

CHAPTER SIX

THE POST-KEYNESIAN SCHOOL

“Labor Market functions more by the invisible handshake than the invisible hand of a competitive Market Mechanism”

_____ Arthur Okun

6.1 Emergence of Macroeconomics:

- Advances that immediately followed the publication of the General theory in fields of economic analysis and public policy were generally connected with three problems;
 1. First, study on the short term changes in the level of economic activity;
 2. Second, ways to get out of a depression; and
 3. Long-term trend of economic system towards stagnation.
- Much of these advances took place in United States under the able leadership of **Prof. Alvin Hansen** of the Harvard University.
- Alvin H. Hansen (1887–1975) was born in Viborg, South Dakota, where he spent his early years of education in a one-room schoolhouse.
- He published **Business Cycle Theory** (1927), a book that earned him a reputation as being one of the nation’s leading macroeconomic scholars.
- Macroeconomics is an elaborated version of the ‘New Economics’.
- It may be interesting to note that prior to the beginning of the ‘New economics’, economic thinkers had in the main concentrated their efforts on the study of Microeconomic problems (the individual or the firm).
- They failed to explain the behavior of the economy as a whole, not to speak of dealing with its misbehavior.
- The concentration of efforts on the study, of microeconomics problems was to such an extent that it led people to think the economic theory had reached a stage of stagnation.
- Macroeconomics owes its origin to ‘New Economics’ and is a complete departure in economic methodology.

- It is different from Microeconomics and is ‘concerned with the problems of unemployment, economic instability, inflation and economic growth.’
- **Gardner Ackley** prefers to describe it as an ‘income and employment analysis’
- While **Prof. Samuelsson** defines it as ‘the study of the aggregate performance of the whole GDP and the General Price level.’
- Just as the ‘New Economics’ rejected the classical assumption of full employment equilibrium, so does Macroeconomics.

- Macroeconomics deals with the aggregates and the movement of the total economy through time.
- Macroeconomics has had two broad policy implications;
 1. First, Fiscal policy in relation to employment and stability
 2. Second, policy for maintain equilibrium in international payments.
- To describe it briefly, Macroeconomics is the study of the whole economy
- As against the belief of Adam Smith that the national budget can be managed like the budget of any household, macroeconomic analysis proves that the conduct of the national finances is not easy to manage and they play a positive role in shaping the whole of the nation’s economy.
- The occurrence of inflationary or deflationary gaps, caused by over-full employment and underemployment of resources, can be corrected by making suitable change in the fiscal policy and through them to make such changes in the aggregate demand as are necessary to correct the situation.
- Macroeconomics has been effectively applied in the formulation of policy in the field of foreign trade and international payments.
- It would be interesting to know that Keynes has not talked about the theory of international economic relations in the general theory
- And it was only in the immediate post-war period that Keynes showed his utmost concern for international economic issues.
- During this period that Knowledge on effects of tariff, export subsidies, and policies on terms of trade, national income, investment and consumption of different trading areas; changes in the rate of exchange rates, international investments or international capital

movements has been widening at a very rapid pace and the concepts now stand better defined and better understood.

- Another technique for the studying the behavior of the aggregates of the economy which has been developed during the last decades is that of “**Input-Output analysis**” by Prof. **Wassily Leontief** in 1941.
- He has mathematically analyzed the **Input-Output** combinations of different industries and has, thus, tried to discover whether the different resources of the economy have been allocated optimally.
- It may be useful to some of us to know that the science of economics which at one time was considered to be essentially a **British Science**, has Strikingly during the las three or four decades, emerged as an **American Science**.
- It does not, however, mean that Britain has not produced any modern economic thinker during this period. Rather the **British economists** remained engaged in fruitless controversies, mostly on academic type.
- Even in Cambridge, the home of Keynes, interest in Keynesian economics was not welcome, and the Cambridge school remained engaged in the ideal controversy with the London school of economics about the last Versions of Austrian Economics
- But, in United States the ‘New economics’ found a congenial home and once it took roots it engaged the attention of almost every serious-**minded economist** in the universities and research institutions all over the country.

6.2 The Emergence of Econometrics as the Sister Discipline of Economics

- 📖 The ‘second stage’ in the development of numeracy in economics, which haes from the founding in 1883 of the Statistical Section of the British Association for the Advancement of Science and the Statistical Society of London, focused on data collection and statistics for the purpose of establishing ‘correct views’ about the moral sciences and their relationship to the physical sciences.
- 📖 Some thinkers, **William Stanley Jevons** among them, believed that the science of Political Economy ‘might gradually be erected into an exact science.’

