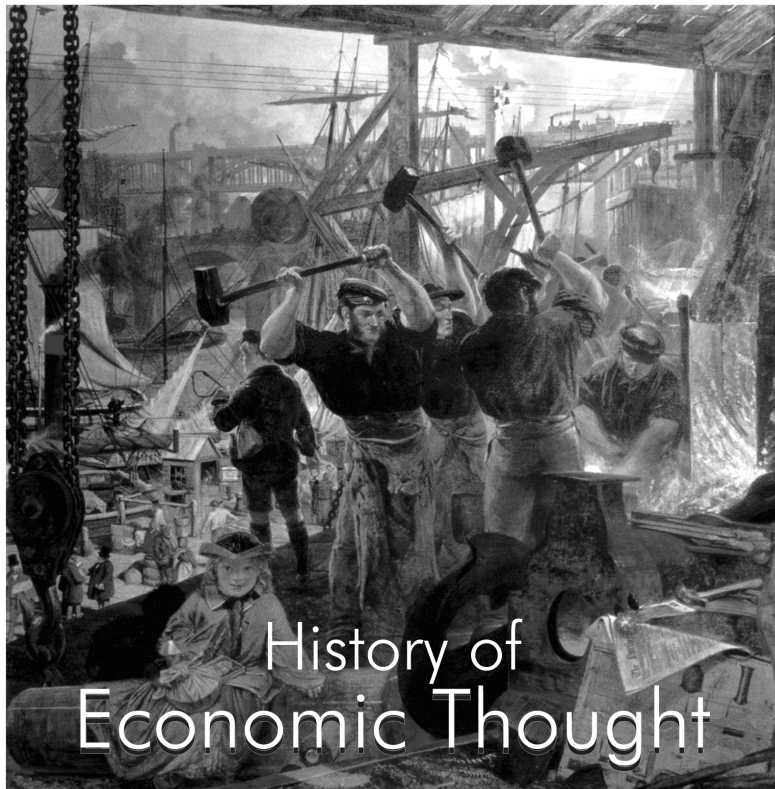

History of Economic Thought

Only study guide for
ECS3705

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IMPORTANT INFORMATION

Please activate your myUnisa and myLife email addresses and ensure that you have regular access to the myUnisa module site ECS3705, depending on which semester you are registered in.

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Introduction to the module

FORMAT OF THE GUIDE

This guide seeks to help you by dividing the prescribed material in the textbook up into seven "bite-sized" chunks, called learning units

For each of the schools or topics within a learning unit (e.g. mercantilists in learning unit 1), it does the following:

- It indicates a number of **SPECIFIC LEARNING OUTCOMES,** which identify what you need to know and understand to master within that particular learning unit. You can then direct your studies towards obtaining that knowledge and understanding.
- It introduces each important historical person or school of thought with an **ACTIVITY**. These "activities" are intended to arouse your interest in these historical persons or schools of thought by way of a fictional or real story or a contemporary perspective on them. Under the heading of **Activities**, you are also encouraged to answer certain questions as a way of practically applying your knowledge.
- **It DEMARCATES** the prescribed textbook readings for the particular section.
- It discusses the demarcated part of the prescribed textbook that formed the prescribed reading, in a section called **CONTENT**, which seeks to give you practical help in going through the relevant study material in the prescribed textbook. Because the prescribed textbook is generally quite lucid, there will often be no need to repeat what is already clearly set out there. Hence the "Content" section will, as a rule, confine itself to some additional explanation and background information where deemed necessary and appropriate. In the process, your lecturer will not shy away from giving his own, at times controversial, opinion on the theoretical as well as socio-economic issues under discussion, which will hopefully further liven up your studies. You should of course feel no obligation whatsoever to agree with your lecturer.
- For each learning unit (or topic within the learning unit), there will follow a **LOOKING BACK AT THE ACTIVITY** section, which will do exactly as the label suggests.
- Under the heading of **RELEVANCE FOR TODAY,** we will occasionally interrupt our discussions by expanding on a certain theme indicated in the study material, where that theme has relevance for modern-day South Africa. "Relevance for Today" sections are typically contained in a box. Once again, your lecturer will not shy away from giving his own, sometimes seriously controversial, opinion in these sections, with which you should again feel no obligation to agree. The "Relevance for Today" sections will occasionally also contain questions intended to stimulate your thoughts.
- Each learning unit will end with a number of **SELECTED SELF-STUDY QUESTIONS**. These have been selected from the end-of-chapter questions in the prescribed textbook. You should not view them as possible exam questions but rather as opportunities to actively reflect, from the angle of the particular question, about what you have learnt in the learning unit. It is in this indirect, rather than direct, way that this exercise should help you in your studies.

GENERAL OVERVIEW OF LEARNING (OR STUDY) UNITS THAT COMPRISE THE MODULE EC3705

The course introduces you to some of the main characters who have contributed to economic thought over the centuries. You will encounter people like Adam Smith, David Ricardo, Karl

Marx, Alfred Marshall and John Maynard Keynes – names you might already have heard of. Then there will be brief encounters with people like Thomas Malthus, Leon Walras and Thorsten Veblen – names that may be strange to you. But they also have made significant contributions to our subject. The course seeks to help you place all these contributions in their historical context and grasp how they have shaped economic theory over the years. Some of these contributions have been integrated into present-day mainstream theory as it is taught at most universities, including ours. Other contributions, by contrast, have led to alternative schools of thought, like the Marxists, the Post-Keynesians, and Neo-Austrians, which are to various degrees antagonistic towards the mainstream. We want you to become aware of some of their ideas too.

Probably the main society promoting the history of economic thought is the (American) History of Economics Society – www. historyofeconomics. org – which has an interesting SHOE e-mail list conveniently archived.

However, over the last decade or more, fewer and fewer undergraduate courses worldwide are being given in the history of economic thought. This is a tragedy since they today provide the only exposure available to undergraduate students to the fact that there currently exists in the "underworld" (i. e. not seen by undergraduate students) of economics a number of alternative schools of economic thought. Long ago one might have said "competing" schools of thought, but, by the 1980s only one school of thought had come to dominate the curriculum in university departments of economics worldwide. This is the neoclassical school or neoclassical synthesis, or today's "mainstream economics" or orthodox economics.

History of economic thought courses thus fulfil a vital function in "keeping alive" the teaching of alternative ways of thinking about how the economy functions. In this module you will, therefore, for the first time be introduced to a range of schools of economic thought for the first time in your graduate studies. Students in other modules will not be so fortunate. Each of these offers a different perspective on how the economy is supposed to function.

While the teaching of the schools of economic thought alternative to the neoclassical school has mainly been relegated to history of economic thought courses, a worldwide economics student-based movement has sprung up, which aims to introduce all of the alternative schools into the teaching of core courses into the economics curriculum so that a "pluralistic" approach is adopted and exposure to these schools is no longer confined to history of economic thought courses. The web site of one such movement is www. rethinkeconomics. org where, if you look carefully, you may recognise one of your lecturers in the large group photograph on the front page!

Apart from these recent student-based initiatives, there are long-standing societies of academic economists who do not subscribe to the mainstream. These are often referred to as "heterodox" economists, that is non-orthodox economists. A prominent example is the Association for Heterodox Economics www. hetecon. net. See also the heterodox economics newsletter at www. heterodoxnews. com Aside from these heterodox groupings, the billionaire George Soros, due to the criticism of economics as a result of the 2008 financial crisis, set up the Institute for New Economic Thinking www.ineteconomics.org to encourage economic research outside the neoclassical box. In a bid to spread its message, this institute has made available hundreds of multimedia items. We will refer to some of their video clips. The purpose of these video clips is to make the course "come alive" and thereby to awaken your interest in the subject. Thus, while these video clips do not form part of the examinable content of the module, if they succeed in stimulating your interest, then your studies should become more meaningful, and this can only benefit your performance in the module.

The first recommended INET video clip features Duncan Foley on "The need for interdisciplinary work", which you can access either via the INET site (under "Thinking" and then "Economics videos" or directly via Google and YouTube. Duncan Foley's main point is

that History of Economic Thought courses should be brought to the fore in the teaching of economics. But listen to his other points!

Another economist who promotes the importance of the history of economic thought is Ha-Joon Chang www.hajoonchang.net. Among his many videos, I recommend that you google the one uploaded by TheRSA on YouTube entitled "Ha-Joon Chang on Economics". This is also one of his shorter video clips at only 21 minutes in length.

GENERAL LEARNING OUTCOMES AND GENERAL ASSESSMENT CRITERIA FOR THE MODULE AS A WHOLE

Outcomes	Assessment criteria
An ability to critically compare and contrast the different schools of thought in the history of economics	Demonstrate, via your answers to tutorial and examination questions, your understanding of the differences between the various schools of thought.
An understanding that the different schools of thought reflect different theories of the economy as a whole	Demonstrate, via your answers to tutorial and examination questions, your understanding that each school represents a different way of viewing how the economy works
An understanding of how these various schools of thought underpin current-day economic theory	Demonstrate, via your answers to tutorial and examination questions, evidence of your unique perspective on how current economic theory has developed from past economic theories.
The ability to bring a unique approach to bear in adopting a critical perspective on current-day economic theories	Demonstrate, via your answers to tutorial and examination questions, evidence of your unique critical perspective on current-day economic theory.
The ability to bring a unique approach to bear in adopting a critical perspective on current-day economic policies	Demonstrate, via your answers to tutorial and examination questions, evidence of your unique critical perspective on current-day economic policy.

SPECIFIC MODULE LEARNING OUTCOMES FOR THE MODULE AS A WHOLE

- A better understanding of the present by way of a better understanding of past economic situations
- A greater appreciation for the fact that many popular ideas, which seem novel and contemporary are, in fact, reformulations of old ideas
- A deeper insight into the "thought world" of famous economists of the past, like Adam Smith, Karl Marx and John Maynard Keynes
- A better grasp of how economic thinking has developed over the centuries
- An improved ability to evaluate old ideas and their relevance for the present
- A better idea of the pros and cons of the various ideological systems as related to economics

More detailed module outcomes for each learning unit can be found at the beginning of each learning unit. Please ***consider these study outcomes carefully*** as the short questions in the

examination paper will be based on these outcomes (see the discussion of the format of the examination paper).

BACKGROUND TO THE MODULE

In order to be able to understand the various schools of economic thought, a rudimentary knowledge of European history of the time period between 1500 to the present is indispensable. We will attempt to provide you with a very brief overview of that period in the hope that you will find it interesting.

But before we come to that, some of you may wonder why the history of economic thought is so overwhelmingly Eurocentric, dealing mainly with European economic thought against the backdrop of European history. This Eurocentrism can be explained by the fact that crucial economic phenomena such as a *high degree of labour specialisation*, *intensive trade and the resultant development of markets*, *the use of bank money* and *the industrial mode of production* manifested themselves earlier and more conspicuously in Europe than elsewhere. It is precisely these phenomena that stimulated economic thought. Economic science developed because people wanted to know why these phenomena occurred, what role they played in wealth creation, which sections of society they benefited most, which government policies could be used to accelerate or slow down their development or counteract their negative side-effects, and so on. Nonetheless, you will also notice that many of the economic problems with which Europe grappled between 1500 and say 1900 are still very relevant for Africa today: wide differences between rich and poor; the concentration of land ownership in the hands of a few; greedy capitalists; intrusive, corrupt and wasteful governments, and suchlike. So the relevance of these phenomena and the issues that arise from them are, by no means, confined to Europe. Whether we like it or not, we are all part of a world with a *high degree of labour specialisation*, *intensive trade*, *the use of bank money* and *the industrial mode of production*.

The period of the Middle Ages is generally considered to have come to an end around the year 1500. In the light of what we said in the previous paragraph, you will understand why the prescribed textbook takes this year as its starting point. Medieval economic life, especially before the year 1000, was fairly uncomplicated, centred on more or less self-sufficient agricultural communities. Because labour specialisation had not progressed very far, there was relatively little trade (also because transport was costly and unsafe) and markets were small. In short, medieval economic processes were just not interesting enough to stimulate systematic analysis, except for the consideration of ethical questions such as the determination of a just price or the admissibility of charging interest. Only once labour specialisation and trade had gained some momentum, which happened between 1200 and 1400 with the development of the late-medieval trade fairs, did economic thinking start to develop. Cities existed in medieval times as well, but from around 1000 onwards they gradually became so rich and powerful that their prosperous merchants and artisans were overtaking the medieval landed aristocracy in economic importance, although traditional land-owning aristocracy still dominated the political arena. Mercantilism (derived from the Latin for "merchant") comprises a body of ideas and policies prevalent during this new period of merchant capitalism.

The heyday of merchant capitalism and the dominance of mercantilist ideas runs from roughly 1500 until around the late 1700s and early 1800s, when the Industrial Revolution and the publication of Adam Smith's *An inquiry into the nature and causes of the wealth of nations* (commonly abbreviated to *The wealth of nations*) inaugurated a new period of liberal-industrial capitalism. Crudely stated, mercantilism was about the use of state power and state intervention to enhance the competitive position of a country's merchants vis-à-vis the merchants of other countries. The aim was to stimulate such a country's exports so that more money-wealth ("treasure") would flow into it, which the monarch could then tax to finance the expansion of empire – particularly through a strong army and navy. To paint a fuller picture of the mercantilist era, it may be interesting to note some of its most significant events

and developments, such as the discovery of America by Columbus in 1492 and the subsequent rapid expansion of the Spanish and Portuguese colonial empires in Middle and South America, the rise of Protestantism around 1500 and the ensuing religious wars all over Europe, which lasted until around 1700, the reign of Elizabeth I (the most important Protestant monarch of her time) in England from 1558 to 1603, the defeat of the Spanish Armada by English and to a lesser degree Dutch ships in 1588, the birth of Shakespeare and Galileo in 1564, the birth of Rembrandt in 1606 (who painted *The Nightwatch* in 1642), the height of Dutch commercial power centred on Amsterdam between 1600 and 1700, the arrival of Jan van Riebeeck at the Cape in 1652, the British overtaking of the Dutch in commercial importance around 1700 (British economic supremacy lasting until roughly 1890, when first the United States and then Germany overtook Britain in industrial output – but we are running ahead of our story), the birth of Adam Smith in 1723, the death of Newton in 1727 and the birth of Mozart in 1756 who composed his famous piano concertos between 1782 and 1786. As already indicated, the ending of the mercantilist period was in no small measure due to the monumental influence of Adam Smith's *The wealth of nations* published in 1776, which incidentally was the same year that 12 British colonies situated on the East coast of the North American continent gained independence from Britain (after a fairly bloody war of independence), to form the United States of America.

Prior to the publication of *The wealth of nations*, there had already been an anti-mercantilist movement in France called "the physiocracy", which had, in fact, been an important inspiration to Smith. The heyday of physiocratic thought ran from about 1760 to 1780, as you can read off the prescribed textbook's introductory "Time Scale" that we mentioned above. Because the physiocracy was predominantly a French phenomenon, our description of its historical background can confine itself to France. The economic resilience of France was finally broken after decades of excessively high and unjust taxation, crippling mercantilist regulation, a corrupt state officialdom and a wasteful government burdened by the court extravagance and warring of its Bourbon kings – starting with the "Sun King" Louis XIV, and lasting until Louis XVI and his wife Marie Antoinette who were beheaded during the French Revolution in 1793. In fact, the seeds of the French Revolution, which broke out in 1789, were already clearly evident during the mercantilist period, given the desperate situation of the French workers and peasants and the radicalism of its intellectuals. This is speculation, but had some of the proposals of the physiocrats and Adam Smith been implemented earlier, the destruction and bloodshed of the French Revolution and its Napoleonic aftermath may, perhaps, have been avoided. Napoleon, incidentally, started his public career as an officer in the revolutionary army of France. In the power vacuum that ensued after the revolution had degenerated into chaos and the indiscriminate killing of even the original revolutionary leaders themselves ("the revolution devours its own children"), Napoleon seized control of France, made himself Emperor and started a campaign to conquer all of Europe, which was again enormously wasteful both in human life and economic resources, even if it gave France back some lost dignity. Napoleon was finally defeated in 1813 at the battle of Waterloo by the combined forces of England, Holland and Germany, and was exiled to the island of St Helena, where he died in 1823. There is a South African connection to this story: when in exile on St Helena, Napoleon is reputed to have developed a taste for South African wines, which were especially shipped out to him from the Cape.

The subsequent liberal-industrial period in Europe roughly covered the 19th century (the 1800s). It was the period in which Adam Smith's ideas about free trade and minimal government were largely implemented, especially in Britain. These measures were indeed amazingly successful in raising the average standard of living, not least of all because they coincided with what is known as the Industrial Revolution. Industrialisation means that production processes are increasingly performed by machines rather than by the strength and dexterity of the human hand (sometimes aided by animals). Mechanisation obviously implied a great increase in productivity and a reduction in prices. Britain was the first country to industrialise, as illustrated by the fact that the steam engine (the first real machine) was patented there by James Watt in 1769. After the defeat of Napoleon, industrialisation

spread rapidly all over Europe and everywhere industrial manufacturing plants powered by steam engines sprang up. The 19th century was indeed a period of tremendous scientific progress and cultural optimism. Europeans were confident that, through the agencies of science and reason, society could gradually evolve towards a state of happiness and fulfilment for all. The savagery and destruction of World War I (1914–1918) and the Russian Revolution of 1918 cruelly destroyed that illusion.

Moreover, industrialisation proved to be a mixed blessing. On the one hand, it created scope for large increases in productivity and made it possible for a broader section of society to live comfortable middle-class lives. On the other hand, industrialisation, because it goes hand-in-hand with increased capital intensity and a greater average size of firms, also created a greater concentration of economic power and wealth in the hands of the people now owning the much reduced number of firms. This trend towards concentration of economic power became even more pronounced after the limited-liability corporation had become the dominant form of industrial organisation around 1900. Previously, only firms involved in international trade, infrastructure and banking tended to be incorporated (or "chartered" as the term then was) while the majority of manufacturing firms were still organised around families as proprietorships or partnerships. In addition, the wages and working conditions of labourers were initially very poor, giving rise to the socialist movement, the most important representative of which was, of course, Marx. Marx was born in 1818 and (together with Engels) wrote the *Communist manifesto* in 1848.

The 19th century also inherited from its medieval past an extremely uneven distribution of land ownership, whereby relatively few aristocratic landlords owned most of the agricultural land, which they rented out to tenant farmers for cultivation. This circumstance played an important role in the economics of Ricardo, who published his *Principles of political economy and taxation* in 1817. However, as industrialisation progressed and the relative contribution of agriculture towards the national product fell, the concentration of ownership in agricultural land became a less important contributory factor to the inequality of income. Even so, in some cases industrialisation meant enormous windfall gains for those aristocratic landlords whose ancestral lands happened to lie around the new expanding centres of industrialisation and urbanisation, which they could thus sell at massively increased prices. Some of the richest aristocratic families in Europe amassed their fortune in precisely that way.

The liberal values of the 19th century did not only have economic consequences. It soon became evident that the greater rights and freedoms which governments granted to their citizens could no longer be confined to the economic sphere; people wanted political freedom and rights as well. So the days of absolute monarchy (i. e. the system according to which sovereignty rests with hereditary kings and queens) were numbered and most European countries indeed became full-blown parliamentary democracies around the 1850s, although the vote was still far from universal, women for example being excluded; universal suffrage had to wait another 60 years, to around 1910. Most monarchies transformed themselves into so-called "constitutional monarchies", whereby monarchs became little more than ceremonial figureheads. The United States of America had, of course, preceded Europe in this trend towards democratisation by already becoming a democracy at independence in 1776. The US is, in fact, the world's oldest, still existing democracy. Interestingly enough, precisely those European monarchies, which did not democratise during the 19th century, namely Imperial Germany, Austria and Russia, were lost during the conflicts of the early 20th century (in particular World War I and the Russian Revolution); there is no longer a German, Austrian or Russian monarchy, although the respective royal families (Hohenzollern, Habsburg and Romanov) still exist. The main point to be noted is that democracy too can be regarded as a manifestation of 19th century liberalism. Capitalism (in the sense of free enterprise) and democracy (in the sense of representative government, an elected parliament and freedom of expression through a free press) are closely linked, both philosophically and historically.

The marginalist/neoclassical school of thought, which sprang up around the second half of the 19th century, remained classical, in that it broadly favoured the liberal values of free trade and minimal government inherited from Smith, Ricardo and Mill. Its differences from the classical school were more theoretical than ideological. Neoclassical theory rejected the typically classical labour theory of value according to which value and price are determined solely from the supply side by labour cost (which Smith, Ricardo and Marx had in common). Instead, the neoclassical school offered a theory of value according to which price is determined by the interaction between supply and demand. The marginalist/neoclassical school was, of course, also different from classical theory because it made more extensive use of the marginal principle, meaning that it theorised in terms of profit or utility maximisation, which is reached when cost equals revenue at the margin.

The negative side-effects of industrialisation, such as a relatively marked inequality of income and concentration of economic power in the hands of a few, carried over into the 20th century. There are, however, a few respects in which 20th century capitalism is different from its 19th century predecessor. First, in the 20th century inequalities have to a greater degree been counteracted by government measures to limit the power of firm owners and give extra power to workers, particularly by stimulating the formation of trade unions. Secondly, 20th century capitalism afforded a greater role for government to provide social security as well as various social services like health care and education on an equal basis to all its citizens. Particularly the provision of good-quality education for all meant that the opportunities for economic advancement were open to a larger section of society than had ever been the case before. In the light of this, it is a tragedy that South African state education for the previously disadvantaged (especially at the primary and secondary level) is generally still of such a poor quality.

All in all, some of the rougher edges of early capitalism were thus removed in the 20th century. The irony is, however, that the cultural optimism of the 19th century had given way in the 20th century to a greater cultural pessimism and sense of unease about the sustainability and moral defensibility of the Western industrialised lifestyle. Although the average standard of living in the most advanced capitalist nations is very high indeed, problems remain. There is an ever-widening gap between rich and poor, within nations as well as between nations; there is an ever-increasing concentration of economic power in the hands of relatively few big corporations; there is an ever-greater instability and volatility of world financial markets; there is an ever-more worrying state of the natural environment; and there is an ever-growing sense of social fragmentation and alienation among the increasingly urbanised masses of society in the wake of the weakening of traditional social structures like the family and the local community (the village or the tribe). At the same time, any radical communist alternative, at least in its collectivist form where most production factors are kept in the hands of an authoritarian absolute state, appears not only to lead to even greater poverty, inequality and environmental degradation, but to the loss of personal freedom and political rights as well. These are some of the dilemmas with which our current, 21st century generation will need to grapple, just as any generation has had to grapple with the problems of its time. When studying the history of economic thought one becomes aware that many of the current debates are not new; a study of the history of economic thought will hopefully help us to avoid some of the old mistakes as well as to pick up and develop some of the old good ideas.

The institutionalist school of thought, which rose in the early 1900s with economists such as Veblen, already displayed some of this 20th century cultural pessimism of which we spoke in the previous paragraph. Although institutionalists were, and are, not necessarily pro-communist or socialist, they do have grave doubts about the justice and sustainability of capitalism in its current form. Analytically, the institutionalists reacted against the increasing mathematisation of neoclassical/marginalist theory in particular, believing that mathematical economic theory does not do justice to the human element in economic behaviour and to the way in which institutions shape and condition that behaviour. Humans are not machines and

their behaviour cannot, therefore, be described mathematically. On the other hand, institutionalists have not yet offered a credible theoretical alternative to neoclassical, mathematically inclined theory.

A further difference between the 19th and the 20th century lies on the monetary front. Most countries in the 19th century were on the Gold Standard. Roughly, according to this monetary system, legal tender consisted of bank money (deposits, notes and token coins) issued by a central bank and denominated in abstract money units, which were convertible into gold by fixing the gold price in abstract money units. The central bank guaranteed such convertibility and kept large amounts of gold reserves for that purpose. At the same time, a considerable proportion of the total money stock consisted, not of the legal tender (notes and deposits) issued by the central bank, but of deposits issued by commercial banks in the course of granting credit to, and buying real or financial assets from, the non-bank public. In the 20th century two things changed. First, from around the 1930s onwards, central banks suspended convertibility of notes and token coins into gold; only the American Federal Reserve Bank maintained the convertibility of the dollar into gold, while the dollar became the unofficial reserve currency for non-American central banks. Second, the proportion of the total money stock consisting of deposits issued by commercial banks in the course of granting loans and buying real or financial assets increased even further to around 90% or more. These differences in the monetary system gave rise to different opinions about the role of money in the economy, as well as about the inherent stability of the total demand for goods in a capitalist system. The controversy between Keynesians and monetarists (the Chicago school) can be understood along those lines. John Maynard Keynes was born in 1883, the same year that Karl Marx died.

We can conclude with a few interesting dates relating to South Africa. Right up to the end of the 19th century (the late 1800s), European involvement and settlement in Africa had been largely confined to coastal areas. In this respect, South Africa was the exception, where the Boers had already moved inland during the 1830s to escape from British rule in the Cape. This movement, together with the settlement of British farmers in the Eastern Cape around the 1820s and later in KwaZulu-Natal, gave rise to a great number of clashes with indigenous black people. King Shaka ruled his Zulu empire during the period between around 1810 and 1828, and the battle of Isandlwana when Zulu impis routed a British regiment took place in 1879. The discovery of gold around Johannesburg in the 1880s not only led to the Boer Wars but also shaped the South African economic landscape as no other event did. Roughly at the same time that British farmers settled in the Eastern Cape, the famous classical economist Ricardo died in Britain in 1823 from an ear infection at the age of 51; you see, penicillin was only discovered in the 1930s by a Scotsman named Alexander Fleming.

