Epochs of Economic Theory

A. K. Dasgupta

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Preface

The following chapters grew out of an address which I presented to the Indian Economic Association at its Annual Conference in 1960.[1] In it I argued that the systems of economic theory, as they have grown over the years, have attempted to answer specific questions that assumed importance from time to time, and they are to be viewed as independent of each other. I argued, for example, that marginalist economics ('neo-classical', as it is often misleadingly called), far from being an emendation of classical political economy, was a challenge to it, having shifted economic theory away from the problem which concerned the classical economists. Similarly, modern growth theory, in so far as it is derived from Keynesian economics, I argued, was as far removed from marginalist economics as the latter was from classical political economy. The history of economic thought, I submitted, could be seen as consisting of 'epochs', each epoch giving rise to a new set of questions, and hence to new theories for answering them.

Friends advised, and I agreed, that the thesis deserved following up. I indeed promised myself that I would write a book illustrating my propositions by reference to the major shifts that have taken place in economic theory in the course of its development. The project, however, was held up for a long time; various assignments took me to other fields of research. It was only in 1976 when I accepted an invitation from Jawaharlal Nehru University to an honorary professorship that I regained my interest in the project. There were no specific duties attached to the job, and the atmosphere in the University was congenial to theoretical speculation. I gave a course of lectures to the University's School of International

[1]'Tendencies in Economic Theory', *Indian Economic Journal*, January-March, 1961; reproduced in my *Planning and Economic Growth* (George Allen & Unwin, London, 1965).

Studies during the sessions 1977–80, in which I presented an outline of my scheme. The response from those who attended was encouraging. A grant from the Indian Council of Social Science Research provided a further stimulus. Yet progress was slow, and I do not know how long I would have taken to finish the work had it not been for a persistent pressure from Amartya Sen and Partha Dasgupta, to whom I dedicate the book.

While the work was in progress I presented a summary view of the project in my C. N. Vakil Memorial Lecture held under the auspices of the Indian Economic Association in 1980.[2] Traces of this lecture will be noticed in the present book.

I should remind the reader that this is *not* a book on the history of economic theory. Its aim is rather to provide a perspective for viewing the history of economic theory. The development of economic theory is shown here, as was indeed done earlier, as consisting of epochs, each epoch being marked by specific historical and socio-economic situations. To illustrate my point of view I have chosen representative economists from each epoch, beginning with Adam Smith and concluding with John Maynard Keynes. Attention has been drawn in particular to the metamorphosis of capitalism and its impact upon economic theory over the period.

During the past few years I have had discussions on various aspects of my work with colleagues and friends. I have profited greatly from these discussions. My chief debt is of course to Amartya Sen and Partha Dasgupta, who not only encouraged me in my work from the outset but also made valuable comments on earlier drafts. There is also another name which I would gratefully mention. Marion O'Brien not only undertook to do the final copy for the Press, accepting the drudgery of inserting the author's corrections and emendations over months, she also wrote understanding notes to me on the chapters as she typed them. This was reassuring. The unenviable job of rescuing the text from a most clumsy manuscript fell on Shib Narayan Prasad, who did it cheerfully. Among those of my friends and colleagues who in the course of the progress of

[2]'How One May View the Development of Economic Theory', *Indian Economic Journal*, January–March, 1981; reproduced in my *Phases of Capitalism and Economic Theory* (Oxford University Press, Delhi, 1983).

the work stimulated my thinking, I would make special mention of Sabyasachi Bhattacharya, Sukhomoy Chakravarty, Sandwip Das, Amita Datta, Amlan Datta, Anupam Gupta, Ashok Mitra, Iswari Prasad and Samar Ranjan Sen. Finally, I am most grateful to René Olivieri for the intimate interest that he has shown in the publication of the book.

A. K. Dasgupta
Santiniketan
May 1985

To Amartya and Partha
but for whose encouragement
the book would not have been written

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Preview

Relativity of Economic Theory

Historians of economic theory seem inclined to believe that there is a continuity in the development of their science. The progress of economic science is supposed to be continuous and cumulative in a manner in which the progress of sciences usually is – a progress from the particular to the general. If, it is contended, the labour theory of value has been supplanted by the marginal utility theory, it is because the latter provides a more general framework for the interpretation of value as it operates in the market, covering cases which the labour theory could not accommodate. Similarly the theory of underemployment equilibrium is said to be a more general theory, covering cases of market failures which the Walrasian system did not envisage; indeed the author of the theory overtly claims it to be a general theory, subsuming 'full employment' equilibrium as a special case.

