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DEPARTMENT OF ECONOMICS

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“HISTORY OF ECONOMIC THOUGHT II”
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MODULE DESCRIPTION

History of Economic Thought II mainly deals with economic theories and School of thoughts that have developed after Classical School of thought. This course is mainly about the major families of thought namely Neoclassical, Institutional school and the other non-Marxian heterodox economic thoughts, Keynesian school and their most recent reformulations and reinterpretations.

MODULE OBJECTIVE

The main objective of this module is not provision of where, how and what a given economist brought in to the field of economics but mainly to provide students with a broader understanding of contemporary economic theories through a critical analysis of the main succeeding schools of thought beginning with the economic ideas of the ancient philosophers to those of recent economic thinkers.

The specific objectives are:

- ☞ To acquaint students with the creation and evolution of alternative school of thought
- ☞ To investigate the technological, ideological, and social forces that has influenced these schools of thought and the associated theories that were used to explain and analyzed particular choices.
- ☞ To encourage the discussion and study of how the rapidly changing events will alter society's and the student's perspective about economic relationships. What new economic theories will these altered perspectives encourage?
- ☞ To consider the impacts that alternative schools of thought have had on "main stream" economics
- ☞ To encourage the discussion and create brain storming environmental for students to forward their reflection freely.
- ☞ Above all to help students to see what is going on behind the scene of the Mainstream economics.

A GENERAL OVERVIEW

STRANGE AND TORRID LIVES:

This is a book about a handful of men with a curious claim to fame. By all the rules of schoolboy history books, they were nonentities: they command no armies, sent no men to their deaths, ruled no empires, and took little part in history in making decisions. A few of them achieved renown, but none was ever a national hero; a few were roundly abused. Yet what they did was more decisive for history than many acts of statesman's who basked in brighter glory, often more profoundly disturbing than the shuttling of armies back and forth across frontiers, more powerful for good and bad than the edicts of kings and legislatures. They shaped and swayed men's minds.

And because he who enlists a man's mind wields a power even greater than the sword and the scepter, few of them lifted a finger in action: they worked without much regard for what the world had to say about them. But they left in their train shattered empires and exploded continents; they set class against class and even nation against nation—not because they plotted mischief, because of the extraordinary power of their ideas.

Economics, it is said, is undeniably important, but it is cold and difficult, and best left to those who are at home in abstruse realms of thought. A man who thinks that economics is only a matter of professors forgets that this is the science that has sent man to the barricades. A man who has looked into an economist textbook and concluded that economics is boring is like a man who has read a primer on logistics and decided that the study of warfare must be dull.

Unlike the ideas of great philosophers, they did not make great difference to our daily working lives: the experiments they urged could not like the scientists be carried out in the isolation of a laboratory. The notions of the great economists were world-shaking, and their mistakes nothing short of calamitous.

“The ideas of economist and Great philosophers” by LORD KEYNES, himself a great economist, “both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economists. Madmen in authority, who hear voices in the air, are distilling their frenzy

from some academic scribbler of a few year back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas.

If economics today has a little glamour, if its sense of great adventure is often lacking, it has no one to blame but its own practitioners. For the great economists were no mere intellectual fustians. They took the whole world as their subject and portrayed that world in a dozen bold attitudes—angry, desperate, and hopeful.

Their viewpoints toward the world were as varied as their fortunes. One was a lifelong advocate women's right; another insisted that women were demonstrably inferior to men. One held that "gentlemen" were only barbarians in disguise; whereas another maintained that "non-gentlemen" were savages. One of them—who was very rich—urged the abolition of very rich; another—quite poor—disapproved of charity. They were all fascinated by the world about them, by its complexity and its seeming disorders. They were all of them absorbed in the behavior of their fellow man, first as he created material wealth, and then as he trod on the toes of his neighbor to gain a share of it.

Hence they can be called the worldly philosophers, for they sought to embrace in a scheme of philosophy the most worldly of man's activities—**his drive for wealth**. It is not, perhaps, the most elegant kind of philosophy, but there is no more intriguing or more important one. Who will look for order and design in pauper family and a speculator breathlessly awaiting ruin, or seek consistent laws and principles in mob marching in a street and a greengrocer smiling at his customers?

Once the economists had unfolded their patterns, the pauper and the speculator, the greengrocer and the mob were no longer incongruous actors inexplicably thrown together on a stage; but each is understood to play a role, happy or otherwise, that was essential for the advancement of human drama itself. When the economists were done, what had been only a humdrum or a chaotic world, become an ordered society with a meaningful life history of its own.

Yet our story is not just an account of conflicting ideas. It is also an amazing tale of idle dreamers, academic scribblers, occasional quacks, and madmen in authority. The lives of economists are often just as exciting and unusual (even bizarre) as those of most famous people.

In History of Economics, you will find the story of:

- A professor of moral philosophy who burned his clothes, then burned his papers before dying;
- A Cambridge economist who may have been a secret agent for the Soviet Union during World War II;
- A revolutionary who, though his income was in the top 5 percent in Europe constantly begged for money and speculated wildly in the stock market;
- A government advisor who was so fascinated with people's palms that he had casts made of his friend's hands;
- A multimillionaire who lost everything during the stock market crash of 1929;
- A wealthy economist who was murdered by his housekeeper;
- A utilitarian thinker who demanded that his preserved body remain on display at the University College of London;
- A free-market advocate who invented income tax withholding to help finance World War II;
- A multimillionaire broker who gave all his wealth to his only son, even though he had seven daughters;
- An economist who spent two months in jail, charged with blasphemy against the Virgin Mary;
- A philosopher who learned Greek at age three and suffered a mental breakdown at age twenty;
- A famous minister of finance who paraded around the streets of Vienna with two prostitutes and later became president of the American Economic Association;
- An American economist who refused to use a telephone, make his bed, do the dishes, or clean his clothes, and gave all his students the same grade, regardless of their work;
- A European professor who was determined not to use charts or graphs of any kind in his voluminous writings, and who was a confirmed bachelor until age fifty-seven.

It would be unfair to dismiss a philosopher's theories simply because he may have been a bad husband or a drunk. Ideas must stand on their own merit, not on the basis of who invented them. Yet we study and judge the actions of our heroes and villains, not just to prove or disprove their philosophies, but to better understand them, and why they said what they said.

CHAPTER ONE

THE MARGINALIST REVOLUTION

1.1 Overview of the Marginalist School

- ❖ Marginalism is a kind of revolution which was adopted in France and other western countries in 1870 for the first time. The year 1871 marked a turning point in the history of economic thoughts. It witnessed the rise of a new school of economic thought: the Marginalist school. About one hundred years after Adam Smith, Marginalism was well on its way to displacing classical economics.
- ❖ Marginalism reigned supreme in western economic thought until it was suddenly challenged by the Keynesian onslaught in 1936.
- ❖ Marginalism, having adapted itself to new ideas and new situations, has changed considerably from its earliest form. It is still the dominant school in microeconomics.
- ❖ The Marginalist school developed in several countries and through the efforts of different people working independently of each other at first. Prominent names associated with this initial development of this revolution are **Gossen, Jevons, Walras, and Menger**. More specifically, Marginalism developed in the hands of almost all prominent writers of Mathematical School and Austrian School. Among them Walras occupied *a pride of place*, as he enunciated the principle of marginal utility in 1874.
- ❖ The characteristic feature of the Marginalist school was the introduction of marginal analysis. The Marginalist approach was characterized by:
 - ✓ The use of mathematical tools- geometry, and differential and integral calculus
 - ✓ Its reasoning and notation were mathematical in nature.
 - ✓ The method of analysis was primarily deductive and abstract though Jevons is known for promoting the use of statistics and statistical tools also.
 - ✓ The analysis of this new group of economists was hedonistic in nature, making use of the concept utility and disutility.
 - ✓ They followed subjectivism which was nothing but a reaction against the objectivism of the classical writers. Subjectivism led the Marginalist revolution.
- ❖ In all these respects a “Marginalist Revolution” (or a great divide) is said to have come in 1870s. However, the Marginalists cannot claim to have come up with something suddenly.

- ❖ The traces of Marginalism and the tool of margin are found in the history of earlier economic thought also. Although the Marginalist revolution was admitted to be started in 1870's, Marginalists cannot claim that they were the original writers of this concept. The marks of Marginalism were also available in the early history of economic thought. Even Ricardo and others were aware of the concept of 'margin' and a number of thinkers came quite close to, say, the principles of diminishing marginal utility. Similarly, the law of diminishing return was known not only to Ricardo and Malthus but was a common feature in those days.
- ❖ Thus, the Marginalists had their predecessors. The only difference had been some lack in clarity on their part and a different kind of emphasis in choosing the relevant problems and variables. The Marginalists borrowed from the earlier economists a few starting principles like economic rationality, the techniques of equilibrium, etc.

In this chapter, we will develop an overview of the Marginalist school and discuss the ideas of these three forerunners and the writings of the individuals who brought the Marginalist school to prominence. This school eventually became part of neoclassical economics, or contemporary microeconomics

The Historical Background of the Marginalist School

Serious economic and social problems remained unsolved even a hundred years after the beginning of the industrial revolution. Poverty was widespread, although productivity was increasing dramatically. The extremely uneven distribution of wealth and income created much dissatisfaction even though the general standard of living was rising. Business fluctuations affected many people adversely; individuals could no longer depend exclusively on their own initiative and ability to overcome conditions that were thrust upon them. Farmers and farm laborers had their difficulties; many drifted into cities, lured by the carrot of better opportunities and driven by the club of rural poverty. Industrial accidents often brought serious hardships to workers and their families before adequate workers' compensation laws were enacted. Long hours of labor, dangerous and unhealthy working conditions, the preponderant economic power of employers in bargaining with workers, the rise of monopolistic enterprises, and insecurity in old age were among the many problems that caused people to seek solutions beyond the narrow confines of classical economic thinking.

The trend of the nineteenth century in Europe was to develop three approaches of attack on pressing social problems, and all three flouted classical economic precepts. These approaches were to promote socialism; to bolster trade unionism; or to demand government action to ameliorate conditions by regulating the economy, eliminating abuses, and redistributing income. The Marginalists opposed all three “solutions.” They theorized with seemingly Olympian impartiality and concluded that, although the value and distribution theories of the classical economists were inaccurate, their policy views were correct. The Marginalists defended market allocation and distribution, deplored government intervention, denounced socialism, and sought to discourage labor unionism as either ineffective or pernicious.

To the leading early Marginalists, classical value and distribution theories erred in seemingly concluding that land rent is an unearned income and that exchange value is based on the labor time involved in the production process. The first idea was seized and expanded by the American economist Henry George, the second by Karl Marx. If classical economics could be made to say what its creators never intended—namely, that rent is immoral and labor creates all value—then the science of economics was overdue for a thorough revision.

Major Tenets of the Marginalist School

The basic ideas of the Marginalist school are listed next and amplified later in the discussion of the forerunners and leading Marginalist economists.

- **Focus on the margin:** This school focused its attention on the point of change where decisions are made; in other words, on the margin. The Marginalists extended to all economic theory the marginal principle that Ricardo developed in his theory of rent.
- **Rational economic behavior:** The Marginalists assumed that people act rationally in balancing pleasures and pains, in measuring marginal utilities of different goods, and in balancing present against future needs. They also assumed that purposeful behavior is normal and typical and that random abnormalities will cancel each other out. The approach employed by the Marginalists had its roots in the works of Jeremy Bentham, in that they assumed the dominant drive of human action is to seek utility and avoid disutility (negative utility).

- **Microeconomic emphasis:** The individual person and firm take center stage in the Marginalist drama. Instead of considering the aggregate economy, or macroeconomics, the Marginalists considered individual decision making, market conditions for a single type of good, the output of specific firms, and so forth.
- **The use of the abstract, deductive method:** The Marginalists rejected the historical method in favor of the analytical, abstract approach pioneered by Ricardo and other classicists.
- **The pure competition emphasis:** The Marginalists normally based their analysis on the assumption of pure competition. This is the world of small, individualistic, independent entrepreneurs; numerous buyers; many sellers; homogeneous products; uniform prices; and no advertising. No one person or firm has enough economic power to influence market prices perceptibly. Individuals can adapt their own actions to demand, supply, and price as worked out in the market through the interactions of thousands of people. Each person is such a tiny operator relative to the size of the market that no one notices his or her presence or absence.
- **Demand-oriented price theory:** For the early Marginalists, demand became the primary force in price determination. The classical economist emphasized cost of production (supply) as the significant determinant of exchange value. The earliest Marginalists swung to the opposite extreme and emphasized demand to the virtual exclusion of supply. Alfred Marshall synthesized supply and demand into what may be called neoclassical economics. This type of economics is basically Marginalism with a judicious recognition of the surviving contributions of the classical school.
- **Emphasis on subjective utility:** According to Marginalists, demand depends on marginal utility, which is a subjective, psychological phenomenon. Costs of production include the sacrifices and irksomeness of working, managing a business, and saving money to form a capital fund.
- **Equilibrium approach:** The Marginalists believed that economic forces generally tend toward equilibrium- a balancing of opposing forces. Whenever disturbances cause dislocations, new movements toward equilibrium occur.

- **Merger of land with capital goods:** The Marginalists lumped land and capital resources together in their analysis and spoke of interest, rent, and profits as being the return to property resources. This had its advantages analytically and also combated the conclusion drawn by some that land rent is unearned income and an unnecessary payment in order to ensure the use of land. Marginalists generally coupled the reward to the landowner with interest theory.
- **Minimal government involvement:** The Marginalists continued the classical school's defense of minimal government involvement in the economy as the most desirable policy. In most cases, no interference with natural economic laws was in order if maximum social benefits were to be realized.

Whom Did the Marginalists Benefit or Seek to Benefit?

The Marginalists sought to advance the interest of all of humankind through promoting a better understanding of how a market system efficiently allocates resources and promotes economic liberty. To a great extent, the Marginalists succeeded in this goal. By showing that, under competitive circumstances, the pay received by workers would be equal to their contribution to the value of the output, the Marginalists helped counter the Marxian call for revolution by the proletariat.

But Marginalism- the economics of liberalism or political conservatism— also benefited those whose interests were simply in maintaining the status quo; that is, those who resisted change. This type of theory benefited employers (even though most of them did not really understand it) by opposing unions and by attributing unemployment to wages that were artificially high, inflexible on the downward side, or both. Marginalism also defended landowners against attacks based on Ricardian rent theory. This school also could be said to have benefited the wealthy, who generally opposed government intervention that might redistribute income.

How Was the Marginalist School Valid, Useful, or Correct in Its Time?

The Marginalist school developed new and powerful tools of analysis, especially geometric diagrams and mathematical techniques. Thanks to these thinkers, economics became a more exact social science. Conditions of demand were given their rightful importance as one set of determinants for prices of both final goods and factors of production. The school emphasized the

forces that shape individual decisions; this was valid in a world where such decisions were significant in determining the course of economic activities. The Marginalists' explicitly stated fundamental assumptions underlying economic analysis, as opposed to leaving them lurking in the background as did many of the classical economists. The methodological controversies that the Marginalists aroused resulted in a separation of objective and verifiable principles that are based on stated assumptions from those principles that depend on value judgments and philosophical outlook.

The method of partial equilibrium analysis championed by many members of this school was useful for abstracting from the complexity of the real world. This approach—allowing one variable at a time to change while holding all other variables temporarily constant—enabled the investigators to dissect complex phenomena one step at a time. The problems of the immensely complicated society with its countless variables was thereby simplified and penetrated in an orderly and systematic manner. As the Marginalists introduced successive variables, they eventually approached more realistic situations.

There is a certain virtue in not neglecting the individual economic unit or the small sectors of the economy; the microeconomic approach of Marginalism complements the macroeconomic approach, which may overlook many problems by viewing the economy as a whole. As examples, we cite the following: (1) certain groups of people may become increasingly impoverished, although average real per-capita income for the nation may be rising; (2) the business cycle is of prime importance to the profitability of a large automobile company, but to the owner of a convenience grocery store, the business cycle is relatively less important than the opening of a competing store down the street; (3) aggregate analysis tells us that investments in some forms of human capital (for example, college education) pay higher returns than some investments in physical capital; yet a banker may be justified in not lending money to an individual to go to college unless the government guarantees the loan. Clearly the microeconomic approach of Marginalism has an important place in economic theory.

Which Tenets of the Marginalist School Became Lasting Contributions?

Several tenets of the Marginalist school were subsequently challenged, and some were rejected. Keynes pointed to the alleged fallacy of composition associated with Marginalist and

neoclassical employment theory. If one firm were to cut wages, it could expand its market by selling more goods at lower prices. The decline in purchasing power among its own employees would not affect it, because they would normally buy only a negligible portion of its output. However, if all employers were to cut wages, they might find their markets shrinking rather than expanding. Also, critics argued that the assumption of pure competition was a reasonable abstraction looking backward from the 1870s, but it was too restrictive to be useful as competition declined after the 1870s. Today, pure competition can be found in only a few sectors of the economy.

The marginalist's view that the best government is the one that interferes the least became outdated as new events transpired and new economic theories developed. The analysis of these thinkers originally was static, timeless, and unsubstantiated with empirical evidence. There were few attempts at inductive verification of theories; in fact, hypotheses often were framed in ways that precluded testing. Business cycles were generally ignored in the firm conviction that supply creates its own demand and therefore that full employment is the rule. The school failed to explain economic growth, and its theory proved to be inadequate for slowly developing countries.

But despite these and other criticisms, many of the Marginalist theories remained relatively unscathed, as attested to by the fact that they can be found in contemporary textbooks on principles of economics and microeconomics. The school eventually was absorbed by the broader neoclassical school, which, together with variations of Keynesian macroeconomics, dominates economic analysis in Western countries and shares the international field with socialism. We will discover in the following discussion, and in the next chapter that follow, that these economists and their forerunners developed such lasting contributions as mathematical economics, the basic monopoly model, a theory of duopoly, the theory of diminishing marginal utility, the theory of rational consumer choice, the law of demand, the law of diminishing marginal returns as it applies to manufacturing enterprises, the concept of returns to scale, work-leisure choice analysis, the marginal productivity theory of factor returns, and so forth.

1.2 Forerunners of Marginalism

Among other Marginalist writers, we cannot forget the names of Cournot, Johann Von Thunen, Dupuit and so on, who also contributed to the development of the concept of 'Margin'. Besides this, Marginalism finds its comprehensive application in Marshallian economics. Throughout Marshallian approach the decision-making process is governed in view of margin.

I. Augustine Cournot (1801- 1877)

- ❖ Augustine Cournot was a French Mathematician, a student of probability theory and a philosopher. It was Cournot- an eminent French economist who for the first time made use of Mathematics in economic theories in 1838.
- ❖ In 1838 he published his principal work "Recherchessur les principes mathematique de la theorie des richesses" (Researches into the Mathematical principles of the Theory of Wealth), 1838. It was his misfortune that in spite of important contribution of this book, not a single copy of this was sold.
- ❖ In 1863, he recast the work, omitted the algebraic formulae and published it as "principes de la theorie des richesses". In 1876, he diluted it still further and published it. But even then the book did not become popular.
- ❖ He was an accomplished scholar in Mathematics and Philosophy and was interested in mathematical economics. Cournot was a great defender of mathematical method in economic science. To him the task of mathematics was not simply to handle the numerical data but to investigate the functional relationship between different variables.
- ❖ He started with an attempt to reconstruct economics in "pure" or mathematical terms which could yield economic laws of formal validity.
- ❖ Cournot did not bother with the features of utility; his concern was focused on demand functions directly which he considered to be deducible from empirical fact.
- ❖ He maintained that demand, costs and prices were functionally related.

- ❖ He was the first person to express the demand function in algebraic form as $D = f(P)$. Cournot was able to give us the usual demand functions represented as demand schedule and demand curves with a negative slope.
- ❖ Cournot was also the first to draw demand and supply functions, in price –quantity space.
- ❖ This, of course, was not all: in addition to demand functions, Cournot introduces the concept of marginal revenue, marginal cost, the concept of the profit maximizing firm, monopoly, duopoly, perfect competition, and of course, his famous “reaction functions”. But marginal utility were not in sight.
- ❖ He also gave us the golden rule that to the one where the marginal cost and marginal revenue are equal. This is, thus, extended to the case of perfect competition in stages and thus we get a complete theory of the firm under all market conditions.
- ❖ Cournot is well known for his solutions of the problem of duopoly in which two sellers are faced by numerous buyers. But it may be noted that Cournot here makes certain assumptions which are quite unrealistic- though logically quite valid and acceptable. He assume that each individual seller proceeds on the on the assumption that his rival`s output is constant and that rival will not react to the action taken by our seller.

II. John Heinrich Von Thunen (1783- 1850)

- He made use of marginal analysis/ principle in the theory of production, and showed how to measure marginal productivity of labor or capital and thus pointed out the way for its application to the theory of distribution.
- Thunen was able to provide us with the crude version of the law of variable proportions.
- He also tells us that maximum profitability position is attained when the value of the marginal product is equal to the marginal factor cost.

III. Arsene Jules Dupuit (1804 - 1866)

- ❖ He was a French Engineer.
- ❖ His work *De l'utiliteet de sa mesure* (on Utility and its Measures) appeared in 1853.
- ❖ Unlike Cournot, Dupuit did not rest his demand curve on empirical intuition but rather identified the demand curve as the marginal utility curve itself.
- ❖ Dupuit closely anticipates his followers in depicting diminishing marginal utility through graphs. Dupuit's basic idea was this: as quantity rises, the marginal utility of the goods declines. Consequently, one should also say that as the quantity rises, the willingness of a person to pay for that good declines. Thus, the concept of diminishing marginal utility should translate itself into a downward – sloping demand curve.

1.3 The Economics of Jevons and Menger

- ❖ The period from mid 1840s to 1873 was one of rapid economic expansion through most of Europe.
- ❖ Industrialization was taking place in continental Europe as well as USA.
- ❖ During this period, there also revolutionary changes in transportation and communication.
- ❖ Thus, the new form of capitalism was quite clearly by 1870's.
- ❖ During the early 1870's, three very famous economics texts were published;
 1. Jevons's "Theory of political economy" in 1871.
 2. Menger's "Principles of Economics" in 1871
 3. Leon Walras's "Elements of pure Economics" in 1872
- ❖ These economists formulated the version of utility theory of value that remains at the heart of "**neo-classical orthodoxy**" to this day.
- ❖ They were the first thinkers to provide a consistent theory of value within the general utilitarian perspective.
- ❖ The term Marginalist Revolution is commonly utilized to indicate:
 - A sudden change of direction in economic science.
 - Abandonment of the classical approach.
 - Shift to a new approach based on a subjective theory of value.

- ❖ The analytical notion of Marginal utility.
- ❖ Marginalism permitted the utilitarian version of human nature to be formulated in terms of **differential calculus** (mathematical formulation of economic theories)

William Stanley Jevons (1835-1882):

- ❖ He wrote on a wide variety of topics, ranging from **Methodology to logic to economics**.
- ❖ His most important work was his “**theory of political Economy**”
- ❖ In the preface to the theory, he stated that “**Bentham’s ideas . . . are . . . the starting point of the theory given in his work.**”
- ❖ He had no doubt that utilitarianism was the only possible foundation for scientific economic theory.
- ❖ The ultimate truth, according to him, was “**that the value depends entirely upon utility**”
- ❖ When Jevons uses the term value, he always meant simply **exchange value or price**.
- ❖ Thus, he was interested in prices. He restricted his economic analysis to **the sphere of circulation**, the market.
- ❖ When Jevons wrote of people, he **avoided** any real discussion of **social relations**.
- ❖ People, in Jevons view, had only two characteristics that defined them as economic agents;
 - 1) They derive utility from consuming commodities:
“Anything which an individual is found to desire . . . must be assumed to possess for him utility.”
 - 2) Every person was a rational, calculating maximize
“And rational, calculating, maximizing behavior was the only element of human action to be studied by Economics”
 . . . Jevons
- ❖ The error of previous economists, Jevons believed, lays in their failure to distinguish between the **total utility** (TU) and the **final degree of utility (what in later Neo-classical terminology Marginal utility)**.
- ❖ It was “the final degree of utility or MU” that concerned Jevons.