- ▣ He became an avid student of commercial fluctuations in search of laws that governed seasonal and cyclical variations by linking them to meteorological changes, but his enthusiasms were not widely shared.
- ▣ So that British economists disassociated themselves from the notion of utility as a measurable magnitude
- ▣ Jevons' views on the prospective role of inductive research in economics failed to dominate, because many contemporaries were of the opinion that, as a moral science, economics is inherently deductive.
- ▣ By the mid-1920s, the **deductive method** had long since become the accepted mode of inquiry for discovering laws relating to the behavior of market phenomena. There was little concern about reinforcing deductive analysis with empiricism beyond the casual sort.
- ▣ Marshall's Principles and his strong reservations about the application of mathematical methods to economics influenced most economists to teach deductive analysis to their students and relied on it for their own work. Thus, Mathematics and statistics existed as disciplines that remained quite separate from economics.
- ▣ Concern about cyclical phenomena and the usefulness of the **ex-ante ex post** construct of the **Stockholm School** are among the intellectual breakthroughs of the period
- ▣ Unlike the neoclassical concept of equilibrium, which focused on the requisites for an **economy's return to stability**, the ex-ante ex- post construct offered a way of conceiving of an economy in the process of changing from one phase of the business cycle to another.
- ▣ Once suggested, this idea implied the need to invent a method to evaluate the relative merits of one plausible cycle theory as opposed to another equally plausible theory
- ▣ League of Nations, which commissioned Jan Tinbergen, a Dutch scholar, to evaluate their relative merits empirically. Jointly, with the Norwegian Ragnar Frisch, he became the 1969 recipient of the Nobel Prize in economics.
- ▣ Tinbergen's 1939 statistical verification of alternative business cycle theories, which pioneered the method of least squares and regression analysis, marks the beginning of econometrics as the sister discipline of economics.
- ▣ It also marks the beginning of the **third and present stage of numeracy**, in which economics has emerged as a **predictive rather than as a moral science**.

- ▣ Econometrics is the branch of economics that is concerned with establishing empirical content into economic relations. The term, which is a combination of the words economics and metrics (from the Greek metron, which means ‘measurement’) was apparently coined by **Ragnar Frisch, one of the founders of the Econometrics Society in 1930.**
- ▣ More precisely, econometrics is concerned with ‘the quantitative analysis of actual economic phenomena based on the concurrent development of theory and observation, related by appropriate methods of inference.
- ▣ Modern-day quantitative analysis is clearly dependent on computer technology
- ▣ The computer technology advances since the 1950s are thus among the reasons why econometrics has not only flourished as a separate discipline, but has in fact become ‘the existing methodology of economics.
- ▣ While the lack of technology for processing large quantities of data was a central reason why econometrics as a separate field dates only from the 1950s, there are other reasons, especially in view of the fact that many nineteenth- and early twentieth- century contributors to economics they were fearful that the very precision of mathematics and statistics would give the impression of exactness to economic conclusions, which they regarded as unwarranted.

European influences:

a) The anticipations of Ragnar Frisch

- Ragnar Frisch (1895–1973) came into economics via the University of Oslo where he earned a degree in mathematical statistics in 1926.
- The Great Depression encouraged his interest in social planning and economic dynamics.
- The latter interests led him to propose that economists use the terms static and dynamic
- He described a relation as static if the variables it includes relate to a single point in time. Analogously, a relation whose variables relate to different points in time is dynamic.
- He concluded that, in and of itself, the acceleration principle is unable to explain the turning points of business cycles and demonstrated that, by including a replacement demand for investment goods into the relation
- Accelerator principle is the principle that a change in consumer demand will have an even greater percentage change on the demand for capital goods, so that firms produce more of a

commodity when demand is rising and less when demand is falling. This has the effect of exaggerating booms and depressions in the economy. Also called **acceleration principle**

- What he found is that the interaction of consumption and investment magnitudes could simulate various 'paths' for the economy: monotonic oscillatory, damped or explosive.
- Thus, he inferred that the phenomenon of the business cycles requires an exogenous impulse mechanism to put it into motion and sustain it.
- Ragnar Frisch's formulation of mathematical laws of the economy's cyclical behavior represents something of a 'bridge' between the second and third stages of the development of measurement and quantification techniques in economics.
- Frisch thus envisioned the possibility of establishing economics **as a predictive science**, thereby anticipating the subsequent marriage of **regression analysis and general equilibrium theory** as the essential building blocks for the present stage of econometric model

b) **Keynes on the laws of probability and Tinbergen's business-cycle study:**

- Tinbergen maintained that it is possible, in principle, to predict changes in the system on the basis of the equations that describe its logical structure.
- These relationships may also be represented as a system of equations in which each equation expresses how changes in one variable cause changes in other variables
- But long before he was asked to review Tinbergen's statistical analysis of business cycles, Keynes had already studied the usefulness of mathematical probabilities for addressing questions arising in the so called moral sciences, economics and psychology
- Keynes had taken the position that prediction of human behavior and events cannot be successfully addressed by means of the principles of probability.
- Among those who also addressed the problem of business-cycle prediction, no one came closer than **Oskar Morgenstern** to sharing Keynes's view.
- Specifically he addressed the problem of predicting the behavior of economic variables that derives from the interdependence among market participants.
- He recognized that economics is concerned with **live variables rather than with dead variables** such as are encountered in nature. He argued that prediction is only possible when '**dead**' variables are involved.

