

# Karl Polanyi's *The Great Transformation*: perverse effects, protectionism and *Gemeinschaft*

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(draft)

## ABSTRACT

Drawing upon Karl Polanyi's journalistic writings and unpublished lectures from the 1920s and 1930s, this article reconstructs the lineaments of his research programme that was to assume its finished form in *The Great Transformation*. It identifies and corrects a common misinterpretation of the thesis of that book, and argues that Polanyi's basic theoretical framework is best conceived as Tönniesian: the 'protective counter-movement' of *The Great Transformation* is *Gemeinschaft*, understood dynamically, while the market society is *Gesellschaft*. It examines the two central mechanisms by which, in Polanyi's understanding, *Gesellschaft* broke down in the mid-twentieth century: the 'clash between democracy and capitalism,' and a doctrine of 'perverse effects' whereby political intervention in markets impairs profitability and saps the vitality of the market system.

**KEYWORDS:** Karl Polanyi, Ferdinand Tönnies, perverse effects doctrine, Great Depression, capitalism, democracy

## **Karl Polanyi's *The Great Transformation*: perverse effects, protectionism and *Gemeinschaft***

In debates on globalisation, neoliberalism, world order, and transnational social movements, few texts are cited more frequently than *The Great Transformation*, and few are subject to such varying interpretations.<sup>1</sup> In the space of the last decade it has been read as a Liberal Manifesto (Katznelson, 2003) yet also as a blueprint for the obliteration of capitalism and its replacement by a socialist society (Lacher 2007). Between these antipodes, Karl Polanyi's *magnum opus* has been hitched to a range of radical and social-democratic causes. It is invoked by William Greider (2003, pp. 44-8) to bolster his case for American capitalism to "be made to conform more faithfully to society's broad values," by Robert Cox (2002, p. 94) in support of the view that Keynesian and 'Fordist' techniques in the post-war decades enabled "politics" to substantially "redress the inequities of the market," and by Elmar Altvater and Birgit Mahnkopf (1999, p.453), among many others, in their call for a movement to "restrain" global capitalism.

If it is only natural that such a widely read and intricately argued book be interpreted in diverse ways there are in the case of *The Great Transformation* (TGT) several additional factors to bear in mind. There is the tendency of its author, his gaze fixed on distant horizons, to neglect to keep shorter-range concepts in sharp focus. Second, there is the lack of context: most of those who cite the book are familiar with little else of Polanyi's output. (Of his other monographs, the readerships of *The Livelihood of Man* and *Dahomey and the Slave Trade* are small, while that of *Europe To-day* barely exists. Of his essays, the nine that are collected in *Primitive, Archaic and Modern Economies* and *Trade and Markets in the Early Empires* are well known but hundreds more are not. As for his unpublished writings -- collected in the Karl Polanyi Archive at Montréal's Concordia University -- few scholars have plumbed their depths.) Third, as a result of the intellectual and political reorientation that Polanyi was undertaking while writing it, there is in TGT a clash of conceptual frameworks that contributes to ambiguity.

This last line of reasoning is associated above all with U.S. political economist Fred Block (2001, 2003). In his reading of the unpublished texts from the 1930s, Polanyi had embraced a Hegelian form of Marxism in that decade, not unlike that of his childhood friend Georg Lukacs, and it was within a solidly Marxist framework that TGT was initially conceived. In the early 1940s, while writing TGT, he came round to the Weberian view that power and compulsion are inevitable in "complex" societies and moved rapidly away from Marxism – a development that can be deduced from the complete absence in TGT of certain Marxist terms (such as 'ruling class') and the scarcity of others (such as 'capitalism') that had earlier been present, as well as the introduction of new, non-Marxist expressions such as 'fictitious commodities,' the 'double movement' and the 'embedded economy.' In developing these concepts, Block contends, Polanyi found himself increasingly pulled out of the Marxist orbit.

How persuasive is Block's thesis? There is no doubt that in the 1930s – I would push the date back to 1921-2 – Polanyi was definitively situated within the gravitational field of Marxist movements and ideas, or that their pull weakened through the 1940s and 1950s, or that in these latter decades Weber was the greater influence. In other aspects, however, the case is less convincing. Block deduces too much from terminological variations – 'capitalism' and 'ruling class' are hardly the monopoly of Marxist discourse, and the latter does appear in TGT, despite his claim to the contrary. He fails to notice that, in many if not all of his writings on political power during the interwar period, Polanyi did indeed insist upon the inevitability

of states and of compulsion. More importantly, the concepts that Block assumes to have been innovated during the writing of TGT were all developed in the 1920s and especially in the 1930s -- in his view, Polanyi's Marxist phase.<sup>2</sup>

To these difficulties presented by a critical reading of Block's argument there would appear to be two solutions. Either the core concepts of TGT belong to a coherent Marxist framework that Polanyi maintained while writing that work. Or Block makes too much of Polanyi's Marxism in the preceding period. It is the latter solution that I find convincing, but it prompts further questions. If Polanyi did not derive the concepts fictitious commodities, the double movement and the embedded economy directly from Marxian theory, how did he develop them? How, indeed, can his method best be characterised?

In this essay I explore these questions by reconstructing the lineaments of Polanyi's research programme that was to assume its finished form in TGT. Given that TGT's central concept of 'double movement' is commonly and misleadingly reduced to one simple thesis -- that the advent of the self-regulating market in nineteenth-century Britain provoked a protectionist 'counter-movement' -- I begin by briefly presenting the gist of the argument and elucidating some of the complexities of the double movement thesis. I go on to examine the evolution of Polanyi's ideas in the interwar period, drawing attention to his experience of the 'equilibrium of classes' in 1920s Vienna and how this affected his understanding of the clash between democracy and capitalism, the influence of 'perverse effects doctrines' according to which political intervention in market economies cause them to malfunction, and his reading of the nineteenth-century sociologist Ferdinand Tönnies, whose concepts foreshadow those of TGT. In pursuing this argument I draw primarily upon several hundred texts contained in the Karl Polanyi Archive, but have also benefited from half a dozen interviews with Polanyi's daughter, Kari Polanyi-Levitt and from the recent publication of six score of Polanyi's essays -- some of which were previously unpublished, others having appeared in a variety of periodicals (notably the *Österreichische Volkswirt*) in the 1920s and 1930s -- in the three-volume *Chronik der großen Transformation*.

### *The Great Transformation*

The subject of TGT is the decline of the liberal order of the mid-nineteenth century. Instead of progressing from strength to strength, as contemporaries had tended to expect, it veered towards protectionism and nationalism in the century's final quarter, was suspended during World War One, failed in the attempt to re-establish itself in the 1920s and then collapsed in the 1930s. "Having once striven to revitalize the world, liberalism has been barren for fifty years," was Polanyi's verdict in 1928. Competition had been "crushed by its creature, monopoly" and the spirit of freedom, "renounced by liberalism, had been picked up by the working classes and turned toward socialism."<sup>3</sup> In his role as journalist on the *Österreichische Volkswirt*, Polanyi reported on the statecraft and political economy of the day, charting their gradual but seemingly inexorable drift from liberal moorings.

The core thesis of TGT is that *laissez-faire* liberalism and the protectionist reactions that it provoked are best understood as a 'double movement.' In its initial thrust, as pioneered in early nineteenth century Britain, mercantilism was usurped by the self-regulating market system. Under mercantilism, labour and land formed part of "the organic structure" of society, but in the early nineteenth century that organic unity dissolved, economic behaviour became "disembedded" from the social fabric due to the commodification of land and labour. Polanyi (1968, p. 35; 1977, p.10) terms these "fictitious commodities": because they are "either not produced at all (like land) or, if so, not for sale (like labor)" they are, strictly speaking, not commodities at all. Labour is inseparable from the human beings of which

society consists, and land is their natural habitat; but the fiction of their being so produced was to become the organizing principle of nineteenth-century society. The insertion of land and labour as fictitious commodities into the market mechanism brought the subjugation of “the substance of society itself to the laws of the market” (Polanyi 1957, p. 71). The gravamen of Polanyi’s indictment of the self-regulating market is that it demands “the institutional separation of society into an economic and political sphere” (1968, p. 30). “It is generally characteristic of human society,” Polanyi would tell his students, “that its legal, moral and economic organisation is *one*, i.e., that it is artificial to insist upon these differences. Thus the present state of affairs is unique in that a distinct economic sphere has developed which is *separate from the political*.”<sup>4</sup> In a fundamental departure from all previous human history the state is deprived of its major regulatory functions and restricted instead to a narrow, ‘nightwatchman’ role as enforcer of the rules of the market. The trajectory – the twists and turns of which are traced in the subsection of TGT entitled ‘Satanic Mill’ – was towards an alienated world in which economic institutions elude conscious human control.