- ❖ By introducing the term **Marginalism** into utilitarian economics, he considers human beings as **Rational, calculating maximizers** that could be in mathematical terms.
- ❖ If the TU one received from consuming a commodity depends on the quantity consumed;
 - $TU=f(Q)$
 - $MU=f'(Q) \rightarrow$ first order derivative
 - $TU=\text{maximum} \rightarrow$ when $MU=0$
- ❖ When consumption involved costs let say for 2 commodities “X” & “Y”;
 - ✓ If $\frac{MU_x}{MU_y} > \frac{P_x}{P_y}$, then an individual could gain by trading some of his “Y” for some “X”
 - ✓ The process will continue until the individual had exhausted the gains from exchange i.e. $\frac{MU_x}{MU_y} = \frac{P_x}{P_y}$.
 - ✓ To put the same thing differently, $\frac{MU_x}{MU_y}$ would tell one how much additional utility one would get (or give up) if one purchased (or sold) an additional dollar’s worth of commodity “X”
 - ✓ If now $\frac{MU_x}{P_x} > \frac{MU_y}{P_y}$, then that individual would sell “Y” and buy “X”, thereby losing less for giving up a dollar’s worth of “Y” than he gained from the additional dollar’s worth of “X”
 - ✓ This process continues until $\frac{MU_x}{P_x} = \frac{MU_y}{P_y}$
 - ✓ As he gave up “Y” and gained “X”, the principle of diminishing MU meant that MU_y increase and MU_x decreases until $\frac{MU_x}{P_x} = \frac{MU_y}{P_y}$
 - ✓ At that point **no further gains** from exchange could be realized.
 - ✓ All prior utilitarian theorists had realized that in voluntary exchange, an individual bought or sold as long as what he or she purchased give more utility than the utility lost in what he or she sold.
 - ✓ This had always been the basis for advocating **free exchange** and for the belief that exchange **harmonized everyone’s interest**.
 - ✓ Jevons only addition had been;
 - To give this principle a mathematical formulation

❖ To make explicit distinction between TU& MU.

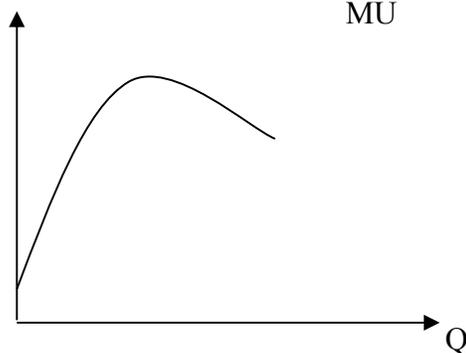
- ❖ Not surprisingly, he felt certain that **social harmony and not class conflict** was the natural state of **Market capitalism**.
- ❖ He asserted that “**the supposed conflict of labor with capital is a delusion**”
- ❖ Appealing to universal Brotherhood, he added “*we should not look at such subjects from a class point of view, because in economics at any rate we should regard all men as brothers*”
- ❖ This “**brotherhood**” of social harmony arose, of course, because all people appear essentially **equal** and in the same light when seen exclusively as **exchangers**.

Carl Menger (1840-1921):

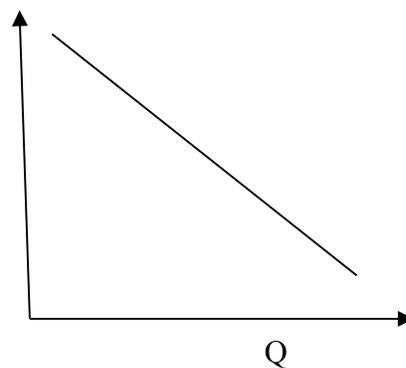
- ❖ He also regarded as the **founding father of Austrian School** of economics.
- ❖ In his economic theory, he **rejected** the use of **mathematical equations** and expressed his theories **verbally** with the aid of numerical examples.
- ❖ He made two important contributions to economics; one involved **value theory** and the other concerned **Economic Methodology**.
- ❖ He was one of the first economists to discover the MU theory of value and the principle of diminishing MU.
- ❖ He was one of the earliest advocates of a **subjective theory of value**.
- ❖ He also involved in a heated debate over the nature of economics and the proper way to do economic analysis.
- ❖ His description of TU and MU was similar to that of Jevons.
- ❖ He illustrated the principle with a table of numbers. From the table;
 - ✓ To find the MU of some of the commodity (say type II) one goes to the second column and then reads down to the number of units consumed.
 - ✓ If six unit of commodity II were consumed, the MU of the six units would be 4.
 - ✓ The TU (not illustrated on the table) can be calculated by simply summing the marginal utilities down to the number of unites consumed
E.g. six unite of commodity II yield TU=39
 - ✓ The relationship between MU and TU can be graphed (like latter neo-classical economists in similar matter)

Number of unit consumed	Types of commodities									
	I	II	III	IV	V	VI	VII	VIII	IX	X
1	10	9	8	7	6	5	4	3	2	1
2	9	8	7	6	5	4	3	2	1	0
3	8	7	6	5	4	3	2	1	0	
4	7	6	5	4	3	2	1	0		
5	6	5	4	3	2	1	0			
6	5	4	3	2	1	0				
7	4	3	2	1	0					
8	3	2	1	0						
9	2	1	0							
10	1	0								
11	0									

Graphically: TU



MU



- ❖ As far as prices are concerned, Menger explained them on the basis of SS & DD.
- ❖ SS & DD determined “prices”, and SS & DD were, in turn explained by utility.
- ❖ Hence, utility was ultimate determinant of the prices of consumer goods.
- ❖ The prices of the factors of production were also determined by the supply and demand.
- ❖ Their supply was determined by the calculation of utility on the part of their owners.
- ❖ And their demand was determined by their productivity in producing consumer goods as well as by the utility consumers derived from consuming these goods.

- ❖ Thus, in utility perspective; wages, rent, and profits were at least partially determined by the prices of consumer goods.
- ❖ As Menger Explained demand for a particular consumer good:
 - If the price of that commodity greater than the MU that most consumers could get from that commodity, most consumers get more utility by keeping their money than by spending on that good.
 - But as the price of the good dropped more consumers would find that the MU derived from consuming that commodity “exceeded” the utility that they lost by giving up the smaller amount of money.
 - Moreover as the price dropped consumers who already consuming the good find that the utility maximization required them to buy more of the good.
 - Thus he derived the law of demand (inverse relation between the price and the quantity demanded)
- ❖ Menger’s discussion of supply was less adequate.
- ❖ He usually treated supply as a “**pre-existing**” quantity already in the hands of the seller.
- ❖ The seller, using utility maximization as a guide, decided what quantities he wished to sell at a given price.
- ❖ The combination of the desire to buy and sell (all determined by the utility considerations) determined prices.
- ❖ He went to show that a monopolist selling a commodity would charge higher prices and sell smaller quantities than would have obtained if the quantity had been sold by many competitive sellers.
- ❖ Menger, therefore, extolled the benefit of **free competition**.

Menger’s Arguments on Methodology:

- ❖ He was one of the most important participants in an excessive debate over proper methodology for social science.
- ❖ The debate occupied the attention of many of the leading German-speaking intellectuals in the late 19thc and has come to be known as the **Methodenstreit**.
- ❖ We will merely discuss two of the central assertions that Menger attempted to defend;

First:

- “**Pure science**” was always **value free**. Normative, moral or ethical values were, he believed, completely **foreign to science**.
- In their values, individuals are influenced by their personal circumstances, class position and emotions.
- Science, however, was a description and understanding of actual reality—not **a reality as one wished it to be**.
- Economics, then, to the extent that it was a science, was a value free.
- Menger believed that many of the confusions in the writings of earlier economists had been the results of their failure to understand that ethical judgments have **no place** in pure economic theory.

“The so-called “ethical orientation” of the political economy is thus a vague postulate devoid of any deeper meaning both in respect to the theoretical and practical problem of the latter.”

. . . Menger

Second:

- Economists could significantly understand only individual households or business firms (Menger called these **individual economics**)
 - Economists could never develop a similar scientific understanding of social aggregates such as classes or nations.
 - This position has come to be known as Methodological individualism
- ❖ Thus we see that Menger’s Methodological individualism and his belief that his theories were value free led to the belief that existing institutions and laws were above reform.
 - ❖ **Reform efforts** were, in his opinion, **unscientific and socially harmful**.

CHAPTER TWO

THE CONSTRUCTION OF NEO-CLASSICAL ORTHODOXY

Marshalling the Troops: Scientific Economics Comes of Age

“The success of the marginal revolution is intimately associated with the professionalization of economics in the last quarter of the nineteenth century.”

—Mark Blaug (Black *et al.* 1973: 14)

2.1 From Political Economy to Economics:

(Alfred Marshal, John Clark and Irving Fisher)

- ◆ After the last quarter of the 19th c, the discipline of political economy was never the same. It was rapidly becoming a grownup science, with its own box of tools, systematic laws, and quantitative analysis.
- ◆ Economists hoped that political economy, once the domain of theology, philosophy, and law, could become a new science that would match the logic and precision of mathematics and the physical sciences.
- ◆ It was time to unburden the world of what Carlyle had caustically labeled the “dismal science,” and replace it with a more formal objective discipline.
- ◆ Economics was originally called “**political economy**,” not as an ideological dogma but to distinguish it from “household economy.” It meant the economics of society or polity.
- ◆ During the late nineteenth century, there was a strong move to discard the unwieldy name “political economy” in favor of something more up to date and scientifically precise.
- ◆ Authors suggested several choices, such as “plutology,” “ergonomy,” “chrematistics,” “catallactics,” and “ophelimity.” Marshall and other professors preferred economics. The principal economist to carry out this revolutionary shift was **Alfred Marshall (1842–1924)**, a famed Cambridge professor. Why?

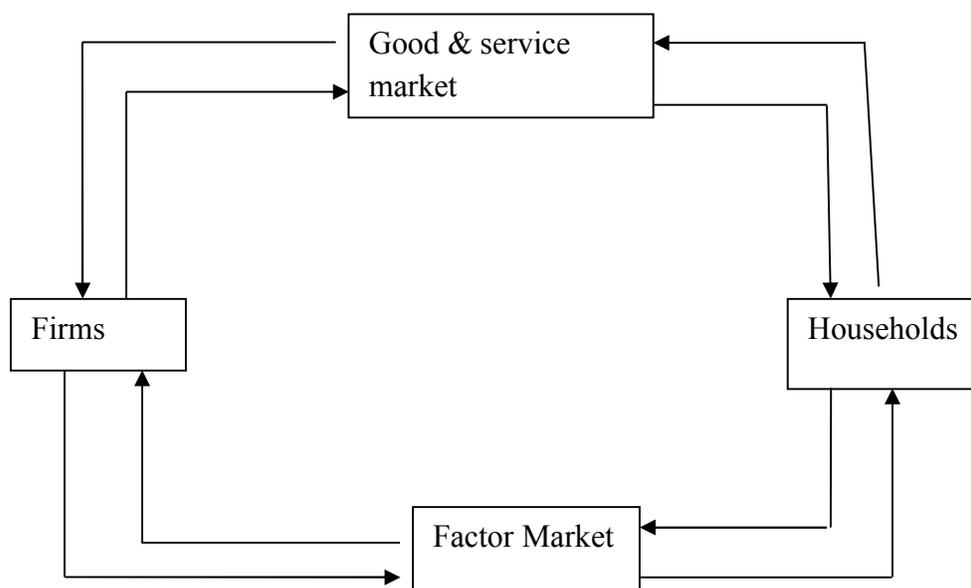
*“I cannot help thinking that it would be well to discard, as quickly as possible, the old troublesome double-worded name of our Science. . . . But why do we need anything better than Economics? This term, besides being more familiar and closely related to the old term, is perfectly analogous to Mathematics, Ethics, Aesthetics, and the names of various other branches of knowledge, and it has moreover the authority of usage from the time of Aristotle. . . . It is thus to be hoped that Economics will become the recognized name of a science, which nearly a century ago was known to the French Economists as **la science economique**”*

_____ (Jevons 1965 [1871]: xiv–xv)

- By calling his textbook *Principles of Economics*, he altered the name of the discipline from “political economy” to “economics,” sending a signal that economics was as much a formal science as physics, mathematics, or other precise body of Knowledge.
- Moreover, it acknowledged that the economy is governed by natural law rather than by political policy.
- His path breaking 1890 textbook introduced graphs of supply and demand, mathematical formulas, quantitative measurements of “elasticity” of demand, and other terms borrowed from physics, engineering, and biology like fare—equilibrium and disequilibrium, statics and dynamics, velocity of money and inflation, and frictional unemployment.
- The period surrounding Marshall’s textbook was a time of new beginnings in economic science like;
 - Official associations were established—the American Economic Association in 1885 and the British Economic Association in 1890.
 - Journals were established—the *Quarterly Journal of Economics* at Harvard in 1887, the *Economic Journal* at Cambridge in 1891, and the *Journal of Political Economy* at Chicago in 1892 (although the *Journal des Economistes* in France had been publishing since December 1841)
 - In 1894, Macmillan published the prestigious three-volume *Palgrave’s Dictionary of Political Economy*, in which economist Henry Sidgwick noted that the term “economics” had “recently come more and more into use as a preferable alternative for political economy.
 - By the turn of the century, major universities had finally established their own departments of economics, separate from law, mathematics, and political science.
 - In 1895, the London School of Economics (LSE) was established, devoted almost entirely to economic studies.

2.2 The Construction of Neo-Classical Orthodoxy:

- Neo-classical economics is a term variously used for approaches to economics focusing on;
 1. How individuals and firms should behave to maximize their own objective functions.
 2. Activities that are coordinated by price mechanism
 3. The economy that were assumed to be in equilibrium at all times
- The term Neo-classical was originally introduced by Thorsten Veblen in 1900 to distinguish Marginalist in the tradition of Alfred Marshal from those of Austrian School.
- Today Neo-classical used to refer to Mainstream (dominant) economics.
- In Neo-classical the economic process is seen as having two important focal points
 - 1) Households
 - 2) Firms
- There are two continuous circular flows between this points
 1. Real flow
 2. Monetary flow



- From household side there is real flow (utility maximization) and from the firms side there is monetary flow (profit maximization)
- Households' attempts to maximize the excess of utility derived from the consumption goods purchased over the utility given up in the sale of productive factors (**real flow**).
- Firms attempts to maximize the difference between the money it pays for productive factors and the money it receives from the sale of consumption goods (**monetary flow**).

2.2.1 Alfred Marshall (1872-1924) builds on Jevons's Incomplete Work

- Alfred Marshall was a Mathematician turned economist who taught economics at Cambridge University. He published his **principle of economics** in 1890, which gradually came to replace Mill's principle of political economy. He is responsible for what Keynes called "**diagrammatic economics**" or the translation of economic concepts into **simple graphs**.
- He more than anyone else made economics a field of study in its own right. He set out to make economics an independent field of study that stood on its own. In 1903 succeeded and a separate school and degree in economics was started at Cambridge University. He was a founder of **partial equilibrium analysis** (ignoring the impact of one market on the other)
- Jevons's work was incomplete and he never developed the downward-sloping demand curve, or a complete supply-and-demand diagram. That work remained for Marshall to accomplish. What did Marshall accomplish? Unlike Jevons, Marshall founded his own school, the so-called British or Cambridge school, with student prodigies such as A.C. Pigou and John Maynard Keynes.
- He was a synthesizer, combining the classical economics of cost (supply) and the marginalist economics of utility (demand). He often compared supply and demand to the combination of the blades of scissors—each is necessary to determine price. He took supply and demand far beyond a written expression. He developed the graphics for supply and demand, the mathematics of elasticity, and new concepts such as consumer's surplus. His formulas now serve as the foundation of any course in microeconomics.
- In order to study individual markets Marshall developed the tools of Supply and demand;
 - The upward sloping supply curve demonstrate the law of supply
 - The downward sloping demand curve demonstrate the law of demand

- The “two scissors” of supply and demand determine the price of each good and the amount of each good that would be provided!
- Marshal also;
 - Defined and elaborated the notion of “**the price elasticity of demand**”
 - Showed how exceptional circumstances could result in an upward slopping demand curve.

Symmetry between neo-classical theories of households and the firm:

- In order for the theory of firm to be stated in terms of a maximization problem similar to the maximization problem of the household, it is necessary to see:
 - ➔ Factors of production as analogous to consumption goods
 - ➔ Revenue received as analogous to utility
- The problem for the firm in Marshall’s analysis was **identical**. A firm wanted to maximize the difference between revenue received and cost paid i.e. it wanted to maximize profit.
- The maximization problem for the firm would be **essentially identical** to that of the household if;
 - ➔ Factors of productions are substitutable
 - ➔ Consumption goods are substitutable
- The firm purchased inputs and sold outputs.
- It attempts to maximize the difference between the cost of its inputs and the revenue of its outputs.
- Hence firms maximization problem can be seen two vantage points;
 1. Revenue (output) side: maximization of revenues: MR, AR, TR
 2. Cost (input) side: minimization of costs: MC, AC, TC
- Looking at firm’s maximization problem from the vantage point of output is usually associated with the theory of the firm in contemporary economic literature.
- Looking at firm’s maximization problem from the vantage point of inputs has become the bases of the neo-classical theory of income distribution which was **inadequately developed** by Marshall
- Superior formulations of the theory of income distribution were developed by an American, **John Bates Clark**.

Marshall's theory of the firm:

- His analysis of the firm was an integral part of his analysis of **price determination**.
- Prices were determined by supply and demand.
- Demand was determined by consumers' utility schedules and supply was determined by firms' cost schedules.
- His analysis were devoted to analyzing the situation in which an industry consisted of numerous competing firms (**price taker firms**)
- Assumptions for the theory of the firm:
 - a. Perfect competitive firm
 - b. Profit will equalize (normal profit) for each firm in the industry.
 - c. A representative firm is a price taker.
- Marshall's theory depicted what he called a "**representative firm**" in a competitive industry.
- The representative firm:
 - Was in a sense an average firm.
 - Had no special advantages or disadvantages
 - Its cost of production reflects the AC of various firms within the industry.
- His analysis was based on the distinction between 3 time period:
 - a. **Market period**: supply was fixed and prices depended on the strength fold in relation to fixed supply.
 - b. **Short run**: capital is fixed but labor is variable.
 - c. **Long run**: all inputs (both capital and labor) are variable.

The firm's production and cost curves in the short run:

- In the short run firms productive facilities (capital) is fixed and they expand or contract output by using a larger or smaller number of workers (labor)

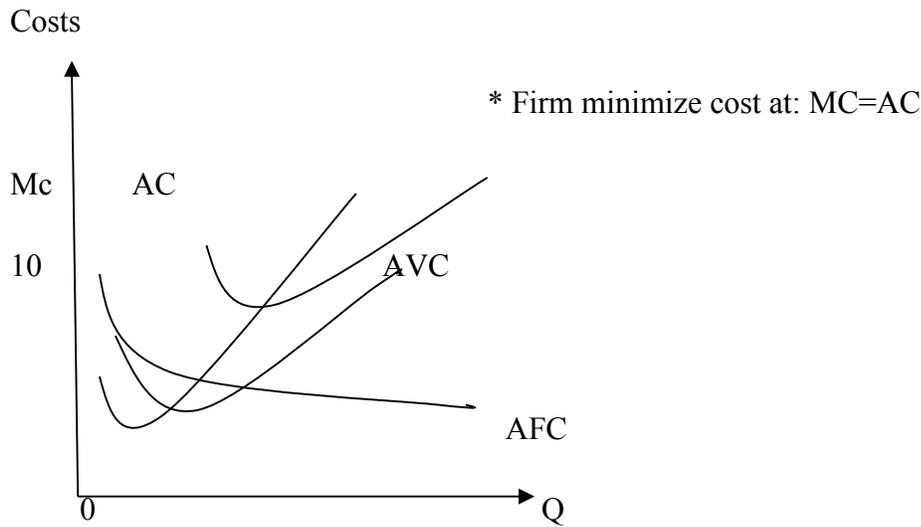


Fig. 1 cost curves

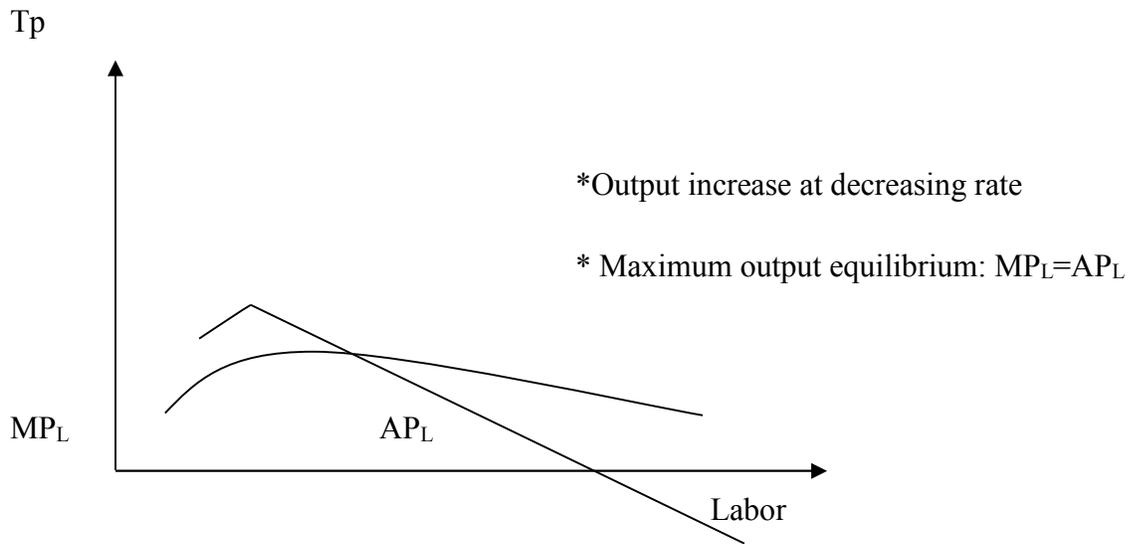
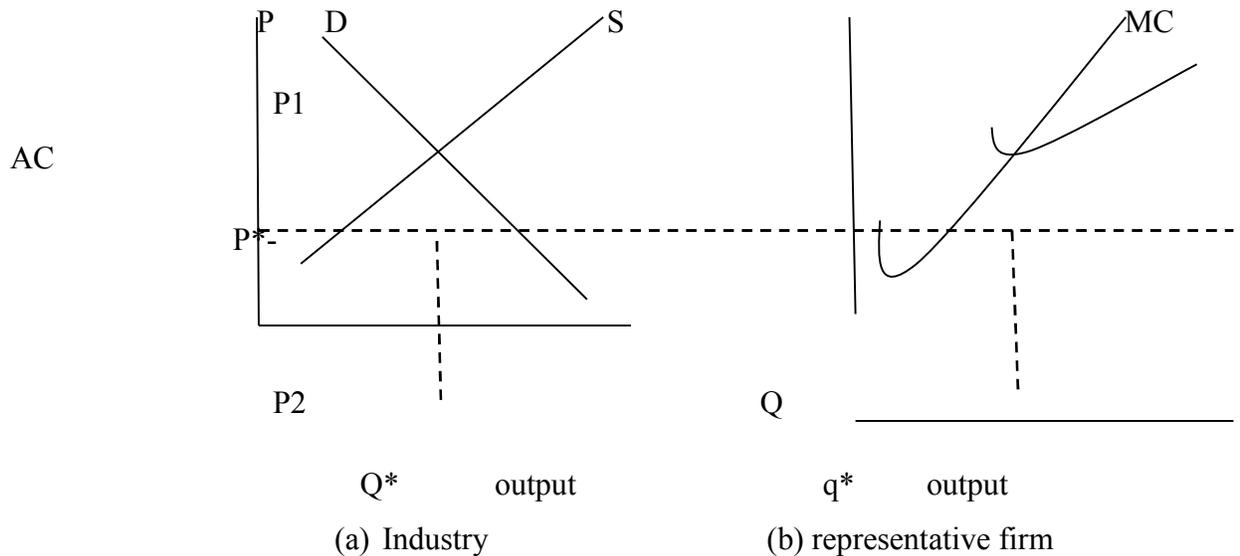


Fig.2 product curve (law of variable proportion)

Equilibrium in the short Run:

- The firms maximizes its profits by producing the level of outputs at which the price (as determined in the industry-wide market) equals the rising MC
- If $MC > P$, additional cost of additional outputs exceed the price received for additional
- output (i.e. there will be **less supply**)

- If $MC < p$, the price received for additional output exceed the additional costs of additional output (i.e. there will be **more supply**)
- Hence, the MC curve shows the amounts a profit maximizing firm will supply at various prices and is the firm's supply curve.