- When **live variables** are in operation, the matter is conceptually different, because these represent the wills of other persons that may impact on another's behavior and thereby influence predicted events.
- His famous '**Sherlock Holmes-Moriarity**' example (inspired by the exploits of Conan Doyle's fictional detective and his equally clever, but criminal, arch rival) illustrated why the premise that either man would outthink the other is untenable and made it clear that the problem posed when human beings interact is, necessarily, one of strategy.
- That is, a new action by either party not only changes the outcome, but also the scenario for future actions. Morgenstern was, therefore, doubtful about the possibility for successful forecasting.
- He argued
 - (1) That the use of economic theory and statistics\for the purpose of forecasting is impossible in principle and
 - (2) That even if a technique for forecasting can be developed, it would not be applicable in actual situations (i.e. the forecast would itself alter the outcome)

c) **John von Neumann and game theory**

- ✧ His paper identified, in principle, the possibility that interacting parties can achieve mutually compatible maxima (or minima).
- ✧ The winner-take-all outcome of a two-person game is not the only outcome if the possibilities envisioned are allowed to be more complex than the either/or outcome of '**Holmes arrests Moriarity**' or '**Moriarity escapes.**'
- ✧ Such games as 'Treasure Hunt' or 'Bridge' readily envision outcomes in which the skill (and luck) of the participants result in a 'saddle point,' or a division of treasure or tricks; that is, a minimax (least loss) or a maximin (least gain) outcome
- ✧ Von Neumann's approach was thus the key to solving the puzzle of the indeterminate two-person game and led to the **later collaboration** on The Theory of Games and Economic Behavior.

d) **The Haavelmo Contribution: stochastic models**

- ✧ Although systems of equations can be used to express interdependencies among variables, identification of causal relationships is complicated by the fact that while certain elements are constant throughout the period of observation, others are changing.
- ✧ The changing element reflects the influence of unknown variables whose precise effect is, as Morgenstern and Keynes both argued, unpredictable.
- ✧ His argument was that the gap between the **exactness of a theory and the necessarily compromised accuracy of observational fact** can be bridged by evaluating measurement errors in terms of probability laws.
- ✧ By properly specifying a stochastic (or probabilistic) model, the admissible set of values can be identified and weighted.
- ✧ In sense, what Haavelmo proposed is thus the statistical counterpart of simultaneous equations of the **Walras-Pareto type**
- ✧ His method, for which he was honored as a Nobel laureate in economics in 1989.

e) **The Cowles Commission**

- ✧ Alfred Cowles founded the research institution bearing his name in 1932 after the stock market crash of 1929 and the depression that followed called attention to the information gap as it relates to stock prices.
- ✧ Shortly afterward, the Cowles Commission became associated with the Econometric Society, which was organized in 1930 by a small group of academics— among them Irving Fisher, who was the Society’s first president, Ragnar Frisch and Charles Roos.
- ✧ The quality of their research work, established a base for a ‘university in exile’ as refugee scholars fled the Nazis
- ✧ After Cowles moved his business headquarters to Chicago in 1939.
- ✧ The move to Chicago marked the beginning of financial support by the Rockefeller Foundation, the National Bureau of Economic Research, the Social Science Research Committee of the University of Chicago, and various sponsors in Canada and Europe.
- ✧ The theory and practice of resource allocation became an important research focus of the Cowles Commission during the war years

- ❖ **Tjallingis Koopmans**, a physicist who was also a former **Tinbergen** student, who had worked with the British-American Combined Shipping Adjustment Board, studying merchant shipping problems during World War II
- ❖ This work provided the foundation for the subsequent development of activity analysis, or linear programming, after he joined the Cowles Commission in 1944.

6.3 The Monetarists: The Reformation of the Quantity Theory of Money

- ✚ We have quantity theory of money;
 1. The Fisherian quantity theory of money
 2. The Cambridge quantity theory of money
 3. The restatement of quantity theory by Milton Friedman
- ✚ Early development of monetarism centered on redefining the quantity theory of money in the light of Keynes' attack.
- ✚ The Fisherian quantity theory of money stated with stable Velocity of money, $MV=PT$, using the First proposition & with stable velocity means not only that changes in “M” will cause changes in “PT” but also that only changes in “M” can change “PT”.
- ✚ The mathematics of quantity theory may be clear from Fisherian equation but what about the economics? How do changes in the money supply affect the price level? This question can be answered more easily after considering another variant of the quantity theory; the Cambridge approach.
- ✚ The Cambridge approach by A. Marshall stated that money held (demanded) in the anticipation of daily transaction and to meet unexpected obligations & A.C. Pigou stated that **“currency held in the hand yields no income”**
- ✚ So money will be held only insofar as its yield in terms of convenient & security outweighs the income lost from not investing it in productive activity or satisfaction lost by not simply using the money to purchase goods to consume.
- ✚ On these criteria, how much money will it will be optimal to hold?
- ✚ Marshall and the other Cambridge economists assumed that the demand for money would be proportional of nominal income;

$$M^d = kPY$$

📖 Where “k” is the payment habit of the society which assumed to be stable.

