# How the Concept of Development Got Started

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### *A. Introduction: Development Is a Concept Tied to the Evolution of Capitalism*

"Economic development" or "development" is a term that economists, politicians, and others have used frequently in the 20th century. The concept, however, has been in existence in the West for centuries. Modernization, Westernization, and especially Industrialization are other terms people have used when discussing economic development. Although no one is sure when the concept originated, most people agree that development is closely bound up with the evolution of capitalism and the demise of feudalism.

Development has many meanings. The meaning a particular person attaches to the term depends on her subjective view of the world. Indeed, the meaning of development is not only a product of the individual's perspective but also of the particular period in time when the word is being uttered. Thus, in order to understand the various theories of development, one must place them in a historical context.

This section will be historical in nature. We will trace the evolution of capitalism and the theories that have been developed to explain how the process works and what its impact has been on society. When you finish this section, you will have a basic understanding of the economic development of Western European society.

The first part of this section will focus on the transition from feudalism to capitalism. We will compare the feudal view of economic development with that of the early capitalist middle class or "bourgeoisie." On a historical time-line, this covers the time period beginning in the 13th century and ending in the early 18th century. You will learn that the concept of development as we know it today, which stresses continuous improvement of social welfare, did not exist in feudal society. However, with the decline of feudalism and the rise of the nation-state came increased government concern regarding general economic welfare. Government-led efforts to increase wealth through exports became an explicit goal under a set of beliefs referred to as mercantilism.

The second part will cover 1700-1860, a period labeled the Age of Competitive Capitalism. During that period, political and economic power moved from the feudal aristocracy to the capitalist bourgeoisie. With the elimination of the last vestiges of feudalism in Europe, the bourgeoisie turned its attention to the rest of the world. Capitalism was exported to the rest of the world via the colonial system.

Two schools of thought, Classical Political Economy and Historical Materialism, emerged during this period. Both sought to explain the role of capitalism in economic development. Adam Smith was a proponent of classical political economy. Karl Marx was the main representative of the historical materialism school.

The third part explores the Age of Imperialism from 1860 to 1945, during which time the small enterprise lost ground to large, monopolistic cartels. Two main schools of thought relating to development arose during this period: neo-classical economic theory and the classical theory of imperialism. Various theorists are associated with each school. We will limit our discussion to the works of Alfred Marshall and Vladimir I. Lenin.

The section will conclude with a summary of Keynesian economics, which attempted to explain why the capitalist economies were on the verge of collapsing and how capitalism could be modified to preserve itself. The critical aspect of the economic puzzle related to unemployment. Keynes' theory of unemployment attempted to solve the puzzle through state intervention in the economy via government spending. An understanding of this theory is crucial to understanding post-war theories of development and the creation of the International Monetary Fund and the World Bank.

## *B. The Transition from Feudalism to Capitalism: The Early Stages of Capitalism*

### 1. Development Policy Did Not Exist in Feudal Society.

Following the collapse of the Roman Empire, the West experienced a time in which all effective public authority vanished. Feudalism was a system whose ultimate goal was to create decentralized government. The system was based on a contractual relationship among members of the nobility in Europe, and it evolved around the most important warrior in the region—the Count. The Count maintained strict control over all the lesser warriors (lords) in his region. The lords accepted the Count as their Lord (or were forced to do so), thereby becoming vassals of the Count. The Count's duty was to protect the lords and settle any dispute that arose between them. Most importantly, the Count guaranteed that as long as the vassals remained loyal they would be allowed to remain in possession of their land or fiefdoms. This pattern was replicated all over Europe.

Consequently, a highly localized form of "government" evolved during the Middle

Ages. One of the principal purposes of feudal government was to combine political and military service with landholding in order to prevent Medieval Europe from disintegrating into thousands of "seigneuries" or independent estates run by different lords. In other words, government was essentially a system of cooperation that existed to protect and perpetuate the feudal system and to preserve order. Given society's vulnerability to unpredictable harvests, to whatever type of governance prevailed at the time, and to frequent wars, active and consciously designed government programs to improve the welfare of society simply did not exist. No one conceived of a bureaucracy of government officials responsible for designing programs to provide people with a better standard of living.