Question: You may well wonder at the overwhelmingly Eurocentric history that has been given as background reading for the module. As has been said, this is simply a result of it being the foundation for more or less the whole of current-day mainstream economic theory and policy throughout the bulk of the industrialised world. To what extent do you think is this current-day body of theory applicable to South Africa?

DEMARCATED READING

You should, at this point, read all of chapter 1.

CONTENT

Because chapter 1 of the prescribed textbook provides a useful overview of the module, there is no need to attempt our own here.

Pay particular attention to the "A time scale of economic ideas" (2013:2– 3) [2007:2– 3] appearing on the inside of the front cover. Make sure you understand the logic of the graph with its various kinds of arrows.

Take note of the "Five major questions" that the prescribed textbook (2013:3–6) (2007:3–6) plans to use in its interrogation of the various schools of thought:

1. What was the historical background?
2. What were the major tenets?
3. Whom did it benefit or seek to benefit?
4. How was it valid, useful, or correct in its time?
5. Which tenets became lasting contributions?

These are good questions, which facilitate penetrating discussion, as you are soon to find out. Make sure you understand what the questions are about. In the context of question 1, pay particular attention to the disagreement between those who argue that economic ideas are primarily conceived in reaction to the problems of the day and those who, by contrast, argue that economic ideas are primarily formed in reaction to the logical inconsistencies and paradoxes found in previous theories. In the context of question 4, the prescribed textbook points towards two opposing dangers in the study of the history of ideas: either the danger of viewing "the latest as the best" with the implicit suggestion that past writers were somewhat naive or ignorant, or the danger of giving up all critical examination of past theory in the belief that what was written then was fine for the time. The study of the history of ideas will have to steer something of a middle course in this regard.

The above "five major questions" are used to examine the following schools of thought: mercantilism in chapter 2 (2013:13) [2007:13], the physiocrats in chapter 3 (2013:35) [2007:33], the classical school in chapter 4 (2013:49) [2007:45], socialism in chapter 9 (2013:161) [2007:149], the German historical school in chapter 11 (2013:205) [2007:193], the marginalist school in chapter 12 (2013:223) [2007:211], the institutionalist school in chapter 19 (2013:395) [2007:369), the Keynesian school in chapter 21 (2013:455) [2007:427] and the Chicago school in chapter 24 (2013:529) [2007:493]. As you can check in table 1, all this material is prescribed for the examination.

Take careful note of the prescribed textbook's discussion of "The value of studying economics and its history" (2013:7–8) [2007:6–8]. This discussion should motivate you in your studies, especially the remark: "It is hoped that, as our economic understanding grows and our mastery over social problems increases, as our material well-being rises, as our appreciation of the cultural, aesthetic, and intellectual facets of life enlarges, we will become more civilized, more humane, and more considerate of each other" (2013:7–8) [2007:7–8]. As far as your lecturer is concerned, this is indeed what the study of the history of economic thought is all about.

Once again, do not ignore the appendix to chapter 1 (2013:9–12) [2007:9–12] as it really does provide useful information for further study. If you have access to the internet, do try to have a look at some of the relevant websites, which should prove stimulating.

LOOKING BACK

Throughout the module, we endeavour, to highlight cases where it is argued to be applicable to the current issues that affect the South African economy. As you progress through the module, we ask you to ask yourself to what extent the policy-makers are correct and to what extent current economic theory taught in South Africa requires input from the institutional circumstances of South Africa?

RELEVANCE FOR TODAY

Given the wide scope of this module, in terms of historical depth as well as in terms of introducing you to schools of economic thought that fall outside the prescribed syllabus for more or less the whole of undergraduate as well as postgraduate study, this module can claim to be the most relevant module in terms of equipping young economists in South Africa today with uniquely wide perspective on the problems of attempting to effect the economic policies most relevant for the circumstances and needs of South Africa in the rapidly changing (and globalising) world of the 21st century.

SELECTED SELF-STUDY QUESTIONS

1. List the five major questions used in this book to organise discussion of schools of economic thought. Briefly explain why each question is important to understanding and assessing the major schools.
2. Of what value is it to know something about the social, political, and economic setting in which a particular economist lived and wrote?
3. Evaluate this quote: "The danger of arrogance towards the writers of the past is certainly a real one – but so too is ancestor worship". Evaluate this quote.

LEARNING UNIT

1 Mercantilists, physiocrats and classical forerunners

MERCANTILISM

STUDY OUTCOMES

When studying this section, you should aim at gaining knowledge and understanding of the following:

- the historical background to mercantilism, with particular reference to the growth in commerce, the development of cities as centres of economic power and wealth, and the rise of the nation-state with its greater centralisation of political power in the hands of the monarch
- the meaning of bullionism, and the advantage of wealth-as-money (as opposed to wealth-as-useful-goods) for the monarch
- the meaning of the "fear of goods"
- the view of international trade as a zero-sum game and how it presupposes that international trade can only benefit a nation at the expense of another nation
- the various ways in which state power was used for mercantilist ends
- how mercantilist policies favoured the interest of the king, the merchants and state officialdom at the expense of the common populace
- mercantilism as "rent-seeking behaviour"
- the role of "derived demand" in mercantilist thought
- the ways in which bullionism did make some economic sense at the time
- the merits of mercantilism in enhancing our understanding of (a) the economic contribution of commerce and trade, international trade in particular, (b) the concept of the balance of payments, (c) the benefit of state regulation in certain areas, and (d) the role and nature of the chartered trading company as the forerunner to the modern limited-liability corporation

1.1

ACTIVITY

Consider the following fictitious musings of Elisabeth I, Queen of England between 1558 and 1603.

> *"My name is Elisabeth. I am Queen of England in the line of the Tudors. I love my country and my people. God Himself has entrusted me with the sacred duty of protecting England against the mighty King of Spain who has since long been plotting England's downfall and the destruction of her ancient freedoms, in particular the freedom to practise the new religion which has spread to our island from Germany where Herr Luther started a revolt against the Roman church. But God has also given me the authority to rule. I am Queen by Divine Right and my subjects, therefore, owe me allegiance. Without their loyalty and devotion, I cannot execute my God-given task of protecting England, preserve her freedom, promote her power, wealth and fame and so further the splendour of my own dynasty too. Not only do I need the loyalty and devotion of my subjects, I also need money.*
>
> *It is money which enables me to afford the lifestyle which befits the dignity of England's Queen. And it is money which allows me to pay the soldiers and build the warships necessary to defend the independence of my beloved realm. I will save money where I can on my court expenses, but if I am to resist the King of Spain I need more money, lots more money. Who has the money around here? There are the aristocratic landlords; they are good as military strategists, army officers, political advisors and ambassadors, but not particularly adapt at the commercial arts. Due to their extravagant lifestyle they are also likely to be as cash-strapped as I am. And their income, typically derived from land rents, does not add to the total amount of money circulating in England. I will impoverish England if I tax more of their money. Only the international merchants of places like London or Bristol bring money into the country so that I hurt England less if I tax them. There must be ways of enabling these merchants to bring even more money into England and then to tax part of that money for my sake and the sake of England. I will speak to my Lord Chancellor about this."*

Question: You are the Lord Chancellor (call him an economic advisor) to Elisabeth. She is your Queen and you are her loyal and devoted servant. After having studied this section on mercantilism, seek an audience with your Queen and give her some useful advice in the mercantilist tradition. But do be careful to point out to her that your advice may have some negative side-effects too and that you are not always sure about the efficacy of some of your suggestions. Your Queen will expect nothing less than total honesty from you. Now do your duty to Queen and country, and diligently study the ideas of the mercantilists!

DEMARCATED READING

You should at this point read chapter 2: only the section "Overview of mercantilism" (2013:13–20, excluding "2-1 Past as prologue" on p 17) [2007:13–20, also excluding p 17]

CONTENT

As already mentioned in the introduction, the period of the Middle Ages is considered to have ended roughly around 1500. By that time, the unique military function of the feudal lord (that of soldier on horseback) as well as his economic power base (as big landowner) had lost a great deal of their functionality and significance. Economic life had become less and less organised around largely self-sufficient, agricultural communities headed by the landlord and more and more around cities dominated by craftsmen and merchants. These cities eventually became so prosperous and powerful that they undermined medieval power relations. Moreover, concurrent with the rise of merchant capitalism around the cities, there

was a trend towards the increased centralisation of political power in the hands of the monarch at the expense of regionally based noble lords, which signified an increased importance of the nation-state. Hence the rise of nationalism, especially in France, England and Spain.

Mercantilism can roughly be characterised as an exercise in nation-building by way of an alliance between the city merchant and the monarch, both of whom had gained in power and prestige as a result of the trends mentioned above. The monarch (king or queen) gave the merchant the protection and privileges of monopoly that he needed for his business endeavours and, conversely, the merchant provided the monarch with the tax income in the form of precious metals (gold and silver) to finance his or her wars. Given that a significant proportion of the state's tax income was derived from duties on imports and exports levied at the country's harbours and border posts, the volume of international trade often had a large, direct impact on state income. Also, bear in mind that armies in those days consisted almost exclusively of paid mercenaries, who obviously had to be compensated in cash (gold and silver coin); conscription, which already existed in Roman times, was only re-introduced into the modern era by Napoleon in the late 1700s. It was thus in the interest of the king to gear policies towards the accumulation of precious metals within the borders of his realm.

Bullion is another word for plain bars of (unminted or uncoined) precious metal. Accordingly, the idea that wealth is equal to precious metal money (gold and silver or "treasure") and that a nation's wealth, therefore, consists of the total amount of gold and silver within its borders. This is called "bullionism". The modern contrary view is that the wealth of a nation consists of the quantity and quality of useful goods (food, housing, clothing, education, law and order, entertainment, etc) which its citizens can enjoy. Hence, a "wealthy" nation is a nation in which people can enjoy an abundance of such goods as measured by the country's GDP. Mercantilists view wealth as money rather than as useful goods, because wealth in the form of money is malleable. It can be taxed and redirected in accordance with the particular preferences and ambitions of the king, which is mostly to finance his court and his military ventures. Wealth as useful goods already has a purpose, namely to meet the needs, which these goods are designed to meet for the common people. Thus mercantilism boils down to a programme of enriching the king (and the merchant) at the expense of the general population.

An important element of that programme consisted of policies aimed at manipulating the balance of payments so as to ensure a surplus, because such a surplus would cause the local stock of bullion (gold and silver coin) to increase. This was done by encouraging exports (through subsidisation) and discouraging imports (through outright bans or tariffs). Only the imports of raw material that the home country did not have were allowed to go through unhampered and only the export of bullion was blocked unless it was clear that foreign investment was likely to bring in more bullion into the country later on. International trade was implicitly viewed as a zero-sum game, that is, it was supposed that the balance of payments of all nations taken together should add up to zero. Hence, in the view of the mercantilists, a nation can only achieve a surplus on the balance of payments and gain bullion at the expense of a deficit on the balance of payments of other nations, which would lose bullion. Obviously only nations with gold or silver mines in their realm could increase their bullion-wealth without a surplus on their balance of payments. As will be noted in the next learning unit, Adam Smith saw international trade as a positive-sum game, according to which all countries can gain by specialising in producing and exporting goods in which they have an absolute advantage. Thanks for this point (gain what?), but I think I will leave this as is: it will be sufficiently clear to a third year student.

Because the prescribed textbook's (2013:13–20) [2007:13–20] "Overview of mercantilism" is pretty self-explanatory, the clarification of only a few concepts will suffice.

The prescribed textbook (2013:14) [2007:14] speaks about "derived demand". This term is often used in the context of the labour market, meaning that the demand for labour is derived from the demand for goods, either generally for all goods or particularly for a certain good

requiring a particular labour skill. In this context, the demand for fishermen is derived from an enforced demand for fish (by enacting a law coercing people to eat fish on Friday – still a common practice in many European countries), which in turn guaranteed a supply of experienced sailors for a country's navy.

The prescribed textbook (2013:15) [2007:14] notes how merchant capitalism "wanted to keep the colonies eternally dependent upon and subservient to the mother country", which is probably primarily written with the United States in mind (remember, Grant and Brue are American). In mercantilist times, the United States was still a colony of Britain with colonists indeed being discriminated against by the mother country through a host of restrictions and punitive taxations. It was this type of discrimination that motivated the American colonies to fight for independence from Britain. The battle cry "no taxation without representation", which was sometimes used during the days of struggle in this country as well, actually originated with the Americans during their war of independence.

The prescribed textbook also mentions (2013:15) [2007:15] the opposition of mercantilists to "internal tolls, taxes and other restrictions on the movements of goods", because these were measures that hampered *intra*national (as opposed to *inter*national) trade. Note that these measures were an inheritance from the Middle Ages, as the beneficiaries of such tolls and restrictions were often the landlords. Due to its greater feudal flavour, French mercantilism still maintained such measures.

The strong mercantilist emphasis on state regulation may sound strange on modern ears; after all, modern merchants and capitalists advocate *laissez-faire* and economic freedom rather than government regulation. Government regulation can, however, also be used to favour commercial interests, namely when aimed at preserving monopoly rights and keeping out any emerging competitors. Such was indeed part of the nature of mercantilist state regulation. Even today's businesses often lobby government for certain types of regulation and protection, thereby not quite sticking to the liberal philosophy, which is the foundation of their basic rights and freedoms. Indeed such lobbying for government favours can be regarded as "rent seeking", on which the textbook (2013:18) [2007:16–18] elaborates.

The prescribed textbook (2013:19) [2007:19] mentions as one of the lasting contributions of mercantilism an increased appreciation for the economic contribution of trade ("the merchant") – international trade, in particular. But what actually is the productive contribution of middlemen between the producers and ultimate users of a good? Given that traders do not alter any of the physical qualities of a good, this contribution does not seem obvious. In essence, traders are what we currently call "market specialists". A market specialist is a person who specialises in obtaining market information in a particular market, meaning that he or she has invested time and money in finding out who wants to supply or demand what, where, when, in what quantity, and at what price in that market. Because market specialists specialise in obtaining market information in that particular market, they can obtain and distribute that information at a much lower cost than the average occasional buyer and seller in that market can. Rather than trying to obtain market information themselves, it may then be worthwhile for occasional market participants to seek the services of a market specialist. That is why we often make use of an estate agent when we buy or sell a house. Market specialists come in two basic forms: brokers and dealers. Brokers will attempt to bring prospective buyers and sellers together without buying or selling the goods themselves, like estate agents. Accordingly, they do not keep an inventory of the relevant goods. Brokers make their money by charging a fee for services rendered. Contrary to brokers, dealers do keep an inventory of the relevant goods. They buy the goods from producers in order to sell them on to users. The fact that dealers keep an inventory means that they can serve their buyers by making the good immediately available at a convenient location – which is essentially what a shopkeeper does. For that purpose, dealers often incur the cost of warehousing and transporting goods. Without dealers, buyers have to look for producers themselves, order the good at these producers, wait for the good to be finished, and arrange for its transport to their preferred location, which can be highly inconvenient

and costly. It may also be worthwhile for producers to work through dealers because dealers can often guarantee them a more steady stream of larger orders. Dealers obviously make their money out of the difference between the price at which they buy from producers and sell to consumers.

As a further lasting contribution of mercantilism, the prescribed textbook mentions that it indirectly encouraged the gradual introduction of the corporate form of enterprise into capitalism. We tend to think of the limited-liability corporation as an integral part of private enterprise. But it has not always been like that. During mercantilist times the colonial trading companies, like the British and Dutch East India Companies, were really the only incorporated business firms, or "chartered companies" as the term then was. All other business ventures were still unincorporated proprietorships or partnerships with full liability for their owners. At the time, private citizens did not have the right to freely incorporate their businesses as they presently have. Instead, the incorporation of one's business was a privilege, which the state granted on the basis of the business serving some area of public interest. Colonial trading was considered one of these public interests. Moreover, the state sanctioned corporate status for a limited period only, after which it was up for review by parliament. In addition to colonial trading, governments came to bestow corporate status on other types of activity too, like infrastructural development (road, railway or canal building), central banking, commercial banking, and insurance. During the 1700s and 1800s, the typical manufacturing company was still organised as an unincorporated proprietorship or partnership. The right of business people freely to incorporate their firms dates from the late 1800s. Corporate business started to dominate manufacturing from only the early 1900s onwards.

A brief explanation of the general idea of incorporation may be in place. The essence of an incorporated business firm is that its assets are owned by the firm as a legal entity in its own right, separate from its shareholder-owners and managers. The company becomes a legal person, meaning that the law regards it as a person able to sue and be sued, even if it is not a natural person. If, for argument's sake, you own half of all the shares of Shell Incorporated, you do not own half its oil refineries, petrol stations and whatever else Shell may own. You own none of Shell's assets; corporate shareholders do not own any corporate assets. Ownership in half the shares in Shell Incorporated merely entitles you to half the dividends as and when declared, and half the voting rights in shareholder meetings to elect management. The assets of Shell are owned by Shell as a legal person separate from shareholders and management. Because shareholders have no ownership rights over the assets of the corporation, they also are not responsible for its debts. Shell as a legal entity in its own right has that responsibility. Therefore, if Shell were incapable of meeting its debts and go bankrupt, its creditors cannot lay claim to the assets of Shell's shareholders to recover the unpaid debts. As a result, shareholders in Shell Incorporated can at the most lose their initial investment. It is in that sense that shareholders in incorporated businesses enjoy "limited liability". By contrast, the partners in unincorporated partnerships or the proprietor in an unincorporated sole proprietorship are also the owners of their firm's assets. Hence, they are also fully liable for its debts.

Being a legal entity in its own right (separate from office bearers) was originally a characteristic attribute of the state. It prevented the state's office bearers (ultimately the king) from claiming personal ownership of the state and so denied them the right to rule it at their own discretion. The French king, Louis XIV, was famous for claiming "l'état, c'est moi", meaning "I am the state", by which he asserted his absolute right to rule as he pleased. Denying kings ownership of the state and granting the state corporate status meant that it could be run in accordance with law rather than the king's whim. The king could now be placed under the law, and his powers circumscribed by law. Giving the state a legal entity separate from office bearers was thus an essential element in the rule of law, which made it possible to curb state absolutism and allowed citizens of Western nations a freedom, which was generally not enjoyed elsewhere. From the 1600s onwards, however, governments

increasingly granted private firms corporate status if they felt that these firms served some area of public interest and were, in that sense, regarded as arms of the state. There was an evident advantage to having corporate status: the limited liability which shareholders enjoyed allowed corporate firms to bring together the capital contributions of a much larger number of shareholders than unincorporated partnerships ever could. The corporate form of business thus stimulated capital intensity and made it possible to realise much larger economies of scale. For that reason, governments have from the 1860s onwards generally granted their citizens the freedom to incorporate their firms at their own discretion, without needing prior approval by the state. Whereas previously corporate status was granted by the state as a privilege on the basis of serving the public interest, it now became the right of every private citizen to incorporate his business, irrespective of whether it served the public interest. Since that time corporate business has started to dominate Western capitalism. But it all started with the colonial trading companies of the mercantilist era, such as the English and Dutch East India Companies – the latter well-known to South Africans.[1]

LOOKING BACK AT ACTIVITY 1.1

Have you already prepared your advice to the Queen? Make haste, the King of Spain is building an Armada and your Queen is in distress!

. . . .

PHYSIOCRACY

STUDY OUTCOMES

- the particular nature of French mercantilism at the time (from 1759 until the outbreak of the French Revolution in 1789) against which the physiocrats reacted
- the role of "the natural order" and "the rule of nature" in physiocratic ideas
- physiocratic views on the role of government as following from their ideas about the natural order
- physiocratic views on the contribution of agriculture and the other economic sectors (manufacturing, finance and trade) to wealth creation
- how taxation was organised under French mercantilism
- physiocratic tax reform proposals with their emphasis on the taxation of land rents received by landowners
- the physiocratic preference for large-scale over small-scale farming
- Henry George's views on land rents as "unearned income" and their taxation
- the role of "tax shifting" in physiocratic thought
- how the policies of the physiocrats unintentionally favoured industrial economic development
- Quesnay's representation of the "circulation of wealth and goods" analogous to the circulation of blood in living organisms

1. For more on the corporation, see Van Eeghen, PH. 1997. The capitalist case against the corporation. *Review of Political Economy* 55:85–113; and Van Eeghen, PH. 2005. The corporation at issue; part I and part II. *Journal of Libertarian Studies* 19(3 and 4):49–70 and 37–57.

1.2

ACTIVITY

As an introduction to physiocratic thought, consider the following fictitious conversation between a contemporary white South African farmer and a contemporary black South African land reformer. We call the white farmer Tom and the black land reformer Sipho, who, while in opposite political camps, have been old friends from school. They meet again at some school reunion. We catch them in the middle of an increasingly heated debate.

Sipho: *The government's land reform policy of "willing buyer, willing seller" is just not working. It takes too long and costs too much. The wrongs of the past are not being put right quickly enough; at this pace, we will have to wait till Judgement Day for justice to be done. We will need to resort to expropriation of white-owned land. I am afraid, my mate, your land may just be a candidate.*

Tom: *Wow wow, my family has owned and farmed my land for five generations. We built it up from nothing. We carried off the boulders, built the fences, provided the irrigation system, built the barns ... and now you want to take all that away from us without proper compensation and give it to someone with no experience in commercial farming …*

Sipho: *I am not so sure your people did all that carrying off of boulders and building of fences on their own. You probably used black workers to do that for you, and you probably paid them preciously little in return. And the fact that your family has been owning and farming this land for five generations … well, the more reason to right the wrongs of the past all the more speedily and return the land to its rightful owners as soon as possible. Your great-great grandfather stole the land from us.*

Tom: *Granted, my forebears did take the land from you guys. But regard it simply as military conquest. You blacks also fought wars among each other and the victorious party also took the land (and women) of the defeated party. Shaka defeated other tribes and took their land. When black people take land from each other through military conquest, you don't moan. But when whites take land from blacks through the same process, it suddenly becomes a crime! Is that not a double standard? Moreover, by farming the land productively, I feel we have in the mean time earned the right to own it. You and your family want to eat "pap en vleis" and buy it at a reasonable price, don't you? That requires efficient, commercial farming. That is what we do, and we are doing it well. It is true that my forebears may have used a great deal of black labour and it is true that they may have underpaid them. But my forebears were quite poor for the first couple of generations too and could barely survive themselves . . . thanks, in part, to some of you guys who kept on stealing our cattle. And, in any case, I now pay my workers a reasonable salary (especially considering all the additional benefits), although I admit that many farmers don't …*

Sipho: *Not so fast, my broer. I don't care about the wars Shaka fought all these years ago, and they may well have been wrong. If you want to use warfare as a justification for your stealing of our land . . ., well then we just stole your cattle as a way of warfare too. "All is fair in love and war", or is it? The point is that we are now one country and that a white minority now owns by far the greatest proportion of good agricultural land in this country. Surely that can't be right. Surely my people ought to get a fair share in the land of their forefathers. Why should the natural resources of a country by controlled by a small minority? The warmth of the sun and the air that we breathe are not monopolised by a minority, so why should the land be? Our people need food and they need to get it at a reasonable price, I agree. But I am not so sure that white farmers always farm so very productively and I am frankly offended by your suggestion that the average black farmer would not be able to be as productive as the average white farmer is – given sufficient support and skills transfer.*

Tom: *I am sorry if I offended you. I did not want to say that black farmers would not be able to farm as efficiently as white farmers do. I was merely trying to make the point that current land owners have earned the right to their land by farming it efficiently. You say that your people have a right to a fair share in the land. That may be so. But with the right to own land comes the responsibility to farm it productively. The nation needs to be fed. Because I am farming my land productively, I feel that I am contributing towards feeding the nation. As a result, I feel I have earned the right to keep my land, which you, therefore, have no right to take from me. And let us do some straight talking here. Black farmers may certainly farm my land as productively as I do, but it does not seem a priority in your land reform policies that my land is indeed given to serious black farmers. For all I can see, you have destined my land to be given to people, however legitimate their historical claims, who have no serious intention to farm it commercially. And worse still, it may well be given to someone with connections high up.*

Sipho: *Stop, stop!! If you want to talk straight, let me do some straight talking myself. Don't speak to me as we are in Zimbabwe. This is South Africa. I am no fan of Uncle Bob. His is not proper land reform but a land grab to the benefit of his cronies. I have already told you that the productivity of farming ought to be a consideration in land reform policies, but it cannot be the only consideration. There are issues of justice and equity too. Land ownership cannot be monopolised by a minority, as if the majority does not exist. Land is important to us black people; it is part of our identity; each black person desires deep in his heart to own his bit of Africa.*

Tom: *And why do I not qualify? Is five generations not enough to make me an African? I don't want to leave. I may not be black but I feel an African too; this is where my heart lies. And your land reform will, in any case, not be able to give land to each and every black person. Your vision of giving each African his bit of Africa is just not on the cards – at least not when it comes to agricultural land. If agricultural land is commercially farmed on a fairly large scale, it is inevitable that a minority owns most of that land. Given that in modern societies agriculture makes only a relatively small contribution towards total production and employment, this inequality contributes relatively little to overall inequality anyway. It is only a minority of white people that now owns most of the agricultural land, and the likely outcome of your land reform is that it will be a minority of black people who then own most of the land. In other words, agricultural land ownership will remain a minority affair, whether it is black or white. The only interest which the vast majority of black and white people have in agriculture is that sufficient food gets produced at a reasonable price. And when it comes to poverty, land redistribution will barely make any difference. The handful of new black farmers will hardly make a dent into the poverty problem in this country. And what makes you think that these black farmers will, on average, treat their workers so much better than we do? Plus, although successful land redistribution will hardly contribute much to alleviate the plight of the poor, unsuccessful land redistribution will seriously harm the plight of the poor. Land reform is, therefore, risky business for our country. If land redistribution were to damage employment and productivity in agriculture, the poor will be hit the hardest. A disproportionate number of the poor find employment in commercial agriculture. And the poor are disproportionately dependent on affordable basic foodstuffs produced by commercial agriculture. Should we not be more concerned about poverty than some abstract idea of justice which, in any case, will benefit only a handful of new black land owners . . . ?*

Sipho: *Go away, Tom. Since when are you so desperately concerned about the plight of the poor? Why should land redistribution be unsuccessful? If properly managed, food production should not suffer. And while it may be true that land reform will not turn the broad mass of black people into land owners, it will at least make the race composition of land ownership more representative of the total population. And that is important too! It seems to me that you cannot get away from this racist idea that black people cannot farm as productively as white people can. What makes you think that white people invariably make such wonderful farmers? What makes you think that we wish to expropriate all white-owned land? You keep on thinking in Zimbabwe-inspired stereotypes and caricatures.*

Tom: *You may be right. I may think in stereotypes and caricatures. But I have another concern which does make me worry we are on the Zimbabwe road: if the government is so keen on increasing black land ownership, why doesn't it start with land which is already owned by the state and which could straightaway be handed over to black farmers. Why does it start with land that is white-owned, as if it is more important to reduce white land ownership than it is to increase black land ownership? Such an attitude smacks of racism to me, in that disadvantaging the whites is implicitly regarded as more important than advantaging the blacks. It is such racism that makes me worry we are on the Zimbabwe road.*

Sipho: *I think you are grossly overreacting now, and don't you talk to me about racism!! Even so, I admit that much more state-owned land could already have been handed over to blacks. Remember that I am not the government. I do not wish to defend everything they do. Also bear in mind that far from all currently white-owned land is optimally used. Much of it is badly farmed or not farmed at al! Such land could easily be redistributed to blacks without any risk to agricultural productivity.*

Tom: *Okay, okay – granted. But then start expropriate that type of underutilised land first, and leave my farm alone! I do farm my land fairly productively – although one always feels one can do better. Incidentally, if you still wish to expropriate my land and give it to somebody who is not serious about commercial farming, I would even be prepared to lease it back from him so long as the rent is reasonable and I get some sort of security of tenure – otherwise there is no incentive for me to keep on investing in the land. In that way he will get a steady stream of cash income from the land, and I can keep my farm. Is that a proposition?*

Sipho: *Yes, but that depends on . . .*

Tom: *Okay, but why not . . .*

Sipho: *Perhaps there is merit, but . . .*

Tom: *So why don't you and I work together on this and . . .*

Question: After having studied this section on the physiocrats and our comments below, see how the insights you have gained can inspire you to write a continuation of the debate between Tom and Sipho, and bring it to some sort of mutually acceptable resolution.