- Given exogenous money supply (M), at equilibrium;

$$M = M^d = kPY$$

$$M = kPY$$

$$M \frac{1}{k} = PY \text{ where, } V = \frac{1}{k}$$

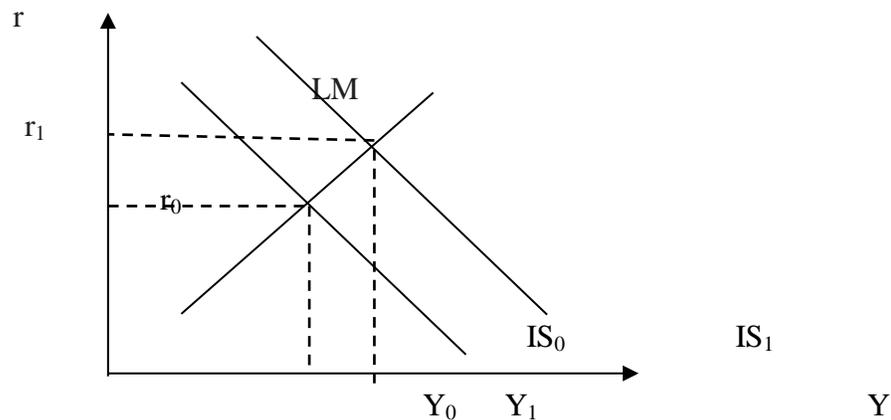
$$MV = PY$$

- For example if the individual want to hold one fourth of his nominal income, the velocity of transaction of money will be four

Money and the Early Keynesians:

- In the Keynesian system money was one of the important determinants of economic activity.
- In Keynesian system, Velocity was not constant or independently determined. It is systematically determined within the system.

Graphically;



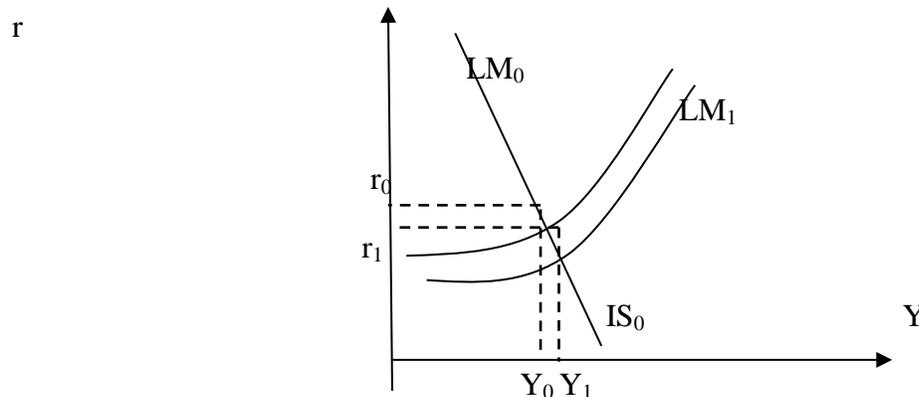
Fig; effects of an increase in Government spending through Bond selling; The Keynesian View

- From the graph;
 - Hence “G” financed by selling Bond
 - The increase in income ($Y_0 \rightarrow Y_1$) causes a higher transactions demand for money with constant money supply.
 - Bringing money demand back to equality with the unchanged money supply requires a rise interest rate from $r_0 \rightarrow r_1$ (decreasing speculative demand for money)
 - Hence velocity varies positively with interest rate and the same money supply can support the increased income.

- Hence for Keynesian, Velocity of money is not stable. But this does not mean money is unimportant for Keynesian.
- **But many early Keynesians believe money was a liitle importance due to the 1930's situation of IS-LM curve.**

✚ In 1930's;

- LM was quite flat (high interest elasticity of money demand)(liquidity trap)
- IS was quite steep (low interest elasticity of investment demand)
- Due to the above two factors early Keynesians concluded that money was unimportant
- Graphically;



Fig; Early Keynesian View of Monetary policy ineffectiveness:

✚ Illustrations:

- Increase in money supply shift LM to the right which reduces “r” to “r₁”
- Since “IS” is steep and insensitive to change in “r”, “Y” increases by a smaller amount.
- For early Keynesians the Money demand is highly unstable due to the liquidity trap.