Thus, development policy as we think of it today did not exist in feudal society. For much of the period in question, a person did not witness or expect significant changes in society during his or her lifetime. One's position in that society was pre-determined and fixed at birth. Serfs, who worked for the vassals, could not "move up" and become knights or barons; such mobility was unheard of. Individuals viewed themselves as victims of their destiny and environment. It never occurred to the average person that his or her destiny could be tailored and that nature could be conquered. R.H. Tawney, a well-known historian, captured this frame of mind when he wrote:

> Rapid economic change as a fact, and continuous economic progress as an ideal, are the notes, not of the history of the West, but of little more than the last four centuries...[prior to that] the common man looked to the good days of the past, not to the possibilities of the future, for a standard of conduct and criterion of the present; accepted the world, with plague, pestilence and famine, as heaven had made it; and were incurious as to the arts by which restless spirits would improve on nature, if not actually suspicious of them as smelling of complicity with malign powers.

Keep in mind that medieval society was not completely static. Change did occur. But it was not the product of a systematic approach encompassing the application of science and technology to the production of material goods, a hallmark of the industrial revolution.

## 2. The Transition to Capitalism Was Driven by Ambition and Self-Interest; Government Involvement in the Process Was Marginal.

Exactly what fueled the transition from feudalism to capitalism in its early stages is an issue that is hotly debated. We will probably never know. What is known, however, is that government played a very marginal role in the process. The movement was a local one driven by ambitious men. Some were in search of fame, others sought prestige. But most of all, individuals were in search of personal financial gain. Development, or "progress," as the early bourgeoisie called it, was synonymous with the improvement of an individual's lot in society.

There was no generalized idea that the welfare of society as a whole needed to be taken into account. Medieval institutions that impeded progress were dismantled not because people felt that society as a whole would be better off but because the early capitalists would be better off. They fought for the freedom of the serf with almost the same tenacity that they fought for free trade. A victory in both fields was crucial to their personal economic well-being. A free peasantry would provide the labor for the capitalist's factories and free trade would expand the market for the factories' manufactured goods.

### 3. Development Became an Objective of Government Policy With the Rise of the Nation-State and the Need to Perpetuate State Power.

Feudalism began to decline after its zenith in the 13th century. By the end of the 15th century, the power of the feudal governments had eroded through wars and feudal rebellion. Banditry was almost out of control. All of this impeded trade and commerce, which was being driven at the time by the emerging capitalist middle class. The concomitant rise of the nation-state and the concentration of power in the hands of sovereigns laid the foundation for post-Medieval progress and development.

In response to the strife of the period, various powerful rulers attempted to bring peace to Western Europe. These rulers became known as the New Monarchs. They consolidated the smaller feudal governments under the institution of monarchy, which became the legitimate form of public power. Loyalty and respect for the monarchy were obtained through force, marriage, or peaceful (and sometimes not-so-peaceful) negotiations. The monarchs especially sought out and received the support of the middle class townspeople, who were tired of the petty wars and abuses of the feudal lords that impeded economic activity.

The monarchs quickly realized, however, that maintaining a strong central government was expensive. To maintain control of their nation-state they needed their own private army; they could no longer depend on the nobles for military purposes. Because they had to pay the private army, the monarchs realized that their survival was dependent on an important aspect of development—a growing and sound tax base.

Tax revenues could be increased in two ways: increasing the size of the tax base—

the number of people that could be taxed—or stimulating an increase in production. Most rulers opted for a combination of the two. But wars to expand the tax base tended to be too costly, prompting rulers to stress increases in production. Thus, the promotion of economic development can be said to have become an objective of state policy during this time period. Gradually, the notion of promoting sustained increases in economic wealth became an independent and legitimate aspect of state policy, which came to be known as mercantilism.

#### 4. Under Mercantilism, the Government Was Viewed as the Catalyst for Capitalist Economic Growth Via Exports to Foreign Countries.

In its early phase, mercantilism was characterized by a nation-state's desire to accumulate gold and silver. This policy gradually gave way to one geared at building and maintaining a strong and self-sufficient economy. Self-sufficiency was to be accomplished by putting the poor to work. The goal was to create full employment, and to discourage idleness, begging and vagabondage. The government introduced new crafts and manufacturing processes into the country. Favorable treatment was given to merchants who created jobs at home and to those who sold their products abroad.