Alongside satanic mills, however, the nineteenth century free market also brought peace and stability. In the first chapter of TGT, entitled ‘The Hundred Years Peace,’ Polanyi accounts for the absence of major wars between the Great Powers in the century bracketed by the battles at Waterloo and nearby Mons. In his view, the international order of the age was “peacefully imperialistic”: peaceful in that war between the major powers was largely avoided, imperialistic in that “under the gold standard the leading powers insisted on spreading their business pattern to all countries and forced them to accept their institutions, without which trade was then not possible.”<sup>5</sup> Adopting a form of commercial peace theory, Polanyi explains the long peace in terms of the rise of an international economic system that formed “the axis of the material existence” of the human race and “needed peace in order to function.”<sup>6</sup> The system was underpinned by the gold standard, which provided a framework that obliged countries to adopt policies aimed at securing balanced budgets and stable currencies. The price system within each country would adapt to international conditions, enabling capital to flow freely.<sup>7</sup> This situation was well suited to high finance, and “by functional determination it fell to *haute finance* to avert general wars” (Polanyi, 1957, p.13). Learning that their aims could better be achieved through the spread of constitutional government, free markets and the gold standard, financiers directed their energies and investments towards peaceful concerns. War, at least between the Great Powers, came to be seen as bad for business.

International peace and stability, a world market based upon principles of free trade, and a global financial system organised through the gold standard: such was the promise of nineteenth century liberal civilisation. It was doomed. World War One put an end to peace and stability, and the world trading system began to fragment, before disintegrating in the 1930s. The question that TGT addresses is why the institutions that seemed to underwrite peace and stability in one century were to yield the opposite in the next. The answer, Polanyi finds, lies in the nature of the self-regulating market system. “Once a market-economy is established, industry seems to run all by itself,” he writes. Considered in the abstract, a self-regulating economy could be perfectly efficient, but in the real world it depends upon non-commodified inputs: people and nature. The commodification of land and labour evokes protective “countermoves” on the part of society. “Constant action on the part of the government is needed to ensure the functioning of free markets without fatal harm to the community.

The protective measures mainly concern labour and land, i.e., human beings and their habitat.”<sup>8</sup> They blunt the “self-destructive” trends of the market and empower the state in its roles as regulator of the economy and guarantor of basic social welfare (Polanyi, 1957, p.

76). Social history in the nineteenth century may thus be understood as “the result of a double movement: the extension of the market organization in respect to genuine commodities was accompanied by its restriction in respect to fictitious ones” (Polanyi, 1957, p. 76). The drive to protect labour from raw market forces culminated in the welfare state, trade unionism and social democracy, institutions which tended to ‘re-embed’ the economy in society.

In readings of TGT the double movement is commonly interpreted as a conflictual dynamic that develops along a single axis: following the unleashing of the free market, ‘society’ forces governments to take protective measures. But a closer reading reveals two further axes. One is that the tension between market expansion and protectionism became entangled with a developing dichotomy between national and international spheres. The self-regulating market rested upon three institutions -- the competitive labour market, the gold standard, and international free trade -- two of which are necessarily international. “The sacrifices involved in achieving any one of them were useless, if not worse, unless the other two were equally secured. ... Nothing less than a self-regulating market on a world scale could ensure the functioning of this stupendous mechanism” (Polanyi, 1957, p. 138). The protective response, by contrast, contributed to a national consolidation of political and economic life particularly in the half century from about 1880, when “Western societies developed into closely knit units” (Polanyi, 1957, p. 201). With the Great Depression of 1873-1896 liberal confidence in the benefits of cross-border trade and investment evaporated; businesses responded to declining profits by forming cartels and lobbying for higher import tariffs; governments reacted to the heightened economic and social pressures by initiating imperialist adventures. In the ten years around 1880 (Polanyi, 1957, p. 202),

protectionism everywhere was producing the hard shell of the emerging unit of social life. The new entity was cast in the national mold, but had otherwise only little resemblance to its predecessors, the easygoing nations of the past. The new crustacean type of nation expressed its identity through national token currencies safeguarded by a type of sovereignty more jealous and absolute than anything known before.

The internationalism of market expansion and the nationalism of protectionism were not discrete tendencies but were internally related. The drive to international free trade coupled with adherence to the gold standard necessitated the implementation of protective measures such as import quotas and capital controls; the paramount obligation accorded to maintaining the value of the national currency under the gold standard served to strengthen “national solidarity” (Polanyi, 1957, p. 215). The strains emanating from the free market shifted to and fro between economics and politics, between the national and international spheres. To take the example of unemployment – which for Polanyi illustrates the case better than any other – the social pressures emanating from it could be addressed by expanding bank credit, but this tended to translate into rising prices, falling exports, a worsening balance of payments and pressure on the currency. Alternatively, the same pressures might be deflected into the political sphere, for example through a scramble for colonies and zones of influence. “Imperialism and preparation for autarchy,” Polanyi concludes, “were the bent of Powers which found themselves more and more dependent upon an increasingly unreliable system of world economy” (Polanyi, 1957, p. 217).

The third axis of the double movement is developed out of Polanyi’s thesis that the contradictions between self-regulating market and ‘society’ cannot be sustained over the long run. In order to function, the self-regulating market depends upon protection, but the two mechanisms cannot remain in equilibrium. The market economy, he explained to an audience at Columbia University,

works only as long as you do not interfere with prices, whether commodity prices, rent, wages, or interest. [...] This is why there must be under this system a free market for all factors of production, not only for commodities but also for land, labour and capital. Unless the price system is flexible and prices are allowed to move freely according to the intercommunication of the various markets, the system ceases to be self-regulating even in principle and the vast mechanism must fail, leaving mankind in immediate danger of mass unemployment, cessation of production, loss of incomes and consequent social anarchy and chaos.

This, the great paradox of the market system, played itself out in the decades around the turn of the twentieth century. On one hand, protective measures such as tariff policies and monopolistic trade union practices “were the only means to save society from destruction through the blind action of the market-mechanism.” On the other, these same measures “were directly responsible for the aggravation of slumps and the restriction of trade.”<sup>9</sup> Protectionism acted as a positive feedback, exacerbating the contradictions of the market economy that had elicited it, thereby creating further protectionist pressures. When, for example (Polanyi, 1957, p. 206),

the trade cycle failed to come round and restore employment, when imports failed to produce exports, when bank reserve regulations threatened business with a panic, when foreign debtors refused to pay, governments had to respond to the strain. In an emergency the unity of society asserted itself through the medium of intervention.

As reference to ‘the unity of society’ suggests, Polanyi interprets protectionism as, at root, a product of the institutional separation of politics and economics. Negative phenomena originating in the economic sphere elicit a political response, primarily intervention by government, which acts on behalf of society. The benefits of protective measures accrue to society by way of the safeguarding of human beings and the environment, while their “disadvantages are mostly economic,” for such measures reduce the “social dividend.”<sup>10</sup>

For much of the nineteenth century the contradiction between market expansion and protective response did not express itself in particularly baleful ways. Indeed, in the last quarter of that century protective measures successfully ameliorated the excessive impositions emanating from the self-regulating market.<sup>11</sup> However, in the same period experiments in democratic reform were altering political systems in Britain and elsewhere – “The protective movement in Europe was closely linked with the advance of popular government,” notes Polanyi.<sup>12</sup> Workers used their newly won vote to demand protection, and had the tension between market economics and protective response been permitted to follow its course the latter would have debouched into “a more complete reintegration of economics and politics,” entailing a “restoration of the unity of society.” This benign outcome was prevented, for beneath the “superficial and incomplete reintegration” effected by protectionist policies “the basic incompatibility of capitalism and political democracy continued.” A stalemate ensued, which Polanyi summarised, in unpublished notes, as: “Economic power wielded by one class. Political power, in virtue of numbers, by another. The economic system becoming the fortress of the one class, the political system of another.”<sup>13</sup> This ensured that the tendency of protectionist measures to lead to the recreation of a truly integrated society was thwarted, the monopolisation of economic power in private hands ensuring that challenges to the sway of the market remained haphazard and isolated. ‘Society’ demanded comprehensive protection but received only half measures in the form of social policy, coupled with attempts to marshal the protective impulse behind support for imperialist adventures and immigration control.

A substantial part of TGT is devoted to analysing the consequences of the stalemate

between self-regulating market and protective response, an impasse that went critical during the inter-war period. The ‘Great War’ was, in Polanyi’s view, no accident but the product of the contradictions just outlined, which it in turn exacerbated. For its duration, the nineteenth century order was suspended – liberal states, gold standard, international *haute finance* and all. In its aftermath persistent efforts were undertaken to resurrect the previously dominant rules and institutions – which is why Polanyi designates the 1920s as a “conservative decade.” But that decade also witnessed the first glimpses of paths out of the impasse: the sacrifice of democracy in Italy and the overturning of capitalism in Russia. In conditions of world market collapse, the gold standard was finally abandoned and “history almost at once reversed its trend” (Polanyi, 1957, p. 26). The models developed in Italy and Russia were imitated elsewhere, and were augmented by a variety of forms of corporatism in liberal democracies and former colonies. In what Polanyi terms the “revolutionary 1930s,” the market utopia was laid to rest.

