

Imperfectionism in Macroeconomics: New Light on an Old Controversy

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ABSTRACT

The issues at stake in recent debates about ‘imperfectionism’ in macroeconomic theory are strikingly similar to questions raised in the revisionist controversy in German Marxism in the later 1890s and beyond. Orthodox Marxists claimed that the law of value could operate effectively only under free competition, while their revisionist critics countered that the growth of monopoly would improve coordination between different sectors of the economy and reduce the severity of crises. Some strange and unwitting intellectual alliances can be identified. New Keynesian thinking shows clear affinities with orthodox Marxism, while Post Keynesian ideas on this question resemble closely those of the revisionists.

If fluctuations in aggregate demand dominate short-run variations in real output, that must be because some wages and prices are not flexible enough to clear their markets more or less continuously (Solow, 1997, p. 231).

1. INTRODUCTION

The macroeconomic implications of the shift from freely competitive to monopolistic capitalism featured prominently in the debates between revisionists and orthodox Marxists in the 1890s, and subsequently generated controversy among social democratic and Communist theorists between the wars. The term ‘imperfectionist’, however, originated with Eatwell and Milgate (1983), who used it to describe ‘those models which rely on imperfections or arbitrary constraints in order to analyse the phenomenon under consideration’. They applied the term to models of unemployment ‘in which imperfections such as sticky prices, or the effects of uncertainty, are imposed on a Walrasian model, thus disrupting the Walrasian relationship between price formation and the determination of levels of output which implies clearing of the markets for endowments of factor services’ (Eatwell, 1987, p. 726). New Keynesian macroeconomics is clearly imperfectionist in this sense, while Old Keynesian thinking is not (Tobin, 1993).

It is sometimes suggested that Michal Kalecki was an imperfectionist. Paul Davidson, for example, argues that in Kalecki's system involuntary unemployment results from market imperfections, which manifest themselves in wage and price rigidities. 'Kalecki's theory requires the fixity of money wages and prices', Davidson claims, 'to explain unemployment equilibrium' (Davidson, 2002, p. 641). Thus Kalecki belongs in the New Keynesian camp, and cannot be considered a Post Keynesian:

In other words, Kalecki's analysis suggests that a full employment outcome could be automatically maintained by sufficient competition in the product market. Kalecki's theory of effective demand, therefore, like the classical theory that preceded it and the New Keynesian theories of modern times, places the ultimate cause of unemployment on the absence of competition in product markets and not on liquidity, speculation in financial markets, and expectations about an uncertain and statistically unreliable predictive future — or what can be termed a nonergodic environment. (Davidson, 2000, p. 5).

In view of Kalecki's brutal two-page demolition of the Pigou effect (Kalecki, 1944), this depiction of him as a forerunner of the New Keynesians seems misguided, and it has been justifiably criticised by Julio López (2002) and Peter Kriesler (2002).

But Davidson has a point, less in relation to Kalecki than to the milieu in which his ideas emerged: that is to say, the Marxian tradition of political economy between (roughly) 1883 and 1939. One important issue at stake in the revisionist controversy in the late 1890s was precisely whether the rise of monopoly would increase the stability of the capitalist system, or reduce it. Eduard Bernstein and the revisionists took the former position, while their orthodox opponents denied it. There is thus a clear and rather pleasing affinity between New Keynesian macroeconomics, epitomised by Robert Solow in the quotation at the head of this paper, and the orthodox Marxists. Twenty-first century Post Keynesians, like Geoff Harcourt (2004), Sven Larson (2002) and Nina Shapiro (1997), by contrast, tend to side with the revisionists.