The government's goal was to increase the exports of manufactured products and reduce all imports except those necessary to produce manufactured goods. With its trading partners having to pay for their imports in either gold or silver, the result would be a favorable trade balance for the country—that is, more gold and silver would flow into the country than flow out. If a state was able to export more than it imported, at the end of the year it would be richer than its trading partners.

It was during this period that capitalism was exported to the rest of the world. A driving force behind Europe's desire to explore and colonize was the desire to create new markets for European manufactured goods. The exploitation of colonies was viewed as a legitimate means of acquiring precious metals as well as the raw materials for export industries.

### *C. Competitive Capitalism (1700-1860)*

#### 1. Capitalism Witnessed the Rise of the Industrial Sector and Increased Demand for Unskilled Laborers Whose Wages Were Not Enough to Cover Basic Needs.

During the 18th and 19th centuries, capitalism became the dominant economic force in Western Europe, thereby planting the seeds for many of the elements of 20th century development policy. For example, mercantilism contributed to a shift in focus from agriculture to industrial development. The industrial sector was geared to the production of goods for consumption. It was composed of small firms which bought and sold their products freely in a very competitive open market. Production took place in factories, which churned out manufactured products using rudimentary but labor-intensive technologies.

The new factories generally required only unskilled labor. Skilled craftsmen found themselves replaced by machines with which they could not compete. Consequently, they were forced to join the army of unskilled workers populating the new factories. An unskilled factory worker earned more than his counterpart working in the fields. Still, that factory worker did not earn enough to support a family. The wage was at times not even enough to provide for the worker's basic necessities. To survive, the entire family had to work. The work at the factories was so mechanical that it could be performed by a six year old child. Indeed, employers often preferred women and children because they did not have to be paid as much.

#### 2. Capitalism Expanded Outward in Search of Raw Materials and Consumers.

In the international arena, this era was characterized by a push to bring in new regions into the capitalist sphere through the process of colonialism, which since the 15th century had expanded Western European power and control to the East Indies and the Americas. Thus, for example, the English East India Company became a quasi-governmental entity in the 18th century and, after the British defeated the French in the Seven Years War, proceeded to conquer India's mainland. After the Napoleonic Wars, the newly independent Latin American countries entered the world economy as suppliers of raw materials and consumers of manufactured goods. And the British Empire of the late 18th century ensured that Asia and Africa would perform the same function.

### *D. Classical Political Economy: Adam Smith and "Laissez Faire"*

#### 1. Classical Political Economy Argued that Government Should Play a Limited Role in the Economy.

In 1776, Adam Smith published *Wealth of Nations*, where he criticized the concept of mercantilism. Smith's views regarding limited government intervention and free markets, better known as the "laissez faire" system, would become key components of one school of development policy which continues to this day.

Smith felt that the regulatory and monopolistic practices characteristic of mercantilism limited a country's economic growth. He believed that the best way to increase the wealth of a nation was through the reduction of barriers that hindered growth. To Smith, government intervention in the economy was such a barrier. He criticized the provincial view of the proponents of mercantilism and argued that the economic system was world-wide, and as such should not be burdened by political or national barriers. Tariffs on traded goods should be eliminated; free trade should be the norm.

Contrary to popular belief, Smith never proposed a complete ban on government involvement in the economy. He was an advocate of limited government intervention, arguing that a government's role should be limited to national defense, internal security, and the provision of reasonable laws and fair courts in which private disputes could be peacefully adjudicated.

### 2. Adam Smith Believed that Economic Growth Depended on the Free Market and the Entrepreneurial Spirit of Private Persons.

Under Smith's model, government involvement in any area other than those stated above would have a negative impact on economic growth. This is because economic growth is determined by the needs of a free market and the entrepreneurial nature of private persons. If there is a shortage of a product its price will rise, and so stimulate producers to produce more, while at the same time attracting new persons into that line of production. If there is an excess supply of a product (more of the product than people are willing to buy), prices will fall and producers will focus their energy and money in other areas where there is a shortage or where there is a need which no one has yet satisfied (thereby creating a new market).

Smith argued that this system would be regulated by the self-interest of each individual capitalist. He believed that each individual knows his own interest better than anyone, especially the government. In Smith's model, the sum total of individual interests will maximize the general welfare and liberty of all.