### *Gesellschaft* as fiction

It was in the 1930s that Polanyi developed the core theses of TGT, and in most of the following I shall be looking at his writings from that decade. But I would conjecture that an article from as far back as 1909 may be relevant to its genesis. In that year Polanyi published ‘The Crisis in our Ideologies,’ an intervention into debates within the socialist movement, that predicted a regulated and stable epoch of capitalism. Thanks to “restrictions and limitations on competition ... as well as the increasing organization and regulation of the labor market,” it ventured, the forthcoming epoch, will produce “stable conditions of material existence.” Some doubt remained in his mind as to the precise degree to which “competition and the business cycle will be modified or eliminated,” but not as regards the fact that the world was on the cusp of “a period of regulated and stabilized capitalism.” A “tendency towards stabilization,” the article concluded, “will be the main feature of the period.”<sup>14</sup> Had the publication of ‘The Crisis in our Ideologies’ been delayed by four decades it would justly be considered prophetic, but thirty years earlier the prediction could scarcely have been less accurate. Given the truth of the adage that people learn through mistakes it is not inconceivable that an awareness, conscious or otherwise, of his erroneous forecast of 1909 – which already seemed woefully over-optimistic in the four years of world war, and in the ensuing period of economic dislocation and political revolutions, but which was then decisively refuted during what E. H. Carr called the ‘twenty years crisis’ of 1919-39 – lay behind Polanyi’s dedication to explaining the nature and causes of that crisis.

Be that as it may, it was in the early 1930s that Polanyi began to adumbrate the central theses of TGT, and by 1937 he had spelt them out in detail. “No society,” he taught his students in that year,

could exist in which land and labour were merely a commodity bought and sold, produced and reproduced according to laws of the market. ... Labour as a commodity has a human being attached to it as an appendage; this makes it almost a satanic joke to regard labour actually as a commodity.<sup>15</sup>

If economic liberalism were to fully take hold of society’s material life, therefore, it would surely destroy it – and in early nineteenth century England a dread of this all too visible fate had prompted a twin response: “from enlightened conservatives, led by Christian reformers of

the type of Wilberforce; [and from] radicals of the type of Bentham who based their social criticism on the strength of human reason.” These movements prepared the ground for future radical currents, notably Christian Socialism and “the Socialist criticism of the Morris type.” The history of the nineteenth century, the lecture concludes,

is dominated by the reaction of society as a whole to the new growth in its midst. The vast extension of government functions was its main consequence. In countries where, as in England, the powers of the state were limited other factors emerged: voluntary associations, such as Trade Unions, Cooperatives, the Churches, and restricted the principle of unchecked competition.

The key passage in this lecture is the description of ‘fictitious commodities,’ a term that is widely thought to have been coined by Polanyi, and which he utilises to show the utopian and unnatural constitution of the self-regulating market. That he developed this notion may have resulted from his own engagement with socialism ‘of the Morris type,’ of which the most important avatar in the early twentieth century was Guild Socialism. Its originator, A. J. Penty, a disciple of Ruskin and Morris, held that the new industrial system had corrupted morality, craftsmanship and imagination, replacing all with drudgery. The Guild Socialists developed a critique of what they termed the ‘commodity theory of labour’. In their view, labour possessed an almost religious character; its purchase and use for private profit gave them great offence (Glass, 1966, p.9). Guildsmen of a Christian persuasion took this stance, but so did nonbelievers, such as Polanyi’s good friend G. D. H. Cole. “National Guildsmen,” wrote Cole (1919, p.77), “repudiate utterly the idea that labour is a commodity, or that it ought to be bought and sold for what it will fetch in a ‘labour market.’” Instead, all citizens – in sickness as in health, in employment and unemployment – should receive remuneration from a collectively managed fund; and workers should control production (Cole, 1919, p. 77).

Other explanations of the origins of Polanyi’s notion of fictitious commodities are, however, available. Following the demise of the Guilds movement, Polanyi immersed himself in the study of Austrian liberal economics. He reserved particular admiration for Carl Menger, whose idiosyncratic definition of the commodity – not merely as a good exchanged on markets but a good *produced for sale* on markets – chimed with his own. From this definition, with its reference to human intentionality, is it not but a short step to refusing land, labour and money the status of ‘genuine’ commodities? Alternatively, it has been suggested, for example by Polanyi’s friend Felix Schaffer, that the concept of fictitious commodities “derives directly from Marx” (Polanyi-Levitt, 1990, p. 123). But Polanyi himself begs to differ. Marx’s assertion of the fetish character of the value of commodities, he writes, “refers to the exchange value of genuine commodities and has nothing in common with the fictitious commodities” mentioned in TGT (Polanyi 1957, p. 72).

Given that Marx’s theories of alienation and commodity fetishism provided such inspiration for Polanyi in the 1930s my feeling is that his ‘nothing in common’ may be protesting too much. However, there is reason to suppose that his interpretation is closer to the mark than Schaffer’s. In notes that he took while reading works by Ferdinand Tönnies he concurred with the German sociologist’s criticisms of the author of *Capital*, adding that “T[önnies] rejects the Marxian derivation of surplus value; *much* more precise than Marx.”<sup>16</sup> And it is, I would suggest, to Tönnies and not to Marx, Menger or even Guild Socialism that Polanyi’s ‘fictitious commodity’ owes the most. If his notes collected in the Polanyi Institute Archive can be taken as a guide, he studied Tönnies more closely than any other author, with the possible exceptions of Eugen Dühring and Joseph Schumpeter. His daughter, Kari Polanyi-Levitt, confirms that he “engaged intensively with Tönnies” and that the German sociologist was “certainly of importance in the formation of my father’s conception of



ideas.”<sup>17</sup>

In *Community and Society*, Tönnies famously contrasts the two terms of the title as ideal types. *Gemeinschaft* denotes an ‘organic’ and ‘natural’ condition of society in which actions are rooted in an *a priori* unity and manifest the will and spirit of that unity even when performed by an individual. Its “highest expression is witnessed in the fellowship of work, the guild or corporation, and the fellowship of cult, the fraternity, the religious community” (Tönnies, 1988, p. 50). By contrast, *Gesellschaft* – a term which Tönnies uses interchangeably with bourgeois society – is a realm of inauthentic experience in which individuals exist in a permanent condition of separation from, and latent or overt tension with, others. It is characterised by the terms ‘abstract,’ ‘artificial’ and ‘fictitious’ (Tönnies, 1988, p. 76); in a later work Tönnies (1974, pp. 173-4) describes it as a “fictitious totality.” In *Gesellschaft*, characterised as it is by the sharp separation of social spheres, the common values that enable group behaviour to function are not organic, rooted in custom and governed by face-to-face relations but have to be deliberately fashioned with the aid of abstract systems:

What somebody has and enjoys, he has and enjoys to the exclusion of all others. So, in reality, something that has a common value does not exist. Its existence may, however, be brought about through fiction on the part of the individuals, which means that they have to invent a common personality and his will, to whom this common value has to bear reference. ... [for example] when we consider the simple action of the delivery of an object by one individual and its acceptance by another one (Tönnies, 1988, p. 65).

When contracts are formed a common will is momentarily and artificially constructed. On the labour market, for example,

labour is bought and paid for as if it represented merely future services to be consumed in the performance itself. The fiction underlying this is that the [manufacturer, capitalist or joint stock company] is the real author and producer and hires workers only as helpers. This fiction gains in verisimilitude the more the conditions of co-operation and later the implements of production – all of which are the property of the manufacturers – become, as it were, alive and set in motion and capable of carrying out automatic imitation of human craft and skill through their cleverly planned construction (Tönnies, 1988, p. 98).<sup>18</sup>

Labour power, it follows, is (Tönnies, 1988, p. 101) “a purely fictitious, unnatural commodity created by human will.” Tönnies (1988, pp. 93, 82) gives pride of place to labour as the fictitious commodity that defines *Gesellschaft*, but extends the same analysis to land (which “cannot be made or fabricated”) and to money (which, being held by people who have not produced it themselves, is “a purely abstract commodity”). Tönnies (1988, p. 82) perceived that what he termed the “great transformation” from *Gemeinschaft* to *Gesellschaft* was irreversible and tragic, and yet believed that, thanks to the waxing influence of the working classes, a new communal era could yet dawn. For him, the road thereto was not signposted class struggle but moral enlightenment and political reform.

Following closely in Tönnies’ footsteps but able to draw upon the latest ethnographic research, Polanyi engaged in detailed study of so-called ‘primitive societies.’ From Malinowski and Thurnwald he learned that such societies depend for their reproduction upon a sense of community which economic self-interest tends to erode. Man does not “act so as to safeguard his individual interest in the possession of material goods, but acts so as to safeguard his social standing, his social claims, his social assets. He values material goods only insofar as they serve this end” (Polanyi, 1968, p. 7). He learned that the economy in primitive societies is ‘invisible,’ in the sense that its core features are inextricably entangled

with non-economic values and institutions. In societies such as Western Melanesia economic institutions are “embedded in social relations.”<sup>19</sup> ‘Community’ absorbs ‘economy’: it directs it, and infuses it with its values.