DEMARCATED READING

You should at this point read all of chapter 3, excluding "3-1 Past as prologue".

CONTENT

French mercantilism differed from its English counterpart in two main ways. First, it had a stronger feudal flavour, meaning that its policies and regulations were also aimed at protecting the interests of the landed nobility in addition to the interests of the merchants. That is why tolls and other restrictions on *intra*national trade were part of mercantilist state regulation in France too. Second, French mercantilism was probably stricter, more elaborate, more intrusive and more crippling than anywhere else in Europe. Add to that the exceptional corruptness of French state officialdom as well as the court extravagance and wasteful warring of its Bourbon kings, and one can understand why France had become desperately poor at the time, that is, the second half of the 1700s (2013:35–36) [2007:33–34].

The physiocracy was the first anti-mercantilist movement in Europe, which sought to rebuild France, primarily by liberating its agriculture from mercantilist restrictions and tax burdens, but also by making government less corrupt and wasteful. Physiocracy means "rule of nature", as its advocates believed in the existence of natural laws which, when given the chance, would spontaneously steer the economy towards harmony and prosperity – a philosophical idea, which also underlied Smith's economics as we will see shortly. The detailed direction of economic life by a coercive government was, therefore, considered

unnecessary as well as harmful, which one can understand given the particularly stifling nature of French mercantilism. And remember that government intervention was, at the time, used primarily to favour the interests of the rich and powerful rather than the poor, which is indeed not uncommon even in modern times!

For a more detailed examination of the policies and ideas of the Physiocrats, the prescribed textbook's "Overview of the physiocrats" (2013:35–39) [2007:33–37] is once again comprehensive as well as fairly easy to follow. Only Quesnay's *tableau economique* (*economic table*) may be a bit more challenging, for which we will, therefore, provide some additional explanation. Otherwise, just a few remarks as "asides" will suffice.

The physiocrats overcame mercantilist bullionism by acknowledging that wealth consists of useful goods rather than precious metals. But they added to this sound idea the odd idea that only those goods produced in the primary sector (mainly agriculture, but also mining and fisheries) contributed to the national product. Manufacturing, trade, finance and the professions were considered sterile, meaning that the value of their output was merely equal to the cost of production, no extra value being added. The potentially tremendous contribution to national wealth of manufacturing, especially when industrialised, was thus insufficiently appreciated by the physiocrats, although their emphasis on *laissez-faire* and their proposed freedom of taxation for all non-landowners unwittingly gave scope for industrialisation. Nonetheless, when an economy lies in complete ruins, it is not a bad idea to start rebuilding it by focusing on its agriculture – then, at least, people have food to eat and a surplus is created to feed people involved in non-agricultural pursuits, like manufacturing and trade. The mistaken idea that only production in the primary sector adds value seems to be based on the erroneous view that only tangible, material goods are useful and that intangible, immaterial goods (services), therefore, have no value. After all, the secondary sector (manufacturing) merely reshapes the tangible raw material obtained from the primary sector and, as such, adds no matter and thus seemingly no value to its end products, while the tertiary sector (trade and services) produces intangible, immaterial goods.

The prescribed textbook (2013:37) [2007:35] argues that the physiocratic preference for taxing the rent received by landlords is based on the mistaken notion that "only agriculture ... produced a surplus". But this seems just a part of the story. While the physiocrats did not question the right of landlords to receive rent as a reward for the capital expended to originally acquire the land (see 2013:42–44 [2007:40–42]), they also regarded rent as partially *unearned income*, which is part of the reason why they wanted to tax it as well. And the physiocrats would be correct to a degree. Landlords did run a risk on the capital invested when originally obtaining the land: the risk that land values drop (if land is held speculatively) and the risk that land is farmed irresponsibly by tenants, leading to soil erosion or other forms of permanent land degradation. Landlords obviously also ran a risk on the capital invested in land improvements such as fencing, irrigation, fertilisation and the built-up structures like farmhouses and barns. Rent rightly compensated landlords for these kinds of risk. But rent clearly compensates for more than only these risks. It is also a reward for contributing the original productive powers of the soil, which, in so far as the land is farmed responsibly, are everlasting and, therefore, not subject to depreciation. When there is no depreciation, nothing is given up to merit a reward. The portion of rent, which is a reward for contributing these original productive powers of the soil (and the sun), therefore, does seem to constitute unearned income, as also indicated by the simple fact that human beings do not cause the plants to grow or the animals to increase. It is this unearned portion of the rent that the physiocrats wanted to tax away. Adam Smith, who had been influenced by the physiocrats, significantly remarked in this regard that "landlords, like all other men, loved to reap where they did not sow and demand a rent even for [land's] ... natural produce". One should, of course, be cautious about saying the same of modern farmers, like farmers in South Africa, who cultivate their own land – by contrast, the landlords of physiocratic times were not cultivators of their land. They merely owned and rented it out to tenants who did the real farming. Even so modern farmers' incomes do also contain, according to the

physiocratic logic, a portion of unearned income, although it may be argued that farmers anyhow lose that unearned income in the form of taxes paid on earned income.

The prescribed textbook (2013:37) [2007:35] mentions how the physiocrats sought to replace the complex indirect-tax system of the mercantilists with a simpler system of direct taxation on rent. We take it you understand the difference between direct and indirect taxation. Direct tax is tax on income (in the form of profit, rent, wage or interest), while indirect tax is a tax on goods, like our modern VAT, import duties or excise tax on alcohol and tobacco.

We provide some additional explanation of Quesnay's *tableau economique* (see 2013:39– 42) [2007:37–40], not only because figure 3-1 may be somewhat confusing, but also because the figure nicely sums up some of the main ideas of the physiocrats. For that purpose, we introduce three income-spending statements, for tenant farmers (productive class), landlords (proprietor class) and manufacturers/traders (sterile class) respectively. The numbers used in these statements correspond with those used in figure 3-1.

Tenant farmers (productive class)

Income		**Spending**	
Sales of agricultural goods to landlords	1 billion livre	Purchases of manufactured goods from manufacturers/ traders	1 billion livre
Sales of agricultural goods to manufacturers/ traders	2 billion livre	Surplus (= rent) paid to land-lords in this period	2 billion livre
Total	3 billion livre	Total	3 billion livre

This period's total agricultural production is 5 billion livre (the livre was the pre-Revolution French money unit), of which 2 billion is cost of production in the form of seeds and food needed by the tenant farmers themselves. So tenant farmers sell only 3 billion worth of agricultural produce, as can be seen from the total on the left-hand side of the statement. Of that 3 billion, they sell 1 billion to landlords and 2 billion to manufacturers and traders, as can also be seen from the left-hand side of the statement. Tenant farmers used their 3 billion income to buy 1 billion worth of manufactured goods from manufacturers/traders, while the remaining 2 billion is rent, which they pay to the landlords. See right-hand side of the statement.

The next income-spending statement is that of the landlords (proprietary class).

Landlords (proprietary class)

Income		**Spending**	
Previous period's rent from tenant farmers	2 billion livre	Purchases of manufactured goods from manufacturers/ traders	1 billion livre
		Purchases of agricultural goods from tenant farmers	1 billion livre
Total	2 billion livre	Total	2 billion livre

Their rent income (see right-hand side of the statement) of 2 billion corresponds with the 2 billion rent, which tenant farmers pay to landlords, except that this 2 billion is rent paid during the previous period, while the 2 billion rent paid by tenant farmers during this period is only income for landlords during the next period. Note that periods repeat themselves in a

uniform manner. Landlords spend their 2 billion rent income on 1 billion worth of manufactured goods from manufacturers/traders, and 1 billion worth of agricultural goods from tenant farmers, which is also recorded on the income side of the tenant farmers. As you can see from this income-spending statements, landlords do not generate a surplus. In accordance with physiocratic ideas, only tenant farmers do.

Lastly, the income-spending statement of manufacturers/traders (the sterile class):

Manufacturers/traders (sterile class)

Income		**Spending**	
Sales of manufactured goods to landlords	1 billion livre	Purchases of agricultural goods (including raw material) from tenant farmers	2 billion livre
Sales of manufactured goods to tenant farmers	1 billion livre		
Total	2 billion livre	Total	2 billion livre

Their income from selling manufactured goods to landlords and tenant farmers also appears as spending categories in their income-spending statements. Manufacturers' spending on agricultural goods, which comprises food for the manufacturer and raw material for his production, are also recorded as income for tenant farmers above. You notice that the cost and the sales value of their production are equal (2 billion livre), which illustrates how the manufacturing sector is supposed to be "sterile" in the sense of not producing a surplus. Again, only the tenant farmers produce a surplus in physiocratic thought.

Of course, it is easy to shoot holes in the *Tableau*. For instance, how would any manufacturer be able to accumulate capital to finance implements and tools, if he or she cannot make a genuine profit? Why would one want to expend the extraordinary effort of running a business if there is hardly any profit incentive? Even so, Quesnay's *Tableau* is important in that it was the first attempt to highlight the interconnection between economic sectors. As such, it is a rudimentary form of national-income accounting and input-output analysis. The *Tableau* also expressed physiocratic concerns about the non-interruption of the circular flow of the net product, which they believed was achieved when the investments made by tenant-cultivators got back to them so that the same amount of investment could be repeated and agricultural production could expand to the benefit of society at large. These are foreshadowings of modern Keynesian concerns about leakages from the circular flow of money, which could lead to a contraction of aggregate investment or aggregate demand in general. We pay more detailed attention to the income-spending circulatory stream at the macro level in our discussion of Say's Law and of Keynes below.

The physiocrats were also modern, in that they already recognised the phenomenon of *tax shifting* (see 2013:39, 44–46) [2007:37, 42–43]. Tax shifting occurs, for example, when a manager of a big corporation makes his salary demands in after-tax terms, which means that the income tax is effectively borne by the firm rather than the manager on whom it is levied. The physiocrats argued that all taxes were eventually borne by the landowners because of tax shifting, so that one might as well tax their income directly. Their reasoning was based on the idea that everybody apart from landowners more or less operated on a subsistence income and so already paid the maximum they could afford – any income losses would mean starvation. Price increases due to taxation would, therefore, eventually reduce rent paid by the tenant-cultivators to their landowners. In general, the degree of tax shifting, as with the passing on of any cost increase, depends on the relative market power of those on whom it is levied. For example, when management skills are scarce, managers may have the market power to shift their tax payments onto firms and negotiate their salary in after-tax terms.

Similarly, continually living on a minimum salary awkwardly gives one bargaining power to shift one's increased taxes forward, assuming that others, eventually landlords, do not wish you to starve. Take note of Hume's disagreement with this argument (see 2013:61) [2007:57]. Instead, Hume believed that wages are determined by demand and supply and that competitive relations in the labour market are not always such that workers live on the bread line or have no bargaining power whatsoever other than the threat of starvation.

The fact that the physiocrats wished to tax only landlords but not craftsmen or merchants should obviously not be taken to mean that they were somehow pro-craftsman and pro-merchant and anti-landlord, although some landlords of the time would undoubtedly have accused them of exactly that. If anything, the physiocrats looked rather askance at merchants in particular, questioning whether trade adds any value to goods. The physiocrats argued that, because of tax shifting, all the tax would anyhow be carried by the landlord, and that using the landlord's rent income as the tax base would simply be a more convenient way of collecting tax plus a way of keeping the price of agricultural products low, which was in the interest of all classes of society (see 2013:42–43) [2007:42–43].

The section on Turgot (2013:42–46) [2007:40–43] makes interesting reading, even if it does not have a great deal of extra information about physiocratic ideas. The prescribed textbook (2013:40) [2007:37] speaks of the "dauphin of France"; the "dauphin" is another name that the French used for their crown prince, the heir to the French throne.

LOOKING BACK AT ACTIVITY 1.2

Have Tom and Sipho stopped arguing already?

THE CLASSICAL SCHOOL AND CLASSICAL FORERUNNERS

STUDY OUTCOMES

- Hume's price specie-flow mechanism and why it undermines the practicality of mercantilist policy
- Hume's reasoning as to why international trade may not be a zero-sum game
- Hume's reasoning as to why international trade will tend to melt away the differences between rich and poor nations

1.3 ACTIVITY

Classical liberalism is now regarded as a conservative ideology. But at its inception it was seen as very progressive and even subversive of the status quo, which was dominated by mercantilist ideas. As an introduction to the classical school, consider the following imaginary reflections of a typical mercantilist government official who notices, with alarm, the increasing popularity of classical liberal ideas.

"These liberals, these rascals! They think they do our Kingdom a favour by removing all proper government controls on entry into the crafts, do away with all controls on the price and quality of the goods produced and cancel all controls on trade between nations. Every Tom, Dick and Harry can now become a candlestick maker and sell his candlesticks at any price he wants. How will the public know that the candlesticks are of the required quality? And how will existing candlestick makers be able to make a living if anybody with half an idea of how to make a proper candle can sell his rubbish at any price to the unsuspecting public? And how can it serve the interest of our country if foreigners are allowed freely to sell their products in our country and so take the jobs and incomes away from our own people? It is ridiculous! This new-fangled idea of giving the uneducated masses the freedom to do what they want is a recipe for disaster. How can there be order in the chaos of freedom? We, of the old school, brought peace and order to this country. We made sure that things were done properly, with a proper price for a properly produced good. Liberty is fine as far as it goes, but surely you can't give unrestricted liberty to the uncivilised masses, the majority of which do not know what to do with it anyway. It will be chaos, I am telling you!

"These liberals, these rascals! The vices of greed and licentiousness will go rampant! And now the liberals want to grant people the liberty to practice their own self-invented religion too. What is next? There should be one religion, the True Religion, and the King should make sure that everybody practises it in the proper way. Imagine all the nonsense that people will start to believe in if you allow them to believe what they want? Chaos, I'm telling you! Just now they want to follow that mischievous new country, the United States of America, and give the rabble the right to elect the government of their choice! Sedition, that is what it is! What will happen to our beloved King?! What has become of the world? Where will I find another job at my age ...?"

. . . .

Question: After having studied the "Overview of the classical school", how would you evaluate the ideas of this conservative mercantilist? To what extent should the government curtail freedom in an effort to protect its citizens against their own ignorance or folly, and to what extent should the government allow people to make their own decisions with the implication that they may need to suffer the negative consequences of these decisions? What alternative, non-governmental controls on economic life are possible?

DEMARCATED READING

You should at this point read Chapter 4: Only the sections "Overview of the classical school" and "David Hume".

CONTENT

As mentioned in the introduction, the classical school began with the publication of Adam Smith's *The wealth of nations*, which was published in 1776 and dealt a death blow to mercantilism. Nonetheless, as is often the case with scientific breakthroughs, many of the central ideas were already formulated by others in partial or rudimentary forms.

Once more, Brue and Grant's (2013:49–53) [2007:45–49] "Overview of the classical school" is clear enough so we do not need to add much by way of additional explanation; also, much of its content is repeated and elaborated on when the textbook discusses the classical economists themselves, like Smith, Ricardo and Mill. This is not to say these sections are less worthy of careful study. Brue and Grant's (2013:49– 51) [2007:45– 47] discussion of the two "revolutions" that contributed to classical liberal thought – the scientific revolution and the industrial revolution – is particularly interesting and revealing. A careful reading of these sections will give you an appreciation for the fact that both were real *revolutions*: they dramatically changed the way people thought (scientific revolution) and lived (industrial revolution) at the time. The industrial revolution, among other things, caused the demise of traditional handicraft production in favour of factory production, which has a major impact

on social life; it further shifted economic power and wealth away from agriculture towards industry and trade; and it dramatically increased urbanisation and stimulated large-scale agriculture.

We will clarify just a few terms here.

Just as the concept of monopoly refers to a market form where there is only one supplier, so the concept of monopsony (2013:53) [2007:49] refers to a market in which there is only one demander. Both monopolists and monopsonists would have almost total power to set the price in their markets.

The prescribed textbook (2013:53) [2007:49] refers to public goods being "indivisible", which is an unusual way of describing them. Public goods are more commonly described as *non-excludable* and *non-rival*. Non-excludability means that non-payers cannot be excluded from the benefits of these goods when they are provided, like the benefit of defence against foreign aggression by an army. Non-excludability thus implies the problem of *free-riding*. Goods are non-rival when their increased consumption by some does not diminish their availability to others. The general idea is that unless public goods are provided by the state, they tend not to be provided at all. Hence there is an argument that such goods should be provided by the state and financed out of taxation. The services of military defence and lighthouses are often used examples.

Of the classical forerunners, you need to study only Hume (2013:58–63) [2007:54–57]. Pay particular attention to Hume's *price specie-flow mechanism*, with which you should already be familiar if you have taken a course in international trade. The price specie-flow mechanism suggests how surpluses and deficits on the balance of payments trigger forces that will cause the balance of payment to spontaneously revert back to equilibrium. The basic presupposition of this mechanism is that the exchange rate between local and foreign currencies remains more or less unchanged, which is to be expected if local and foreign money units (say, the pound, euro, or dollar) reflect given amounts of precious metal (say, one ounce of gold), as they did at the time. If we then assume, for example, a surplus on the balance of payments, the resultant increase in the local money stock will cause local prices to rise, which will make exports less and imports more competitive, which, in turn, will eventually cause the surplus to dwindle and equilibrium on the balance of payments to be restored again. When exchange rates are flexible (as they are in modern times), an important part of the necessary adjustment in import and export prices is brought about by changes in the exchange rate, which may cause the balance of payment to revert back to equilibrium quicker and with less impact on the local money supply, and hence on local prices. Hume, of course, used the specie-flow mechanism to show how surpluses on the balances of payments cannot be maintained indefinitely, so that mercantilist policies to stimulate the inflow of bullion (monetary gold and silver) by way of the stimulation of exports and the discouragement of imports are unsustainable and self-defeating.

Hume's controversial assertion that the difference between rich and poor nations would eventually even out is interesting. As Brue and Grant (2013:61) [2007:56] correctly emphasise, there is a kind of self-reinforcing tendency according to which rich nations get richer and poor nations poorer. Because rich nations accumulate more capital, they can grow faster. This growth, in turn, expands the size of their market, which creates scope for further investment, innovation and growth. Moreover, rich nations are able to lure away the best talent from other, poorer nations, which adds impetus to their wealth-creating ability. But, as Hume already noted, there are also contrary forces. For one, prices and labour cost tend to be higher in richer nations, which creates an opportunity for poorer nations to supply technologically unsophisticated, labour-intensive produced goods at a price that is competitive and attractive in the richer nations' markets. The profits generated in this way can then be used to accumulate capital, which enables poorer nations steadily to move into more capital-intensive, more technologically sophisticated production. Taiwan, South Korea and China have successfully applied this very strategy over the last couple of decades – a strategy that

was already identified by Hume. However, it presupposes a deliberate low-wage policy (at least at the initial stages), which may not be feasible in South Africa where the difference between rich and poor is already so stark. Ironically, China could enforce a low-wage policy, because its government was, and still is, communist and in that sense completely authoritarian. It tolerates no dissent.

LOOKING BACK AT ACTIVITY 1.3

Classical liberalism, with its emphasis on individual freedom, private property and minimal government, is alive and well today. Yet it is also under stress. Societies are struggling to strike a balance between individual rights and individual responsibilities, between "society owes me" and "I owe society", between allowing people to make their own decisions and not allowing them to hurt the common good, and between the wealth of the few and the poverty of the many. Somehow it seems increasingly difficult to strike such a balance, mainly because the irresponsibility of the few (say, a few Wall Street bankers) tend to have increasingly large negative spillovers for the many.

RELEVANCE FOR TODAY: A

Mercantilism prevailed during a time of absolute monarchy. Absolute monarchs were prone to equate the interest of their realm with their own personal interest. This is not to deny that these interests *were* often closely connected and that many monarchs *did* often self-sacrificially offer their lives on the battlefield in an effort to protect their subjects against the rape and pillage of advancing barbarian hordes. But driven by personal ambition and pride, monarchs could also involve their country in meaningless wars, which wasted the lives and property of countless of their subjects. Because of their inclination to equate their own interest with that of their country, monarchs found it easy to sacrifice the life and property of their subjects for the sake of their own glory and fame. You can take some of the mercantilist policies as a case in point. The ostensible intent of mercantilist ideas is not primarily to further the prosperity of the broad mass of people themselves, but rather to raise tax income for the king – tax income, which was sometimes used to serve a genuine public interest but often also to satisfy the personal ambitions of the king.

The issue has relevance for modern times: there is an abiding temptation for anyone in power to imagine that one is serving the interest of the people when, in reality, one is merely protecting one's own interest. With an appeal to the interest of the people, a great many injustices have been perpetrated against the people by the supposed representatives of the people.

RELEVANCE FOR TODAY: B

Drawing on the writings of the physiocrats, the 19th century American economist Henry George (mentioned and criticised by the prescribed textbook (2013:38, 286) [2007:36, 270] proposed to tax away the value of unimproved land (the pure site value of land expressed as an annual rent) for redistribution and social spending, while scrapping all other forms of taxation. Apart from whether George's proposal is practicable, which is open to debate, he does tackle an issue of potentially great relevance to our region. Henry George's classic work is entitled *Progress and Poverty*, and is still worth a read for those who are interested (although some of the analysis is flawed). Very briefly, George advocated that land be privately owned but that private land owners compensate all other citizens for the right to exclude them from their parcel of land by paying an annual rent representing the naked site-value of land (the value of land net of man-made improvements). The pool of funds thus collected could then be used for social spending or evenly distributed over all citizens as some kind of a basic income grant. Land does seem unique in that, unlike any other good, it is not man-made (it is a gift of nature), is fixed in supply and its site-value is, in part, socially determined by the spill-over effects from how others use the surrounding land parcels and from the public infrastructure available on surrounding land parcels. Your lecturer is not yet fully convinced that George's ideas are practicable, but it does seem worthy of closer investigation, especially since land ownership is such a hot and divisive issue in South Africa with the potential of creating major and very damaging social strife. It is interesting that a free-market advocate like Friedrich Hayek is surprisingly complementary about Henry George's ideas: "[George's proposals] seem to me to the present day the most defensible of all socialist proposals and impractical only because of the de facto impossibility of distinguishing between the original and permanent power of the soil and the different kinds of improvements."[2]

The prescribed textbook (2013:38, 286) [2007:36, 270] criticises George's policy proposal on the grounds that it reduces the market price of the site value of land to virtually zero, which would cause major losses to people who had just bought land for large sums of money. The criticism could, however, be overcome by giving people tax credits up to the value of the price they originally paid for the land as an interim measure.

