Since the latter decades of the 19th century, orthodox economic theory has made its main business the demonstration that a well-oiled market mechanism will produce the most efficient allocation of scarce resources among competing ends. This preoccupation has in turn dictated a characteristic mode of analysis, in which the economy is conceived in terms of ‘agencies,’ or institutions, which, whatever their other differences, find their common denominators in terms of their market functions. Thus Rockefellers and sharecroppers are both ‘households,’ GM and the corner grocery are both ‘firms.’ Households, rich and poor, all demand ‘final goods’ and supply labor and other ‘services’ (meaning the use of capital and land); firms, big and small, demand labor and other factor services, and in turn supply final goods.

This way of subdividing the economy fits neatly into the framework of ‘rational choice.’ Factors supply services and demand goods in the amounts and proportions that will maximize their ‘utilities,’ given their ‘initial endowments,’ a polite way of referring to property holdings. It can be shown that the amounts finally chosen, the so-called equilibrium supplies and demands, will be simultaneously compatible solutions to all these different individual maximizing problems.

The task of high theory, then, is twofold: first, since the models are complex, to show that there are, indeed, such simultaneous, mutually compatible solutions. This is not obvious, and, in fact, not always true. Secondly, of equal mathematical and of greater ideological importance, are what might be called the Invisible Hand Theorems, which show that the system of market incentives will direct the economy toward these equilibrium prices, supplies, and demands. In other words, the Invisible Hand Theorems demonstrate that the system is automatically self-adjusting and self-regulating.

This architecture of thought has many strengths. Market incentives often do direct the system in various predictable ways. Maximizing is, under some conditions, an indispensable part of rational behavior, and so must be spelled out. That it is all done at an exceptionally high level of abstraction.
is not only not an objection, but – it is claimed – may be a positive merit. The analysis is not cluttered with irrelevancies.

But when all is said, the theory of the efficiency of competitive markets has never provided much practical insight into historical reality. Since it presupposes effective market incentives and institutions devoted to maximizing behavior, it cannot easily be applied to the study either of pre-market economics or of post-market ones – i.e., ideal communist (or anarchist) societies. More important, traditional theory fails to provide a good model for studying the working and misworking of present-day capitalism.

There is a simple reason for this very important failure. Basically, orthodox theory is a theory of markets and market interdependence. It is a theory of general equilibrium as applied to exchange, extended almost as an afterthought to cover production and distribution. But exchange is a limited aspect of economic, much less social, reality. Therefore, orthodox theory is not a theory of economic power and social class, much less of a social system in its entirety. As we have noted, the initial ‘endowments,’ wealth, skills, and property of the populations are taken as given. Moreover, since the object of the theory is to demonstrate the tendency toward equilibrium, class and sectoral conflict tend to be ruled out almost by assumption.

As a result, the orthodox approach has comparatively little interesting to say about such important socioeconomic questions as the distribution of wealth and income. It cannot say how these came about originally; nor how different they might be under another kind of economic system. It does, however, have one major claim to social and historical relevance. It offers a definite though limited theory of the division of the value of net output between land, labor, and capital in a market system. This is known as ‘marginal productivity’ theory. Briefly, it states that each agent in the system will tend to be rewarded in proportion to – and as a limiting case, in direct equivalence with – the contribution he makes to output. Thus a man earns what he (literally) makes; a landlord reaps what he (metaphorically) sows.

But with the revival of interest in recent years in the great problems of Political Economy, this central claim has come under increasingly heavy attack. This attack, which began as particular and limited objections to specific orthodox doctrines, has in the past few years developed into an alternative conception of the economic system as a whole. It is no longer simply a rival theory of market dispensations – a ‘non-neo-Classical’ theory; nor can it be regarded merely as a return to the approach of the Classical greats – Smith, Ricardo, and Marx. It is both of these, but it is also considerably more. In currently fashionable terminology, it is the emergence of a new paradigm.

To see this, let us contrast the view of income distribution given by the new paradigm with that of orthodox marginal productivity theory. At first glance, marginal productivity theory appears eminently sensible. Essentially, it states that factors – land, labor, and capital – will be hired as long as they produce more than they cost to hire. Expanding the employment of any one factor, the others held constant, will (the theory assumes) cause the returns on the extra units of that factor to decline, since it has proportionately less of the others to work with. Thus employment will cease when the declining returns to the factor in question just equal the cost of hiring more of the factor. Competition will cause each factor to be used up to the point where the gain from employing it equals that obtainable from the other factors. The total earnings of any factor will then be equal to the amount of it that is employed, times its marginal product, summed up over all the industries in which it is used. Clearly the relative shares of factors – land, labor, and capital – will then depend on their respective marginal products.

