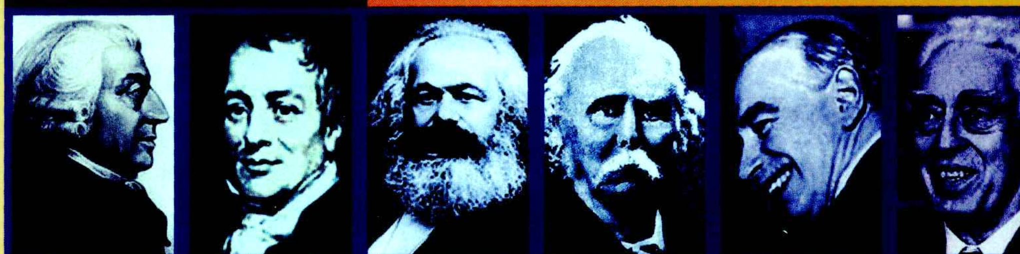
Lefteris Tsoulfidis



# Competing Schools of Economic Thought

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# Chapter 1
# Introduction

## 1.1 Introduction

This book was born out of our reaction to the way in which the usual texts cover the subject of the history of economic thought. In most of these texts, there is a tendency to emphasize the similarities and differences between all the important economists and form a repository of encyclopedic knowledge where one can study the seemingly important economic ideas. In this book, we argue that it is much more fruitful to focus on the essential ideas of each and every school of economic thought and relate them to present-day problems, than to engage into a sterile discussion of the ideas and the lives of the great economists of the past.

Thus, although this book deals with the history of economic thought, it does not necessarily follow a historic (in the sense of the order of presentation) approach, but rather a logical one, that is to say it deals with the social conditions associated with the emergence of a school of economic thought, its evolution, and its contemporary influence. One cannot write a book on the history of economic thought without writing separate chapters on the major economists of the past, that is, Adam Smith, David Ricardo, Karl Marx, and J.M. Keynes. Of course these economists formed schools of economic thought, that is, the classical and the Keynesian. As for the neoclassical school of economic thought, the ideas of its founders, that is, Stanley Jevons, Karl Menger, Léon Walras, and Alfred Marshal are put together into a single chapter and school of economic thought. The book also studies the evolution of current mainly macroeconomic approaches, that is, monetarism, new classical economics, real business cycles, and new Keynesian economics. Furthermore, we include separate chapters such as the microeconomic revolution of the 1930s, the upshot of Sraffa's-based critique of the neoclassical theory of the firm, the neoclassical synthesis, capital theory, and a final chapter that summarizes and critically evaluates the major schools of economic thought.

The main goal of the book is to present those theories that survived over time and that can inform us about current developments and economic policies. Thus, although the book includes the major economists, such as Adam Smith and John M. Keynes,

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the objective is not an encyclopedic narrative of their lives and works but rather to use their theories to the understanding of the underlying mechanisms that govern the current economic system and address contemporary problems and issues. In this sense, although we recognize that Malthus is one of the major economists of the past, nevertheless we do not examine him in a separate chapter, as is usual in the history of economic thought texts. In fact, we do justice to his views by referring to the mechanics of his population law in the chapters of Smith and Ricardo in connection to their theories of economic growth as well as to policy issues such as taxation. Furthermore, Malthus's underconsumption theory is discussed in connection to the classical conception of effective demand and the possibility of generalized gluts and Keynes's theory of effective demand. In this sense, we discuss Marx's theory of money, not in order to present just another theory among many, but rather because this specific theory may be used to explain current phenomena of inflation and exchange rate fluctuations. The same is true with the labor theory of value, which can shed new light on the variations in actual prices of contemporary economies. Similarly, Marx's theory of the tendential fall in the rate of profit is discussed in order to explain the actual state of the economy (growing or stagnating).

