

Development
of
Economic
Analysis

Fifth Edition

INGRID HAHNE RIMA

F201
R575
E.5

9761221

Development of ECONOMIC ANALYSIS

Fifth Edition

Ingrid Hahne Rima



E9761221



London and New York

First published by Richard D. Irwin, Inc., 1967, 1972, 1978,
1986, and 1991

This edition published 1996
by Routledge
11 New Fetter Lane, London EC4P 4EE

Simultaneously published in the USA and Canada
by Routledge
29 West 35th Street, New York, NY 10001

© 1996 Ingrid Hahne Rima

Typeset in 10/12 Times Roman by Bookmasters, Inc.
Printed and bound in Great Britain by
Redwood Books, Trowbridge, Wiltshire

All rights reserved. No part of this book may be reprinted or
reproduced or utilized in any form or by any electronic,
mechanical, or other means, now known or hereafter invented,
including photocopying and recording, or in any information
storage or retrieval system, without permission in writing from
the publishers.

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British
Library

Library of Congress Cataloguing in Publication Data

A catalogue record for this book has been requested

ISBN 0-415-14306-3 (hbk)
ISBN 0-415-14307-1 (pbk)

Development of ECONOMIC ANALYSIS

Fifth Edition

This volume traces the development of economic theory from its pre-analytical stage to modern micro-macro analysis. All the major movements are covered in six chronological parts which blend historical analysis and contemporary theoretical and diagrammatic exposition to establish the relationship between modern theory and its roots. Its user-friendly features include:

- An unusual introductory chapter, "The Origins of Analytical Economics", which sets the stage for understanding the development of economics as a science by carefully distinguishing the economic thought of pre-eighteenth century from economic analysis.
- A "family tree" at the beginning of each section illustrating how the key streams and people connect and develop, accompanied by a list of the most important publications for that period.
- Integrates selections from the major works within their context, thus enabling reference to source material.
- The subject matter is divided to allow individual users to follow their preferences. The text also includes guidelines for use on a one semester course.
- Each part ends with a summary and questions to discuss, along with glossaries and suggestions for further reading.

The book provides a valuable aid to the study of the development of economic analysis *per se* while at the same time encouraging students to examine its relevance to contemporary theory. Now in its fifth edition, this modern classic has established itself as the foremost undergraduate text for understanding the development of economic analysis.

Ingrid Hahne Rima is Professor of Economics at Temple University.

To my students – the diamonds of our acres

Preface

The present edition seeks to ride the crest of the continuing wave of enthusiasm about the history of economics, much of which has been generated by the younger members of the profession. Their training in the use of modern analytical tools and concepts is helping to bridge the artificial hiatus that has too long persisted between the study of the history of economics and contemporary theory. While the chief objective of this book is to encourage the study of the history of economics for its own sake, the bridging of that separation is also among the objectives of this edition, as it was of earlier editions. I hope it will encourage yet another generation of students to catch the intellectual excitement of returning to the classics. The Physiocrats, Adam Smith, David Ricardo, Thomas Malthus, the Mills, and Alfred Marshall pioneered in the development of the analytical tools and concepts on which our modern discipline rests.

Those who teach and those who learn generally agree that there is no substitute for studying their intellectual legacy from original sources. Lengthy collateral readings from the masterworks are thus a standard feature even for undergraduate course offerings, though their effective use is often problematical. It is in the hope of addressing these difficulties that the present edition undertakes to integrate selections from the masterworks. These are introduced within the context of the many controversial issues to which those who shaped economics gave their attention. This format offers the double advantage of providing easy access to original source readings while reenforcing our appreciation of the intensely practical concerns of our intellectual forebears as problem solvers. The differing “answers” that they offered also make it manifestly clear that intellectual controversy has been a characteristic of economic inquiry from its earliest days.