Freidman's Restatement of the quantity Theory:

❖ Freidman

- Did not deny the fallacy of full employment by classical (wage adjust quickly)
- But he believed that the Keynesians wrongly concluded that the depression disproved the quantity theory of money.
- Contrary to Keynes, he believed that demand for money was stable.
- Contrary to Keynes, he maintained interest elasticity of money demand was not infinite (near liquidity trap) rather small.
- The quantity of money, far from being unimportant, was the dominant influence on the level of economic activity
- Conclusion rest on Restatement of the quantity theory of money
- He restated the quantity theory of money in the light of Cambridge approach and Keynes' theory of money demand (the Three motives):
- Friedman Money demand can be written as;

$$M^d = L(P, Y, r_B, r_E, r_D)$$

☞ Where p= price

Y=income

r_B =Nominal interest rate on bond

r_E = Nominal returns on equities (shares)

r_D = Nominal returns on durable goods (land & Houses) inversely related to money demand

- Thus, the demand for money is a demand for real balances as a function of real variables.
- **Quantity theorists maintain that the demand for money (in real terms) is highly stable** and are satisfied that there is empirical evidence to verify this hypothesis.
- **Philip Cagan's** study, in particular, identified the stability of the real demand for money with his finding that changes in the rate of change of prices affect the nominal quantity of money demanded. The higher the rate of change of prices, the

lower will be the nominal quantity of money held because it makes alternative forms of holding wealth more attractive.

- ❖ Freidman's theory differ from the Keynes in several aspects;
 1. Stability of money demand, Keynes maintained instability of money demand due to change in public confidence in the economy
 2. Freidman does not separate the demand for money in 3 motives.
 3. Freidman includes separate yields for bonds, equities, and durable goods while Keynes only considered assets as money & bond.

❖ Hence Freidman money demand;

$$M^d = k(r_B, r_E, r_D)PY$$

- ❖ Where instead of a constant "k" we now have "k" a function of the rates of return on the alternative assets.
- ❖ A rise in the rate of returns on any of these alternative assets would cause "k" to fall.
- ❖ Now how the Re-stated (Freidman) differ from Keynesians?
 1. Money demand is stable
 2. Demand function plays an important role in determining the level of economic activity
 3. Quantity of money strongly affect by money supply factors.

$$\text{Hence; } M = M^d = k(r_B, r_E, r_D)PY$$

- ❖ Now given stable money demand, increase in money supply has to be balanced either;
 - A rise in "PY" or, decline in (r_B, r_E, r_D) or
 - A rise in "k"
- ❖ Hence changes in the quantity of money are important in determining nominal income (PY) (from $M \rightarrow PY$)
- ❖ Unlike early Keynesians, for Freidman LM is nearly vertical and IS is quite flatter which make monetary policy more effective than that of fiscal policy.

6.4 The Development of Modern Macroeconomic Thought:

(The Rise of New Classical Economics & Keynesian Responses to the New Classicals)

a) **The New Classical Economics: rational expectations:**

- The thinking that underlies the concept of a vertical Phillips curve is attributable chiefly to Milton Friedman who provided the essential foundation for what is today identified as the New Classical Economics.
- Its starting point, as it relates to the behavior of the labor market, is that workers (and employers) respond to expected (rather than current) real wages.
- The premise is that workers have ‘rational expectations’ about what wage and price levels are likely to be.
- While individual workers are likely to err in their expectations about rising or falling future price levels, these errors are likely to cancel out; it can thus be assumed that workers in the aggregate are able to anticipate inflation or deflation.
- Within this framework of inquiry, the phenomenon of unemployment (i.e. joblessness among persons who want to work at prevailing real wage levels) is attributable to the failure of the unemployed to forecast the rate of inflation correctly, which leads them to refuse jobs they would normally accept.
- Without a sufficient number of unemployed workers with suitable job skills, employers will have to offer higher nominal (or money) wages.
- New Classical theory argues that workers will interpret higher wage offers as representing higher real wages, not having a reason to anticipate a rise in commodity prices over the period of their wage contracts.
- Yet, employers will pass the costs of rising wages along to consumers as higher commodity prices so that, in fact, workers are not receiving higher real wages. Nor will they be ‘fooled’ into thinking they are better off.
- Proponents of the natural rate hypothesis believe that the Phillips curve is resistant to policy measures to reduce the unemployment rate, except in the short run.
- Such measures are viewed as **self-defeating**, because they are anticipated by workers and by the public generally, which acts to circumvent policy outcomes.
- The view that the Phillips curve is vertical in the long-run pertains to thinkers who **favor laissez-faire free market** outcomes.

b) **The Keynesians Counter Critique:**

- Major areas in which Keynesians have raised objections to the new Classical view are;
 - I. The question of Persistence
 - II. The extreme informational assumption of Rational Expectations
 - III. Auction Market Versus contractual Views of the Labor Market

The question of Persistence:

- We saw that new classical, with the concept of rational expectation, could explain deviation from potential output.
- We also saw that how employment & output restated to the initial point.
- But how can the model explain the movement of the unemployment rate during the deep & prolonged recessions of the mid 1970's and early 1980's and 2007-2009?
- New classicals answer this by saying it takes time before such declines are reversed.
- Firms that have already cut outputs will not find it optimal to restore production immediately because of cost of adjusting output.
- On the labor supply side, workers who have become unemployed will not find it optimal to take the first job offer rather search for the best opportunities
- Hence this is all adjustment lag for new classicals for the prolonged unemployment of 1970's & the other years.
- But Keynesians asserted that for how long the Adjustment lag & **Modigliani** states what happened to United States in 1930's was a sever attack of contagious **laziness**.