Another salient feature of our approach is the detailed study of the conditions within which modern schools of economic thought have developed and unlike other texts does not leave such a discussion to advanced macroeconomic courses. In these chapters we argue that only in microeconomic theory there is a consensus among, at least, neoclassical economists. In fact, we have known that microeconomic texts are used for many years and when they change, the change is about the use of new techniques and not about the development of new theories. In microeconomics, we do not really have new theoretical approaches as opposed to macroeconomics, which since the late 1960s is a deeply divided into rival approaches and so macroeconomics has been in a stage of flux making the distinction of each of its strands an increasingly more difficult task. If there is a consensus in macroeconomics this is the need for the provision of solid theoretical microeconomic foundations, that is, the need to assign optimizing behavior to all economic agents. The provision of microfoundation is an expression that in microeconomics there is agreement and the disagreement is in the macroeconomic level. In our opinion, this is also true in the recently celebrated New Consensus Macroeconomics where the word consensus is used rather as a euphemism for the current state of macroeconomics and its inability to address the problems of the severe recession that started for most economists in the end of year 2007 and continues up until of this writing.

As the efforts for achieving consensus among macroeconomists intensify in the years ahead the deeply recessionary years of 2008 and 2009 may contribute to the emergence of new and even radical ideas. The usual approach in macroeconomics treats the various schools of macroeconomic thought as rather random events, where graph follows graph and equation follows equation; as a consequence, the knowledge that one obtains cannot be placed in the appropriate theoretical context and historical conditions. Pedagogically speaking it is much more interesting, and at the same time a deeper understanding of macroeconomics is achieved much more effectively, when one follows the logical–historical approach. This means that each approach is presented in the historical context of its emergence and is evaluated according to logical and not necessarily ideological criteria.

By way of an example, it would be a mistake to present and, at the same time, discard monetarism on the basis of ones opposition to the ideology of neoliberalism, which is associated with monetarism. According to our approach, the presentation must be based on the texts of monetarists and their evaluation must be carried out on the basis of primarily logical criteria and only secondarily on empirical and ideological criteria. The same should be applied also to the other schools of economic thought and respective economists. For example, Ricardo's theory of value should be based on Ricardo's text and not on the secondary literature. As we argue in the relevant chapter the presentation of Ricardo's theory of value (*e.g.*, in Marshall or Marx) differ (often in substantial ways) from that which is derived from Ricardo's text.

In this book, we advance the claim that new economic theories might be the result of three nonmutually exclusive conditions: first, a new theory might be the product of the elaboration of an existing theory; second, it might be the outcome of systematic failures of the dominant theory to account for phenomena that it was designed to explain; third, it may lead to economic policy conclusions that are more relevant to current situations than the policies proposed by the existing and prevailing theory. When at least one of these conditions is met then various adjustment processes might be activated that could lead to the advancement of an altogether new theory. In order to establish our claim we combine economic history and the history of economic thought. The intuitive idea is that economic history constitutes the testing terrain for economic theory, thus enabling us to understand the past and present in a fuller and more precise manner, while also enabling us to confront the reality of the future in a more prepared way.

While each chapter is self-contained and can be read in isolation and according to one's interests or needs, the structure of the book is oriented to contemporary economies and in this sense it compares and critically evaluates the core ideas of the major schools of economic thought and places them into proper historical perspective. An additional feature of the book is that it explores the dynamics of shifting from one school of economic thought to another. The above not only stimulate one's interest to explore further the subject and its historical development, but also provides the reader with the necessary background to deal with more advanced current developments in macroeconomics. This is something that differentiates our approach from others because it also enables the discussion of the modern schools of macroeconomic approaches, which are usually left out of analysis in the usual books of the history of economic thought.