So far, so good. To be sure, this story depends on the existence of markets, specifically on markets for land, labor, and capital, so that the theory won’t be much use in examining the emergence or evolution of the market system. But note that, in a sleight of hand so deft as to have passed virtually unnoticed for an intellectual generation, the theory attributes responsibility for the distribution of income (under market competition) wholly and solely to the impersonal agency of technology. It is technology, not man, nor God, least of all politics, that has decreed what the shares of labor and capital are to be in the total product. For it is technology that determines how rapidly returns diminish. Thus only through technological changes, inventions that alter the engineering possibilities, can relative shares be changed. For if income shares are to change, marginal products must change faster or slower than they will change simply by the slow changes in the relative supplies of factors – e.g., population growth. Thus everything depends on how rapidly marginal returns to the different factors diminish, relative to one another, and this is a matter that depends only on technology.¹

From this perspective the class struggle is an illusion, and unions are valuable only as mother substitutes – providers of security and a sense of identification. Minimum-wage legislation may or may not raise wages, but in all cases the effect will depend entirely on what the technology permits. Only moves that change the relative marginal products of labor and capital can affect income distribution (though even they might not change if, for example, the movement in the relative amounts of labor and capital employed just offsets the changes in their marginal products). The influence of factor supplies is felt only through marginal productivity. Hence
technology is what finally determines income distribution. Aggregate demand, monetary policy, inflation, unions, politics, even revolutions, are, in the end, all alike, irrelevant insofar as Who Gets What.

Socialist and left-wing economists, indeed social critics generally, have always gagged on this. Property and power, they maintain, are the essential elements in class struggles and sectional conflicts; it is ridiculous to say they don’t matter – that the outcome, given the competitive market, is predetermined by the accidents of technological inventiveness. From their vantage point, income distribution – the division of society’s annual product among the members of society – is the central question. For if we put income distribution at the center of the stage, the concern of the orthodox theorists with how factors spend their incomes seems relatively minor. The framework of rational choice looks flimsier and more makeshift; essentially a consumer-oriented theory, it has come to resemble so many consumer products: ingenious, brilliant, but unsuited to human needs.

This is not to say that the Political Economist rejects the theory of rational choice outright: he rejects it merely as an appropriate framework for the analysis of production and distribution in the aggregate. The framework he erects in its place is one that reveals the links between sectors and classes; shows how the products of one industry or set of industries are used as inputs by other industries (whose products, in turn, are used by still others); and makes clear how the earnings of one class are spent supporting production in some sector or industry. These interindustry and intersectoral relations are crucial to understanding how changes in demand or in technology transmute themselves into prosperity for some, disaster for others. Links between revenue from sales, social classes, and spending are crucial for understanding how the distribution of income is established and maintained in the face of considerable changes in the composition of output and in government policy.

The difference may seem one more of emphasis than of substance, but putting income distribution at the center and relating it to different patterns of linkages, of payment streams, and of technological dependencies between industries, sectors, and classes, leads to an altogether different vision of how the economy works.

III

The new vision can be called a ‘general equilibrium’ approach, if one likes. But it immediately departs from the orthodox meaning of that phrase by emphasizing the interdependence of production, rather than of markets; technical and institutional ‘interlocks’ – or their absence – rather than purely market relationships.

A second difference between the new approach and the old lies in the treatment of ‘substitution.’ In the old picture, substitution is the law of life on both the supply and demand sides. In response to price changes, different patterns of goods and/or factors will be chosen; when prices change, cheaper things will be substituted for more expensive ones in household budgets and industrial processes. The problem is that this conventional picture assumes that households and firms have given ends – the maximization of ‘utility’ or output respectively. Hence, it does not deal with the more important questions of introducing altogether new products and processes, changes that often alter the parameters of the system or perhaps even the consciousness of society. Even within the narrow focus of the neo-Classical lens, however, many alleged cases of ‘substitution’ involve something quite different – technological progress, changes in the nature of the product, external effects on parameters of the system, and so on. Indeed, in this wider sense, neo-Classical substitution is only a special case, and that is how the matter is treated in the new vision.

Thirdly, the old vision treats the consumer as sovereign, and the effects of his choices enter into the determination of all major variables. This, of course, does not render the old vision incapable of discussing market power, producer sovereignty, or the ‘new industrial state.’ But, inevitably, such phenomena appear as special cases, limitations on the general principle of consumer sovereignty. In the new vision the consumer is cut down to size from the start. Her preferences have little or no effect on prices or income distribution.

