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Chapter V. Perspectives on Economic Theory

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Chapter V

Perspective On Economic Theory

I. Introduction

The question "Why is our economy so unstable?" leads to a different perspective from that which underlies today's standard economic theory. This standard economic theory, which is the intellectual capital of the policy advising economists, is commonly called the neo-classical synthesis (Joan Robinson has pithily labeled it as "Bastard Keynesianism"). Instability as a normal functioning result is ~~force~~ foreign to this economic theory. As a result, today's policy advising economists view each episode of instability as the result of special circumstances not of systemic influences. As a result of their shortcoming economic policy of necessity is floundering.

In all disciplines theory serves as a lens and as blinders. Like a lens, theory focuses thought upon specified problems. By focusing thought theory enables conditional statements to be made about causal relations for a well defined but limited set of phenomena.

Like blinders, theory narrows the field of vision. Questions that are meaningful in the world are often nonsense questions within a theory. If such "nonsense" questions are often posed by developments in the world, then the discipline should be ripe for a revolution in theory. Such a revolution requires the development of new instruments of thought; changing theory is a difficult intellectual process.

Within standard economic theory "Why is our economy so unstable?" is just such a nonsense question. Standard economic theory not only doesn't lead to an explanation of instability as a systemic attribute, it really doesn't recognize that instability is a problem that a satisfactory theory must explain.

Policy advising economists are neither fools nor knaves: they know instability exists. Nevertheless professionals base their advice upon a theory that cannot explain instability. They "stick to" the neo-classical system because it provides answers to deep and serious questions, and has had some success (e.g. in the 50's and 60's) as a basis for policy.) Before ~~abandoning~~ ~~economics can~~ ~~more beyond~~ ~~neo classical theory we have to understand its strengths; the importance of the questions it does treat in a successful way understand what it is that neo-~~ classical theory does explain in a good fashion and why ~~it has been~~ the areas ~~in which the neo-classical theory is successful are needed.~~

It is necessary to understand the deep and serious questions

Before abandoning or radically revising neo-classical theory it is necessary to understand ~~to~~ the ~~strengths for it has~~ significance of the deep and ~~serious~~ serious questions that neo classical theory does ~~explain~~ answer and why any economic theory must come to grips with the questions that neo classical theory addresses.

II. The Importance of Theory

An understanding of the strengths and weaknesses of standard economic theory is particularly important because active economic policy now is the norm rather than the exception. It is now generally accepted that government will use monetary and fiscal measures to steer the economy.

In a society in which active economic policy is the normal order of the day Keynes' famous dictum, that ". . . the ideas of economists and political philosophers, 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."[1] is especially relevant. In a world of active policy the content of economic theories and the significance of differences in theory for policy is of special interest. James Tobin, who was a member of the Council of Economic Advisors during Kennedy's first two years, noted that "The terms in which a problem is stated and in which the relevant information is organized can have a great influence on the solution" (James Tobin: The Intellectual Revolution In U.S. Policy Making, Noel Buxton Lectures, 1966, University of Essex, England, p. 14). But the way "a problem" is stated and the identification of "relevant information" reflects the economic theory of the policy advisor. That is the "game" of policy making is rigged. "Theory" determines the questions that are asked and the options that are presented to the political leadership.

Keynes' dictum becomes especially relevant once a policy advising process becomes organized. Whereas Keynes referred to "some academic scribbler of a few years back", once the advising process is ~~finalized~~ formalized the views of today's

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[1]J. M. Keynes, The General Theory of Employment, Interest and Money, Volume VII of the Collected Writings of John Maynard Keynes, MacMillan for the Royal Economic Society, London, 1973, p. 383.

crop of advisers is important: the lag between ideas and policies that reflect the ideas becomes shorter.

The press and the business literature makes much about the distinction between monetarists and Keynesians. In truth there is no significant difference in the economic theory used by these economists: Monetarists and "Keynesians" use the same standard economic theory.

Today's standard economic theory is largely a creature of the years since World War II. It integrates some aspects of Keynes' thought from his General Theory of 1936 with the older classical analysis that Keynes believed he was replacing. It is this neo-classical synthesis that guides economic policy even though it cannot explain instability.