The manuscript came out from the course of history of economic theories that I teach for many years in the University of Macedonia in Thessaloniki. I also taught parts of the manuscript in the graduate courses of macroeconomics and political economy. During this long gestation period, I am particularly indebted to Persefoni Tsaliki (Aristotle University) with whom I discussed the structure of the book and benefited from her comments on each and every of its chapters. Our joint works have certainly influenced the writing of the book in many ways. At various stages of the work I have also benefited from the comments of Theodore Mariolis (Panteion University), Michalis Psalidopoulos (University of Athens). Special thanks also go to Aris Papageorgiou, who read the whole manuscript, and his remarks gave solutions to many problems. Of course, I have the full responsibility for the ideas expressed in this book.

# Chapter 2
# The Origins of Economic Theory

*Independent of men's will [...] far from being an arbitrary value or a value which is established by agreement between the contracting parties.*

(Quesnay cited in Meek 1962, p. 90)

*The fundamental price of commodities is determined by the expenses or costs which have to be incurred in their production or preparation. If they are sold for less than they have cost, their price sinks to a level at which a loss is made. If they are sold at a price which is high enough to yield a gain sufficient to encourage people to maintain or increase their production, they are at their proper price.*

(Quesnay cited in Meek 1962, p. 93)

## 2.1 Introduction

Economics as a scientific discipline originated with the emergence of capitalism, that is, the system that solves the problems of organisation of production and distribution through the generalised functioning of markets. Markets in capitalism do not work accidentally, occasionally or in the fringes of economic life, but at its epicentre, and they tend to encompass the operation of the entire economy. The salient feature of capitalism is the presence and the systematic operation of markets for the factors of production and in particular the market for the services of labour activity. Capitalism was established through a long and, at the same time, slow process that started in Western Europe in the sixteenth century and gained momentum with the advent of the industrial revolution in the mid to late eighteenth century. The publication of Adam Smith's book the *Wealth of Nations* in 1776 marks the period when capitalism dominated (at least in Great Britain) and at the same time the beginning of economics as a scientific discipline. This is not to say that in the period before the industrial revolution, there was no economic thinking; on the contrary, the philosophers, theologians and social thinkers in general were constantly making policy recommendations to the authorities to deal with specific

L. Tsoulfidis, *Competing Schools of Economic Thought*,
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economic problems.[1] These policy recommendations, however – whether they were correct or not for the period that they were applied to – were not characterised by generality. The reason is that the circumstances under which these policies were applied did not normally (re)appear and, therefore, there were no hidden economic forces that were working beneath the surface and could be theorised. For example, the slaves in ancient Greece or Rome worked according to the dictates of their owners. The product of their labour was appropriated by the owners, who also determined the standard of living of their slaves. Similarly, in feudalism, the serfs worked according to the dictates of tradition. The product of their labour was distributed according to the customs and also the power of the lord. Under these circumstances, non-economic forces such as political power or tradition clarified the rules of who produced what, how it was produced and who received the fruits of production. Consequently, in these societies, everything was simple and plain, and there was not much that could be theorised.

Social thinkers before the industrial revolution therefore dealt with economic questions without the existence of markets that operate systematically and determine the economic outcomes. Consequently, their analyses were based on the lack of competition. We know, however, that in the case of insufficient competition – for example, as with bilateral monopoly and isolated exchanges, in general – the equilibrium price and quantity are usually uncertain. The idea is that non-economic forces, such as the social status and the bargaining power of the traders, affect the price–quantity combination that finally prevails. This is the reason why scholastic writers of the past introduced the notion of just price (*justum pretium*). The idea was to protect the weak side of the market from the possible discretionary policies of those possessing political power. The just price is in essence a normative and at the same time administrative way of price determination of products in non-competitive conditions. With the establishment of just price, the benefits from trade are secured even for those merchants or producers with a weak bargaining position. Only with the dominance of the market as a mechanism for the arrangement of the questions of production and distribution of the social product is it possible to study the appearance of economic forces independently. Under these conditions, the development of economic thought with scientific character becomes possible, since only under these circumstances do economic phenomena make a systematic appearance and become subject to the operation of laws that govern their appearance. The evolution of economic thought reflects, to a great extent, the evolution of the capitalist economy.

