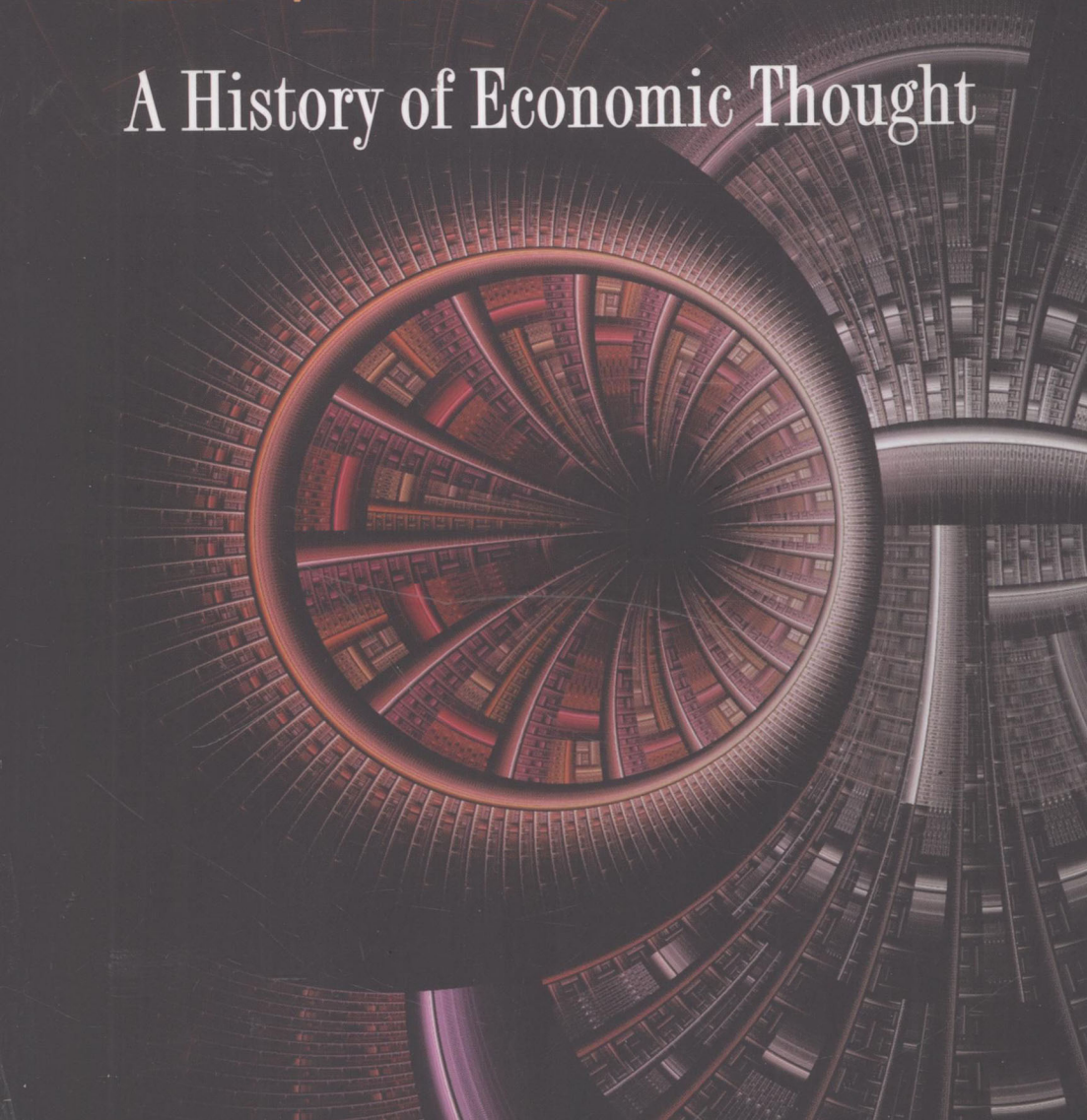


—∞— AGNAR SANDMO —∞—

ECONOMICS EVOLVING

A History of Economic Thought



Economics Evolving

A HISTORY OF ECONOMIC THOUGHT

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AGNAR SANDMO



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Economics Evolving

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* *Preface* *

THE HISTORY OF ECONOMIC THOUGHT may be approached from several different perspectives. The title of this book suggests one such perspective: the scientific study of economics is a developing field where economists of the past have strived to extend their understanding of the workings of the economic system and of the policies and institutions whose adoption might seem likely to improve its performance. What is true of the past is true of the present, so that knowledge of the history of the subject makes one better able to appreciate the fact that the science of economics is still a developing one, driven forward by the realization that there are still large gaps both in theoretical insights and empirical knowledge concerning how the economy functions and how it could be made to function differently. The present financial crisis is an illustration of this, but it is in a historical perspective only one of many events that have led to revisions of the research agenda of economists.

Every history of economic thought has to be selective, both regarding time periods and personalities. The present book focuses on the period from the time of Adam Smith in the late eighteenth century to the beginning of the 1970s. The reasons for this focus are explained in the text; at this point it need only be said that this is the time when the foundations of modern economics were laid and the period whose literature can still be studied without serious difficulties by the modern reader. In terms of personalities the book is selective in giving most attention to the major economists in every period, sometimes to the neglect of lesser figures who may still have given valuable contributions to economic knowledge.

Selectivity is also an issue with regard to the topics covered. Economics is a large field and not every aspect of it can be discussed in a single book. The central core of economic theory, such as the theory of prices and markets, income distribution and employment, must obviously be included. In addition, I present some of the major economists' thoughts on problems of economic policy and social welfare and some of their reflections on wider issues such as the choice between alternative economic systems.