It is ironical that an economic theory which purports to be based on Keynes fails because it cannot explain instability. The essential aspect of General Theory is a deep analysis of how financial forces--which we can characterize as Wall Street--interact with production and consumption forces to determine output, employment, and prices. One proposition that emerges from Keynes' theory is that from time to time a capitalist economy will be characterized by persistent unemployment. The neo-classical synthesis uses this result even as a deeper result, which is that a capital-using capitalist economy with sophisticated financial practices (i.e., the type of economy we live in) is inherently unstable, is ignored. Keynes analysis that led to the ignored result provides the foundation for an alternative economic theory which allows us to understand instability.

The neo-classical systhesis combines a model that explains how persistent unemployment may be generated with a model of labor and commodity markets that explains coherence, i.e., full employment. The neo-classical synthesis shows that (1) fiscal and monetary policy measures can eliminate persistent unemployment and (2) there are self-correcting forces within decentralized markets that set the economy at full employment. The neo-classical synthesis "speaks" with a forked tongue: On the one hand, interventionist policy can eliminate persistent unemployment or chronic inflation and on the other, if nothing is done, in time and of its own workings, the economy will settle in a stable price, full-employment regime. In its later manifestations the theory holds that if "something" is done but what is done is predictable then the system will settle into a natural order of unemployment and "activism" will only affect the course of prices.[1]

This neo-classical synthesis will not do for our economy in our time. Unless we understand what it is that leads to instability we cannot prescribe--make policy--to modify or eliminate instability. Identifying a phenomenon is not enough, we need a theory which makes instability a normal result in our economy.

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[1]The natural rate of unemployment may be "socially" and "politically" unacceptable but that is not taken to be an "economists'" problem.

III. The Three Questions of Economic Theory

To understand economic theory we should begin at the beginning, with Adam Smith. In The Wealth of Nations Smith identified two questions that economics must address: "Why does a decentralized market mechanism not result in chaos; i.e., why does it lead to a coherent result?", and "Why is one economy richer or poorer than another?" We now know that there is a third question; "Why is our economy unstable?"

We have shown that in 1966, 1970, and 1974-75 strong destabilizing forces were evident in our economy. Instability--which was absent for some twenty years after World War II--is again a fact of life. Intermittently our economy seems to generate financial instability and threats of a deep depression. The history of American capitalism can be written in terms of periods of stability alternating with periods of turbulence and instability. The behavior of our economy forces us to build an economic theory that explains intermittent instability; i.e., the intermittent breakdown of coherence.

A. Coherence

The coherence problem was identified when Smith argued that if "the propensity to truck, barter, and exchange one thing for another" is allowed a relatively free reign, the result will be coherent. In a market economy a seemingly proper amount of each of the multitude of goods and services are produced and used. Furthermore over time the relative terms on which different alternatives are available tend to be approximately the same. Regularity and order, both over time and in response to changes, is observed. Wherever coherence exists--whether for the economy as a whole or for subsets of the economy--intervention is not necessary to achieve order. The market mechanism can serve as an instrument of coordination and control. On the other hand if market processes produce incoherence control cannot be left to the market: policy, in the form of stabilizers and regulators, is required.

The "fact" that decentralized markets can lead to a coherent result was used by the theorists of market socialism, Oscar Lange and Abba Lerner, to argue that market processes can and should be used in socialism. The principal guiding market socialism is that the market is an effective signalling and coordinating device, once income distribution and investment are determined outside the market. Income distribution is the prime equity problem that besets all economies. Instability is a result of the way a capitalist economy determines and finances investment and ownership of capital assets. Lange and Lerner had two messages: socialist economies can use markets and that there is nothing much wrong with market capitalism if equity and stability are achieved.

Once it was "observed" that unguided and unplanned market mechanisms lead to coherent results the question "how come?" had to be addressed. Are there deep and fundamental characteristics of the various commodities that explain why they seem to exchange one for the other in apparently stable ratios? The search for reasons why commodities exchange in apparently stable ratios led to various forms of "value" theory. In particular Smith and many of his followers--Ricardo, Marx--looked to the labor or pain cost of production as an explanation of exchange values. This was followed by Benthamite explanations of exchange value in terms of utility and, as economists discovered the calculus, marginal utility. Ultimately "costs" and "utility" (benefits) were combined into a "supply and demand" theory of exchange value; costs being embodied in the supply conditions and benefits in demand curves.