To facilitate exploration of the development of economic theory, the present text retains the division of the subject matter into six Parts. Part I focuses on the preclassical period that antedated Smith’s *Wealth of Nations* and that laid the groundwork for the transition to classical economics. Part II explores the major themes of “Classical Economics” in terms of the specific contributions of Smith, Malthus, Ricardo, John Stuart Mill, and Nassau Senior. Part III, “The Critics of Classicism,” focuses on writers who, like Jevons and the Austrians, rejected the mainstream tradition. Karl Marx’s alternative analytical system is included among those that reflect dissent from classicism, even though Marx may also be thought of as the last of the great 19th-century classicists.

Part IV “The Neoclassical Tradition” begins with the eclectic efforts of Alfred Marshall to join marginalist techniques and thinking to the classical tradition. Between 1890 and the close of World War II in 1945, Marshall’s oral and written tradition was refined and embellished by his students and colleagues, as well as by American scholars who came under their influence. Modern welfare theory, the theories of imperfect and monopolistic competition, and even the business cycle theories that matured out of Austrian capital theory are appropriately examined within the context of the neoclassical paradigm. These developments are part of the stunning intellectual breakthroughs that were achieved during the period George Shackle so colorfully called “the years of high theory.”

The years of high theory were also characterized by the dissenting voices of the institutionalists, the theoretical socialists, and John Maynard Keynes, whose intent was nothing less than to generate an

intellectual revolution. The issues of their dissent are examined in Part V, which sets the stage for our concluding Part VI, "Beyond High Theory," which undertakes to provide a historical guide to contemporary theory. The long-term legacy of high theory for economics can be fully appreciated only in relation to the emergence of econometrics as the sister discipline of economics. The history of econometrics and its relation to economic theory are among the important new research areas to which historians of economics have turned their energies. The role that econometric techniques have played in shaping contemporary micro and macroeconomic theory, as well as the increasing econometric literacy of students of economics, provides persuasive reasons for including a chapter that examines this important research area. This is the task of Chapter 21, which introduces Part VI, and which interprets econometrics as playing a key role in shaping not only contemporary economics, but in defining critical areas of controversy and dissent. These topics are more fully articulated in Chapters 22–24, which examine the competing paradigms of contemporary economics within the framework of their historical traditions.

Methodological questions and their relationship to paradigm changes are also discussed more fully in this edition, which is consistent with contemporary interest in this aspect of the discipline. The objective is to provide students with an understanding of economics as a science and an appreciation of the reasons why its intellectual revolutions appear to be different from those that characterize the natural sciences.

As in the previous edition, the division of the subject matter is intended to accommodate the preferences of individual users in tailoring their course of content. For users who prefer a firm delineation between the history of economic thought and contemporary economics, Parts I through IV comprise a substantially traditional course. Their focus is on the development of neoclassical economics up to approximately 1945. The overview at the beginning of each part facilitates omission of certain chapters, if necessary, without sacrificing continuity. For users who also wish to examine criticisms of mainstream thinking during the same period, Institutional, Socialist, and Keynesian contributions are given extended treatment in Part V. Part VI is intended chiefly for those who prefer to examine the continuum of ideas that links contemporary theory with the history of thought.

For users who are attracted to Part VI but do not have time to use the entire text, I offer the following outline for a one-semester course. Assign Chapters 1 and 2; proceed to Part II, omitting Chapters 6 and 8; continue with Part III, assigning the overview and Chapters 10 and 12. These chapters examine the essentials of the classical tradition and the subsequent dissent from it. The overview and Chapters 14 and 15 of Part IV provide the essentials of the neoclassical tradition as it developed between 1890 and 1945. The overview of Part V and Chapters 18 and 20 provide an equivalent treatment of the dissent from neoclassicism during the same period. These four chapters provide sufficient background to enable a reasonably advanced undergraduate to understand the four chapters that comprise Part VI. This selection of 15 chapters is somewhat more technical than an equivalent number selected from the earlier part of the book, but it provides an effective semester course in which the history of economics is linked to contemporary theory.

