reducing thus the scope of liberty.

To put it in a nutshell: Involuntary (mass-) unemployment and a very inequitable distribution of incomes lead to a *struggle for survival,* concretely to a struggle for raw materials, markets, and, ultimately, workplaces. This may lead to conflicts between social, ethnic and religious groups, and even states. Full employment and a reasonably equitable distribution, however, render possible the peaceful living together of most diverse social and political formations, associated with the possibility of mutual spiritual, intellectual and material enrichment. However, the aim is not to create an ideal society, but to set up a reasonably good society, in which the social conditions are such that *all* social individuals can, potentially, prosper, that is, unfold their dispositions and perfect and broaden their capacities.

2.1. Some general policy implications

Governing, setting up appropriate institutions and permanently maintain their proper functioning, is a most difficult long-term task in a social liberal world, requiring a very solid system of political economy and a vision of how a political society should look like. This leads to a case for the small and medium sized-state: the state should not be too large to be governable [Aristotle!]. Given this, large states (Brazil, China, India, Russia, the United States) would have to decentralise substantially on the basis of the Principle of Subsidiarity. Moreover, since there is no tendency towards full employment, large free-trade areas are not appropriate institutions; in fact, economic instability is likely to increase with the size of the free-trade area, also on account of the free flow of financial capital which favours bubbles in the financial sector and reinforces business cycles. However, stability within each country would produce stability on the continental and global levels. Hence Europe, and, in fact, the world should become a family of nations, eventually to be structured by historical-geographical federations (Bortis 2009c, section *On the world order of Modernity*). This is not a case against Europe. Quite the contrary. Stable socio-economic and political conditions within countries is the most solid basis for co-operation in Europe and for conceiving supranational institutions on the basis of the principle of subsidiarity, dealing with common European problems and with coordinating activities. Poland and France, *the* two nations *par excellence,* should try to direct Europe toward a family of states. If stable, near full employment conditions, could be created within the European polities, the unrestricted mobility of individuals between countries and the free flow of capital would be no problems. In terms of section 4 below the presently dominating *external (outward directed)* development mechanism associated to free trade ought to replaced by the *internal (inward directed) development mechanism;* here development would be driven by internal forces, with the outside world providing assistance if required (see also Bortis 1997/2006, pp. 190-98 and chapter 6, specifically pp. 326-343).

Relying on the internal development mechanism implies that each state must have its own money to be able to mobilise its resources. Governments must spend in order to get taxes. In fact, government expenditures (G) *create* the taxes ($T = t\ Q$), that finance these expenditures ($G = t\ Q$); this is analogous to the famous Keynesian formula: investment precedes saving and, precisely, brings about the saving required to ensure the real financing of investment ($I = s\ Q$); the relation between government expenditures and social product ($G = t\ Q$) implies that a carefully thought out composition and size of government expenditures and a solid tax system (indirect taxes and taxes at source) represent the backbone of a modern monetary production economy and the associated institutional system. In fact, to determine the size and the composition of government expenditures and to set up a tax system such that full employment obtains is a fundamental, but also most difficult task governments would be *permanently* facing in a social liberal world.

However, when output (Q) and employment (N) increase on account of a permanent increase of government expenditures G, deficits in the current account might arise: [$X < M = \pi\ (b_1 + b_2)\ Q$ (X = exports, M = imports, π = terms of trade, b_1 = coefficient of necessary imports required in production, b_2 = coefficient of non-necessary imports associated to non-necessary consumption, Q = social product).] This requires a slight management of imports: the coefficient of non-necessary imports (b_2) must be adjusted such that, broadly, an equilibrium in the balance of current account [X = M] obtains in the long run. Given this, a first central task of the IMF would be to assist all countries to bring about a broad equilibrium in the balance of current account. The other fundamental IMF task would be the transfer of resources from higher developed to less developed countries; in the case of foreign investment, the terrain in the recipient country must be prepared by increased effective demand, through rising G for instance; otherwise, foreign resources may simply displace domestic resources (Bortis 1979). To enable the IMF to carry out these tasks, a supranational world currency, the *Bancor,* should be set up along the lines proposed by Maynard Keynes at Bretton Woods in 1944 (Keynes, Collected Works, vol. XXV). The management of the world currency would be the basic task of the World Bank, of course in close collaboration with the IMF.