It is my contention in this book that this manner of viewing the development of economic theory is misleading. It no doubt has an appeal to those who, like Joseph Schumpeter, would like to claim for economic science a status similar to that of the physical sciences. But the claim, it is contended here, is exaggerated; it ignores elements which distinguish economics conspicuously from the physical sciences. It is not the problem of precision, or lack of it, which concerns us here, for on this account the difference between the two sciences is one of degree only; propositions of economic science are admittedly less precise than those of the physical sciences, in so far as they are used to interpret reality. The difference that we would here emphasize is one of kind, a difference which arises from the fact that the propositions of economic science do not satisfy what one might call the universality criterion. The reality with which the physical sciences are concerned is supposed to be given and constant. The assumptions that a scientist makes concerning the occurrence of physical phenomena are thus valid universally not only with respect to space but also with respect to time. The apple falls on the ground at all places and has done so, one imagines, at all times. New phenomena are no doubt discovered from time to time, which necessitate revision of existing theories. However, it is not that these phenomena did not exist before, it is only that they were not known before. The objective world is not supposed to change, it is the scientist's appreciation of it that changes. The scientist thus builds one theory upon another, so as to accommodate more phenomena than had been observed before. 'A scientist's present thoughts and actions', writes P. B. Medawar, 'are of necessity shaped by what others have done before him; they are the wave-front of a continuous secular process in which the past does not have a dignified independent existence of its own.'[1] The description does not fit economic science (or indeed any social science). Economists deal with a universe where data are freakish and are not valid universally, and where phenomena emerge which were not only not known before but had not existed before. It is of the nature of economic science that it involves events and phenomena which not only change complexion from time to time but do not also occur at all places. Problems that emerge as crucial at one time may turn out to be totally irrelevant at another time in the same economy, and those that are relevant in the context of one economy may well be irrelevant elsewhere. In economics old theories do not die. And they do not die not because one is built on the other but because one is independent of the other.

Consider, for example, the theory of wages. In the wake of the agrarian revolution in England a large body of labourers were released from the land; in view of the enclosure movement the former freeholders of land were deprived of their access to land, and mechanization of agriculture rendered the newly created landless labourers largely redundant. Industrialization, on the other hand, was yet in its early stage and altogether inadequate for the urban section to absorb the surplus labour. In such a situation, in so far as the labour market was free, a subsistence theory of wages could be vindicated as an approximation to reality. With the progress of industrialization, however, labour tended to become scarce, and

[1] P. B. Medawar, *The Hope of Progress* (Wildwood House, London, 1972), p. 105.

there had to be a substantial modification of the theory. Whereas previously the level of wages could be held as independent of demand, in the new situation demand came into its own and had to be reckoned as a determinant of wages. A theory which had a reasonable degree of validity in the context of the British economy in the early decades of the nineteenth century thus became totally irrelevant to the same economy by the second half of the century. Hence the emergence of what is known as the marginal productivity theory.[2] The advent of trade unions complicated the matter still further. The labour market took on the character of a bilateral monopoly where wage fixing came to depend on the relative bargaining power of the two parties, the employer and the employed. An element of indeterminacy was thus introduced in the labour market, calling for the intervention of the state. On the other hand, in a country like India, where the pace of industrialization and agricultural expansion is yet not commensurate with the growth of population, and where only a tiny fraction of the labour force is covered by trade unions, the older theory does seem to come closer to reality; a precarious physiological minimum sets the level of wages in such an economy.

The same sort of consideration applies to the theory of unemployment – to take another example, also from the labour market. How does it happen that an economy carries an excess supply of labour and yet remains in a state of equilibrium? This is the problem. The phenomenon may occur in an industrially mature economy, it may also occur in an underdeveloped economy. However, the explanation of the phenomenon is unlikely to be the same in the two cases. A theory of unemployment which is appropriate for one may not be so for the other. Thus the arrival of a new theory based on a possible 'insufficiency of effective demand' does not suggest demolition of an older theory which derives from a deficiency in the 'capacity of equipment'.[3] In economics, unlike in the physical

[2]Note that the marginal productivity theory of wages does not subsume the classical minimum subsistence theory. Where a minimum subsistence theory of wages applies, the marginal productivity theory fails. To know the marginal productivity of labour one has to know what the volume of employment is. However, in an economy where there is an abundance of labour, and where therefore wages are supposed to conform to the minimum subsistence of labour, employment is not given externally, and wages are determined independently of the demand for labour. It is, in fact, the marginal product of labour which in such cases adjusts itself to minimum subsistence.

[3]See M. Kalecki, 'Three Ways to Full Employment' in *The Economics of Full Employment* (Basil Blackwell, Oxford, 1945).

sciences, theories have grown laterally rather than in a hierarchical order. They are to be understood with reference to special contexts; to designate an economic theory as 'general' is somewhat over-ambitious.