## *E. Karl Marx and the Socialist Revolution*

### 1. According to Marx, the Government was a Tool Used by Capitalists to Perpetuate Themselves in Power.

In 1867 Karl Marx published *Das Kapital*, a work that systematically and historically analyzed the capitalist system. His theories would provide much of the material for arguments that have opposed development models based on capitalism and the laissez faire system.

Marx lived at a time when capitalism was at its prime—it was spreading throughout the world. Members of the capitalist class had become masters of both the social and political spheres. Their power was the fruit of the industrial revolution and of the many political and military battles that the capitalist class had waged against the nobility. The capitalists had joined with the working class to wrestle power away from the nobility. The first great battle, labeled the French Revolution, was fought in 1789 in France. In 1848, once again beginning in Paris, the capitalists staged a new revolution with the help of the working class. As a result of these victorious revolutions, the capitalists obtained political control. According to Marx, this allowed the capitalist class to create a government that would allow it to exploit the working people. Thus, for Marx the government was nothing more than a tool of the capitalist class.

**2. From a Marxist Perspective, Development is a Process of Class Struggle.**

Marx believed that just as the bourgeoisie (the capitalist middle class) had relied on revolutionary movements to wrestle power from the nobility, so, too, could the working class, called the "proletariat," eventually overthrow the bourgeoisie. For Marx, the eventual fall of the bourgeoisie was not only desirable, it was inevitable. He reached this conclusion based on his economic theory of labor. Specifically, he developed the doctrine of surplus value. At the heart of the doctrine was the conclusion that the worker was being robbed. The worker received only a fraction of the value of the product which his labor produced. The remainder was kept by the capitalist class. This theft eventually led to an economic crisis caused by overproduction- the vast majority of the population could not afford to consume the products that the owners of capital produced. The capitalist's answer to this problem was the continual creation of new markets.

Marx saw capitalism as an historical necessity because it was the most productive and flexible economic system in human history. It could move capital and labor to meet demand faster than any of the previous systems that it had replaced. Marx, however, refused to accept capitalism as the ultimate mode of production (economic system). He believed the system was plagued with internal contradictions that would inevitably lead to its destruction and replacement by a more advanced system.

According to Marx, the relations of production (the way people interact in a particular economic system) create different economic classes. For example, under the feudal economic system, two classes existed: the nobility and the peasantry. The dominant class, the nobility, created a system to maintain its position. Religion, government, laws, and morals reflected the needs of the dominant class and were used to perpetuate its position of power. As capitalism emerged, a new dominant class, the bourgeoisie, began to appear. The nobles and the bourgeoisie eventually clashed and the latter was victorious.

### 3. According to Marx, Capitalism's Inherent Contradictions Would Eventually Cause its Downfall.

Marx believed that the advent of capitalism set in motion its own final downfall. He reasoned as follows. The capitalist system cannot exist without workers. As more factories are built, more people will be forced to work in them. Thus, under capitalism, the army of workers will continually expand. With the expansion of capitalism around the world comes the global creation of a working class.

This system is ruthless, however. In order to survive, capitalists must continually strive to outproduce one another. But not all capitalists will be able to compete. Capital will become concentrated in fewer hands. Those bourgeoisie that are unable to compete will be forced to join the working class or perish. This process will continue until one day the proletariat masses will be able to take control of the system by overthrowing the bourgeoisie, resulting in a classless society. No new class will arise because class arises from economic differences, and capitalism will have eliminated these differences by making everyone a proletariat.

Since the concepts of state, religion, morality, and laws were mechanisms to maintain class differences, they, too, will disappear. Government will not be eliminated immediately, however. A limited form of government (a proletariat dictatorship) will be put in place to prevent a possible attack by any surviving bourgeoisie. This dictatorship will eventually become useless, and when it does, it will "wither away." At this point, socialism will have been achieved.

### 4. Marxism Views Government-Led Social Reform and Nationalism as Mechanisms to Perpetuate Exploitative Development.

For Marx economic development was tied to class struggle. Economic development could only be achieved as a class; individual achievement was not emphasized. Trust in the government and cooperation with its goals were also viewed as betrayals of the class struggle. The government's involvement in social reform was nothing more than an attempt by the bourgeoisie to appease the workers and thereby force them to abandon the struggle. Since the government reflects the will of the dominant class, it would never enact any law benefiting the subservient class.