2. THE REVISIONIST CONTROVERSY

The revisionists and their critics were arguing, *inter alia*, about the macroeconomic implications of the Marxian 'law of value'. Unfortunately this law means many things to many people, and operates at many levels of generality. I am not referring to it here either as an algorithm for calculating prices and profits or as a broad socio-economic statement about the interdependence of apparently independent commodity producers and the associated phenomena of alienation and fetishism (these are the 'quantitative' and 'qualitative' meanings of value theory first distinguished by Sweezy, 1942). Marx himself, and many of his followers, often used 'the law of value' in a rather different way, to summarise the forces that bring some degree of order to an unplanned, anar-

chic and potentially chaotic capitalist economy. What ensures, in such an economy, that the commodities that are produced bear some relationship to people's needs? (Remember that the relevant 'people' are for the most part capitalists, not workers). What ensures that these commodities are produced at something close to minimum cost? Marx's answer is the operation of the law of value, by which he meant the forces of free competition that reward success and penalise failure. Note that we are dealing here with Dr Marx, not Dr Pangloss. There is no presumption that the bundle of commodities actually produced is in any way socially optimal, *à la* Pareto, still less that it will grow over time in a smooth and harmonious manner. On the contrary, Marx tells us, competitive capitalism is characterised by deep cyclical fluctuations, possibly increasing in their severity. But there is no chaos. Order — after a fashion — does prevail.

Now the law of value, in this medium-range sense, works only in conditions of free competition (there is no presumption in Marx of anything resembling 'pure' or 'perfect' competition. See Clifton, 1977). What, then, would be the consequences for the capitalist economy if these conditions no longer applied? How could the system function if the concentration and centralisation of capital gave rise to steadily increasing monopoly power? Since the withering away of free competition was precisely what Marx anticipated (Howard and King, 2004), this question was a very important one for all Marxian theorists. It was also quintessentially a *Marxian* question. It is hard to imagine Jevons or Marshall asking themselves 'Why does capitalism continue to function?', any more than they would have asked whether the sun would continue to rise in the east each morning.

By the time of Marx's death, his prediction concerning the growth of monopoly power appeared to be coming true, and the question could no longer be avoided. It provoked first a major theoretical controversy and, eventually, also a fundamental political division — crudely put, between revisionists and orthodox Marxists. The first prominent reformist was Eduard Bernstein, exiled in England between 1888 and 1901 and therefore in close contact with that country's Fabian socialists. Bernstein himself denied that he was influenced in any significant way by the Fabians. Peter Gay suggests that he was, but refers only to the labour theory of value, the theory of exploitation and certain fundamental epistemological issues; there is no evidence that Fabian thinking on crisis theory (such as it was) or on the macroeconomic implications of monopoly power had any significant impact on the revisionist critique of orthodox Marxism (Gay, 1952 [1970], pp. 107-9, 162, 182). He argued that the decline of free competition was making capitalism more orderly and producing *greater* stability. Capitalists had already begun to organise themselves in trusts and cartels. They were replacing the now-inoperative law of value with conscious planning of production, sometimes as a matter of purely private initiative, but increasingly with the active involvement of the state (and also of organised labour since, with the rise of trade unions, wage and employment

issues were being taken out of the marketplace, too). All this had clear macro-economic consequences. Cyclical crises were becoming less severe and the process of capital accumulation was proceeding more evenly.

The capitalist attack on free trade was an unnatural and potentially dangerous phenomenon, Bernstein maintained. But

Protective tariffs are not a product of the economy but an intervention in the economy by political authorities seeking to bring about economic effects. The industrial cartel as such is a very different animal. Even when nurtured hothouse-fashion by protective tariffs, it has grown out of the soil of the economy itself and is a characteristic means of adjusting production to the movements of the market. There is no question that at the same time it is, or can become, a means for monopolistic exploitation. But neither is there any question that, in its first capacity, it represents an enhancement of all previous remedies for overproduction. With much less risk than an individual enterprise, it can temporarily limit production in times of a glut on the market. What is better, it is also in a position to take steps against unfair competition from abroad. To deny this is to deny the superiority of organisation over anarchic competition. But that is what we do when we deny in principle that cartels can have a modifying effect on the nature and frequency of crises. (Bernstein, 1899 [1993], p. 94).