As a consequence, markets and the ‘price mechanism’ are not seen in the new vision as a stable method of bringing about social optimality. On the contrary, prices are seen as determined largely from the supply side, and so depend on income distribution, which in turn may be influenced by many nonmarket and even noneconomic considerations. Ideologically, this means that the ‘market’ should not be seen as some sort of alternative to bureaucracy, or as a method of allocating resources. Allocation depends on distribution, which depends at least in part on property and class.

A further fundamental difference can be seen when we consider the purposes of the two visions. The basic constituents of the old vision are consumers and firms, agents whose optimizing behavior, individually or in the aggregate, the equations of the models describe. In particular, maximizing behavior is what the theory is all about, and the object of the theory, by and large, is to predict the consequences of such behavior. But the circumstances in which this behavior takes place are taken for granted.

By contrast – and oversimplifying – the new vision is primarily interested in structure, in the patterns of dependency between established institutions, in how the system hangs together, and how it works or fails to work. The job of economic theory is to delineate the blueprint of the economic system, of the environment in which economic behavior takes place. The basic constituents of theory are industries, sectors, processes, or
The supply determines the rate of profit. This must be rejected. No sense can be given to the ‘contribution’ to production of a fund of capital (Ch. 7).

This is not to say that saving and investment, and their long-run consequences, are irrelevant to determining the rate of profits and relative shares. Quite the reverse; by eliminating the alleged ‘contribution of capital’ in production as an influence or determinant of distribution, we open the way for a theory of distribution based on the relation between the growth of spending, of capacity, and of the labor force, on the one hand; and on the market power available to the various parties, on the other. Unequal rates of inflation of money wages and prices necessarily imply changes in the relative shares going to capital and labor, as Keynes pointed out in the Treatise on Money, his earlier major and now neglected work. Inflation is partly a consequence of the ratio of demand to supply, but it also reflects relative market power. And here is where the rules of the game – the rules of property – come in. For property confers advantages, though not absolute ones, in the setting of prices and in bargaining for money wages. Exactly what these advantages are, how they work, and by what kinds of forces, are among the questions that a theory of distribution should be able to answer. (See Chs 9 and 10.)

In short, the new vision adopts a picture of the relation between production and distribution altogether distinct from that which has ruled the economist’s roost since the Marginalist Revolution. This, in turn, entails rejecting some widely used techniques of empirical analysis, in favor with both radical and orthodox economists. In particular, ‘production function’ studies – e.g., of technical progress, the contribution of education, the effects of discrimination, and of shares during growth – all involve a fatal flaw. For insofar as they proceed by assuming that a factor’s income share indicates in any way its productive power at the margin, they are based on precisely the relationship that the new vision rejects.¹

It thus seems that conventional theory, although it contains much of value and importance, contains serious deficiencies.² The neo-Classical theory of the general equilibrium of production, distribution, and exchange holds that the payments in the factor markets are exchanges in the same sense as payments in the product markets. ‘Distribution is the species of exchange,’ wrote Edgeworth, ‘by which produce is divided between the parties who have contributed to its production.’ Distribution, say the proponents of the new vision, is not a species of exchange; and capital goods, rather than capital, contribute to production. The ideological teeth begin to bite; an exchange, in equilibrium, means that value equivalent is traded for value equivalent. No exploitation there. But if distribution is not a form of exchange, then we must ask Who Whom?

This catalogue of differences, and especially the last point, can be nicely illustrated by comparing two simple diagrams that visually summarize the two paradigms. The first, Figure 1.1, adapted from Samuelson...
Obvious objections to this economic schema can easily be raised. For instance, not all ‘households’ are on a par, since some own all the firms between them, while the rest merely work for the firms. Also the distribution of profit and similar income is not an exchange, since the only ‘service’ that the owner of a business (in his capacity as owner) need supply in return for its profits is that of permitting it to be owned by him. He does bear risks, of course, but so do the employees who will be out of their jobs in the event of failure. Other objections were mentioned earlier in the charge that orthodox neo-Classicism ignores technological interdependencies and institutional relationships, as the circular flow picture makes evident. Nowhere in it can one find social classes or any specific information about patterns of technical interdependence.

All these objections look at first like strong empirical problems that neo-Classicists should meet head on. In fact, however, the customary orthodox defense is oblique and of dubious validity. To the charge that their model rests on unrealistic assumptions, they reply that the only test of a model is the success of its predictions. So there is no a priori error in making unrealistic assumptions. Moreover, ‘simplifying assumptions’ and ‘theoretical constructs’ are bound to be, in some sense, ‘unrealistic,’ and there is no predicting without them. Unrealistic assumptions may therefore be warranted and the warrant is philosophical, positivism itself.