Indeed, Marx viewed politics as a mechanism created by the bourgeoisie to confuse the workers and divide them. Political divisions fuel nationalism which, in turn, misleads workers from one country into believing that the workers of another country are enemies. Marx would argue, for example, that there is no difference between the class relations in Mexico and those in the United States. Workers in both countries are being exploited.

### *F. Imperialism and Economic Theory (1860-1945)*

Capitalism flourished during the latter half of the nineteenth century and first half of the twentieth. Alfred Marshall and Vladimir Lenin were two well-known thinkers whose theories about capitalism would lay additional groundwork for post-World War II development theory. Before describing their work, we will provide you with important background.

#### 1. Imperialism Flourished During this Period.

##### a. During this period, capitalism spread to most of the world; but not all areas of the world partook equally of the wealth.

By the beginning of the twentieth century it was safe to say that a truly global economy existed (today's globalization is not a new phenomenon). Most, if not all, of the traits characteristic of capitalism could be found almost anywhere in the world. A traveler could board a ship in England headed for the Americas, Africa, India or Asia with little or no concern of what he would find there. If he was headed to a "modern" or civilized place, he would be able to find anything that he could find at home. Capitalism had by this time help spread Western European science, weapons, industry, medicine and lifestyle to almost every corner of the globe. Any corner void of capitalism's presence was considered savage or uncivilized.

Not all people, nor all regions, reaped the rewards of capitalism. Western European nations divided most of the world's economically underdeveloped areas among themselves. As the capitalist modes of production spread around the world, capitalism supplanted local industries and with them the livelihood of many local craftsmen. The need for raw materials by the industrialized Western European countries led to a realignment of land use. Indigenous populations were driven out of their lands.

**b. European nations dominated most of the world economically and politically.**

Western Europeans were no longer satisfied with purchasing what the "natives" could produce. They wanted goods of a type or in a quantity that local craftsmen could not produce. Europeans invested capital and transferred the technology necessary to meet their needs. The economies of these regions were assimilated into the capitalist market. Traditions and customs had to give way to progress. Indigenous people had to give up their lifestyles and join the working class. Their fortunes were now tied to the market. If the market thrived, they survived. In times of economic depressions, they starved.

Control was obtained and maintained through the use of force. Europe relied on its economic power and its modern military weapons to maintain control of the rest of the world. As a point of reference, between 1875 and 1900 Great Britain added 4,500,000 square miles to her empire; France added 3,500,000; Germany, 1,000,000; Belgium, 900,000; Russia 500,000; Italy 185,000; and the United States, 125,000. This colonial system was to remain in place until World War I. Indeed, the imperialistic rivalries among the various European powers led to the Great War.

**2. Alfred Marshall, a Neoclassical Economist, Believed Capitalism Would Benefit Everyone in the Long Term.**

In the late nineteenth century, neoclassical economists shifted the focus of economic analysis from the impact of scarce resources on prices (the focus of the classical economist) to the effect of consumer preferences on supply and demand (and therefore on price). The British neoclassical economist Alfred Marshall explained demand based on a product's marginal utility to a consumer (the consumer's satisfaction with the last unit consumed), and supply by marginal productivity (the cost of producing the last item of a given quantity). Markets performed efficiently by allowing prices to be set by fully informed producers and consumers. This type of analysis is still influential today.

**a. Marshall believed that capitalism would lead to a civilized and classless society.**

Marshall's thinking was also important in a broader context, for he tried to rationalize the imperialistic exploits of capitalism. Marshall believed that capitalism would triumph over the challenge posed by the socialist movement. He argued that progress would abolish all classes; in the long-run, every man would become a gentleman. The classless gentleman was to be created through better education, a reduction in physical labor, shorter working hours and through a greater distribution of society's wealth. This process was not going to happen overnight nor through a revolution. This classless society was to be a by-product of capitalism. As capitalism advanced, the proletariat would be transformed from unskilled workers to skilled workers.