- The output for the industry (Q^*) is, of course, many times greater than the output for the representative firm (q^*). For the representative firm, the industry **price equals its AC**. This does not mean that the representative firm earns no profit at equilibrium.
- For neo-classical in the short-run profit would be included in the average costs (**as a part of its AFCs components**). Any firm in this industry having **higher** costs than the representative firm will receive **lower than normal profit**. Any firm in this industry having **lower** costs than the representative firm will receive **higher than normal profit or excess profits**. He called such excess profits “**quasi-rents**”, and argued that they are similar to the “**Ricardian rents**” received by the owners of superior grades of land.
- In the long-run equilibrium such “**quasi-rents**” will be incorporated into the firm's cost curves as ordinary rent costs, and every firm will ultimately receive only the **normal rate of profit**.

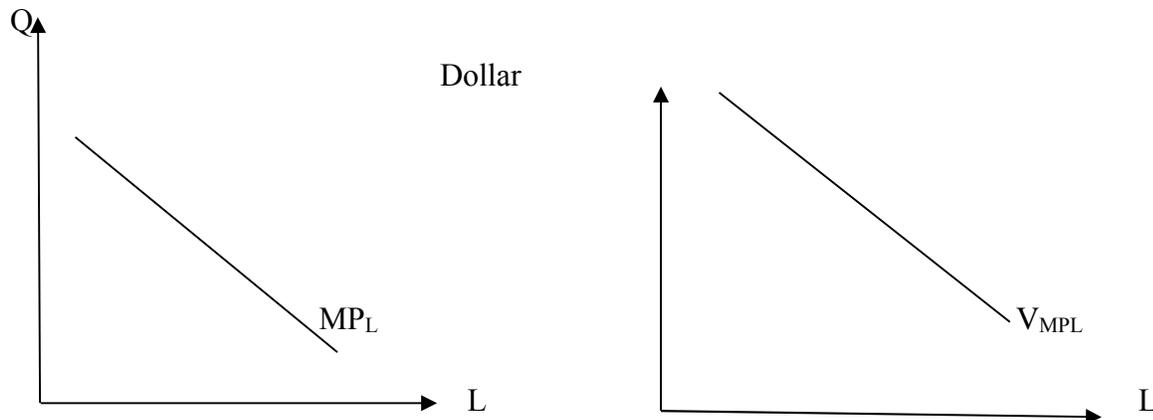
The long run (period) analysis and the problem competition:

- In Marshall's long period;
 - ☞ All productive factors could be varied
 - ☞ All costs were variable costs
 - ☞ All “**quasi-rents**” disappeared
- For Marshall, he had 3 returns to scale:
 1. Constant returns to scale (CRS)
 2. Increasing returns to scale (IRS)
 3. Decreasing returns to scale (DRS)
- For land based activities a proportionate increase in labor inputs result in a less production (proportionate) in output (Ricardian DRS). For manufacturing activities a proportionate increase in capita input result a more than a proportionate increase in output (IRS). If we accept CRS, the cost for a small firm is the same for large companies. Hence we have no justification for large companies because their cost is similar to smaller companies. If we accept IRS, the cost of large firms or corporations less than the cost of small firms.
- Hence efficiency gain from having big corporation is justified (low cost as firm's scale of operation increases)But this large scale operation may result Oligopolistic or monopolistic type of firms (**market imperfection in contrary to Marshall's assumption of perfect competition**)
- It therefore it seems that Marshall's theory would have led him to one of three conclusions:
 - II. He could have abandoned the general utilitarian argument (that the invisible hand of competitive market harmonized all interests) and accept the social advantages of giant oligopolistic business corporations.
 - III. He could have supported massive government intervention in the economy designed to break up large corporations and force them in to perfectly competitive market.
 - IV. He could have taken Marx's view that competition inevitably led to industrial concentration and therefore, advocate some form of **socialism**.

- However, Marshall was unwilling to accept anyone of these only possible practical conclusions. He wanted to retain. **The utilitarian theory of the harmony of the invisible hand of the market.** How then could one reconcile Marshall's belief that greater efficiency of large firm's with perfect competition??? This was Marshall's most difficult problem.
- Marshall was saved by his **Evolutionary theory of the life cycle of natural organisms.** He insisted "we may read a lesson from the young trees of the forest as they struggle upwards through the benumbing shades of their older rivals. "Although these taller, better established trees "have a better access to light and air than their rivals, they gradually lose vitality "As it was with trees, so it was with business firms. Hence, Marshall was able to salvage his faith in the performance of perfect competition by believing that an industry was like a forest. Just as trees are constantly growing and dying, so with business: a firm's "decay in one direction insure to be more than balanced growth in another"

2.2.2 John Clark and The marginal productivity distribution:

- This theory designed to explain the principles that determine how much income different people receive, and thus the principles affecting the distribution of income in an economy. While Marshall developed the neo-classical "theory of the firm" from perspective of output. The latter (John Bates Clark) stand point represents the foundation of the Neo-classical "theory of income distribution" from input perspective.



$$V_{MPL} = PMP_L$$

A. At equilibrium (assume the labor supply is fixed) $v=f(K,L^*)$

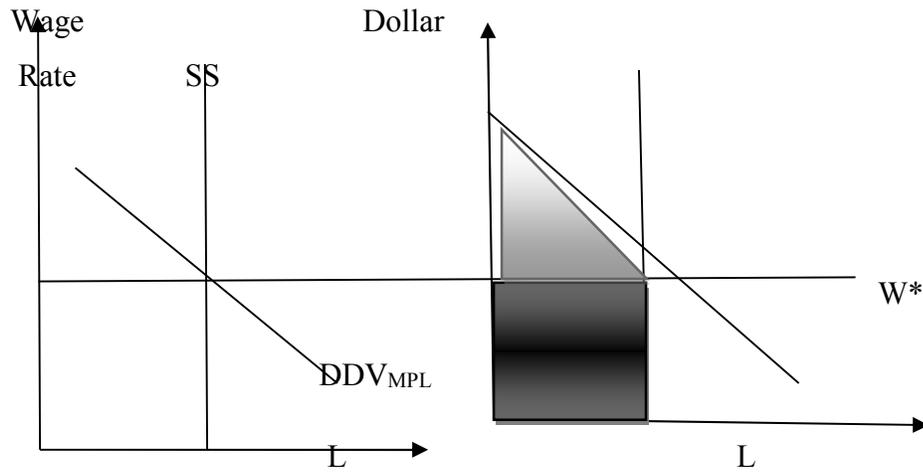


Fig 1

Key:



→ Interest rate



→ Wage rate

B. At equilibrium (assume the capital supply is fixed) $v=f(K^*,L)$

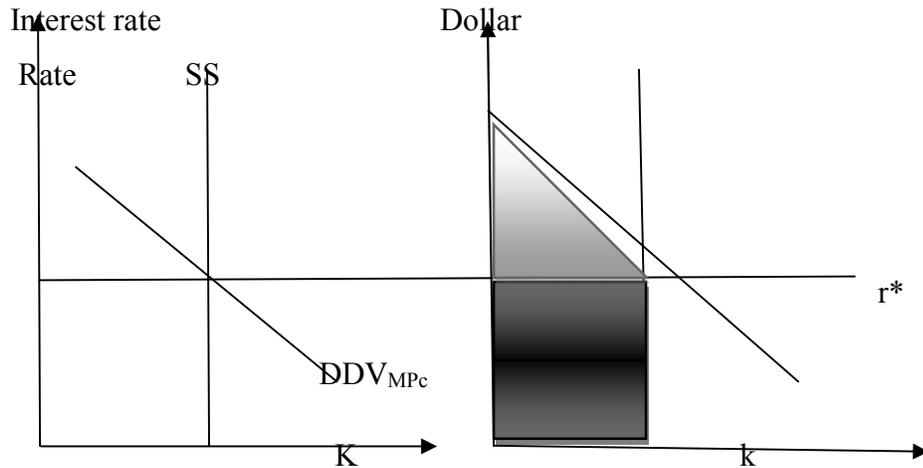


Fig 2

Key:



→ Wage rate



→ Interest rate

For Clark:

- Capitalist were rewarded by receiving what they created just as were laborers
- Hence no exploitation (**surplus**)
- Each person receives the value of what his factor produces

2.2.3 Irving Fisher (1867-1947):

- He was an American economist known for the development of monetary theory and mathematical economics. He got his doctorate degree in Mathematics which very well goes to prove his interest in mathematics, and the application of mathematical formulae and equations to economics problems. Like other neo-classical economists, he based his analysis on:
 - Perfect competition
 - Stationary state
 - Freedom of choice
- He was the first economist in United States who made the use of the concept of indifference curves. He wrote the introduction and prepared an elaborate bibliography of mathematical economics.
- He wrote many books:
 - Mathematical investigations in the theory of value and price
 - The nature of capital and income
 - Elementary principles of economics
 - The money illusion

His views:

1. He realized that utility could not be measured. Hence consumers will arrange his consumption in such a way that the marginal utility of each commodity purchased from one unit of money would be equal.
2. Hence price is determined at a point where $MU=MU$
3. In his analysis the value of each commodity is dependent on the values or prices of all other commodities.

4. According to Fisher, capital includes all wealth, even the human resources. Income is merely the flow of goods and services emanating from the use of capital. Thus, capital and income are two aspects of the same problem.
5. According to him the rate of interest depends upon the “**time preference**” of individuals for the present over future goods.
6. In any case he deserves credit for establishing relationships between the value of money and the rate of interest.
7. He made an outstanding contribution in the field of monetary economics. According to him, monetary individualism was a curse and inflation, whatever be its source and cause i.e. paper or gold or increased supply of gold is ruinous, and disastrous. And similar to deflation.
8. He has attempted to prove that the salvation was only in the stabilization of the price level which he stated in the quantity theory of money ($MV=PY$).
 - His thought suffers from internal inconsistency and he deals with variations of correlations with such freedom that the entire analysis appears to be far away from the realities of life.

2.2.4 The Stockholm School

- It also known as Swedish School was founded by Knut Wicksell, E.Lindahl, B.Ohlin, and Gunnar Myrdal are the most illustrious members. The school had its influence in the Scandinavian countries. It was represented by Frisch in **Norway** and **Zeuthen** in Denmark. Wicksell also influenced the thought of Von Hayek and that of Keynes and Hicks in England.

i. **Knut Wicksell (1851-1926):**

- He was born in 1851 & took up his degree in Mathematics in 1885.He took is PhD degree in 1895. In 1900 he was appointed as assistant professor at Lund University.
- His chief works are:
 - Value, capital and Rent (1893)
 - Studies in finance theory (1896)
 - Interest and price (1898)
 - Lectures on political economy

- His thought was greatly influenced by the depression and the sharp decline in prices during 1873-1895
- In 1898 his book entitled *Interest and prices* appeared in which he has coordinated the theories of price and interest with the theory of value of money and has emphasized the part played by credit in the price movements.
- His economic views:
 - He developed his theory of value and distribution around the theory of marginal productivity. He assumed that all factors of production are so employed that no economies from a large scale of production are possible. He also analyzed the relation of money rates and the natural rate of interest and also the effects of this relationship on the general price level.
 - According to him **capital** is “a coherent mass of stored-up labor and saved-up land.”
 - After recognizing the importance of “**time element**”, he has taken up “**period analysis**”.
 - He assumes that capital saved during the preceding years helps in the production in the current year and, therefore, for obtaining the advantages of capital’s use, a corresponding part of the current years’ resources must be saved up for being used during the next year.
 - For him **interest** is “*the marginal productivity of waiting*”
 - Interest is the difference between the marginal productivity of saved-up labor and land, and the marginal productivity of currently used labor and land.
 - He says that the **current** labor and land are relatively **abundance** while the saved-up labor and land are **not**; therefore, the difference in the marginal productivity of the two types of labor and land is interest.
 - The interest may disappear if the difference disappears but this will never happen since the falling rates of interest will be followed by longer investment period and increased capital values which will counteract the decline between current and future goods.
 - He stated that a high rate of interest stimulates saving and a low rate discourage it.
 - This will bring us to the idea of natural and market interest rates.
 - The natural rate of interest is the one which equates saving with investment.
 - The market rate of interest is the price of money which tends to equalize the natural rate, but it may be below or above it.

- If it is lower, the saving will be discouraged, consumption will rise, and investment will be stimulated, untimely leading to the rise in the price level.
- If the market rate is higher, there would be a decline in the general price level, since it would not be profitable for entrepreneurs to make investments.
- He, therefore, suggest that the market rate may be kept below the natural rate and price kept rising, as long as the supply of loadable funds is supplemented by credits, or by dishoarding.

1) Saving and investment:

- He believed that since the expenditure of one is the income of the other, the aggregate purchasing power would always remain the same i.e. **aggregate income equals aggregate spending**. Hence income not spent on consumption is spent on capital and the price level will remain constant.
- Since decisions to save and invest are taken by different people, amount of saving may be more than the investment. In such situation income would be reduced, consumption would decline, and price would fall.
- If investments are more than saving, the price would rise.
- He suggests that this could be controlled by manipulating the banking rate or market rate of interest i.e. by keeping it above or below the natural rate of interest.
- This is what is known as the “**the cumulative process of Wicksell**”
- He has emphasized the **effectiveness of monetary control** for the **stability of the price level**.
- He asserted that in other spheres, circumstances like technique, natural conditions; individual or social differences play a role which is beyond the survey and control of the science.
- But so far as money is concerned, everything is determined by human beings i.e. statesmen and economists and hence the banks rate policy is the most effective weapon for keeping the price level stable.

2) Trade cycle:

- For him trade cycle is the outcome of the cumulative process of unstable disequilibrium.
- The trade cycle appears because the technical progress does not increase in perfect simultaneity with the increase in population.

2.2.5 Other Members of this school:

- Gunnar Myrdal has been chiefly concerned with the analysis of the effects of uncertainty in on the determination of price. He has analyzed the effects of businessmen's **expectations** on investment and price.
- Eric Lindahl, in 1930 published his book entitled *the means of monetary policy*. His analysis is based on the assumption of a perfect economy and also includes the study of the effects of the changes in financial policy of the state.
- Ohlin and Lundberg are also known in the field of equilibrium analysis.
- In spite of its realistic approach the school failed to give an adequate explanation of the relationship between the rate of interest and the decision of people regarding saving or investment.
- Their weakness lay in the **extreme optimism** regarding the efficiency of **the bank rate policy** in determining the level of employment in the economy.

2.3 The Neo-Classical School; Departure from Pure Competition:

(Piero –Sraffa, Edward Hastings Chamberlin, Jean Robinson and the Cambridge continues with Sidgwick and Nicholson)

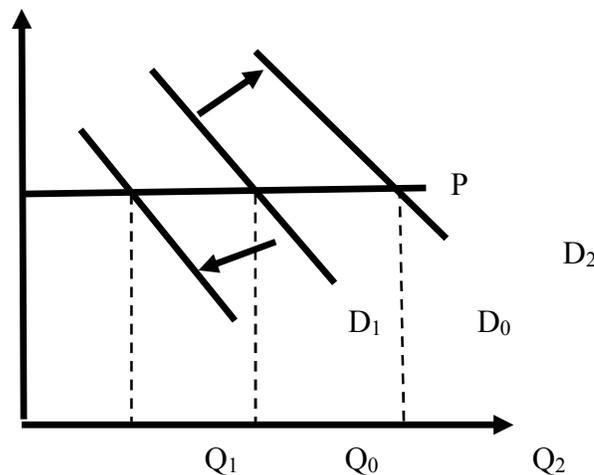
- Marshall's theoretical system, perhaps precisely because of his wish to understand the real world and his attempt to link social evolutionism to the utilitarian ethic, ended up by assuming an ambiguous character and provoked a critical reaction.
- Marshall's Principles, besides being a great work of economics, it is permeated by a deep sense of history. But Marshall's followers chose to develop only the analytical part of the book, ignoring its cultural and philosophical background. This unfortunate gap between Marshall's intentions and those of his followers led to more than a few misunderstandings.
- At the center of these criticisms was the question of the compatibility between the hypothesis of perfect competition and the partial-equilibrium method. In the Principles, Marshall had discussed the existence of different productive sectors characterized by decreasing, constant, and increasing costs.

- It follows that the long-run supply curve of the sector is not necessarily rising, but may be horizontal or falling. Now, it is impossible to establish a priori which of the three situations is most plausible or probable
- However, it is possible to say, in general, that there is no ‘law’ of long-run supply establishing a direct relationship between prices and quantity. In the long run, and at the sector level, there is no ‘law of variable proportions’ which generates a rising supply curve.
- Economic historian **John Harold Clapham** in 1922, by criticizing economic theory of his time for being too abstract and formalist, Clapham pointed out the frustrations faced by applied economists in trying to utilize, in empirical research, Marshall’s division of industries into the three types of increasing, constant, and decreasing costs.
- In the controversy that followed, **Pigou** tried a defense of Marshallian orthodoxy with the intention of preserving the theoretical support it gave to the policies he had proposed in **The Economics of Welfare**. In his view, the state should try to maximize social welfare by taxing the firms facing decreasing returns to scale and subsidizing those enjoying increasing returns.
- His daring conclusion was that, if empirical observation did not confirm the theory of supply based on non-proportional costs, this must be due to the backwardness of the statistical documentation and methodology.

A. Sraffa’s criticism of the Marshallian theoretical system:

- Piero Sraffa followed a substantially different line of attack in ‘**Sullerelazionitracosto e quantita` prodotta**’ (1925). With the **partial-equilibrium** method it has to be assumed that the market investigated has to be separate from all other markets so that what happens in it does not influence the prices of the other goods in any relevant way. Now, in a sector characterized by increasing (decreasing) costs, an increase in production will cause the prices of the productive factors to increase (decrease).
- Therefore, if one wishes to continue to reason in terms of partial equilibrium, it is necessary to postulate that the inputs, whose prices increase (or decrease) with production, are those that are utilized only by the industry in question. Otherwise, the variations in their prices would modify the prices of the goods produced in other sectors.

- In order to uphold the logical coherence of the Marshallian edifice, it is also necessary to postulate that the economies (or the diseconomies) of scale are external to the firms but internal to the sector.
- In fact, if they were internal to the firm, the latter would be encouraged to expand (contract) its own level of activity, and would eventually become a monopolist in its industry (or pull out of the market).
- Both cases are incompatible with the hypothesis of competition. If, on the other hand, the economies or diseconomies were external to the sector, a partial-equilibrium analysis would no longer make sense, and it would be necessary to move to a general-equilibrium approach.
- The gist of Sraffa's criticism is that the Marshallian theory of competitive equilibrium cannot escape from the following dilemma: either it is contradictory or it is irrelevant. The only case which is logically compatible with the partial-equilibrium analysis of a perfectly competitive sector is that of **constant costs**.
- But in this case the 'classical and neoclassical synthesis' of Marshall (and of Pantaleoni, whom Sraffa also had criticized) basically led to the same results as classical economics: **prices** are determined exclusively by **the costs of production**, while the conditions of **demand** only contribute to determine the **quantities** produced.



- After a reformulation of his 1925 criticism, Sraffa noted that increasing returns are de facto important in industrial sectors, and consequently that the typical cost curve of these sectors is probably negatively sloped.

- Thus, rather than developing an analysis of competitive markets on the basis of the hypothesis of constant costs (as it would have been natural to expect) he started off along a completely different track: ‘to abandon the path of free competition and turn in the opposite direction, namely, **towards monopoly**.
- Sraffa pointed out the existence of market imperfections which are not simple frictions but are themselves active forces which produce permanent and even cumulative effects on prices and quantities.
- He argued that these obstacles to competition are ‘endowed with sufficient stability to enable them to be made the subject of analysis based on static assumptions.
- Among the obstacles to the regular operation of a perfectly competitive market, Sraffa indicated the possession of specific natural resources, legal privileges, and control of a given percentage of total production.
- The dilemma created for the traditional theory of perfect competition by the assumption of decreasing costs (**increasing returns to scale**) can be solved either:
 1. by introducing a demand curve for the single firm which descends from left to right, or
 2. by abandoning the partial-equilibrium approach in favor of general equilibrium, so as to be able to take into account the movements of the cost curves induced by economies external either to the firm or to the sector
- Sraffa agreed that the first of these two alternatives had a greater explanatory value. What actually prevents the unlimited growth of a firm is not, in his opinion, an increasing cost curve but a decreasing demand curve. The solution proposed by Sraffa presupposed ‘**the absence of indifference on the part of the buyers of goods as between the different producers**’. This absence was attributed to causes such as ‘long custom, personal acquaintance, confidence in the quality of the product, etc.
- Thus, beginning with the identification of a logical difficulty within the Marshallian analysis of competition, Sraffa ended up by opening a new field of research which was immediately accepted in Cambridge, especially by Joan Robinson.

B. Chamberlin's theory of monopolistic competition:

- In 1933 **Edward Chamberlin** published *The Theory of Monopolistic Competition*. In this work he acknowledged that real-world markets do not operate in perfect competition, and rejected the idea of the firm as a passive price-taker. On the contrary, he maintained that the firm is able to influence the demand decisions for its own products by means of product differentiation, promotional activity, and advertising. This was the origin of a new theory, a theory of markets which are neither in perfect competition nor under monopoly.
- The theory of monopolistic competition rests on two basic assumptions:
 1. **The majority of firms set their sale prices**; i.e. they are price-setters: this means that single firms **retain some monopoly power** and, if they increase prices, they do not lose all their customers, as happens in perfect competition.
 2. **There is no natural monopoly in the majority of the productive sectors**; if **extra profits are made in a given sector, this encourages new firms to enter**; in other words, the firms operate within a context which is, to a certain degree, competitive.
- This is due to the fact that the entry of new firms on the market produces two different effects. On the one hand, competition encourages the entry of new firms, which contribute to eliminate the extra profits. This process leads to the creation of 'too many' firms—too much respect to the number of consumers. On the other hand, the entry of new firms increases the variety of products and thus raises the customers' welfare, at least to the extent to which the latter are able to choose from a wider range of products.
- But, since firms do not have the opportunity to appropriate the consumer surplus, as would be possible in a monopoly, they will have little incentive to differentiate the product. Which of the two effects predominates will depend on the circumstances.
- Even though Chamberlin and Robinson reached the same solution in regard to the equilibrium of the single firm and the sector, there were more than a few important differences in their work. Their theoretical roots were also different.

- While Robinson in the introduction of her book acknowledged Sraffa as her source of inspiration, Chamberlin took the trouble to point out that most of his conclusions had already been set out in the dissertation he had presented at Harvard in April 1927, which he had written under the supervision of **Allyn Young** without having first read Sraffa's article.
- There are several difficulties with Chamberlin's model:
 - (1) The hypotheses of product differentiation and atomistic behavior do not seem compatible, for the simple reason that firms are always aware of the actions and behavior of competitors who offer close substitutes.
 - (2) The second difficulty is that product differentiation, in that it leads to an entry barrier, is not compatible with the assumption of free entry into the sector.
 - (3) Finally, product differentiation tends to make the notion of an industrial sector meaningless. More specifically, it is incompatible with the device of the 'representative firm' in the Marshallian sense, so that it becomes necessary to take into account the relationships between individual cost and demand curves.

N.B

- **world of atomistic competition** is a world in which no agent of the productive mechanism, on the side of labor and capital, was powerful enough to interfere with or to resist the pressures of competition.
- Stigler, in particular, argued that the definition of group of firms is ambiguous. The group must be defined in such a way as to include only firms that sell homogeneous products. But if this is the case, there is no reason to assume that the demand curves of the single firms are downward-sloping.
- Other authors have focused their attention on the logical weakness of the way in which Chamberlin arrived at the determination of the long-run equilibrium position. **Harrod**, for example, pointed out that Chamberlin's firm, in order to determine the quantity produced and the optimum size of its plant, uses a short-run marginal-revenue curve and a long-run marginal-cost curve, and ends by setting the price at a level which encourages new firms to enter the market. But this, by reducing the market share of each firm, would determine a leftward shift of the marginal-revenue curve. Of course, these sharp criticisms do not lessen the importance of Chamberlin's work.