A world economic and financial order along these lines would have a very important cultural implication: each country and region would be able to set up a way of life of its own, based upon implementing the fundamental values in a specific manner: that is, the good state and the good life, guided by a sense of life; the pursuit of truth in the natural, social and human sciences; the realisation of beauty in all spheres. In this way the cultural diversity would be restored and maintained worldwide, enabling global mutual enrichment on the spiritual, intellectual and material levels. Hence globalisation should not end up in a uniform world along Western lines but in a rich and diversified world in which traditional ways of life would be preserved and gradually adapted to Modernity in line with these ways of life.

2.2. Some specific policy conclusions for Poland and other transition economies

The general policy conclusions imply that Poland ought to move in the direction of a social liberal state of affairs. Indeed, when we speak of transition, a specific question immediately arises: *transition to what?* If neo-liberal Capitalism is found unsatisfactory, then only Keynes's Social Liberalism remains, that is the Middle Way alternative to Capitalism and Socialism Keynes was in search of for the whole of his life.

A first step would be to get conscious about the existence of the social philosophy of Social Liberalism and of the associated system of Classical-Keynesian Political Economy and its theoretical and practical potential. Teaching Classical-Keynesian Political Economy at the Universities, still utterly dominated by neoclassical mainstream economics, would be essential.

The first policy step would be to move away from the presently prevailing external employment mechanism in the direction of the internal employment mechanism (Bortis 1997/2006, pp. 190-98, and section 4 of this paper). In the classical-Keynesian system, dominated by quantity adjustments, *government expenditures* should dictate the pace of economic development, not exports. Indeed, in transition economies exports may not be sufficient to bring about high employment levels. Moreover, heavy import dependence may lead on to current account deficits and growing foreign indebtedness. The constant threat of unemployment produces a struggle for survival, and a permanent pressure on producers who have to fear elimination from the market. One should note, however, that the internal employment mechanism does *not* restrict foreign trade in any way. Exports and imports may be balanced at any level, which may be very high.

Subsequently, a discussion on what should be public, mixed and private should be initiated, and a solid tax system established. Here, indirect taxes should dominate; this requires an incomes policy: minimum money wages ought to be high to bring about a socially acceptable minimum real wage.

According to the internal employment mechanism, government expenditures set economic activity into motion. The employment effect of government expenditures will be enhanced through a high spending power of the population, which is brought about by a relatively equal distribution of incomes. Hence a permanent incomes policy is needed. In the long run investment is derived demand (Bortis 1997/2006 and 2003). If efforts are undertaken to maintain current account equilibrium and if full employment prevails, a climate of sound competition may develop and production may go on in tranquil conditions. Pressure on producers and workers and employees would largely vanish. This would greatly improve the whole social climate. The economy would become a solid basis upon which the social individuals may prosper, that is, unfold their abilities and broaden and perfect their capacities. Given this, the size and the composition of government expenditures crucially shape the way of life in any country.

Two points may be added here. First, the regional distribution of government expenditures is very important in view of reducing regional disparities and promoting a balanced regional development; this implies that less developed regions should benefit from relatively higher shares government expenditures. And second, finance should not place any restriction on expanding government expenditures as long as there are unused resources. Money is endogenous in a classical-Keynesian world; consequently, the central bank may finance of any level of government expenditures. However, at full employment, the state budget must be balanced if the long run is considered. This is required to ensure the real financing of government expenditures through taxes, which release the resources required to produce public goods and services.

An important aspect of the internal employment and development mechanism is the relationship between industry and agriculture as seen by Adam Smith in his development model set out in Book III of the *Wealth of Nations*. To start with, the agricultural surplus is sold to workers and employees in industry. The monetary revenue so obtained is spent by agriculture to buy industrial goods. Obviously, the market for industrial goods in agriculture gets larger if the prices of agricultural goods are relatively high, that is, if the agricultural producers have high revenues. To fix the prices for agricultural products at a relatively high level should go along with a general promotion of agriculture through agricultural formation centres and agricultural banks. In our view, the general promotion of agriculture would be a very important policy measure in all transition economies, which all have a large agricultural sector, particularly so Poland, the Ukraine and Russia.