We will return to these defenses. But first consider quite a different picture of capitalist society. Figure 1.2 epitomizes the new approach, which, if the old is ‘neo-Classical,’ could be dubbed ‘Classical-Marxian.’ It cannot be claimed that this is the only, or necessarily the best, distillation of an alternative picture from that tradition, but it will serve to illustrate the contrasts.

To keep Figure 1.2 comparable to Figure 1.1, we retain the circle for the final goods market and the box standing for industry, though we shall interpret both quite differently. ‘Households’ and the ‘factor market’ disappear altogether. Instead we have a pyramid, representing the social hierarchy, divided into two parts: a small upper class of owners and a large lower class of workers. Owners own industry and receive profits; workers work for industry and receive wages. Workers consume, but do not, in this simplified model, save; owners both consume and save, in order to invest.

Now consider the flows of services and money payments. Labor is the only ‘factor input;’ other inputs are produced by industry itself, which is assumed to have access to land, mines, etc. (We are lumping landlords and capitalists together.) Hence we might expect to be able to value the total product in terms of labor, and though the mathematics is complicated, this can indeed be done, though not in all cases. The arrows running back and forth between factories represent interindustry transactions, the exchanges between industries necessary to replace used-up means of production. The Net Social Product is sold for Total Receipts, and consists of all goods over and above those needed for replacement. These can be divided (for

(1948–present) and echoed in all major textbooks, presents what might be called a same-level division of society: business and the public (producers and consumers) confront each other more or less as equals in the markets for both products and factors. (The equality is an overall one; there are some large or allied firms, some collective consumers.) Households demand final goods and services and supply the services of productive factors, in both cases in accord with what economists rather pompously call ‘their given relative preference schedules,’ meaning, what they like best. Businesses supply final goods and services according to their cost schedules in relation to the prices that consumers are prepared to pay, and demand the services of productive factors according to their technical opportunities and needs in relation to consumer demand for products.

So goods and services flow counterclockwise, while money flows clockwise. In each set of markets, equivalents are traded for equivalents, the value of goods and services flowing in one direction being just matched by the stream of revenue in the other. No exploitation is possible in competitive equilibrium. The value of household factor supplies just matches aggregate household demand, and the output of goods and services matches business demands. This may seem to ignore the fact that households save and businesses invest, meaning that some final demand flows not from the Public but from Business. But that is easily allowed for. To finance this demand, Business must borrow Household savings, by supplying bonds that the public demands. Bonds are treated as a kind of good, flowing counterclockwise. These points enable the microflow picture to be summed up as a macroflow picture, illustrating in the simplest way how macro rests on microfoundations.
Method and Approach

The Revival of Political Economy

The tools, equipment, etc., replacement and depreciation of which is already counted in) have produced the entire product. Is labor not therefore exploited? Does it not deserve the whole product?

The latter question opens Pandora's box; as for the former, it all depends on what you mean. What does certainly follow, however, is that distribution is not an exchange, profits are not paid for anything and serve no function which cannot be met in other ways. This may not be exploitation but it shows clearly that the traditional economic justification – the ‘reward’ for services – cannot be applied to profits, interest, dividends, and the like. Moreover, since the payment of profit is no exchange, there can be no equilibrium in the usual sense. A century-old school of thought, holding that our troubles come from the excessive profits sucked in by giant monopolies, and idolizing small competitive enterprise earning ‘normal profits,’ is thereby undercut. There is no merit in ‘normal profit;’ indeed there is no such thing. The issue for Political Economy is the profit system itself, not its alleged abuse.

But surely, under both capitalism and market socialism, do not profits serve the essential function of indicating where investment can most advantageously be directed? Does not the rate of profit, similarly, serve to allocate productive resources between producing for current consumption and expansion for the future?

There are two things wrong with this common claim. First (as sophisticated neo-Classical economists will quickly admit), the function of profits and the rate of profit as indicators require merely that they be calculated, not that they be actually paid out. Calculated profit indicators are compatible with many different incentive schemes (e.g., salary bonuses to managers of state-owned enterprises, moral incentives, etc.). Second, profit-based indicators are only one set among several. In a stationary economy, for example, the correct indicators to achieve maximum output would be based not on profits but on labor values!\(^7\) Indeed, profit indicators alone are likely to be misleading; the rate and pattern of growth must also be considered in trying to identify the best investment plans.