RELEVANCE FOR TODAY: C

It is interesting to note that the main leaders of the physiocratic movement, Quesnay and Turgot, came from the class of aristocratic landowners themselves. Apparently they were able to overlook the narrow interests of the class into which they were born for the sake of justice and the broader interest of France as a whole, which is to be admired indeed. South Africa could do with a few more politicians and business leaders like those.

LEARNING UNIT 1: SELECTED SELF-STUDY QUESTIONS

1. Comment on the following statement: Mercantilism is as much a set of observed policies as it is a truly unified economic doctrine set forth by major scholars.
2. In which respects was the physiocratic school a reaction to mercantilism? Why did it develop in France?
3. Compare the list of the major tenets of the classical school with those of the physiocratic school. Which are similar? Which are dissimilar? Based on this comparison, would you characterise the physiocrats as forerunners to the classical school? Explain.

2. Hayek, FA. (1994). *Hayek on Hayek: an autobiographical dialogue*, edited by S Kresge & L Wenar. Chicago: University of Chicago Press: 63.

LEARNING UNIT

2 Adam Smith

STUDY OUTCOMES

When studying this unit, you should aim at gaining knowledge and understanding of the following:

- the main tenets of the Enlightenment worldview
- how both the *Theory of Moral Sentiments* and the *Wealth of nations* suggest different ways of reconciling individual freedom with the achievement of the common good
- how the division of labour enhances productivity and ultimately leads to mechanisation and industrialisation
- how the size of the market limits the division of labour
- the meaning of Smith's concept of self-interest and how that concept may be differentiated from pure selfishness or greed
- why in modern capitalism competition is less likely to guide private interests towards the common good than in Smith's time
- the two main reasons why, according to Smith, state interference is likely to be ineffective in furthering the common good
- the forms of state interference which Smith, nonetheless, advocates
- Smith's argument in favour of free international trade
- Smith's distinction between *value in use* and *value in exchange*
- the meaning of the *water-diamond paradox*, why it caused Smith to focus on value in exchange and ignore value in use (utility)
- the distinction between *relative price* and *absolute nominal price*, and the role it plays in Smith's labour theory of exchange value
- the distinction between short-term *market price* and long-term *natural price*, and the role it plays in Smith's labour theory of exchange value
- the sense in which Smith's labour theory of exchange value is applicable to an "early and rude state of society"
- how, according to Smith (and Hume), the general price level is determined by the quantity of money in circulation
- the wages-fund theory, and why it is more applicable to an agricultural society than to a modern industrial society
- on what grounds Smith disagreed with the low wage doctrine of the mercantilists, and the "iron law of wages" of later classical authors
- Smith's determinants of the wage structure in a free society
- Smith's view of profit as the reward for risk-taking
- how the classical authors in general insufficiently distinguished between profit and interest
- why profit rates, according to Smith, tend to be lower in rapidly advancing nations than in poor stagnating nations, which can be more than offset by the lower wages paid in poor nations
- how Smith's theory of rent is similar to Ricardo's (after having also studied Ricardo)

- how Smith's anti-bullionist stance caused him to underestimate the contribution of money to wealth creation
- the grounds on which Smith opposed the rising national debt of his day
- the virtuous circle implicit in Smith's ideas, according to which increased productivity and wealth creation leads to even greater increases in productivity and wealth creation
- Smith's distinction between productive and unproductive labour

2.1 ACTIVITY

Consider the following fictitious deliberations of the very Adam Smith himself, which illustrate the Enlightenment worldview.

Only about 100 years ago, people thought that the workings of nature, the movement of material objects like the stars, were an impenetrable mystery. Since Mr Newton's discoveries, we now realise that nature is actually ordered; it can be rationally understood. This is utterly amazing! There is a beautiful harmony in the behaviour of things, which can elegantly be described with the aid of mathematics. Nature is not random; it obeys certain laws. And it is the duty of science to discover these laws to the benefit of mankind. It seems that the Almighty has given man a brain capable of comprehending the world round about him. The implications are stupendous! Away with all woolly speculation and superstition! We no longer need to take seriously the babblings of self-styled prophets, mystics and other such crackpots who get pleasure out of frightening people. Our rational faculty is the yardstick of all truth. Only that which is rationally understandable and conforms to the laws of nature qualifies as valid knowledge. All the rest is humbug. Moreover, if each human being is endowed with this rational faculty, then governments no longer need to prescribe to people what is good for them and what is right for them to believe. People can discover that for themselves. People can be free! If there are natural laws which govern the behaviour of physical objects, surely there must be natural laws which govern the behaviour of people too. If we can discover such laws and give them free rein, there can be spontaneous harmony in human affairs. Society can be spontaneously ordered, without having to impose that order from above by an oppressive and coercive government. This vision is truly inspiring. It defines my life's work!

Question: Smith's vision of reality can be regarded as the essence of the Enlightenment worldview, which dominated the intellectual climate in Europe from the early 1700s onwards. Although the Enlightenment worldview was an important cultural advance, it is not beyond criticism. After having studied Adam Smith's ideas can you possibly identify some weaknesses in the Enlightenment worldview (nowadays more popularly labelled "modernism")? Can nature be completely demystified by human intelligence? Can all aspects of life be rationally understood in the way of physical science or mathematics? Can human behaviour be adequately described by way of laws analogous to the laws of physics?[3]

3. It would be a caricature to suggest that the Enlightenment as an intellectual movement was necessarily anti-religion, even though it would be against the state enforcing the monopoly of one religion on the populace. The Enlightenment worldview is better described as pro-rationalistic ("accept only that which can be rationally and logically understood"), anti-tradition ("reject all culturally accepted norms unless their worth can be demonstrated empirically") and anti-mystic ("reject all knowledge gained through intuition, feeling or some 'higher' consciousness"). There were, and still are, both religious and irreligious supporters of the Enlightenment. And one gets atheist traditionalists and mystics, just as there are rationalistic believers in God.

DEMARCATED READING

You should at this point read Chapter 4: only the "Overview of classical school" (2013:49–53) [2007:45– 49], again and all of chapter 5, excluding "5-1 Past as prologue" (2013:82– 83) [2007:75–76].

CONTENT

Although the prescribed textbook's discussion of Smith is again lucid, needing little further clarification, we will make quite a few additional comments, which we hope you will find useful and interesting. Many of these comments will apply not only to Smith, but to all classical authors (in particular Ricardo and Mill). In the next learning unit (learning unit 3), you will, therefore, find reason regularly to refer back to this learning unit.

The prescribed textbook pays significant attention to Smith's *Theory of moral sentiments*, which makes for interesting reading. The essence of the section on Smith's *Moral sentiments* is aptly summed up by the prescribed textbook **(2007:65)** as follows:

> *Both Moral sentiments and Wealth of nations reconcile the individual with social interest through the principle of the invisible hand, or natural harmony, and the principle of natural liberty of the individual, or the right to justice. In Moral sentiments, sympathy and benevolence restrain selfishness; in Wealth of nations, competition channels economic self-interest toward the social good.*

In the *Wealth of nations*, Smith portrays self-interest as the driving force behind free-enterprise capitalism, as illustrated by the famous quote: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest" (2013:73) [2007:67]. This self-interest is supposed to be kept in check by competition, understood as the existence of a large number of suppliers or demanders in a market. If, for example, your butcher charges unreasonably high prices for his meat, competition gives you the opportunity to go to another butcher. Butchers are thus forced, by the threat of losing customers to competing butchers, to be reasonable in the pricing of their meat. That is how their self-interest is kept in check by competition and how the "invisible hand" of competition, analogous to Newton's law of gravity in a system of natural harmony, automatically guides self-interest towards the common good.

While Smith's argument thus presented contains important truths, it is open to a number of misunderstandings. We will spend some time expelling some of these misunderstandings, which are still widespread in our day.

Many people mistakenly regard Smith's idea of self-interest as equivalent to selfishness, in the morally objectionable sense of being only and exclusively concerned with one's own interests at the expense, if necessary, of the interest of others. There is, however, a subtle but important difference between Smith's self-interest and plain selfishness. Smith's self-interest refers to the desire to meet one's own needs – earn one's own income and pay for one's own food, clothes and housing. Clearly, that kind of self-interest is entirely moral, even if only minimally so. While morality most certainly challenges people to go a step further and also be concerned about the needs of others, people must at least look after themselves. Otherwise, that step further would not even be possible; only people who have already looked after their own needs can afford to be concerned about the needs of others. Self-interest as the desire to meet one's own needs is thus not inherently immoral, selfish or greedy. It becomes immoral, selfish and greedy only when done *at the exclusion of a concern for the interests of others*, that is, when it is pushed so far that it squeezes out any generosity or any desire to see others get a fair deal too, which is not at all what Smith had in mind. Smith did not exclude the possibility that his "butcher, brewer or baker", even while being self-interested, were also keen to give their clients a fair deal or to spend part of their fairly earned income on contributing towards the needs of others. While generosity and fair play are not inherent in Smith's concept of self-interest, they are not excluded by it.

Therefore, Smith's idea that self-interested people can serve the common good should not be interpreted as a justification for selfishness: "Why should I worry about being selfish if my selfishness serves the common good?" Although this interpretation was not intended by Smith, he is partly to blame for it. The problem lies in Smith's proposition that the invisible hand of competition operates like an impersonal natural law (akin to the law of gravity) and that the mechanism is, therefore, automatic and inevitable. But contrary to harmony in the material world of physics, harmony in the world of human affairs is never automatic or inevitable, for which there are a number of reasons. First, markets are far from always sufficiently competitive to constrain rampant self-interest and guide it towards honesty and decency in business dealings. Second, even if markets were sufficiently competitive, people are still in need of some degree of moral restraint and benevolence, if their behaviour is to be in the interest of all. In essence: competition cannot completely replace the role of moral self-restraint. But then Smith argued in the *Theory of moral sentiments* that the majority of decent people do practise a degree of moral self-restraint, as we will see below.

Similarly, by emphasising self-interest as the driving force behind liberal capitalism, Smith does not wish to suggest that liberal capitalism is based on selfishness or even on greed. While liberal capitalism gives people considerable freedom to pursue their own interests according to their own values, it would be a caricature to suggest that its core value is that of the "law of the jungle" where "might is right" and selfishness is given free rein. It would be more correct to argue that Smith's ideal of a liberal, free-enterprise system is based on the idea that the responsibility to provide for one's own needs lies, first and foremost, with private individuals themselves. In such a society, instead of looking to the state or their fellowmen for their means of existence, private individuals have to accept responsibility for their own needs, even if it may still be the duty of a liberal state to create an environment that makes it reasonably possible for people to look after themselves. In addition most liberals, in accordance with Smith, would wish the state to provide some minimum safety net for those who fail to make an adequate living for themselves. And if people are to carry the responsibility to provide for their own needs, they must also be given the freedom to do so, which requires that the means of production be privately owned and that exchange be largely voluntary. Because freedom can be abused (freedoms can always be abused; this is their drawback but not always a good enough reason to abolish them), selfishness, greed and social injury can play a role too – see again Smith's *Moral sentiments*. But, says Adam Smith, the scope for such abuse of freedom can be brought back to acceptable proportions when there is sufficient competition (*Wealth of nations*) and when there is a sufficiently strong sense of voluntary self-restraint based on moral conviction (*Theory of moral sentiments*).

This brings us to the *Wealth of nations* itself. As the textbook points out, economics as a separate field of inquiry was really established by this book; previously economics had been treated more as a branch of applied moral philosophy. Apart from being a towering achievement, *Wealth of nations* is also still a surprisingly readable and accessible book. Do yourself a favour and take the book out from the library or access it on the internet. We would not expect you to read it from cover to cover (there being 900 pages to it!), but you will be surprised what a good and stimulating read it still is, on just about all it covers.

Note how Smith explains the "wealth of nations" primarily in terms of the division of labour, a greater division of labour (labour specialisation) creating scope for greater productivity (2013:72–73) [2007:66–67]. Labour specialisation, in general, occurs in two forms. The first is specialisation in producing a particular product. For example, some people specialise in baking bread, others in brewing beer and still further people in producing pins; call this "product specialisation". The second form is the specialisation in certain parts of the production process necessary to produce a given product; call this "operation specialisation". For example, staying with Smith's pin example, some people specialise in cutting wire, others in straightening wire, still others in sharpening the end of a wire, etc. When Smith refers to labour specialisation, he more particularly means what we call operation specialisation,

although it is clear that product specialisation will most often imply a degree of operation specialisation as well.

Smith mentions various reasons why a greater division of labour (more labour specialisation) increases productivity: more scope for developing better skills, less time lost in changing over from the one task to the next, etc. But by far the most important reason, which is perhaps not sufficiently emphasised, is that labour specialisation creates possibilities for mechanisation and, as such, paves the way for industrialisation. Labour (operation) specialisation facilitates mechanisation, because it divides up the production process into a large number of repetitive, standardised productive handlings, which makes it possible for machines to take over these repetitive handlings. The enormous productivity gains from industrialisation and mechanisation, which Smith only partly anticipated, can thus indirectly be attributed to Smithian labour specialisation too.

Always be aware of the fact that the scope for labour specialisation, and thus for industrialisation too, is limited by the *size of the market*.

Incidentally, when we speak of a market, we obviously do not mean a physical market place where people come together to trade their goods. In the modern world, people can trade with each other without physically meeting. A market should, therefore, more generally be understood as a collection of demanders and suppliers who, given their preferences and abilities, are potentially interested in trading with each other, because they are able to communicate market information with each other (types of good on offer, prices, qualities, delivery times etc) and reliably transport the relevant goods and money to each other at an non-prohibitive price. Hence, the size of the market, for a supplier, is determined by the number of potential demanders as well as the average purchasing power of each potential demander.

Back to our point as to why the size of the market limits the scope for labour specialisation. The prescribed textbook emphasises this important point only later in the chapter, when it discusses Smith's views on economic development (2013:86– 88) [2007:79– 81], although it does not provide a clear explanation for it. The size of the market limits the scope for labour specialisation, because increased specialisation, whether in product or in productive operation, always involves dividing up the market into smaller sub-markets – one for each specialised product or productive operation. In short: the division of labour implies a division of the market too. As a result, only when the market is initially large enough can its division into these sub-markets keep these sub-markets large enough for a specialist to make a living. That is why the growth of a market, say of the population of a town, leads to the establishment of more specialised shops in that town. When a town is really small, only a single general store can make a living there. As the town grows, however, a specialised bakery, butchery and clothing shop may be able to establish themselves, offering better quality, a wider selection and better prices than the general store previously could. That general store, therefore, goes out of business unless it specialises itself. As the town grows even further, there may even be space for a watch-maker, a tobacco shop and a dentist. And so the process goes on. Note that there is a way in which labour specialisation in itself already increases the size of the market: by being more productive and lowering the cost of production and thus the price of goods, more people can afford these goods, which in itself enlarges the market for these goods. This effect is, however, never quite so strong that the size of the market never limits the possibilities for labour specialisation.

Given that the size of the market limits labour specialisation and industrialisation, any measure that increases the size of the market aids the scope for labour specialisation and thus for greater prosperity in general. Three ways in which markets can expand spring to mind.

First, given that the ability of potential demanders and suppliers to communicate with each other and transport goods (and money) to each other defines a market – as stated above – it is clear that improvements in transport and communication technology increase the size of

markets. As transport and communication keep on getting faster and cheaper, the market, which any given producer with access to that technology can reach keeps on growing too, to the point where the whole world has now just about become one huge market for everyone. On the downside, if transport and communication were somehow to deteriorate through increased cost, slowness, unsafety or other forms of unreliability, the effects on the achievable degree of productivity through reduced specialisation and industrialisation will be equally significant. In some ways, modern industrialised economies have thus become more vulnerable. If the road, railway, air traffic and communication infrastructure were somehow to deteriorate, farmers could no longer reliably and cheaply get their crops to their market, information about available qualities and prices could no longer be spread among potential market participants quickly and cheaply, producers could no longer reach their market except for those who live in close proximity to their factory, and so on. When markets shrink in this way, possibilities for labour specialisation decrease and productivity declines. There is a lesson for South Africa in this: it is imperative that we take good care of our transport and communications infrastructure.

Second, markets can grow by removing restrictions on international trade. Smith’s advocacy of free international trade (2013:75–76) [2007:69–70] is based on precisely this point. Smith’s argument is really obvious. If, for example, South Africa wants to make laptop computers and smart phones available to its citizens, which it cannot develop and produce very effectively and efficiently itself (it has no absolute advantage in these goods), then it has to provide other countries with goods in which it does have an absolute advantage, like natural beauty and wildlife, which attracts tourism (a form of exports) and resources like coal and platinum, which other countries do not have. In that way, the welfare of both South Africa and other countries may be enhanced beyond what it would have been if South Africans were to have developed their own laptops and iPhones and foreigners had to go on vacation at home or try to find the necessary minerals in their own soil. Such is the basic idea of Smith's theory of free international trade.

However, Smith takes for granted that countries always have some area in which to develop an absolute advantage vis-à-vis other countries and that its absolute advantage is at least as large as the absolute advantage of other countries. One cannot, however, exclude the possibility that a country has an absolute advantage in fewer goods than foreigners, or no absolute advantage in any good at all. If that is the case, a country will not necessarily benefit by free trade (but see Ricardo's theory of international trade in the next learning unit). While its citizens may be able to buy imported goods more cheaply, many of its citizens may also lose their employment or be prevented from getting employment due to the replacement of locally produced goods for imports from abroad. Moreover, when free international trade causes a country to develop a balance of payments deficit, its money stock will shrink, which in Smith’s time will have caused the outflow of gold and silver to foreign countries. And a reduction in the local money may constrain local economic activity for as long as the outflow of money is not neutralised by the contrary inflow of money in accordance with Hume’s specie-flow mechanism. In this regard, the mercantilists may have had a point, even if their bullionism remains misguided.

Hence, the German historical school of the 1800s (see learning unit 6) may have been correct in not embracing free international trade for as long as Germany lagged behind Britain in industrialisation and would find it difficult to gain an absolute advantage in at least an equal number of goods as England. German consumers will have gained from free international trade by being able to buy goods at a lower price and a higher quality than local German producers would have been able to supply them at the time, but at the cost of many German workers losing their jobs (or not finding new jobs) in the affected industries and at the cost of a deficit on the German BoP, which could have constrained local economic activity for a period.

Third, the market for an individual firm can also expand by reducing the number of competing firms. Such a reduction is often a more or less spontaneous by-product of the

process of advancing mechanisation: the firms that are quickest to apply the latest, most efficient machinery are typically also the ones that can produce at the lowest cost. By thus being able to offer the goods at a lower price, they obtain a larger share of the market often at the expense of a multitude of smaller, less progressive operators, who are then forced out of business. That is partly why oligopoly rather than perfect competition is the typical market form in the modern industrialised world, in spite of the fact that markets have kept on growing due to the falling cost and increasing efficiency of transport and communication. You should bear in mind that highly mechanised firms can only exist by virtue of large-scale production, which means that, for a given size of the total market, there may only be space for a handful of firms – if we wish firms to produce at the lowest possible price. It seems that the loss of competition in markets is, to some extent, the inevitable downside of the economies of scale and the higher standard of living made possible by mechanisation and mass production.

As noted before, Smith assigns an important role to competition as the invisible hand that spontaneously guides individual interests towards the common good. In Smith's day (late 1700s), however, industrialisation had not progressed very far in Britain. There were hardly any big factories. Most production was still handicraft production performed by artisans in small family enterprises organised as unincorporated proprietorships or partnerships. Under these circumstances, there was indeed a good chance that competition was vigorous in most markets, although guilds (in so far still operative) could limit entry into trades. Modern capitalism with its far advanced industrialisation dominated by corporate firms may have had huge advantages in terms of raised productivity, but it has not been conducive to competitive markets. Most markets in modern capitalism are oligopolistic rather than perfectly competitive. Hence, Smith's invisible hand has a much reduced chance of success in modern capitalism than it had in Smith's own day.

According to Smith, government intervention through coercive laws does not further the common good for two main reasons. First, people know their own interest better than government officials do: "[E]very individual, it is evident, can, in his local situation judge [his own economic interest] much better than any statesman or lawgiver can do for him … It is the highest impertinence and presumption … in kings and ministers to pretend to watch over the economy of private people" (2013:74–75) [2007:68]. Second, government officials tend to waste public resources: "They are themselves always, and without any exception, the greatest spendthrifts in the society. Let them look after their own expense and they may safely trust private people with theirs." (textbook, ibid). Take note, however, that Smith is not entirely against government involvement and interference. Government still plays an important role in Smithian liberal capitalism and he still assigns some essential functions to it (2013:76–77) [2007:70–71]. Make sure you know what these functions are.

Smith was the first to think more systematically about what determines the value of a good. As an introduction to his theory of value (2013:78–80) [2007:71–73], we will briefly discuss the basic principles of value determination.

Smith already distinguished between two value concepts: *value in use* and *value in exchange*. Value in use, or *utility*, is about how much pleasure or convenience someone gets out of owning and using a good, which is, of course, subjective and difficult to measure objectively. By contrast, value in exchange, or market price, is about the price that a good would fetch when selling it in the market, which is obviously objective and easy to measure in quantities of money (10 rand or 6 dollar).

A market price (value in exchange) is basically an agreement between a demander and a supplier about the price that is mutually acceptable to both. A mutually acceptable market price must lie somewhere in between the demander's and the supplier's valuation of the good. If the price rises above the demander's valuation, he would no longer benefit from the deal, as he would have to pay more money for the good than what it is worth to him. The demander's valuation is, therefore, a *maximum cut-off price* for him, determined by value in

use (utility): how much pleasure he expects to get out of consuming the good. Similarly, if the market price falls below the supplier's valuation, she would lose from the deal as she would obtain less money for the good than what it is worth to her. The supplier's valuation is thus a *minimum cut-off price* for her, which is determined by the cost incurred in producing the good as well as by a minimum acceptable mark-up in compensation for the effort and capital spent in making the good available. While cost of production can more or less objectively be determined as the amount of money spent in making the good available (money cost), the reward that she wants in compensation for the entrepreneurship and risk in making the good available would be more subjective. Hence, the supplier's valuation is also partly subjective.

The market price can obviously be influenced by both the demander and the supplier's valuation of the good, depending on the valuation of all the other demanders and suppliers in the market and on the degree of competition in that market. That is why we study demand and supply curves (which are essentially collections of demander and supplier valuations) and market forms, like perfect competition, monopoly and oligopoly. Broadly speaking, the degree to which the market price is determined by the demander or the supplier's valuation depends on where the bargaining power advantage lies. If suppliers have a bargaining advantage over demanders (demanders are numerous but suppliers are few), the market price will be pushed up towards the maximum price acceptable for demanders. And if the bargaining advantage lies on the side of demanders (suppliers are numerous but demanders are few), the price would be pushed down towards the minimum price acceptable for suppliers. That is where the relevance of market forms comes in: monopoly, perfect competition, oligopoly, et cetera.

Now, Adam Smith saw an irreconcilable conflict between value in use (subjective utility) and value in exchange (objective market price), as exemplified by the water-diamond paradox (2013:78) [2007:71]: how was it possible that water has a very high value in use but a very low value in exchange, while diamonds have a very low value in use but a very high value in exchange? Unable to resolve this conflict, Smith rejected the relevance of value in use (utility) as a determinant of exchange price and looked only at cost of production. As such, Smith ignored the demander's valuation (*maximum cut-off price*) and considered only the supplier's valuation (*minimum cut-off price*) and made the latter the sole determinant of a good's market price.

Brue and Grant (2013:78) [2007:71] argue that the solution to the water-diamond paradox lies in the distinction that later economists made between total utility (for example, the pleasure derived from eating a whole apple) and marginal utility (for example, the pleasure derived from eating one additional bite of the apple). But there seems an even easier solution, if it is borne in mind that market price can be influenced by both the demander's valuation (utility) and the supplier's valuation (cost of production plus reward for entrepreneurial effort) of a good. Water has a very low market price in spite of its high utility because its cost of production is very low. And since it is in abundant supply (permanent excess supply), the bargaining advantage lies on the side of demanders who will then have the power to push the market price down towards this very low minimum price, which is the supplier's valuation. By contrast, diamonds have a high market price in spite of their low utility because their cost of production is high. And since diamonds are relatively scarce, the bargaining advantage lies on the side of suppliers who will then have the power to push the market price up towards the maximum as determined by the demanders' valuation of diamonds (their utility or value in use). Part of Smith's problem is that he polarises between two options and forces us to choose between these options, which are not mutually exclusive: value in use (utility) and value in exchange (market price). The dichotomy between value in use and value in exchange is false, because the former is one of the determinants of the latter – be it not the only determinant.