Foreign investment is highly desirable for two reasons, to relieve bottlenecks and to increase the total volume of investment. However, foreign investment can only add to domestic investment if there is sufficient effective demand. According to the internal development mechanism, additional effective demand can be created through stepping up government expenditures, for example, to improve the educational system through an increased number of teachers and correspondingly smaller school classes.

2.3. Two specific policy conclusions for Russia

All the policy measures alluded to in the previous subsection would also hold for Russia. In this country, however, two specific policy conclusions would add. First, and quite evidently, Russia must decentralise if the internal development mechanism is to be applied successfully. In cooperation with the central government, the regional authorities would promote the policies outlined in the previous two subsections.

Second, Russia ought to deal, and is perhaps already dealing adequately with her immense resources of primary goods (raw materials and energy resources). The relevant policy point could be made as follows. Imagine two Russia: Russia I with primary goods, and Russia II without primary goods. In principle, Russia I ought to develop according to the internal development mechanism in the same way as Russia II. However, Russia I ought to be permanently richer than Russia II, because there would be the additional wealth brought about the stocks of primary goods that produce a flow of exports. Indeed, the imports rendered possible through these exports (consumption and investment goods) would add to Russia's domestically produced consumption and investment goods. Hence, more consumption goods would be available increasing Russian material welfare; the imported investment goods, possibly embodying advanced technologies, would speed up the process of development and growth. Given this, Russia II would be separated from Russia I through a permanently growing wealth gap. It is well known that this process does, as a rule, not take place in countries richly endowed with primary goods. The reason is, of course, that primaries are exported and industrial goods imported. This hampers the growth of the industrial sector, which heavily depresses the level of employment; indeed, as Nicholas Kaldor argued, primaries are land-intensive, industrial goods labour-intensive. On the other hand it is equally well known that countries with no or little primaries belong to the richest countries in the world. Germany, Japan and Switzerland would be cases in point. This situation is not normal. Indeed, considering the very long run, Russia, on account of her immense natural resources, ought to be one of the richest countries in the world.

Some important topics associated to Social Liberalism and to Classical-Keynesian Political Economy

3. On Social Liberalism

Right at the beginning a possible misunderstanding has to be dealt with. Social Liberal doctrine sees *man* and *society* as entities. This does *in no way* imply totalitarianism where the individual is, essentially, an exchangeable part of the social machine. Just the contrary is true, as is brought to the open in Bortis (1997, chapters 2 and 7). Indeed, according to the doctrine of *Social Liberalism,* society and the state are *indispensable, but ancillary* for the individuals who can unfold their potentials only *within* and *through* society. *Within* society means that there must be preconditions or social foundations that have to be there if *all* the social individuals are to be given the possibility for a good and decent life: full employment, fair distribution of incomes, a public education system, a well-suited legal system, a diversified set of cultural institutions. *Through* society signifies that the social individuals get more perfect through social activities, for example going to school, to university, discussing, reading, contemplating works of art and architecture, practising sports, and, last, but not least, the enhancing of manual skills; in a world with ever scarcer natural resources skilled trades –

craftsmanship - might become of crucial importance again; Richard Sennett's very important book *The Craftsman* is greatly significant in this context; indeed, the fundamental theme of the book is to reconcile Man and the world of Labour again.

4. Monetary Theory of Production and Employment Determination: the internal and the external employment mechanism

(taken from Bortis 2003a, pp. 72-77, in partly modified form)

The starting point is Keynes's contribution to the *Festschrift* for Arthur Spiethoff *A Monetary Theory of Production* (Keynes 1933, Collected Works, vol. XIII, 408-11) where he distinguishes between the ‚real exchange economy' and the ‚monetary production economy'. The notion of the ‚real exchange economy', symbolically represented by scheme

$$C – M - C' \qquad (1)$$

(C = commodities, M = money), underlies the whole of neoclassical economic theory, Walras's General Equilibrium Theory and Marshall's Partial Equilibrium Approach, most importantly. In such an economy money does *not* play any significant role.