The style of exposition is basically nontechnical, and an attempt has been made to make the book accessible to readers who have

PREFACE

little formal training in economics but who are still interested in the history of economic ideas. There are some diagrams and a very few examples of the use of mathematical symbols, but these can easily be skipped by the reader who is not familiar with their use.

Each chapter closes with some suggestions for further reading. These are deliberately very selective; the idea is to offer some suggestions for reading the original works of the authors covered and to provide some references to the secondary literature that to me seem especially well suited for those who wish to follow up the discussion of the present text. References are given in the familiar form of "Keynes (1936)." In some cases, a book has come out in several editions; in such cases it is referred to in the form illustrated by "Jevons (1871; 1970)." Here 1871 is the year of the original publication, while 1970 is the date of the edition that I quote from. I use this form even when, as in this case, the 1970 edition is based on the second edition of Jevons's book, which came out in 1879. The reason for this is just practical: I like to keep 1871 in the reader's mind as the year of first publication, while it is obviously important to give exact page references to the edition that I use. To be precise about the different editions would have required references of the form "Jevons (1871; 1879; 1970)," and this seems excessively pedantic.

The book is partly a translation, partly a revision and extension, of a book that was written in Norwegian and published by Norwegian University Press in 2006. I received valuable comments on the manuscript of that book from many people; of these, Dagfinn Føllesdal, Einar Lie, Kalle Moene, Preben Munthe, and Erling Sandmo should be especially mentioned as well as my editor, Erik Juel. In addition, some friends and colleagues have given me advice and encouragement regarding the English edition; these include Avinash Dixit, Ray Rees, Bo Sandelin, and David Wildasin. Both my editor at Princeton University Press, Richard Baggaley, and two anonymous reviewers have given me much useful advice regarding the English version of the book. Astrid Oline Ervik helped me with the diagrams. To all of these I am extremely grateful. Last but not least my wife Tone has as always been a source of inspiration and support.