It has often been said that an economist is a parrot which has been trained to say supply and demand. The economists of about a century ago--Marshall, Walras, Casells--developed an explanation of the observed coherence in terms of interrelated supply and demand curves and reactions ~~dynamics~~ in various markets that generate the relative prices at which supply equals demand for each commodity. As theory evolved 'preference systems of individuals' and production functions for commodities were used to describe how supply and demand curves are determined. In economic theory individual consumption and production decisions generate the observable market variables and the terms on which exchanges can take place constrains the behavior of producing and consuming units.

Preference systems--unexplained and taken for given--and the production possibilities--given by technology and perhaps changeable in response to economic conditions--are the basic building blocks of the theory that explains coherence. The system can predict how observed variables change when taxes, subsidies, quantities available, etc. change because of external developments, including policy decisions. Thus the model not only explains coherence but it also explains changes and effects of policy actions.

This theory is powerful. The result that the behavior of individual decision units guided by self interest and constrained by market exchange possibilities will lead to an orderly world is not obvious. The proposition that market determined prices are an effective control and coordination mechanism is a powerful insight to how social systems operate. The knowledge that decentralized markets work, in the conditional sense that under specified conditions they can yield a coherent result, is what distinguishes those who understand economics from those who do not. Because standard theory leads to an understanding of how decentralized systems that seem to be conducive to chaos are in fact characterized by order, economists will not easily abandon standard theory. Economists try to force explanations of diverse phenomena they need explain into the mold provided by production function-preference system or the supply and demand apparatus of standard theory. The loyalty to standard theory is well deserved. Any economic theory that explains the emergence of instability will also need to explain why the price system does at times work so well.

We should note that standard theory demonstrates that coherence results from market processes. Scientific theory cannot assert that market processes yield a "best" result, for "the best" implies a value judgment. Nevertheless the invisible hand proposition of Adam Smith that an individual "By pursuing his own industry he frequently promotes that of society more effectually than when he really intends to promote it" [p. 423, Modern Library Edition], i.e., he is "led by an invisible hand to promote an end which was no part of his attention" [p. 423] has been blown up by generations of economists to prove that the coherent solution that can be observed is in some sense a best result.

One argument that is used to advance the proposition that a trading system yields a "best" result is that if the transactions that take place are voluntary, if each participant is free to transact or not to transact, then each party to the transaction is in "his" own mind made better off by the transaction. Therefore transactions will take place only if they are mutually beneficial, i.e., both parties gain. But the most that follows from trading is that every participating party is better off, not that a best has been achieved.

In bargaining, the apportionment of potential benefits among the transactors depends upon the anxiety to trade of the transactors. One who is anxious or is forced to trade, is likely to do poorly in trading. For each transaction to be mutually beneficial and for the gains to be apportioned in a best way, the pre-trade position of each transactor must be compatable with the sustaining of life. If one party must trade to survive and the other is free not to trade, then the apportionment of the gains is likely to be biased. One who has only labor to sell and who cannot survive without selling labor is likely not to gain a fair share from trading. Trade does make both parties better off, but power can be so distributed that "exploitation" takes place--exploitation in the sense that some participants in the transactions realize but a small portion of the gains from trade.

President Kennedy is supposed to have remarked that the "World is not fair". The claims that are often made for the price system is that it yields a result that is fair. This claim is only possible if it is assumed that all transactors are faced with a myriad of possible trading partners, and each of this myriad is equally powerful, in wealth, in information and in the perfection of foresight. These assumptions are so heroic, so contrary to fact, that the claim to fairness as a universal result evaporates. Decentralized markets yields a coherent, not necessarily a fair, result.

The market mechanism works through a system of relative prices. The theory ~~of prices~~ shows that if relative prices are allowed to adjust, then the quantities of goods and services supplied and demanded will vary in such ways so that for each item the quantity supplied will equal quantity demanded. That is there is one, but perhaps more, set of relative prices at which all the markets will clear, i.e., at which quantities supplied equals quantities demanded. This result depends upon two conditions: relative prices are free to vary and quantities taken and quantities sold will adjust to changes in relative price. The adjustment to changes in relative prices takes the form of substituting against the relatively more expensive commodities or services.