The concept of the *monetary production economy* is basic for the mercantilist-Keynesian theory and its developments, for example, post Keynesian and classical-Keynesian political economy. As a consequence, all these theoretical strands are, explicitly or implicitly, based upon a more or less complete *monetary theory of production:*

$$M – C \;....\; \mathbf{P} \;....\; C' – M' \qquad (2)$$

Money and finance M is used to buy means of production C (labour, machines, raw materials) which, within the social process of production, **P**, are transformed into final goods C' that are exchanged against money M'. [Money plays evidently a *crucial* role (Bortis 2009a, 2009b)].

While in a real exchange economy, the level of output and employment is supply determined, economic activity is demand determined in a monetary production economy. *Goods are always exchanged against money, not against other goods, as is the case in a real exchange economy*. Given this, in a real-exchange economy, the great economic problems are, in principle, solved by competitive markets. In principle, the labour-market and the market for new capital-goods (investment goods) interact in such a way that a strong tendency towards full employment obtains.

This is not the case in a monetary production economy. Here, economic activity is set into motion by autonomous expenditures, government expenditures G and exports X, as is exhibited in the supermultiplier relation (3) (Bortis 1997, pp. 143-46; and ch. 4).

$$Q = \frac{G + X}{z_s[1 - \frac{1}{k})] + \pi(b_1 + b_2) - (g + d)v} \qquad (3)$$

The supermultiplier now links the autonomous variables with output Q (and, hence to 'profit sector' employment N, because of Q = AN, where A is labour productivity). The long-period trend or 'equilibrium' output Q may be at any level below full employment output Q_f.

The supermultiplier relation is of a long-period nature. All the prices and quantities involved represent a system equilibrium and are, as such, governed by technology and institutions which are constant or slowly evolving.

To bring to the open the essential features of the supermultiplier relation we postulate that ordinary or normal wages – governed by collective or individual bargaining - are entirely consumed. The leakage as a fraction of property income is $z_S = 1 - c_S = s_S + t_S$ (c_s, s_s, t_S = fractions of property income consumed, saved and paid for taxes, respectively). The property share income (profits, land and labour rents, the latter arising on account of special abilities or of privileges) is 1-(1/k), where k is the mark-up on ordinary wages (the ‚variable costs' in a vertically integrated economy); b_1 is the propensity to import of necessary goods, required in the process of production, b_2 stands for the import propensity of non-necessary goods which are related to state and private consumption and π equals the terms of trade; (g + d) v is the gross investment-income ratio: g is the – trend – growth rate of the autonomous variables (G+X), d is the drop-out ratio of fixed capital – depending on physical and technical obsolescence and hence upon the innovative dynamism of the entrepreneurs - and v represents the capital coefficient.

Given the autonomous variables, output Q is, in principle, positively linked with a large investment-output ratio (g+d)v, negatively with a strong import dependence, as is reflected in large import coefficients, and in unfavourable terms of trade (π is high). Most importantly, an unequal income distribution, reflected in a relatively large value of the property share [1-(1/k)] is, in principle, associated with a lower level of output and employment; if property income is itself unequally distributed, the leakage coefficient z_S will be large – because of a high saving coefficient s_S - which further depresses output Q and employment N. The negative link between unequal distribution, and output and employment is *the* crucial feature of the supermultiplier relation.

The supermultiplier governs the long-period output and employment trend and, as a consequence, persistent, long-period unemployment; all the prices and quantities are, in a classical vein, governed by persistent and slowly evolving factors, which are technology and institutions (Bortis, 1997, ch. 3 and 4).

The relevant point now is that the supermultiplier embodies two employment mechanisms, the internal and the external employment mechanism (Bortis, 1997, pp. 190-98). The internal employment mechanism is based upon the macroeconomic equilibrium condition S = I (relation 4 below), the external employment mechanism on the balance on current account, $X = \pi M = \pi\,(b_1 + b_2)\,Q$ (relation 5 below); see Bortis (1997, pp. 190 ff.).