In its underlying social theory TGT owes a great deal to Tönnies. Polanyi’s ‘embedded economy’ is a synonym of *Gemeinschaft* (Polanyi, 1968, p. 84), and he also follows the father of German sociology in conceiving of *Gesellschaft* as a cleft, two-class society, a social division that has become redundant and the retention of which “therefore, turns into a denial of community.”<sup>20</sup> When stark social inequality had been the accessory of an advancing bourgeois civilisation it was justifiably regarded as a price to be paid for progress, but that situation no longer obtained. All around were signs that the absence of proper social integration, above all between the political and economic spheres, was generating crisis. However, when relating the “denial of community” under modern capitalist conditions to the detailed character and processes of the inter-war crisis, Tönniesian theory proved insufficient. Polanyi looked elsewhere, drawing upon a palette of contemporary political and economic theories to produce his distinctive portrait of what he called the ‘cataclysm.’

### Democracy, capitalism and the impasse

In theorizing the institutional separation of the spheres, Polanyi drew upon Tönnies as well as the ‘utopian socialists’ Robert Owen and Jean Charles de Sismondi, and Marx, but all of these had developed the concept before the advent of universal suffrage. Polanyi was interested in how democracy impacted upon the separation. He believed there to be a contradiction in the modern, democratic period whereby every citizen is, in the political sphere, invited to exercise self-determination and responsibility while in economic life the structure of ownership makes that impossible for all but a minority.<sup>21</sup> This he understood as “the incompatibility of liberal capitalism and democracy” (Polanyi 2005a, p. 251).

Polanyi had been formed within a social-democratic culture in which the notion that “universal suffrage is the equivalent of political power for the working class” (as Marx put it in 1852) appeared a self-evident truth. He was familiar with Eduard Bernstein’s argument that democratic reforms were opening the way to a gradual and peaceful transition to socialism as the labour movement initiated what Bernstein termed “a counteraction” to the exploitative tendencies of capital, one which propels it to growing sway over economic and political life via trade unions, co-operatives and local and national government. Nor were such views monopolised by the Left. It had been an article of faith amongst nineteenth century elites that enfranchising the working classes would herald the end of capitalism. “I conceive that civilization rests on the security of property,” expounded the British historian and Member of Parliament, Thomas Babington Macaulay. “This principle follows: that we never can without absolute danger entrust the superior government of this country to any class which would, to a moral certainty, commit great and systematic inroads on the security of property” (Polanyi (2005b, p. 286). Such fears, here voiced by a Whig, were felt more fervently still on the Tory benches. Wealth, then no less than now, translated efficiently into political power. In Macaulay’s Britain, for example, bondholders comprised between one and two per cent of the population yet exerted inordinate influence over Whitehall. Bond prices, relates Niall Ferguson, were “a kind of daily opinion poll, an expression of confidence in the bond-issuing regimes.” If bondholders “bid up the price of a government’s bonds, that government could feel secure; if they did the reverse, that government was quite possibly living on borrowed

time as well as money.” A fall in the price of a government’s bonds would be “interpreted as a ‘vote’ by the market against its fiscal policy, or against any policy which the market sees as increasing the likelihood of default, inflation or depreciation” (Ferguson, 2002, pp.204-5).

In Polanyi’s schema, industrial capitalism is intrinsically antagonistic towards “all forms of people’s rule,” yet different phases in the development of that conflict should be discerned (Polanyi, 2005b, p. 278). For most of the nineteenth century, Western Europe had experienced the forcible creation of national labour markets and demands for democracy were vehemently rejected by established elites. Liberals had insisted that the laws of the market prevented any intervention in economic life on behalf of the working population, which would inevitably ensue if the franchise were extended to them. “Even devoted friends of the labouring classes” such as Robert Owen “believed that the popular vote would destroy the new economy and all its achievements.”<sup>22</sup> In a second phase, towards the end of the century, several countries broadened the suffrage, and without much ado; the hostility between democracy and capitalism appeared to be abating. But the ceasefire was only temporary (“The illusion of harmony was the result of transitory factors, such as the enormous expansion of markets, [and] the sharing of trade unions and labour parties of the benefits of the advance”).<sup>23</sup>

The third phase commenced when the end of the ‘Great War’ heralded a twin transformation: from *laissez-faire* to regulated capitalism – which meant that “political power now became an effective instrument of influencing the economic sphere”<sup>24</sup> – and the extension of the franchise. Whereas before the war only three nation states had introduced near-universal suffrage, around a dozen followed in the first two post-war years alone, including Austria – to which Polanyi emigrated in 1919. In Vienna, he witnessed the new turn taken by the clash between capitalism and democracy, and became captivated by the social-democratic experiment in progress, supervised by the Sozial Demokratische Arbeiter Partei (SDAP), a powerful organisation whose membership in the 1920s comprised roughly one-tenth of Austria’s population. Its strategic assumptions were those of Second International socialism: that the ground for capitalism’s demise was being prepared by the concentration and centralisation of industry, while the growth of trade unions, together with universal suffrage, would enable the working classes to exercise a preponderant influence within the state. In Vienna there were grounds for optimism that a socialist transition was underway. The SDAP oversaw an ambitious programme of reforms centred upon social housing construction and rent control and the funding of cultural events. In addition, Polanyi expressed his admiration for the energy that was directed to propagating what his cousin-in-law Hans Zeisel (1985, p. 121) described as a new style of living that featured teetotalism, “decent sexual relations” and communion with nature.

Yet if a socialist-voting working class prevailed in the capital it was only an outpost within the republic as a whole and this, as SDAP leader Otto Bauer saw it, rendered a full-scale assault on capitalist power inconceivable. Although in Vienna and the industrial regions of Austria “all actual power was in the hands of the proletariat,” that class could not achieve power in the country as a whole for it was balanced by the “clerical peasantry” (Bauer, 1976, pp.653, 149). “The conflicting classes,” Bauer summarised the problem in 1921, “hold each other in equilibrium,” necessitating compromise. Because “no class was strong enough to rule the other classes, all classes had to share the power of state with each other” (cited in Lowenberg, 1985, p. 72). But would all sides compromise and, if so, on what terms? Would liberal and conservative elites attempt to tame, co-opt or suppress the SDAP? Or would the growing political experience of the Austrian working class tip the balance, year by year, towards a socialist transformation?

Bauer (1976, p. 150) initially envisaged that the extension of the franchise paved for the proletariat a “safe and painless road to power.” Yet, as the 1920s wore on the power

balance drifted away from the SDAP. Following the hyperinflation of 1922, the krone was replaced by a new currency, the schilling, backed by a League of Nations Stabilisation Programme that imposed severe reductions in public services, enforced by League-appointed commissioners. The same year saw the SDAP lose its hold on power. In Vienna unemployment rose steeply, and in the ten years from 1924 the level of homelessness trebled (Helmut Gruber, 1985, p. 234). The bourgeoisie, Bauer lamented (1976, p. 960), had succeeded in using economic power to turn the democratic republic into an instrument of its rule.

Given this trajectory in Austria, any sanguine expectations that the progress of the socialist movement would be linear were bound to fade – and this conclusion was confirmed for Polanyi by events elsewhere, not least in Britain, the country on which he filed the bulk of his reports for the *Österreichische Volkswirt*. As in Austria, the first two post-war years had seen the socialist and trade union movements surge forward but then slide back. From a crest in 1920 trade union membership declined, and the Labour government of 1924 failed to act upon its promises of radical reform. For Polanyi, 1926 was a crunch year. In Belgium and France economic elites broke social-democrat governments. A general strike in Britain was led to defeat by the political and industrial arms of the labour movement – much to Polanyi’s dismay, for he had long held the Labour Party, and in particular its leader, Ramsay MacDonald, in high esteem.<sup>25</sup> He saw the defeats of 1926 as marking “the end of a historical period, one in which it had seemed possible for the growing political influence of the workers’ movement operating within democratic institutions to lead to the gradual achieving of a real democracy in all spheres, including the economic” (Cangiani, 1994, p. 10). In the late 1920s and 1930s the earlier social-democratic optimism that the conflict between democracy and capitalism would lead straightforwardly to victory for the former, in the guise of parliamentary socialism, appeared naïve. Polanyi and Bauer developed an alternative perspective: that the same conflict would still open the way to socialist transformation, but only following an intervening ‘impasse’ -- an economic and social crisis precipitated by workers’ gains undermining economic growth and the resulting forceful response from economic elites – that formed a crossroads from which other, non-socialist pathways could also branch.