Adjustments of demand to changes in relative prices leads to substituting against those goods and services whose relative price has increased. If the dollar price of coffee explodes relative to that of tea then the amount of coffee bought will tend to decrease and the quantity of tea will tend to increase. The dollar price of tea will tend to rise, but by a smaller ratio than that of coffee. The total amount spent on tea and coffee may increase, decrease or remain constant. Furthermore the rise in the prices of tea and coffee and the change in the total spent on tea and coffee will affect markets for other commodities. A wave of repercussions will spread from an initial disturbance, but this wave of repercussions will dampen out. A new "equilibrium" of unchanging relative prices is achieved after the elapse of some time and the progression to the new equilibrium is orderly. Coherence requires both that market clearing relative prices exist and that the adjustment process is orderly.

B. Relative Riches

Why is one country poor and another opulent and how is it that the opulence of a country varies over time? This question concerned Smith and it concerns us today. Efforts to aid and abet the enrichment of the currently poor countries and to achieve an accretion of opulence in the richer countries are ever present challenges to economic policy.

Smith gave a complex answer to explain relative richness of countries. In his mind social structure, political stability and accidents of history were important determinants of relative richness. However the social, political and historical determinants of relative riches were of secondary importance compared to the comparative stock of capital assets per worker. The critical condition was that the workers in rich countries had more and better capital assets than the workers in the poor country.

Capital assets are not original endowments due to nature, they are the result of past accumulation ~~on~~ OR investment. One country is richer or poorer than another exactly as it has accumulated more in the past. In order to accumulate output must exceed consumption: Those who produce consumer goods must produce more than they themselves consume so that a surplus exists to support those who produce investment goods. The initial prerequisite for economic progress is that agriculture yields more foodstuffs than the farmers use so that an excess exists which can support a non-agricultural population. Thus a surplus whether in agriculture or in output in general is necessary for accumulation.

As economists impute differences in wealth among countries to differences in past accumulation it follows that any improvement in well-being over time is due to the accumulation of capital. Inasmuch as accumulation requires a prior surplus, the question of opulence or economic growth becomes how does an economy generate and allocate a surplus? A theory of how a sophisticated complex capitalist society generates and allocates its surplus is required if we are to explain the behavior of our economy.

The supply and demand apparatus is successful in explaining behavior in commodity markets. Once a discipline has a successful bit of apparatus it is quite natural to apply that apparatus to additional problems that arise. Thus the neo-classical economist approaches the problem of the generation and allocation of the surplus in the same way he approaches any problem: He breaks it down into supply and demand factors, and a price that tends to equate the quantities supplied and demand. The surplus, i.e., the supply of resources available to produce investment goods, becomes the savings of the economy. The incentive to save is a future gain which is identified with "the" interest rate.

The demand for the output that the surplus can produce is investment. Investment is motivated by a flow of expected profits: the relation between profit flows and investment goods prices can be represented by "the" interest rate. The explanation of accumulation by the supply and demand apparatus leads to a savings and investment model in which the "interest rate" is the "equa~~ling~~ting" price.

The view that the savings-investment process is just another supply and demand problem was attacked by Keynes in his General Theory. One flaw in the use of supply and demand analysis to explain accumulation is that investment demand is not a "timeless" phenomenon. Investment demand is not singly an allocation of income by a household. In a capitalist framework it is determined by expected future profits and available finance. Thus is drawing supply and demand curves for savings and investment a question of temporal compatability arises: The savings schedule reflects current and past behavior of the economy ~~and~~ whereas the investment schedule reflects expectations of future income.

Neo-classical theory is largely based upon the view that the savings function is generated by consumer preferences and that investment adjusts to conform to the savings forthcoming. Keynes' theory is that financial investment forces a surplus which equals the investment and that the size of the surplus is varied by varying income: A larger financial investment increases income which yields more savings.

A major issue in theory is whether the generation and allocation of the surplus can be treated as just another problem in supply and demand analysis or whether the problems surrounding accumulation requires a different analytical framework. A direct attack on the accumulation problem leads to the question

of how does the economic mechanism assume that the workers cannot buy all of what is produced. Part of what is produced--the investment goods--becomes the property of the capitalists or rentiers in a capitalist economy or the property of the state in a socialist society. Workers receive income from the production of both investment and consumption goods. Consumer goods need be priced so that they absorb all of wage income. Profits or tax revenues emerge out of the ~~way~~ process by
which the result, that all of wage income buys only a part of workers output, is brought about. The surplus is forced by prices of commodities exceeding wage costs: There is a strong correlation between the pace of investment and profits.