Agnar Sandmo
Bergen, December 2009

Economics Evolving

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A Science and Its History

THIS IS A BOOK about the history of economic thought and the thinkers behind it. It is natural to begin such a history with some reflections on the nature of economics as a scientific discipline: What is the essential nature of economics as a field of research and study? Over the years several attempts have been made to formulate a definition of the subject that would capture its essence in a single sentence, at once striking and deep. Possibly the most famous example of such a definition was proposed by the English economist Lionel Robbins in the 1930s according to which economics was the study of human behavior as a relationship between given ends and scarce means that have alternative uses. The formulation is a perceptive one that clearly goes to the core of a set of problems that economists are interested in. Sixty years earlier, Alfred Marshall had written that economics was the study of men "in the ordinary business of life," another interesting definition that communicates something of the special nature of the field. Nevertheless, most economists would probably feel that if a noneconomist were to ask them the question "What is economics?" both Robbins's and Marshall's definitions would be much too abstract and obscure to provide the outsider with a helpful answer. A more informative response would be to reply that economics is the study of the functioning of economic life in society, adding some illustrations of central issues that economists are concerned with: What determines the prices of goods and services? What are the causes of unemployment? Which factors decide the distribution of income between individuals and families in society? Why are some countries rich and some poor? What are the effects of public policy such as taxes and public expenditure on prices and the distribution of income? What are the determinants of trade flows between countries? An answer of this kind, although longer and less elegant than the definitions of Robbins and Marshall, is certain to give the outsider a much better idea of what economics is all about.

The list of specialized areas could obviously be made much longer and more detailed, and if we compare such a list with the set of topics that have engaged economists over the last two and a half centuries we will quickly discover that over time a number of interesting changes have occurred regarding the focus of economic research. On the one hand, the list of topics has expanded: with the development of analytical tools, economists discovered that their discipline could be applied to a wider set of issues than before, so that a number of specializations emerged within the field. Health economics, energy economics, and financial economics are examples of specializations that have grown up during the last decades of the twentieth century. On the other hand, with the passage of time, economics has been more sharply delimited toward other fields of science, with the result that in some respects it has become narrower. Thus the economists of the eighteenth and early nineteenth centuries did not draw any clear borderlines between economics and the field that is presently known as political science, and in general expositions of the subject they also took up many problems that we now think of as belonging to philosophy, sociology, or psychology. It is also worth noting that the relative importance of subfields has varied substantially over time. The conviction of the classical economists that the study of population movements belonged to the core of economics has left few traces in modern textbooks of economics. John Maynard Keynes's analysis of the problem of unemployment in the 1930s became so influential that it led to a change in the research agenda of economics that lasted for decades. The current interest in the economic aspects of environmental problems has no counterpart in the economics literature of the nineteenth century.

A book on the history of economic thought that was written with the ambition to cover all of the special fields within the subject could hardly be written, and certainly not as a one-man undertaking; it also seems doubtful whether it would attract many readers. A more modest and reader-friendly ambition is to give an impression of the history of ideas within the most central areas of economic theory. One such central area is the functioning of the market mechanism. The problem of price determination for goods and services and the question of whether the market mechanism can be said to work for the common good have been

at the core of the subject throughout its existence. Another central area is the role of the public sector in the economy, its interactions with the private sector, and the determination of a rational balance between the market and the state. A third important area of research is the study of the time path of economic development: economic fluctuations between good and bad times, unemployment, inflation, and growth of productivity and the standard of living. Broad problems of this kind will be at the center of attention in the chapters that follow.

ECONOMICS AS A SOCIAL SCIENCE

The view of economics on which this book is based is that economics is one of the social sciences that study how society works. It is possible, however, to take a broader view of the subject by considering all applications of the methods of economic theory and method. In that case it would also be necessary to cover the history of applications of economics to problems that are internal to the individual business firm, but this large and important field will be left out here. The same holds true for the discipline of accounting, which is also in the nature of a tool for better decision making within firms and organizations. Although the basic theory and analytical methods of these areas have much in common with economics as usually understood, the objective of the analysis is different: in business applications the role of economic methods is to provide a more solid foundation for decisions that further the objectives of the firm, not to lead us to better understanding of the economic life of society as a whole. Of course, the borderlines between the areas are not entirely fixed. To understand the functioning of the market mechanism, it is sometimes important for economists to try to understand the internal workings of the firm. Similarly, for business economists who study the strategic decisions in firms, it is often essential to understand the properties of the markets in which the firms operate.

The term *economics* has been used in English as a name for the subject since the 1890s. Before then, the name commonly used for it was *political economy*. The older name indicated the connections between the study of the economy and the political life and institutions of society—in modern usage between economics and po-

litical science—but it also served as a reminder that many writers on economics believed that one of its central tasks was to provide governments with a better foundation for the design of economic policy. Today, “political economy” survives partly in the name of one of the leading economic journals (*Journal of Political Economy*) and partly as a term denoting a particular approach to the study of economic policy. In several other languages there has been a similar movement away from terms that gave the impression of economics as mainly a line of inquiry in the direct service of the government.