As a rule, output determined by the internal mechanism (Q_I) and by the external mechanism (Q_E) diverge. This will be reflected in a current account surplus or deficit appearing in the numerator of relation (4). Various possibilities exist to adjust both employment levels to each other. For example, Q_I and Q_E may adjust mutually to each other through variations in government expenditures G or through variations in the propensity to import non-necessary goods related to consumption (b_2). As a rule, however, the external mechanism will govern economic activity in the long run, implying that Q_I will have to adjust to Q_E (Bortis, 1997, p. 169 and pp. 190-99).

$$Q_I = \frac{G + (X - \pi M)}{z_s[1 - \frac{1}{k})] - (g + d)v} \qquad (4)$$

The internal mechanism (4) will, as a rule, determine economic activity in large countries like the United States, Russia, China, France. Hence, government expenditures, income distribution and gross investment will be crucial in governing economic activity. The foreign balance will, in normal circumstances, play a secondary role.

Densely populated countries lacking primary resources (agricultural products, raw materials and energy resources) are, as a rule, outward oriented with the external mechanism (5) governing economic activity. Obvious examples are Germany, Japan, Singapore, Switzerland, Taiwan.

$$Q_E = \frac{X}{\pi(b_1 + b_2)} \qquad (5)$$

The internal employment mechanism (relation 4) is politically exceedingly difficult to manage in an open economy. There is, first, an inherent difficulty. The internal employment mechanism in fact requires establishing socially sound proportions between state and the private sector, reflected by the ratio G/Q, *and* a socially acceptable distribution of incomes, such that economic activity is near to, or, ideally at, the full employment level. And, second, internal policies must be such that the external balance ($X = \pi M$) is broadly preserved.

Given the immense difficulties associated with the internal employment mechanism it is natural that, with the creation of large free-trade areas and with globalisation, more and more countries will rely upon the external employment mechanism to secure levels of employment as high as possible. The employment effect of foreign trade will be particularly strong if the bulk of exports consists of high-quality industrial products and services and if imports are, in the main, made up of primary goods as is necessarily the case with the successful exporters just mentioned, and with the terms of trade being favourable. High-quality industrial goods and services are, as Nicholas Kaldor has emphasised time and again, labour-intensive - if account is taken of direct and indirect labour – while primaries are land-intensive.

Now, there is, in our view, a contradiction between the external and the internal employment mechanism at the world level. In fact, world economic activity (Q_W) must be governed by the internal employment mechanism (relation 6 below) since the world as a whole is a closed system. The share of world economic activity attributed to each country is, however, governed by the external employment mechanism (relation 5 above). Hereby, the shares in world industrial production and services activities are, of course, of particular importance.

$$Q_W = \frac{G}{z_s[1 - \frac{1}{k})] - (g + d)v} \qquad (6)$$

In order to successfully set to work the external employment mechanism, countries and regions have to offer favourable conditions in order to attract firms, which create additional work places and, subsequently, export the bulk of their production. The work force has to be of good quality, but wages not too high, the infrastructure should be in a good state and should be available at low costs to the users, public services, education in the main, should be of high quality, but taxes not too high. Taxes may, in turn, be lowered if state activities are privatised. Given the endeavour to create, in each country, a favourable environment for exporting firms, it is likely that government expenditures stagnate or even decline at the world level. Even more importantly, income distribution has become markedly more unequal in the last twenty years or so, as James K. Galbraith convincingly argues. According to relation (6) a more unequal income distribution and stagnating or eventually declining government expenditures both imply that, in principle, long-period world economic activity – output and employment - remains more or less constant or even declines. As a consequence, the struggle for world market shares, mainly of industrial goods and services, will intensify. Through the external employment mechanism the successful exporters of high-quality industrial goods and services may nevertheless enjoy a satisfactory, even a booming economic situation. The losers, however, will be precipitated into the abyss of mass unemployment and of social and political instability. Owing to the law of increasing returns and to the principle of effective demand, Kaldorian cumulative processes may be set into motion resulting in larger inequalities of income, wealth and employment opportunities worldwide.