In 1929 Labour was re-elected and MacDonald proclaimed that his administration “will go down in history as the Government of Employment” (Cliff and Gluckstein, 1988, p. 152). His boast was four months old when the Dow Jones index tumbled. As Britain and the world slipped into crisis MacDonald’s government, far from following a socialist – or even ‘pro-employment’ – economic policy, adopted the orthodox prescription of balanced budgets, free trade and defending the value of sterling, an approach that won the approbation of established elites. Liberal Party leader Herbert Samuel put it frankly when he remarked that “in view of the fact that the necessary economies would prove most unpalatable to the working class, it would be to the general interest if they could be imposed by a Labour Government” (Cliff and Gluckstein, 1988, p. 156). Imposed they were, but not by Labour. In 1931, following consultation with the Bank of England, MacDonald proposed a ten per cent cut in unemployment benefit. Although a majority of his cabinet supported him, anything less than unanimity was too little for the Labour leader who, along with Philip Snowden and Jimmy Thomas, broke from the Parliamentary Labour Party to form a ‘National Government’ with the Conservatives and Liberals. Observing events from Vienna, Polanyi was, if not greatly surprised, then certainly dismayed. The crisis, he believed, attested to a society riven between workers and capital, between politics and economics. It revealed an inner connection between “democracy and currency,” as the socially protective policies promised by the elected government provoked a response by wealthy elites in the form of capital flight and pressure on sterling that then compelled government ministers to dilute their plans – or, as in

1931, to abandon progressive reforms altogether and enter an alliance with bourgeois parties (Polanyi, 2002, p. 125).

Drawing lessons from the British coup of 1931, which corroborated his analysis of earlier developments in Belgium, France and Weimar Germany, Polanyi proceeded to theoretical generalisation. By enfranchising the working class, democratic government in the modern era had come to clash with the rule of capital. Class conflict mapped onto the separation of politics and economics, with workers gaining strength in the former while the latter remained the fief of a tiny elite. Workers were bound to defend themselves against the effects of the market by pushing for political intervention:

They are provoked to this interference as a reaction against the secret capitalist influence trying to pervert the natural functions of political democracy; they are almost invited to do so when during acute economic depressions Big Business itself calls on political Democracy to help it in its difficulties; they are literally constrained to do it under fear of destruction, when the actual cessation of industrial activity threatens them with starvation.<sup>26</sup>

Under the heading ‘the perversion of functions,’ Polanyi describes how parliaments “weaken, discredit and disorganise the economic machinery of capitalism” by aspiring to meddle with its self-regulating mechanisms, and that it is the common people who bear the costs of the ensuing crisis. Democracy, in consequence, is seen to be dysfunctional, while for their part, economic stakeholders receive a “markedly lower social dividend” (Polanyi, 2005c, p. 235). Because owners of capital have to organise production profitably they cannot be accused of parasitism; their function is to be “the guardians of the reasonable use of the means of production.” Yet their purview is restricted to one narrow sphere; they act not as parasites but as members of a dangerous sect, a cabal with immense power that is directed to restricted and self-serving ends. In contrast, the role of the working classes is universal: they become “the guardians of the interests of society as a whole. Their immediate interests make them use this position to the full. ... The other classes enlist on one side or the other.”<sup>27</sup> The conflict of economy and polity, it follows, is also that of economy and society. Already by 1934, this thesis had reached the form in which it would appear ten years later in TGT: capitalist *Gesellschaft* had entered a crisis the root of which is located “in a functional maladjustment; in the mutual incompatibility of our political and economic systems. Democracy, as it is, and Capitalism, as it is, cannot function side by side.”<sup>28</sup> Social unity needs must be re-established, through the abolition of one or the other.

Unlike some of his peers, Polanyi was insistent that the inter-war crisis should not be understood in narrowly economic terms as a crisis of capitalism, and yet it did patently have economic consequences. Although capitalism is “in itself far from being an ideal system,” the greatest contemporary threats were “due not directly to this fact, but to the incompatibility of capitalist leadership in the economic field with the ever-increasing influence of the working class in the political field.”<sup>29</sup> Democracy and capitalism,

i.e., the existing political and economic system, have reached a deadlock, because they have become the instruments of two different classes of opposing interests. But the threat of disruption comes not from these opposing interests. It comes from the deadlock. The distinction is vital. The forces springing into action in order to avoid the deadlock [i.e. socialism and fascism] are infinitely stronger than the forces of the opposing interests which cause the deadlock.<sup>30</sup>

However, although the crisis was not of economic origin, it did have economic consequences.

Because workers use the state to shield themselves from the effects of economic crisis, the resulting interference “actually makes capitalism work even worse than it would otherwise.” Although democracy does not in itself cause economic crisis, “it prevents its cure and makes it longer and worse.”<sup>31</sup> Not only, then, does capitalism conflict with democracy, but a consequence of the collision is that the functioning of the market is impaired. In notes, articles and lectures in the 1930s Polanyi explored the mechanism by which this occurs in some considerable detail.

#### ‘Sand in the machine’: the perverse-effect doctrine

The notion that workers’ demands act as a check upon economic growth was common currency in Polanyi’s day. In William Morris’ *News From Nowhere* it is the centrepiece of ‘old Hammond’s tale,’ in which the historical origins of the socialist utopia that forms the novel’s setting are revealed. As Hammond relates (Morris, 1992, pp.90-93), the transition from industrial capitalism to rural idyll had begun when concessions granted to labour served to clog the wheels of industry, generating suffering amongst the masses, who looked to communist ideas, as well as demands by capitalists for the state to intervene, which it did through regulation and nationalisation, unwittingly paving the way to socialist transformation. Morris’s fictional chronicle quite precisely anticipates Polanyi’s prediction of capitalist collapse. But Polanyi, steeped in the literature of Austrian economics and writing in the context of the Great Depression, was to produce a reworking of this general notion which in its specifics was entirely his own.

In the early 1920s, Polanyi moved away from Liberal Socialism and towards the “functional (pluralistic) socialism” that was associated with the Guild Socialists in Britain and, following their lead, Otto Bauer in Austria. ‘Functional theory’ resurrected a medieval tradition of thought that delighted “in contemplating the moral purpose revealed in social organization,” in contrast to later, bourgeois theories that sought to prove “that to the curious mechanism of human society a moral purpose was superfluous or disturbing” (Tawney, 1938, p. 35). Whereas in its medieval incarnation the accent was placed upon each individual’s acceptance of their function -- prayer, defence, merchandise, tilling the soil -- within the social organism, Polanyi’s updated version operated primarily at the institutional level, centring on the thesis that an organisation’s function should determine its realm of activity. The Churches should stick to the spiritual realm and not interfere in politics or economics, while the function of states was “to exercise authority on matters that affect their subjects equally” – thus, if states interfere directly in economic affairs they are contradicting their essential nature.<sup>32</sup> On this basis Polanyi took it for granted that insofar as non-market factors enter the sphere of markets they should be regarded not as necessary adjuncts but as “flaws.”<sup>33</sup> How, then, did he theorise the persistent transgression of the boundary between economics and politics, whereby business elites and trade unions seek to influence state policy? Quite starkly: as a “perversion of functions” the consequence of which is that “severe disruptions develop in the life of the community.”<sup>34</sup>

In the same decade Polanyi developed an interest in the writings of Ludwig von Mises. On most issues they were adversaries, and debated their differences in public, but on one they shared common ground. The passages of the Austrian economist’s *Liberalism* from which Polanyi took the most copious notes argue that *collective interventions in the market mechanism are ineluctably counter-productive* (Mises, 1995, pp.68-9). If, to take a representative example, the state imposes a price reduction on one good, either demand for

that good will exceed supply, necessitating rationing, or producers will curtail production, obliging the state to support them by forcing down prices of inputs (including wages). For the state to be effective in that goal, price controls must needs be generalised across the economy or else capital and labour would rush into the remaining free areas. An equally perverse logic applies to trade union pressure for higher pay: this imposes increased costs upon businesses which, passed on to consumers via higher prices, causes lower production and revenues and the withholding of investment, ensuring that wages fall or unemployment rises (Mises, 1995, p. 73). If states then offer support to the jobless this simply postpones workers' adjustment to changing economic conditions, resulting in a prolongation of high levels of unemployment (Mises, 1995, p. 74). This final argument particularly impressed Polanyi even though Mises's conclusion – that the only viable form of human social relations, given a division of labour, is *laissez-faire* capitalism – was anathema.<sup>35</sup>

In the 1930s, Polanyi kept abreast of the literature that was grappling with the nature of the world-economic crisis. One pamphlet that caught his eye was *Dreifache Krise: Die Deutsche Wirtschaft im Jahre 1930*, by the German business journalist Erich Welter. It was a passage entitled 'Sand in der Maschine' to which he was particularly drawn.<sup>36</sup> As the metaphor suggests, protectionism, in Welter's account, acts to slow the wheels of industry: it inhibits the flourishing of an international division of labour, reducing the potential for productivity gains and inhibiting growth (Welter, 1931, p. 47). For Welter that does not mean that state intervention should be eschewed, for economic growth is not the sole criterion upon which policy should be based. *Dreifache Krise* lists many sound reasons why states may intrude into economic life and holds no truck with those who believe that this presages economic calamity.