What saved Smith's cost-of-production theory of value from being entirely unrealistic is that he did not wish to use his theory to explain the short-term, day-to-day level of prices, in which demand factors (and thus utility) will play a more important role. Rather, Smith used

his theory to explain long-term price levels, that is, those levels that short-term prices are supposed to gravitate towards or fluctuate around. Now, if we assume that there is enough competition in a market (which Smith takes for granted) and that production technology remains stable (unchanged long-term average cost or "constant cost per unit of output" as the textbook calls it), it is not unrealistic to claim that market price will fluctuate around some stable level predominantly determined by cost of production, given that cost of production will include some level of normal profit too. So, by explaining long-term rather than actual short-term prices, the defect of Smith's theory – its neglect of utility (demand factors) – could be compensated for.

Note furthermore that Smith wished to explain, not the absolute money price of a good but its relative price, which is the price of one good (say, shoes) relative to another (say, trousers). Therefore, Smith did not intend his theory to explain why shoes cost R300 or trousers R200, but why the price of shoes relative to trousers is 3:2. This distinction between the absolute money price and the relative price of a good can, however, also be misleading, because of the sense in which an absolute money price is a relative price too. After all, the absolute money price of R300 for a pair of trousers expresses the value of the trousers relative to the value of money. When I say that a pair of trousers is worth at least R300 to me, what I am actually saying is that it is worth at least 300 times the value of R1 to me. Value is in essence a subjective concept (my estimation of the degree to which some good is expected to meet some need in me). Therefore, to make it objectively quantifiable, we have to express it as a ratio of two subjective values: either the value of one good relative to the value of money (absolute money price) or the value of one good relative to the value of another good (relative price). We will come back to this issue in learning unit 5.

Of course, Smith's theory of value is not merely a cost-of-production theory of value, but more specifically a labour-cost-of-production theory of value. Particularly, relative amounts of labour cost are supposed to determine relative price. As the prescribed textbook (2013:78–80) [2007:72–73] points out, this may be a reasonable proposition if labour cost can be regarded as the only cost of production, which would demand "an early and rude state of society which precedes both the accumulation of stock [of capital] and the appropriation of land", that is, people make no use of capital, and land can be used for free. Otherwise, the use of capital and land will also create cost, and relative price can no longer be determined by relative amounts of labour cost only.

Moreover, Smith measures labour cost as labour time. The reason that the price of shoes relative to trousers is 3:2 is that it takes, for example, 3 hours to produce shoes but only 2 hours to produce a pair of trousers. For this to be a valid proposition, Smith must additionally assume that a labour hour in both the shoes and the trousers sectors is equally productive, stands for the same amount of effort and skill, and is equally priced, which, furthermore, presupposes that capital-labour ratios are roughly the same in both sectors.

All these restrictive assumptions make his theory, of course, rather artificial and contrived.

To overcome these problems, Smith argues that in an advanced economy, while labour may no longer be regarded as the source of value (a labour-cost or labour-time theory), it can still function as the measure of value (a labour-command theory), which seems an awkward step. After all, if Smith is sincere in wishing to relinquish the idea that relative labour cost determines relative price, he has to abandon his ambition to explain long-run natural prices as well – such prices being explicable in terms of cost of production only. Moreover, labour as a measure of value (the labour-command theory) seems superfluous, since that function is already adequately performed by money. In short, Smith wrestled somewhat unsuccessfully with the problems inherent in the idea that relative labour time used in production determines relative market price. While labour time, or cost of production in general, can undoubtedly have an influence on market price, it is difficult to maintain that it is the only determinant of market price, whether nominal or relative. We will find Ricardo and Marx wrestling with similar problems.

The prescribed textbook (2013:80–85) [2007:74–78] subsequently discusses Smith's theories about wage, profit and rent determination. Wage, profit and rent are also called *factor rewards*, because they are supposed to be the rewards for the contribution towards wealth creation made by the various production factors (labour, capital and land), which also represent the three main classes in society (workers, capitalists and landowners). Similarly, the wage rate (wage per unit of labour), profit rate (profit per unit of capital) and rent rate (rent per unit of land) are collectively referred to as *factor prices*. Now, the classical writers presupposed that, once they had developed a theory of factor prices, they had thereby established a theory of the functional distribution of income as well, that is a theory about how the total national income is distributed over wages, profits and rent and thus over workers, capitalists and landowners. But for this to be true, the total amount of real productive contributions and the general price level need to be fixed and unaffected by the factor prices established; in other words, the size of the cake must remain the same irrespective of how it gets carved up. Workers must work equally hard irrespective of the wages they get paid, tenants must cultivate the land equally well irrespective of the rent they must hand over to their landlords, and entrepreneurs/capitalists must be equally enterprising and take equal amounts of risk irrespective of the profits they receive. All this seems unlikely, especially in the medium to longer term. As the prescribed textbook (2013:150) [2007:139] notes in chapter 8 while discussing Mill (see learning unit 3):

> *[P]roduction and distribution are interrelated and . . . interference with one involves interference with the other. [There is no] mass of goods already produced. They appear as a continuous flow that gets produced through the incentives provided by payments to the factors of production.*

As for the general price level, the classics simultaneously assumed that a more or less given total amount of money in circulation would guarantee a stable general price level, which is the substance of the *quantity theory of money* first formulated by Hume (see the paragraph of the textbook (2013:59) [2007:55], beginning "Hume did not believe ..."). With the general price level (and productive contributions) being the same, an increase in the nominal profit rate would have to go at the expense of a decrease in the nominal rent or wage rates and vice versa. In the modern world, however, increases in nominal wage rates need not be accompanied by decreases in nominal profit rates but can also lead to inflation, that is, a rise in the general price level. The reason is that suppliers (whether they be workers as suppliers of labour or producers as suppliers of goods) are today in a position to pass on their cost increases in the form of higher wages or prices. Moreover, in modern economies the total money supply is more flexible and can, therefore, more easily adapt itself to the economy's increased money needs due to higher prices.

A further troublesome aspect of the classical theory of distribution is that it is unclear which production factor is rewarded in the form of profit. While it is reasonably clear that wage is the reward for contributing labour (at least, in blue-collar form involved in physical production) and rent is the reward for contributing land, profit seems to contain a mix of rewards for making various factor contributions, not only that of furnishing capital. In actual fact, profit is the reward that accrues to the ownership of a firm. So whatever the owners happen to have contributed to wealth creation is what profit rewards. Because (to be able to own the firm) an owner must at least have supplied some of the necessary capital and entrepreneurship, profit must contain at least a reward for both these contributions – in proportions which are difficult to determine. But owners, especially of smaller firms, sometimes do some of the actual productive, blue-collar work themselves as well, in which case profit will also contain a reward for labour. In fact, we can only separate the contributions of the various production factors and determine a separate market price for them, when these production factors are externally supplied by non-owners.

To sum up, the classics worked with only three production factors: labour, capital and land. Labour is rewarded in the form of wage, capital in the form of profit and land (which provides raw material) in the form of rent. Owners of firms were thereby implicitly regarded

as contributing only capital, with the result that the classical concepts of profit and interest were somewhat hazily defined and often, *and* mistakenly, used interchangeably, and that the productive contribution of entrepreneurship tended to be overlooked or undervalued.

While studying Smith's wages fund theory in the context of his theory of wages (2013:80) [2007:74], it may be useful simultaneously to consult the textbook's (2013:150–152) [2007:139–140] criticism of the wages fund theory in its discussion of Mill. The theory seems to be applicable only to a predominantly agricultural society, which Britain still was in Smith's days – although the contribution of commerce was not insignificant and manufacturing was rapidly advancing as a result of increased industrialisation. The peculiarity of farming, especially at the time, is that it mostly yields only one crop per year. A single production round per year implies that all the input cost incurred during the year, the greatest proportion of which will be wages, must be financed ahead of selling the crop. In other words, because farming has only one production round per year, a large proportion of its capital goes towards paying wages. So the total amount of capital available in society becomes an important determinant of aggregate wages paid. However, in manufacturing, one production round probably does not take more than a week and output is continually sold, with the result that the capital requirements to finance wages ahead of sales are much smaller. Moreover, in modern economies, workers get paid at the end of each month, which allows significant time for some or all of that month's production to get sold. Hence, modern manufacturers can finance a significant part of their monthly wage bill out of the proceeds from selling the same month's production. Wage payment thus requires a much reduced amount of working capital, and the constraining influence of total available capital on wage payments is thus much smaller too – also because, in modern economies, firms can much more easily and quickly supplement their working capital requirements by access to banks or financial markets. In their discussion of Mill later on in the book, Brue and Grant (2013:151) [2007:140] sum up the weakness of the wages fund doctrine well:

> *The wages fund concept was erroneous because there is no predetermined proportion of capital that must go to labour. The idea of a fund arose because the harvest of one season was used to provide the subsistence for labour for the following year. But once a business gets established, wages are paid not from an advance fund of so-called circulating capital but rather from a current flow of revenue derived from the sale of the output. [Hence] . . . the decision to hire a worker is based not on the availability of past revenue, but rather on the prospective revenue that the firm will receive by selling the output that the worker helps produce.*

Nonetheless it remains true that, for a given amount of total revenue (total sales), the more firms pay in wages the less they make in profit, and vice versa. Hence, if workers were to push up their wages so far that firm owners are no longer reasonably compensated or are threatened even to lose money, employment will suffer. Such is the real limit to wage payment.

Smith saw as "the wealth of nations" not the total amount of money within their borders (as the mercantilists did) but the total amount of useful goods ("necessities and conveniences"), which they produced within a certain period, which is indeed a more correct view of things. But note, however, that Smith excluded services from these useful goods. So Smith did not regard doctors, lawyers, politicians or comedians as contributing towards the total national product. Note also how Smith's view about wealth as constituting *useful* goods does not sit comfortably with his disregard for *utility* as a determinant of value.

Smith's opposition to bullionism leads him to underestimate the importance of money and the contribution it does make towards wealth creation. Bullionism is indeed fallacious; wealth should be equated with useful goods not with money. But that does not mean, as Smith appears to argue, that money is productively sterile. Money may not be a production factor: it does not directly contribute to production in the same way that raw material, tools, labour or machinery do. But money does indirectly contribute towards the productivity of

society by making it easier to trade. Recall how increased labour specialisation (an increased division of labour) must be accompanied by an increased intensity of trade. When everybody bakes their own bread, builds their own homes, grows their own wheat, and makes their own clothes, there is little need for trade. But as soon as people start to specialise, trade necessarily intensifies. Bakers must trade with builders, farmers, and tailors, et cetera. The absence of money, by frustrating trade, will thus frustrate labour specialisation too. Hence, the productivity gains attributed to increased labour specialisation and the use of machinery (capital) should also, partly, be attributed to money. Similarly, money may indirectly contribute towards wealth creation by allowing the easier accumulation of saved-up resources over time (money as a "store of wealth"), in order to finance capital-intensive production processes in the future.

Observe how Smith is in favour of bank money (notes and deposits) replacing commodity money (gold and silver coin) because it allows for the cheaper and easier production of money. But be aware that Smith was still in favour of a *convertible* currency, meaning that the bank notes and deposits were still to be fully convertible into gold and silver coin – even if they may no longer be fully backed by gold and silver coin. Smith did not envision anything like a modern fiat money system in which currency is no longer convertible into anything. For more about that, see our discussion of Malthus in the next learning unit.

Note that Smith's objection to public debt runs along very much the same lines as that advanced by modern Chicago school economists (see learning unit 7): that public borrowing could crowd out private borrowing via higher interest rates, while private borrowing is regarded as more productively and usefully invested.

The key idea in Smith's theory of economic development (2013:86–88) [2007:79–81] is that the extent of the division of labour is limited by the size of the market, as already discussed in detail above. As markets grow, the scope for productivity gains through mechanisation can, therefore, grow too.

LOOKING BACK AT ACTIVITY 2.1

The 19th century was a century of tremendous cultural optimism. Smith's liberal ideas typical of the Enlightenment had basically triumphed. There was a solid and steadfast belief in "progress". All social problems were regarded as solvable through the application of human reason. Technology and science, including economic science, would be able to bring heaven down to earth.

Now that you are more familiar with Smith's ideas, does the Enlightenment worldview ("modernism") remain equally attractive and inspiring to you? Your lecturer has to admit that he still finds the Enlightenment worldview, despite its weaknesses, tremendously inspiring. It should never be rejected wholesale, even if it needs to be seriously qualified. While the limits of human reason need to be acknowledged in certain contexts (especially the area of ultimate meaning and responsibility), and while science and technology cannot in themselves bring down heaven to earth (and, in fact, have had some seriously negative side-effects), it would be disastrous if people came to reject human reason altogether, abandoning themselves to instinct and intuition, as some strands of "postmodern" thought appear to advocate. Then we truly regress to the darkest of Dark Ages. The overstatements and partial failures of the modernist agenda do not justify us to go back to pre-modern worldviews. Both reason/observation and intuition/instinct have a role to play in our search for truth, and we should never entirely abandon the one for the sake of the other. They need to keep each other in tension.

RELEVANCE FOR TODAY: A

Some of Smith's remarks in *Moral sentiments* can be surprisingly modern and relevant as well as full of practical wisdom. Take the following observation: "Society may subsist, though not in the most comfortable state, without beneficence; but the prevalence of injustice must utterly destroy it." In other words, a society without beneficence (that is, human solidarity or people caring for each other) will not be a very nice place, but it will survive. However, a society without law and order where another man's life and property are easily taken, will utterly destroy itself. Those responsible for law and order in South Africa take note!

RELEVANCE FOR TODAY: B

Smith assigns an important role to competition as the invisible hand, which spontaneously guides individual interests towards the common good. As such, competition functions as a protection mechanism against the excesses of self-interest.

But competition, understood as the existence of many alternative suppliers or demanders, is a particular incidence of a more general principle. That general principle can formally be stated as follows: disassociation provides the best protection against possible harm resulting from association.

For example, if I join an association like a trade union, a business agreement, a business partnership, a church or a sports club, but my associates turn out to be unpleasant, unreliable or even positively harmful and dangerous, I protect myself from any further harm by simply disassociating myself from them: leave that trade union, business agreement, business partnership, church or sports club, and possibly join another.

It is for that reason that both the freedom of association (the freedom to cooperate with others for mutual benefit) and the freedom of disassociation (the freedom to terminate that cooperation with others when it is perceived to be no longer beneficial) are necessary to balance the potential benefit and the potential harm of human cooperation. When the freedom of disassociation is lacking, I get locked into association with certain people (no exit). These people can then gain undue power over me, which creates scope for abuse. Such is also the power of monopoly, that is, the lack of competition (no exit).

Hence, ideally, governments should respect the freedom to associate as well as the freedom to disassociate; the freedom to remain independent and pursue one's own goals as well as the freedom to join others for some common cause. The advantage of a free society would be that these freedoms are permitted to counterbalance each other and mitigate each other's negatives. That is why enforced collectivism and enforced isolationist individualism, both of which are typically practised by totalitarian regimes, are an unqualified evil. We will further develop this theme in our discussion of Marx.

Competition as an expression of the right to disassociate is, of course, not an unqualified good. It can also be harmful when it leads to the loss of potentially fruitful cooperation between people or when it produces nastiness or even violence in interpersonal rivalry, as the violence between competing taxi associations in South Africa illustrates. But then cooperation and association between people is also not an unqualified good. It all depends on whether the aim of association is positive or negative. Increased cooperation between people for some charitable cause enhances the welfare of society, but increased cooperation between firms to collude and force up the price of some good damages the welfare of society.

The fact is, there is potentially both conflict and harmony of interest between individuals as well as between classes in society. There is potential harmony because by cooperating and associating people can achieve more. In addition, human beings are social animals which need each other for warmth and happiness. But there is also potential conflict between individuals and classes of society, because, by closer cooperation and association, people increase the scope for harming each other, too.

RELEVANCE FOR TODAY: C

To give an example closer to home, competition from China has virtually annihilated the South African textile and shoe industry. Many South Africans have gained by being able to buy their shirts and shoes for less money, but at the expense of other (admittedly fewer) South Africans who have lost their jobs and income in the textile and shoe-making industry. What is better? The issue remains open to debate.

It seems necessary to admit that there is potentially both a harmony and a conflict of interest between nations. If so, both Smith and the mercantilists seem to have overstated their case for or against free international trade. While international trade is not a zero-sum game as the mercantilists presumed, neither is it necessarily a positive sum game as Smith suggested (although Smith acknowledged that infant industries may need to be protected). The positives of international trade can be unevenly distributed, even to the point of causing net harm to some nations.

When a country is hurt in the short term by free international trade, the free trade argument then points out that a country, when exposed to the winds of competition, will eventually develop competitive strength in some area, just as talented soccer players tend to improve their game when playing consistently against stronger opponents. And there may be merit in the argument.

The current trade policy of the South African government is roughly based on this very idea: the economy is gradually exposed to international competition by reducing its legacy of import protection and export subsidisation (partly because international trade agreements force the government to do so), in the hope that the South African economy will react to this greater competition by eventually developing its own strengths. There are signs that this is indeed happening.

Of course, when countries judge that they benefit from protecting or subsidising their own industries, they risk retaliation by other countries whose exports are negatively affected by such protection and subsidisation. The risk of a trade war needs to be factored in when countries decide on such steps. All in all, trade relations and trade agreements need to be carefully handled – as they indeed are by most modern governments, including the South African government.

RELEVANCE FOR TODAY: D

Even in modern-day South Africa, many people have a view of the nation's wealth as if it were a treasure chest which is somehow always filled to the brim with wealth (a "mass of goods already produced"). Hence, they envision that getting wealthy is merely a matter of getting hold of the key to the treasure chest – the key representing some kind of political or economic power by which its possessor can channel wealth towards him- or herself.

This view of how to get wealthy is, of course, not entirely without merit. The possession of political or economic power can most certainly be an important determinant of people's wealth: political influence can be used to seek rents (see "rent seeking" as discussed under the previous learning unit), and market prices can be manipulated by monopolistic or oligopolistic power.

But the view is also flawed in that wealth is not solely obtained through the exercise of political or economic power, if only because wealth needs to be produced. Treasure chests are not automatically filled with wealth. Basically, wealth creation involves the investment of energy, skill, saved-up resources and entrepreneurship through a cooperative effort between both the owners of firms and their worker-employees.

The inescapable reality is that, if some get rewarded beyond their productive contribution, others must have put in a productive contribution for which they were not duly rewarded. And when productive effort remains unrewarded, it is bound to be discouraged. Therefore, if some section of society seeks to channel wealth towards itself in such a way that the investment of effort, skill, saved-up resources and entrepreneurship gets compromised, production shrinks and everybody suffers.

To some degree, people tolerate making productive contributions without being rewarded for them, also because it is always difficult to gauge objectively what exactly one's due reward is. Nonetheless, there is a limit to such forbearance. If that limit is reached, the continued manipulation of economic outcomes by means of political or economic power will eventually drive an economy towards break-down. Any system can endure a certain amount of abuse, but there will come a point where the extent of the abuse is such that structural damage occurs. The wealth and employment creating ability of an economy will then be compromised to the detriment of all – but especially those with the least resources and skills (others can escape to seek their fortune elsewhere).

The South African economy may still be fairly far off breaking point, but it may be a good idea not to push the system too close to that point. Note that this warning is directed at the powerful in both the private and the public sector.

LEARNING UNIT 2: SELECTED SELF-STUDY QUESTIONS

1. How did Smith's ideas echo those of the physiocrats? In what ways did Smith expand theory beyond those ideas?
2. What is the general theme of Smith's *Theory of moral sentiments*? How does it relate to his *Wealth of nations*?
3. Is Smith's natural price determined by supply, demand, or both? Explain carefully.

LEARNING UNIT

Malthus and Say, Ricardo and Mill 3

MALTHUS AND SAY

STUDY OUTCOMES

When studying this section, you should aim at gaining knowledge and understanding of the following:

- Malthus' population theory: the assumed geometric growth in population and the arithmetic growth in agricultural production
- Malthus' preventative and positive checks to population
- Malthus' views on the Poor Laws and their relation to his population theory
- the relevance of Malthus' population theory for today
- the meaning of Say's law and on what basis the classical authors, Say in particular, thought the law would hold
- Malthus' particular arguments against Say's law, and how he thought aggregate demand failure (a general glut) could be overcome
- the background to Malthus' support for the Corn Laws, the landlords' support for the Corn Laws and the business class's opposition to the Corn Laws
- the reasons why Say's law has less chance to hold in a modern fiat money economy than in the commodity money economy of classical times

Note: When you read the chapter on Malthus, be prepared for the possibility that Malthus' ideas will upset, if not infuriate you; 18th century people were often quite fierce and forthright in the expression of their ideas and Malthus is a prime example. It is hard not to be stirred by Malthus' words and arguments, not only because he says such heartless things but also because the unrelenting growth in the world's population is an issue of enormous concern.

3.1

ACTIVITY

Consider the following contemporary perspectives on Malthus' population theory and the problem of population growth in general:

Population: An underlying theme in addressing some of the world's most challenging problems

Source: The Population Media Centre, http://www.populationmedia.org/issues/population/?gclid=CMySk63qi64CFVE8fAodtF-Ga4w. Accessed 19 March 2012.

The world's population is now [2010] more than 6.8 billion [7 billion was reached in 2012] and continues to grow by 83 million people per year. During the last half-century, the world's population more than doubled. Between 1960 and 2010, the world population rose from 3 billion to 6.8 billion. In other words, there has been more growth in population in the last fifty years than the previous 2 million years that humans have existed. Currently the rate of population increase is 1.2% per year, which means the planet's human population is on a trajectory to double again in 58 years.

The true enormity of a "billion" is important to understand when thinking about human population. For example, if a person is fined a million dollars and ordered to pay $100 dollars per day towards the total due, it would take 27.4 years to pay off the debt. If however, the fine were a billion dollars, the time required to pay off the debt would be 27,397 years. When discussing a billion of anything, one should take a moment to appreciate the titanic size involved.

The extreme growth in human population – now counted by an additional billion people every 12 to 13 years — is mortally taxing the Earth and its resources. Each individual person has a unique impact on the planet's environment. Some people may be relatively less damaging than others, but no living individual is without an ecological footprint. In other words, each person needs basic resources and almost all people aspire to utilise significantly more resources than are required by their basic needs. As these needs and aspirations are multiplied by a factor of 6.8 billion, day after day and year after year, the stability of the planet's ecosphere has been, and will continue to be, severely compromised.

As a result, the Earth is attempting to impose its own checks on human population. We can witness these "checks" in the form of widespread disease and the emergence of new disease strains, food and water shortages, poor harvests and violent and destructive weather caused by climate change. While it should be obvious that the Earth is a finite sphere and cannot endure infinite growth by any single species, we should also remember that Earth's current web of life is the result of billions of years of complex evolution. It is irreplaceable.

Beyond the dour environmental implications of current and future global population growth, there is a human tragedy in process as well. When we look forward to the next 40 years, the most significant population increases will take place in the areas of our world where natural resources and the infrastructure of modernity are already the scarcest. Ninety-five percent of human population growth is occurring in countries already struggling with poverty, illiteracy and civil unrest. In fact, developing countries are in need of approximately $1 trillion per year in new infrastructure (school rooms, for example) to accommodate the dramatic increases to their populations. This figure is effectively impossible to meet, which means the continued expansion of human population will result in an increase in the number of people living in poverty, unemployment and with inadequate health care.

The median projection of population size by the U.N. Population Division suggests that population growth rates will decline over the coming several decades, with a possible stabilisation around the year 2050. But achieving this will take an enormous amount of hard work, creativity and financing – it is by no means a *fiat accompli*. And, even if population is stabilised between 8 and 9 billion, a scenario which becomes less likely with each passing day, the increase to human population will still be between 20% and 30%.

That magnitude of this increase, coming on top of the unprecedented growth that has occurred in the last half-century, will be felt in all aspects of life. It will further stress already strained ecological systems and worsen poverty in much of the developing world, thus aggravating threats to international security.

Population growth is not the only threat facing humanity, but it will be a major contributor to the crises that await us and the planet in the coming century. Overpopulating the planet puts us all at risk of extreme environmental and social consequences that we are beginning to witness today.

The Malthusian Catastrophe (excerpt)

Source: Wikipedia. Accessed 19 March 2012.

At the time, Malthus wrote, and for 150 years thereafter, most societies had populations at or beyond their agricultural limits. After World War II, mechanised agriculture produced a dramatic increase in productivity of agriculture and the so-called Green Revolution greatly increased crop yields, expanding the world's food supply while lowering food prices. In response, the growth rate of the world's population accelerated rapidly, resulting in predictions by Paul R. Ehrlich, Simon Hopkins, and many others of an imminent Malthusian catastrophe. However, populations of most developed countries grew slowly enough to be outpaced by gains in productivity. By1990, agricultural production appeared to begin peaking in several world regions.