5. The genesis of classical-Keynesian political economy – a historical sketch

Keynes's great works, the *Treatise on Money* and the *General Theory,* gave rise to post Keynesian economics, from which classical-Keynesian political economy emerged. However, this line of development has been of secondary importance up to now. In fact, the three decades after World War II were dominated by Samuelson's Neoclassical Synthesis, a combination of Keynes and Marshall, summarised by the IS-LM diagram, which took on a dominating position in the first editions of his *Economics;* Joan Robinson complained that the IS-LM model made of Keynes an equilibrium economist since, in her view, each point of the IS curve represented a *golden age:* the same rate of profits must have prevailed for a long time such that the rate of profit embodied in the prices of capital-goods equalled the discount rate of future earnings of precisely these capital-goods. Even less plausible are the New and Neo-Keynesian interpretations of Keynes which transform Keynes into a predominantly Walrasian neoclassical economist; here, sticky prices and money wages and imperfect competition appear as the basic causes of unemployment.

This seems to be a mistaken interpretation of Keynes who lived in a Marshallian monetary exchange or supply-and-demand world where *quantity* variations lead to an equilibrium. Keynes now applied the Marshallian supply and demand apparatus to the economy as a whole, postulating that saving depended, in principle, on national income, not on the rate of interest. At the point of effective demand, prices are given, since money wages are given;

changes in money wage would work out through a changing 'real' quantity of money; given this, a full employment equilibrium cannot be reached because of a lack of effective demand.
Now, the point is that during Shackle's *Years of High Theory 1926-1939,* a *twin* revolution took place in economic theory. Indeed, „[our] period opens with the Sraffian Manifesto of 1926 [*The Laws of Returns under Competitive Conditions*], demanding the revision of [Marshallian] value theory [which, finally, in 1960, resulted in a classical theory of production, value and distribution]. The other great traditional branch of economics is monetary theory, and our period sees it transformed by [Keynes into a general theory of output and employment, interest and money, which, for the first time, convincingly challenged Say's Law]" (Shackle 1967, *Years of High Theory 1926-1939,* p. 12). Undeniably, Keynes and Sraffa laid the foundations for a monetary theory of production, capable of carrying a solid theoretical structure, and initiated a tremendous discussion, critical and constructive, on this subject. However, no coherent – post Keynesian - theoretical system capable of competing with neoclassical Walrasian-Marshallian economics has come into being so far.
Indeed, Joan Robinson later remarked on this twin revolution that "Keynes evidently did not make much of [Sraffa's 1928 draft of *Production of Commodities by Means of Commodities*] and Sraffa, in turn, never made much of the *General Theory*. It is the task of post-Keynesians to reconcile the two" (Joan Robinson, *Keynes and Ricardo,* Journal of Post Keynesian Economics, 1, 1978, 14). But how to reconcile Keynes's short-period model set in historical time, where uncertainty and expectations prevail, with Sraffa's timeless and deterministic long-period equilibrium model? There was, in fact, a deep gap between Keynes and Sraffa.
Later, this cleavage showed up within post Keynesian economics which emerged in the 1950s and 1960s, comprising three broad, partly overlapping strands, the Keynesian Fundamentalists, the Robinsonian-Kaleckians, and the neo-Ricardians (Harcourt and Hamouda). In the main, the Keynesian Fundamentalists and the neo-Ricardians largely ignored each other from the 1950s until the present.
It was Luigi Pasinetti who brought together Keynes and Sraffa on the level of principles creating therefore the basis for classical-Keynesian political economy, which represents an elaborated synthesis of post Keynesian political economy. This process is set out in *Toward a Synthesis in Post-Keynesian Economics in Luigi Pasinetti's Contribution* (Bortis 2006). The analytical basis for classical-Keynesian political economy is set forth in *Keynes and the Classics – Notes on the Monetary Theory of Production* (Bortis 2003) and set into a wider

context of the social and political sciences, including history, in *Institutions, Behaviour and Economic Theory – A Contribution to Classical-Keynesian Political Economy* (Bortis 1997/2006). Finally, in the manuscript *An Essay in the Philosophy and Theory of World History* (Bortis 2009a) some fundamentals in world history in relation to the destiny of Mankind are suggested in a probable and tentative way.