**b. He also believed that the state should play an important but limited role in achieving long-term growth.**

Marshall built incrementally upon the thinking of classical economists regarding the state. For him, the role of the state should not be limited to providing external security and domestic law and order, as classical economists had argued. Marshall believed the state should also advance education, encourage trade unions, provide public health, restrict monopolies, and provide relief to the poor by creating employment for them. But he stopped there. He agreed with the classical school that the state should not otherwise intervene in the operation of the economy.

### 3. Vladimir I. Lenin

Vladimir Lenin also attempted to rationalize the capitalism of the imperialist era, although he did not share Marshall's optimism about the long-term prospects of capitalism. Given the conditions in Russia in the early twentieth century, Lenin pushed for a socialist revolution sooner rather than later. This belief would influence the theories of a particular school of development in the 1960s-1970s.

**a. Lenin believed a socialist revolution was possible even before capitalism had eliminated all traces of feudalism.**

In order to understand Lenin's theories, you must understand the historical context in which he lived. Lenin was from Russia, which at the beginning of the twentieth century was still a feudal society. Political, and to some extent, economic power still remained in the hands of the nobility. This is not to say that capitalistic modes of production or a capitalist class did not exist in Russia. They both did. Using Marx's theory on the composition of a society, it could be said that Russian society was composed of four classes: the peasantry, the nobility, the proletariat and the bourgeoisie.

Given the state of global capitalism at the time, Lenin argued that capitalism had entered its highest and final stage—i.e., that the proletariat had firmly established and consolidated itself as a class and that it had replaced the bourgeoisie as the revolutionary class. He argued, however, that the bourgeoisie, who viewed the proletariat as a threat, would align themselves with the nobility on many issues. This new alignment allowed many feudal practices to continue. The promised democratic freedoms would never materialize because the capitalist class was afraid that such freedoms would allow the proletariat to organize and carry out its class struggle more effectively.

Thus, Lenin believed it was up to the proletariat to take over the struggle, with the peasantry as an ally. The end result would be that the proletariat and the peasantry would overthrow the capitalist state and establish a dictatorship. The dictatorship would serve three purposes. First, it would destroy any counter-revolutionary activity. Second, it would completely abolish all vestiges of feudalism and establish conditions under which the proletariat could enjoy democratic freedoms. Finally, it would improve the material condition of the working class.

#### b. Lenin believed the state should promote economic development by generating wealth and distributing it.

Lenin's view of development differed from that of Marx. Marx believed that given the continual deterioration of the proletariat's plight and the continual concentration of economic forces in a smaller and smaller number of people, the capitalist system would be unable to perpetuate itself. The workers would revolt and a new socialist economy would be created. After the capitalist wealth was distributed, all forms of government would eventually wither away.

By contrast, under Lenin's theory, the proletariat class was expected to take an active role in bringing about that downfall of the capitalist class even before capitalism has eliminated all traces of feudalism. Because the state would not have generated the kind of wealth Marx had envisioned, Lenin's model required the state—in the form of a proletariat dictatorship—to pursue economic policies to generate wealth for subsequent distribution.

## *G. John Maynard Keynes and the State*

John Maynard Keynes was a student of Alfred Marshall and an exponent of the neoclassical school until the 1930s. After the Great Depression, many policymakers lost faith in the neoclassical school's promise that the market would eventually bring prosperity for all. Keynes' subsequent work provided policymakers with the justification for state-driven development.

### 1. Unlike Neoclassical Theory, Keynes' Theories Seemed to Provide Plausible Explanations for the Near-Destruction of Capitalism.

The severity of the Great Depression of 1929, the resulting growth in unemployment, and the spectacular growth of the non-capitalist market in the USSR caused many economists to become dissatisfied with orthodox classical and neoclassical views of development. The traditional view held that unemployment in a capitalist economy was a short-term adjustment problem. The economy would eventually reach an equilibrium point in which the supply of labor would equal the demand for labor. Given the high unemployment rate in the capitalist markets, economists began to doubt that employment was determined by supply and demand. Indeed, the USSR's non-market economy did not experience unemployment in the 1930s.

Thus, the world envisioned by many neoclassical economists, in which supply and demand was in equilibrium in every market and every economic aspect was determined by the equilibrium of supply and demand, no longer made sense. The rise in unemployment that the capitalist world was experiencing was not an isolated event. It was not limited to a geographical region or an isolated economic sector. If the system was to be saved, drastic countermeasures were in order. Appropriate countermeasures, however, could not be put in place until the cause of the malady was understood.