By the early 21st century, many technologically developed countries had passed through the demographic transition, a complex social development encompassing a drop in total fertility rates in response to lower infant mortality, more education of women, increased urbanisation, and a wider availability of effective birth control, causing the demographic-economic paradox. Developed and developing countries follow two distinct paths. Most developed countries have sufficient food supply, low fertility rates, and stable (in some cases even declining) populations [while the opposite path applies to developing countries].

David Pimentel and Ron Nielsen, working independently, determined that the human population as a whole has passed the numerical point where all can live in comfort, and that we have entered a stage where many of the world's citizens and future generations are trapped in misery. There is evidence that a catastrophe is underway as of at least the 1990s; for example, by the year 2000, children in developing countries were dying at the rate of approximately 11,000,000 per annum from strictly preventable diseases. These data suggest that, by the standard of misery, the catastrophe is underway. The term 'misery' can generally be construed as: high infant mortality, low standards of sanitation, malnutrition, inadequate drinking water, widespread diseases, war, and political unrest.

Regarding famines, data demonstrate the world's food production has peaked in some of the very regions where food is needed the most. For example, in South Asia, approximately half of the land has been degraded such that it no longer has the capacity for food production.

On the assumption that the demographic transition is now spreading from the developed countries to less developed countries, the United Nations Population Fund estimates that human population may peak in the late 21st century rather than continue to grow until it has exhausted available resources. Some have expressed doubt about the validity of the UN projections, claiming that they are below the projections by others. The most important point is that none of the projections show the population growth beginning to decline before 2050. Indeed, the UN "high" estimate does not decline at all, even out to 2300, indicating the potential for a Malthusian catastrophe.

A 2004 study by a group of prominent economists and ecologists, including Kenneth Arrow and Paul Ehrlich, suggests that the central concerns regarding sustainability have shifted from population growth to the consumption/savings ratio, due to shifts in population growth rates since the 1970s. Empirical estimates show that public policy (taxes or the establishment of more complete property rights) can promote more efficient consumption and investment that are sustainable in an ecological sense; that is, given the current (relatively low) population growth rate, the Malthusian catastrophe can be avoided by either a shift in consumer preferences or public policy that induces a similar shift. However, some contend that the Malthusian catastrophe is not imminent.

A 2002 study by the UN Food and Agriculture Organization predicts that world food production will be in excess of the needs of the human population by the year 2030; however, that source also states that hundreds of millions will remain hungry (presumably due to economic realities and political issues).

Another way of applying the Malthusian theory is to substitute other resources, such as sources of energy for food, and energy consumption for population. (Since modern food production and logistics is energy and resource intensive, this is not a big jump. Most of the criteria for applying the theory are still satisfied.) Since energy consumption is increasing much faster than population, and most energy comes from non-renewable sources, the catastrophe appears more imminent, though perhaps not as certain, than when considering food and population continue to behave in a manner contradicting Malthus' assumptions.

Retired physics professor Albert Bartlett, a modern-day Malthusian, has lectured on “Arithmetic, Population and Energy” over 1 500 times. He published an article entitled “Thoughts on Long-Term Energy Supplies: Scientists and the Silent Lie” in *Physics Today* (July 2004). For a response to Bartlett’s argument, see two articles on energy and population in *Physics Today*, November 2004, and following letters to the editor. A further way of analysing resource limitation is the dwindling area for storage of soil contaminants and water pollution. The high rate of increase in toxic chemicals in the environment (especially persistent organic chemicals and endocrine altering chemicals) is creating a circumstance of resource limitation (e.g. safe potable water and safe arable land).

Ester Boserup wrote in her book *The conditions of agricultural growth: the economics of Agrarian change under population pressure*, that population levels determine agricultural methods, rather than agricultural methods determining population (via food supply). A major point of her book is that “necessity is the mother of invention”. Julian Simon was one of many economists who challenged the Malthusian catastrophe, citing (1) the existence of new knowledge, and educated people to take advantage of it, and (2) “economic freedom”, that is, the ability of the world to increase production when there is a profitable opportunity to do so. The economist Henry George argued that Malthus didn't provide any evidence of a natural tendency for a population to overwhelm its ability to provide for itself. George wrote that even the main body of Malthus’ work refuted this theory; that examples given show social causes for misery, such as “ignorance and greed ... bad government, unjust laws, or war,” rather than insufficient food production.

DEMARCATED READING

At this point you should read all of **chapter 6**, and in **chapter 8**, only the section “Say’s Law of Markets” (2013:141–142) [2007:130–131].

CONTENT

Chapter 6 on Malthus is clearly written and you should have little difficulty understanding it. A possible exception is the section on Malthus’ theory of market gluts (his rejection of Say’s law) for which we will provide some additional explanation. Do pay particular attention to the historical background of the Corn Laws (2013:91– 92) [2007:85– 86]; follow up further references to the Corn Laws in the index). We will come back to the Corn Laws in our discussion of Ricardo in the next section.

The weakness in Malthus’ “dismal” population theory was, of course, that he seriously underestimated the potential for productivity increases in agriculture. When we talk about the productivity gains of industrialisation and mechanisation, we are inclined to think that these were mainly confined to manufacturing. But this was by no means the case.

Mechanisation also revolutionised agriculture. For instance, the introduction of mechanised ploughing and sowing in the course of the 19th century made large-scale agriculture on the vast American plains possible, which improved productivity enormously. In more recent years, better seeds, fertilisation, irrigation and pest control have also dramatically improved productivity (the Green Revolution), although it has also made agriculture more capital-intensive and, therefore, more risky (which is particularly problematic in the unstable climatic conditions of South Africa) as well as more dependent on fossil fuels. Malthus did not foresee and could not have foreseen such trends. Generally speaking, it has been the staggering increases in agricultural productivity over the years that have enabled the earth to sustain its alarmingly increasing population. There is, however, reason to believe that the scope for increased productivity in agriculture will at some stage get saturated, which would mean that Malthus may, after all, be proven right. See the two readings in activity 3.1 above.

You should study the section in chapter 8, "Say's law of markets" (2013:141–142) [2007:130–131] simultaneously with Malthus' theory of market gluts. Malthus was of the opinion that aggregate effective demand could fall short of aggregate supply, thus leading to a contraction in aggregate output (a market glut). By contrast, the French classical economist, Jean Baptiste Say, argued that aggregate effective demand would always be sufficient to buy up aggregate supply (total production), an idea which Keynes (1936) attributed to Say and hence labelled "Say's law". Most of the classical authors, including Ricardo and John Stuart Mill, subscribed to Say's law (2013:126–127) [2007:116–117]. The current opinion among historians of economic thought is that Keynes was incorrect in attributing the law to Say. It was in all likelihood not Say, but John Stuart Mill's father, James Mill, who first formulated the law. We explore the meaning of Say's law in somewhat more depth, because it still plays an important role in contemporary debates on macroeconomic issues.

The law is most commonly expressed as "supply creates its own demand", meaning that total income created during a given production round is sufficient to buy up the production of that same production round. Notice that Say's law does not claim that the very act of supplying an individual good will create a demand for it. That would mean that producers are always guaranteed of selling whatever they produce, which is nonsensical. No, Say's law applies only to the aggregate level. It claims that *aggregate* supply creates its own *aggregate* demand, which may not be quite so nonsensical. To appreciate the logic of Say's law, call to mind the circular income-spending stream of your first-year macroeconomics textbook. Take as your starting point all those in the economy who, at a given moment, spend money on buying goods. Their spending will create income for the sellers of these goods. If these sellers subsequently spend their entire recently earned income on buying goods again, total demand for goods will sustain itself at an unchanged level. If that level were originally sufficient to buy up total production and there was no increase in output (no economic growth), the re-spending of all income would guarantee that there would be no market glut. Say's law holds. While the demand for some individual good may be more than what is supplied and the demand for another individual good less than what is supplied, overall demand for all goods will be more or less sufficient.

The problem comes in when people do not fully re-spend their income, which would mean that they hoard more money or spend more money on non-recently produced goods (second-hand goods, secondary financial assets, existing real estate or imported goods). These would constitute a leakage from the recently produced goods circulation, causing total demand for recently produced goods to fall and Say's law to fail. The classical economists like Say were aware of the possibility of increased hoarding. But they reasoned that total hoarding would never increase indefinitely. Because people do not hold money for its own sake but to buy goods with it, hoarding levels would at some stage come down again, and total spending would be restored to its original level (Brue & Grant 2013:141–142) [2007:130–131]. While Say's law may thus fail in the short run, it will hold in the medium to longer term.

Another possible reason for the failure of Say's law would be that the growth in the money stock would not keep up with the growth in total output and the total volume of trade. The

classics would then reason that economic growth would not be so fast that coin production (gold and silver mining and minting) could not keep up with it. And even if coin production could not keep up, a shortage of money would cause a fall in the general price level, thereby effectively increasing the *real* supply of money. Large increases in the volume of trade in non-recently produced goods were probably also unlikely in classical times, because financial markets were still relatively small and trade volumes in real estate low. Hence, in classical times under a commodity money system, Say's law was not such an unreasonable proposition.

A commodity money system refers to a system where money is either a commodity itself like gold or silver coin, or a claim on such a commodity like notes and deposits issued by a bank (otherwise called "bank money"). Under a commodity money system, bank money is thus convertible into gold or silver coin, even if it need not be 100% backed by gold and silver coin. The type of money into which bank money (notes and deposits) is convertible is also referred to as "cash", "currency", "base money" or "the monetary base". Under a commodity money system, cash thus consists of gold and silver coin.

Under a contemporary fiat money system, cash no longer consists of gold or silver coin but of the bank money issued by the central bank: notes, token coin and deposits (the central bank issues its deposits only to banks and the government, not to the public). Moreover, this cash is no longer convertible into gold or silver coin, but does function as legal tender. In other words, the legal tender is now inconvertible, which is why it is called "fiat" money. The deposits that commercial banks issue to the public, which makes up the bulk of the total money stock (often more than 90%), is still convertible. But commercial-bank deposits are not convertible into gold or silver coin, but into the inconvertible legal tender (notes and token coin) issued by the central bank. Almost all money, under a modern fiat money system, is created when commercial banks grant credit to the nonbank sector, in the process of which they issue more deposits to nonbanks. If you want to understand more about such issues, pursue a course in *monetary economics* or in *money, banking and financial markets*.

There is a much reduced likelihood that Say's law holds under a modern fiat money system than under the commodity money system of classical times. The reason is that, under a modern system, the income-spending stream is subject to more, and larger, injections into it and leakages from it. Money gets created when banks grant credit to the nonbank public, which would be an injection. But money gets destroyed again when the public services its loans (pays interest and repays principal), which would be a leakage. Hence, when there is a net increase in bank lending (people take up more bank loans than they repay) the money stock increases, which is an injection. And when there is a net decrease in bank lending (people repay more bank loans than they take up bank loans – as recently happened during the subprime crisis) – the money stock falls, which is a leakage. The main point is that the public's desire to demand credit from banks depends largely on inherently unstable future expectations; people take up more bank loans when they are optimistic about the future, but repay more of their bank loans when they are pessimistic about the future. This dependency on unstable future expectations causes the total money stock to fluctuate more strongly under a fiat money system, which will also cause total spending to be more unstable. Another potentially important leakage under a modern fiat money system is formed by increases in the volume of trade in non-recently produced goods, including secondary financial assets, second-hand cars, and existing real estate, which can be quite large and variable. A deficit on the balance of payments will equally reduce the money stock and form a leakage, just as a surplus on the balance of payments will form an injection.

The fact that Malthus is right in claiming that Say's law does not necessarily hold and that market gluts can occur, does not mean that his reasoning as to why Say's law fails and how market gluts can be avoided, are necessarily correct.

When they reasoned about Say's law, the classical economists, Malthus included, tended to picture the economy as having perfectly synchronised production rounds of equal length. In

other words, all firms start producing at the same time, pay wages at the same time, and start selling their finished output at the same time. It would then appear that the finance to buy up the output of the current production round consists of nothing more than the wages paid out during the current production round. If so, entrepreneurs are prevented from making any profit even when workers spend their wages in full (no leakages). Because these wage payments are a cost of production for firms, the following must hold for the firm sector as a whole: aggregate demand for goods = cost of producing these goods.

If so, firms can at best earn back what they previously paid in wages and demand is never sufficient for firms to make a profit (profit = 0). As a result of not making a profit, firms would not be inclined to invest and economic activity would stagnate. That was the problem as Malthus saw it. We will notice below how Marx saw a similar problem. According to Malthus, the only way for firms to make a profit and to avert stagnation was to find a source of demand for their goods, which is not a cost of production for them. A good candidate is the demand financed out of the rent income of landlords (2013:97–100) [2007:91–95]. Hence, the higher the rent income of landlords, the better the chances that Say's law holds and that total spending in society is sufficient to buy up total production and leave a profit for firms. That was the solution as Malthus saw it, and the background to his support for the Corn Laws.

Malthus' argument fails on several counts.

First, the relevant finance to buy up current output consists not only of wage income but also of realised entrepreneurial profit. When production rounds are seen as perfectly synchronised, these profits are less visible because realised by selling the output of a *previous* production round. In the more realistic situation of a large number of unequal production rounds beginning and ending at any time, profits continually become available as finance for spending. When these profits together with wage incomes are fully re-spent, there is obviously enough demand to buy up current output and leave an equal amount of profit – provided we abstract from output growth.

Second, there is no such thing as income which is not also a cost of production for the firm sector. Given that land cultivators are part of the firm sector (they too run business enterprises), the rent they pay to landlords is also a cost of production for the firm sector. Thirdly, what contributes towards aggregate demand is not the spending of income-which – is-not-a-cost-of-production (such income does not exist), but (1) reductions in aggregate hoarding levels, (2) reductions in spending on non-recently produced goods (second-hand goods and assets), and (3) increases in the total money stock. The total money stock increases (a) when additional gold or silver coins are produced (no longer relevant), (b) when credit extension by banks to the nonbank sector (including government) increases, and (c) when there is a surplus on the balance of payments.

The possible failure of Say's law and the resultant occurrence of insufficient aggregate demand is, of course, mainly what modern Keynesian macroeconomics is about. The main aim of modern monetary and fiscal policy is indeed to try to counteract the various monetary disturbances so as to ensure that Say's law does not fail, or fails minimally, and that aggregate demand is maintained at more or less the level of aggregate supply (no "output gap").

The prescribed textbook's (2013:100– 104) [2007:95– 97] "Assessment of Malthus' contributions" neatly sums up the strong and weak points in Malthus' various arguments. Have a careful look at it.

LOOKING BACK AT ACTIVITY 3.1

Malthus' economics is disturbing. He says some very rude and uncomfortable things. But it does seem that, when it comes to population growth, his ghost is still hovering over us. A world of limited space and resources cannot sustain an exponentially growing population, especially if a third of that growing population is starting to industrialise for the first time, as China and India now do. At some stage we are bound to hit some hard limits. What will happen then? Nobody knows for certain, but the best estimates do not look attractive.

RICARDO

STUDY OUTCOMES

When studying this section, you should aim at gaining knowledge and understanding of the following:

- Ricardo's "abstract reasoning" and his deductive method as opposed to the inductive method
- the nature of rent
- how rent emerges at the extensive margin of cultivation in Ricardo's theory of rent
- why "rent is price-determined, not price-determining" in Ricardo's theory of rent
- the focus in Ricardo's theory of exchange value on relative price rather than absolute price, and on long-term natural price rather than short-term market price
- how, in Ricardo's theory of value, the long-term natural price is determined by supply factors (cost of production as measured in labour hours) and the short-term market price by both supply factors (cost of production) and demand factors (utility)
- the role which Ricardo's (contrary to Smith's) theory of value assigns to utility
- how Ricardo's (contrary to Smith's) theory of value includes capital and raw material in the cost of production measured in labour hours
- the problem of differing capital-labour ratios in Ricardo's theory of value
- the problem of differences in labour quality in Ricardo's theory of value
- why changes in the wage rate, profit rate and rent rate do not affect relative exchange value in Ricardo's theory of value
- why profits and wages vary inversely in Ricardo's theory of value
- the determinants of the natural wage rate, and the reasons for its long-term tendency towards subsistence level (the "iron law of wages") – in Ricardo's theory of income distribution
- the determinants of the natural profit rate, its tendency towards equality in all sectors, and the reasons for its long-term decline – in Ricardo's theory of income distribution
- the determinants of the natural rent rate, and the reasons for its long-term rise – in Ricardo's theory of income distribution
- graphical illustration of the long-term tendencies in the wage rate, profit rate and rent rate
- how Ricardo's theory of income distribution suggests a conflict of interest between workers and capitalists as well as between landlords and the rest of society
- why, according to Ricardo, the introduction of a tax on rent does not raise the price of agricultural output, and how this idea was taken up by Henry George
- Ricardo's opposition to the Poor Laws and the Corn Laws
- Ricardo's views on the benefits of free international trade
- Ricardo's theory of comparative advantage and the role which the concept of opportunity cost plays in it
- Ricardo's views on the influence of mechanisation on real wage and employment levels, and why they are largely incorrect.

3.2

ACTIVITY

In Ricardo's days, the Industrial Revolution was in full swing and busy changing the social landscape of England. One of the questions that Ricardo addressed was whether the introduction of increasingly sophisticated machinery is in the interest of workers, that is, whether it raises wage rates and employment levels. This question has obviously never lost its relevance and controversial edge. As an introduction to the topic, consider the following fictitious discussion between two Unisa economics students, John and Tandi, who are enjoying some drinks on the terrace of a restaurant while basking in the African sun.

John: *I hear you are enrolled on a course on the history of economic thought. How are you finding it?*

Tandi: *Fascinating and boring in parts. One of the more interesting parts is about this English dude called Ricardo who has been dead for a century and a half.*

John: *Gee, if he has been dead for so long, how can he be interesting? By the way, I am having another drink. Would you like to join me?*

Tandi: *No thanks, not now; I may have later. No, he is interesting, although some of his stuff takes some time and effort to get to grips with. For example, he discusses the very question that we were talking about the other day, namely whether machines replace people and so take away their jobs.*

John: *Correct, I just heard of a firm that built a brand-new bottling plant, which produces millions of beer and cool drink bottles a year but is operated by only six people sitting behind computers. The rest is all conveyor belt, machinery and robots. Not even that long ago the production of that number of bottles would probably have given employment to at least a hundred workers. Clearly, machines replace workers, all because the bosses want more money. And mechanisation has the added advantage for these fat, cigar-smoking capitalists that machines do not go on strike, so that they do not have to bother with unions. It is all too cynical!*

Tandi: *Hey John, be careful not to offend some of your own heroes. Is Fidel Castro not also somewhat heavy around the middle and does he not also smoke cigars? Jokes aside, I understand your sentiment. But the issue is just more complicated than what you make it out to be. First, that new bottling plant easily halves the cost of producing a bottle, so that the drink that you just ordered for yourself is now cheaper. You have already benefitted from the new technology! Second, can anybody stop technological advancement? I mean, your brother is studying engineering. You can't prevent clever people from thinking up better ways of doing things, can you?*

John: *No, I suppose not. But why should clever people necessarily think up the type of things that reduce employment, spew more CO_2 in the air and raise the dominance of big corporates over our lives? Why can't they apply their clever minds to things that increase employment, make the production process cleaner, and raise the advantage of the small operator with less capital resources over the big corporation with access to limitless amounts of capital? It is invariably the big corporations that buy and utilise these new technologies, increasing their grip on our lives ...*

Tandi: *You are getting a bit carried away now, John. But, in fact, there are recent technological developments that do make it easier for smaller companies to challenge the bigger guys. An example is the ever cheaper and more powerful PC. But let's not go there now; you can entertain your engineering brother with that issue. Let's return to the main question: is this seemingly unstoppable trend towards mechanisation and automation to the detriment of workers? You seem to say: definitely it is. I say: it depends.*

John: *On what?*

Tandi: *Well, it depends on various things. The point is that techno advances both create jobs and destroy jobs. They destroy jobs because machines can replace workers – we already established that. But they also create jobs because they open up new markets and arouse new needs in people.*

John: *Yes, typically capitalist … big companies forcing stuff on people that they don't really need ...*

Tandi: *Well, yes and no (that's what an economist would say, wouldn't she?). Take television and motor cars. I know you enjoy your TV soapies and your leftist leanings have never prevented you from positively lòòòòving fast cars. A century ago virtually nobody was employed in the motor industry and complementary industries like repair workshops, the oil industry, and road construction. And virtually nobody was employed in the electronics industry as well as the entertainment industries that create content for TV. There you have technologies, which created enormous numbers of new jobs. But, mind you, at the time they also destroyed jobs. The advent of the car probably meant that many a horse breeder and ferrier (horseshoe-maker) lost his livelihood. Come on John, did the big corporates really create your desire for fast cars and TV entertainment? These desires were certainly latent in you!*

John: *Granted. But not all techno advances open up new markets by meeting new needs, such as cars and TVs did. Most new technologies merely save labour in the production of existing products, which serve existing needs, like that new high-tech bottling plant that I mentioned. In that case, there are only job losses – no job creation at all. Have there recently been any techno advances that actually opened up entirely new markets by meeting entirely new needs, like the motor car or the TV did?*

Tandi: *There have not been many, but the IT revolution was certainly a highly significant recent one. It created all sorts of new jobs like software writers, website designers, PC skills trainers, IT managers, and the like. These jobs meet needs that previously did not exist at all. Definitely a case of a new technology opening up an entirely new market, otherwise referred to as a "technological revolution"; so there was a motorcar revolution, a household electronics revolution and now an IT revolution. And even if, like in case of your bottling plant, the techno-advances are not revolutionary and do not open up new markets, the monetary savings that people make in buying cheaper bottles means that money is freed up to be spent on other things, like restaurant visits, further education or weekends away, which will create additional jobs elsewhere. I mean, money needs to be spent on something! Automation and mechanisation may destroy jobs in the manufacturing sector, but new jobs may spring up in other sectors, like services. As long as there is enough money to go around, other jobs will emerge. Furthermore, many economic activities do not lend themselves to mechanisation and automation and will always be fairly labour-intensive, like construction (building houses, roads and the like), agriculture, mining, and services like entertainment, hospitality, education and tourism. Without any need for technological revolutions, employment in these sectors can keep on steadily growing as long as there is enough money, and demand keeps on growing at a sufficient pace.*

John: *Now it is my turn to show off some of my economics knowledge: that growing demand requires that Say's law holds (no serious net leakages from the circulatory income-spending stream) plus that the money stock grows at a pace, which keeps up with productive capacity. This raises further issues about how to grow the money stock without it being inflationary and without people getting into too much debt, which I will leave for now. The question remains though: will it be enough? Will we, as a country, be able to create enough employment?*

Tandi: *Well, again, it depends. Three factors probably play a role: (a) how well educated, (b) how flexible and (c) how entrepreneurial the population is. Obviously, every new technology makes new and often greater demands on the skills of its work force. Let's discuss them in turn. As for education, if our country is to benefit from any new technologies, we must make sure that our people become better educated, especially in the science, technology and engineering fields. Otherwise South Africa loses out and the jobs go elsewhere. Whether we like it or not (and it does not help crying about it): in this globalised world economy, you have to stay with the best or you are left behind. As for flexibility, this is important because the pace at which old types of jobs will be lost and opportunities for new types of jobs will emerge, will probably increase.*

People must increasingly be able and willing to redirect, relocate and re-school themselves. And entrepreneurship is important, because in an increasingly changing world, one needs even more alert and astute entrepreneurship. As you will remember from your Economics I course, an entrepreneur is somebody with the willingness and ability to create jobs for more people than only him- or herself. The entrepreneur does so by developing a vision for a new selling opportunity (either an entirely new market or a gap in an existing market), and by bringing people and resources together in such a way that this opportunity is realised at a profit. You may not like the idea of profit (for you lefties, it sounds too much like greed), but nobody can be expected to lose money in the process of creating jobs for others.

John: *Yes I do worry about the greediness of business, but I take your point. And there is something else: a very large section of our people is low- or unskilled. You are not going to turn them into medium- or high-skilled people overnight. It will take an entire new generation! What are you going to do about them?*

Tandi: *Paradoxically, most job opportunities for low- or unskilled workers still lie in the manufacturing sector: the sector that makes things, commonly with machines. Somehow we will need to find ways of making it profitable and worthwhile for businesses to move into manufacturing and compete successfully in our own and foreign markets with foreign firms.*

John: *Yeah, and that means that you will probably want to create sweat shops where people work long hours for hardly any money – like what happens in China.*

Tandi: *That is a bit of a caricature, John. Be fair: far from all Chinese manufacturing is done in sweat shops. Nonetheless, I take your point. The problem is, if developing countries without a high-tech manufacturing base want to compete on world markets, they often have no choice but to pay low wages and concentrate on low-tech, labour-intensive manufacturing. That is often the only way to get a foot in the door. Once such countries have established themselves and have accumulated more capital and skills, they can gradually move into more high-tech manufacturing, which will then allow them to pay higher wages too. In other words, a low-wage policy may just be a necessary but temporary phase. Countries like Japan and Korea have shown how economies can move beyond that phase into more high-tech and higher wages. China seems to be fast moving in that direction too.*

John: *I do not, for now, have an argument to counter you, but I just do not like the sound of that at all. Low wages will further increase the gap between rich and poor in this country, which is already unacceptably wide. There must be other ways.*

Tandi: *You may be right. But that will mean that South Africans will just have to up their game and be more resourceful and entrepreneurial. They will have to find new ways of doing business in this ever-changing world, new ways of creating employment without putting their workers in sweat shops. Come to think of it, that actually fills me with hope. South Africans of all races have a history of rising to the challenge when the chips were down. Necessity is the mother of invention. We may just have what it takes, although it will not be easy.*

John: *I agree.*

Tandi: *Finally some agreement! Let's drink to that. You can order me that drink now.*

DEMARCATED READING

At this point you should read all of chapter 7, excluding "The currency question" (2013:109–110) [2007:101–102], "Rent at the intensive margin of cultivation" (2013:112–114) [2007:104–105] and "7-1 Past as prologue" (2013:118–119) [2007:109–110]

CONTENT

Some of you may find the chapter on Ricardo (chapter 7) slightly more challenging than other chapters, so we will attempt to clarify a few things in a bit more detail.