Bernstein tended to hedge his bets when discussing whether the cartels' potential for reducing the severity of crises was actually operating in contemporary reality (compare *ibid*, pp. 83-4 and 94-5). On balance, however, he believed that cartels, operating 'even on an international level here and there', had 'the ability to influence the relationship between productive activity and market conditions in such a way that the danger of crises is diminished' (*ibid*, pp. 90-1).

Bernstein was no great theorist and made no attempt to formalise his argument, but David Laibman's numerical example of how a realisation crisis might occur, using a two-department model of reproduction like those in volume II of *Capital*, makes the German revisionist's point very clearly (Laibman, 1997, pp. 88-92). In part A of Table 1 the columns depict the quantities of capital used in each department (K); the wages paid (W); the surplus value consumed by capitalists $[(1-a)P]$; the surplus value that is accumulated (aP); and total output (Y). All are measured in labour values; for the sake of simplicity, raw materials are ignored (for an exposition of Marx's analysis with raw materials included, see Howard and King, 1985, chapter 11). In part A of the Table the capital-output ratio is 2, the profit share in output is 0.4 and the proportion of surplus value accumulated is 0.5. Capitalists and workers in department I buy consumer goods from the capitalists in department II, to a value of 80; capitalists in department II buy additional capital goods, of the same value, from their counterparts in department I. These transactions between

the two departments are highlighted in the boxes. Part B shows the same relations in the following year, with all magnitudes 10 per cent greater; thus capital has increased by 100, and output by 50. Again the demand from department I for consumer-goods is equal to the demand from department II for additional capital-goods (88).

Table 1: A Realisation Crisis, and How to Cure It

		K	W	$(1-a)P$	aP	Y
A	I	200	60 + 20	+	20	= 100
	II	800	240 + 80	+	80	= 400
B	I	220	66 + 22	+	22	= 110
	II	880	264 + 88	+	88	= 440
C	I	220	55 + 27.5	+	27.5	= 110
	II	880	220 + 110	+	110	= 440

Source: Laibman 1997, Table 9.1, p. 89.

In part C the numbers have been manipulated to destroy this balance between the two departments. The profit share has been increased from 0.4 to 0.5; this leads to increased accumulation, since all savings are invested and capitalists have a positive savings propensity while workers never save anything. Now the demand from department I for consumer-goods (82.5) is less than the demand from department II for additional means of production (110). There is a surplus of consumer goods and a corresponding shortage of capital goods. The result is a realisation crisis, which (Laibman suggests) cannot be avoided either by price changes or by migration of capital from II to I. In a competitive system, individual capitalists cannot know the state of the economy that is summarised in Table C; neither can they be sure of the necessary response. The only safe conclusion for them to draw is the need 'to withdraw capital....liquidate'; if enough of department II's capitalists do so, the outcome for the system as a whole will be 'a sudden rush into liquidity and consequent collapse of demand' (Laibman, 1997, p. 88; emphasis in the original). This is the consequence of the unplanned, spontaneous, anarchic nature of capitalist production: 'If a *coordinated* shift of capital from II to I could occur, the sur-

plus of consumer goods would quickly be eliminated. The *individual capital* in II, however, cannot make that move independently; consequently, the move cannot be made, without an intervening crisis' (*ibid*, p. 92; emphasis in the original). 'Precisely so', Bernstein would have responded; 'and such coordination is exactly what monopoly capitalism is working towards'.

Bernstein's heretical views were soon attacked by orthodox Marxists like Karl Kautsky, Rudolf Hilferding and (first of all) Rosa Luxemburg, for whom the growth of monopoly and consequent repeal of the law of value had removed the only mechanism capable of regulating the capitalist system. More disorder, greater instability, more serious macroeconomic problems — this was what the orthodox Marxists expected. The state would indeed increasingly be implicated, but only so that its capacity for violence could be used to export the contradictions of monopoly capitalism to the rest of the world. Where Bernstein saw imperialism as an inexplicable error, the orthodox Marxists believed it to be an inescapable consequence of growing economic disorder (Howard and King, 1989, chapter 5).