- Furthermore, in addition to the important notion of product differentiation which Chamberlin introduced in the theory of price, the notion of promotional sales activity is an element of undoubted realism.
- Not only this, but the invention of the ex-ante and ex post demand curves was to give rise to a whole series of further theoretical contributions, among which it is worth recalling the kinked demand curve, widely used in the study of the structure of oligopolistic markets.
- The Theory of Monopolistic Competition aroused considerable interest in the 1940s. Among those who have attempted to deepen and extend Chamberlin's work we must recall **Robert Triffin**, who tried to introduce imperfect competition into the general-equilibrium model. However, he ran up against the problem of the determination of the number of firms operating in equilibrium.

C. Joan Robinson's theory of imperfect competition:

- The Economics of Imperfect Competition was also published in 1933 by Grandniece of the Christian socialist F. D. Maurice and daughter of a general, Joan Robinson assimilated with ease the humanitarian and reformist spirit of Cambridge Pigouvian economics.
- The core of Pigou's social philosophy consisted of the idea that scientific research should aim at identifying those deficiencies of the economic system which could be remedied by government intervention.
- She also followed Pigou in regard to method. She herself presented her book as 'a box of tools [that] can make only an indirect contribution to our knowledge of the actual world'). The book was directed at the analytical economist; there was nothing in it for the businessman
- Robinson's austere view of economic theory may seem strange in the light of her declaration that the principal aim of economics is to contribute to the welfare of mankind. It is certain that her book gave a powerful thrust to the development of formalism in economics

- One achievement of Robinson was to rescue from oblivion Cournot's notion of marginal revenue. The utilization of the apparatus of average and marginal curves is one of the results of Robinson's work, in which is also to be found, for the first time, the general relationship between average and marginal curves.
- Robinson accepted the idea of the equilibrium of the group presented in the last part of Sraffa's essay and developed it, with the help of Richard Kahn, removing the simplifying hypothesis that the number of firms, and therefore the set of products, is fixed. The resulting analysis seems more general than that of Sraffa, but also less robust. The problem lies in the demand curve.
- Marshall had considered a monopoly in which a single firm controls the industry; the demand curve of the industry is therefore the same as that of the monopolist. Sraffa's monopolists, by contrast, have no privileged access to the demand curve of the sector. A price increase by a firm would provoke the transfer of some of its customers towards other industries and/or towards rival producers in the same industry.
- Robinson realized the difficulties in Sraffa's way of treating the demand curve of the single firm, but, rather than run the risks of dealing with these, she chose to set them aside. Her stratagem was to deal with the problems posed by the interdependence among firms by postulating that these had already been resolved in a previous stage of the analysis; and this is still today a frequent practice, especially in the theory of oligopoly.
- Robinson was aware of the 'misdeed', but certain difficulties must be ignored if one wishes to get on with the analysis!
- In the period of the publication of *The Economics of Imperfect Competition*, most economists did not perceive the deliberate sense of irony in the use of the adjective 'imperfect'.

“The very terminology of ‘imperfect competition’ is heavy with implications that the objective is to move towards perfection.”

_____ Chamberlain

- The veiled accusation here is that the Cambridge economist, far from achieving a breakthrough in the theory of competitive value, gave shape to an **elegant continuation of the Marshallian tradition**.
- In 1969, Robinson explicitly stated that it had been her precise intention to show that, if one attempts to construct a logically coherent Marginalist theory of the firm, a conclusion will be reached which is in contrast to the neoclassical view of the world: that the free operation of market forces leads to an economic structure in which unsatisfied consumers' needs and excess capacity of firms can coexist.
- The argument is, in short, the following. A firm in perfect competition can sell all that it wishes without influencing the price, for the simple reason that its increasing cost curves prevent it from producing more than a small percentage of the total output.
- By contrast, the firm with decreasing cost curves is unable to expand its sales without lowering the price of its output. On the other hand, if the demand curve of the firm is decreasing, so will the marginal revenue curve, so that, beyond a certain point, sales will bring forth negative marginal revenues. But before this point is reached the marginal revenues will begin to be lower than the marginal costs. An attempt to expand sales reduces the profits of the firm, so that it has no interest in pushing other firms out of the market. This is the type of limited competition Robinson tried to formalize in her book.
- The implications for welfare economics are worrying: the market mechanism operates in such ways that not only are the workers not paid according to the full value of their marginal productivity, but even the principle of consumer sovereignty is impaired. This theory was very influential in the anti-trust policies taken up by many Western countries in the 1940s and 1950s.
- Towards the end of the 1930s, Robinson changed her research interests and focused on Keynesian theory. Not only she abandoned the debate which her book had opened, but even underrated the theoretical value of her own contribution.

D. Sidgwick (1838-1900):

- Sidgwick and Nicholson represented the Transition from Orthodox classicalism to Neo-classicalism. Sidgwick's *principle of political economy* went a long way in restoring to economics its old prestige. The book is founded on Mill's idea, including Walker's wage theory, of course, modified in the light of Jevons' theory.
- Since primarily a philosopher, he combined economics with ethics. His utilitarianism, unlike Bentham and Mill, setup, an “**instinctive moral sense**” as the criterion of the good. He also rejected the materialist aspects of Spencer's utilitarianism which is based on the concept of survival of the fittest.
- While supporting Mill's theory of value he has stated that the equation of supply and demand does not provide an explanation to the determination of value when both supply and demand change with price. He has criticized Mill for his theory of international values and emphasized the **costs of carriage in the problem**.

E. Nicholson(1850-1927):

- His *principle of political economy* is based on Mill's principle. He has restated the classical doctrines in the light of the criticisms of the historical school and mathematical analysis. His analysis of relative prices and of profits and wages was remarkable.
- He has accepted, in most parts, the classical economics and has adopted the concepts of consumer's surplus and quasi-rent. He did not have much fascination for the use of advanced mathematics, which the Marginal utility economists had advocated.
- Both Sidgwick and Nicholson were closely related to the Cambridge school and its founder—Alfred Marshall.

Self-Exercises

- 1) What are the main difficulties that Marshal faced in conclusion of his theory of Perfect completion?
- 2) What are difficulties with Chamberlin's model?
- 3) Towards the end of the 1930s, Robinson not only she abandoned the debate which her book had opened, but even underrated the theoretical value of her own contribution. Why?

CHAPTER THREE

THE INSTITUTIONALIST SCHOOL

“Economic Laws are not universal”

-Schmoller

THE INSTITUTIONALIST SCHOOL

The institutionalist school, an American contribution to economic thought, began around 1900 and continues to the present. By 1900 its founder, Thorstein Veblen, had published his first book as well as many articles and book reviews.

In this chapter, after providing an overview of the traditional institutionalist school, we will discuss Veblen, who critically dissected orthodox thinking and provided the theoretical approach of institutionalist economics; Wesley C. Mitchell, who introduced transaction economics; and John K. Galbraith, who popularized several institutionalist themes.

3.1 Overview of the Institutional School

A. The Historical Background of the School

In the period between the Civil War and World War I, the achievements of American capitalism were impressive. Rapid growth made the United States the biggest and most powerful industrial system in the world. The improvements in living conditions of many wage earners, however, fell far short of their aspirations and of the possibilities created by the general rise in national income. Hours of labor were long; housing often was inadequate; security in times of sickness, unemployment, and old age was negligible; higher education was inaccessible for most workers' children; job security was virtually nonexistent; and health and safety regulations were inadequate. Frequently, employers organized company towns and dominated the workers, even in their personal lives; large-scale immigration tended to undermine wage rates; taxation was regressive; usury was widespread; and recurring recessions were devastating to those who lost their jobs.

The age of monopoly may be said to have begun in the 1870s, and this movement accelerated around the turn of the century. Conservative voices predominated in the schools, in the press, in the pulpits, and in government. The state and federal governments, which proclaimed laissez-faire with respect to workers' interests, were quick to use the police and militia against labor in industrial disputes. They were also generous in establishing tariff protection for business and in granting large subsidies to railroads.

The American political and economic environment of the late nineteenth century led many economists to question the assumptions and conclusions of the neoclassical school. The doctrine that minimal government interference produces the maximum social well-being increasingly seemed untenable. There was much concern about monopoly, poverty, depression, and waste. The movement for social control and reform was gathering momentum, and it was in this milieu that institutional economics grew.

At the time two major methods of achieving social change were recognized:

(1) Reorganize society along socialist lines and (2) undertake social reform, that is, ameliorate conditions through government intervention in the economy. The object of this second approach was to save capitalism by improving the conditions of the masses. Veblen was critical of social movements and favored a radical reconstruction of society. Nevertheless, the institutionalist school he founded reflected the reformist approach. The changes wrought by the New Deal in the 1930s, for example, were greatly influenced by institutionalism.

The influence of the German historical school on American institutionalism is quite visible. Most of the leaders of the American Economic Association, which was founded in 1885, were familiar and friendly toward the German movement and its methodology. Some of Veblen's illustrious teachers had studied in Germany. John Bates Clark, who taught and encouraged Veblen at Carleton College, was one of these.

Although Clark's Marginalist theory had nothing in common with German historicism, he also formulated a creed of Christian reform that had much in common with German reformist thinking. Veblen was impressed with the lectures of George S. Morris at Johns Hopkins; Morris was the teacher of John Dewey and was one of the Hegelians trained in the German universities. Richard T. Ely of Johns Hopkins taught and worked with both Veblen and another institutionalist, John R. Commons. Ely had studied under some of the leading historical economists in Germany, and he became an ardent believer in the superiority of the inductive method of research over the deductive method. We should note, however, that despite certain similarities in methodology between the German historical school and American institutionalism, the latter was not nationalistic, and it was more liberal and democratic in its outlook.

B. Major Tenets of the Institutional School

The following describe seven key ideas of this school:

- **Holistic, broad perspective.** The economy must be examined as a whole, rather than examined as small parts or separate entities isolated from the whole. A complex organism cannot be understood if each segment is treated as if it were unrelated to the larger entity. Economic activity is not merely the sum of the activities of persons motivated individually and mechanically by the desire for maximum monetary gain. In economic activity, there are also patterns of collective action that are greater than the sum of the parts. A union, for example, develops a character, an ideology, and a method of operation of its own.

Its features cannot be deduced from the study of the individual members who belong to it. Even the concept of economic activity is too narrow in the institutionalists' view. Economics, they assert, is intertwined with politics, sociology, law, custom, ideology, tradition, and other areas of human belief and experience. Institutional economics deals with social processes, social relationships, and society in all its facets.

- **Focus on institutions.** This school emphasized the role of institutions in economic life. An institution is not merely an organization or establishment for the promotion of a particular objective, like a school, a prison, a union, or a federal reserve bank. It is also an organized pattern of group behavior, well established and accepted as a fundamental part of the culture. It includes customs, social habits, laws, modes of thinking, and ways of living. Slavery and a belief in slavery were institutions. Other examples are the beliefs in laissez-faire, or unionism, or a government social security system. Going out on New Year's Eve to raise a din and clatter is an institution. So was communist ideology in the Soviet Union and anticommunism in the United States. Economic life, said the institutionalists, is regulated by economic institutions, not by economic laws. Group social behavior and the thought patterns that influence it are more germane to economic analysis than is the individualism emphasized in Marginalist theory. The institutionalists were especially interested in analyzing and reforming the institutions of credit, monopoly, absentee ownership, labor-management relations, social security, and the distribution of income. They advocated economic planning and the mitigation of the swings of the business cycle.

- **Darwinian, evolutionary approach.** The evolutionary approach should be used in economic analysis, because society and its institutions are constantly changing. The institutionalists disagreed with the static viewpoint that sought to discover eternal economic truths without regard for differences of time and place, without concern for changes that were occurring constantly. Instead of asking “What is?” the institutionalists asked “How did we get here, and where are we going?” The evolution and functioning of economic institutions should be the central theme in economics. This approach requires knowledge not only of economics but also of history, cultural anthropology, political science, sociology, philosophy, and psychology.

- **Rejection of the idea of normal equilibrium.** Rather than the idea of equilibrium, institutionalists emphasized the principle of circular causation, or cumulative changes that may be either salutary or harmful in seeking economic and social goals. Maladjustments in economic life are not departures from normal equilibrium but rather are themselves normal. Before World War II, the outstanding maladjustment was the business slump. Then the problems of economic development became the center of attention. In the late 1970s, the problem became stagflation, the simultaneous occurrence of inflation and unemployment, whereas in the mid-1980s, problems of trade deficits and federal budget deficits arose. The institutionalists are convinced that collective controls through government are necessary to continually correct and overcome deficiencies and maladjustments in economic life.

- **Clashes of interest.** Instead of the harmony of interests that most of their contemporaries and predecessors deduced from their theories, the institutionalists recognized serious differences of interests. People, said the institutionalists, are cooperative, collective creatures. They organize themselves into groups for the members’ mutual self-interest, which becomes the common interest of the group. There are, however, clashes of interests between groups, such as big business against small business, consumers against producers, farmers against urban dwellers, employers against workers, importers against domestic producers, and the makers of goods against the lenders of money. Here, again, a representative and impartial government must reconcile or override clashing interests for the common good and for the efficient working of the economic system.

- **Liberal, democratic reform.** The institutionalists espoused reforms in order to bring about the more equitable distribution of wealth and income. They denied that market prices are adequate

indices of individual and social welfare and that unregulated markets lead to the efficient allocation of resources and a just distribution of income. The institutionalists invariably condemned laissez-faire and favored a larger role for government in economic and social affairs.

- **Rejection of pleasure-pain psychology.** The institutionalists repudiated the Benthamite underpinnings of economic analysis. They reached out instead for a better psychology, and some of them incorporated Freudian and behaviorist ideas into their thinking.

C. Whom Did Institutionalism Benefit or Seek to Benefit?

The school embodied the middle-class desire for reform in an era of growing big business and banker capitalism. It represented the needs and interests of agrarian, small business, and labor groups. Government workers, reformers, humanitarians, leaders of consumers 'organizations, and union members were attracted to the institutionalist ideas, which they hoped might alter the orientation of private business enterprise in favor of their own interests. Many academicians in fields other than economics praised the institutionalists' interdisciplinary focus and their advocacy of social change.

D. How Was the Institutional School Valid, Useful, or Correct in Its Time?

The institutionalists challenged the development of rigid orthodoxy in economic thinking. Many of their criticisms of orthodox theory were valid and helped to revise that type of theory to make it more tenable. The institutionalists' stress on looking at the economy as a whole as part of an evolutionary process and in an institutional setting added elements of realism to economic analysis.

The institutionalists roused belated, but deep and lasting, concern over business cycles and monopolies. They promoted a reform movement that effectively removed many of the rough edges of capitalism. The emphasis of some of their members on inductive studies reduced the gap between economic theory and practice. Gathering and analyzing statistical data became popular in government circles, among private, nonprofit research organizations, in business and labor organizations, and among individual economists.

The National Bureau of Economic Research, founded by Wesley C. Mitchell and others in 1920 and guided by him for many years, is a monument to this method.

E. Which Tenets of the Institutional School Became Lasting Contributions?

The broader perspective that institutionalists advocated became a reality within the economic mainstream with the appearance and widespread acceptance of Keynesian macroeconomics. In fact, with their aggregate approach, their prescriptions for stabilizing the economy, and their attraction to political liberals, Keynesianism and post-Keynesianism tended to co-opt and supersede institutionalism.

The reform movements promoted by the institutionalists remain alive today. Modest steps toward national economic planning for limited objectives such as conservation, full employment, and international competitiveness are in line with institutionalist thought. Legal protection of unionism, social insurance, and minimum wage and maximum hour legislation are all legacies of the institutionalist challenge to orthodox economic thinking.

With the greatly expanded interest in problems of economic development, there has been new emphasis in this field of economics on the influence of the institutional environment on economic relations. By their nature, the problems of economic development involve diverse cultural factors and are dynamic and evolutionary. Lasting contributions of institutionalists are also found in other fields, such as labor relations, law and economics, and industrial organization. Ironically, some of the more innovative neoclassical contributions of the past three decades consist of a new institutional analysis. For example, orthodox economists have analyzed such divergent institutions as property rights, seniority, retirement policies, and the family. But unlike the old-line institutionalists, these new theorists have sought to determine the economic rationality of institutions- the economic logic underlying their emergence and how their presence currently contributes to or detracts from economic efficiency.

Traditional institutional economics still has a presence within the United States today. The membership of the Association for Evolutionary Economics is largely composed of economists who are oriented toward institutionalist methods, policy perspectives, or both. The organization meets regularly and publishes the Journal of Economic Issues. Nevertheless, the overall penetration of institutionalism into the mainstream of economics remains modest. In this respect, R. A. Gordon's assessment is as true today as it was over four decades ago:

It is clear ...that what passes for orthodox economics is today more institutional than it was before, say, the Great Depression.... In an important sense, however, the central core of economic theory is about as “non-institutional” as it was in Veblen’s day. Samuelson’s *Foundations* or Hicks’s *Value and Capital* is developed in much more of an institutional vacuum than was Marshall’s *Principles*. Theoretically inclined economists, with some exceptions, do not take kindly to the study of institutional arrangements or institutional development [they leave that to historians and sociologists]. Despite some of the new developments in the theory of the firm and of market behavior, micro economic theory is still concerned primarily with the kind of “equilibrium” which Veblen so severely criticized.

We next turn to Thorstein Veblen, the brooding, enigmatic genius who is considered to be the founder of the institutionalist school.

3.2 Thorstein Bunde Veblen

Thorstein Bunde Veblen (1857–1929), the son of Norwegian immigrants, was born on a frontier farm in Wisconsin and raised in rural Minnesota. He completed his undergraduate college education at Carleton College, Minnesota, where he was a student of J. B. Clark. His graduate work was done at Johns Hopkins, where he failed to obtain a scholarship, and at Yale, where he received a doctorate in philosophy. No academic position was available to him, however, largely because he held agnostic views at a time when a divinity degree was considered a desirable prerequisite for teaching philosophy.

Veblen received fellowships at Cornell and at the University of Chicago for postdoctoral work. He became the editor of the *Journal of Political Economy* at Chicago. Veblen never reached the rank of full professor, despite his eleven books and his lasting world reputation.

Because of marital troubles, indifference to most of his students, involvement with women, and poor teaching techniques, he had to move from college to college. After Chicago, he taught at Stanford, the University of Missouri, and the New School for Social Research. In 1918, he worked briefly for the Food Administration in Washington, D.C., and served as an editor of the journal *The Dial*. A former student aided him financially in his later years. He died in August 1929, a few months before the great stock market crash and the beginning of the depression he had been predicting.

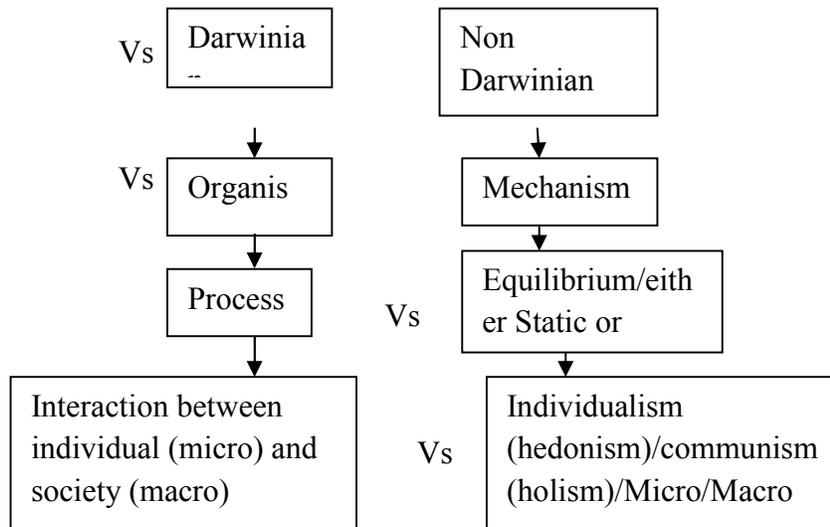
Veblen was a bitter, skeptical, pessimistic, and lonely man. His books, though written somewhat ponderously and obscurely, are replete with wit, wisdom, and sardonic attacks on middle-class virtues.

3.3 Original Institutionalism; Veblen's evolutionary institutionalism:

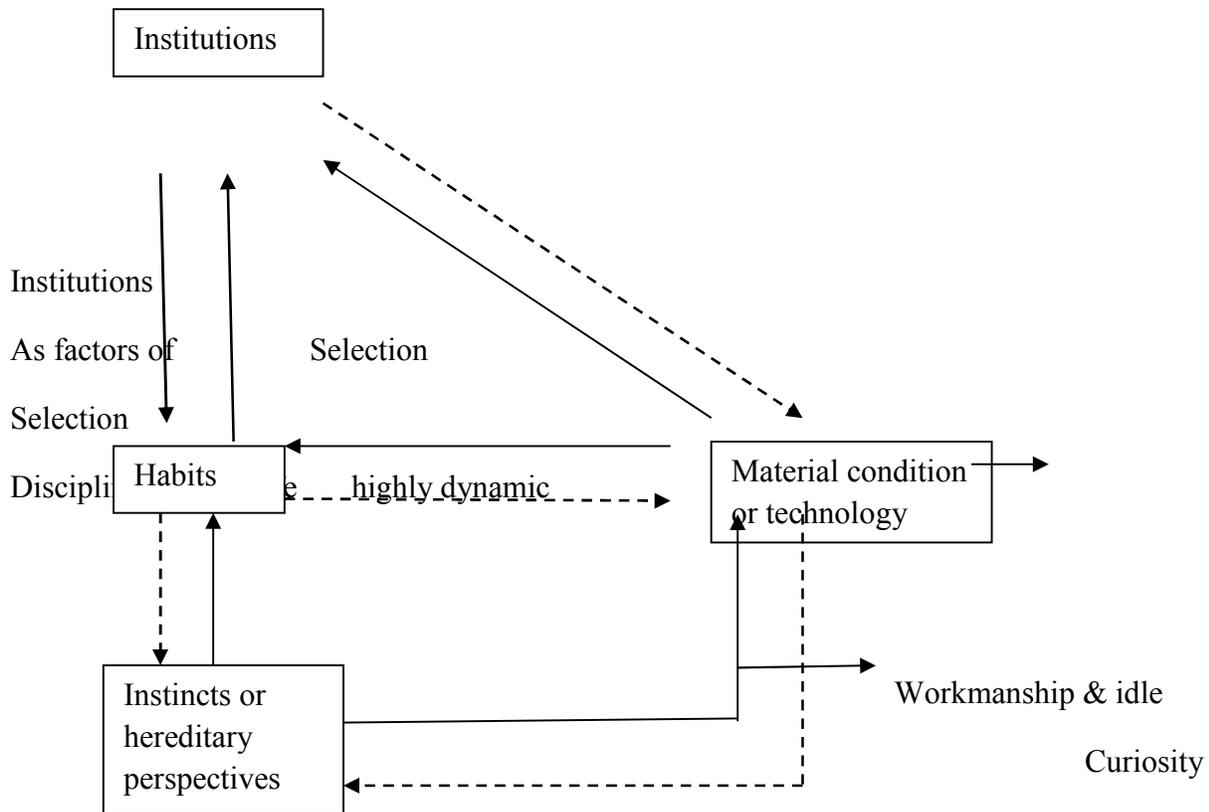
- In the end of 19thc, economics had not yet become **an evolutionary science** (in other words a theory that focuses on process or an unfolding sequence having neither origin nor a final term).
- On the contrary traditional /classical theories/laws, equilibrium of Marshal Causes lead in the end to a system of **economic Taxonomy**.
- An evolutionary economic theory;
 - Have economic action as its subject.
 - Individual life admitably represents “an unfolding activity of a teleological kind i.e. one aims at certain objectives but this objectives are not immutable i.e. there is a cumulative process of adaptation i.e. means become an end and an end become a means & the process goes on.
 - Hence there is no legitimate trend towards predetermined end (like classical or neo-classical)
 - Rather there is cumulative sequence.
 - One might say that in this approach institutional change is deemed endogenous to long-term economic movement (non-teleological or finalistic)
 - For Veblen this genetic method aims to recognize social phenomena into a theoretical structure in causal terms.

Nature and Origin of institution for Veblen:

- Institutions are the result of a process where each state without an end without origin rather than classicals.



- ✦ For Veblen, society in General and economy in particular are evolutionary groupings of institutions.
- ✦ The evolutionary economic science that Veblen tries to construct is, therefore, centered on institutions, which are “*prevalent habits of thought and action in the social community.*”
- ✦ Hence for Veblen institutions are;
 - Prevalent habits from all
 - Their essential feature is a certain relative **inertia** with regard to social evolution.
 - They were formed in the past and are inherited from the past.
 - They are products of past process.
 - They are adapted to past circumstances and are therefore never in full accord with the requirements of the present.
 - However, they emanate from habits of life.
- ✦ But habits of thought are outcomes of habits of life.
- ✦ Whether there it is intentionally directed to the education of the individual or not, the discipline of daily life acts to alter or reinforce the received institutions under which man lived.