The prescribed textbook (2013:107) [2007:99] refers to Ricardo as having "demonstrated the possibilities of using the abstract method of reasoning to formulate economic theories". What is the abstract method of reasoning? Roughly speaking, it is the method whereby the theorist stylises real-life human behaviour in such a way that it becomes regular and determinate, meaning that a certain change in the circumstances of the relevant people will always have the same definite and predictable effect on their behaviour. This stylisation involves mainly two things.

First, it requires the "restrictive assumption" (2013:109) [2007:101] that only one aspect in the environment of the relevant people changes, and that all other aspects remain the same. As a result, there is no external interference with the assumed causal mechanism: a certain effect is attributed to only one cause, whereby all other possible causes for the same effect are assumed unchanged. Such is the essence of the so-called "ceteris paribus" clause. For example, when the abstract method attributes a change in price to a change in demand, all other possible variables that can potentially influence price (like changes in income or in the price of complementary goods) are assumed to remain unchanged.

Second, the stylisation involves assuming that the change in people's environment, say a change in demand, has a uniform effect on their behaviour, say the relevant agents effect a change in price. What this requires, among other things, is that people are uniformly motivated by only profit or utility, and that they are perfectly rational and knowledgeable about how to pursue that motive. In other words, they behave like what has come to be known as "the economic man" or *homo economicus*.

Because in the real world the ceteris paribus clause cannot always be relied upon and people do not strictly behave like economic men, the results of the abstract method must be treated with a degree of caution.

These two stylisations need not make abstract theory completely useless or unrealistic. Changes in demand may still have the predicted effect on price, but it is just that demand may not have changed very much, that other influences on price have overshadowed it, or that demanders have been motivated by other things besides maximising their utility. When it comes to their behaviour in the market place, people are roughly and broadly motivated by profit or utility, even if they may not maximise it to the absolute limit. We come back to these issues in learning unit 5 when discussing neoclassical economics.

The prescribed textbook (2013:108–109) [2007:100–101] mentions the difference between inductive and deductive reasoning. Inductive reasoning argues from the specific to the general. For example, by observing many specific instances of elephants, we could on the basis of inductive reasoning arrive at the general conclusion that elephants have trunks. By contrast, deductive reasoning draws logical implications from general principles, which are then applied to specific circumstances. These logical implications are considered valid by virtue of the assumed validity of the general principles from which they were drawn. For example, on the basis of the general rule (or law) that all elephants have trunks (and that no other animals have trunks) the validity of which is taken for granted, it could safely be inferred that any specific animal with a trunk is an elephant. Ricardo favoured the deductive style, in that he

was inclined to argue from some sweeping general law, which he took as almost self-evidently true. Nor was he shy about applying such a law to any specific historical instance. But because these laws were often obtained by a high degree of abstraction (see previous paragraphs), they were unfortunately not always generally applicable, although they may have been applicable to the specific historical case for which Ricardo used them.

The section on the "Currency Question" is ***not prescribed***.

We move on to Ricardo's Theory of Diminishing Returns and Rent (2013:110–112) [2007:102–104]. In order to understand this theory, you must have a clear grasp of the meaning of the concept of rent. Rent refers to land rent: it is the productive value of land expressed as a monthly or annual income which land owners can extract from their land. As such, rent would also be the money that tenant-cultivators pay to the landlords for the right to till the land. Such tenant-cultivators would normally not be in the employ of landowners. They would be independent farmers with their own farming businesses, except for the fact that they rented the land and some of its infrastructure from landowners.

Rent thus reflects the value and relative scarcity of land's productive contribution. As a result, when land is in superabundant supply, rent would be zero. As an example of land superabundance, imagine the situation of a large uninhabited island where a limited number of settlers first set foot on land. In such a situation of land superabundance, the price of agricultural products grown on land would merely contain the cultivators' input cost as well as a reward for their labour, but no rent. However, settler-farmers would obviously start to cultivate the best land first – land that is most fertile and closest to their market. That best land would, therefore, soon become scarce, which means that it would start to earn rent.

The logic of how the scarcity of the best land causes it to earn rent goes as follows. As the population of the settlement grows and the demand for agricultural products increases, all the best land would soon be used up and settler-farmers would need to bring second-best land under cultivation – land that is less fertile and/or further away from the market. But the lower fertility or greater distance from the market of that second-best land means that its production costs for a given unit of output are higher. This increase in cost of production would necessitate a rise in the price of agricultural output if the second-best land is to be put under cultivation. Such a price rise, however, implies that agricultural products grown on the best land, which have lower production cost, now earn additional profit – profit in excess of the cultivators' input cost and a normal reward for their labour. That additional profit is rent. Given the competitive relations between landowners and their cultivator-tenants, that rent is presumed to end up in the hand of the landlords as rent payments rather than as additional profit for cultivator-tenants.

The prescribed textbook explains the principles of Ricardo's rent theory with reference to the extensive and the intensive margin of cultivation, which are quite similar. The case of rent at the intensive margin of cultivation (2013:112–114) [2007:104–105] is ***not prescribed***. You can concentrate on the case of rent at the extensive margin of cultivation, which is illustrated by table 7-1 (2013:112) [2007:103].

This table may appear complicated at first inspection, but it really just illustrates the logic of rent as explained in the previous paragraph. The various rows show different prices of wheat per bushel, ascending from $0.50 to $2.50 per bushel. The various columns show different grades of land, grade A being the best land and grade E the worst. The inputs into the harvest of each grade of land are the same: they cost $10 including an amount of "normal" profit. But these same inputs yield different outputs, 20 bushels per acre for grade A land descending to 4 bushels per acre for grade E land. Now look at the row which represents an output price of $0.50 per bushel. On the best land (grade A), farmers will make 20 x $0.50 = $10, which is just sufficient to cover the input cost of $10 which includes normal profit. Hence farmers of grade A will just break even, and their excess profit = 0 as indicated. At that price no lower grade land will be cultivated at all, because it will make a loss; hence no numbers

are indicated for lower grade land. Take the next row when the price is $0.66⅔. The sales income of farmers on grade A land will then be 20 x $0.66⅔ = $13.33. Subtracting the input cost of $10, these farmers will earn an excess profit of $3.33 as indicated on the table. That excess profit is rent. At the price of $0.66⅔ per bushel, farmers on grade B land will realise a sales income of 15 x $0.66⅔ = $10, which is just sufficient to cover input cost (and a small amount of normal profit). No excess profit and hence no rent. Cultivation of lower grade land (C, D and E) will not happen at that price because yielding a loss. You can repeat the same exercise for the rows representing an output price of $1.00, $2.00 and $2.50 per bushel. As the price rises you will notice how intra-marginal land earns an increasing amount of excess profit (= rent), but how marginal land just breaks even (rent = 0).

To sum up, the main points of the table are these: (a) rent is excess profit (profit over and above normal average profit) on intra-marginal (better) land, (b) as populations increase and more land needs to be put under cultivation to feed more people, the price of agricultural output must increase to induce the cultivation of lower grade land, (c) as the price of agricultural output rises, rent on intra-marginal, higher grade land increases. Ricardo was the first of the classical economists to recognise the importance of the marginal principle, witness the roles which marginal land (least productive, non-rent earning land) and intra-marginal land (more productive, rent earning land) plays in his analysis.

Take note of the central conclusion of the Ricardo's rent theory, which enters crucially into the discussion surrounding the Corn Laws: "Rent is price determined, not price determining. That is, high rents are explained by high grain prices; high prices cannot be explained by high rents." How could Ricardo arrive at this conclusion?

In its final assessment of Ricardo, the prescribed textbook (2013:128– 129) [2007:117– 118] argues that Ricardo could ignore the influence of rent on price, because he (Ricardo) assumed a single use of agricultural land, say grain production. There being no alternative uses, the opportunity cost of grain production is zero. As an opportunity cost of land use, rent is therefore zero; so it cannot influence price. This reasoning seems questionable.

Opportunity cost, as you know, is the benefit foregone on the next best application of a scarce resource. As such, it may determine the decision on how a scarce resource is to be allocated in preference to its alternative uses. But because it is not an actual cost incurred (it is a profit foregone), opportunity cost does not normally enter into the cost of production, in which case it will anyhow not influence output price. As the textbook confirms in its discussion of opportunity cost (2013:262) [2007:247], not prescribed): "[I]t is not at all clear that this idea [i.e. opportunity cost] explains anything fundamental about exchange value [i.e. price]." If it is granted that opportunity costs do not influence price, the fact that they are zero has little to do with why rent has no influence on price.

The real reason why rent does not influence agricultural price is much simpler. It is that Ricardo assumes "marginal cost pricing" of agricultural products (price = marginal cost), while rent is not part of the marginal cost of the land cultivator. Rather it is a fixed cost, which remains the same, irrespective of how much the land cultivator produces on his parcel of land. But, as standard price theory teaches us, marginal cost pricing presupposes perfect competition in the relevant market, with suppliers having no influence over price (see your second-year microeconomics textbook). If, however, the market for some agricultural crop were less than perfectly competitive, the cultivator-suppliers in that market may be able to exercise some influence over price, which will then be determined on the basis of "average cost plus mark-up" rather than marginal cost. Because rent is calculated as part of average cost (total cost divided by quantity produced), rent will then impact price.

Moreover, in Ricardo's theory, rent is really a kind of producer surplus (see Brue and Grant (2013:306) [2007:287], learning unit 5, or any second-year micro textbook), which, assuming perfect competition in the output market, accrues to the producer: in our case, the land cultivator. In Ricardo's theory, rent accrues not to the land cultivator but to the land owner.

The implicit assumption thereby is that land owners have such a strong competitive position vis-à-vis land cultivators that the latter cannot earn more than just an average, normal profit. All excess profit, which is what rent is, is presumed to be extracted by land owners. One could, however, also imagine situations where land cultivators do have some bargaining power vis-à-vis land owners, so that at least some of the rent-as-excess-profit goes to them as well.

Ricardo and Smith's theories of exchange value are quite similar. Both wished to explain the long-term natural price of a good, rather than its short-term market price. And both intended their theory to explain relative rather than nominal prices, that is, not why a cup of tea costs R2 and a cup of coffee R3 but why the price of a cup of tea relative to coffee is 2:3. Ricardo, however, used the labour theory of value, not so much to explain relative price ratios themselves but *changes in relative price ratios*, or in the textbook's terms "*changes in exchange values over time*" (2013:115) [2007:106]. Hence when the price ratio between a cup of tea and the cup of coffee changes from 2:3 to 2:2 (or 1:1), it means that the number of labour hours that go into producing tea relative to coffee has decreased such that it now takes the same number of hours.

Many of our comments on the weakness of Smith's labour theory of value in the previous chapter are applicable to Ricardo's as well. There are, however, a few differences (2013:114–117) [2007:105–108].

First, while Smith denies that utility can have any influence on exchange value, Ricardo acknowledges that the possession of utility (use value) is a precondition for a good to have exchange value, even if utility is not a measure of that value. As a result, the greater usefulness of a good still does not, according to Ricardo, mean that its exchange price will be higher. Only the value of non-reproducible goods can be so influenced by utility, simply because the supply of such goods is fixed, with the result that demand factors (utility) will have to determine value. But for reproducible goods, Ricardo maintains that supply factors (cost of production as determined by labour cost measured in labour hours) will be the dominant force determining exchange value. Bear in mind, however, that Ricardo's theory was intended to explain long-term natural prices, which are indeed likely to be mainly determined by cost of production, as we also indicated in our discussion of Smith's theory of value in the previous learning unit.

Second, Ricardo had a somewhat different way of dealing with the problems posed by a labour theory of value. Once again, these problems stem from the fact that labour is obviously not the only production factor and, therefore, not the only source of production cost. Because capital and land can also contribute towards production, they can also create cost and, as such, influence price. How does Ricardo get round these problems? The answer is: with great difficulty.

Ricardo attempted to include the cost of machinery and raw material by valuing their productive contribution in labour hours too, that is, the labour hours that went into producing that machinery and raw material. We will see in the next learning unit how Marx follows Ricardo in this respect, calling the labour embodied in machinery and raw material "dead labour", and the labour embodied in existing workers "life labour". For example, if a coffee-roasting machine costs 300 hours to produce and the roasting of 1 kilo of coffee causes wear and tear on that machine of one thousandth (1/1000) of its lifetime, then this machine would add 0.3 labour hour to the value of 1 kilo of roasted coffee. The implicit assumption is that the productive contribution of a machine is exactly proportional to the number of hours that went into producing it, which does not seem obvious at all. Similarly, if the average 1 kg of raw coffee beans costs 0.5 labour hours to farm and transport to the roasting factory, then the raw material of coffee will add 0.5 hours to the value of 1 kg of roasted coffee. The problem with this treatment of raw material is that coffee beans are not entirely produced by farmers and transporters, but also by nature: the soil, the sun, and the miracle of spontaneous

growth in plants. The contribution of land (or nature in general) cannot be reduced to the contribution of labour only.

The prescribed textbook mentions a couple of further problems with Ricardo's theory of exchange value.

First, goods that require the same amount of labour time to produce, but are produced with differing amounts of capital, yield differing profit rates (profit/capital). You, the student, may react with: so what? The problem is that the existence of differing profit rates conflicts with another part of classical theory, making classical theory internally inconsistent. That other part, upheld by both Smith and Ricardo (and Marx), is that profit rates should tend towards equality in all sectors. Brue and Grant (2013:115– 116) [2007:106– 108] use an example to illustrate how profit rates may differ in Ricardo's value theory, which seems unnecessarily complicated. There is a reason for this complicatedness, which need not be further explained here. The possibility of differing profit rates in Ricardo's theory can be illustrated in a much simpler way. Imagine two different goods, a car and a (small) house. These two goods are obviously produced in different sectors with different amounts of capital used, but they happen to have the same Ricardian value: 25 labour hours, which is made up of 20 hours of production cost plus 5 hours of profit. When the car manufacturer has a larger balance sheet (uses more machinery) than the builder, their profit rates (profit/capital) are obviously different. Differing capital/labour ratios thus lead to differing profit rates, which is a problem if profit rates should tend towards equality.

Second, the prescribed textbook (2013:116) [2007:107] also mentions the fact that a labour hour need not reflect the same amount of productive effort and skill in all sectors. And these differences in effort and skill need not be perfectly compensated for by differences in the wage rate.

All in all, Ricardo's labour theory of value requires many qualifications, assumptions and amendments for it to be applicable. Such is what happens when the basic premise of your theory is already wrong: in Ricardo's case, that market price is determined by cost of production measured in labour hours only. If you start with the wrong premise and then wish to make your theory applicable to real-world situations, you will always need lots of qualifications, assumptions and amendments.

The whole aim of Ricardo's value theory was then to show how changes in relative prices reflect changes in relative labour time, whereby changes in the profit rate, wage rate or rent rate do not influence the relative prices thus established (2013:116–117) [2007:107–108].

Changes in the profit rate do not cause changes in relative prices if the average profit rate and the average capital-labour ratio are the same in all sectors – as Ricardo assumes. To illustrate Ricardo's reasoning, take the example of the cost of producing 1 kg of tea and 1 kg of coffee. Their relative price is, for argument sake, ⅔, meaning that the number of labour hours spent in the production of 1 kg of tea is ⅔ of the number of labour hours necessary to produce 1 kg of coffee. The cost of producing 1 kg of tea and 1 kg of coffee can be expressed as CoP_{tea} and CoP_{coffee} respectively. CoP_{tea} and CoP_{coffee} include the depreciation, measured in labour hours, on machinery attributable to the production of the tea and coffee, the cost of raw coffee beans and tea leafs (the raw material extracted from nature) measured in labour hours, and the number of actual labour hours used up in turning raw tea and coffee into the finished product as bought in the shops. The relative price of tea in terms of coffee will then be: $CoP_{tea}/CoP_{coffee} = ⅔$. If one adds the wage rate per labour hour (w), the formula becomes: $w.(CoP_{tea})/w.(CoP_{coffee}) = CoP_{tea}/CoP_{coffee} = ⅔$. Because w appears in both the numerator and the denominator, it cancels out. The relative price remains unaffected at ⅔. Hence, assuming that the wage rate is the same in all sectors, changes in the wage rate do not influence relative prices. Similarly if we were to include the profit rate (p = profit/capital) and we assume that the capital/labour ratio (c) is the same for all sectors and can be defined as c = capital/CoP, the relative price of tea versus coffee can be calculated as: $(1+p).c.w.CoP_{tea}/ (1+p).c.w.CoP_{coffee} =$

CoP_{tea}/CoP_{coffee} = ⅔. Again, because (1+p).c.w is in the numerator and the denominator, it cancels out. The relative price remains unaffected at ⅔. Therefore, according to Ricardo, changes in the profit rate also do not influence relative price.

Ricardo, furthermore, argues that an increase in the wage rate will reduce the profit rate (and vice versa), but does not influence exchange value as determined by relative labour hours: CoP_{tea}/CoP_{coffee}. The underlying assumption seems to be that the value of (1 +p). c. w. is presumed fixed and given. In that case, if the profit rate (p) increases, the wage rate (w) must correspondingly decrease, so that the value of (1+p).c.w. remains unchanged. Of course, for a given sales volume, it is in any case true that a raise in the wage bill will reduce profits, and vice versa. We already noted this in the context of Smith's wages fund theory.

Changes in the rent rate do not cause changes in the cost of production, because, according to Ricardo, rent does not influence exchange prices of agricultural as well as non-agricultural output. It's rather the other way round: exchange prices influence the level of rent.

It is thus shown how changes in the profit rate, wage rate or rent rate do not influence relative prices, which are solely determined by the relative amount of labour hours used up in production (2013:116–117) [2007:107–108].

The prescribed textbook's (2013:117– 122) [2007:108– 113] discussion of Ricardo's theory of distribution is clear enough, but do revisit our remarks on the classical theory of income distribution in learning unit 2 above. Note especially how the classics assumed that total real production and the general price level remain unaffected by factor price changes (wage rate, profit rate and rent rate). In other words, changes in the rewards paid to workers, capitalists/ entrepreneurs and land owners, are assumed not to affect their productive effort. This is borne out by the fact that, in figure 7-1 (2013:121) [2007:113], the total product curve is given by technological factors (decreasing marginal returns) only. The wage, profit or rent rates have no influence on total product, but only on how it is distributed over landowners, workers and capitalists. How the total cake is carved up and distributed has no influence on the size of the cake.

Take note of the main ideas of Ricardo's theory of income distribution, which is that there is a conflict of interest between

(a) workers and capitalists (which is further developed by Marx, on which we comment in detail in the next learning unit); and
(b) landlords and the entire rest of society.

The first conflict follows from the fact that an increase in the wage rate lowers the profit rate and vice versa. But it must then be assumed that changes in the wage or profit rates indeed have no influence on total production, which can thus be treated as fixed and given. Irrespective of how much workers are paid, they remain equally productive. And irrespective of how much profits they make, firm owners are equally enterprising. The second conflict results from the fact that rent rates must increase at the expense of profit and wage rates, because food prices are bound to rise under the influence of scarce land, unchanged agricultural technology and an increasing population. However, if we assume the "iron law of wages" according to which wages are always at their subsistence level (they do not rise above or fall below it), there is only a conflict between landlords and capitalists. Wage rates remaining the same, the inevitable increase in rents must be realised at the expense of a decrease in the profit rate – see figure 7.1 (2013:121) [2007:113].

Carefully consider the three main policy implications (2013:122–123) [2007:113–114] of Ricardo's theory of income distribution: (1) wages should not be regulated by law, (2) a tax on rent would not increase the price or lower the quantity of agricultural production, and (3) opposition to the Corn Laws.

The first policy implication presumes that labour markets are indeed "fair and free [ly]" competitive, which need not be the case. In modern economies where firms tend to be large

corporations, the individual worker would indeed be in an "unfair" bargaining disadvantage vis-à-vis his or her large corporate employer. But bear in mind that most business enterprises in Ricardo's time were not yet large corporations, but relatively small proprietorships and partnerships. It is indeed significant that labour only started to organise itself into unions in order to enhance its bargaining power vis-à-vis employers, once the corporate form of business had started to dominate private enterprise (especially manufacturing), which happened in the late 1800s, early 1900s. From then on, it became a matter of "big business" bargaining against "big labour".

The second policy implication is interesting in relation to Henry George's proposal to tax rent and redistribute the revenue over all citizens (see also the section on the physiocrats). Modern advocates of a Georgian tax often mention the advantage of such a tax in that it has no detrimental effect on prices or production volumes of agricultural products. This advantage does not, however, depend on the validity of Ricardo's rent theory. It follows from marginal cost pricing and the fact that rent payments are a fixed cost for land cultivators. In so far agricultural markets are freely competitive and individual farmer-suppliers cannot influence the price there, these advocates of Henry George's policies would be right: the tax on rent would not push up food prices or negatively affect food production.

With reference to the third policy implication, make sure you know what the Corn Laws are and why Ricardo was against them. If you don't, follow up the references to the Corn Laws in the index (also see our discussion of Malthus above).

As to Ricardo's theory of comparative cost in international trade, the prescribed textbook's (2013:123–125) [2007:114–116] discussion should again be sufficiently clear. Of course it remains surprising how a country can gain from international trade when it has no absolute advantage at all and is less efficient than other countries in all of its sectors. The reason, according to Ricardo, is that scope for mutually beneficial trade arises not only in countries that have absolute efficiency advantages over each other in different goods (Portugal can produce wine more efficiently than England, and England can produce cloth more efficiently than Portugal), but also in countries that have comparative efficiency advantages over each other (the difference in efficiency in wine relative to cloth production is greater in Portugal than in England). If we apply this principle to persons rather than countries, it may become more intuitively understandable.

If John is better at baking bread and his brother Peter is better at making shoes, both could gain by specialising in what they are better at. John could spend all his time baking bread and Peter could spend all his time making shoes, and they could trade to cater for each other's bread and shoe requirements. This is basic Adam Smith. Now along comes David Ricardo. Even if John is better than his brother Peter at both shoemaking and baking, there may still be scope for specialisation and interpersonal trade – that is, when the difference between John's baking and shoemaking skills is greater than the difference between Peter's, for example, when John is enormously better at baking bread but only marginally better at making shoes than his brother Peter. Under these circumstances, the bread production foregone in making shoes (the opportunity cost of making shoes) could be greater for John than for Peter. As a result, John would spend his time better by baking only bread and leave shoe production to his brother Peter, even if he is a more efficient shoe producer than Peter.

Ricardo merely applied this principle to countries. Note, however, the fairly restrictive assumptions which underlie Ricardo's theory, which may cause it not to be generally applicable to all real-world situations (again, an instance where Ricardo's laws may not be generally applicable): capital and labour are perfectly immobile between countries, but perfectly mobile within countries without loss of productivity, and there are no quality differences between goods produced in different countries.

In the context of Ricardo's views on unemployment (2013:126–128) [2007:116–117], note Ricardo's stance on Say's law and compare it with Malthus'. With the aid of our discussion of

Say's law above, you should have an improved ability to assess the merits of both their arguments. In the same section ("Ricardo on Unemployment"), also note Ricardo's ideas about technological unemployment and the use of machinery.

In the first two editions of Ricardo's main book (*Principles of political economy and Taxation*), he argued that mechanisation (the increased use of machinery in production) was in the interest of all classes of society: workers, capitalists and landlords. Improved productivity and the resultant lower unit cost of goods produced would reduce prices and thus increase the real income of all. Aggregate employment would also not fall, because the technological unemployment (that is, unemployment due to the replacement of men by machines) in some sectors would be compensated for by the increased employment in other sectors. In other words, the job losses in some outdated sectors would be offset by the job gains in the new sectors, which serve new markets. Ricardo thereby implicitly assumed a "technological revolution", as we used the term in our fictitious discussion between John and Tandi in the Economics in Action section above.

But in the third edition Ricardo changed his mind somewhat, arguing that the introduction of machinery may harm the interest of workers – at least in the short run. Ricardo based his argument on the fact that investment spending reduces the wages fund, which would reduce nominal wages. In the long run, however, Ricardo reasoned that falling prices due to productivity gains would more than compensate for the fall in nominal wages, so that workers would eventually gain too.