In this chapter, we provide a broad outline of the essential aspects of two schools of economic thought, the mercantilist and the physiocratic. The common characteristic of these two schools is that they were essentially developed in an

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[1]Hence, it is fair to say that there were many economists in the eighteenth century or even before whose work had anticipated, to a great extent, Adam Smith's ideas. However, it is also fair to say that in the wealth of Nations we have for the first time a systematic exposition of economic ideas that are applicable to capitalism.

environment, the backdrop of which was the just emerging systematic operation of the market mechanism.

## 2.2 Mercantilism

Mercantilism is a label that was invented by Adam Smith, who defined 'the system of commerce' or 'mercantile system' as the set of economic ideas that prevailed in Europe during the period that started around 1500 A.D. and continued up until the end of the eighteenth century. Smith, by virtue of his personality, imposed his viewpoint on the historians of economic thought. For Smith, mercantilists claim that the wealth of a society is estimated by the availability of precious metals. A country secures wealth, especially gold, if it exports more goods than it imports. On the basis of this, it is evident that the policies of a country in general must promote exports and discourage imports. The trade balance, therefore, should not be left to be determined by the free operation of market forces; the government must assume an active role so as to achieve, and at the same time maintain, a growing trade surplus. In this framework, military power and state intervention constituted the *sine qua non* for the establishment and maintenance of trade surplus.

The views of mercantilists have been developed in various countries and during different time periods. In England, for example, we have Thomas Mun (1571–1641) and William Petty (1623–1687), while in France, Jean-Babtiste Colbert (1619–1683), Louis XIV's powerful economic adviser, dominated. The texts that refer to mercantilists are relatively few and mostly do not do justice to the ideas of these thinkers. For example, some authors of late mercantilism such as Petty developed ideas that are closer to those of classical economists. The same can be said of James Steuart (1712–1780) and David Hume (1711–1776) to refer to just two from a long list of names. As a first step, it is important to point out that there have never been economists who would call themselves Mercantilists. Authors who are usually classified in the area of mercantilism are characterised by such heterogeneity that they cannot constitute a school of economic thought as, for example, is the case of the Physiocrats that we examine below.

The policies that mercantilists suggested included the maintenance of low prices for agricultural products as a precondition for low wages[2] and cheap industrial products. Mercantilists encouraged the export of industrial products, while their imports were discouraged; hence, we have the case of 'fear of goods'. Exactly the opposite policies were followed for agricultural products. The idea is that if, for example, cheap agricultural products were exported, then it might be possible for rival countries to produce their own industrial products at lower cost and so expand their market share in the foreign markets at the expense of the home industries.

[2]High wages, according to mercantilists, tend to reduce workers effort and by decreasing their productivity raise the cost of production.

A characteristic example of mercantilist policy would be the famous navigation acts that were introduced by the British Parliament in 1651 and 1660. These laws allowed the import of goods into Great Britain if, and only if, they were carried on British ships or on ships from the country of origin of the goods. Some colonial goods had to be sold exclusively in England, while some other goods had to be exported, firstly to England and then to other countries. Colonies were not allowed to import goods from countries other than England. In addition, they were not allowed to produce industrial goods and they were restricted to exporting their raw material to England and importing industrial goods. With respect to domestic trade, mercantilists developed policies encouraging domestic trade by lifting many restrictions such as the payment of tolls going from one region to another. Mercantilists, however, did not want trade to be carried out under conditions of absolute freedom. This is the reason why they were in favour of the granting of monopoly rights and exclusive privileges in the trading of goods.

In France, during the period of Colbert's ministry from 1661 to 1683, there were specific policy proposals for the encouragement of manufacturing. Among them were included the institution of state factories, the provision of incentives for the growth of population, the prohibition of migration of skilled workers, *etc*. Moreover, there were instituted specifications for the production of various commodities that guilds had to observe, while some of the impediments to international trade were gradually lifted. Colbert's influence was so strong that it continued even after his death and his name became synonymous with French mercantilism.