Instinct and habits for Veblen:

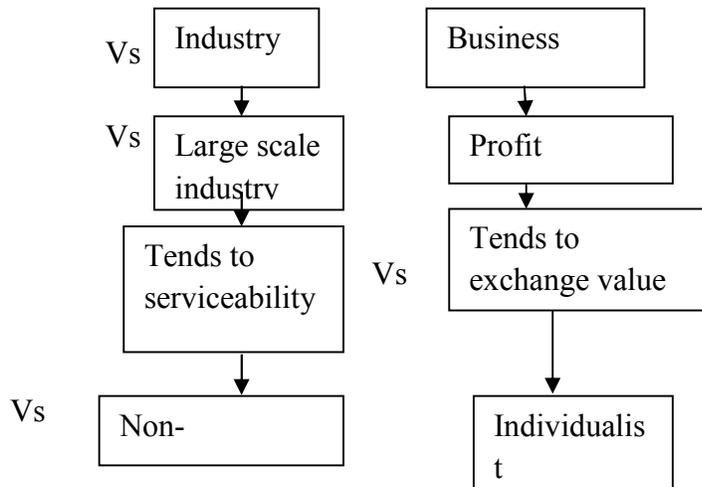
- The formation of institutions or habits of thought, results from a complex interaction between various levels and temporalities of evolution.
- Instincts;
 - Are deepest nature of human behavior
 - Hence they are very slow for evolution/almost fixed.
 - Veblen divided them into two
 - I. Those operating for the benefit of the group (non-individualist)
E.g. workmanship, parental bent & idle curiosity
 - II. Those operating counter the benefit of the group (individualist)
E.g. predatory instinct, propensity for emulation, self-regarding instincts, etc.
- These two sets of instincts “*mutually influence or contaminate each other*”
- Instinct is the first level of evolution towards institutions.
- Habits;
 - The second level of evolution

- They are ways of thinking and acting that are formed in particular historic and material circumstances (technology)
- Institutions;
 - The third level of evolution
 - Habitual life of human changes, cumulatively everyday resulting a continued proliferous growth of institutions.
- Continued change of institutional structure results from change in alternative discipline of life (habits), but human nature (instincts) remains specifically the same.
- The **dash line** in the above figure shows how **slowly** instincts affect by habits or technology.

Veblen Dichotomy and Dualism:

- Veblen's interpretation often use the word "Dichotomy" to describe the contrasting interaction he find to be operating between technology and institutions;
 - Technology is always dynamic
 - Institutions are resistant to change (*institutional inertia due to past adaptation*)
- In Marx there is successive conflict between;
 - 1) Forces of production which is dynamic like technology
 - 2) Relation of production which is similar to institution
- Dualist oppositions are numerous in Veblen's theory, however, with their ultimate foundation to be found in the conflict of instincts.

E.g. Workmanship Vs Predatory
- This two instincts take one over the other in different period of history;
 - i. Primitive savage; Workmanship > Predatory
 - ii. Barbarian; Workmanship < Predatory
 - iii. Handicrafts; Revival of Workmanship
 - iv. Era of Machines; Revival of Predatory
- As Veblen stated since he is non-teleological we don't know which instinct come latter
- The interplay of this different dualism culminates in the opposition between **industry and business that is typical of capitalism.**



Institutional Evolution for Veblen:

- Veblen consequently affirms the existence of an interaction between; **Technology (highly dynamic) and slow moving instinct & habit** which results selection of institution.
- He differs from 19thc idea of uni-linear progressive evolution due to institutional inertia.
- These institutions are representing an outgrowth of habit and the growth of culture is a cumulative sequence of habituation.
- Due to institutional inertia Veblen was skeptical and critical of institutions but underlines their essential role in the economy and the society.

Cumulative causality:

- It is a central to Veblen's evolutionary institutionalism.
- It implies;
 - Sequence approach to change (whether positive or negative) irreversibility of time.
 - It is recursive causality (cause↔effect unlike deterministic causality (cause→effect)).
- This form of causality is found in these implies institutions are an objects but also a factor of selection in the evolutionary process

- I.e. institutions can be taken as a frame work in which habits are selected
- Hence Veblen distance himself from Holism and Hedonism
- Hence situation of today shapes tomorrow through selective and cumulative process.
- For Veblen the “**preferences**” of individuals are endogenized rather than constrained or unexplained by mysterious data conceding individual action.

The Evolutionary selection of institutions:

- Veblen also took selection theory of Darwin from Biology to institutions
- Hence he implies;
 - The prevailing or the dominant habit or attitude or mode of life will be selected and, therefore, in turn efficient factors of selection of habits (selecting the fittest habit) (non-teleological)
 - Hence a complex combination of co-evolution and reciprocal determination which is called institutional dialect.
 - But in this dialect instincts are stable on Historic scale

Veblen Critics on Neo-classical:

- In Veblen’s theory Charles Darwin model taken as a general model besides being biological evolution.
- He states every economic system is a peculiar economic state of **evolution**.
- He called classical, Marx and German historical School (to some extent) **Teleological (finalistic) non-Darwinian (non-evolutionist)**
- Veblen is essential criticism of the established economic theories is that they are pre-Darwinian.
- Veblen is the inventor of the term Neo-classical.
- This term underlines the continuity between classical & those of Marshall Theories.
- He criticizes classical for their **Teleological bias** and also for confusion between normative and factual analysis.
- I.e. the classical tradition was “**Taxonomic**” meaning it had remained at the stage of the classification of categories; **it was not evolutionary or genetic**.

- For him classical invented inaugural stage of the economy in order to justify its normative nature.
- He criticized Neo-classical;
 - The static equilibria which leads them to **Teleological**
 - They limited their investigation to the constraints posed by economic conditions without wondering about cumulative transactions and institutional change.
- In Neo-classical (utilitarian's);
 - Institutional factors were taken for granted, denied, or explained away.
 - He calls them Hedonism (humans are a lightning calculators of pleasures and pain who oscillates like a homogeneous globe. They have neither antecedents nor consequent, and isolated)
 - I.e. for utilitarian human is not a living process but is driven by external forces.
- The fundamental error of both the Austrian (Marshall) school and the English economist was to postulate a **passive** and substantially inert and immutably given human nature.
- In the end, Veblen's criticisms of the theories existing in his time formulated and anticipated a large number of Heterodox **criticisms** of the dominant current economic thought, especially concerning the following points;
 - ✓ The implicit role played by normative postulates
 - ✓ Antagonism between equilibrium centered(physical) and general science of evolution (mechanical)
 - ✓ The exogenous and immutable character of the assumed preference of the individual, reduced to a rational calculator and having no motivation other than person utility
 - ✓ The neglect of the essential role of institutions in real life economic progress.

Veblen Critics on Marx and the Historical school

- Despite having been strongly influenced by Marxian thought, Veblen is notable for having formulated a rarely heard criticism of Marx.
- For Marx due to class struggle, each class will act in reasoned fashion in the light of their own interests.

- In a Darwinian approach, however, there is nothing to guarantee that the interest of the working class will lead to oppose the capitalist class.
 - I.e. workers may accept the chaining condition (inferiority).
 - He stresses the Neo-Hegelian teleologism underlying the Marxian conception of history in general and of capitalism in particular, which is romantic and pre-Darwinian.
- ✪ Veblen criticizes Historical Schools based on the following;
- German historical school (old) they are descriptive not theoretical
 - While the young German historical School closer to Darwinian evolutionary process, Veblen criticize them based on their inability to distinguish between theoretical reflections and social reform.

3.4 The New Institutional Economics:

(Oliver Williamson & Douglas North)

A. Williamson Transaction Economics:

- 📌 Williamson was he inventor of the term “New institutional Economics”
- 📌 He tried to analyze institutional matter with the instruments of standard economic theory with certain arrangements. He undoubtedly implies a certain relationship with the old institutional economics but his criticism of the latter remains.
- 📌 In 1940’s—neo classical economics was the dominant one (equilibrium and the invisible hand were dominant)
- 📌 In 1970’s new idea of institutional economics came up (New Institutional Economic) (NIE’s).
- 📌 They are indebted to original institutionalist (Schmoller and Veblen)
- 📌 The initial themes of NIE’s is **organizations** (essentially the firm, or in Williamson’s terminology, the **hierarchy**)
- 📌 Williamson;
 - 📌 He is A father of transaction cost economics
 - 📌 He Criticize the original institutionalist based on they have no general theory (Like Veblen or German Historical School)
 - 📌 He took an idea from “**Ronald Coase: The nature of the Firm.**”

- ❖ The firm is the dominant individual figure in Capitalist economy
- ❖ So why the firm is so important and the dominant figure?
- ❖ This explanation actually lies in the ‘costs of using the price mechanism’ or the ‘operation of a market costs’. These costs relate to the search for appropriate prices and to the negotiation of separate contracts
- ❖ When these costs are high, an individual may choose to work in a firm, placing himself voluntarily under the authority of an entrepreneur rather than selling his services or his products directly on the market. In this case, the firm replaces the market, permitting the ‘economizing’ of the costs involved in the determination of prices.
- ❖ He supposes, metaphorically speaking, that ‘**in the beginning there were markets**’ and goes on to state that firms sprang up from the market by differentiation, because of the importance of transaction costs. These transaction costs are not taken into account in the neo-classical context, which considers only production costs.
- ❖ The author also distances himself from the neoclassical school by introducing his notion of ‘bounded rationality’ (partly borrowed from Simon) and his thesis of ‘opportunism’.
- ❖ ‘Contractual man’ differs from ‘economic man’ in that he is ready to lie and cheat to defend his interests.
- ❖ Contrary to earlier conceptions – where the economic institutions of capitalism are explained by reference to class interests, technology, and/or monopoly power – the transaction cost approach maintains that these institutions have the main purpose and effect of economizing on transaction costs.

B. Douglas North: formal and informal institutions:

- ❖ He is a particularly significant exponent of the NIE’s.
- ❖ His work as an economic historian has evolved from a fairly radical neo-classical position, placing the accent on quantitative methods of measurement in history (‘cliometrics’).
- ❖ ‘Cliometrics’ is the application of econometrics on the past.
- ❖ The principal errors of neo-classical tradition, in his view are;
 - ❖ It ignores institution and time
 - ❖ It neglects transaction costs
 - ❖ It neglects the role of ideas and ideologies

■ Its concept of “**Rationality**”

- He emphasizes the concept of “**bounded rationality**” evoking the context of “**uncertainty**” involved in most economic & political decisions.

Formal and informal institutions, ‘enforcement’ For Douglas North:

- For North, institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self-imposed codes of conduct), and their enforcement characteristics. North uses the metaphor of ‘**rules of the game**’ to describe institutions, but from a perspective somewhat different from that of **game theory**.
- Starting with his 1990 book, North has increasingly stressed the role of **structures of belief**.
- If the neo-classical assumption of rationality is open to dispute, this is because ‘history demonstrates that ideas, ideologies, myths, dogmas and prejudices matter’
- Both ideologies and institutions can be viewed as ‘**classes of shared mental models**’
- In situations of great uncertainty, the individual faced with making choices goes through a learning process with the help of a mental model
- And then communication between individuals generates shared mental models, leading to ‘the creation of ideologies and institutions in a co-evolutionary process’
- The reader may have the impression of a rediscovery of a Veblenian thesis, according to which institutions are ‘**shared habits of thought**’
- In his early work, North adopted a neo-classical approach to institutions, in which the latter represented efficient solutions to economic problems.
- Through a progressive evolution, he then completely abandoned this approach and seemed even to reverse it by declaring that institutions are in reality based on power.
- Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to create new rules. As a consequence, it is exceptional to find economic markets that approximate the conditions necessary for efficiency. It is impossible to find ‘political markets’ that do so. Note that entrepreneurs or ‘principals’ nevertheless remain, in his view, utilitarian rational maximizers

Organizations and institutions:

- Contrary to original institutional economics, North states that it is essential to distinguish institutions from organizations.
- If institutions are the rules of the game, organizations and their entrepreneurs are the players.
- The rules define the way in which the game is played, while the teams try to win within the framework of these rules using strategy, co-ordination, competences and fair or foul means.
- Organizations are made up of groups of individuals bound by some common project to achieve objectives; these can be divided into political, economic, social and educational organizations
- The institutional framework conditions the type of organization that will be created, as it does their evolution, but in their turn the organizations will be at the source of institutional change
- That is, if the institutional framework rewards piracy then piratical organizations will come into existence; and if the institutional framework rewards productive activities then organizations – firms – will come into existence to engage in productive activities
- The institutional framework is usually a mixed bag of institutions with two contrary dimension;
 - that promote such productivity-raising activities and
 - institutions that provide barriers to entry, encourage monopolistic restrictions, and impede the low-cost flow of information'
- The existing institutions therefore determine the incentives or opportunities that will benefit pre-existing organizations, or entrepreneurs, which will then create new organizations; the organizations will in their turn evolve in the established framework but will also try to modify this framework (Like Veblen's cumulative causality).

Institutional change and Performance for Douglas North;

- In all cases, and in predominant fashion throughout history, institutional change is gradual and progressive; radical large-scale changes are rarer, consisting of war, conquest, revolution and natural disaster.

- The mental models also have a tendency to evolve progressively, in Darwinian fashion, over long periods, followed by briefer episodes of major change. This type of evolution recalls the ‘punctuated equilibria’ of Gould and Eldredge (Denzau and North, 1994).
- Formal and informal institutions are not subject to the same time frames with regard to change.
- While it is relatively easy to change rapidly or even overnight in the case of the formal institutions, the modification of informal institutions takes place very gradually.
- This is why revolutionary transformations are never as far-reaching as their advocates would like and why the transfer or imitation of formal institutions between countries does not achieve the hoped-for results.
- And economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement.
- The implication is that transferring the formal political and economic rules of successful Western market economies to Third World and Eastern European economies is not a sufficient condition for good economic performance.

The causal sequence of change

Mental models and ideologies (beliefs)



Institutional framework of polity and economy



Incentive structure



Organizations



Policies



Performance

3.5 The Quasi institutionalist Paradigm:

(Joseph Schumpeter, Gunnar Myrdal & John Kenneth Galbraith)

The modern institutionalist school consisting of Veblen, Commons, Mitchell and their followers remained a tightly knit group. However, there are other economists who followed the institutionalist approach but their line of work is too individualist to fit them in any group. In this lecture we discuss three such economists: Joseph Schumpeter, Gunnar Myrdal and John Galbraith.

A. Joseph Schumpeter (1883 –1950)

- Schumpeter was never interested about the equilibrium focused approach of neo classical economics.
- He was concerned about the dynamic aspect of the economies. He became famous for his concept of *creative destruction*.
- The idea of creative destruction deals with the destruction of old technology and products with the creation of new ones.
- He criticized the use of static models by the neo-classical group.
- He was not a Marxian even though he acknowledged the power of Marx's vision.
- He declared his interest and supports for the orthodox paradigm comprising mathematics and econometrics, even though his own work mostly did not use these techniques.

B. Gunnar Myrdal (1898-1987)

- His major criticisms of orthodox economic theory center on:
 1. The role of value judgments,
 2. The scope and methodology, and
 3. The implicit Laissez faire bias of the orthodox theory.
- Myrdal concludes that attempts by orthodox Economists theorists to develop a positive science free of normative judgments have failed. He maintained that it is impossible to separate normative from positive
- He another major criticism against orthodox theory is that it is too narrowly defined. He also criticized economics for being so conversed about short run.

- Like Schumpeter he was also more interested about long run is economics where we can look at the development aspects of an economy.
- He said that orthodox economics is pre-occupied with equilibrium which is inappropriate for analyzing social outcomes.
- Myrdal was very critical of the way orthodox theories promote laissez faire as the best policy to follow. Myrdal believed that in the post-World War era western countries are going through welfare statehood. In this phase government takes welfare measures in piecemeal fashion to ease the pressure off the society. Hence there is a lack of coordination which can be remedied by overall planning of macroeconomic goals.
- Orthodox theory of growth is based on the logic of capital accumulation. In his study Myrdal found that orthodox theory is not very helpful for explaining situations is LDCS.
- He finds that labor efficiency in LDC'S are very low. So that capital accumulation will not deliver the desired result.

C. John Kenneth Galbraith

- Galbraith was a major critique of the orthodox economics but did not provide any alternative theoretical structure.
- His major work consists of three books:
 - 1) Countervailing power
 - 2) The Affluent society and
 - 3) The new industrial state.

American Capitalism (1952)

- Standard economics takes competition as the benchmark case and imperfect competition as the aberrations. From American economy experience however, it's very clear that Monopoly and Oligopoly are not aberrations but essence of the economy.
- He said that when competition declined following the rise of large corporations, another power started rising out of the customers or suppliers of the big corporations. He calls this power the *countervailing power*.

For example, growth of large corporation led to the growth of powerful unions. This countervailing power keeps a balance in the economy by restraining the existing power.

The Affluent society (1958)

- While American capitalism focuses on the efficiency of resource allocation in the private sector, in affluent society he concentrated on allocation of resources between private and public.
- He said that the orthodox price theory is good to explain allocation problem in a society which is concerned about providing basic necessities. A society such as the American one has solved that problem and now moving towards the production of low priority goods.
- He finds that with increase in GDP focus has shifted to producing even more. He contends that this is because of unequal distribution of income, individual insecurity and recurring economic depression. Societies try to solve these issues by having ever growing output.
- He maintained that in a traditional, scarcity based society preferences is exogenous. But in an affluent society desire is constructed by the producers
- This requires a completely new consumer theory which does not presuppose consumer sovereignty.

New industrial state (1967)

- Nine years after the publication of *The Affluent Society*, *New Industrial State* was published.
- In this book he mainly criticized the orthodox theory of firm.
- He observed that Modern technology → Large scale firm. Large scale firms have the following characteristics
 - Separation of ownership and control.
 - Planning which includes the management of consumer preference is now essential.
- Orthodox theory assumes sovereign consumers who reveal their preference through price signal. Accordingly firms produce
- Galbraith says this sequence is a myth.
 - Firms can construct preference.
 - Social attitudes are constructed by techno structures.

- Hence, in American society, according to Galbraith, the sequence is reversed. It is the corporations which to a large extent can influence/control consumer's attitude. Affluent society and new industrial society project a darker reality than American Capitalism.
- However, going through Galbraith's work reveals some inherent inconsistencies.
- In American capitalism he was optimistic about the restraining capacity of countervailing which is completely missing in the next two books.
- In *The Affluent Society* and *The New Industrial State*, the corporations are the most powerful which can create demand and then meet then with supply.
- This provides a rather simplistic description of the society. Essentially this ignores all the inherent contradictions in a society.

3.6 Post-Keynesian and Institutionalism:

- There are similarities between the post Keynesian and institutionalist theories that allow us to understand not only the instability of contemporary economies but, most of all, the relevance of institutions in coordinating them.
- Keynes and the post Keynesians demonstrate that, in an uncertain and unknown world, economic agents prefer to retain money rather than make investment decisions. The consequence of this rational preference is the insufficiency of effective demand.
- In a similar vein, institutionalists believe that the “economic environment” has nothing to do with the notion of “equilibrium”.
- The post Keynesian and institutionalist theories try to answer the following questions:
 - How do agents make rational decisions?
 - How do agents form expectations concerning saving or investment?
 - Why do they retain (or decide not to retain) money?
 - Can the institutional environment influence the decisions referred to above? If so, in what way?
- Uncertainty is the fundamental element of Keynes's theory.

*“Keynes without uncertainty is something like Hamlet without the Prince”
... Minsky*

- For the institutionalists, uncertainty is related to the notion of bounded rationality described by Simon (1983). According to Simon, agents faced with incomplete information adopt strategies characterized by conventions.
- In the Keynesian and post Keynesian theories, the concept of uncertainty appears explicitly, while in the institutional theory it is implicit in the theoretical approach.
- The concept of uncertainty is very important because it allow us to understand not only the instability of contemporary economies but, most of all, the relevance of institutions in coordinating them.
- In such an economy, fluctuations in effective demand and employment occur because, in a world in which the future is uncertain and unknown, individuals prefer to retain money, postponing consumption and investment decisions.
- Minsky emphasizes the financial character of contemporary capitalism, in which institutions are fundamental in providing continuity and credibility to the system.
- Both schools reject the idea of stability subordinated to the cannon of long term equilibrium.
- The institutional environment, is culturally and historically conditioned, and is subject to permanent alterations and rearrangements.
- The existence of a process of structural transformation in economies, foreign to orthodox schools of thought, is fundamental to the post Keynesian and institutionalist frameworks.
- The affirmation that Keynesian and institutionalist thought are opposed to such hypotheses does not imply that the two schools are similar, but that the basic critiques of the capitalist economy and its functioning are very similar.
- The similarity between Minsky and the institutionalists is in the critique of capitalism as inherently unstable, subjected to a process in which economic decisions must be made amidst

Self-Exercises

- 1) Do you think that economic Laws are Universal like the Ten Commandments?
Why/Why not?
- 2) Why institutions really matters in the study of economics?
- 3) What meant by institutional Inertia?
- 4) What was the main criticism by Veblen on Marxian theory? Explain using your working environment?

CHAPTER FOUR

GENERAL EQUILIBRIUM AND WELFARE ECONOMICS

“The orthodox economists are the creators of a bastard science.”

...Ruskin

4.1 Walrasian General Equilibrium

Leon Walras (1834-1910)

- ❖ He was one of several independent discoverers of the notion of MU.
- ❖ He also one of the first and strongest advocates of Methodological individualism.
- ❖ But his most important and lasting contribution to economic theory was his theory of “**general Economic equilibrium**”.
- ❖ He took a very abstract and theoretical problem about how all markets in the economy are related, applied sophisticated mathematics to the problem, and arrived at a solution.
- ❖ His solution showed that all the markets in the economy could be simultaneously achieve equilibrium.
- ❖ Walras added two important things to this vision;
 1. A mathematical representation of how all markets were interrelated.
 2. An argument that economics would move towards equilibrium in all markets.
- ❖ He realized that the forces of demand and supply in one market depended in varying degrees on the prices prevailing in innumerable others markets.
- ❖ In so far;
 - Price of any good was, for the utility theorists, determined solely by the supply and demand for that good.
 - Demand for any good was determined by both all consumers’ utilities from consuming it.
- ❖ Now Walras followed that to determine the price of good, the prices of other goods would have to be known.
- ❖ And the demand for those other goods (and their price) also depended on the price of the good in question!
- ❖ Hence
 - A general theory of price determination was required
 - In the general theory of price determination all prices would have to be determined simultaneously by both;
 - The total of all consumers utilities
 - The interrelations that existed among all markets

- ❖ However, such interrelations did not exist only in the demand for consumer goods. They also existed in the supply of consumer goods.
- ❖ Warlas attempted to formulate a general theoretical framework within which he could show how, through the interaction of all markets, all prices could be determined simultaneously.
- ❖ Needless to say, no theory can explain everything simultaneously. This could require an **Omniscience** by which the entire universe was completely understood.
- ❖ Obviously all “general” theories are “partial” theories in the sense that there are innumerable phenomenon that they do not purport to explain.
- ❖ The difference between general equilibrium theory and partial equilibrium theory in economics is;
 - The former usually attempts to explain all prices and quantities exchanged within an entire economy for a given period.
 - The latter takes as given all prices and quantities exchanged except for one or two and attempts to explain it.
- ❖ There are 3 important institutional factors in Warlas theory;
 1. The acceptance of the existing laws of and distribution of property as mutually right and just.
 2. He assumed perfect competition (existence of a number of small powerless firms) (ignored monopoly)
 3. People were simply assumed to have measurable MU schedule. There was no discussion of how these utility schedules came to existence or how they changed over time (thus, utility was a “Metaphysically given(**fixed**)”)
- ❖ After assuming these institutional factors, Warlas developed his system of equations to show what quantities of various commodities were exchanged and how their prices were determined.
- ❖ The purely logical requirements for such a general equilibrium theory was that the number of unknown variables must be **equal** the independent equations to determine the variables.