The space requirements for integrating selections from the masterworks were necessarily substantial and dictated omissions elsewhere. The cost-benefit evaluation of space allocation that emerged from my own experience was that the two or three pages devoted to presenting "Notes for Further Reading" in a narrative format could be sacrificed with minimum loss to my students. Fortunately, the mammoth four-volume *New Palgrave Dictionary*, edited by John Eatwell, Murray Milgate and Peter Newman, is now widely available and its entries lend themselves to identification as a primary reference. Accordingly, the most relevant entries are listed at the end of each chapter along with

“Questions to Discuss or Write About.” The latter can serve such multiple purposes as self-study, providing topics for term papers (especially when used jointly with “Notes for Further Reading”) or essay examination questions. Glossaries of Terms and Concepts have been retained; their substantial value as a learning aid easily justifies their relatively small space requirement.

My greatest intellectual debt in the preparation of this edition is to my many colleagues in the History of Economics Society. The Society’s annual meetings provide a rare combination of intellectual stimulation and good fellowship. Nancy Wulwick, in particular, offered numerous suggestions for masterwork selections and their effective use in the text. To mention all the others by name would be to substantially republish the Society’s membership list. I have instead incorporated their names into suggestions for further reading and trust that this acknowledgment will serve to express my intellectual debt to them as well as my appreciation for their warm friendship. Last, but far from least, a special word of thanks is owed to Lynne Basler for her able assistance in resolving the problems that invariably arise even in the most carefully conceived production program.

Ingrid Hahne Rima

Contents

Part I	Preclassical Economics	2
	An Overview of Preclassical Economics	
1	<i>Early Masterworks as Sources of Economic Thought</i>	7
	<i>Politics as Economic Thought / Philosophy as Economic Thought / Ethics as Economic Thought / Church Doctrine as Economic Thought</i>	
2	<i>The Origins of Analytic Economics</i>	23
	<i>Introduction / Stimuli to Economic Inquiry / The Decline of the Manorial System: The End of Feudalism / Emergence of a Wage Class: The Putting out System / The Protestant Ethic: Individualism and Accumulation / Modern Science / New Political Concepts: The State and Natural Law / Statecraft as Economic Thought: Sources of Early Mercantilist Thought / The Balance of Trade and the Acquisition of Wealth / Monetary Analysis / Mercantilist Views on Production and Related Matters</i>	
3	<i>The Transition to Classical Economics</i>	43
	<i>The Environment and Leading Contributors / The Changing Concepts of the Transitional Period / The Nature of Wealth / The Quantity Theory / The Cantillon Effect / The Propriety of Interest and Determination of Its Rate / Rent and the Value of Land / The Value of Commodities</i>	
Part II	Classical Economics	60
	An Overview of Classical Economics	
4	<i>Physiocracy: The Beginning of Analytical Economics</i>	64
	<i>Introduction / Origins and Philosophy of Physiocracy / Economic Analysis / Philosophy and Method / Concepts / The Tableau Economique / The Usury Question Revisited / Proposals for Reform / Tax Reform / The Reorganization of Agriculture / Trade</i>	
5	<i>Adam Smith: From Moral Philosophy to Political Economy</i>	83
	<i>Introduction / Life and Times (1723–1790) / The Theory of Moral Sentiments (1759) / Smith's Theory of the Social Origin of Moral Judgments / The Wealth of Nations / Philosophical and Psychological Backgrounds / Plan and Scope / Productive and Unproductive Labor / The Theory of Value and Exchange / The Origin and Use of Money /</i>	

Use Value and Exchange Value / Labor and Value / The Theory of Distribution / Classical Distribution Theory / Wages / Profits on Stock and Interest / Rent / The Argument for Economic Liberty / Economic Progress among Different European Nations / The Attack on Mercantilism / The Agricultural System

6 Thomas Malthus and J. B. Say: The Political Economy of Population Behavior and Aggregate Demand 114

Introduction / Moral Restraint: The Preventative Check / The Tendency toward Subsistence Wages / The Tendency for Rents to Rise / The Progress of Population and Wealth / The Problem of Commodity Gluts / The Philosophical Aspects of Post-Smithian Economics: Utilitarianism / Malthus's Rebuttal: The Need for Unproductive Consumption / Rent as a Differential Surplus / Progress and the Structure of Economy