WHY STUDY THE HISTORY OF ECONOMIC THOUGHT?

In many countries, the study of the history of economic ideas was previously considered to be an indispensable part of the training of an economist.¹ This point of view, however, has been losing ground for a number of years. Many contemporary economists take no interest in the history of their subject, and some are decidedly doubtful about the value of acquiring historical knowledge. There may be several explanations for this, but a main reason is probably that modern economists more than their predecessors regard economics as a cumulative science in which new research and new insights are based on existing knowledge that is constantly being extended and improved. In a cumulative science, therefore, new insights will always tend to make the views of earlier scientists dated and erroneous. The science as it appears today is, according to this view, the result of a systematic process of sorting whereby the valid elements of earlier thinking have been preserved, while the parts of it that were wrong or uninteresting have been discarded. If we go back fifty or a hundred years in time, however, it would have been more difficult to argue in this way. This is because, first, economic theories

¹ A British economist who got his first university position at the end of the 1940s told me that during his first interview with the department chairman he was asked, “What is your period?” In this department the position of the history of economic thought was apparently so strong that it was expected of every member of the staff that he had some kind of expertise on a particular period. However, this young economist thought that the question reflected an obsolete view of the subject and answered with great self-confidence, “It is the future!”

were formulated with a much lower degree of logical precision than is presently the case and, second, that the opportunities for systematic empirical testing of the theories were considerably poorer. It was accordingly a much more complicated issue that it now is to decide on the exact assumptions on which a theory was based, whether its construction was logically rigorous, and if it was consistent with our knowledge of empirical reality. The old views therefore tended to live on beside the new, and a well-educated economist ought therefore to have some knowledge of the economic thought of earlier times.

The adherents of the cumulative science view of economics regard this question in a different light. They see themselves primarily as problem solvers, either because they wish to contribute to the advancement of academic research or because they have a desire to contribute to practical problems of economic policy. Whichever line of problem solving they wish to pursue, it may seem clear that what they need in the form of scientific training is knowledge of the present contents of economics. That knowledge can be obtained by reading the best modern textbooks and getting acquainted with the research literature of the last twenty to thirty years. But a study of the older literature is only likely to convince one that what is valid in it has been restated later in a better, clearer, and more general way. The American economist Kenneth Boulding (1971) has told the story of an economist who said that he had no interest in the history of thought because it was only about "the wrong opinions of dead men."

It is clearly undeniable that economics has many of the features of a cumulative science, so that it may be worth reflecting on the question of why it should be worthwhile to spend time on the study of its intellectual history. Here are some reasons why it might be reasonable to use some time and effort getting to know the history of economics.

1. It is fun. Anyone with some familiarity with modern economics should find it interesting to read about the thinkers and theories of the past, and some will no doubt feel that time spent on the history of economic ideas does not need any further justification. The opinions of dead men may be fascinating to study even if one believes them to be wrong. Einstein's discoveries did not turn Newton into an irrelevant character in history; in a

similar vein, Paul Samuelson and other twentieth-century economists did not make the life and work of Adam Smith a subject of no relevance and interest.

2. Some knowledge of the history of thought should form part of the liberal education of an economist. In books and articles—sometimes even in the popular press—one comes across terms like “Adam Smith’s invisible hand,” “Walrasian equilibrium,” “Pareto optimality,” “Pigouvian taxes,” and “Keynesian policies.” A well-educated economist clearly ought to know something about the persons that the terms refer to.
3. Some familiarity with the history of thought contributes to a better understanding of the fact that the discipline of economics is in a permanent process of change and development, thereby leading to a better understanding of the nature of economic research. The common nonhistorical way of teaching economics may easily give a false impression of the subject as one that has found its final form. The history of thought makes one realize that economic science has always progressed through the efforts of people who have seen that it contains deficiencies and errors.

