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ECONOMICS U P D A T E D **EXPLAINED**

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Economics Explained

*Robert L. Heilbroner
and Lester C. Thurow*

UPDATED EDITION

A TOUCHSTONE BOOK

Published by Simon & Schuster Inc.

New York London Toronto Sydney Tokyo Singapore

The boxed material in this book and the Appendix on banking are taken directly from Robert L. Heilbroner and Lester C. Thurow, *The Economic Problem*, 6th ed., Prentice-Hall, 1980

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Updated Touchstone Edition, 1987

Published by Simon & Schuster, Inc.
Simon & Schuster Building
Rockefeller Center
1230 Avenue of the Americas
New York, NY 10020

TOUCHSTONE and colophon is a registered trademark of
Simon & Schuster, Inc.

Manufactured in the United States of America

10 9 8 7 Pbk.

Library of Congress Cataloging-in-Publication Data
Heilbroner, Robert L.
Economics explained.

(A Touchstone book)
Includes index.

1.Economics. 2.United States—Economic
conditions—1945— I.Thurow, Lester C.

II.Title. III.Series.

HB171.H479 1987 330 87-12807

ISBN 0-671-64556-0 Pbk.

Introduction

Books on economics abound. Most of them have two purposes. They tell you how to make a great deal of money—in the stock market, in real estate, in gold; or they tout some kind of economic salvation—less government or more government, less regulation or more regulation, less capitalism, more capitalism.

There is one overwhelming problem with both kinds of books. They don't work. The books about money do not make you money—if they did, the United States would be crawling with millionaires. And the books about economic salvation do not set your mind at ease. They just make you feel better for a moment.

Then why do people go on buying these books? At bottom, we believe it is because they are in search of something more serious than instant riches or saving the world. *They want to understand the nature of the economic forces that are upsetting their lives.* They want to know the meaning of the incomprehensible vocabulary they read every morning in the newspapers and hear every night on TV—the “money supply” and “gross national product” and “government deficits” that are somehow connected with their personal and public woes and misfortunes. Is it not the truth that we simply do not understand the very words that are supposed to tell us what is the matter?

That explains the purpose of this book. To say it as directly as possible, we have written a book based on our conviction that a great many people seriously want to know what economics is all about. Thereafter, if they still want advice on getting rich, or a tract for our times, fine. At least they will then understand the words the author is using.

Our belief in an audience that wants to learn about economics comes from personal experience. We are the authors of a college text, *The Economic Problem*, that has gone through many editions. But increasingly it has dawned on us that the people who are most eager to understand economics are not students who want to pass a course, but men and women in the real world who need to make their way intelligently through life. This is the economics they ought to know—not to get rich, and not to have a particular point of view, but simply to be effective investors, educated persons, informed workers or just good citizens.

Now a word about the book itself. It is, of course, meant to be read straight through, and it will present a coherent story about economics if you do so. But it is also designed to fit different needs. Someone who wants to know about international economics, for instance, can turn to Part IV. Readers who can't wait to find out what we have to say about inflation can begin with Chapter Twelve. Needless to say, later chapters will mean more if you have read the earlier ones, but the book can be used selectively—skipped over, dipped into, read from back to front if you want.

Economics Explained is very different from the text from which it derived its original inspiration. But two resemblances remain—we hope. First, it is a book of teaching, not preaching. There are plenty of controversial opinions in the book, but they are always labeled as such, never slipped across as The Truth. Second, the test of a textbook is whether a student sells it back to the college bookstore at the end of the year or keeps it around because, who knows, it's the kind of book he or she might want to look into again someday. We would like this to be that kind of book for you.

Robert Heilbroner
Lester Thurow

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I

THE ECONOMIC BACKGROUND

One

Capitalism: Where Do We Come From?

We live in a capitalist economic system. Politicians constantly talk about capitalism, or if they don't like the word, about the free-enterprise system. We are aware that the world is divided between capitalist and noncapitalist systems; and we are constantly being told that capitalism is the wave of the future, or would be the wave of the future if only it were left alone, or that capitalism is in decline and will fall of its own weight, like the Roman Empire.

Perhaps there is no more important economic question than the future of capitalism, none that affects more deeply our private destinies and those of our children. As we will see in our next chapter, the great economists of the past were vitally concerned with this issue. Modern economists are wiser or blinder, depending on how you look at it, and say relatively little about our long-term prospects. Nonetheless, we feel that it is impossible to understand capitalism without at least some understanding of its roots. So we are going to begin the study of our economic system rather the way a doctor begins to become acquainted with a patient—by taking its history.

Many people speak about capitalism as if it were as old as the hills, as ancient as the Bible, implying that there is something about the system that accords with human nature. Yet, on reflection, this is clearly not the case. Nobody ever called the Egyptian pharaohs capitalists. The Greeks about whom Homer wrote did not comprise a business society, even though there were merchants and traders in Greece. Medieval Europe was certainly not capitalist. Nor would anyone have used the word to describe the brilliant civilizations of India and China about which Marco Polo wrote, or the great empires of ancient Africa, or the Islamic societies of which we catch glimpses in *The Arabian Nights*.