Given the state of neoclassical economic theory and the actual crisis in the real economy, time seems ripe for classical-Keynesian political economy to replace not only neoclassical theory but also the IS-LM Neoclassical Synthesis and the Walrasian interpretations of Keynes. Similarly, neo-liberal Capitalism should now give way to Social Liberalism. In the next section, some reasons are provided to substantiate this proposition.

6. The Need for an Alternative to Neoclassical Economics

The classical-Keynesian, post Keynesian and Keynesian strands are, in fact, part of a wider monetary theory of production and circulation. The Keynesians deal with the short run, where productive capacities are given. Uncertainty and expectations are crucial for determining the investment behaviour of entrepreneurs. The main subject matter of post Keynesian economics is the (investment) behaviour of entrepreneurs and its interaction with the socio-economic system in the medium-term, where cyclical movements take place. Broadly speaking, one may say that classical-Keynesian political economy is the long-term part of this paradigm and deals with the functioning of the socio-economic *system*. However, classical-Keynesian political economy also encompasses Keynesian and post Keynesian political economy.

Neoclassical economics represents the economic theory of *Liberalism,* where the individual and exchange are moved to the fore. Here, Walras's *General Equilibrium Model* is the basic framework, which is rendered operational through Marshall's *Partial Equilibrium Theory*. The neoclassicals postulate a strong tendency towards full employment if competitive conditions prevail.

Classical-Keynesian political economy constitutes the economic theory of *Social Liberalism* (which we have denoted *(Comprehensive) Humanism* in earlier publications). Here, society - the technological and institutional system – provides the starting point for the analysis of the major socio-economic issues like value, distribution, and employment. The policy aim is to lay social foundations such that individuals and collectives *enjoy a maximum sphere of liberty* and, as a consequence, may prosper by developing their individual and social dispositions and abilities. The most important economic aspects of these social foundations are full employment and a ‚fair', socially acceptable distribution of incomes. Full employment is particularly important: Involuntary (mass-) unemployment leads to *struggle for survival,* concretely to a struggle for raw materials, markets, and, ultimately, workplaces. This may lead to conflicts between social, ethnic and religious groups. Full employment, however, renders possible the peaceful living together of most diverse social formations, associated with the possibility of mutual spiritual, intellectual and material enrichment. The aim is not to create an ideal society but to create the social conditions such that all ‚social individuals' can live in dignity. As is well known, this is far from being the case presently. Indeed, according to eminent international organisations about *two thirds* of the world population lives in *misery,* with less than two dollars per person and per day (in this respect, the distinction between misery and poverty is important; poverty may be a choice or one may get out of it; misery, by contrast, crushes the individual). Moreover, out of a world working population of about *three* billion, *one billion is involuntarily unemployed or underemployed.* These are the main socio-economic reasons why an alternative to neoclassical economics is needed, but there are other reasons, too, which we now briefly present.

Economic theory is, at present, dominated by (Neoclassical) Walrasian General Equilibrium Theory as far as fundamentals are concerned. This has very important implications at the level of economic theorising and of policy making. In fact, the idea of *self-regulation* of an economy is put to the fore. To be sure, a full employment equilibrium only obtains if conditions are sufficiently competitive. Hence the endeavour to weaken or to eliminate all the obstacles to competition, for example, monopolies, cartels, even trade unions. To establish competitive markets has become the hallmark of liberal economic policies in the present age of globalisation. Of course, this is the liberal doctrine of sound competition, which forces producers to constantly improve techniques of production and to introduce new products in order to obtain the best possible price/quality relationship. This may also hold in a capitalist reality where, however, there is also a struggle for survival forcing even very large enterprises into alliances to maintain or to increase market shares or to ensure survival.

The self-regulating mechanism of liberal economics is the market, i.e. the mechanism of supply and demand, or the price mechanism, based on exchange. Specifically, production becomes a market problem in the sense that factor price ratios govern factor proportions through the minimum-cost combination. In fact, there are factor markets, which, in principle, regulate the employment of resources, their proportions, and the distribution of incomes. Behind the demand and supply curves of goods and factor markets stands the marginal principle in various forms, as marginal utility, marginal costs and, most importantly, marginal productivities. An important implication of equilibrium economics is that economic activity is supply-determined and that prices are scarcity indicators.