The German version of mercantilism is known as 'cameralism' from the German word 'camera', which means state vault. The cameralists were state employees, whose main concern was the application of effective economic policies. Their ideology was nationalism and their policy prescriptions had as a goal the strengthening of the exporting capacity of a nation, the growth of population, *etc*. One of the reasons for the development of cameralism in Germany can be traced to the slow growth of its commercial class relative to that of England or France. So in Germany the nationalistic concerns of the state bureaucrats made them assume the role of providing the necessary requirements to the commercial class so as to grow stronger and be able to compete internationally.

Smith's simplistic description of mercantilism and his emphasis on cohesiveness do not do justice to the contributions of a host of economists of the seventeenth and eighteenth centuries. It is important to stress that mercantilism is not characterised by a set of common principles that are shared by the economists that are usually classified as mercantilists. We know that the views that are attributed to mercantilists differ between countries and also differ in the same country in various time periods. Consequently, the ideas of these authors are characterised by such heterogeneity that they cannot constitute a school of economic thought in the strict sense of the term.

A rather more balanced view on mercantilism has been expressed by Marx in his *Theories* I, where he distinguishes between two basic components of the mercantile system. First, with regard to economic policy, which is oriented towards the accumulation of precious metals and second, with regard to the theory, where mercantilism seeks to discover economic laws in the sphere of circulation of goods (in the domestic and mostly international trade). The underlying principle of the mercantilist system is 'buying cheap and selling dear'; the difference between the two prices is called 'profit upon alienation', which is realised in the form of precious metals. The fact that surplus is created in the sphere of production is something that, although pointed out, by many mercantilists, (*e.g.*, William Petty, James Hume, *inter alia*) did not receive the attention it deserved. Of course, there is nothing wrong with the idea that the difference in price between purchase and sale gives rise to profit. The trouble, however, is that by no means can this constitute a general explanation for the creation of wealth, since the profit of one party is necessarily the loss of the other.

Keynes praised the 'practical wisdom' of mercantilists. In the *General Theory* (1936), he devoted an entire chapter to mercantilism, where he develops its essential points. However, it is important to point out that Keynes treats them as if they were a unified school of economic thought. In mercantilism, Keynes finds support for his views of government intervention and the encouragement of demand in an effort to correct the weaknesses of the market system. For example, he mentions a doctrine that the classical school has repudiated as childish, but that deserves rehabilitation and honour (Keynes 1936, p. 351).

Some of the ideas of mercantilist authors that are praised by Keynes are as follows: the stock of money must be at such a level that the rate of interest is maintained at a low level so as to encourage investment; the idea that creeping inflation may exert a positive effect on the level of economic activity; and the lack of adequate amounts of money is what might be responsible for unemployment, and therefore, the expansion of credit and government deficit spending can reduce unemployment. Mercantilist authors had no illusions about the nationalistic character of their policies and their tendency to promote wars (Keynes 1936, p.346). However, according to Keynes, protectionism and nationalism are policies that contribute to full employment in a given country.

Keynes's version of mercantilism is based, to a large extent, on Heckscher's (1931) book on Mercantilism. In the second edition of his book, Heckshser (1955), however, criticised Keynes, for treating the economic categories of modern economies as if they were similar to those of the period of mercantilism. In particular, unemployment that is caused from withholding of investment is no doubt a modern phenomenon that was unknown or its meaning was quite different in the seventeenth century. In fact, for mercantilists unemployment was related to the latent labour force in agriculture and to its widespread migration to towns. Consequently, unemployment of this type does not have much in common with Keynes's unemployment due to the lack of effective demand.

## 2.3 Physiocracy

Physiocrats constitute the first school of economic thought that was developed, almost exclusively, in France during a relatively short period of time (from approximately 1750 to 1780). The founder of this school is François Quesnay