The Extreme Informational Assumption of Rational expectation:

- Keynesians Accepted the new classical Criticism of Backward expectation of prices
- But Keynesians states that rational expectation put economic agents are **unrealistically sophisticated forecasters**.
- Kenyans criticize the assumption that individual use all the available information to forecast about the future.
- Such assumption ignores cost of gathering information
- In rational expectations individuals also uses information intelligently & they are also able to understand the systematic response pattern of policy makers.

- It means if a policy maker increases money supply, agents know what will come next due to rational expectation.
- For Keynesians such Rational expectation might be realistic in the long-run
- But in the short-run cost of gathering information are high
- Now if expectations are not Rational, there is a role for aggregate demand management to stabilize output & employment.
- If private sector aggregate demand is unstable, Keynesians believe it is, a stabilization policy needed.
- Keynesians regarded the rational expectation assumption as reasonably correct when applied to policy makers
- For Keynesians rational expectations (new classicals) **are long run models like classicals.**
- New classicals defend Rational expectation by saying all theories or models are unrealistic rather simplified
- New classicals favored rational expectation rather than price expectation based only on the past history of prices.

Auction Market Vs contractual Views of labor Market:

- ❖ New classicals and classicals assumed money wage adjust quickly to clear labor market. This is Auction Market characterization.
- ❖ In contrast, in the Keynesian contractual View of labor market, **“wages are not set to clear markets in the short-run”**
- ❖ In the Keynesian labor Market;
 - ✓ Money wage is Sticky in the downward direction
“Labor Market functions more by the invisible handshake than the invisible hand of a competitive Market Mechanism”
 - _____ Arthur Okun
 - ✓ A decline in the aggregate demands results reduction in employment than fall in money wage.
 - ✓ Hence such relation fix money wage, while leaving the employer to adjust hours of work.

- ✓ This explains the money wage stickiness
- ❖ New classicals deny this money wage stickiness by saying, if money wage specified is too high to maintain the market clearing level of employment, workers could give up other provisions in the contract & in extreme cases allow revision of the wage in some fashion.

Conclusions:

- ✎ On the theoretical level, new classical economists question the soundness of the Keynesian model, arguing that many of its relationships are not finally based on **individual optimizing behavior**.
- ✎ They criticize Keynesians wage stickiness and consequent involuntary unemployment
- ✎ They argue at non-interventionist policy conclusions due to rational expectations.
- ✎ Keynesians attacked them on several ground;
 - I. The question of persistence: prolonged unemployment
 - II. The unrealistic assumption of rational expectations
 - III. The wage stickiness

6.5 The Development of Modern Microeconomic Theory

The Chicago approach to Microeconomics & Modern Microeconomics:

- The premise that individuals are capable of maximizing behavior in the markets in which they operate, whether as consumers, producers, savers, investors, workers, and/or employers, is the leitmotif of the tradition that has become associated with the Chicago School of economics.
- Chicago economists are, first and foremost, advocates of an individualistic market economy.
- Indeed, they are sometimes referred to as ‘the Chicago school of libertarian economists.
- The Chicago economists unlike the other Market Oriented economists;
 1. They do not necessarily believe that individual liberty (political as well as economic) cannot exist outside a free enterprise system or that a free-enterprise system is more productive than any other.
 2. Their beliefs that the market economy is characterized by commodity prices and wage rates that are, by and large, flexible.

3. Chicago economists tend to be less concerned with, and give less weight than others to, the implications of oligopoly and labor unions largely because they maintain that these do not significantly alter the essentially competitive nature of the economy.
 4. Their concern with questions relating to the distribution of income and wealth is similarly limited.
- On the positive side, Chicagoans are committed to the usefulness and relevance of a theory of individual choice based on the assumption that sovereign consumers are capable of engaging in ‘maximizing behavior’ in their economic activity.
 - They have brought an impressive range of problems within the purview of the economist. Among those, particular mention may be made of the **economics of education, of crime, marriage contracts, birth rates, and the behavior of voters**, which have traditionally been viewed as lying outside the scope of economics.
 - There are thus substantial differences in focus among individual Chicagoans.
 - Milton Friedman and others concerned chiefly with **the price level and monetary economics** should be identified separately from **Gary Becker, Jacob Mincer, Ronald Coase**, and others who are chiefly concerned with problems of **allocative efficiency**. The latter are chiefly responsible for the development of the **new microeconomics**.
 - Since the monetarist concerns of Friedman and others were examined in the preceding chapter, this chapter will focus chiefly on the concerns of Becker, Mincer, Coase, et al. That is,
 1. The problem of allocative efficiency with respect to using the time and income resources of the individual household,
 2. Allocative efficiency in market activities that involves common property,
 3. The role of the market mechanism in promoting economic growth in less developed countries and
 4. The nature and role of property rights.