Thus, from the strict economic point of view, forgetting social complications, the best choices for maximizing consumption may differ from the best choices for maximizing growth. Once we allow for quality, the effect on the environment, and so on, the variety of possible indicators becomes considerable.

To return to the diagram in Figure 1.2: the new model helps us to understand how the division of income comes about. Remember that the orthodox doctrines held that the distribution of income was determined in the factor market, by the marginal ‘contribution’ of factors in conjunction
with their relative scarcity. The diagram makes it clear that income distribution interacts with all aspects of the economy, not just with the 'factor market.' This point can be made quite simply, though its consequences are far-reaching. Labor's share is given by the real wage times the amount of work. But the real wage is the money wage divided by an index of consumer goods prices. The money wage is set in the labor market, but prices are set in the final goods market. Labor's share, then, depends on both markets. Thus the system is interdependent in ways no hint of which can be found in orthodox teaching.9 (See Ch. 24.)

This puts inflation in a new and clearer light. The standard approach is to distinguish 'demand-pull' inflation (originating in the final goods market) from 'cost-push' inflation (originating in the factor market). Very few actual cases seem to fit either category. On the new approach this should come as no surprise, for the question has been wrongly posed. This issue is not where inflation originates, but how fast it proceeds in different markets. In the orthodox diagram it is natural to suppose that a price increase in the product market will be transmitted directly to the factor market, and vice versa. Unless costs and prices rise together the circular flow cannot continue unimpeded. In the new diagram it is evident that this is not so — costs and prices rising in the same proportion will be the special, limiting case. In all other cases the effect will be to raise or lower Profits. When wages rise faster than prices, there will be Profit Deflation; when prices rise faster than wages, Profit Inflation, to use the terminology suggested by Keynes in the Treatise on Money. In all cases except the limiting one, then, inflation will affect income distribution and so aggregate demand and employment.10 (See Ch. 23.)

What determines the relative rate of price and wage increases? The first answer, of course, must be 'supply and demand,' and this is surely right. For example, large numbers of unemployed will tend to act as a drag on money wages. But the same balance of supply and demand may have a very different total impact on price in different circumstances, depending on market power; on the financial position of companies and unions; on the ability to make use of the law, or state agencies, to manipulate the press and the media; and so on. These considerations are preeminently ones of Political Economy, but they play an essential role in theory, for they determine the relative responsiveness of markets, and hence the relative speed of wage and price inflation.

V

We have now presented and contrasted the two paradigms. The neo-Classical one is far better known, and most contemporary work is conceived in its terms. But if the preceding argument is sound, it is significantly misleading. The new paradigm, by contrast, is clearly more realistic sociologically, and is capable of handling questions, such as those concerning property income and social class, that the other tends to submerge.

These two claims, that the old paradigm is misleading and the new more realistic, suggest that there is a strong prima facie case for adopting the new. This conclusion, however, is widely resisted, and the reasons, already mentioned, are interesting. Those who defend the old approach often contend that a paradigm cannot be 'misleading' in its representation of institutions if it leads to models that predict well. 'Realism' is not important; abstraction must take place, and a model can abstract from anything, so long as it performs well.

Such a defense must be seen for what it is. It is a methodological claim, and one based on a particular, and today rather questionable, philosophy of science. One straightforward retort might be that neo-Classical models have not done very well on their chosen ground.11 Prediction has not been the greatest success of modern economics. But a more fundamental response would be to challenge the methodology itself. There is no time to argue the case now, but there is an intuitive appeal to the idea that a model of social institutions must be a good representation of things as they are at a given moment of time, regardless of how they work out over time. To demand of economics that it predict what will happen may be asking too much.12 In modern industrial societies the economic system is too closely interlocked with other aspects of society; it cannot be isolated enough for effective tests to be run. But to add a long string of ceteri paribus clauses simply tends to reduce predictions to vacuity. Instead, we must examine the definitions and assumptions of our models for their realism, and for the extent to which they incorporate the essentials. If they are realistic, then the working of the model should mirror the working of the economic system in relatively simple and abstract form. To argue this further would take us far afield.13 It should be clear, though, that the case we have presented can be defended from the methodological objections of the Positivists.

In short, the new approach presents a coherent picture of the economy, perfectly adapted to modern empirical methods and capable of providing technical analysis of a sophisticated nature.14 But it has not been developed for its own sake, or simply because it presents a better, more accurate picture of capitalism. The new picture is intended precisely as Political Economics, as a guide to the criticism of the capitalist socioeconomic system. Its basic challenge to orthodox thinking is that, in treating the distribution of income as a form of exchange, it misrepresents the way the system works. But if it is not an exchange then someone is getting something for which he is not giving a value-equivalent. The step to social criticism is then short.