Luxemburg had taken issue with Bernstein from the start, and much of the discussion of cartels in his book is addressed to her arguments. In 1898 she summarised her objections in a series of articles in the *Leipziger Volkszeitung*, which were later reprinted in pamphlet form as *Social Reform or Revolution?* While capitalism had been prone to crises in its earlier, competitive phase, she claimed, it had recently become more unstable, not less so as Bernstein believed. In fact cartels represented a distinct phase of capitalist development, which

...ultimately serve only to increase the anarchy of the capitalist world and to express and bring to fruition all its immanent contradictions. They intensify the contradiction between the mode of production and the mode of exchange by pushing the conflict between producer and consumer to its extreme limit. Furthermore, they intensify the contradiction between the mode of production and the mode of appropriation by confronting the work-force with the superior might of organised capital, thus bringing the antagonism between capital and labour into the sharpest possible focus.

Finally, they intensify the contradiction between the international character of the capitalist world economy and the national character of the capitalist state by bringing in their wake a general tariff war, thus pushing to extremes the antagonism between individual capitalist states. To which we must add the direct and highly revolutionary effect of cartels on the concentration of production, technical progress, etc.

So, in their long-term effect on the capitalist economy, cartels seem to be, not 'means of adaptation', which obliterate its contradictions, but actually means created by capitalism itself to increase its own anarchy, bring its internal contradictions to a head, and hasten its own demise. (Luxemburg, 1898 [1988], pp. 255-6).

The choice was thus between socialism and barbarism, as Luxemburg was later to put it.

3. MARXISM BETWEEN THE WARS

Before 1914 Rudolf Hilferding was a firm opponent of Bernstein, albeit from a slightly different perspective from that of Luxemburg. In his masterpiece, *Finance Capital*, he treated crises and monopoly power as almost entirely separate questions, noting only - in apparent contradiction of the revisionist position — that cartels worked best in boom conditions rather than in depressions (Hilferding, 1910 [1981], p. 409 n.11). By 1924, however, he had come to agree with Bernstein on all essential points. The era of free competition, he wrote, was drawing to a close, and the big monopolies were becoming the decisive factor in the economy. Industrial, commercial and banking capital, formerly quite distinct, were coming together in the form of finance capital:

This means a transition from the capitalism of free competition to organised capitalism. The socialisation of the labour process in large concerns is moving towards the socialisation of the labour process of entire branches of industry and the complete unification of the socialised branches. As a result, the conscious regulation and direction of the economy is growing at the same time, and is striving to overcome the inherent anarchy of freely competitive capitalism. If this tendency were able to proceed unchecked, it would certainly produce an organised economy, albeit one organised hierarchically and in an antagonistic form...

The instability of capitalist production relations would be reduced and crises made milder — or at least their effects on the workers. The planned allocation of new investment by the trusts, a certain restraint in new investment in fixed capital in booms, postponing it until periods of slack trade, corresponding regulation of credit by the big banks, supported by an appropriate monetary policy on the part of the central bank — these would be the instruments of such a policy. These problems have already begun to feature in the economic literature in America and England, if not yet from this theoretical viewpoint. (Hilferding, 1924, p. 2).

As he implied in his reference to the 'antagonistic form' that would be taken by the new organised economy, Hilferding did not believe that it signified the end of the class struggle, still less the end of history (Howard and King, 2003). But he did claim that organised capitalism had clear macroeconomic advantages over a regime of free competition.