7 David Ricardo: Economic Analysis of the Distributive Shares 137

Introduction / Life and Times (1772–1823) / Principles of Political Economy and Taxation / Introduction / Controversy about Interpreting Ricardo's Work / The Theory of Exchange Value / The Measurement of Exchange Value / The Source of Exchange Value / The Influence of Land Rent on Exchange Values / The Influence of Wage and Profit Levels on Exchange Values / Why Ricardo's Is Not a Labor Theory of Value / Distribution / An Overview of Ricardo's System / The Wage Share and the Wage Rate / Profits / The Positive Long-Run Case for Machinery / Concluding Remarks on the Wage-Fund Doctrine / International Trade and Finance / Income Shares and the Corn Laws / The International Financial Mechanism

8 Nassau Senior and John Stuart Mill: Classicism Comes of Age 168

Introduction / Senior's Contribution to Economics / The Four Postulates / Capital and Its Returns / Value and Distribution / Mill's Principles of Political Economy / The Laws of Production and Distribution / Production / Distribution / Exchange Value

9 Classical Theory in Review 188

Scope and Method / Laws Relating to Economic Growth / Classicism and Utilitarianism / Natural Price as a "Center of Gravity" / Say's Law / The Quantity Theory of Money / Classical Writers as Parliamentarians / appraisal of Classicism

Part III The Critics of Classicism 200

An Overview of Dissent / The German Historical School / The Socialist Critique / Marginalism as an Alternative to Classicism

10 Marx: An Inquiry into the "Law of Motion" of the Capitalist System 207

Introduction / Life and Times (1818–1883) / The Backgrounds for Marxian Economic Theory / Socialist Thought / Hegel's Philosophy of History / Ricardian Economics /

The Origin, Nature, and Functioning of Capitalism / *The Economic Interpretation* / Use Value and Exchange Value / Simple Reproduction and Extended Reproduction / The Equalization of Rates of Profit / Capital Accumulation and the Tendency toward a Falling Rate of Profit / Capitalist Crisis / Monopoly Capitalism

11 Forerunners of Marginalism 232

The Utility Concept before the Marginal Revolution / *The Classical and Early Continental Conception* / Gossen's Conception of Utility / Dupuit's Conception of Utility / Cost and Revenue Concepts before the Marginal Revolution / *The Classical Conception* / Cournot and Marginal Revenue / Cournot on Duopoly / Productivity and Distribution Theory before the Marginal Revolution / *The Classical Theory* / Von Thünen and the Marginal Product

12 First-Generation Marginalists: Jevons, Walras, and Menger 248

The Economics of William Stanley Jevons (1835–1882) / *The Subjective Aspects of Exchange Value* / *The Limits of Exchange* / *The Concept of the Trading Body* / The Economics of Leon Walras / *The Subjective Aspects of Value* / *The Derivation of Individual Demand Curve* / General Equilibrium Analysis / The Economics of Carl Menger / *Menger on Subjective Aspects of Value* / The Theory of Imputation / *Menger's Theory of Negative Imputation*

13 Second-Generation Marginalists 276

The Theory of Production / *Edgeworth on the Laws of Return in the Short Run* / Wicksteed on Returns to Scale: Euler's Theorem / The Marginal Productivity Theory of Distribution / *Clark's Generalization of Ricardo's Theory on Rent* / *Clark's Ethical Interpretation of Marginal Productivity Theory* / *The Marginal Productivity Theory of Distribution* / Wicksell and the Adding-Up Problem / *Limitations of the Marginal Productivity Theory: A Recapitulation* / *The Austrian School* / Wicksell's Theory of Capital and Interest / *Capital's Accumulation and the Distributive Share* / *The Wicksell Effect* / *The Indirect Mechanism of Price Change*