Orthodox economics tries to show that the markets allocate scarce resources according to relative efficiency; Political Economics tries to show
that markets distribute income according to relative power. It is good to
know about efficiency, but in the world we live in, it tends to be subservient
to power.\textsuperscript{15} By failing to appreciate this, and consequently failing also to
accord the distribution of income between labor and capital a properly
central role, orthodox economics has become cut off from the central
economic issues of our time, drifting further into ever more abstract and
mathematically sophisticated reformulations of essentially the same prop-
ositions. The heart of the matter is the concept of 'capital' and its relation
to social class and economic power. When this is put right, as in the new
paradigm, economic theory can once again speak to the critical issues of
the day.

Appendix: Post-Keynesian
Flow Diagrams

The reader should first refer back to the discussion of the 'neo-Classical picture' on
pp. 10-11, and Figures 1.1 and 1.2. Figure 1.2 suggests relationships not evident in
the circular flow model. Owners consume without working; workers consume
without owning.\textsuperscript{16} Production and intermediate transactions (which largely set
relative prices, i.e., 'real' exchange ratios) occur in the manufacturing sector, which
supplies the Social Product and pays out Wages and Profits to Workers and to
Banks and Boards of Directors respectively. However, the model shows that the
Financial Management then decides how much will be distributed to owners and
how much will be retained for investment and liquidity purposes.

Consumer demand is subdivided here, showing separate propensities to consume
and save out of earned and property income. (The flow of property income to
households will be determined in the money, bond and stock markets.) Investment
demand is presumed to depend on competition in growth, constrained by the need
for funds. An important point is that money wages and the volume of employment
are determined in the labor market, where they are obviously influenced by the
level of capacity utilization, desired investment, and other factors influencing the
demand for labor. Money prices, however, will be set in the market for final goods.
However, given the rate of profit, or the rate of growth, relative prices will be
determined by the production equations, and will be set in intermediate trans-
actions. That is, money prices are set in a market of business vs households;
relative or real, prices in business vs business transactions.

The net social product will be a kind of 'surplus,' including, however, wage
goods. The notion of surplus can be defined as the net output over and above
whatever goes to replace the total means of production and sources of energy used
up in the course of producing. Strictly speaking, of course, wages should not be
counted in a surplus; so the net social product here is really surplus plus wages. The
idea is important, however, for it anchors the concept of national income firmly in
the sea of technology, in contrast to the neo-Classicals who leave it floating in the
ethereal skies of 'utility.' The final total of Aggregate Demand and Supply, then,
will depend on the interaction of all of these parts, and so will be determined
together with the distribution of income.

A number of differences should be evident between this and the neo-Classical
diagram in Figure 1.2. Wage-earners' Consumption primarily reproduces their
ability to work. In any case the total Consumer demand depends on the distribution
of income. Only work in the production sector is productive. Distribution of
income and exchange of goods are completely different; owners and workers have
separate economic roles, and the financial sector mediates between owners and the
firms they own, which are run by managers. Money prices and relative prices are
determined in different markets, and thus only the money wage, not the real wage,
is set in the labor market. (The real wage will therefore only emerge from
interaction of the entire system.)

Thus, the relationships suggested in this simple model are different and rely on
different methodological strategies from those of the neo-Classics. The latter
predicate behavioral functions of\textit{individual} decision-makers, paying little attention
to institutional detail, except where it can be expressed in behavioral functions (as
in the imperfect competitor's downward-sloping demand curve or the kinked oligopoly demand curve). By way of contrast, 'Classical-Marxian' theorists base their equations on institutional structures and tend to use fewer behavioral equations. This reflects a difference in political theory. Neo-Classicalists see behavior characterized as the outcome of maximizing decisions; Classical-Marxian theorists find behavior expressed (as with the classical savings function) in sociological and institutional data. They do not discard maximizing; on the contrary, it is seen both as an instrument for deciding the best means to an end and sometimes, but by no means always or necessarily, as a description of what men do. This reflects a difference in philosophies of mind and theories of action. Neo-Classicalists treat 'sound' theory as the upshot of testing predictions with success; Classical-Marxian theorists insist that the 'specification' of a model, that is, the relationships we postulate, and the 'identification' of the results of testing (to use the technical term for interpretation) be determined by reflecting on what must be the case for our capitalist institutional institutions to maintain themselves and work the way they do. All models must be grounded in the basic blueprint. Two further comments:

1. Figure 1A.1 can be simplified by leaving out the Financial Management sector. The resulting picture brings out more sharply the contrast between Wages, which are paid for Work, and Profits, which are paid because of ownership rights, and not in exchange for anything at all. Profits are important, given the system, because, as Figures 1A.1 and 1.2 make clear, they provide the funds which finance investment. But they are not paid in exchange for anything and workers have no say in their disposition. Investment decisions, which, of course, affect workers, too, are the exclusive prerogative of the capitalist class. Nothing of this is indicated by the conventional diagram.