a) *The Menger-Knight heritage: The utility principle*

- The microeconomic propositions formulated and subjected to empirical testing by modern Chicagoans build chiefly on the work of **Carl Menger** as interpreted and transmitted by **Frank Knight**.
- Their analyses proceed from the premise that choice is governed by individual perceptions of the utility associated with alternative courses of action.
- Following Menger, Knight maintained that the relevant cost of any economic decision is the utility of the alternatives sacrificed. No resource has any value other than that imputed to it by the consumer.
- Knight's commitment to Menger's utility principle became the basis for his defense of the concept of '**economic man**' which, in turn, became fundamental to his defense of neoclassicism.
- Its assumption is that the material aspects of an individual's life conditions behavior so as to maximize gains, both as a consumer of goods and services and as a producer.
- He reasons that economic activity is simply a matter of maximizing producer and consumer gains.
- Knight therefore rejected Veblen's argument that consumer sovereignty is destroyed because people are conditioned to imitate the consumption patterns of the financially well-to-do. Hence, Knight believes in **consumer sovereignty based on the concept of Economic Man**.
- Not only is the consumer sovereign, but, according to Knight, the producer who, in an uncertain world, correctly anticipates what forms of production are most likely to find favor with consumers will be rewarded with profits that arise as a residual after contractual obligations have been met.
- **Profit is the return for bearing uncertainty:** there is no assurance that sovereign consumers will actually purchase what has been produced.

- Modern writers in the Chicago tradition have built on this Menger-Knight perspective of the relationship between utility and cost (i.e. the cost of any choice is the utility lost in choosing one alternative rather than another)
- An impressive range of topics traditionally examined by sociologists or psychologists has come within their scope of analysis.
- Using the framework provided by economic theory, the ‘new microeconomics’ has examined **such topics as**;
 - The allocation of time to education and training as investment in human capital,
 - The rearing of children, criminal behavior as an alternative to market behavior, and
 - The choice among sexual partners.
- The modern micro economists’ emphasis on time as a scarce allocable input reflects, it should be noted, a different conception of time than the Marshallian one that relates to processes maturing through time.

b) Courtship and marriage:

- Studies of the family and the relationships among its members are generally considered to lie in the intellectual domain of sociologists and social psychologists.
- Chicagoans have chosen to ignore this traditional division of intellectual labor and made the family unit the focal point of analysis.
- Viewed in this light, the family is a producing unit. It is, in effect, a firm, which utilizes time and other resources at its disposal to produce the utilities desired by family members.
- Within this analytical framework, marriage is identified as a contract in which the parties have made commitments with respect to the time each will allocate to market and non-market activity, including housework, further schooling and training, leisure, and the bearing and rearing of children.

- Thus, **Becker** conceives of dating and engagement as providing opportunities for couples to work out ‘the rules of the game’ and arrive at the contractual arrangement under which they will live their life together.
- According to this line of reasoning, the **search for a marriage partner is extended until the expected marginal benefit is equal to the marginal cost.**
- **Courtship is, in this sense, an investment process expected to eventuate into the flow of returns associated with marriage.** It produces a flow of returns or benefits in the form of goods and services that the family desires and that ‘mature out’ over the expected life of the marriage contract. Some economists include children among these goods.
- The net benefit of the marriage relationship reflects the difference between the flow of the benefits it yields and the costs it imposes.
- Improved efficiency in the production of wanted goods and services as a result of specialization and division of labor in the household and trade among family members is a major benefit. A chief cost, which is among several that must be evaluated in order to assess the net return from a family relationship, is that associated with joint decision making.
- In general, it is more costly to make a decision when the preferences of both parties need to be taken into account. These costs tend to increase directly with **the number of family members** (i.e. older children) and the extent of their participation in the process of decision making and production
- The analytical framework of the family unit has also been used to examine the allocation of time by family members between works in the home and work in the market.
- One of its implications is that the traditional female role of homemaking and caring for children is not wholly dictated by socially determined values.
- These do play a role, but the chief determinant is the relative value of the labor time of men and women in the market place. The cost of a woman’s time in the performance of household and child-care duties is the wage she loses by remaining outside the market.

- Since men typically command higher wages than their partners (either because they are more productive or they experience less discrimination), having men engage in market activity while women work in the home minimizes the household's cost of producing the goods it wants.

c) **Child production:**

- Extensive work by **Gary Becker, and others at the National Bureau of Economic Research**, has contributed significantly toward reaffirming the economists' interest in demographic questions.
- Thus, he has suggested that, from the standpoint of economics, children might be considered as consumer goods that, in common with other commodities, yield satisfactions but can be **acquired only at a price**.
- The price of children consists of the time and goods sacrificed in bearing and rearing them.
- There are **direct costs** congealed in the prices of goods and services associated with their birth and nurture, and the additional indirect cost of the time parents spend with their children.
- Assuming that the care **of children falls largely on the mother**, the price of the mother's time is a major component of the overall price of children.
- From this, it may be inferred that an increase in female wage rates or fringe benefits raises the price of children and thus potentially reduces the demand for them.
- By the same reasoning, and assuming **that children are not inferior goods**, the demand for them is, presumably, positively related to income.
- This logic has provided a basis for the hypothesis that each level of satisfaction a household can achieve, given its income, is compatible with various **combinations of children and other goods among which the household is indifferent**.

