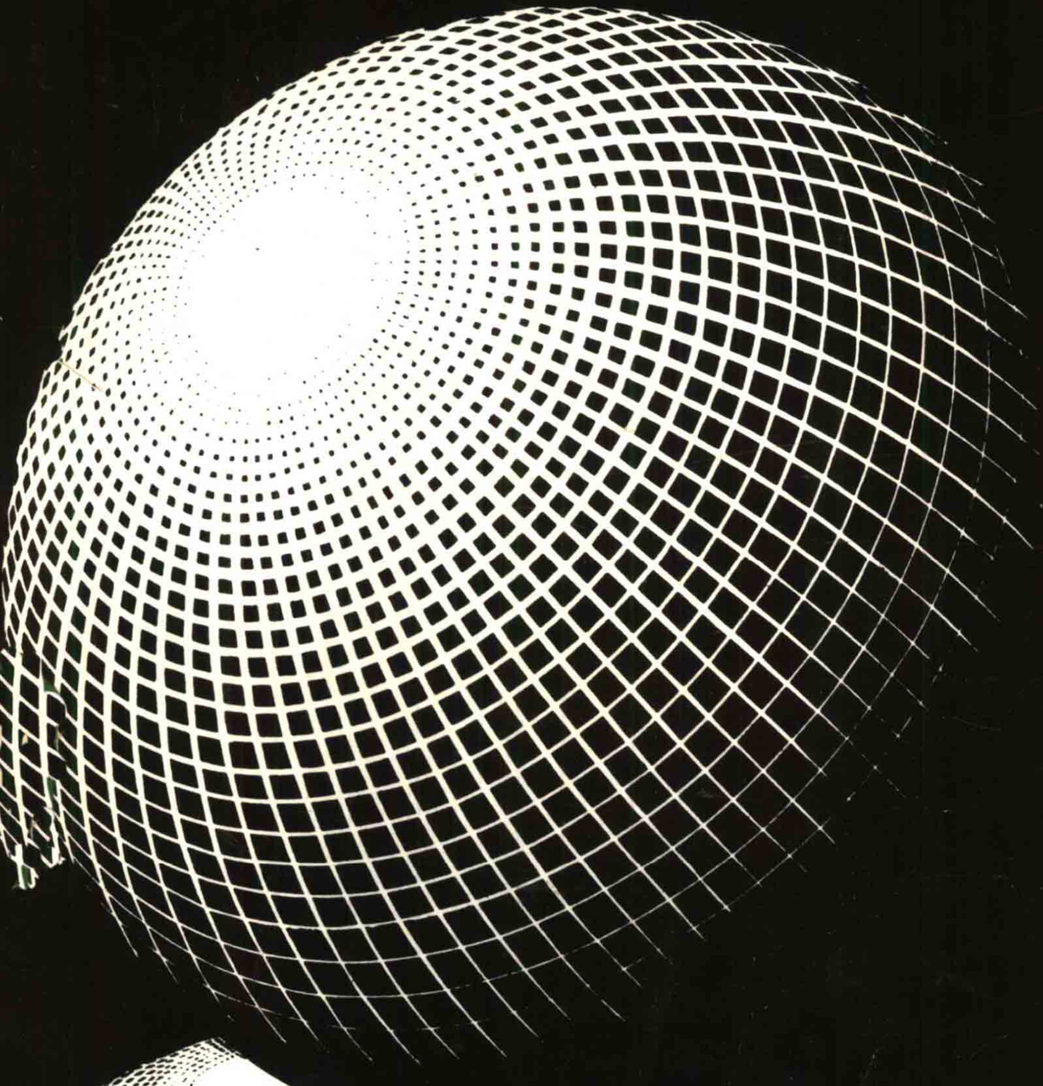
The MAKING *of* ECONOMICS

THIRD EDITION

E. RAY CANTERBERY



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PREFACE

Change is the modern constant, and the study of economics offers no exception. As economic theory responds to modern economic problems and incorporates new methods of analysis, more readers feel the need for economics books that are transitional. The earlier editions of *The Making of Economics* were intended to bridge the gap between what economics has been and what it is becoming. This new edition is a continuing statement about the escalating desire for such a linkage as well as a sharpening vision of the destiny of economics.