In his writings and lectures propaedeutic to TGT, Polanyi wavers between Welterian and Misesian positions. At times he adopts the more circumspect approach: "The liberal economic system *does not work to its best advantage* when it is not free to rearrange the factors of production entirely irrespective of the effects on human life,"<sup>37</sup> "Rigidity of wages is universally recognized *as a hindrance* to the functioning of a competitive market economy."<sup>38</sup> More often the tone is adamant. In lectures on British history he declares the Speenhamland system of 1795-1834 – which offers a "startling parallel" to inter-war interventionism<sup>39</sup> – to have been "*incompatible with capitalism*" on the grounds that "If a man earns only part of his living then society owes him the rest."<sup>40</sup> In a lecture on nineteenth century "infringements on *laissez-faire*" he concludes that factory, minimum wage, and trade union legislation enabled wages to be

upheld and Trade Unions to regulate conditions of labour and to maintain standards of payment. Basically, this was incompatible with liberal capitalism, for the freedom of the labour market was impaired: the price of labour was influenced and therefore stabilized by state action.<sup>41</sup>

Later, in TGT (1957, pp.176, 231), he approvingly quotes Mises' argument that if workers did not "act as trade unionists, but reduced their demands and changed their locations and occupations according to the requirements of the labor market, they could eventually find work," and goes on to insist that "any" method of state intervention "that offers protection to the workers must obstruct the mechanism of the self-regulating market, and diminish the very fund of consumers' goods that provides them with wages." The result can be economic depression, and these, he mistakenly claimed during the greatest of them, "do not pass away unless the price system [is] *elastic*."<sup>42</sup>

Mises' thesis exemplifies what Albert Hirschman (1991, p.27ff) calls the "perverse-effect doctrine" of the effect of public policy upon wages and prices, whereby purposive

action aimed at improving some feature of the economic order only exacerbates the condition it intends to remedy. Arguments outlining the perverse effects of interference with wages were first put forward by liberal and conservative economists during the debates on the pre-1834 Poor Laws in Britain. Critics of these laws, from Malthus to Tocqueville, scoffed at the notion that they were merely a safety net. Rather, they would encourage sloth and create the very poverty that they set out to alleviate. The late nineteenth century saw the rise of neoclassical economics, which is committed to the view that the freer the market, the closer is Pareto optimality – that economic policy is at best useless, at worst counterproductive. The twentieth century saw a long line of liberal economists elaborate their own versions of the perverse effect doctrine, including Milton Friedman, with his hypothesis that imposing a minimum wage lowers wages for all.

Broadly speaking two types of criticism of the Misesian perverse-effect argumentation can be made. One, the ‘so what?’ response, accepts that political intervention may well impair market functioning but without undue damage to the community as a whole. (Polanyi’s close friend Peter Drucker, the business studies guru, put the point rather bluntly to him after reading TGT: “your premise that a society must collapse if it functions at less than 100% efficiency can not be maintained.”<sup>43</sup>) The other is that intervention not only need not have deleterious economic consequences but can produce the opposite. Thus, in *Wages, Price and Profit*, Marx (1975, pp. 13-14) takes to task Mises’ predecessor, Nassau Senior, who claimed that the Ten Hours Bill, which led to a sudden and compulsory rise of wages, would sound the death-knell of British industry. What actually ensued was

a rise in the money wages of the factory operatives ... a great increase in the number of factory hands employed, a continuous fall in the prices of their products, a marvellous development in the productive powers of their labour, an unheard-of progressive expansion of the markets for their commodities.

Not only are the effects of political support for wages not necessarily perverse, they can be positive. This was a thesis that Keynes developed further, with his notion of the ‘multiplier effect’ and his arguments for the deliberate use of government policy to sustain employment.

A further relevant contribution to this debate was made by Karl Polanyi’s own brother. In the late 1930s Michael Polanyi assimilated Keynesian theory to orthodox economics in a version of what later became known as the ‘neoclassical synthesis.’ Although unsparing in his critique of leftist and centre-left Keynesians, he also singled out for censure the belief in the perverse effect doctrine.

There is an element of superstitious fear in the idea of orthodox Liberals that the market takes revenge on society for any interference with its mechanism by inflicting on it the curse of unemployment. ... The orthodox Liberals maintain that, if the market is limited by the fixation of some of its elements, then it must cease to function, the implication being that there exists a logical system of complete *laissez faire*, the only rational alternative to which is collectivism (Polanyi, 1940, pp. 58-9).

Karl disagreed with his brother on this, and with Marx and Keynes. However, his rendering of the perverse effect doctrine, although registering the same mechanisms and predicting a similar future of ‘*laissez faire* or collectivism’ as in orthodox Liberal theory, sets it within a wholly different conceptual framework. Liberal economists such as Mises, he maintained (Polanyi, 1957, pp. 141-2),

offer an account of the double movement substantially similar to our own, but they put an



entirely different interpretation on it. While in our view the concept of a self-regulating market was utopian, and its progress was stopped by the realistic self-protection of society, in their view all protectionism was a mistake due to impatience, greed, and shortsightedness, but for which the market would have resolved its difficulties.

Polanyi accepts Mises' theses that workers' organisation diminishes wage flexibility, that this necessarily leads to the withholding of investments and reduction in aggregate demand, and that the strengthening of labour movements depletes capitalism's curative powers. Yet, whereas for Mises (1932, p. 475) the transition to socialism in Europe would spell civilisational collapse, swiftly followed by the plundering intrusion of nomadic tribes from Asia (for who would be able to mount resistance "when the weapons inherited from capitalism, with its superior technology, had been used up?"), Polanyi is dismissive of such neo-liberal bogeys. For him, the 'perverse effects' are the product of a perverse situation: that society is moulded around impersonal market forces, with human labour relegated to the status of commodity. For him, the inter-war crisis instead opens the way towards an advance of human freedom and social unity; the initially perverse logic ultimately yields a benign outcome. It is to his explication of the inter-war crisis at the international level, including the explanatory role assigned to 'perverse effects,' that I now turn.

#### World crisis, squared

In a series of lectures on Modern European History given in 1939-40, Polanyi laid down his thesis in the form in which it was shortly to take in TGT, as a matrix of four sets of contemporary problems:

[1] Democracy and Dictatorship, (Crisis of Democracy); [2] Market Economy and Planning, (Crisis of Capitalism); [3] Total War and the Organisation of Peace, (Crisis of Peace); [4] World Trade and Self-sufficiency, (Crisis of the International Economic System).<sup>44</sup>

Tracing this cluster of crises back to its roots, he found the self-regulating market with its concomitants of a free labour market, international free trade and the gold standard; the 'utopianism' of this system is the inner contradiction from which all others flow. This central argument is spelt out with particular concision in notes drafted for the same lecture series:

*Interference* with the markets causes them to function less well. On the other hand, such intervention [is] entirely inevitable on account of the *social* effects of such a utopian system. [The] main effect of regulation: the price system becomes *less elastic*. ... The inevitable coming of regulation must therefore lead to a crisis of Market-economy which suggests the necessity of Planning.<sup>45</sup>

In its reliance on a Misesian 'perverse effects doctrine' this thesis is in my view unsound. But the secondary arguments, in which Polanyi traces the ways in which 'strains' shuttle between the national and international and the political and economic, accumulating strength on the way, are insightful, and in some cases relevant to our own times.

For Polanyi's analysis of the inter-war crisis the comparator is the nineteenth century, for a good part of which the market system demonstrated its ability to expand relatively smoothly and peacefully. In the heyday of *laissez-faire*, when prices were highly elastic, he notes, "the intrusion of new commodities caused no serious disturbance; neither employment nor profits necessarily suffered. Accordingly the nineteenth century was not a period of major wars; methods of expansion, as a rule, [were] not violent."<sup>46</sup> But that could not last. *Laissez-faire* capitalism gave way to what Polanyi terms variously imperialism, regulated capitalism or finance capitalism. The main reasons for the shift may be bracketed under four headings.<sup>47</sup> The first, 'international,' includes innovations, notably in transport (which increased the volatility of the economic environment in Europe and depressed agricultural prices), the fluctuations in employment that resulted, and the deflation of 1873-9. In reaction to these developments, secondly, protectionist measures were implemented, including factory laws, tariffs and subsidies. Third, as cheap imports threatened, countries sought to blunt the negative effects on politically powerful sectors by jacking up tariffs and taking steps to dissociate domestic price levels from world prices in order to protect employment from international market fluctuations. The fourth factor was the growth of international trade and the concomitant lobbying of businesses upon governments to support their export drives.