What made these societies noncapitalist was not anything they possessed in common, for they were as different as civilizations could be, but rather, some things they *lacked* in common. To be-

come aware of these lacks will give us a sharp sense of the uniqueness and special characteristics of capitalism itself.

To begin with, all these noncapitalist societies lacked the institution of private property. Of course, all of them recognized the right of some individuals to own wealth, often vast wealth. But none of them legally accorded the right of ownership to all persons. Land, for instance, was rarely owned by the peasants who worked it. Slaves, who were a common feature of most precapitalist systems, were only rarely permitted to own property—indeed, they *were* property. The idea that a person's property was inviolate was as unacknowledged as that his person was inviolate. The Tudor monarchs, for example, relatively enlightened as sixteenth-century monarchies went, could and did strip many a person or religious order of their possessions.

Second, none of these variegated societies possessed a central attribute of capitalism—a market system. To be sure, all of them had markets where spices, gold, slaves, cloth, pottery, and food-stuffs were offered for sale. But when we look over the expanses of ancient Asia, Africa, or the Egyptian and Roman empires, we can see nothing like the great web of transactions that binds our own economy together. Most production and most distribution took place by following the dictates of tradition or the orders of a lord. In general, only the small leftovers found their way to the market stalls. Even more important, there was no organized market at all to buy and sell land, or to hire labor, or to lend money. Markets were the ornaments of society, tradition and command its iron structure.

Under such conditions, the idea of economic freedom was held in little regard. When peasants were not free to move as they wished, when artisans were bound to their trades for life, when the relations of field-workers to their masters were that of serf to lord, who could worry about the right of contract or the right to withhold one's labor? The distinction is crucial in separating capitalism from what came before: a capitalist employee has the legal right to work or not work as he or she chooses; and whereas this right may seem to count for little under conditions of Dickensian poverty, it must be compared with the near-slavery of the serf legally bound to his lord's land and to the work his lord assigned him.

In such a setting, moneymaking itself was not much esteemed. Ambitious persons from the better walks of life sought fame and fortune in military exploits, in the service of the court, or in the hierarchies of religion. In this regard, it is interesting to reflect how twisted and grasping are the faces of merchants depicted by medi-

eval artists, in contrast to the noble mien of soldiers and courtiers. Moneymaking was generally considered to be beneath a person of noble blood; indeed, in Christendom it was a pursuit uncomfortably close to sin. Usury—lending at interest—*was* a sin—in fact, a mortal sin.

As a consequence of all this, society's wealth was not owned by "the rich"—that is, by those whose main efforts were directly aimed at moneymaking—but rather by the powerful, who seized it in the struggle for lands and privileges. Of course, the winners in this struggle became rich, sometimes unimaginably rich, but their riches flowed from their power, not the other way around. Julius Caesar, for example, only became rich because he was appointed governor of Spain, from which he profited fabulously, as all provincial governors were supposed to do and did.

Last, and in some ways most significant, economic life was stable. It may not have seemed so to the peasants and merchants whose lives were constantly disrupted by war, famine, merciless taxation, and brigandage. But it was very stable compared to the tenor of economic life in our own time. The basic rhythms and techniques of economic existence were steady and repetitive. Men and women sowed and reaped, potters and metalworkers turned and hammered, weavers spun and wove—all using much the same kinds of equipment for decades, generations, sometimes centuries. How similar are the clothes and utensils, the materials of buildings, the means of conveyance that we see in the background of a Renaissance picture to those that we can make out on a Greek vase! How little material progress took place over a thousand years! That gives us a sense of how vast a change capitalism would bring when it finally burst upon the historic scene.

MARKET SOCIETY EMERGES

Thus we see that far from representing an eternal "human nature," capitalism comes as a volcanic disruption to time-honored routines of life. We begin to understand the immense inertia that prevented capitalism from developing in most earlier societies. From one of these societies to another, of course, different obstacles and barriers stood in the way of creating an economic way of life built on principles utterly alien to those that existed. But in all these societies, perhaps no barrier was more difficult to breach than the hold of tradition and command as the means of organizing economic life, and the need to substitute a market system in their place.

What is a market system? Essentially, it is one in which economic activities are left to men and women freely responding to the opportunities and discouragements of the marketplace, not to the established routines of tradition or the dictates of someone's command. Thus, in a market system most individuals are not only free to seek work where they wish, but must shop around for a job; by way of contrast, serfs or tradition-bound artisans were born to their employ and could only with great difficulty quit it for another. In a market system anyone is free to buy up land or to sell it: a farm can become a shopping center. By way of contrast again, land in most precapitalist societies was no more for sale than are the counties of our states.

Finally, a market in capital means that there is a regular flow of wealth into production—a flow of savings and investment—organized through banks and other financial companies, where borrowers pay interest as the reward for having the use of the wealth of the lenders. There was nothing like this before capitalism, except in the very small and disreputable capital markets personified in the despised moneylender.

The services of labor, land, and capital that are hired or fired in a market society are called the *factors of production*, and a great deal of economics is about how the market combines their essential contributions to production. Because they *are* essential, a question must be answered. How were the factors of production put to use prior to the market system? The answer comes as something of a shock, but it tells us a great deal.