C. Instability; Incoherence

Smith's <u>Wealth of Nations</u> was published in 1776, the year America declared its independence. In England capitalism was young, and the banking system was just getting started. The problems of instability that were to plague capitalist economies in the next two centuries were barely perceptible. As a result Smith did not ask the third question "Why is our economy so given to fluctuations?"; instability was not there for him to observe. Today's standard theory has not moved on to this third question even though instability is an evident trait of our economy.

We will develop a theory of why our economy fluctuates which shows that those fluctuations of a capitalist economy that are associated with financial difficulties are related to the techniques by which the surplus is forced.
is forced
The surplus by the process by which investment is financed.

To build a railroad in the United States in the 19th century it was necessary to get an assurance that finance will be available from J. P. Morgan or one of the other great nabobs of Wall Street. Today when corporations dominate the scene, investment plans are based upon the expected availability of finance from internal (profit flows) and external (banking, bond issues, etc.) sources. Finance, not in the sense of cash on hand but in the sense of funds that will be available from one source to another, is the critical element that forces the surplus in a capitalist economy.

The instability and incoherence that capitalist economies exhibit from time to time is related to the development of fragile financial structures in the normal course of financi~~al~~ng control over capital-assets and investment. The speculative elements of capitalist finance are due to the way financial (debt) contracts link today and a succession of tomorrows, and how current profits depend~~s~~ upon investment activity, which in turn is based upon the expectation of future profits.

IV. The Status of Laissez-Faire

Laissez-faire, in the simple sense of non-intervention or minimal government involvement in the economy, is dead; it may never have lived. In Britain in the late 18th and early 19th century an inherited system of economic institutions, which tended to constrain and restrict the role of the market in the economy, was dismantled. But what was left was far from an unconstrained market economy. Furthermore as the constraints were relaxed instability and inequity became evident so that new interventions were quickly introduced.

As recently as the Hoover Administration the from time to time occurrence of a deep depression was taken for granted. Government was viewed as being powerless to prevent or ameliorate such disasters. Today it is accepted that government is responsible for preventing or aborting great depressions.

There are many possible systems of government intervention into economic life and many possible ways to organize product, labor, and financial markets. Whatever exists is by its nature a "special case" that is the result of legislation and the evolution of institutions in response to market forces. The legislation that determines institutions reflects the power relations and the views as to how the economy functions that were dominant when the legislation was enacted. As economic theory changes the views that affect legislation and policy decisions change.

Legislation is usually incremental, in that new measures are added onto an existing body of legislation. As a result the economic theory underlying one portion of the legislated institutional structure is likely to be inconsistent with that underlying another part. In principle policy and institutions should reflect a consistent view of the economy. In fact the inherited policy structure is replete with inconsistencies.

A great American proponent of liberal economic ideas, Henry C. Simons of the University of Chicago, titled his most passionate and persuasive tract "A Positive Program for Laissez-Faire".[1] The message of this tract is that active government intervention is needed to first organize and then sustain the conditions under which decentralized markets can function to achieve an apt set of outputs and an adequately equitable income distribution. Even as Simons argued that free and decentralized markets can do the job of organizing the details of economic life, he realized--largely because he was writing in 1934 in the midst of the Great Depression--that active government policy was needed to sustain appropriate overall conditions in the economy so that decentralized markets can do their job. Simons implicitly recognized that the problems and the instruments of policy change as the economy forces new dimensions of behavior to the fore and as economic theory develops new understandings of the reasons why the economy performs as it does, even as he explicitly recognized that the need for policy does not change.

Economic theory is not now and has never been a set of propositions relevant to our economy which are universally accepted as valid by all certified professional practitioners. Controversy attaches to almost all propositions asserted as being valid for our particular capitalist economy. In part this controversy reflects the inescapably normative content of economics. In the application of theory to practical matters questions as to "for whom" and "what kind" cannot be avoided. Every policy decision has a 'for whom and what kind' implication, even though an explicit discussion of these issues is often avoided.