It will perhaps be argued that our existing theories are yet incomplete, and that they may possess features which would lend themselves to further abstraction, thus providing possibilities of a hierarchical system. Such possibilities cannot of course be denied. Refinements of theories, so as to extend their explanatory domain, are as much a concern of economics as of the physical sciences. What is contended here, if our supposition concerning the occurrence of economic phenomena is correct, is that there are limits to such possibilities. As it is, the main developments in economic theory have taken place in specific historical contexts; herein indeed lies the distinctive property of economic science. Attempts to transcend them would seem to be a futile exercise.

Identification of Epochs

A system of economic theory evolves in response to questions that are provoked by a given set of circumstances in an economy. As circumstances change, or people's attitude to them changes, questions are revised, and a new system springs up. It is wrong to say that the new system is an improvement on an older one; it is different. No doubt there is often progress from a lower to a higher level of abstraction in a particular line of analysis. The passage from Smith's 'primitive' concept of division of labour to the modern theory of increasing returns is an outstanding example of such progress; one is derived from the other and is an improvement on the other. One would, however, go off on a false scent if one were to say this of the marginal utility theory as compared to the labour theory. These two theories, despite their appearances, belong to different planes of discourse.

In what follows the development of economic theory is seen as consisting of 'epochs'. Our frame of reference is the British economy. For it is there that the major innovations with which we are concerned took shape. Three epochs are identified – classical, marginalist and, as one would like to call it, Keynesian, from the name of the economist who ushered it in. It is contended that each epoch threw up specific questions, and economists devised modes of answering them.[4] Systems of economic theory grew out of these efforts. The systems, it is urged, should be viewed as independent of one another, answering different sorts of questions. The marginalist system does not mark a 'progress' over classical political economy, nor is it an alternative; it is different. The analytical technique that it offers, powerful as it is in the context of its own framework, is hardly relevant to the problems that are central to classical political economy. Nor does the Keynesian theory of aggregate output and employment have any direct affiliation with the marginalist theory of relative prices. No wonder that the author of the theory lumps Ricardian economics and marginalist economics together as 'classical' and dissociates his own economics from both.

The term 'epoch' is meant to stand for a 'period in history'. It does not, however, carry any suggestion of a revolutionary happening. Historians of economic theory often characterize the advent of marginalism as 'Jevonian revolution', or the advent of the theory of underemployment equilibrium as 'Keynesian revolution'. The characterization is misleading. The course of progress of economic science over the last two hundred years or so has not been smooth. There have been breaks at times; but these breaks have not at any stage brought about anything like a revolution. They are landmarks where new questions have been asked and new modes of answering them have been sought.

Let us then see the backgrounds against which the three systems grew. The background of classical political economy is clear. Classical questions centred on progress and poverty, two conspicuous features of the British economy during the early phase of the industrial revolution. Questions on progress led on to the theory

[4]The term 'epoch' is borrowed from Charles Gide and Charles Rist (*A History of Economic Doctrines* (George G. Harrap, London, 1945), Preface, pp. xiv–xv). The periodization followed by Gide and Rist, however, seems to be based on views on questions rather than on questions as such. Accordingly the authors group the critics of the classical liberal principle, such as Marx, under a separate epoch, while John Stuart Mill is allowed to represent an epoch which is said to mark 'the triumph of the liberal school' as against the early socialists. My epochs, on the other hand, divide themselves in terms of the character of questions asked rather than the views expressed; thus the procedure adopted here puts Ricardo, Malthus, Mill and Marx under one banner, even though their views on questions differ ever so conspicuously. Nor, for that matter does our epoch conform to Schumpeter's definition of 'school', as representing 'one master, one doctrine, personal coherence'. See J. Schumpeter, *History of Economic Analysis* (George Allen & Unwin, London, 1954), p. 470; also 'Keynes, the Economist' in *The New Economics*, ed. Seymour Harris (Dennis Dobson, London, 1947), p. 97. Schumpeter thus speaks of a Ricardo-school, a Marx-school or a Keynes-school, the reference being to the political implications of the respective theories. Our reference here is to the systems of economic theory as such.

of accumulation and innovation. Questions on poverty led on to the theory of population (or as Marx would have it, to the theory of exploitation). Finally, analysis of the interaction between accumulation and population led on to the classical theory of economic growth.

It is not as if the momentum of progress had spent itself in the years preceding the advent of marginalism; in what is regarded as the second phase of the industrial revolution, the British economy experienced a rate of growth which was even higher than in the earlier phase. There was no doubt a depression in the last quarter of the century, the years of the ascendancy of the marginalist system. But the depression was one of prices and profits rather than of production as such.[5] How does one explain the emergence, in this milieu, of a system which totally suppressed the classical questions?