The goals of this book are many. I want to convey accurately where economics has been, where it is now, and how it got to be this way. I want to discuss current developments in economics, and where economics might go from here. I want to catch the new sense of excitement by setting my sails in the winds of change. I try to accomplish my goals in the following ways:

1. By describing the development of economic organization from feudalism, to the market economy, to the complex mixed economy, to the present day.
2. By analyzing the ideas of those who formulated the basic principles upon which economics rests—Smith, Ricardo, Mill, Marshall, and Keynes—and those who have provided penetrating critiques of the mainstream economics of their day—Marx, Veblen, Galbraith, the monetarists, the new radicals (left *and* right), and the post-Keynesians.
3. By examining the social and intellectual influences that have shaped the thinking of the great economists. Perhaps the most incessant charge leveled against economics is that it lacks relevance. A major theme throughout this book is that economists of the recent past have tended to formulate economic laws as if they were

immutable laws of nature, with the implication that economic phenomena can be analyzed in the same way as physical phenomena. I question this assumption throughout the book and attempt to show that economics must deal with people as well as with inanimate objects. Since the first edition, the recognition of the social and political nature of economics has grown among economists.

4. *By weaving economic ideas out of the fabric of economic history.* Any subject, even a mathematical natural science, cannot avoid humanity and thereby avoid becoming humane when it is studied as history.
5. By examining the current economic crises and how economic theory is responding. My first three goals are relevant here. When chaos prevails, we often look back at the past to see where we are going.

In convergence upon these objectives, an accelerating trend toward optimistism and a sense of direction about the nature of new economic ideas characterize the recent editions. The dogmatic position formerly held by many economists that economic science had achieved its final and permanent state has softened, a mutation appropriately considered. The end of dogmatism could be timely. The world is beset by economic problems, and many of the problems we face—such as stagnation, unemployment, national budget crises, global debt crises—apparently have no solutions to which reasonable people can agree. It is important for all of us to try to understand how and why these crises have occurred. Because the present is rooted in the past, we gain a good deal of understanding from the study of the ideas of the great economists who have formulated the basic principles on which modern economics rests.

Our analysis is not concerned only with economic thinking, however. We also look at the social and economic conditions to which these economists responded and consider the relationship between *what* economists think and *why* they think it. Like men and women in every walk of life, most economists reflect the values of their society and want to be accepted by their fellow citizens as responsible members of society. Their thinking, therefore, is a reflection of their social world, and vice versa.

Our detailed study of economists will begin with Adam Smith (1723–1790) and continue to the present day. Smith thought and wrote as the Industrial Revolution was getting under way in England. Business and manufacturing firms were still quite small, with many competitors in the same field. Smith's economic theories conformed with this business atmosphere of intense competition, and thus he wrote, in a sense, what most of the eighteenth-century traders and merchants wanted to read. But there was more to Smith than met eighteenth-century eyes, otherwise his ideas would not have endured so long. He revolutionized economic thought, and much of what he had to say forms the basis of economic theory today.

Smith was profoundly affected by the English scientist and mathematician Isaac Newton (1642–1727), whose scientific work had caused great changes in the prevailing world view of most educated people. The universe pictured by Newton operated with the order and precision of a giant clock. Smith adapted Newtonian harmony to eighteenth-century commercial activity, finding, for example, an almost perfect equilibrium between supply and demand in a business world of perfect (or nearly perfect) competition.

Economics today still works with many of Adam Smith's assumptions, such as the world of perfect competition, even though the most powerful elements in the modern economy bear little resemblance to the world of Adam Smith. Natural science has undergone several revolutions since Newton's time; economics has not. Until the late 1970s, many economists, in the face of giant unmet crises, seemed to be content with mechanistic refinements of thoughts forged in another world. One of our purposes throughout this book will be to try to discover why this happened. We will also envision a future economics that might alleviate some of these crises.

History tells us that major steps forward in economic theory have resulted from attention to the realities of hunger, depression, inflation, war, social discontent, and other maladies. A return to a concern with such problems—and we shall examine many that plague modern-day society—may lead to a transformation of economics.

Economic crises are with us today because we have not yet resolved conflicts that have plagued humanity throughout 5,000 years of history. We are still quarreling over such fundamental issues as the degree of private ownership versus common ownership; individual freedom versus the common good; the virtue of private versus public monopolies; the advantages of rapid technological change versus the pastoral pleasures of an undisturbed natural world; and the gains of science versus its danger to human survival.