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[1]H. C. Simons, "A Positive Program for Laissez-Faire" in H. C. Simons, Economic Policy for a Free Society, The University of Chicago Press, Chicago, IL, 1948, pp. ix - 353.

In addition economists differ in the questions they hold that economic theory must address. Traditional economic theory has mainly addressed the problem of whether a decentralized market mechanism yields a coherent result. It is obvious that chaos is not the rule in economies without central planning. Thus an economic theory was developed that shows how the observation, the absence of chaos, is brought about.

However the absence of chaos is not the same as a social best or optimum, to use a word much loved by economists. The theory which demonstrates coherence (non-chaos) does not demonstrate that an optimum results from decentralized markets. Furthermore even though the proposition that a decentralized market mechanism is coherent is true under a fairly broad set of conditions, it has not been shown that coherence holds for an economy in which capital-assets, money or finance, and time are important.

The proposition that a decentralized market mechanism yields a social best is used as a foundation for the advocacy of Laissez-Faire. However this proposition is valid in a very limited sense. The existing distribution of the income and wealth must be taken as given and correct before it is possible to claim that the market can yield an optimum. Furthermore our type of economy exhibits incoherence from time to time. Intermittent incoherence has been observed within a wide variety of institutions. It follows from the observation that intermittent incoherence exists, the flaw in the logic of extrapolating from an abstract economy to our economy, and the limited definition of the social optimum that is used in economics that Laissez-Faire is not a valid universal policy prescription.

One of the major sources of controversy and confusion in economic policy is the continued belief by publicists, politicians and some economists who are in the public eye that economics has demonstrated that Laissez-Faire, in the sense of virtual anarchy, leads to a social best. Even if it is desired to let the market do the job of determining the allocation of scarce resources among alternative employments, intervention is needed to prevent the emergence of incoherence. The fact of instability implies that laissez-faire won't do as a policy strategy.

V. Conclusion

When Keynes summarized the import of his new theory, he stated that "this then is why our economy is so given to fluctuations" (QJE 1937). However fluctuations of the type that concerned Keynes are foreign to the behavior of the economy that is described in standard economic theory. In particular now that business cycles that involve financial crises are once again a readily apparent danger economists need to explain how "incoherent behavior"--such as a financial crisis--is generated. In the light of the behavior of the economy in the years since the middle 1960's any economic analysis that claims to be relevant needs to address:

(1) How the ruling market mechanism achieves coherence in particular outputs and prices,

(2) How the path of incomes, outputs and prices is determined, and

(3) Why coherence breaks down, i.e., why is the economy susceptible to threats if not the actuality of deep depressions.

These questions need to be answered in the context of the institutions and usages which exist, not in terms of an abstract economy.

Standard economic theory abstracts from the institutional, and in particular the financial, detail of our economy. This theory is not able to explain the business cycles we are now experiencing as outcomes of the internal operation of the economy. A question which follows is whether that which the theory ignores, institutions and in particular financial institutions, lead to the observations it cannot explain. Given this failure of standard theory a fundamental question that economic policy analysis must confront is whether, and over what domain market processes can be relied upon to achieve a satisfactory economic performance.

Appeals to the wisdom of the market, as to the abstract virtues of something called the American Free Enterprise System have to be disciplined by the awareness of market flaws, failures, and imperfections.

The general view that our analysis sustains is that the market mechanism is a good enough device for making social decision about unimportant matters such as the mix of colors in the production of frocks, the length of skirts, or the mix of flavors of ice cream. The unconstrained market cannot be--and in fact is not--relied upon for important "big" matters--such as the final distribution of income, the maintenance of economic stability, and the education and training of the young. Any serious analyses for policy needs to explore and define the areas in which markets can be used.

The market's big advantages over government direction and control is that it requires less oversight by a bureaucracy. In a market system each decision is small and errors are censored or penalized. Market organizations minimize the social impact of individual mistakes. The ability of error to lead to mischievious results is perhaps best minimized by properly decentralized markets--which is a major virtue of properly organized markets.

Thus we start, with a bias in favor of using the market mechanism to the fullest extent possible to achieve social goals, but with a recognition not only that regimes of completely free markets is seemingly intrinsically unstable, but also that it quite apparently leads to distasteful distributions of wealth and power.