These are three good reasons for studying the history of economic thought. Regarding the last of the three, there can be little doubt that economics in general and economic theory in particular have never been as well developed as they now are. Students who read modern textbooks in macro- and microeconomics, public finance, and international trade clearly acquire more solid knowledge and better analytical skills than those who read the textbooks of fifty or one hundred years ago.² One of the benefits to be gained by getting acquainted with the older literature is a better understanding of the internal dynamics of the subject. The concepts and theories that today’s students encounter during their first year are the results of the work of earlier generations of economists on the frontiers of research.

² A small reservation may be in order at this point: they get a better insight in the problems that are taken up in *today’s textbooks*. But if one goes back to a book like Marshall’s *Principles of Economics* from 1890, one will find that this book considers a number of issues that do not receive much attention in modern expositions. A comparison of then and now that focuses exclusively on the treatment of modern topics in the older literature will therefore be systematically biased in favor of the present.

Consider the following example: one of the first theoretical concepts that one encounters in the study of economic theory is the demand curve, that is, the graphical representation of the connection between the quantity demanded and the price of a commodity. But the demand curve is not something that actually exists "out there"; it is a theoretical construction created by economists to understand how markets function. When in 1838 the demand curve was drawn (or at least appeared in print) for the first time it was a great scientific breakthrough! The realization that concepts and theories that today are regarded as elementary and obvious were once major intellectual challenges for the sharpest minds among economists gives us an important insight into the nature of the research process. It also shows that what presently appears to be simple elements in the theory may not in fact be quite as self-evident as we tend to believe, and this recognition may in turn come to deepen our insights in the modern version of economic theory.

The understanding that economics has developed as a continuous process which continues today is in itself an inspiration for those who wish to attempt to gain a better knowledge of the subject and perhaps even contribute to its further development. In addition, it could even be the case that the study of the older literature may encourage new research by the discovery and reconsideration of problems and fruitful insights that have been neglected in contemporary work.

STYLES IN THE HISTORY OF ECONOMIC THOUGHT

There are several ways to present the history of economic thought. One possibility is to analyze the changing nature of economic theory in conjunction with the social and economic development of society, while another is to emphasize economic thinking as part of the main currents of philosophical and political ideas. Yet another alternative is to emphasize the internal dynamics of the science where new insights and results emerge as a consequence of economists' awareness of the shortcomings of the present state of the subject. The main emphasis in the following will be on the third of these perspectives, but in a number of cases it is also necessary to draw on other approaches to reach a clear understand-

ing of why a particular theoretical reorientation took place. When in the 1930s John Maynard Keynes worked out his new analysis of the causes of unemployment it was in part motivated by what he saw as the weaknesses of existing theory but to a large extent also by the mass unemployment that he observed both in Britain and other countries. If in addition we are to understand the background of some of his policy proposals for a way out of the crisis it is also useful to have some knowledge of the attitudes to social engineering and expert rule that were so influential in the intellectual and political climate of the interwar period.

In earlier times it was common to judge the thought of previous generations of economists from what one considered to be their own preconditions without relating them to modern theory. This approach easily leads to what one may call scientific *relativism*: all theories become correct and valuable relative to the context in which the authors lived and worked. This point of view may come to imply a complete denial of the cumulative nature of economics and consequently of the possibility of progress in economics, a point of view that most people today would consider to be an unreasonable position to hold. However, as late as 1931 the historian of thought Alexander Gray was able to write that “economic science, if it be a science, differs from other sciences in this, that there is no inevitable advance from less to greater certainty; there is no ruthless tracking down of truth which, once unbarred, shall be truth to all times to the complete confusion of any contrary doctrine” (Gray 1931; 1980, pp. 2–3).

Gray’s meaning may perhaps not be entirely clear. If he simply means to say that the search for eternal truths is made difficult or impossible by the fact that the economy and its institutions are in a process of constant change, it is not difficult to agree with him in principle. But if he is to be interpreted more generally as saying that there is no scientific progress in economics, it becomes more problematic to support his view. On the contrary, the following chapters will present a number of examples of how economists have been able to achieve a more secure understanding of the assumptions underlying their theories and of the connections between their assumptions and conclusions. Moreover, there can be no doubt that great progress has occurred in regard to the production of knowledge about the empirical facts of economic life.