- ❖ There were **four sets of equations** in this economic model within two markets;
 - a. Product markets with two equations
 - b. Factor markets with two equations
- ❖ For product market:
 - The first set showed the quantity of each good that consumers demanded
 - The second set showed what determines the price of every good bought by households.
 - Warlas assumed perfect competitive, this enables him to set the price of each good **equal** to the cost of production.
- ❖ For factor market:
 - One set shows quantity of inputs or factors (land, labor & capital) offered to help produce goods.
 - Owners of factor inputs (workers, landlords, capitalist) determine the quantity of factors of production they wish to supply.
 - A final set of equations show the quantity of inputs or factors that business want to buy.
 - This depends on the final demand for goods (how much consumers want to buy at different prices)
- ❖ So far we have four set of equations;
 - 1. One showing the quantity of good demanded
 - 2. One showing price to cost of production
 - 3. One showing the quantity of inputs supplied
 - 4. One showing the quantity of inputs demanded.
- ❖ Hence we have four sets of unknowns that we need to solve for;
 - 1. The price of each good
 - 2. The quantity each final good bought and sold
 - 3. The price of each factors of production
 - 4. The quantity of each factor supplied and bought.
- ❖ But Warlas added one more equation to his mathematical system. This equation stipulates that all the money received by factors of production must be used buy something.

- ❖ This can be done either directly by each household spending all their income, or indirectly by some households saving money and then lending this money to other households.
- ❖ This extra equation created a difficult problem for Walras. He now knows that he had one more equation than the number of unknowns.
- ❖ To deal with this problem he selected one good, “**GI**”, arbitrary and the price of all other goods would be determined relative to “**GI**”.
- ❖ Hence the price of “**GI**” thus would be a **standard of comparison** or **numeraire**.
- ❖ Mathematically the number of unknowns would now be equal the number of equations in the general equilibrium representation of the economy.
- ❖ The system could be thus be solved for the price of all goods “**relative to GI**”
- ❖ The solution **could not** explain the **absolute level of prices**, or why a dozen of eggs cost \$2 rather than \$1 or \$4. **But it could explain why a dozen of egg costs twice as a litter of Milk** (relative price).
- ❖ Walras’s theoretical framework for his general equilibrium model was still remains significant.
- ❖ If we drop his highly unrealistic **faith in automaticity of the market**, his system of market interrelationships shows just how difficult it would be for a capitalist system ever to achieve a full employment general equilibrium.
- ❖ The theory can also show how, once a crisis started, it spreads to all sectors of the economy and becomes a general crises or depression.
- ❖ Walras shared several characteristics with nearly all the economic theorists writings in the utility tradition.
- ❖ First, he viewed the economy almost entirely from **exchange perspective**.
- ❖ Even when he wrote about production, like most utility theorists, he viewed production primarily as a series of “**exchanges**” and never from the perspective of the “**class relationships**” involved in production.

Thus, his analysis remained in what Marx called the “**sphere of circulation**”

4.2 Early neoclassical approach to welfare economics;

(Hobson & Pigou Welfare economics)

- England is the home of welfare economics, which was a direct refutation of classical economics, especially the Laissez-faire doctrine.
- As against the objective of maximization of production and wealth, pursued by classical economists, the welfare economists emphasize 'welfare', to be direct objective of all economic thought and policies.
- Whereas classical economists emphasized production, supply, and cost, the welfare economists lay stress on consumption, utility, and demand.
- This emphasis of 'welfare' was not new but it received fillip only after WWI, mainly because of the existence of poverty amidst plenty.
- One come across many books written in Italy during 18thc, whose titles contained the word 'welfare'
- Welfare was also an essential element of the utilitarian economics of Bentham and his followers.
- **J.S. Mill** was the first to declare that while the laws of production were unchangeable, those of distribution could be changed and adopted to maximize the national welfare.
- In England, trade union leaders and Fabian socialists, worked with full zeal for providing relief to the bulk of population consisting of the working classes, from the distressing conditions of their living. And they achieved success too.
- The concomitant result was that the need for the socialization of British economic life was recognized and orthodox economics came to be looked up on with suspicion.
- The 20thc welfare economics is realistic and pragmatic. Prof. A. Marshall has been regarded as the founder of the welfare economics. It has been further developed by;
 - J. Hobson
 - A. Pigou
 - V. Pareto
 - J. Hicks
 - N. Kaldor, etc

- Welfare economics has been described as a tendency to modify the classical doctrines and to make economics deal with social policies, directed towards achieving the goal of ‘social welfare’
- According to **Reder**, welfare economics is “**the branch of economic science that attempts to establish and apply criteria of propriety to economic policy**”
- Reder regards it as scientific as medicine.
- Regarding the measurement of welfare, **Reder** says, “economics welfare increases when the algebraic sum of all compensating taxes and bounties is positive; it diminishes when that sum is negative and remains unchanged.”

A. J.A. Hobson (1858-1940):

- He was born in Derby in 1858 and leaned early education in Derby school, and later went to Lincoln College, Oxford studying classical language and literature.
- In 1897, he started writing articles for the *Nation* and other magazines and newspapers. Although he treated some of the most important problems, his attitude was not that of an academician. He did not; therefore receive any recognition at the hands of the academic economists of his day.
- He lacked thorough grounding in economic analysis, and hence, his economic ideas have been criticized severely by academicians. Hobson’s writings have been chiefly directed against the classical economics. His chief indictment was that, however well-worded and reasoned the classical economics may be, it fails to provide a satisfactory explanation of the existing inequalities, exploitation and distress.
- His main books were;
 - The economics of distribution (1900)
 - The industrial system (1909)
 - Work and wealth: A Human Valuation (1914)→his most representative work on welfare economics
 - The Economics of Unemployment (1922)

- He was a prolific writer. He wrote voluminously on questions like *inequalities, injustices and maladjustments of economic society under capitalism*.
- Unlike classical economists, he held that competition was often imperfect, and that in the absence of effective demand, market gluts often occurs. He regarded economics as a qualitative science of human value. He considered individual welfare as an **organic** whole which could hardly be explained in terms of **Marginal increment** of specific commodities.
- He was greatly **influenced** by **Toynbee**, then a lecturer at Oxford, **Ruskin and Veblen**. He had **admiration for Veblen and respect for Ruskin**, who he regarded as the “**greatest social teacher of his age**”
- Ruskin;
 - A wealthy man who used his riches in helping the poor people
 - He attacked the orthodox economists as the creators of **a bastard science**.
 - He held that the object of economics must be to increase human welfare
 - He declared “there is no wealth but life; life including all power of love, joy and admiration”
- As we would see latter, Hobson was a true disciple of Ruskin. He criticized the classical economics on the core of **individualism and competition**. According to him, the assumption of free competition is no longer valid. He held that the quantitative approach of the classical economists was improper and the market price was not an index of welfare. By welfare he meant good life.
- In his opinion, the entire analysis of the classical economists with its emphasis on **production** was defective, since it undermines the importance of **consumption**. *He said that production is meant for consumption and, hence, it was subordinate to consumption*. He thought that economics must be studied from the welfare point of view.
- To him economic life was network of business and trade, **but thought, desires and relations were its spiritual texture**.

- Although economics has developed a tendency to become less material in its outlook year by year and to give more attention to the psychological supports of the industrial system, “the science remains distinctively mechanical and unfit for the performance of any human interpretation of industry.”
- The chief reason, why he regards the classical approach as mechanical, is that
 - 1st every phenomenon is measured in terms of money, be it utility, value, cost or wealth
 - 2nd the importance of motives, interests and ideas in invention and other productive work and their importance in life or human progress and happiness is hardly recognized.
- According to him there are three defects in classical economics;
 1. An exaggerated stress upon production, reflected in the terminology and method of science, with a corresponding neglect of consumption.
 2. A standard of values which has no consistent relation to human nature.
 3. A mechanical conception of the economic system due to the treatment of other human action as a means to the production of non-humanly valued wealth.
- According to Hobson, both the vital utility of consumption and the vital cost of production are important

“ . . . All concrete wealth or money income must be estimated in relation to the vital cost of its production and the vital utility of its consumption”

. . . Hobson
- Thus, an economic system which emphasizes cost and undermines human utilities or which exaggerates the importance of production and man as a source of labor and which neglects the utility of consumption and the importance man as a human being is hardly of any practical value.
- Man produces goods according to his needs and puts in certain sacrifices which are a human cost of production and which must be balanced by the utilities created as a result of these sacrifices.

- Saving is a source of capital, which involves sacrifice. Since the human cost among the upper and the middle classes of the society are not heavy, saving in their cases does not involve any sacrifice, it is among the laboring classes that the human costs are the heaviest. Saving in most working-class families, since it has for its objectives future security, is purchased through self-denial, stinting of comforts and education, and the surrender of the amenities of cultured life.
- Hobson's attempt towards the reconstruction of economic science appears to be more important than his other contributions. He wanted to **make 'welfare' the center of economics**, instead of the analysis of **value and price, which according to him was unreal.**
- He did not approve of the evaluation of production and consumption in terms of money by the classical economists. Instead he wanted to evolve a method for the measurement of human costs and utilities. He wanted to analyze the working of economic phenomena through comparative study of costs and utilities.
- Consideration of the **organic origins of industry** lend no support to the assumption of that **production is all "cost and no utility", consumption, all "utility and no cost"**. He wanted Human value to be substituted for money value. The aggregate human value of the real wealth of a nation can be found out by answering the following questions;
 - a) What are the concrete commodities and services included in the real national income?
 - b) How the commodities are produced?
 - c) How they are consumed?
- Business costs can only be expressed in terms of human costs, when one knows
 - a. The quality and kind of human efforts involved in business costs
 - b. The capacities of human beings who put in these efforts
 - c. The distribution of total efforts among those who put in effort

- Every human effort is capable of being resolved into physical and mental reactions expressed through feelings and activities. The net excess of the desirable over the undesirable in these activities would represent the human value of goods or services.
- Likewise, the utility of consumption can be found out by knowing;
 - a) The quality and kind of the satisfaction or utility which is yielded by the ‘economic utility’ that is sold to the consumers
 - b) The capacities of the consumers who obtain this economic utility
 - c) The distribution of the economic utility among the consumers
- He has divided all productive activity into **seven classes**; Art, invention, professional service, organization, management, labor and saving. He has tried to show that in each of these categories costs and utilities differ. In short, he concludes that persons receiving the highest pay in our society incur the lowest cost.
- In laboring class operations workers;
 - get physically tired
 - get involved into accidents and other nervous disorders
 - their energy is dissipated and their morale is very much lowered down
- Again, unemployment and intermittent employment further add to human costs and force women and children to take up employment. While determining the values emanating from the industrial system, human costs must be set against the utilities derived
- For Hobson, despite industrial progress and the improvement of industrial processes, material welfare has not increased because “the large surplus . . . is being consumed in the field of conventional consumption, which leads to economic waste through **frivolousness, sport, sham culture, vain display and drink.**”
- He, therefore, holds that for better **distribution, intervention** by the state is essential.
- He desired the “*costs of production should be distributed according to the ability of the individuals to bear them and commodities should be allotted according to the capacity of the individuals to derive utility from them*”

- Thus, he proposes a social reform through equitable distribution of the surplus produced under scientific process of production on the basis;

“From each in accordance with his ability and to each in accordance with its needs.”

- The classical theory of distribution assumes perfect competition, complete mobility of factors of production and self-interest. Hobson argues that in the presence of **monopolistic element in the modern industrial system cannot be treated as mere exception**
- To him the entire business and the industrial system is a vast organism in which, on one hand, there is a flow of commodities and on the other hand, a flow of money.
- Under dynamic condition it is only through saving that industrial production can be expanded to meet the future demand of the society. Hence, proper balance between savings and investment is essential. If savings and investments increase at the cost of consumption, people will not be able to consume the increased supply of commodities and depression will ensue.
- Since labor economics was a subject so dear to Hobson, he held that labor should be paid according to its **“labor power”**. The higher the labor power of a worker, the higher should be his wages
- Here, he brings in the concept of **depreciation allowance**, similar to that which is required for the repair and replacement of machinery.
- By depreciation allowance he meant the charge on the industry for the repair of labor’s body and recoupment of lost physical energy. Thus, a worker with higher ‘labor power’ would require a great amount to keep himself fit than a worker whose labor power is low.
- That is why he considers it is essential that, since labor’s human costs are the greatest, ***its share in the surplus production should increase at the cost of wealthy parasites.***
- Hobson’s analysis has been a subject of severe criticism at the hands of professional economists.

- It has been pointed out that Hobson failed to provide us with the criterion for the measurement of human costs. In case the measurement is not possible, his reform proposal based on the measurement of human welfare cannot be adopted.
- Similarly, his contention that man who enjoys his work should be paid less than a man who does not enjoy his work appears to be unsound policy. If his suggestion accepted, it would mean that a sweeper who enjoys his work of cleaning the drains should be paid less than a tailor who does not enjoy his work.
- Despite the **weakness in Hobsonian analysis**, he was undoubtedly one of the important source of *inspiration to Keynes*.

B. Arthur Cecil Pigou (1877-1959):

- He was from Cambridge School and faithful pupil of Marshall. He was a product of Cambridge University. He was appointed as professor of economics in the same University in 1908, on the retirement of professor Marshall. His important works are;
 - Wealth and Welfare
 - The Theory of Unemployment and
 - Veil of Money
- The idea of objective thought does not occupy a central place in his thought as was in Marshall's. In his system the concept of **social welfare** is more important.
- He regards social welfare as a sum of individual welfares which depend upon the balance between individual satisfactions and dissatisfactions. He regards welfare as a *psychic good than the mere accumulation of material things*.
- **According to Marshall, the national income represents a general welfare**, but Pigou believes that welfare is not only dependent on the size of nation's income but also on the equality of its distribution. The more equal the distributions of the income the higher will be the level of welfare.

“Any cause which, without the exercise of compulsion or pressure upon people to make them work more than their wishes and interest dictate, increase productive efficiency and, therewith the average volume of national dividend, provided that it neither injures the distribution or augments the variability of the country’s consumable income, will, in general, increase economic welfare . . . any cause which increase the proportion of national dividend received by the poor person, provided that it does not lead to contraction of the dividend and does not injuriously affects its variability, will, in general, increase economic welfare.”

. . . Pigou

- For the achievement of this goal he has suggested government intervention. He has shown that monopoly can prove to be the greatest hurdle and has analyzed the role of the state can play in the regulation of monopolistic organizations.
- He is not in favor of artificially boosting of wages. He has suggested, in his book, entitled *Industrial Fluctuations*, the problem of unemployment could be solved though the manipulation of money wages. But in a later book, entitled *Employment and Equilibrium*, he appears to be much nearer to Keynes when he suggests the manipulation of investments for compacting unemployment.
- Pigou’s was essentially a **socio-ethical approach**. In his book, entitled *The Economics of Welfare*, he clearly stated that the chief aim of economic studies is to help social improvement. It is only then that economic science will be realistic.
- He realized that quantitative analysis of economic problems was very difficult. According to Pigouvian, economic welfare is generally proportional to the size of the national income, “provided the dividend accruing to the poor is not diminished, increases the size of the aggregate national dividend, if they occur in isolation without anything else whatever happening must involve increases in economic welfare.”
- He has suggested that economic welfare could be increased by the transfer of purchasing power from the rich to the poor. In the transference of money-income from a relatively rich man to relatively poor man of similar temperament, since it enables more intense wants to be satisfied at the expense of less intense wants, must increase the aggregate

sum of satisfaction. Any cause which increases the absolute share of the real income in the hand of the poor, provided that it does not lead to a contraction in the size of national dividend from any point of view, will in general, increase economic welfare.

4.3 New Trends in Welfare Economics

- It is quite different from that developed by Pigou and his followers. It has been developed by **Vilfredo Pareto**, and it has been extended by **Edgeworth, Hicks, Kaldor, Samuelson**, etc
- The New Welfare Economics is normative in character and is free from value judgments and utility measurement. It “claims to have established the optimum conditions of production and exchange without adding the utilities of different persons.”
- The New Welfare Economics has been developed in three directions;
 1. **First group**, in which welfare and ideal distribution of income have been treated as ethical concept
 2. **Second group**, in which causes of satisfaction have been regarded as the subject of study i.e. it believes in an equal distribution of income
 3. **Third group**, in which emphasis is on piecemeal planning i.e. it believe in advocating practical measures of the economic conditions of the society
- There are three objectives of New Welfare Economics;
 1. To clarify and express in terms of quantity the vague concept of riches
 2. To clarify what is that the economists has to say on matters of public policy which are, from the economic point of view, desirable or not
 3. To develop those propositions which are scientifically free from ethical considerations and which can serve as a basis for policy making

A. Vilfredo Pareto:

- Vilfredo Pareto, a member of a family which included eminent politicians as well as revolutionaries, succeeded Warlas into the chair of economics at the University of Lausanne, where he published his *Cours d'économie politique* in 1896–7.
- At the turn of the century, Vilfredo Pareto introduced the concept of **ophelimity** in economics and, on the basis of scientific criteria; it should be an ordinal concept, and interpersonal comparisons of ophelimity ought to be ruled out. He had many research interests, including economics, sociology, and political science. Pareto used the technique of indifference curve and scale of preference instead of adding the satisfactions. The optimum position has been defined as one in which no individual can be put “at higher indifference curve on higher behavior line, without causing someone to drop to a lower one. According to Pareto, following are the conditions of this optimum;
 - a. The MRS between any two commodities must be the same for any pair of owners of the same two commodities.
 - b. The marginal rate of transformation (MRT) between any two commodities must be the same for any pair of producers producing both the commodities
 - c. The MRT between any factor and any product must be the same for any pair of producers using the factors and producing the product. The MRS between any pair of factors must be the same for any two producers using both, in producing a given product
 - d. The MRS between any two sets of goods for the community must be the same as the MRS between the same two sets of goods for any consumer consuming them
 - e. The MRS between leisure and product (reward) received from work must be the same (for every individual) as the MRS between work and product for the community as a whole.
 - f. The MRS between assets promising payment at any two moment of time must be the same for any pair of individuals.
- As far as the only uncontroversial normative criterion is the Pareto criterion, welfare economics establishes a clear test: ***a situation is economically efficient if it could not be better for the individuals without decreasing some people's satisfaction***, which implies unanimity to justify any change.

B. The British approach to the New Welfare Economics:

- The British approach, particularly represented by the works of **Nicholas Kaldor (1939)**, **John Hicks (1941)** and **Tibor Scitovsky (1941)**. They essentially coming from the **London School of Economics** developed a new concept of Pareto improvements in order to reach a decision and bypass the problem of comparisons.
- They propose a 'Pareto efficiency criterion' which considers the possibility of **hypothetical compensations**, and then applies the **test of unanimity**.
- Imagine a single individual *i* loses *x* by a new public policy, while all others gain. The strict version of Pareto criterion cannot conclude that this policy should be implemented.
- Imagine now that others gain of an amount that is greater than *x*. would the winners compensate Mrs. *i* by transferring her amount *x*, they would still gain from the new policy, while Mrs. *i* would now be at most indifferent. *The change would be a Pareto-improvement, i.e. would be unanimously better*
- Economists are however not entitled to decide whether or not these transfers should eventually be made; such responsibility should be left to **politicians**. They accepts that there is no guarantee that all the changes will increase welfare without harming anybody as **Reder** says "*that there are very few economic policies that do not involve injury to someone. . . if our welfare criterion applicable only to few policies that harm no one, welfare economics would be quite sterile*"
- They, therefore, uses the principle of compensation principle. If it is possible to compensate those who are harmed by the change so as to leave them as well off as they were before the organization by those who are benefited by reorganization without making any one of them worse off than they were before and if there is surplus it is possible to increase the welfare by distributing that surplus.
- Welfare is increased, decreased or left unchanged by a given economic reorganization depending upon whether the algebraic sum of all the compensating taxes and bounties is positive, negative or Zero.
- Hicks believes that if the efficiency test is fulfilled there would be a strong probability that almost all of them should be better off after the laps of a sufficient length of time.

- Hicks's criterion like that of Kaldor is similar to that of Pareto, *viz.*, welfare is said to have increased if individuals reaches to an higher indifference curve but Hicks goes further than Pareto by stating that all changes may not necessarily improve welfare unless the distribution aspect is considered.
- **Chipman and Moore concluded in 1978:** "judged in relation to its basic objective of enabling economists to make welfare prescriptions **without having to make value judgments** and, in particular, interpersonal comparisons of utility, the New Welfare Economics must be considered a failure."
- In spite of such an acknowledgement, the success of this approach in occupying a leading position in most contemporary works of public economics, industrial economics or international economics remains today unchallenged

C. The American approach to the New Welfare Economics:

- What we shall call here 'the American approach' is associated with the position of **Abram Bergson, from the MIT, and Paul Samuelson, from Harvard University**, *i.e.* both coming from Cambridge (Mass.) in the United States.
- Bergson formalized the concept of **social welfare** in 1938 (Burk 1938). He defines it as a function of all the elements relevant for welfare: **all products, consumer's goods, the amount of work of each type, non-labor factors, characteristics of the environment, etc.** Through the application of the Pareto criterion, the function may emphasize the "fundamental value of individual preference."
- The **social welfare function**, as eventually formulated by Samuelson (1947), is defined as a function of the individual utility functions that each individual derive from the social state.
- In welfare economics, a **social welfare function** is a function that ranks social states (alternative complete descriptions of the society) **as less desirable, more desirable, or indifferent** for every possible pair of social states. Inputs of the function include any variables considered to affect the economic welfare of a society.
- The social welfare function is analogous to the consumer theory of indifference-curve/budget constraint equilibrium for an individual, except that the social welfare function is a mapping of individual preferences or judgments of everyone in the society as to collective choices, which apply to all.

- There are two major distinct but related types of social welfare functions:
 1. A Bergson–Samuelson social welfare function considers welfare for a *given set of individual preferences* or welfare rankings.
 2. **An Arrow social welfare function** considers welfare across *different possible sets of individual preferences* or welfare rankings and apparently reasonable axioms that constrain the function.
- **The impossibility is we cannot derive a collective judgment on the basis of individual preferences unless it is dictatorial.** It is hence questionable whether the notion of collective welfare would at all make sense. For this reason, the New Welfare Economics seemed bound to a failure again.

4.4 Forerunners of the school: A promising future for welfare economics

- Different challenges indeed need to be taken up to restore a future for Welfare economics. It should be possible to make recommendations of public policies; either interpersonal comparisons of utility are impossible and not required, or their meaning and their status should be clearly defended; a framework to explicit which value judgments are at stake is needed; it is necessary to go beyond the **Arrovian impossibility** to legitimate the use of social welfare function.
- We have three developments here;
 - a) **Economics of Happiness**
 - b) **The comparative approach**
 - c) **The theory of equity**
- a) **Economics of Happiness:**
 - Back in the 1950ies, **Richard Easterlin** has examined whether income promoted happiness in the population on the basis of opinion surveys. In his famous article published in 1974, he has observed that, in a given country, people with higher incomes are more likely to claim to be happy.

- However in international comparisons, at least for countries with income high enough to meet basic needs, the expressed level of happiness does not vary much with the national *per capita* income.
- Finally, although the *per capita* income has increased steadily in the United States between 1946 and 1970, expressed happiness recorded no upward trend in the long run, and even decreased between 1960 and 1970.
- Facing the **Easterlin paradox**, the standard public policies, which are based exclusively on economic growth, seem to be missing their target. If growth and wealth is not all what counts, the least would be to primarily identify the factors for happiness.
- It consists in conducting econometric studies of happiness, emotion, subjective well-being, quality of life, life satisfaction based on responses to questionnaires in which participants express how happy they feel.
- Since the Easterlin paradox, many studies have tried to explain why at the aggregate level, growth of national income did not necessarily enhance well-being.
- Among others, results of economics of happiness reveal that poverty reduce more happiness than wealth increases it; an increase of income for a poor person is more likely to increase her happiness that an increase in income for a rich person.
- Happiness can be enhanced by reducing inequalities, improving working conditions, the reduction of working time and in some cases, neutralizing the negative effects of unemployment. Unemployment kills happiness, even after individuals got their jobs back.
- Some think happiness may constitute a yardstick, and that it is possible to transcribe it in money measures, which allow cost-benefit analysis to be completed.
- It appears to be a particularly innovative and important contribution to understanding the determinants of happiness, for making ex post evaluation of certain public policies, and to complete the data needed by policy makers who should not be satisfied with economic data.
- Nevertheless, the analyses of surveys have given rise to many criticisms, at the methodological and the normative level. Some highlight difficulties to interpret the replies, challenge their reliability, and doubt cross-country comparisons are meaningful.