For theoretical and (empirical-) historical reasons, we strongly believe that, probably, there is no tendency at all towards a full employment of resources, above all of labour, although such a tendency might exist at times. The theoretical reasons are associated with the interrelatedness of markets and with the nature of the process of production. In interrelated markets in disequilibrium there may be no tendency towards equilibrium, since the tendency towards equilibrium in one market may deepen the disequilibrium on other markets. For example, when there is unemployment and money wages fall, the demand for consumption goods, and, subsequently, for investment goods may decline, increasing thus the amount of unemployment; or, increasing volumes of investment do not reduce, but raise rates of profit (Kalecki). Moreover, with production being a social process, no regular, well-behaved associations between ‚rates of interest' and ‚quantities of capital', in general between factor prices and factor quantities, exist in principle; this is the main result of the capital-theoretic discussion (Harcourt 1972). This result implies that the concept of factor markets stands on very shaky foundations.

The capital-theoretic discussion culminated, in the mid-sixties, in the publication of several important articles, which are gathered in the *Quarterly Journal of Economics*, vol. 80 (1966); for a brief summary of events see Pasinetti (1977, pp. 169–77, especially footnote 9 on p. 171). Samuelson sums up the discussion in a crucial statement: "Lower interest rates may bring lower steady-state consumption and lower capital–output ratios, and the transition to such lower interest rate can involve denial of diminishing returns and entail reverse capital deepening in which current consumption is augmented rather than sacrificed.

There often turns out to be no unambiguous way of characterizing different processes as more 'capital intensive', more 'mechanized', more 'roundabout' […] If all this causes headaches for those nostalgic for the old time parables of neoclassical writing, we must remind ourselves that scholars are not born to live an easy existence. We must respect, and appraise, the facts of life" (Samuelson 1966, p. 250).

The post-Keynesians and neo-Ricardians could *not benefit from this total theoretical victory because they could not offer a coherent and complete alternative system of economic theory.* The neoclassical economists admitted that there are serious problems with their neoclassical-Walrasian system; for example, money and finance could be disturbing factors, resulting in bubbles in the financial sector and to crisis situations in the real sector. However, the post-Keynesian and neo-Ricardian critics had no convincing answer to the neoclassical question: What kind of comprehensive and coherent theoretical system have you to offer? Indeed an alternative to liberal neoclassical-Walrasian economic theory is only beginning to emerge at present in the form of social liberal classical-Keynesian political economy (Bortis 1997/2006, 2003, 2003a, 2006, 2009a and 2009b).

The historical reasons for abandoning neoclassical theory are, of course, given by the very heavy crises in the last quarter of the 19th century and in the 1930s, and by the present, 2008, crisis. During the crisis of the thirties the faith in the self-regulation of market economies was very seriously shaken, even among many liberal social scientists. To a large extent, this is also the case presently.

Given the obvious fact that neoclassical equilibrium theory was incapable of coming to grips with the great economic problems, reactions developed. Around 1900 the doctrine of New Liberalism (Hobhouse) emerged, suggesting that the state should intervene to relieve socio-economic problems, mainly associated with persistent unemployment. Maynard Keynes took up this idea and struggled for the whole of his life to formulate a theory of the Middle Way between Liberalism and Socialism. The doctrine of Social Liberalism, scattered all over his work, was the social philosophical result of his efforts. Moreover, in the 1930s, in the midst of the heavy crisis, he published his great work, *„The General Theory of Employment, Interest and Money"*. In this book, Keynes showed that, in a monetary production economy, an underemployment equilibrium, involving the existence of system-caused involuntary unemployment could exist. This and other ideas, regarding value, distribution, and money, for instance, have been taken up by the post Keynesians. Classical-Keynesian Political Economy may be considered an elaboration and a synthesis of post Keynesian political economy. This system of Political Economy now broadly stands and is ready to replace neoclassical economic theory as the dominating paradigm.

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