Keynesian economics was an attempt to explain why the capitalist economies were on the verge of collapsing. What factors led to the unemployment of millions of workers? Why did the output of goods and services drop so drastically when the supply of resources and the industrial base remained constant? Keynes felt that all of this could be explained if one understood the basics of unemployment. Through his Theory of Unemployment, Keynes attempted to explain the causes of the near-collapse of capitalism.

## 2. Keynes' Theory of Unemployment was Based on the Inevitable Collapse of Investment.

As a starting point, Keynes examined the process of production. In a given period, a firm produces a certain quantity of goods. These goods are then sold, say for \$100. It cost the firm \$70 to produce the product. The latter figure includes the cost of maintaining the plant and equipment, wages, administrative expenses, the cost of inputs (raw materials) and the cost of capital (the cost associated with having the capitalist's money tied up in the venture). The remaining \$30 is the net profit for that time period. This represents the income of the firm's owner. This, however, is not the total income produced by this firm. Keynes' theory holds that during the production period in question this firm actually produced an income of \$100. The \$70 cost-of-production figure represents income to other participants in the production process. Thus, the worker received part of that $70 in the form of wages, the managers in the form of salary, the landlord in the form of rent and so on.

This simple model is applicable to the entire economy. The value of everything produced in the United States in a given period is equal to the total incomes received during the same period. Thus, if all that is produced is to be sold, people must spend all of their income. Remember, under this theory, total income equals total production. In this manner money moves from the businesses to the public in the form of wages, salaries, rents and profits. It then flows back to the businesses when the public buys goods and services. Keynes termed this process "the circular flow of money." He argued that as long as people spent all of their income, businesses would be able to sell all of their production. As long as this equilibrium was maintained that process would continue.

Keynes argued that a perfect circular flow of money does not occur automatically. Not all money that leaves the business sector as a cost of production is returned to the business via public consumption of goods and services. Keynes identified three reasons for this phenomenon: (1) people do not spend all of their income, (2) people buy goods and services from foreign business sectors, and (3) people do not have control of all of their income—some is taken by the state in the form of taxes. Keynes viewed these occurrences as leakages in the system. If left uncorrected, the leakages would lead businesses to reduce production. The result would be unemployment.

According to Keynes, the effects of the leakages may be neutralized through a proportional infusion of money into the economy. The import leakage may be offset if the country is able to export goods and services of a value equal to that being imported by its citizens. The tax leakage can be plugged if the government spends on goods and services an amount equal to its tax revenue. The leakages caused by private savings will be offset if businesses expand their capital base by borrowing the funds that were saved.

Inherent in this solution is its failure. The capitalist must expand his or her capital base in order to bring private savings back into the system. This expansion results in an expansion of the production capacity of the business sector. To recoup their investment, businesses must increase their output. This, by definition, leads to an increase in income, which, in turn, leads to higher savings.

This cycle repeats itself until it is no longer economically feasible for the business sector to continue to invest. Hence, the result is economic collapse (e.g., the Great Depression), unless a solution is found. Keynes saw government intervention as the solution.

### 3. Keynes Believed Government Spending Could be Used as a Mechanism to Create Full Employment.

Keynes proposed that the vicious cycle described above could be avoided by injecting money back into the system without expanding the capital stock. In other words, increases in the money supply must not be allowed to expand the production capacity of the country. Keynes proposed that when savings exceeded investment, the government should borrow the savings and spend that money on social projects. The government should not invest in projects that will increase the productive capacity or reduce the investment opportunities of the business sector.

Thus, the government should focus its investment in areas where it is not profitable for the private sector to invest. It should build schools, roads, and hospitals and provide other public services. This would result in full employment. Employment would no longer be directly linked to the productive capacity of the business sector. The net result of this government action would be to restore economic equilibrium. The money that had leaked out in the form of private savings would be pumped back into the economy without placing a strain on the business sector's need to invest.

Keynes' proposed degree of government intervention had not been advocated before. Marshall hinted that government should be involved in a limited way but not as a vital component in the capitalist economy. In Keynesian economics, government involvement is seen as a crucial element if the system is to survive. This was the ideology held by many of the leaders at Bretton Woods.