- More generally, the very status of subjective data is discussed. Would individuals be with what they have and what they do, they may be happy out of **adaptation**. This becomes highly problematic if adaptation is nothing but resignation.
- Though very few economists would seriously defend this view, this counter-intuitive example invites to beware of any possible manipulations of happiness indicators.

“happiness is a necessary but not sufficient: even though the economics of happiness can prevent a form of paternalism and ethnocentrism, the surrounding methodological doubts and the objections in principle induce not to consider happiness as the barometer of public action.”

_____Lucie Davoine

b) **The Comparative Approach;**

- Throughout his critical analysis of the welfarist approach, Amartya Sen suggested assessing social situations by **considering quality of life rather than just utility or wealth**. On the one hand, utility, says Sen among many other critics, is too sensitive to adaptation, and on the other hand, resources do not pay attention to the particular individual ability to transform commodities into well-being.
- Quality of life may hence be better captured with functionings, which Sen defines as *“**what the person succeeds in doing with the commodities and characteristics at his or her command.... It is an achievement of a person: what he or she manages to do or to be....**”*
- The alternative combinations of possible functioning a person can achieve and from which he or she can choose one collection” is called ‘capability’. At any moment, according to his situation, his tastes, his life plans, a person may choose some particular functioning among the capability set.
- The wider this set is, the more the individual is free to choose between different lifestyles.
- The use of capabilities as an informational basis to assess quality of life therefore focuses not only on the role of commodities in generating well-being, takes into account individual’s specific ability to transform commodities into well-being, but also values for itself the freedom to choose their lifestyle.

- Here as far as this information is objective in the sense that they are observable and measurable on a common scale, interpersonal comparisons are meaningful
- The assessment of capabilities is based on some valuation of lists of different functionings, themselves being a vector of achieved doings and beings. Such multi-dimensionality is likely to cause moral dilemmas in certain situations, hence to generate substantial **incompleteness**.
- **For instance**, what if I have more health but less education or social relations? A possible answer, specific to Sen, is to accept the rankings of social states may be incomplete.
- Another approach is to gather each functionings into an index by weighting them according to their importance
- The fact that values and weighting are determined by scientists rather than by the individuals themselves explains why this approach is often criticized for its **paternalism**.
- In contrast, Sen's position meets certain relativism, in order to give to public deliberation the main role in a democracy.
- Therefore, he refuses to provide a clear list of functionings which could measure well-being for everyone on a common scale. It is therefore difficult to implement a mere application of Sen's capability approach since it fundamentally relies on the public debate.
- As the approach was generalizing, it has yet lost its specificity, which was to pay special attention to the value of freedom, understood as the possibility for everyone to live the life one has reason to value.

c) The Theory of Equity;

- The theory of **fairness or equity theory**, including fair allocations theory and even applications to public economics, borrowed the axiomatic methods from social choice theory and the theory of bargaining to study the implications of equity criteria in the framework of **Arrow-Debreu general equilibrium model**.
- Different fairness criteria can be contemplated for division rules.
- The idea of 'no-envy' was independently introduced by **Jan Tinbergen (1953)**, **Duncan Foley (1967)** and developed by **Serge- Christophe Kolm (1971)**, **Allan Feldman and Alan Kirman (1974)**.

- An allocation is ‘envy-free’ if no individual would like better anybody else’s basket. A fundamental result of equity theory is such that the competitive equilibrium with equal endowments, that is to say equal budgets, satisfies both the criteria of no-envy and Pareto.
- The no-envy criterion, however, may conflict with the criterion of efficiency. This was proved by **Elisha Pazner and David Schmeidler** in 1974: no allocation respects Pareto efficiency and fairness (as no-envy) in the context of production with unequal skills—in other words with production handicaps.
- This impossibility result can be interpreted as the incompatibility between a principle of reward and a principle of compensation. The non-envy test indeed requires that the allocation of individuals with identical preferences must be on the same indifference curve.
- According to the principle of reward, individuals with similar talents should not envy each other, since it should not be any different treatment for different preferences.
- And, according to the principle of compensation, individuals who have identical preferences should have the same benefit, eliminating the inequalities due to talents.
- The theory of equity took up the different challenges welfare economics was facing:
 - ❖ First, it’s worth noticing it eventually overcame the Arrovian impossibility.
 - ❖ Second, it did reject interpersonal comparisons of utility. Unlike standard economics which relies on the model of subjective revealed preferences, welfare is here described as an index of resources; and unlike the comparative approach, they still keep some account of individual ordinal preferences, which avoids the risk of paternalism.
 - ❖ Third, the theory of fairness accepts the challenge of value judgments transparency in making clear the criteria of justice.

Self-Exercises

- 1) Do the Walrasian General Equilibrium model show absolute price level? Why/why not?
- 2) Explain the following statement: Pareto’s welfare analysis is in the tradition of Walras, whereas Pigou’s welfare analysis is in the tradition of Marshall.

CHAPTER FIVE

THE KEYNESIAN ECONOMICS

“We are all dead in the long-run....if in tempestuous seasons economists can only tell us that when the storm is long past the sea is flat again”

_____ *J.M. Keynes*

5.1 Overview of the Keynesian School

The Keynesian system of ideas is one of the most significant schools of economic thought. The school began with the publication of Keynes's *The General Theory of Employment, Interest and Money* in 1936 and remains a major presence in orthodox economics today. It arose out of the neoclassical school, Keynes himself being steeped in the Marshallian tradition. Although Keynes sharply criticized certain aspects of neoclassical economics, which he lumped together with Ricardian doctrines under the heading of "classical economics," he used many of its postulates and methods. His system was based on a subjective psychological approach, and it was permeated with Marginalist concepts, including static equilibrium economics. Keynes disassociated himself from attacks on the neoclassical theory of value and distribution.

Keynes's ideas were given added impetus by the Great Depression of the 1930s, the worst the Western world had ever known. Yet the roots of his ideas can be traced back to before 1929. The work of many economists, including that of Mitchell and his associates in the National Bureau of Economic Research, was within the framework of aggregate economics, or macroeconomics, rather than the microeconomics of the neoclassical school.

In this chapter, we provide a brief overview of the Keynesian school and discuss Keynes's major ideas.

Major Tenets of the Keynesian School

The major characteristics and principles of Keynesian economics are listed next.

● **Macroeconomic emphasis.** Keynes and his followers concerned themselves with the determinants of the total or aggregate amounts of consumption, saving, income, output, and employment. They were less interested, for example, in how an individual firm decides on its profit-maximizing level of employment than in the relationship between total spending in the economy and the aggregate of such employment decisions.

● **Demand orientation.** Keynesian economists stressed the importance of effective demand (now called aggregate expenditures) as the immediate determinant of national income, output, and employment. Aggregate expenditures, said these economists, consist of the sum of consumption, investment, government, and net export spending. Firms collectively produce a level of real

output that they expect to sell. But sometimes aggregate expenditures are insufficient to buy all the output produced. As unsold goods accumulate, firms lay off workers and cut back output. That is, effective demand establishes the economy's actual output, which in some cases is less than the level of output that would exist if there were full employment (potential output).

● **Instability in the economy.** According to Keynesians, the economy is given to recurring booms and busts because the level of planned investment spending is erratic. Changes in investment plans cause national income and output to change by amounts greater than the initial changes in investment. Equilibrium levels of investment and saving—those that exist after all adjustments have occurred—are achieved through changes in national income, as opposed to changes in the rate of interest.

Investment spending is determined jointly by the rate of interest and the marginal efficiency of capital, or the expected rate of return above the cost on new investments. The interest rate depends on people's preferences for liquidity and the quantity of money. The marginal efficiency of capital depends on the expectation of future profits and the supply price of capital. The expected rate of profit from new investment is unstable, and, therefore, one of the most important causes of business fluctuations.

● **Wage and price rigidity.** Keynesians pointed out that wages tend to be inflexible downward because of such institutional factors as union contracts, minimum wage laws, and implicit contracts (understandings between employers and their workers that wages will not be cut during downturns judged to be temporary). In periods of slack aggregate demand for goods and services, firms respond to lower sales by reducing production and discharging or laying off workers, not by insisting on wage cuts. Prices also are sticky downward; declines in effective demand initially cause reductions in output and employment rather than declines in the price level. Deflation occurs only under conditions of extremely severe depression.

● **Active fiscal and monetary policies.** Keynesian economists advocated that the government should intervene actively through appropriate fiscal and monetary policies to promote full employment, price stability, and economic growth.

To combat recession or depression, government should either increase its spending or reduce taxes, the latter increasing private consumption spending. It also should increase the money

supply to drive down interest rates in the hope that this will bolster investment spending. To counter inflation caused by excessive aggregate expenditures, government should reduce its own spending, increase taxes to reduce private consumption spending, or reduce the money supply to raise interest rates, which will dampen excessive investment spending.

Whom Did the Keynesian School Benefit or Seek to Benefit?

The great success of Keynesian economics came partly because it addressed a pressing problem of its day: depression and unemployment. Also, it offered something for almost everyone and rationalized what was already being done out of necessity. Society gains from full or fuller employment, and those individuals or groups who lose because of it (say, administrators of unemployment compensation programs) can be easily ignored.

How Was the Keynesian School Valid, Useful, or Correct in Its Time?

Keynes geared economic theory to policymaking. World wars, worldwide depressions, and the growing complications of modern life undermined laissez-faire. Demands that something be done about business fluctuations grew more insistent, and Keynes provided both an explanation of fluctuations and a program to mitigate them. The role of economists and economic analysis in shaping the direction of government policy was thus greatly increased.

The Keynesian view that there are alternative means to reductions in nominal wages to achieve full employment was particularly timely. This policy prescription, which had emerged from neoclassical thinking, found little support as a politically practical solution to massive unemployment. More important, according to Keynes, a deep and general reduction of nominal wages makes for bad economic policy. He held that a single firm can increase sales and employment through wage cuts because the demand for its products will remain unaffected. A whole economy, however, cannot easily increase sales by cutting nominal wages (assuming it is isolated from international trade) because wages are a source of demand for goods as well as a cost of production. If wages begin to fall, people may come to expect them to fall still further; this may cause businesses to postpone investment spending, making the depression worse.

If falling wages result in falling prices, this again worsens matters, because the real burden of debts increases, transferring wealth from the entrepreneur to the rentier. In addition, profit

margins become smaller, thus choking off new investments. Because wage cuts hurt wage earners who have high marginal propensities to consume and help employers who have low ones, the overall propensity to consume is diminished, and this further worsens the situation. A practical man, Keynes also objected to wage cuts because they would touch off labor troubles. He was quite successful in converting people to the idea that wage policy should be divorced from policies to counter depression. There are better ways to create full employment, Keynes said.

The Keynesian approach became immensely useful even to those who did not accept Keynes's policy conclusions. It established a new set of analytical tools through which to view the economy, encouraged the further development of national income accounting, stimulated a vast and fruitful effort at empirical studies of the real world, hastened the development of econometrics, and created a new liberalism on which reformers could pin their hopes for aiding those who benefited least from unfettered capitalism.

Which Tenets of the Keynesian School Became Lasting Contributions?

Numerous ideas developed by Keynes and his followers have become orthodox elements of contemporary macroeconomics. In fact, contemporary economics could be said to be a combination of neoclassical microeconomics and Keynesian inspired macroeconomics. Keynesian concepts such as the consumption function; the marginal propensity to consume; the saving function; the marginal propensity to save; the marginal efficiency of capital; the transaction, precautionary, and speculative demands for money; the multiplier; ex post and ex ante saving and investment; fiscal and monetary policy; IS-LM analysis, and so forth are now standard fare in economics textbooks. Several of the earlier Keynesian precepts, such as the view that the economy can be "fine-tuned" to a position of noninflationary full employment, have been largely discredited, but Keynesianism as an analytical method and as a system of ideas still dominates macroeconomics.

This is not to say that all of the ideas of Keynes and his followers proved to be correct. Some general criticisms of Keynes's thinking are discussed in the final section of this chapter.

5.2 John Maynard Keynes (1883-1946)

John Maynard Keynes was born on June 5, 1883. His father John Neville Keynes was a distinguished writer on political economy and logic and was for many years the registrar of the Cambridge University. Keynes was in college at Eton. He won scholarship to King's College in mathematics and classics and graduated from Cambridge University in 1905. He was the president of Cambridge Union, won the member's English Essay prize for an essay on the political opinions of Burke and was twelfth wrangler in the mathematical tripos.

He studied in philosophy and economics and such men as Sedgwick, Whitehead, W.E. Johnson, G.E. Moore and Alfred Marshall, influenced him. In 1906, he passed second in to the civil service, in India, getting his worst marks in economist. During his two years there, from 1906-08 he worked on his fellowship dissertation on "probability," which gained him a prize fellowship at King's. He lectured on money in the Cambridge University.

From 1913-1914, he was a member of the Royal Commission on Indian currency and finance. During the period from 1915 – 1919, he served in the British Treasury. Till 1940 he resigned and returned to teaching at King's. In 1940 he was made a member of the Chancellor of the Exchequer's Consultative Council and played an important part in treasury business. He was made a director of the Bank of England. In 1942 he was created Lord Keynes. In 1943, he was made steward of Cambridge.

He was the leader of the British experts in the preparatory discussion of 1943 and was the author of the "Keynes plan" – the proposal for establishing an international monetary authority. In July, 1944 he led the British delegation of the monetary conference on the United and Associated Nations at Bretton Woods. In February 1946, he was appointed as the Governor of the International Monetary Fund and the International Bank for Reconstruction and Development. He died on April 21, 1946.

Generally during forty out of these sixty-three years, that is, from his leaving the University to his death, he was continually active as an Economist, in every form which was open to him: as thinker, writer, teacher, public servant, and statesman. He was one of the most brilliant conservative economists of the 20ths. With A. Smith and K. Marx, Keynes stands as one of the **three Giant** figures in the history of economics;

- **Smith** can be viewed as **optimist of this trio**
- **Marx** can be viewed as the **pessimist** i.e. capitalism is **self-destroying**
- **Keynes** can be viewed as the **pragmatic saviour** of capitalism

👉 Keynes:

- His first book “*The Economic Consequence of the Peace*” (1919), a book about the **Versailles peace treaty**.

He did not approve of the outcome of the treaty and provided an angry critique of the peace treaty. He claimed that the crushing reparations that Germany was forced to pay the Victorians of the **allies** would disable Germany’s economic recovery. His best known book “*The General Theory of Employment, Interest, and Money*” was published in 1936. This work has been responsible for the development of a whole branch of economics (**Macroeconomics**). In the book, he attempted to show what had happened to capitalism. So that measures could be taken to **preserve the system**.

5.3 The Myth of Self-Adjusting Market: Classical

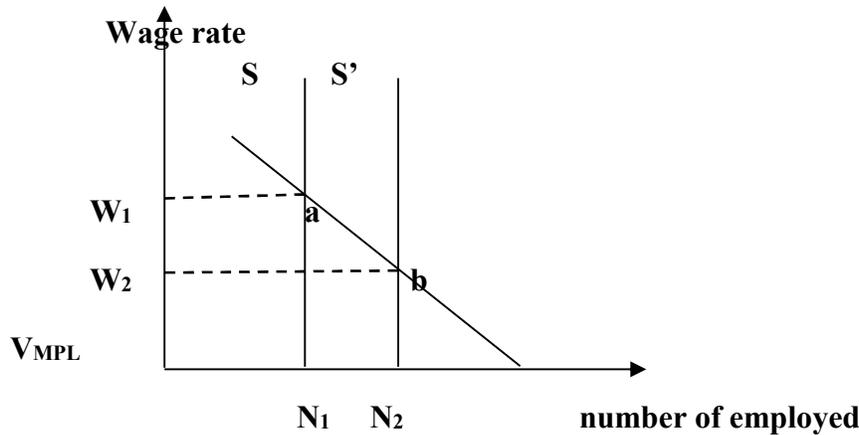
- 👉 The **three principal ideological elements** of neo-classical utilitarianism were;
 1. The marginal productivity theory of distribution, which pictured competitive capitalism as an ideal of **distributive justice**.
 2. The “**invisible hand**” argument, which pictured capitalism as an ideal of rationality and efficiency
 3. The faith in the **automatic**, self-adjusting nature of the market
- 👉 Each of these three of **utilitarian conservatism** promoted the general acceptance of **unfettered profit making**.
- 👉 The argument for self-adjusting markets (Say’s law) was an effective argument for limiting the function of existing governments.
- 👉 But the capitalism market system has never adjusted **smoothly** and **automatically** to **full employment** equilibrium.
- 👉 The capitalist market system has always been **anarchical**; the history of capitalism is a history of **economic instability**.

- ☞ During the first half of 19th c USA had **two sever economic crises** while **England** had **four**. Increasingly frequent depressions plagued capitalism, culminating in the depression of the 1930s. What had happened to reduce the output of goods and services so drastically in 1930's
- ☞ During those times;
 - Natural resources were still as plentiful as ever
 - The nation still had as many factories, tools, and machines
 - The people had the same skills & wanted to put them work
 - Yet millions of workers and their families stood & begged, borrowed, stole, lined up for a pittance from charity, etc. While thousands of factories stood idle & operated at far below capacity.
 - Factories could have been opened and men put to work, but they were not because it was not profitable for businessman to do this.
- ☞ In capitalist economy, production decisions are based primarily on **profit not on people's needs**. But neo-classical economists, with its automaticity of the market, offered **no cure for the malady of capitalism**. *In neo-classical theory depressions did not occur, so there was no need to remedy them*

5.4 The Theoretical Setting of Keynes's Analysis

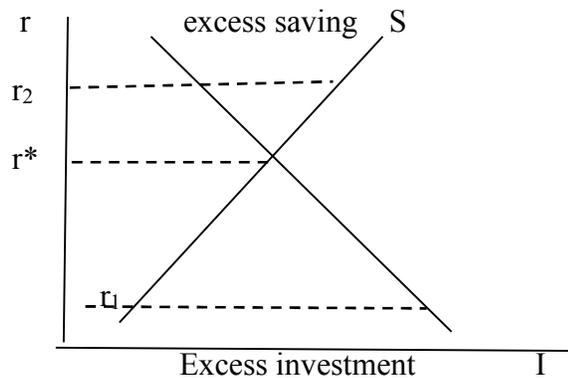
- ☞ Keynes's theory was set in a conceptual contest that was basically the **same as Warlasian General Equilibrium theory**. In the neoclassical vision of how competitive capitalism normally functioned; **Leakages equals Injections**. The three **leakages (saving, imports & taxes)** may be offset by **three spending injections** into income-expenditure flow;
 - 1) Imports can be offset by exports
 - 2) Taxes can be offset by government spending
 - 3) Saving can be offset by investment

In the neo-classical in the short run period, with a **given amount of capital existence**, the **demand for labor** was determined by the V_{MPL}



Illustrations;

- If labor supply increase from $S \rightarrow S'$ wage rate decreases from $W_1 \rightarrow W_2$
- If W_2 were not accepted by the workers then they are voluntarily unemployed (neoclassical). But Keynes calls this **involuntarily unemployed** because wage rate is fixed in the short-run. Rather for Keynes it is better to decrease the real wage ($\frac{W}{P}$) by increasing **price of good than cutting nominal wage (W)(neo-classical)**
- ☞ **For neo-classical all income would normally be spent.** The three injections into the income-expenditure flow would normally equal the three leakages.
- ☞ This was because;
 - 1) Neo-classical theory showed the free play of supply and demand would balance in the international transactions.
 - 2) Sound fiscal policy (Balanced Budget)
 - 3) The **rate of interest would always bring saving and investment into equality.**



- ☞ Hence, in neo-classical theory, competition automatically created an interest rate at which saving & investment were equal i.e.;
- All three leakages from the income-expenditure flow would automatically be bought into equality with all three injections into the flow.
 - **Aggregate demand would automatically equal aggregate supply.**

Theory of Employment

Unlike the classical macroeconomic theory in which the real and monetary sector of the economic reminded dichotomized, in the Keynesian model they remain integrated forming parts of a compact whole. In the Keynesian theory, all the different sectors of the system remain tied together and all the variables are determined together. Not within standing the money crudities and rough edges present in the Keynesian macroeconomic model. We owe it largely to Keynesian s' original pioneering work for the tremendous advances that have taken place in the field of macroeconomic analysis following the publication of Keynes' magnum opus entitles **The General Theory of Employment, Interest, and Money in 1936.**

Simple Keynesian Model

The simple Keynesian model of income and employment determination can be studied either through the aggregate income-expenditure approach in the form of $Y = C + I$ or through the aggregate saving investment approaches in the form of $S = I$. The later approach, aggregate saving-aggregate investment, is going to be considering studying the simple Keynesian model of income determination.

The Keynesian system, unlike the classical model, has a different setting. The saving-investment relationship is no longer immaterial for determining the aggregate output. In fact as a determinant of income, the saving-investment relationship exerts a dominating influence.

According to Keynes, saving is a function of income and is related to income through the marginal propensity to save ($MPS = ds/dy$). MPS is positive but less than one, i.e. $0 < ds/dy < 1$. The saving supply function for the simple aggregate saving – investment Keynesian model can, therefore, be written as: $S = s(y)$ and $ds/dy > 0$. The investment demand may be treated as wholly autonomously determined being unrelated to income. Alternatively it may be treated as

functionally dependent, on income increasing as income increases vice versa. Accordingly the investment demand function can be written as: $I = I(y)$ and $dI/dy > 0$

For the stability of the system it is also necessary to assume that $dI/dy < ds/dy$.

The Effect of Change in Money Wage

The effect of a given change in money wage consequent upon a given rise in money wage, although prices must also rise but the rise in price must be relatively more than the rise in the money wages. This is necessary for the total employment and output to increase because unless the entrepreneur find it profitable to increase employment and output they will not do so. And this is possible only if the prices rose relatively more than the corresponding rise in money wage so that the real wage falls. Stated differently, there must be a rise in prices relative to money wage leading to fall in real wage.

Keynes' argument against general wage-cutting as effective and practical remedy against unemployment was based on the fact that while a policy of wage-cut in one single industry might help to increase the demand for the product of that industry, to jump from this to the conclusion that an economy-wide general cut in wage will likewise also increase the aggregate effective demand was logical error.

Theory of Interest

In Keynesian terminology the rate of interest is the price paid for parting with cash or liquidity and using it for investment in assets. * Interest, thus, is determined by the liquidity preference. It is not the price, which brings into equilibrium the demand for reassures to invest with the readiness to abstain from consumption. It is the price, which equilibrates the desire to hold wealth in the form of cash with the available quantity of cash. In other words the rate of interest in the Keynesian sense, it is determined by the demand for and the supply of money. This theory is therefore, is characterized as the monetary theory of interest, as distinct from the real theory of the classical.

Supply of money: Of the two determinants of the rate of interest, the supply of money referees to the total quantity of money in the country of all purposes at any time. Though the supply of

money is a function of the rate of interest to a desk, yet it is considered to be fixed by the monetary authorities, that is, the supply of money is taken as perfectly inelastic.

Demand for money: for the second determinant, the demand for money, Keynes coined a new term 'liquidity preference' by which his theories of interest is commonly known. Liquidity preference is the desired to hold cash. Thus the higher the liquidity preference, the higher will be rate of interest that will have to be paid to the lower the liquidity preference, the lower will be the rate of interest that will be paid to the cash – holders.

The preference of an individual of a group of individuals for cash to assets is known as liquidity preference. This preference may be for meeting:

- a) The daily needs of life; which according to Keynes is the 'transaction motive'
- b) Contingent needs; and
- c) Business needs, chiefly influenced by the strength of "the speculation motive'.

The rate of interest is, thus, the price paid to an individual for parting with his liquidity preference. In the event of a moderate rate of interest, the community may not be prepared to part with its liquidity, whereas if the rate of interest is high enough, it may be inclined to do so. But the cost of holding cash will have a very limited influence on the first two motives stated above. These two motives are fairly stable in a particular socio-economic setups with a particular level of income. Obviously the higher the liquidity performance, the higher will be the rate of interest and vice versa.

Theory of Money

Keynes approach to the demand for money is contained in his well-known book entitled The General Theory of Employment, Interest and Money. The classical Economists did not stress the permanent store of value function of Money. According to Keynes, the classical approach to the demand for money was incomplete because it ignored the possibility of people choosing to hold money as an asset instead of other financial assets.