The new system that arose between 1875 and 1914 was, to an unprecedented degree, geared to trade and cross-border investments, both of which

depend on the smooth functioning of the world money-markets and capital-markets, and postulate the strict maintenance of the value of the foreign exchanges i.e. *the working of the Gold Standard*. Each of these factors separately, but especially in conjunction with the gold standard demanded imperatively the absence of long and devastating wars.<sup>48</sup>

Simultaneously, however, higher levels of tariffs, taxation, social insurance and wage regulations tended to fix costs "and thus to make the system as a whole less elastic."<sup>49</sup> Because "the self-regulation of the competitive system works via unemployment and transference of labour," Polanyi identifies the "lack of elasticity of the wage system [as] the greatest weakness of regulated capitalism."<sup>50</sup> The new rigidity was especially damaging at the international level, for the gold standard, free trade and capital export could function properly only if domestic prices continually adapt to international conditions.<sup>51</sup>

With its ossified price system and inelastic markets, regulated capitalism was an inherently unstable formation. Its economic contradictions tended to spill out onto the political stage as states strove to influence foreign trade. In these new conditions, commercial peace theory no longer applied, and economic internationalisation only served to exacerbate inter-state tensions. By the end of the century the Great Powers were

competing bitterly for free markets to which goods could be exported without causing trouble to themselves. The fierceness of the rivalry for foreign markets and the consequently increased tension between [them] was thus, in the last resort, [due] to the decreasing elasticity of the internal price system.<sup>52</sup>

At bottom, Polanyi concludes, the First World War "was the outcome of the attempts at easing the economic strain caused by the pressure of free world markets (Gold Standard) on the increasingly inelastic national systems."<sup>53</sup> The war failed to remove the strain and merely reinforced tendencies towards state intervention and autarky.

Polanyi was far from alone in identifying the ossification of the price mechanism as a key cause of the inter-war crisis. A League of Nations report from 1942 (2005, p. 391), for

example, argued that the economies of the industrialised states “had become so rigid that the advantages of lower tariffs were seriously questioned.” If resources had been fully employed and factors of production mobile, lower tariffs should have led to international specialisation. But in the interwar period these conditions were far from fulfilled. Labour was relatively immobile and wages and prices were sticky. In such conditions, lowering tariffs tended to generate an inrush of imports, forcing down prices in some sectors and increasing unemployment in some industries without guaranteeing greater employment elsewhere. “The increased rigidity of the economic system,” the report concluded (2005, p. 421), “results in any reduction in tariffs causing a greater shock and one more slowly absorbed than was the case fifty years ago.”

Yet, in Polanyi’s view the League was itself partly culpable for the conditions of which it complained. Acting as if its motto was “Peace through Gold” it led a foolhardy attempt to recreate the defunct nineteenth century world system, with the gold standard at its centre.<sup>54</sup> In the process it completely

overlooked the intimate causal connection between the chauvinism it feared and the *laissez-faire* it preached. For *laissez-faire* in world economy raised fears in the single nations and these were the real source of economic nationalism. Thus the League unconsciously fostered the nationalism of which it complained and at the same time blocked the road to any true solution.<sup>55</sup>

Polanyi (2003b, pp. 132-3) agreed with the liberals in Geneva that “both theoretically and practically, free trade remains the superior system of economic intercourse” and knew that higher tariffs and the tendency towards self-sufficiency were born of “national egotism” and war. He was aware that protectionism had, in turn, exacerbated nationalisms and contributed to the collapse of the gold standard Polanyi (2003b, p. 135). But he did not hold that the inverse followed: that a return to gold would restore a free trade regime and international peace. Following Keynes, he held the gold standard to be an outworn dogma, a barbarous relic.<sup>56</sup> According paramountcy to fixing exchange rates necessitated the free fluctuation of domestic price levels as well as international cooperation, neither of which were viable in post-war conditions. It was not for nothing that the gold standard had come under fire. The establishment of equilibrium did not occur smoothly but through convulsions: the rapid outflow of gold from a country was an indication of acute crisis and frequently intensified it, creating a credit crunch followed by bankruptcies, rising unemployment and falling wages.<sup>57</sup> Already in the late nineteenth century businesses had chafed against the subordination of national (token) money to gold (commodity money), U.S. farmers had rallied behind the Populist demand for ‘soft money,’ and labour movements had called upon governments to privilege employment and growth, not convertibility and the balance of trade. The success of the gold standard, moreover, depended upon the credibility and cooperation of participant states, but Britain’s decline together with geopolitical rivalries had steadily undermined the willingness of states to cooperate.

After 1918, in Polanyi’s analysis, attempts to restore the gold standard clashed with the waxing political role of labour. When countries attempted to restore gold they were forced to recognise

that major adjustments of the internal price-level had become impracticable. When commodity prices were forced down, profits tended to disappear and unless costs were reduced correspondingly production came to a standstill. But wages and some other items of the costs of production showed a considerable lack of elasticity, on account of the increasing rigidity of the economic system.

The gold standard was deployed as a weapon to restore ‘elasticity’ by subordinating elected governments to its prescriptions – in France, for example, it “was used as an instrument of class war by the capitalists.”<sup>58</sup> But in one country after another the battle was lost; “the attempt to restore the gold standard put an intolerable strain on the social system and had to be abandoned.” By the 1930s, Polanyi was confident that it would not be restored, “for governments can and will not allow the economic system of their countries to be the football of uncontrollable international forces.”<sup>59</sup> Its final collapse provoked further bouts of protectionism and confirmed the division of the world economy into relatively autarkic regions.

Thus did the four crises of the inter-war period – of Democracy, Capitalism, Peace, and the International Economic System – interlace, with each connection multiplying the intensity of the crisis as a whole. Following World War One the four corners of the square interacted in increasingly devastating ways. Liberal elites sought to restore ‘equilibrium,’ but every effort to do so was countered by rentiers, workers and peasants, their demands having been boosted by their wartime experiences, by politicians’ promises, and by the expansion of the franchise.<sup>60</sup> Their attempts to maintain incomes in the difficult post-war years combined with enormous public debts incurred during the war to stoke inflationary tendencies, contributing to the general “postwar social and economic dislocation.”<sup>61</sup> In Central Europe especially, the new political order impeded economic reconstruction as empires were carved into small states in an age characterised by tendencies to autarky. Political tension between the new nations was heightened due to economic competition in straitened times, while economic difficulties undermined the prospects for democracy across the region.<sup>62</sup> Reparations and war debts added to the mix, destabilising the international financial system.<sup>63</sup>

Restricted to national territories, democracy was unable to properly address international problems, leaving ‘economy’ with the whip hand. Yet attempts to revive a liberal world economy intensified pressures upon wage and employment levels and were resisted by working classes whose power had increased thanks to trade unionism and the extension of the vote. This decreased the flexibility of the price system and elasticity of markets, with the consequence that the assumptions that had underpinned the gold standard – that national economies adjust and that governments would be willing to enforce this – no longer held. “National economics have become inelastic and therefore unable to adjust themselves to major changes in the international price level,”<sup>64</sup> Polanyi observed, concluding that in the long run regulated national capitalisms were “bound to prove incompatible with a system of world economics based on economic liberalism.”<sup>65</sup>

Stymied in the attempt to restore a liberal world economy, economic elites sought “to eliminate working class influence on policy” through pressure upon leftist governments.<sup>66</sup> These tended to obey, thus contributing to a crisis of democracy. (Because democracy is not extended to the industrial sphere, Polanyi argued, it “is bound to *degenerate*. Its parties become a nuisance because they absorb the civic energies of the people and divert them to useless purposes.”<sup>67</sup>) Where economic elites still felt threatened by democracy they pressed for its outright abolition, a tendency that reached its acme with the elevation of fascist governments to power in Italy and Germany. Both of these governments rode upon nationalist reactions to the victor’s peace that was Versailles, and their policies, in turn, contributed to the demise of the League of Nations.<sup>68</sup>

In these ways, Polanyi concludes, the vehemence of the inter-war cataclysm, ultimately, “was caused by the fact that the international peace system rested on the international economic system.”<sup>69</sup> It was the dissolution of the latter that precipitated the multiple and inter-locking crises of the inter-war period and “released the forces of a fierce nationalism” which had previously been restrained by the existence of a world economy.<sup>70</sup>

Because the national and international system had been shaped by the “single intent” of establishing a self-regulating market system the collapse, when it finally arrived in the 1930s, “was sudden and complete.”<sup>71</sup> Against those who believed “that the disintegration of our institutional system in the Twenties and Thirties was due to a clash of fascist and bolshevik ideologies” he pointed out that “the crowning institution of international capitalism, namely the gold standard, was destroyed not by a Bolshevik, but by Neville Chamberlain, a representative of the power of the City of London,” and that he was followed in this by the “head of the American democracy,” Franklin Roosevelt.”<sup>72</sup> The true utopians were not socialists or communists but Adam Smith and David Ricardo, who promoted the idea of the self-regulating market, with its corollaries of free markets in labour and land. Social organisation of this sort “is inherently impossible,” and the attempt to institute it produced the sundering of economics from politics that had destroyed the hitherto prevailing “unity of society.”<sup>73</sup>

## Conclusion

*The Great Transformation* is a social-science classic and its core concept, the double movement, is today more widely discussed than ever. Yet that idea is commonly reduced to a simple formula, that the self-regulating market catalyses a counter-movement in the form of protectionism, obscuring the complexity introduced by the second and third ‘axes’ outlined above. More fundamentally, the distinctive and eclectic social theory that Polanyi developed in the inter-war period is only poorly understood. This article has sought to improve that situation by highlighting three foundations upon which the theses of TGT were constructed: the doctrine of ‘perverse effects’ that predicts capitalist breakdown as a result of state intervention; the left-social democratic notion that political democracy and capitalism exist in irreconcilable conflict; and Tönnies’ theorem that the unity of humankind has been primordially broken by the emergence of a separate economic sphere, giving rise to a society that operates according to ‘fictitious’ principles.