2. Figure 1A.1 can also be made to reveal another aspect of the modern economy, at a relatively small cost in additional complexity. Some work obviously contributes to the output of goods and services; some work equally obviously does not. This is the ancient distinction between 'productive' and 'unproductive' labor. Baran and Sweezy (1900) have given this a rather different twist, by distinguishing the costs of producing goods and services from costs of marketing (realizing them, including in these latter not merely advertising, promotion, and selling costs, but also, along with finance and lobbying, all those costs which are related to supporting the capitalist system as such. (Of course, any system will engender some supportive costs; so the foregone opportunity is really the difference between the cost of supporting the current system and that of supporting an alternative.) According to Baran and Sweezy, these non-productive costs come out of the 'surplus' generated by productive labor, using the instruments, plant and equipment available. This is defined as the excess of total output over and above the goods and services required to support productive labor, to replace the used-up means of production and to make up for depreciation of equipment. This surplus, then, will be divided by the Financial and Corporate Managements between Ownership Income (Dividends, Interest, and Realized Capital Gains), Investment, and Marketing Costs, with Owners returning a portion in the form of Bond and Share Purchases and spending the remainder of their income on Capitalist Consumption. Among other things this makes it clear that Marketing Costs, the costs of running the capitalist system, compete with Investment for funds. (See Ch. 17, sections 4 and 5.)

The distinction between productive and unproductive labor has often been criticized, and some of this criticism is valid. Certainly there are many cases which it would be difficult to classify. But it is hard to deny that there is a clear distinction in principle between work in production and work in marketing. It is one thing to argue over where to draw the line, quite another to hold that there is no line to be drawn. The purpose here is simply to exhibit this distinction, indicating its relation to the Profit System.

The Social Accounts are now: Wages + Salaries + Dividends, Interest, and Realized Capital Gains = Bond and Share Purchases = Wages + Surplus = (Worker + Middle Class + Owner) Consumption Demand + Investment Demand = Value of Consumption Goods + Value of Investment Goods = Net Total Revenue = Net Total Product.

Government can be added in two ways. First, traffic lights can be drawn, showing government regulation, and secondly, at the lights, government can add to or siphon off the flow of traffic.

Notes

1. The point can be put more accurately in technical language: relative shares will change with factor supplies according to the elasticity of substitution, which, in turn, depends only on technology. If the elasticity of substitution is unity, then proportional changes in factor ratios will just be offset by proportional changes in marginal products, so that relative shares will be unaltered. In other cases, changes in the relative amounts of factors employed will alter relative shares.

Figure 1A.1
but both by how much and in what direction will depend solely on the
technology.

2. Of course, the available technical possibilities do influence income distribution. Clearly, if it is known that a machine can do a certain job now being performed manually, the laborer doing the job would be most unwise to ask more than the annual cost of installing and running the machine. But this point can be made without accepting the strait jacket of marginal productivity theory. This is important because the technical possibilities of substitution are only one of several sets of influences that bear upon the division of the national income. Differential rates of inflation, both between wages and prices and between sectors, the aggregate level of employment and monopoly power, are at least equally important, for example. Marginal productivity theory tends to blind us to these influences, or to treat them as 'market imperfections,' exceptions rather than the normal working of the system.

3. There is also an interesting technical point. In the neo-Classical vision macroeconomic relationships are supposed to be based on markets and the price mechanism, which are seen as fundamental. But in the new vision, prices depend on income distribution, and that, insofar as it is determined by economic forces, depends largely on macroeconomic factors. The direction of causal influence is reversed.

4. This is perhaps the central issue in the recent dispute over capital theory between the 'two Cambridges,' Cambridge, England, maintaining the view presented here, against Cambridge, Massachusetts, which argued that the essential neo-Classical story could be developed in a 'heterogeneous-capital' model. Unfortunately, to do this, Cambridge, Mass. found it had to assume conditions in which a simple Labor Theory of Value held! It is now widely agreed that neo-Classical capital theory is defective. For a thorough discussion see G.C. Harcourt, Cambridge Controversies in the Theory of Capital (Cambridge: Cambridge University Press, 1972), and Part II of the book.