Part IV The Neoclassical Tradition, 1890–1945 304

14 Alfred Marshall and the Neoclassical Tradition 310

Introduction / *Life and Times (1842–1924)* / Principles of Economics / *Objectives / Methodology* / The Theory of Demand / *Utility and Demand* / *Demand Schedules and Curves* / *Price Elasticity of Demand* / The Theory of Production / *The Laws of Return in the Short Run* / *The Laws of Return in the Long Run* / Costs of Production and Supply / *Real Costs and Money Costs* / *Diminishing Returns and Short-Run Cost Behavior* / *Long-Run Costs and Supply Curves* / The Theory of Price Determination / Prices That Deviate from Cost of Production / *Joint Production and Cost* / *Monopoly Prices* / *Long-Run Competitive Price Determination* / *Welfare Effects of Taxes or*

Subsidies / The Pricing of Productive Factors / Distribution Theory in Relation to Value Theory / Marginal Productivity and Factor Demand / The Supply of Productive Factors / The Pricing of Productive Factors

15 *The New Theory of Welfare and Consumer Behavior* 344

Introduction / The Leading Participants / The Controversy about the Price Mechanism and Resource Allocation / Sidgwick and Pigou on "Externalities" / Pigou on Increasing- and Decreasing-Cost Industries / Knight's Response to Pigou / The Menger Heritage of Frank Knight / Knight on the Methodology of Economics and Consumer Sovereignty / Hicks on Demand Theory / Indifference Curves and Optimum Allocation of Income / Derivation of a Demand Curve / Separation of Income Effects and Substitution Effects / The New Welfare Economics / Logical Positivism and the New Welfare Economics / Optimum Conditions in the Consumer Sector / Optimum Conditions in the Producing Sector

16 *Chamberlin, Robinson, and Other Price Theorists* 369

Introduction / Development of Economic Analysis / Contributors to Modern Price Theory / Some Dark Spots in Neoclassical Value Theory / Assumptions concerning the Firm's Demand Curve / Assumptions regarding the Laws of Return / Equilibrium of the Firm / The Conditions of Stable Equilibrium / Equilibrium When Monopoly Price Discrimination Is Possible / The Equilibrium of the Group / Chamberlin's Concepts of Small and Large Groups / Chamberlin's Equilibrium Analysis / Robinson's Full Equilibrium / The von Stackelberg Approach / Imperfect Competition and Factor Rewards / Factor Rewards under Competition / Monopsony and Factor Exploitation

17 *Neoclassical Monetary and Business-Cycle Theorists* 395

Introduction / Neoclassical Monetary Theory / The Theory of the General Price Level / Acceptance of Say's Law / Hayek's Monetary Overinvestment Theory / Other Considerations / Theories of Innovation / Schumpeter's Theory of Innovation / Innovation and Capital Development / Cassel's Theory of Innovation and Crisis due to Undersaving / The Savings-Investment Controversy / Keynes Treatise on Money / The Ex Ante-Ex Post Construct of the Stockholm School

Part V *The Dissent from Neoclassicism, 1890–1945* 416

18 *The Dissent of American Institutionalists* 421

The Veblenian Challenge / Introduction / Economics as an Evolutionary Science / Wesley Mitchell's Institutionalism / Mitchell's Critique of Orthodox Theory / Mitchell as an Empirical Theorist / The Social Control Economics of John Maurice Clark / Introduction / Clark's Rejection of Marginal Utility Theory / Clark's Economics of Overhead Costs / Clarence Ayres's Critique of Orthodox Economics