In this reading, TGT is in essence a Tönniesian treatise: the protective counter-movement is *Gemeinschaft*, understood dynamically, while the self-regulating market is *Gesellschaft*; the former is characterised by unity, the latter by disintegration. As a result of the counter-movement, the two formerly distinct and separate spheres of state and industry “began to interpenetrate,” but because the new integration was partial and therefore “false” it resulted in “strain” which, originating in the “incomplete self-regulation of industry,” then “spread into politics, where it acted as an irresponsible force.”<sup>74</sup> Strains at the domestic level, interpreted both as the perverse effects of government intervention and as signs of a clash between capitalism and democracy, destabilised the liberal world economy, the disappearance of which, in turn, “tended to undermine the political system of the world.”<sup>75</sup> The tendency towards the unity of the institutional spheres of society could not manifest itself at the international level but instead found resolution on a temporary basis in bloodthirsty form with fascism, in progressive form with the New Deal, and in state-socialist form in Stalin’s Russia.

Polanyi’s desire was to see Soviet Russia democratise, the New Deal reforms deepened and fascism defeated but only one of these came to pass. From the end of World War Two until his death, the theory advanced in TGT did not fit reality: despite vigorous state intervention capitalism enjoyed its greatest ever boom. Yet the book’s strongest feature is its critique of what would nowadays be called neoliberal globalisation, which is why interest has revived in recent decades. Part of this renaissance involves interpretative debate as to

Polanyi's method and meanings; my hope is that this article contributes to that discussion.

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- <sup>1</sup> For helpful comments on an earlier draft of this essay I am grateful to Kari Polanyi-Levitt, Mohammad Nafissi and Michele Cangiani.
- <sup>2</sup> See e.g. 15-2, lecture series 'Conflicting philosophies in modern society,' [1937-8]. References of the form "1-10" are to box and folder numbers of texts in the Polanyi Archive; all refer to texts by Polanyi, with the exception of note 43.
- <sup>3</sup> 3-12, 'Liberale Wirtschaftsreformen in England.'
- <sup>4</sup> 15-2, Lecture 2.
- <sup>5</sup> 20-4, 'Common Man's Masterplan,' [1939-40].
- <sup>6</sup> 15-8 Lecture 24; also Polanyi (1957, p. 18).
- <sup>7</sup> 15-2, Lectures on 'Conflicting Philosophies in Modern Society.'
- <sup>8</sup> 15-10, 'The Study of Human Institutions (Economic and Social).'
- <sup>9</sup> 31-10, 'Lecture 2, 'The trend towards an integrated society,' Columbia University.
- <sup>10</sup> 19-17, 'The Eclipse of Panic and the Outlook for Socialism.'
- <sup>11</sup> 8-7, 'The Christian and the World Economic Crisis.'
- <sup>12</sup> 15-10, 'The Study of Human Institutions (Economic and Social).'
- <sup>13</sup> 8-7, 'The Christian and the World Economic Crisis.'
- <sup>14</sup> 1-6, 'The Crisis in our Ideologies.'
- <sup>15</sup> 15-2, Lecture 2.
- <sup>16</sup> 4-10, 'Notes on readings,' pp. 93, 99-100.
- <sup>17</sup> Kari Polanyi-Levitt, telephone conversation with the author, 06.10.2007 and email to the author, 29.10.2007.
- <sup>18</sup> If, in passages such as this, readers detect a critical engagement with the chapter on commodity fetishism in *Capital* they would not be mistaken.
- <sup>19</sup> 15-10, 'The Study of Human Institutions (Economic and Social).'
- <sup>20</sup> 21-22, 'Community and Society.'
- <sup>21</sup> 21-3, 'Social Values in the Post-war World.'
- <sup>22</sup> 18-8, 'The Fascist Virus'; See also Polanyi (2005b, p. 284).
- <sup>23</sup> 18-8, 'The Fascist Virus.'
- <sup>24</sup> 15-4, Lecture XXVII, Morley College.
- <sup>25</sup> 19-17, 'The Eclipse of Panic and the Outlook for Socialism'; Polanyi (2003a, p. 87); Congdon (1991, p. 231).
- <sup>26</sup> 18-6 [1934] 'Fascism and Marxian Terminology.'
- <sup>27</sup> 20-8, 'Synopsis of "The Fascist Transformation."'
- <sup>28</sup> 18-10, 'What Three-fold State?' [1934] p. 503.
- <sup>29</sup> *Ibid.*
- <sup>30</sup> It is this that accounts for "the cataclysmic vehemence of the social upheavals of our time." 18-9, 'Marxism Re-stated,' [1934].
- <sup>31</sup> 9-2, 'Incompatibility of the present form of democracy with the present form of Capitalism.'
- <sup>32</sup> 2-1, Untitled draft manuscript.
- <sup>33</sup> 31-11, Minutes of 'The Institutionalization of the Economic Process' second meeting, Columbia University.
- <sup>34</sup> 2-1, Untitled draft manuscript. These conclusions from functional theory dovetailed with Polanyi's earlier 'Liberal Socialism,' two of the "commandments" of which he summarised as: guarantee economic autonomy to corporations, and revoke all price and wage regulation. See 2-9, 'Worauf es heute ankommt. Eine Erwiderung.'
- <sup>35</sup> 10-2, 'Notes on readings'; (Mises, 1995, p. 75).
- <sup>36</sup> 10-4, 'Notes on readings.'
- <sup>37</sup> 11-8, 'Notes on readings.' Emphasis added.

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- 38 16-14, lectures on ‘Modern European History.’ Emphasis added.  
39 19-5, ‘Plan of a Book on the “Origins of the Cataclysm,”” p. 8.  
40 16-13, Lecture XXIV ‘Conclusion and Outlook’; [1937-8]; 16-11, Lecture 21. Emphasis in original.  
41 16-13, Lecture XXIII.  
42 15-4, lecture XXIV, Morley College [1936-40].  
43 47-15, Letter, Drucker to Polanyi, 21 May 1945.  
44 16-14, Lectures on "Modern European History."  
45 16-14, lectures on ‘Modern European History.’ Emphases in original.  
46 16-15, lectures on ‘Modern European History,’ [1937-40].  
47 8-15, Meeting 2.  
48 8-15, Meeting 2. Emphasis in the original.  
49 15-2, Lecture 2.  
50 16-14, lectures on ‘Modern European History,’ [1939-40].  
51 15-2, Lecture 2.  
52 16-15, lectures on ‘Modern European History,’ [1937-40].  
53 15-4, Morley College XIX [1936-40].  
54 20-2, ‘Introduction to “Tame Empires,”” [1938-9].  
55 *Ibid.*  
56 45-3 ‘Weekend Notes,’ p.25.  
57 See Geoff Pilling, *The Crisis of Keynesian Economics*, [www.marxists.org/archive/pilling](http://www.marxists.org/archive/pilling)  
58 20-2, ‘Introduction to “Tame Empires,”” [1938-9].  
59 18-38, ‘The Roots of Pacifism.’  
60 19-16, ‘What Is the Real Character of the Economic Crisis?,’ [late 1930s].  
61 *Ibid.*  
62 16-14, lectures on ‘Modern European History.’  
63 19-16, ‘What Is the Real Character of the Economic Crisis?,’ [late 1930s].  
64 16-15, Lecture IX, ‘Can World Economics be Restored?’ [1937-40].  
65 15-4, Lecture XXVII, Morley College [1936-40].  
66 20-8, ‘Synopsis of “The Fascist Transformation.””  
67 17-1, ‘Canterbury XII.’  
68 16-14, lectures on ‘Modern European History.’  
69 42-17, ‘Plan for Work,’ p. 2.  
70 16-15, lectures on ‘Modern European History,’ [1937-40].  
71 19-5, ‘Plan of a Book on the “Origins of the Cataclysm.””  
72 20-2 ‘Introduction to “Tame Empires,”” [1938-9].  
73 8-7, ‘The Christian and the World Economic Crisis’; 15-4, Morley College lecture XXIV, [1936-40].  
Emphasis in original.  
74 19-5, ‘Plan of a Book on the “Origins of the Cataclysm,”” p. 4.  
75 16-15, lectures on ‘Modern European History,’ [1937-40].