5. Put this baldly, of course, it seems an extraordinary assumption for anyone to make seriously. Given what we know about how our society works, if we read the newspapers (or the Valachi papers), we would never in our ordinary thinking expect to explain a change in the income of a group primarily by reference to a change in its marginal productivity. We would certainly think of demand and supply, and of income elasticity; these would provide the framework within which bargaining, power plays, and politics would settle the final (or temporary) outcome. Marginal productivity might or might not come into it; just as it might or might not be measurable, but it would hardly be decisive. Is the shift in the income going to the top few per cent since 1960 to be taken seriously as reflecting an increase in their marginal productivity? Is the relative rise in professional income from 1900–1970 evidence of a long-term upward drift in their productivity at the margin? Yet, in spite of common sense and advanced theory, the production-function studies, aggregate and individual, continue.

6. This should be distinguished from the commonplace (though correct) criticisms that opportunities for substitution are not legion, that changes in techniques of production and consumption are time consuming and costly, that information is hard to come by (and perhaps should be treated as itself a product!), that mobility is sluggish, foresight myopic, and expectations an irregular compound of habit and hope. These points will be readily admitted, for they merely indicate how far the actual world falls short of its own ideal type. The point of the present criticism is that the neo-Classical ideal market economy is not a picture of how the economic system would work under ideal conditions, for it fundamentally misrepresents the relationship of distribution to exchange, whether conditions are 'ideal' or not.

7. The traditional interest in classifying goods along lines such as these, largely abandoned in the face of positivist criticism—these are just value judgements—has been revived in the light of Sraffa's important and far-reaching distinction between basics (goods that enter directly or indirectly into the means of production of all goods) and nonbasics.

8. See R. Goodwin, Elementary Economics from the Higher Standpoint (Cambridge: Cambridge University Press). The point follows directly from the Golden Rule of Accumulation, which states that consumption per head is maximized when the rate of growth equals the rate of profit. When the rate of growth is zero, then in the stationary state, for optimality—maximum consumption per head, or in this case, maximum national income per head—the rate of profit must be zero. But the prices which obtain when the rate of profit is zero can easily be shown to be equal to the amounts of direct and indirect labor embodied—i.e., the labor theory of value holds.

9. This diagram also illustrates a proposition first discovered in the 1930s by the great Polish Marxist economist, Michel Kalecki, who independently and at the same time set forth the main propositions of the General Theory.

\[ \frac{\Delta K}{K} = \frac{s_p P}{K} \]

But

\[ \frac{\Delta K}{K} = g, \text{ the rate of growth} \]

and

\[ P = r, \text{ the rate of profits.} \]

Hence \( g = s_p r \), a simple formula connecting the growth rate and the profit rate. Remembering that \( \Delta K = I \), we also have

\[ \frac{I}{s_p} = P = rK. \]

So, for a given technology, profits are higher and the growth rate lower the greater is the average propensity of the capitalist class to consume out of profits. The extreme simplicity and great generality of this proposition, even now not widely known in the profession, are typical of the results obtained by the new approach.

10. A parallel point should be made about the relative prosperity of different sectors during inflation. The relative rates of price and wage inflation will determine the relative changes in profits, which (on the assumption that most
investment is financed by retained earnings) will set the relative growth rates. Thus inflation, except in the limiting case, will over the course of time bring about changes in the composition of the aggregate economy.


13. For an examination of these points, see Martin Hollis and Edward Nell, *Rational Economic Man* (Cambridge: Cambridge University Press, 1975).

14. The picture can be very much improved as a representation of the modern economy by channeling Profits, not directly to owners but to ‘Wall Street,’ where Banks, Boards of Directors, and Financial Institutions decide how much to retain, how much to invest, and how much to pay out in dividends. Then Capitalist Consumption will come out of Distributed Profits and Realized Capital Gains, and Savings will flow back to Wall Street in the form of bond and share purchases. This properly separates ownership and control, and shows the separation of financial and production decisions, the former dominating the latter. The model can also be modified to take account of worker savings, which, however, are empirically inconsequential.

15. Power, of course, is usually enhanced by efficiency, but the two are nevertheless quite distinct. Economic power ultimately rests on the ability to inflict a loss – the stick. A subsidiary form is the ability to bribe – the carrot. If economists paid as much attention to bribery and extortion as they do to marginal utility, we would be able to develop rough quantitative indices, by means of which one could sensibly discuss (and plan strategy to alter) the distribution of economic power in society.

16. The model can be adapted to account for worker savings.

References