Any new vision must recognize the existence of conflict. We will see that the scientific system of Adam Smith has failed to resolve society's long-standing problems of scarcity, equitable power, equitable income distribution, work satisfaction, and poverty—not because of scientific imprecision but because of the assumptions underlying the system. Borrowing its assumptions from the Scientific Revolution that closed the Middle Ages, too much of modern economics supposes that people behave like inanimate particles. This obvious distortion of human values can continue to influence economics only if we continue to regard the science as an end in itself. To meet the crises of the postindustrial age, we must supplant naive eighteenth-century natural science with a concern for the survival of the human race.

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My reviewers and I are practical. We know that a question always arises about the potential audience for a particular book. The only prerequisite for *The Making of Economics* is an inquiring mind. The book can be read easily by a beginning reader in economics, as I do not presuppose any prior study of economics. I think that *The Making of Economics* will provide the beginning reader with meaningful insights, and I also think that the book will prove interesting and valuable to those who possess a sophisticated understanding of economic theory and history.

I wish to thank the many people who over the years have assisted in making this so. Among my many helpful readers were Ujagar S. Bawa, Bloomsburg State College; Thomas W. Bonsor, Eastern Washington State College; Don C. Bridenstine, San Diego State University; Les Carson, Augustana College; Gordon Galbraith, Portland Community College; James H. Horner, Cameron University; John W. Isbister, University of California at Santa Cruz; Thomas Iwand, University of Nebraska; Robert Keller, Colorado State University; Odin Knudsen, San Jose State University; Floyd B. McFarland, Oregon State University; James W. Nordyke, New Mexico State University; Don V. Plantz, Arizona State University; and Herbert D. Werner, University of Missouri. For the current edition I must add James Angressano, Hampden-Sydney College; Richard Ballman, Augustana College; James Horner and Robert Keller were called back into the game from the bench; Andrew Larkin, Saint Cloud State University; and Stewart Long, California State University.

I also have been fortunate in having inspirational friends and associates. John Q. Adams of the University of Maryland, John Boorman of the IMF, John Hotson of the University of Waterloo, H. Peter Gray of Rutgers University, Sam Skogstad of USAID, and Clifton Grubbs of the University of Texas (Austin) continue to serve as valuable and witty critics. For a few precious years at Florida State University, I had the instructive pleasure of engaging in some remarkable dialogue with the late Abba P. Lerner. I also thank Irvin Sobel, David Rasmussen, Edgar Fresen, William Laird, and Philip Sorenson for some enlightening discussions. I greatly appreciate the careful and critical reading of all

portions of the manuscript that contained references to natural science by a leading physical scientist, Michael Kasha, then Director of the Institute of Molecular Biophysics at Florida State University.

John Kenneth Galbraith graciously read parts of the manuscript and, as always, was a source of kindly encouragement. The late Joan Robinson, Cambridge University, read the sections on the ideas of her friend John Maynard Keynes and provided essential insights and corrections. My dearly missed friend, the late Sidney Weintraub of the University of Pennsylvania, provided thoughtful and meticulous comments on the Keynesians and post-Keynesians. Still another friend, Mancur Olson of the University of Maryland, provided valued reactions to my interpretation of his *Rise and Decline of Nations.* Hyman Minsky of Washington University also devoted considerable thought to and several suggestions for my discussions of finance and investment. Finally, Gerhard Mensch of Case-Western Reserve University provided insightful comments on Chapters 15–17. I exonerate all of the readers from the responsibility for any errors.

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Meanwhile, at Wadsworth, Stephanie Surfus has been my premier cheerleader, and Andrea Cava's production and editing skills have kept me sane. I hope—no, I *believe*—that, when you have closed the final page, you will agree that our goals have been met.

E. Ray Canterbery

CONTENTS

1

VALUES AND ECONOMIC SYSTEMS

Adam Smith (1723–1790), the first great professor of economics, lived and wrote toward the end of the Scientific Revolution and during the beginnings of the English Industrial Revolution. He was a teacher of moral philosophy (broadly speaking, what is today called *ethics*) and obviously not the first person ever to search for a coherent pattern in the apparent chaos of the natural and social world. He is famous because of his success in finding order and harmony in the turbulent business of buying and selling goods. He provided both a moral defense and a scientific blueprint for the market exchange system that is still a major component of the economic organization of the industrial market economies such as the United States, Japan, and the Federal Republic of Germany.