The Great Depression dispelled these illusions. Many Marxists now fell back on the arguments that had once been employed against Bernstein: if there is no law of value there can be no regulating principle, and hence no alternative to chaos, for the capitalist economy. As early as 1928 Eugen Varga, the Comintern's leading economic theorist, was foreshadowing the decline of capi-

talism. Reformists like Hilferding, he noted, claimed that the system had changed for the better because the bourgeois principle of free competition had been replaced by the socialist principle of regulated production. They argued that the state was no longer an instrument of capitalist domination, and could instead be used to implement measures of economic democracy that would accomplish a gradual, peaceful transition to socialism (Varga, 1928, pp. 88-9; on p. 60 he quotes, selectively but at length, from the passage in Hilferding (1924) cited above). Varga denied all this:

Experience shows that monopolies do not prevent crises; such could only be the case with a capitalist planned economy. The formation of monopolies frees the monopolists from the consequences of crises. In free competition capitalism, crises made themselves acutely felt by reducing the value of commodities which were produced in excess of the consumption capacity of society, by a sharp fall in prices to their socially necessary value. In these cases the capitalists bore the chief part of the cost in the form of property losses, bankruptcies, etc. Monopoly capitalism cannot do away with crises, i.e., with the contradiction between the productive forces of society and its consumption power determined by antagonistic relations of distribution. But monopolies are certainly capable of transferring the burden of crises from themselves, because they can maintain high prices even during a crisis, and bring about stability not by depreciating the value of surplus commodities, but by *limiting output*, that is, at the expense of the workers, at the same time being able to reduce wages to a level convenient for them. It is not credit crises, not bankruptcies, not bank failures which characterise the crises of monopoly capitalism, but permanent mass unemployment. The reaction of the crises in the working class is not ameliorated under monopoly capitalism, as Hilferding maintains, but accentuated (*ibid*, pp. 60-1).

Writing in exile in 1935, the German social democratic economist Natalie Moszkowska also rejected Hilferding's conclusions, but on different grounds. The entire 'anarchy of production' approach to crisis theory was mistaken, Moszkowska argued. It confused cause and effect. Crises were the result of underconsumption, not a lack of organisation and planning. Underconsumption itself was the inevitable consequence of the steady rise in the rate of exploitation, and the resulting failure of working-class purchasing power to grow at the same rate as labour productivity. There was no doubt that production was less anarchic under monopoly than it had been in competitive capitalism, but this was simply irrelevant to the question of macro-economic instability. Cartels had failed to prevent crises, not because they were poorly organised but because they faced an impossible task (Moszkowska, 1935, p. 77).

This is an early statement of the later very influential ‘monopoly capital’ version of underconsumption theory that was set out more rigorously by Paul Sweezy (1942) in *Theory of Capitalist Development* and is often attributed also to Michal Kalecki — quite wrongly, according to Andrew Trigg (1994). On this argument the macroeconomic difficulties faced by advanced capitalism, in its monopoly phase, are more serious than those encountered in the earlier, competitive era, since a rising degree of monopoly results in an increased profit share and thus in a decreasing average propensity to consume. This seems to be the model that Paul Davidson has in mind when he describes Kalecki as an ‘imperfector’ and therefore as a forerunner of New Keynesian economics. But, whether Kalecki accepted the monopoly capital theory or not, it is important to note that this theory is *not* quite the same as the ideas that have been discussed in this paper. The revisionists and their orthodox Marxist opponents were arguing about something rather different. What was at stake for them was — as Marx would have put it — the operation of the law of value outside conditions of free competition.

4. CONCLUSION

For Marxists on both sides of the revisionist controversy, the question was not ‘is monopoly the cause of capitalist crisis?’ None of them would have answered this question in the affirmative. Neither would any of them have accepted the New Keynesian position that ‘perfect’ (read, free) competition and price/wage flexibility is the cure for all macroeconomic ills. The correct question, for all the Marxists, was rather this: ‘will the growth of monopoly make crises more severe, or less?’ The answer to this question places Luxemburg and Varga alongside Solow and the New Keynesians, while Bernstein and the later Hilferding agree with those Post Keynesians who, like Harcourt, Larson and Shapiro argue that anything reducing the degree of uncertainty will increase the stability of the capitalist economy. Rosa Luxemburg was not, of course, an early New Keynesian. But there is a sense in which she was an ‘imperfector’, to revert to Paul Davidson’s term, along with the other orthodox Marxists that I have referred to. One lesson that might be drawn from this is that in macroeconomic theory there really is nothing new under the sun.

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ENDNOTES

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