- Attitudes about having children are so traditional that the very suggestion of a **trade-off between children and goods is unfamiliar** and perhaps even repugnant.
- However, it is precisely the objective of the new microeconomics to demonstrate that the usual assumption of rationality with respect to household decision making applies to all aspects of household behavior, including family planning.
- It is the view of the new micro economists that the rationality assumption implies nothing more than that children may be viewed as sources of satisfaction (or **psychic income**) and that the household responds to economic variables (i.e. **prices and incomes**) in making its choices.

d) **The Chicago view of developing economies:**

- ✧ Chicago economists have also had a particular interest in the economics of underdeveloped countries.
- ✧ A major influence in shaping their perspective was the recognition that economic growth cannot be wholly explained in terms of additions to an economy's stock of physical capital and number of workers.
- ✧ The residual, which is the name given to that portion of growth not accounted for by increases in the stock of physical capital and increases in the labor force, has been attributed in part to technical progress and in part to **improvements in human capital**.
- ✧ A major study undertaken by **Theodore W. Schultz** focused on identifying the portion of investment in human capital represented by education.
- ✧ The Chicago school's view of human nature as being universally responsive to market incentives.
- ✧ Many economists take the position that market-oriented behavior is limited to capitalistic economies in which work habits and entrepreneurial activity have traditionally experienced the spur of monetary rewards.

- ✪ Chicagoans, however, maintain that while people in underdeveloped countries are often viewed as strangers to the idea of maximizing gains, there is evidence that the supply of effort is responsive to the incentive of improved rates of remuneration and that wants are elastic through time in large parts of the underdeveloped world.
- ✪ The basis for the Chicago view that the market mechanism can stimulate efficiency and growth in an underdeveloped economy more effectively than the alternative policy of governmental planning as an instrument of economic development.
- ✪ ‘What is required in underdeveloped countries is the release of the energies of millions of able, active, and vigorous people...an atmosphere of freedom, of maximum opportunity for people to experiment, and of incentive for them to do so in an environment in which there are objective tests of success and failure—in short a vigorous, free capitalistic market.’
- ✪ The necessity for encouraging the emergence of ‘**entrepreneurial personalities**’ in underdeveloped countries is a matter of special concern to Chicagoans.
- ✪ Assuming the distribution of entrepreneurially talented people is approximately the same in developed and in underdeveloped countries, they emphasize the need for underdeveloped countries to provide a social **environment that does not militate against development and contributes in a positive way to its realization.**
- ✪ Thus, they urge government to facilitate private investment by supplying information and data not generally available to individual entrepreneurs. Education, free elections, and nationwide communication services are regarded as especially useful for opening up an otherwise closed society.

e) **The property rights approach to pricing and the Coase Theorem:**

- 📌 Property rights are the legally sanctioned relations among persons (and businesses) that arise from the existence and utilization of scarce resources.
- 📌 A leading modern proponent of the property rights approach conceives of economics as ‘the study of property rights over scarce resources.’

- ❖ The question of economics, or of how prices should be determined, is the question of how property rights should be defined and exchanged, and on what terms.’
- ❖ Chicagoans thus promote law and economics as the leading interdisciplinary field of the social sciences.
- ❖ **R.H. Coase’s** now classic article, ‘the problem of social costs,’ has given this interdisciplinary effort direction, and The Journal of Law and Economics, which is published at the University of Chicago, provides a forum for research emanating from **Coase’s article**.
- ❖ The problem of **externalities** been a matter of continuing concern to economists. It will be recalled that **externalities** arise in production or consumption when the activities of one party generate costs (or benefits) for a second party for which the first party is not compensated (or for which there is no payment).
- ❖ Coase notes that **the courts** have been called on many times to determine what is an appropriate action in particular cases in which damages have been inflicted as a result of what the economists call externalities. In Coase’s view, their findings have an implication for the economists’ concept of factors of production.
- ❖ When property rights are assigned factors of production there is necessarily **a reciprocal denial** of others from using it.
- ❖ The assignment of property rights is interpreted by Coase as providing insight into the way in which parties engaged in conflicting activities can resolve their differences without **outside intervention**.
- ❖ There are several arrangements by which externalities can be ‘internalized.’
- ❖ **For example**, the parties might make an agreement according to which the damaged party (A) pays the party inflicting the damage (B) to modify its activities. Or, if B has a legal right against A, A might pay B for putting up with an optimal amount of the loss it is causing B to experience. Thus, the Coase theorem proceeds from the rational two party bargains, which is shown as capable of capturing economic efficiency **without social interference**.

Self-Exercises

1. Contrast the major tenets of the Chicago school with those of the Marginalist school and the institutionalist school?
2. Does the Chicago school (**Courtship and Child production**) apply in the context of Ethiopia?