19	<i>Socialism without Marxism</i>	440
	Introduction / <i>The Debate Continues</i> / <i>The Dissent of the Fabian Socialists</i> / <i>Rent in Fabian Economics</i> / <i>the New Fabian Research Bureau (NFRB)</i>	
20	<i>The Less-than-Full-Employment Economics of J. M. Keynes</i>	451
	Introduction / <i>Life and Times (1883–1946)</i> / <i>The Evolution of The General Theory</i> / <i>The Revival of Macroeconomic Analysis</i> / <i>The Theory of the Interest Rate</i> / <i>Keynes's Theory of Employment, Output, and Income</i> / <i>The Principle of Aggregate Effective Demand</i> / <i>The Determination of Consumption Expenditures</i> / <i>The Marginal Propensity to Consume and the Multiplier</i> / <i>Investment Expenditures: The Role of Expectations</i> / <i>Keynes's Monetary Theory</i> / <i>The Money Supply: Its Origin in the Finance Process</i> / <i>Liquidity Preference: The Demand for Money</i> / <i>The Relationship between Value Theory and Monetary Theory</i>	
	Part VI <u>Beyond High Theory</u>	486
21	<i>The Emergence of Econometrics as a Sister-Discipline of Economics</i>	492
	<i>European Influences</i> / <i>Tinbergen's Business-Cycle Research</i> / <i>Keynes on the Laws of Probability and Tinbergen's Study</i> / <i>Game Theory</i> / <i>The Haavelmo Contribution: Stochastic Models</i> / <i>The Cowles Foundation</i> / <i>Activity Analysis</i> / <i>The Alternative Approach of the National Bureaus</i>	
22	<i>Keynesians, Neo-Walrasians, and Monetarists</i>	504
	<i>Keynesian Economics</i> / <i>The Hicks-Hansen ISLM Apparatus</i> / <i>The Real-Balance Effect and General Equilibrium</i> / <i>Keynesianism and the Phillips Curve</i> / <i>The New Classical Economics: Rational Expectations</i> / <i>Monetarism</i> / <i>Reaffirmation of the Importance of Money</i> / <i>The Modern Quantity Theory</i> / <i>Friedman's Permanent Income Hypothesis</i> / <i>The Perverse Effect of Monetary Expansion on Interest Rates</i> / <i>Friedman's Recommendations for Monetary Policy</i> / <i>Keynes versus the Monetarists</i>	
23	<i>The Chicago Tradition</i>	526
	Introduction / <i>The Menger-Knight Heritage</i> / <i>The Utility Principle</i> / <i>Knight on Consumer Sovereignty and the Methodology of Economics</i> / <i>Courtship and Marriage</i> / <i>Child Production</i> / <i>Law and Economics: The Property Rights Approach to Pricing</i> / <i>The Coase Theorem</i> / <i>The Chicago View of Public Utility Regulation</i> / <i>The Chicago View of Developing Economies</i> / <i>The Perspective</i> / <i>Trade versus Inflation as an Instrument of Development</i>	
24	<i>Some Modern Controversies</i>	544
	<i>The Participants and Issues of Current Controversy</i> / <i>The Neo-Institutionalist Challenge</i> / <i>Clarence Ayres: Towards a Theory of Social Value</i> / <i>Galbraith's New Industrial State</i> /	