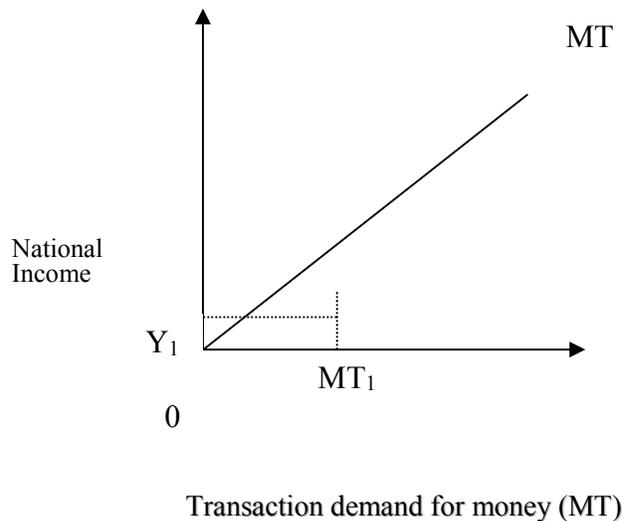
According to Keynes an individual's aggregate demand for money in the given circumstances is the result of a single decision, which is the composite of transactions, precautionary, and the speculative motive for holding money.

Transaction Demand for Money

It is the demand by firms and individuals households for holding of money to finance day-to-day transactions. The amount of money which consumers need for transactions purpose mostly for buying and selling of goods and services depends on the level of their money income, their spending habits and the time interval after which income is received. Given their spending habits and the duration of the pay period, higher the money income higher will be the amount of money which will be required for the transaction purpose. Consequently the transactions demand for money and the level of money income are positively correlated.

According to Keynes, the transaction demand for money was interest inelastic. It is, however, possible to expect the transactions demand for money to vary inversely with changes in the rate of interest.

Graphically,



Precautionary Demand for Money

It is the demand for money, which arises out of uncertainty and the desired not to be caught short of ready cash. That is to say, apart from demanding money for transaction purposes, individuals and businessmen require money to meet unforeseen contingencies. One finds it convenient to hold some cash on which he can lean readily when some unforeseen need arises.

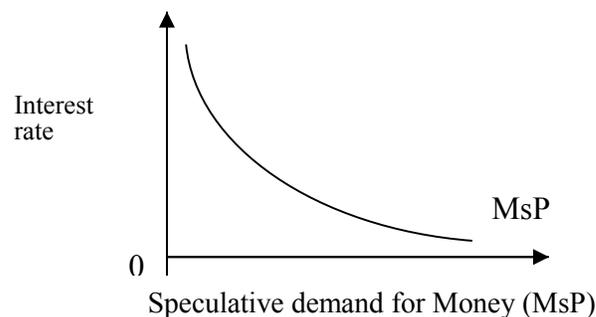
The demand for money is also likely to depend on National income: the higher the total value of transactions, the more money will be needed to guard against unexpected transactions. Rate of interest also influence the precautionary demand. The rate of interest is the opportunity cost of holding money: thus if interest rates rises, consumers and firms may be tempted to reduce their precautionary holdings and hold interest-bearing assets instead.

Speculative Demand for Money

It is the demand for money as a financial asset and therefore part of a wealth portfolio. It was in his analysis of the speculative demand for money that Keynes differed fundamentally from his predecessors.

Keynes argued that individuals would have some expectations or conceptions of the “normal” rate of interest. If the prevailing interest rate is low, the theory predicts a low demand for bonds and consequently, a higher demand for speculative money balances.

In this way, Keynes derived an inverse relationship between the rate of interest and the speculative demand for money.



Speculative dd is inversely
proportional to IR

Theory of Prices

Keynesian analysis of price is quite close to classical analysis. While agreeing with the orthodox view that an increase in the quantity of money in circulation leads to an increase in the price level, Keynes has differed with traditional economists in one respect and, that is regarding the process through which this effect is caused. As a matter of fact, the classical quantity theory of money failed to analyze the process through which the price would be affected.

Keynes tried to fill the gap. According to him, the finding out of the exact process through which the quantity of money affects the price level, would involve the following measures:

- a) Finding the relation between money and aggregate demand
- b) Assessing the effect of changes in aggregate demand on output and
- c) Taking into account the change in the wage rates.

Increase in the supply of money is likely to increase the availability of funds to a certain extent, for speculative purposes. As already stated earlier, an increase in money supply tends to lower the rate of interest and increase the demand for investment, which ultimately leads to an increase in income, employment and output. This increased output can only be possible at an increasing cost beyond a certain point. Price will accordingly rise. "Supply price will increase as output from a given equipment is increased".

Thus, prices do not increase because the quantity of money has increased and the relation between the two is only remote. It would, thus, be observed that Keynes has established the relation between quantity of money and the price through output.

Wages form the most important constituent of the cost of production and since price varies with cost of production, it will ultimately be affected by the cost of labor i.e wage rate. During the period of expanding output, labor will become increasingly scarce and the money wage rates will rise, depending, of course, on the bargaining capacity of the laborers. Such an increase in wage rate would automatically lead to an increase in prices. What portion of this increase would go to wage earners and what proportion the entrepreneurs, would take away, will depend up on their relative bargaining strength.

Theory of Wage Rate

It may be possible that a change in money wage rates may cause a change in the real investment. But if the investment itself is dependent on the level of real income or the volume of real consumption expenditure, it is not clear how such a change would take place. Similarly, the marginal efficiency of capital is not changed by a change in money wage rate. The rate of real investment can be affected in three ways: It may, in the first instance, affect the business confidence. The individual businessmen may think that a cut in the money wage rate reduces their costs.

On the other hand, a cut in wage rates and prices increase the real burden of the debt of the entrepreneurs. A cut will stimulate demand for exports and lead to increased consumption of home goods as compared to foreign goods. This would result in an increase in the real investment and finally in the real income and total employment in the currently. A rise in money wage rates would lead to an opposite situation. It may be possible that these effects may be neutralized by corresponding change in the wage rates of exchange rates in other countries.

A change in the money wage rates, prices and money incomes brings out a change in the demand for cash balances for transportation purpose, in the same direction. If the quantity of money in circulation remains the same, a reduction in the money wage rates would leave a larger supply of money to satisfy the demand for cash balances. The rate of interest would fall and thus, the rate of real investment would increase. Likewise; an increase in money rate would increase the interest rate and diminish the rate of real investment.

This is how Keynes could justify the relationship between money wage rates and implement, in a closed economy, which was really a far-fetched idea. It would be interesting to look at the wage problem in the context of the general theory. Keynes tried to establish first, that there may be involuntary unemployment of labor, and second, that labor may not be able to remove such unemployment by making new money wage bargains. Keynes held that involuntary unemployment may be because additional labor would be offered at the falling money wage rate at the same of lower real wage rates. "Labor upset by a money illusion" will permit its real wage to be reduced by price rises without leaving the market, even when it will not accede to the same reduction in its real wage by a money wage cut. At the same time, labor is powerless to take advantage of potential demand for its services at lower real wage rates, because a reduction in the money wage may not lead to a reduction in the real wage.

Concept of Multiplier

The concept of multiplier was first developed by R.F. Kahn in his article: "The Relation of Home Investment to unemployment", Economic Journal, June 1931. Keynes has also acknowledged this fact.

The aggregate income of the community, thus, is determined by the rate of investment together with the propensity to consume. The ratio between an increment of investment and the resultant increment of the total income, the propensity to consume remaining the same, is called by Keynes as "multiplier". The creation of one gives rise to a number of waves, similarly in Economy, each injection of money gives rise to a series of new money.

The multiplier is, thus, a number by which the increase in investment must be multiplied in order to give the resulting increase in income. If an investment of Birr 1 causes an increase in the total income by Birr 3, then the multiplier is 3. In case the increased income amount to Birr 2 the multiplier is 2. Thus multiplier, in short, is a numerical co-efficient, indicating how great an increase in income result from each increase in investment. The question is: How and why the increase in the total income is more than in proportion to the increase in the investment? The reason is that with each investment, the result and expansion in production and national income is much more than the primary investment.

A part of this increased income will be spent by the wage earners and by the recipients of profits and interest, leveling do increased income to others in the economy. Thus increased income will again be spent and the process will go on repeating.

If the total of all these secondary incomes were immediately spent, the increase in secondary income would be so rapid at each turn-over that it would result in a maximization of income and full employment. If the process continues, the result would be inflation. In case, with an increase in income, there is no increase in consumption, the multiplier effect would be Zero

Thus, the relative proportions of spending and saving, out of the increased income determine the amount of the multiplier. Multiplier depends upon the propensity to consume, which in turn, determines the proportion of savings out of each investment. Whatever the multiplier, the total of savings during all the turnovers will necessarily be equal to the original investment. It would, thus, be observed that investment will result in an increase in income up to the point at which the

saving would be equal to it. The propensity to save being stronger, the increase in income would be small and vice versa. The higher the consumption function or spending, the greater will be the multiplier. If the marginal propensity to consume is $\frac{2}{3}$, the multiplier would be 3. If it is $\frac{1}{2}$, the multiplier would be 2, if it is $\frac{3}{4}$, the multiplier would be 4.

Multiplier always reciprocates with the marginal propensity to save (MPs).

It can be explained as under:

Change in Income = $1/MPs$ x Change in investment OR

Change in Income = $1/1 - MPC$ x Change in investment

If the marginal propensity to save is $\frac{1}{3}$ or the marginal propensity to consume is $\frac{2}{3}$, the equation would be as follows:

1 x Birr 1000 = Birr 3000 (total income) OR

$\frac{1}{3}$

1 x Birr 1000 = Birr 3000 (total income)

1- $\frac{2}{3}$

Theory of Trade Cycle

Keynes never formulated a theory of trade cycle. His purpose was to build up a theoretical structure applicable to all phases of the economy. Since his idea were formulated mostly under the impact of the great depression, these are most suited as cures of depression, from his general theory, one can draw inter encase regarding his views on businesses cycle. To Keynes, the cycles express the relationship between current aware of interest and the marginal efficiency of capital. He believed that fluctuations occur in the economy, throughout the variations in the marginal efficiency of capital. Keynes observed that during the nineteenth century the fluctuations in the marginal efficiency of capital occurred in a rhythmic fashion i.e. a cyclical fashion.

In his words, “there so some recognizable degree of regulation in the time sequences duration of the up word & down ward movements.” Prior to Keynes it was generally be lived that an initial rise in income employment & price would stimulate the economy at an accelerated rate, until the

entire resources of the community are employed or until the point of full employment is reached, or until an artificial check is put by some outside force. Those economists hold that such a break can be put by the inability of the money market to make available the required funds. Keynes, however, emphasized that it is the effective demand that plays an important role.

His analysis is like this during the period of prosperity of the habit and consumption of people being relatively fixed, they tend to spend less than their income. This is because a relatively large part of an increase in income goes to businessmen, whose propensity to consume is relatively lower than that of other classes in the community. The overall prosperity of the entire community to consume tends to fall. Consequently, the businessmen's expected action declines, while at the same time, the increase of business activity has already increased the price of capital goods. Since the marginal efficiency of capital is the ratio between the anticipated earning of future investment and their supply price, the investment schedule shows a declining trend. Thus it is the schedule of marginal efficiencies of capital which creates an imbalance between savings and investments.

In case, savings are more than investments, the growth is checked and vice versa. As soon as these expectations of the businessmen regarding the future profitability of new investment fall, their liquidity preference increases leading to a rise in the rate of interest. This worsens the situation all the more the result would be that the contraction of investments would be at an accelerated rate and when investments fall, the "multiplier" works in the reverse direction and employment is greatly reduced.

Hence, the chronic under-investment and under-consumption lead to depression. The phase of recovery can only start when consumers' demand goes up, without any addition to the present output. This can be possible only through public investments in producing non-market goods or services, where in the rate of profit, expected or actual, no consideration is given. The return to recovery may take some time and it depends upon how soon the marginal efficiency of capital is re-established to businessmen's faith is revived.

The concept of the multiplier establishes a precise relationship between aggregate income and the rate of investment (which is a function of the marginal propensity to save), the marginal propensity to consume remaining the same. The multiplier explains the level of employment expected from a given fluctuation in investment. As Keynes said, "Given the propensity to consume and the

rate of new investment, there will be only one level of employment consistent with “equilibrium”. This concept gives an insight into the working of the economy and the part played by the psychological desire among men to save or to consume. Greater savings during depression are likely to make depression worse and reduce the level of income. High consumption and high investment should, however, go hand in hand and should not compete with each other. This is why Keynes thought that government spending on productive purposes may produce or multiplied increase in employment.

Keynes’s Analysis of Capitalist Depressions

- ☞ He **rejected the notion** that if a capitalist economy started from a situation of **full employment**, then the rate of **interest would automatically equal saving and investment**.
- ☞ His major departures from the doctrines that comprised the neo-classical theory of **automaticity were two fold**;
 - 1) Although he accepted the neoclassical notion that saving was influenced by the rate of interest, he insisted that the level of aggregate income was a far more important influence on the amount of saving than was that of interest.
 - 2) He argued that saving and investment did not determine the rate of interest rate. The rate of interest was a price that equalized the demand and supply of money.
- ☞ The first one is related to the notion of **effective demand** while the latter one is related to the notion of **liquidity preference**.

Effective demand and Employment

- ☞ Let us ignore “NX” & “G”, hence

$$Y=C+I$$

$$C=C_0+cY$$

$$S=C_0+sY$$

☞ $C_0 \rightarrow$ autonomous consumption (never depend on income)

☞ $c \rightarrow$ MPC

☞ $S \rightarrow$ saving

☞ $s \rightarrow$ MPS

☞ $Y \rightarrow$ income

☞ $C \rightarrow$ consumption

5.5 Classical Economics Vs. Keynesian Economics

To some, Keynesian Economics is just the classical Economics restated and further developed. To others, it represents a genuine break. The following are the general departures from the classical Economics.

- 👉 Because output and employment are supply determined, the level of aggregate demand will have no effect on output. As J.S. MILL said so “the legislator, he did not give himself concern over the demand for output.”
- 👉 All demand side factors have no role in determining output and employment. Like: -
 - ⊗ Quantity of money
 - ⊗ Level of government spending
 - ⊗ Level of investment demand by business sector
- 👉 In general
 - ✓ The sticking feature of classical model is the supply determined nature of output and employment. This property follows from the vertical aggregate supply curve.
 - ✓ The classical aggregate supply curve is vertical due to the assumption we have made about the labor market.
 - ✓ Two assumptions implicit in classical representation of labor market are
 - I. Perfectly flexible prices and wages
 - II. Perfect information about prices by the participants of the market
 - ✓ If such a model is to explain employment and output in the short run, prices and wages must be perfectly flexible in that time period.
- 🏠 These two assumptions are the elements of classical theory that **KEYNES** attacked.
- 👉 By 1930's our world face great economic depression. The economy was unable to adjust or came at full employment level
- 👉 According to Keynesian school of thought: -
 - Wages and price are inflexible down ward at least in the short run.
 - Wages, rents and other production costs are set by contracts in the short run and cannot be reduced until the contract is expired sometime in the future.

- Government role is important to influence aggregate demand to ensure full employment.
- The key to Keynes analysis was the role of aggregate demand
- The equilibrium level of GNP determined by the volume of expenditure planned by:
 - Consumers
 - Inventors
 - Government
 - Foreigners

5.6 Keynesian Economics and Underdeveloped Countries

- 👉 The Keynesian postulate that the economy is determined by the forces of demand & supply is a useful piece of theory for analyzing the problem of underdeveloped countries.
- 👉 But we must not forget that, no matter how pure a piece of economic theory is, it rests on some political assumptions.
- 👉 Aggregate demand and supply functions may not have much meaning in an economy where private motivation is far less important than the social motivation, where producers are given to think of the next rather than the present life.
- 👉 We know that some underdeveloped countries prefer to have a **socialistic bias** in their economic planning
- 👉 The producer in the agricultural sectors of underdeveloped countries often included to think in terms of salvation rather than maximization of material satisfaction in the present life.
- 👉 For Keynesian, due to labor unions the laborers inclined to resist reduction in wage, hence equality between aggregate demand & supply would not be guaranteed.
- 👉 However there is an assumption in the Keynesian model that there could be a change decrease/increase the real wage rate because most of the time the laborers are ignorant about the real wage rates
- 👉 But in this regard most underdeveloped agricultural sectors are being paid near minimum of subsistence; do not admit of any reduction at all.
- 👉 For Keynesians the is employers and laborers, the employer will be at equilibrium when aggregate demand and supply prices are equal but as stated earlier the labors would resist any

kind of reduction in wage rate that would make difficult the equilibrium for the laborers market. In this regard the problem with underdeveloped nation is most of the people are self-employed hence the above situation even do not work for them.

- 👉 The taxation policy proposed by the Keynesian economics is progressive tax hence it will encourage people to consume more than save less or it may distribute income from high income group to low income group which makes them beneficiary. This raises the total consumption demand of the economy and help to sustain effective demand
- 👉 Effective demand for Keynesian can be increased by using either increased investment or consumption. But for economies like underdeveloped nations in which there is excess labor supply a progressive tax which inclined to increase effective demand through consumption is highly improbable. This is due to the fact that the excess labor needs more to save rather to invest (**inconsistent with Keynesian investment led saving theory**) which is reduced by progressive tax.
- 👉 Again from monetary side Keynes proposed easy of finance in time of trouble in order to use idle capital. But in underdeveloped countries easy finance may create excessive demand for capital which is already in short supply.
- 👉 This may create undue encouragement to capital intensive biases in production situation where, owing to lot of surplus labor, the need may be more for a capital-saving bias.
- 👉 Deficit financing too is a method of utilizing idle capital through easy finance.
- 👉 When the private sectors are not in a position to invest, the state may undergo through borrowing or creating money. Once the people are employed, no matter even if in digging holes and filling them up again, they get income hence they will demand more production which encourage the reluctant private investor to invest. And thus the tempo of the economy is maintained.

- 👉 But in underdeveloped economies first of all capital stock has to be increased finance itself, it is obvious, is not capital.
- 👉 Keynesian economics proposed foreign investment through surplus BOP that results from protective trade when the home investment is lacking but the protectionist policy may lead to inflationary pressure at home and again if a given economy wants to invest in foreign economy it has to have the same currency like the foreign country or gold metals.

- 👉 A Keynesian investment Multiplier suggest that if more demand for machines has been created, more machines will be immediately produced and made available. If more food is being demanded, more food would be immediately produced and supplied. And so on. In underdeveloped economies we cannot dream of having such automaticity
- 👉 But Keynesian consumption Multiplier is more valid for such underdeveloped economies. It does not require elastic supply like investment multiplier because little changes consumption goods due to tax or foreign aid can make the ball to role.

5.7 Criticism of Keynesians

- 👉 The Keynesian theory of income, output and employment determination has been criticized on several grounds.
- 👉 **Firstly** it has been grounded by the critics that the Keynesian model is too aggregative. It has fewer those necessary variables and relationships. It does not disaggregate the variables involved into their various component parts.
- 👉 **Secondly** the Keynesian model has been criticized as being **“too static”** in the sense of being concerned with equilibrium conditions during the short period in which technology and capital stock are given and are benefit of changes **“On the one hand, the model cannot deal with the short-run dynamics of income change; on the other it is not studied to the analysis of problems of long-term growth.”**
- 👉 **Thirdly** the Keynesian assumption of autonomously determined rigid money wage is analytically unsatisfactory and practically unattainable.
- 👉 **Fourthly** the Keynesian analysis of money and interest rate is defective.
- 👉 **Fifthly** Keynes limits the composition of the asset-portfolios of wealth-holders to money bonds and goods completely ignoring that there are corporate shares, debentures and myriads of other securities, which wealth-holders acquire as a part of their asset-portfolios.
- 👉 **Sixthly** the Keynesian model ignores lagged relationships with the result that it excludes discussion of both the dynamic multiplier and acceleration.

- 👉 **Seventhly** Keynes offered no imperial evidence for making some crucial assumption in his model. These critics are based on Gardner Ackley's discussion of the criticism of the Keynesian model of income and employment.
- 👉 His analysis is like this during the period of prosperity of the habit and consumption of people being relatively fixed, they tend to spend less than the increase in their income. This is because a relatively large part of an increase income goes to businessmen, whose prosperity to consume is relatively lower than that of other classes in the community. The overall prosperity of the entire community to consume tends to fall. Consequently, the businessmen's expect action decline, while at the same time, the increase of business activity has already increased the price of capital goods. Since the marginal efficiency of capital is the ratio between the anticipated earning of future investment and their supply price, the investment shows a declining trend. Thus it is the schedule of marginal efficiencies of capital which creates an imbalance between savings and investments.
- 👉 In case, savings are more than investments, the growth is checked and vice versa. As soon as this expectations of the businessmen regarding the future profitability of new investment fall, their liquidity preference increase leading to a rise in the rate of interest.
- 👉 This worsens the situation all the more the result would be that the contraction of investments would be at an accelerated rate and when investments fall, the "multiplier" works in the reverse direction and employment is greatly reduced.
- 👉 Hence, the chronic under- investment and under-consumption lead to depression.
- 👉 The phase of recovery can only start when consumers' demand goes up, without any addition to the present output. This can be possible only through public investments in producing non-market goods or services, where in the rate of profit, expected or actual, no is consideration.
- 👉 The return to recovery may take some time and it depends upon how soon the marginal efficiency of capital is re-established to businessmen's faith is revived.

Self-Exercises

1. Explain the neo-classical mentality regarding full employment level of production.
2. Explain the essence of Keynesian revolution.
3. Discuss the functional relationship of employment, consumption and investment.
4. Explain, using Keynes's concept of the marginal efficiency of capital, how it is possible for investment spending to decline, even though the market rate of interest remains unchanged

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 if 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;

$$M = M^d = kPY$$

$$M = kPY$$

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

$$MV = PY$$

- 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;

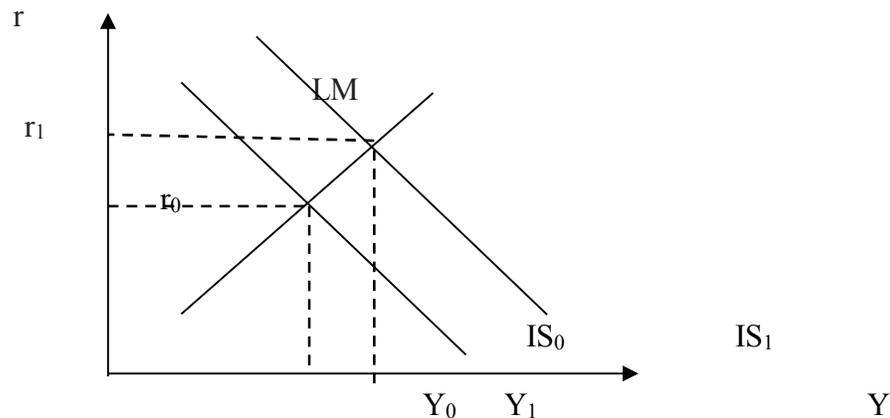
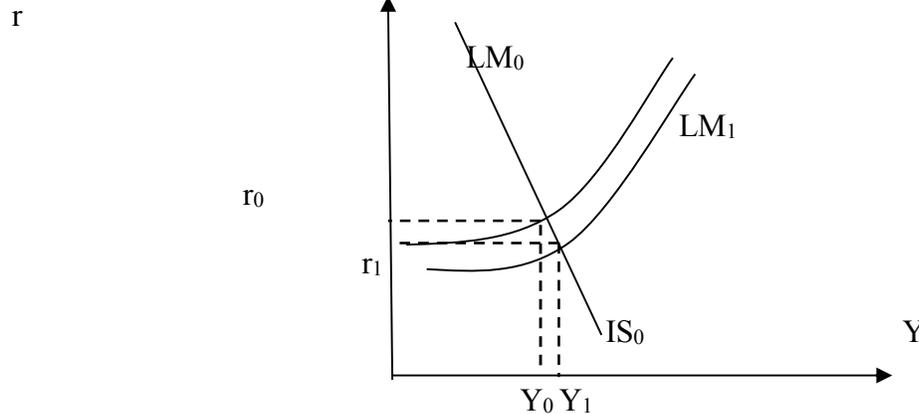


Fig: effects of an increase in Government spending through Bond selling; The Keynesian View

- 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?