The plan of this chapter is first to define and discuss the general ways that economic activity can be organized and the specific forms that such organization has taken. Special emphasis will be given to feudalism, the dominant economic system of Europe during the Middle Ages. Next, we shall discuss how values and the authorities who express them have helped shape and defend various "idealized" economic systems, including Smith's favorite, the market exchange system that evolved out of feudalism.

Throughout this discussion we should keep in mind the distinction between a *natural* order and a *social* order. When we speak of law and justice, for example, we are usually referring to a human social order, such as the one we live in. But Adam Smith believed that the economic laws he talked about resided in nature and were discoverable by human reason. Social rules and laws also are important as a means of reconciling the private passions and interests of individuals to the interests of the whole group or nation. Smith's broader vision of society included social rules as well. Thus, while Smith lay bare the natural laws that keep the market economy together, he warned that in the absence of certain social values each person would be hanged separately—by his neighbors.

ORGANIZING ECONOMIC ACTIVITY

The economic organization of a society is an important factor in its success or failure. A society must continue to produce goods and services or it will die. It must also find a way to distribute the benefits of production or production will cease. This second objective is closely allied with human values because production can be either coerced or voluntary, depending on what the society's members are conditioned to tolerate or demand.

Further, because the resources used in the production of goods and services are limited, any economic organization must answer three basic questions: (1) *what* goods and services will be produced, (2) *how* the available resources will be organized for production, and (3) *for whom* the goods and services will be produced. History shows us that these questions have been answered in a great variety of ways, but for our purposes all these ways can be summarized under four general headings: the customary (or traditional) economy, the command economy, the competitive market economy, and the cooperative economy.

The Customary Economy

In a *customary* economy, each economic function is prescribed by tradition. People do what they do because that is what they and their ancestors have always done. In ancient Egypt, for example, every man was required by the principles of the Egyptian religion to follow the occupation of his father. No one attempted to deal with an economic emergency, such as a crop failure, in a new way because there was already a traditional, known way of meeting such an emergency. In Western society until the fifteenth or sixteenth century, the allocation of tasks was very often hereditary, and a person's economic role was decided at birth. Among some ethnic groups even today, individuals will almost always choose their parents' occupation.

The Command Economy

In a *command* economy, those who produce goods and services are told what to do, like an army that takes orders from a commanding officer. The area of command may be only economic and may coexist with political democracy; people who enjoy abundant civil liberties may demand few economic freedoms. However, slave labor is also a kind of command economy. Again using ancient Egypt as an example, we find the pharaohs ordering some Egyptians to drag stones from quarries in the Arabian mountains down to the Nile; others to receive the stones that were transported down the river; and still others to use the stones in building roads, temples, and pyramids. All this took place while Egyptian agriculture continued to be organized along customary lines.

The Competitive Market Economy

In a *competitive market* economy, the system itself, not tradition or authority, decides what is produced and to whom the outputs are passed. Theoretically, all power is exerted by the market for goods and services. People select occupations according to their own initiative and skills. Families select from marketplaces whatever goods and services they want or need, and producers produce what consumers demand at competitive prices. Because there are opportunities for choice built into it, Adam Smith called the competitive market a "system of liberty."

The United States' economy is often pointed to as an example of a competitive market system, but Americans know that this definition is only approximate. There are few ingredients of a customary economy in the United States today, but a large part of the economy is "public," which means there is a considerable amount of centralized command from the federal government. Moreover, certain large sectors of the economy have only a few producers of a product and are involved in entanglements with giant labor unions in such a way that prices do not always materialize from an atmosphere of unfettered competition.

The Cooperative Economy

The *cooperative economy* is a compromise version of the competitive market economy. Specific quantities of products and prices are determined by a free market system; however, the distribution of incomes is regulated by a democratic government. In other words, the free market system is valued for its efficiency in production, but social judgment is preferred in deciding the distribution of incomes. The cooperative economy requires consensus politics and goal sharing as an integral part of an interaction between the producers in the private sector and government planning agents in the public sector. These efforts may be coordinated through study commissions and administrative boards that involve the joint participation of workers, management, financiers, and government representatives. Social goals would be based upon an extensive dialogue and debate among business leaders, government officials, and the news media. The cooperative economy would