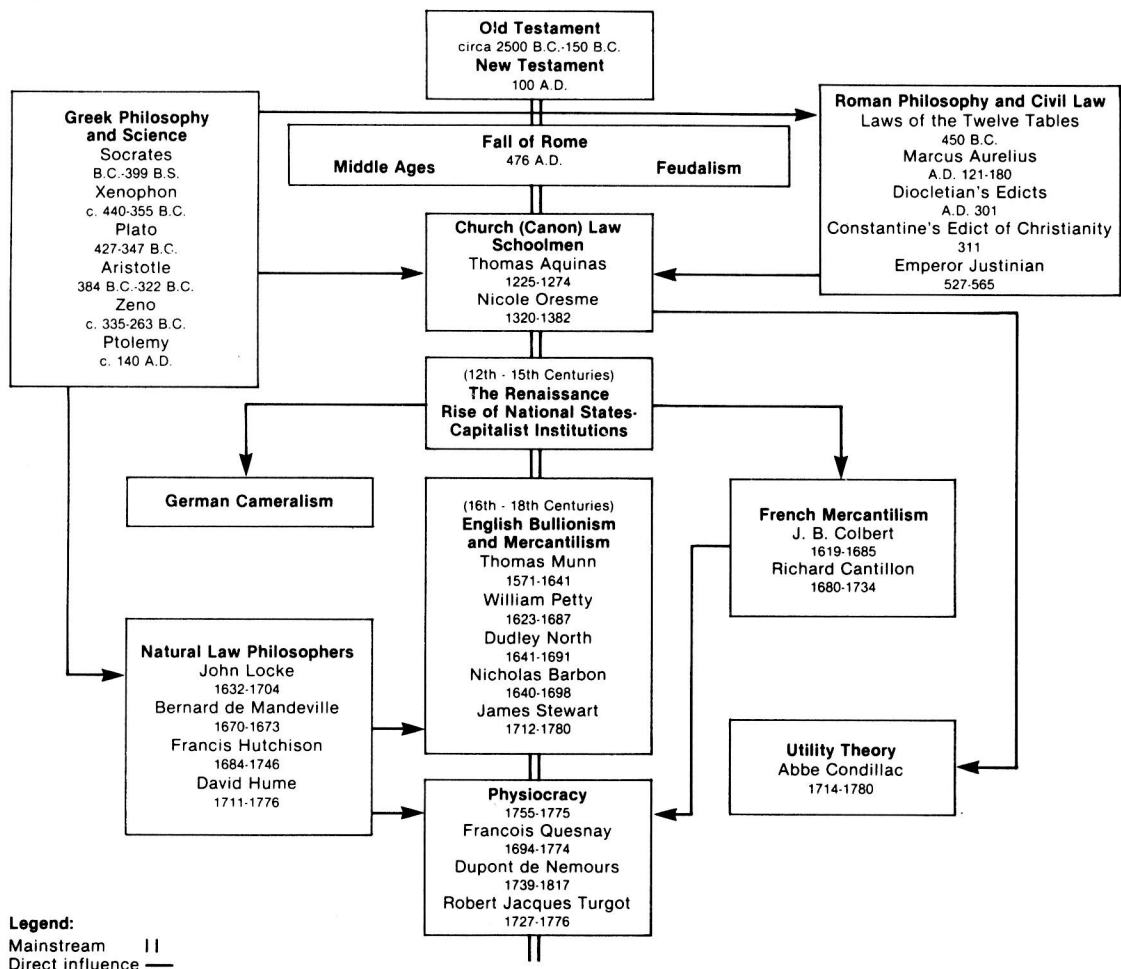
The Planning System / The Challenge of Radical Economics / The Radical Paradigm / Can Capitalism Survive? The Radical View / The Challenge of Post-Keynesian Theory / The Cambridge Post-Keynesians / Weintraub's Classical Keynesianism / Weintraub's Inflation Analysis / Instability, Uncertainty, and Finance / Growth and Dynamics / Modern Austrian Economics / Iconoclasm and Econometrics

<i>Selected References and Further Suggestions for Reading</i>	563
<i>Glossary Index</i>	581
<i>Name Index</i>	585
<i>Subject Index</i>	591

Development of Economic Analysis

Part I

Preclassical Economics



Some Important Publication Dates

c. 369–370 B.C.	<i>Plato</i> The Republic
c. 355 B.C.	<i>Xenophon</i> The Ways and Means to Increase the Revenues of Athens
c. 300 B.C.	<i>Aristotle</i> Politics, The Nicomachean Ethics
c. A.D. 1269–1272	<i>Thomas Aquinas</i> Summa Theologica
c. 1360	<i>Nicholas Oresme</i> Traictie de la Premiere Invention des Monnoies
1613	<i>Antonio Serra</i> A Brief Treatise on the Causes Which Can Make Gold and Silver Plentiful in Kingdoms Where There Are No Mines
1664	<i>Thomas Mun</i> England's Treasure by Forraign Trade
1690	<i>Josiah Child</i> Discourse about Trade
1690	<i>Sir William Petty</i> Political Arithmetick
1692	<i>Dudley North</i> Discourse upon Trade
1696	<i>Nicholas Barbon</i> A Discourse concerning making the New Money Lighter
1714	<i>Bernard de Mandeville</i> The Fable of the Bees: or Private Vices, Publick Benefits
1752	<i>David Hume</i> Political Discourses
1755	<i>Richard Cantillon</i> Essai sur la nature du commerce en général
1767	<i>James Steuart</i> An Inquiry into the Principles of Political Economy