The classical theory of population was weak and had to be abandoned. There was also the emergence of trade unions to reckon with. But these do not explain why there should have been an abandonment of the classical questions altogether. Could it be complacency at the state of the economy? Freedom of trade for which the classical economists fought had been achieved; the last vestiges of protection had been removed by the sixties; the economy was maintaining its momentum of growth in a placid atmosphere of free trade. It could thus be that contemporary economic thinking took growth for granted and turned on relative prices and techniques of production – questions to which the classical answer was weak. This, however, is not a fully satisfactory explanation. It so happens that the new wave of economic theory appeared not only in England but also in two other centres, Vienna and Lausanne, at about the same time. While the explanation may hold for England, it may not hold for the Continent. The explanation of the marginalist challenge – it was indeed a challenge – may have to be sought elsewhere than in the shift of events. It is arguable that the marginalists had misgivings over certain social implications of the classical propositions. And since apparently these propositions rested

[5]See on this Pauline Gregg, *A Social and Economic History of Britain 1760–1972*, 7th edition (Harrap, London, 1973), part II, ch. XVIII. 'Industry remained in a condition of prosperity until 1873. In that year began the great depression which, with a temporary and partial lifting between 1880 and 1882 and between 1886 and 1889, lasted until 1896. Its strangest feature was that, while general agreement existed as to the fact of depression, by most of the criteria generally applied to industry it was a period of prosperity . . . It was a depression, not of production, but of prices and profits.' p. 367.

on the labour theory of value, they chose to concentrate on a field of enquiry where the labour theory was clearly weak and where the new technique which they had discovered was most effective. The field that they chose was thus that of relative prices and resource allocation. In the event the typical classical questions on accumulation and growth were just left aside.[6] This is a possible explanation. We shall have occasion to go into it.

The provocation that led to what we have called the Keynesian epoch is straightforward. Keynes reacted to a state of obstinate depression that gripped the economies of the West in the later years of the inter-war period. The situation was in sharp contrast with what the classical economists had faced. If classical political economy was inspired by the vigour that the British economy showed in the early phase of the industrial revolution, Keynesian economics was provoked by the stagnation into which the economy fell as the forces making for the industrial revolution – accumulation and innovation – were withering away.

Object of the Study

This is not a book on the history of economic theory. Its aim is much more modest; I wish only to suggest a perspective for viewing the development of economic theory. This, I claim, is very important. Much of the controversy which has afflicted the economist's profession over the years could be avoided if it were realized that the different systems of economic theory which the epochs represent were designed to answer different sorts of questions that appeared significant at different points of time. If the marginalist technique fails to explain the growth of an economy as a sequence in time, one must not quarrel over this failure; the technique was not designed for this purpose. It is enough if it succeeds in explaining how the prices and outputs of individual goods are determined in the market, and how these prices and outputs are related to one another. For these are the sorts of questions that the technique was designed to answer.

[6]The questions indeed remained neglected for not less than eighty years until they were revived in the post-war period – this time largely under pressure from underdeveloped countries.

The systems of economic theory that I propose to study are incomplete. They deal with *aspects* of an economy. Whether a synthesis of the various systems will ever be attained is doubtful, very doubtful indeed. Remember that economic science differs fundamentally from the physical sciences. The physical universe, taken as a whole, is supposed to exist independently of time. The universe with which economic science deals is a flow over time and with the passage of time new situations arise in the economic field creating new problems. Physicist Stephen Hawking, in a recent lecture, warned his profession about the prospect of an end of theoretical physics 'in the not too distant future'.[7] Whether the end that Hawking visualizes is near or distant is not the point. What is significant is that the boundary of the physicist's universe of discourse is supposed to be limited. This certainly cannot be said of economic science. The economic scientist can count on being able to retain his occupation indefinitely, thanks to the peculiarity of economic reality – its changing character. This also is why one would feel sceptical about the possibility of the construction of a unified system of economic theory. In economics it appears one has to be content with partial theories, even though one knows that being partial they are in their application only approximations. At any rate this is how it is proposed to proceed in this book; my study takes the systems of economic theory as I find them.

My approach in this book is selective. I have taken for my study representative economists in respect of each epoch. The Keynes epoch is of course straightforward; the *General Theory* is the maker of the epoch. I confine myself to the theory of underemployment equilibrium that Keynes offers, fixing on the peculiar feature of the economy of which the theory is a reflection. Thus one of the things that we shall find is that the *General Theory* is not so general after all as its author claims it to be.

So far as the classical epoch is concerned, the main representatives are Adam Smith, David Ricardo and Karl Marx. It is clear that Smith's *Wealth of Nations* is the source from which much of what is known as classical political economy was derived. It is also clear that David Ricardo gave the system a coherent structure and was the central figure during the heyday of classical political economy. Karl Marx is the odd man out. He does not properly belong to the

[7]See Stephen Hawking's inaugural lecture at Cambridge University – *Is the End in Sight for Theoretical Physics?* (Cambridge, 1980).