There were no factors of production before capitalism. Of course, human labor, nature's gift of land and natural resources, and the artifacts of society have always existed. But labor, land, and capital were not commodities for sale. Labor was performed as part of the social duties of serfs or slaves, who were not paid for doing their work. Indeed, the serf paid fees to his lord for the use of the lord's equipment, and never expected to be remunerated when he turned over a portion of his crop as the lord's due. So, too, land was regarded as the basis for military power or civil administration, just as a county or state is regarded today—not as real estate to be bought and sold. And capital was thought of as treasure or as the necessary equipment of an artisan, not as an abstract sum of wealth with a market value. The idea of liquid, fluid capital would have been as strange in medieval life as would be the thought today of stocks and bonds as heirlooms never to be sold.

How did wageless labor, unrentable land, and private treasures become factors of production; that is, commodities to be bought and sold like so many yards of cloth or bushels of wheat? The answer is that a vast revolution undermined the world of tradition and command and brought into being the market relationships of the modern world. Beginning roughly in the sixteenth century—although with roots that can be traced much further back—a process of change, sometimes gradual, sometimes violent, broke the bonds and customs of the medieval world of Europe and ushered in the market society we know.

We can only touch on that long, tortuous, and sometimes bloody process here. In England the process bore with particular severity on the peasants who were expelled from their lands through the enclosure of common grazing lands. This enclosure took place to make private pasturage for the lord's sheep, whose wool had become a profitable commodity. As late as 1820 the Duchess of Sutherland evicted 15,000 tenants from 794,000 acres, replacing them with 131,000 sheep. The tenants, deprived of their traditional access to the fields, drifted into the towns, where they were forced to sell their services as a factor of production: labor.

In France the creation of factors of production bore painfully on landed property. When gold flowed into sixteenth-century Europe from the New World, prices began to rise and feudal lords found themselves in a vise. Like everything in medieval life, the rents and dues they received from their serfs were fixed and unchangeable. But the prices of merchandise were not fixed. Although more and more of the serfs' obligations were changed from kind (that is, so many dozen eggs or ells of cloth or days of labor) to cash, prices kept rising so fast that the feudal lords found it impossible to meet their bills.

Hence we begin to find a new economic individual, the *impoverished* aristocrat. In the year 1530, in the Gévaudan region of France, the richest manorial lord had an income of five thousand livres; but in towns, some merchants had incomes of sixty-five thousand livres. Thus the balance of power turned against the landed aristocracy, reducing many to shabby gentility. Meanwhile, the upstart merchants lost no time in acquiring lands that they soon came to regard not as ancestral estates but as potential capital.

This brief glance at economic history brings home an important point. The factors of production, without which a market society could not exist, are not eternal attributes of a natural order. They are the creations of a process of historic change, a change that

divorced labor from social life, that created real estate out of ancestral land, and that made treasure into capital. Capitalism is the outcome of a revolutionary change—a change in laws, attitudes, and social relationships as deep and far-reaching as any in history.*

The revolutionary aspect of capitalism lies in the fact that an older, feudal way of life had to be dismantled before the market system could come into being. This brings us to think again about the element of economic freedom that plays such an important role in our definition of capitalism. For we can see that economic freedom did not arise just because men and women directly sought to shake off the bonds of custom and command. It was also thrust upon them, often as a very painful and unwelcome change.

For European feudalism, with all its cruelties and injustices, did provide a modicum of economic security. However mean a serf's life, at least he knew that in bad times he was guaranteed a small dole from his lord's granary. However exploited a journeyman, he knew that he could not be summarily thrown out of work under the rules of his master's guild. However squeezed a lord, he too knew that his rents and dues were secured by law and custom and would be coming in, weather permitting. Elsewhere, in China, India, and Japan, variants of this combination of tradition and command also provided an underpinning of security for economic life.

The eruption of the market system—better, the centuries-long earthquake that broke the hold of tradition and command in England and France and the Lowlands—destroyed that social underpinning. Thus the economic freedom of capitalism came as a two-edged sword. On the one hand, its new freedoms were precious achievements for those individuals who had formerly been deprived of the right to enter into legal contracts. For the up-and-coming bourgeois merchants, it was the passport to a new status in life. Even for some of the poorest classes, the freedom of economic contract was a chance to rise from a station in life from which, in

* One of the many fascinating questions that surround the origins of capitalism is why it arose only in Europe, and never in any other part of the world. One part of the reason is that the collapse of the Roman Empire left many towns without an allegiance to anyone. In time these towns, which were naturally centers of trading and artisan work, grew powerful and managed to bargain for privileges with kings and lords. Capitalism thus grew up in the interstices of the medieval system. A similar opportunity and stimulus did not present itself elsewhere. A controversial but important recent work on the rise of capitalism is Immanuel Wallerstein's *The Modern World System*, Academic Press, two vols., 1974 and 1980. See also Fernand Braudel, *Capitalism and Civilization*, Harper and Row, three vols., 1981, 1982, 1984.