This argument does not seem strong. Mechanisation may damage employment in the short run, but not for the reason advanced by Ricardo. We already noted in our discussion of the wages fund in the previous learning unit (on Adam Smith) that hardly any capital is needed to finance wages in manufacturing because (a) the production round is fairly short (about a week or so) and (b) workers are usually paid at the end of the month when a significant part of the output produced during that month is probably already sold and has already generated an income for the firm out of which wages can be paid. Moreover, firms can always borrow funds externally from banks or through financial markets, which need not affect their ability to pay wages. So the wages fund argument seems false.

The prescribed textbook's (2013:128–129) [2007:117–118] final assessment of Ricardo is useful and important.

LOOKING BACK AT ACTIVITY 3.2

The discussion about the influence of mechanisation on the interest of workers is by no means settled, even among modern economists. Valid reasons can be advanced in support of both sides of the argument – that it damages the interest of workers and that it favours these interests. The problem is that countries often have no choice but to accept the increased use of machinery in production, whether it improves employment and wage payment or damages them. Rejecting mechanisation will often mean that countries become less able to compete on the international scene, which may have an even greater negative impact on employment and wage payment. It is often a matter of choosing the best of two bad situations.

MILL

STUDY OUTCOMES

When studying this section, you should aim at gaining knowledge and understanding of the following:

- Mill's views on the productive contribution of labour, capital and land, and the extent to which they put limits on wealth creation
- the interrelatedness of production and distribution in Mill's theory of income distribution
- Mill's views on the wages fund
- the weakness of the wages fund doctrine in general
- Mill's anticipation of demand and supply schedules as well as of the concept of price elasticity, as later more fully developed by Marshall
- Mill's views on the falling rate of profit and why he thought a falling rate of profit need not constrain investment and wealth creation
- Mill's concept of a "minimum necessary rate of profit"
- Mill's views on competition and socialism
- Mill's views on the role of government, both positive and negative

3.3

ACTIVITY

Among other things, John Stuart Mill addressed the issue of wage determination and the scope for bettering the position of workers through wage increases. As an introduction to this issue, consider the following continuation of the imaginary discussion between John and Tandi.

John: *And what about poverty? Many of our people are low- or unskilled workers. Would it not be an effective way of poverty alleviation if the unions demanded significantly higher wages for the workers in all industries and let firms give up a bit of their overly high profits?*

Tandi: *Again, it depends …*

John: *You are using this phrase "it depends" a bit too often for my taste. I am getting a bit tired of it. Why be so tentative? Why not say "definitely yes" or "definitely no"? Don't be a fence-sitter, show a bit of character and stand for something!*

Tandi: *John, that is just what economic reality is like. Things like the welfare of workers, the level of employment, depend on many factors, all of which need to be considered. It is just a matter of being careful and responsible in one's economic reasoning. Whether demanding significantly higher wages is feasible and in the long-run interest of workers does depend on a number of factors.*

John: *Okay then, what factors?*

Tandi: *Well, among other things, it depends on the profitability of the affected firms. If their actual and expected profits are already meagre, having to pay significantly higher wages may mean that profits fall below what makes it worthwhile for them to continue operating at current production levels, let alone investing in additional production capacity and employing more workers. Whether you like it or not, it is when firms expect good profits that they are inclined to invest and create jobs. So by squeezing the profitability of firms too much, you may actually damage the interest of workers by sacrificing the number of jobs. Nonetheless, there may also be instances where firms pay unreasonably low wages and make unreasonably high profits, so that there is scope to pay the workers better without compromising current or future employment.*

John: *Does this not create a problem? I mean, unions cannot demand different wage increases from different firms, depending on their different current or expected profitability? Surely, unions cannot condone that people who do the same job earn different wages in different firms?*

Tandi: *I know this is a problem. Nonetheless, the difficulty remains that firms are not equally capable to afford the same wage increases. What may be affordable for the one firm (or sector), may be crippling for the other.*

John: *But are firms ever "crippled" by wage increases? Can they not simply increase their prices in order to make up for increased wage cost, and so maintain their real profitability?*

Tandi: *Again, it depends. If the relevant firms face tough competition from abroad, increasing their prices in order to maintain profitability may mean they lose business to foreign firms. And when they lose business, they will eventually have to cut back production and shed jobs. Not in the interest of workers, I'd say.*

John: *Yes, but in my international finance and trade course I learned that when the exchange rate simultaneously falls (the rand loses value vis-à-vis foreign currencies), the increased rand prices translate into more or less the same dollar or euro prices, so that these firms do not become less competitive as compared to other foreign firms ...*

Tandi: *But then you still sit with the problem of inducing more inflation; recall from your international trade and finance course how a falling value of the rand has a strong inflationary impact on local prices in a small open economy like South Africa, which is particularly dependent on imported capital goods (machinery and implements). And inflation will soon wipe out the initial gains from the higher wages. When both wages and prices increase, there is no benefit for workers! And there is the added complication of having to get rid of the inflation again, which is always a hard and painful process accompanied by interest rate increases. By the way, I learned from my course in the history of economic thought of this concept called the "wages fund". An old economist named John Stuart Mill claimed that, with the wages fund fixed in the short run, firms do not have the money to finance wage increases unless they reduce employment.*

John: *This sounds an odd idea to me. Surely, if firms were a bit less greedy and prepared to accept some reduction in profit, they would have the money to pay for higher wages. Even so, I accept that lower profits may mean that firms have less money to invest in new production capacity, which may jeopardise future employment. But are there not other ways of financing investment apart from retained profits (savings) by firms? Can't they borrow from households?*

Tandi: *Sure they can, but that may cause a reduction in consumption expenditure by households, which may compromise their sales and thus their profits again.*

John: *Okay, but they can also borrow from the banks. I learned from my course in monetary economics that bank credit amounts to money creation.*

Tandi: *You are right, they can – and often do – borrow from banks. Even so, firms don't like to borrow when they don't have to (unless they wish to increase their profitability through increased gearing). And the fact remains that the wage cost in this country needs to be comparable to what overseas companies pay their workers, taking productivity into account. Otherwise, the competitiveness of our local economy is compromised and we may battle to sell our products on the local and international markets. If the local economy sells less, employment for our local population will be less too. As I said before: in this highly competitive international economy, you cannot afford to be out of line with what happens internationally, otherwise you lose out. The business goes elsewhere.*

John: *This Mill character, has he said anything else that is interesting?*

Tandi: *Yes he has. But I will need to do some extra studying before I can talk to you about that.*

. . . .

Question: Study the economics of John Stuart Mill and imagine yourself explaining things to John.

DEMARCATED READING

At this point you should read chapter 8: only the section "John Stuart Mill" (2013:145–157) excluding "The law of international value", pp 153 and 154) [2007:135–146, excluding pp 142 and 143].

CONTENT

Mill is the last of the great classical economists. He did not contribute a great deal that was new; he mostly systematised and popularised the teachings of his predecessors, particularly Smith and Ricardo. Yet in his own right Mill had considerable stature, not only as an economist but also as a social philosopher. He did make some important original contributions to economics as well.

Mill distinguished three production factors, labour, capital and land, and the textbook devotes a separate section to Mill's views on the contribution to wealth creation of each.

In the section on production (2013:148–149) [2007:136–138], note that Mill regarded wealth as useful material goods. By implication, he saw the provision of services as unproductive labour, unless these services indirectly contributed to the production of material goods. Modern economists regard both material and immaterial goods as productive. Eating an ice cream or listening to an entertainer may be equally enjoyable to consumers and hence equally contribute to their "wealth".

Mill defines capital as accumulated material goods, which are used as in input into production. He also posits that "capital ... limits the extent of industry", which is still true today. Assuming a capital-intensive mode of production, there cannot be wealth and employment creation without investment in machinery and implements.

Also note Mill's implicit endorsement of Say's law: "Thus the limit of wealth is never deficiency of consumers, but of producers and productive power." In other words, only supply factors limit wealth creation, not demand factors; there will always be enough total demand for total production to be sold. Therefore, investment in additional production capacity need not be held back by worries about future aggregate demand being insufficient to take up the additional production. On the basis of Say's law, Mill also claimed that all savings (unconsumed income) would end up being invested rather than being hoarded.

According to Mill, the real, more dangerous barriers to increased production were the limited extent of land (the supply of land is fixed in a country) and the decreasing return to scale in agriculture. Like Malthus, Mill did not anticipate the huge productivity gains in agriculture due to the various "Green Revolutions" we have had.

When studying the section on distribution (2013:149–150) [2007:138–139], re-read our comments on the issue in learning unit 2 on Adam Smith.

When going through the section on the wages fund concept (2013:150–152) [2007:139–140], also re-read our critique of that concept in learning unit 2, which corresponds with this section's critique of it. In fact, we quoted a fairly large part of this section in our assessment of the wages fund doctrine in learning unit 2.

Also pay attention to Mill's more sophisticated theory of exchange (2013:152–153) [2007:141–142], in which he foreshadowed the marginalist/neoclassical revolution by giving recognition to demand and supply schedules as well as to price elasticities of demand and supply. Indeed, already in his lifetime the classical consensus was beginning to crumble and economists were starting to desert narrow cost-of-production theories of value, in favour of theories that gave equal recognition to both the demand and the supply side in price determination and which recognised the roles of marginal cost and marginal revenue in price determination. Such are,

of course, the pillars of the neoclassical/marginalist school of thought, as we will see in learning unit 5.

The section on the law of international value is ***not prescribed***.

In the section on dynamics in the economy, the prescribed textbook (2013:154–156) [2007:143–144] summarises some interesting thoughts of Mill, which betray typical 19th century cultural optimism: "More security, less destruction by war, reduced private and public violence, improvements in education and justice – all these would reduce the risk of investment and thereby reduce the minimum necessary rate of profit." Why are these considerations important? The reason is that a capital-intensive industrialised economy, while having the upside of being more productive, has the downside of making wealth and job creation more subject to risky investment. A climate of socio-political safety, stability and security is, therefore, of greater importance to such an economy. Also, when the economic environment is safer and more stable, the profit rate required to entice entrepreneurs to take risks will come down, leaving more for payment of wages. These ideas are still worthy of consideration today.

In the same section, it is interesting to consider Mill's sober attitude towards competition in a liberal-capitalist society. On the one hand, he was not "charmed with the idea ... that the trampling, crushing, elbowing, and treading on each other's heels ... are the most desirable lot of industrial progress" (2013:155) [2007:144]. On the other hand, he also realised that this is probably still preferable to "full-blown socialism, which by disparaging competition would promote monopoly" (ibid). The point is that a liberal society is not ultimately based on competition but on personal freedom, which includes both the freedom to compete and the freedom to cooperate. We tend to think of cooperation in positive terms and of competition in negative terms, which is not right. Both, as also noted in learning unit 2, competition and cooperation have an attractive and an ugly side to them. Competition may be ugly in that it allows suppliers to "trample, crush and elbow" each other, but it is also attractive in that it gives demanders a choice between alternative suppliers and so avoid possible exploitation by suppliers. The attractive side of cooperation is that, when people cooperate for a good cause, they can achieve more good. But its ugly side is that people can also create more harm when they cooperate for a bad cause, such as when they collude to form a monopoly to exploit their demanders.

The idea of Mill's liberal society is that, by allowing the freedom to compete as well as the freedom to cooperate, the potential evil of both competition and cooperation can be kept in check. This will by no means create a perfect society, but it may just create the society that is potentially the least bad, given that people are not always inclined towards the good. "Full-blown socialism", as Mill realised, tends to fall victim to the evils of unchecked cooperation, because the state (and the state officialdom behind it) have guaranteed monopoly power. These issues will be developed further in the next learning unit.

The "popular dictum [that] people understand their own business and their own interests better, and care for them more, than the government does, or can be expected to do" (2013:156) [2007:145] captures the quintessentially liberal sentiment. While your lecturer broadly agrees with this "dictum", note that Mill could not apply it without exceptions. He still had to make some significant concessions to it.

LOOKING BACK AT ACTIVITY 3.3

How *do* we improve the lot of the mass of low- or unskilled workers in South Africa? What can we learn from Mill and the other classical economists in this regard? The first thing that we need to admit is that better wages and more employment can be realised only when business is successful. Business must be making money if it is to spend money on wages –

whether by increasing the wage rate or by employing more people at the same wage rate. Of course, when business is successful it has more money both to pay higher wages and to distribute more profits to owners. We may justifiably complain that too great a proportion of this money goes to profit and too small a proportion to wages. But such complaints take nothing away from the inescapable fact that business must be successful if it is to earn the money to pay for either more wages or more profits.

The next question is: How can we allow business to be successful and make the money needed to finance higher wages/profits? Again, we may justifiably complain about the justice of the current globalised world economy. But we are, for now, forced to treat it as a given; South Africa itself cannot change the world. Given this globalised world economy, an important way to ensure business success is to ensure that local firms are competitive: their prices and quality must be such that their products form an attractive proposition for local and foreign buyers. This requirement has a number of implications. *First*, it underscores the importance of maintaining macroeconomic stability in the local economy: low inflation, a steady growth in local demand and an exchange rate which is not overvalued. *Second*, it underlines the importance of socio-political stability: healthy labour relations and a stable, effective and non-corrupt government. *Third*, it highlights the importance of education in the technical, engineering and commercial fields. *Fourth*, it requires some strategic thinking in order to concentrate our efforts on areas where we potentially have a comparative advantage over other countries. However, there also is a domestic non-tradable sector, which includes activities like transport, trade, construction, hospitality, financial and other services and which does not directly compete with foreign firms. That sector may effectively be stimulated locally, provided there is enough money in the economy. Government spending on infrastructure may be a case in point. Nonetheless, recent research has shown that stimulating manufacturing (or the non-resource, tradable sector) remains of crucial importance in stimulating employment, which may require ensuring that profitability in manufacturing does not suffer – as it has done over the last decade or so.

All this presupposes that the pursuit of profit, while possibly being given undue emphasis in current capitalist practice, is at least not considered inherently iniquitous. There is, of course, a school of thought that does regard the profit motive as irredeemably objectionable. That school of thought is the subject of the next learning unit.

RELEVANCE FOR TODAY

At the time of writing this guide, South Africa seems to be entering a phase of increased socio-political and economic instability. Nobody should be surprised that the added uncertainty damages the economy. In a modern industrialised economy, wealth and job creation requires investment. Because investment is earned back in the future, people are inclined to invest only when they have a high degree of confidence in the future. If that confidence falters, investment declines. Nobody can be expected to risk their money if there is no good chance of earning it back. And with declining investment, there is also less wealth and employment creation.

LEARNING UNIT 3: SELECTED SELF-STUDY QUESTIONS

1. Succinctly summarise Malthus' theory of population and relate it to his position on the poor laws. How does this theory relate to his notion of diminishing returns associated with "meliorations" to the soil?
2. Compare and contrast the views of Ricardo and Malthus on each of the following topics: (a) corn laws, (b) subsistence wage, and (c) market gluts.
3. How did Mill's views on distribution differ fundamentally from his views on production? How did Mill's views on distribution differ from those of Ricardo?

LEARNING UNIT

4 Socialism and Marx

4.1

ACTIVITY

As an introduction to the topic of this chapter, consider the following excerpt from a speech by Cosatu secretary general, Zwelenzima Vavi, delivered on 9 December 2007 at the 90th anniversary of the Russian Revolution of 1917.

Commemorating the Russian Revolution of 1917

By Zwelenzima Vavi, 9 December 2007

www.cosatu.org.za (accessed on 11 March 2008)

The October Revolution was the most important event in modern history. It marked the first victorious revolution of the working class since the Paris Commune. It showed the world that the system of power built on the working class and the poor was possible and more progressive than bourgeoisie democracy. The victory of the working class in Russia ushered in a revolutionary epoch that set the world on a path towards social justice. It laid the foundation for the liberation of colonised people from the imperialist yoke and many in Asia and Latin America chose the socialist path.

It [also] contributed to the creation of favourable conditions for the struggle of national liberation movements and dismantling the colonial system. It created a living alternative economic and political system. It revealed and laid bare the weaknesses of capitalism and proved that capitalist development will not resolve the comprehensive structural crisis that has afflicted the world, since this pattern of development is replete with social, political contradictions, conflicts, and polarisation.

The victory of the October revolution provided hope to the poor. It offered support for the peoples of developing countries, including our own people, in their aspirations for freedom and social progress. It tilted the world balance of forces and created new favourable conditions for the peoples of advanced capitalist countries and the struggles of their workers to achieve more social and economic gains.

The Soviet people under the leadership of the [Communist] Party embarked on an ambitious programme to build socialism and to surpass the achievements of capitalism. Indeed, albeit with serious flaws, the soviet society invested heavily in industrial and scientific development to a point where the USSR was the first country to launch a rocket to the moon. This from a country that had an underdeveloped feudal-capitalist system. In human terms the Soviet Union built an egalitarian society, which satisfied the basic needs of its people.

Despite later distortions, it goes without saying that the Soviet achievement in science, industry, education and human development were unparalleled. Even the World Bank had to grudgingly concede the enormous achievement of the socialist bloc. Cuba today has the best health care system based on the needs of its people and has more doctors per capita even exceeding most developed countries.

We stand here today with pride and with great emotion to salute and pay tribute to the heroes and heroines who contributed to the realisation of this victory, which was the first genuine victory of the working class.

What is the record since then? Capitalism remains a crisis-ridden system based on profit for a few. The divisions between the rich and the poor have widened both within and between nations. Rich countries are forcing poor countries to open their markets in search of profits, cheap labour and markets. This is in response to the crisis of profitability faced by capitalism in the rich countries.

Mass impoverishment has become the order of the day as neo-liberalism has shattered social welfare systems and destroyed the public sector in many developing countries. Simultaneous with the restructuring of the working class, profits have soared for the local and international bourgeoisie. In short, mass impoverishment coexists with high levels of profit.

At the same time we have seen a spectacular revolution in the productive forces in areas like communication, transport and bio-medical science that suggest that we have the means to address problems of poverty, poor health care etc. Yet as Marx predicted, a system of private property prevents the application and use of these huge modern resources for the greater good.

For as long as this alarming reality lives with us, a case for a socialist revolution exists. Neo-liberalism has been challenged throughout the world and more forcefully in Latin America. In this context we salute the wave of left-wing parties coming to power in Latin America ... The South African working class has also forcefully challenged the neo-liberal dogma and this year it has sent the message to the bosses that the party is over!

What are the implications for the South African Revolution? We must see our struggles as interlinked with the global struggle against neo-liberal globalisation. Our challenge is to radicalise the current path of the National Democratic Revolution. This means building the power and the confidence of the working class to challenge the hegemony of capital. That requires a reversal of the flirtation with the neo-liberal dogma by the democratic government. It also requires that we consolidate and deepen the leftward shift in economic policy.

4.2 ACTIVITY

Also, consider the following column of Terry Bell in *Business Report* of 19 July 2013.

Ask why Socialism has come to equal Nationalisation

By Terry Bell

www. iol. co. za/business/opinion/columnists/ask-why-socialism-has-come-to-equal-nationalisation/1.1549783 (accessed on 23 July 2013)

Julius Malema's Economic Freedom Fighters (EFF) has now emerged as a new, self-proclaimed socialist party. … Dressed in their red berets, à la Hugo Chavez of Venezuela, the EFF talks of nationalising the banks, mines and monopoly industry and seizing land without compensation.

These are siren calls to a large segment of the voting population and are shared – at least in part, if not always totally – by various trade unions and longer-established political groups. The SACP, for example, is an exponent of overall state control of the economy, albeit during a "second stage" beyond the "national democratic revolution" headed by the ANC. The Democratic Socialist Movement and its offshoot, the Workers and Socialist Party, likewise calls for the nationalisation of the "heights of the economy". So too do various groups allied to the Democratic Left Front, and the Black Consciousness September National Imbizo that is now allied to the EFF echoes the cry. Cosatu and the unions affiliated to the federation proclaim their socialist orientation, support for nationalisation and backing for the SACP as "the workers' party". What all these groups have in common is the policy of nationalisation, of state control at various levels of the economy – and a claimed orientation towards workers, the poor and the dispossessed. The media also generally associates any call for nationalisation with socialism and, by implication, with trade unions and worker movements.

Socialism has, therefore, become a blanket term promising much to the downtrodden and the sellers of labour, but a term hiding a multitude of agendas. It should not, for example, be forgotten that the English translation of Adolf Hitler's Nazi Party was the National Socialist Party. And this is no new debate; it is something that has arisen time and again over more than a century, encouraged by the idea among most groups of the professed political Left that some governments, however repressive, were or are in control of "worker states". Nationalisation, in such cases, was, and is, deemed – especially by orthodox communist parties such as the SACP – to be in the interests of workers and not of capitalists. Which is why Cosatu unions argue that if and when "the workers' party, the SACP" comes to power, state control will equal worker control.

But examples such as the former Soviet Union, China and North Korea do not seem to hold out much hope for workers' rights. The often brutal systems in such states were excused by the late SACP chairman, Joe Slovo, as examples of "socialism where the element of democracy is missing". But this explanation confused matters still further because Slovo professed to be following the ideas of Karl Marx, for whom the extension of existing democracy to one where the majority of people exercise social, political and economic control of society was the essence of socialism. In any event, the simple nationalisation equals socialism equation, widely touted within the trade union movement, has become difficult to sustain. Apartheid South Africa had a higher proportion of its industry nationalised than did "socialist" Czechoslovakia. As a Stellenbosch economist noted in a television debate in the early 1990s, if nationalisation made Czechoslovakia socialist, then apartheid was also a socialist construction.

Perhaps the radical American economist Richard Wolff is correct in arguing, as he did in a televised debate last week, that "there are as many versions of socialism as there are of capitalism". What he did not mention was that this conflation of nationalisation with socialism first came to the fore more than 130 years ago, and seemed to have been dealt with quite comprehensively. The writer who dealt with it was Friedrich Engels, the collaborator of Marx. In 1880, he referred to the nationalisation of several industries in European states as "a kind of spurious socialism". He pointed out: "But the transformation – either into joint stock companies and trusts, or into state ownership – does not do away with the capitalistic nature of the productive forces." In other words, it is the underlying dynamic that counts: do the workers control the enterprise and does it function, even if competitively, on the basis of the greatest good for the greatest number?

Modern capitalist corporations function on the basis of directors having a fiduciary duty to maximise profits to the ultimate benefit of often anonymous shareholders. Yet, as Wolff points out, even in this competitive, capitalist world, there are plentiful examples of the co-operative dynamic at work. He cites, in particular, the Mondragon Corporation of Spain. Started in the Basque country in 1956 with six people, this federation of co-operatives is now the seventh-largest corporation in Spain and operates without the traditional, hugely remunerated executive hierarchy. Mondragon of Spain, Fasinpat in Argentina and many other such enterprises show that massive wage and welfare gaps and ever-increasing profits for shareholders are simply unnecessary. For example, by the collective decision of the more than 83 000 worker members of Mondragon, the average ratio between the highest-paid and lowest-paid worker in any section is not more than 5:1. There is no state shareholding let alone control in such enterprises, where many of the members regard what they are doing as perhaps "a step towards socialism".

Most importantly, as Wolff argues, the existence of such organisations provides proof that the hierarchical, profit-driven model of conventional capitalism is not only unnecessary, it is probably harmful to the well-being of both people and the planet. With the nationalisation debate to the forefront and with a relative plethora of proclaimed socialists aboard the state-control bandwagon, this is where the debate should focus. Unions and workers in general, whether employed or unemployed, could also not go far wrong in adopting the favourite dictum of Marx: question everything.

. . . .

Question: What can you conclude about the type, or the types, of "socialist revolution" which Vavi and Bell advocate in their pieces? To what extent are these types of socialism likely to benefit the poor and the workers?

SOCIALISM

STUDY OUTCOMES

When studying this section, you should aim at gaining knowledge and understanding of the following:

- the nature of the various types of socialism, their differences and similarities
- an alternative classification of types of socialism: dogmatic state socialism (collectivism), pragmatic state socialism, interventionalist socialism, worker participation socialism, and welfare state socialism
- the nature of collectivism and why it leads to state absolutism
- why collectivism tolerates no unions and no worker participation
- collectivist sharing versus capitalist greed

DEMARCATED READING

At this point you should read chapter 9: only the section "Overview of Socialism".

CONTENT

We tend to think of socialism as a single vision or idea. But there are, and have always been, many different shades of socialism. The textbook's "Overview of socialism" is useful in highlighting that diversity.

All forms of socialism are concerned with the poverty and powerlessness of the working class and the power and wealth of the business class. The way in which they wish to address

these concerns, however, may differ. These differences centre around disagreement about the following questions:

(a) *Is the state part of the problem or part of the solution?* The textbook's state socialism, Marxian socialism, revisionism and guild socialism argue the latter, while anarchism and syndicalism argue the former.
(b) *Is the problem caused by the evil in people (their lack of solidarity with, and concern for, the poor and downtrodden) or by the evil in the system (the institutions of private property or coercive government).* Or, to put the same question differently, is the evil innate in people or does the evil lie in the negative social conditioning of people? The textbook's utopian socialism and Christian socialism would be inclined to argue the former, while state socialism, anarchism, Marxian socialism, and communism believe that, given the right system, the ethical standards of people should rise to such an extent that social victimisation (people taking advantage of each other) virtually disappears.
(c) *Is the problem solved by a radical overthrow of the old order or by gradually reforming it?* The textbook's state socialism, anarchism, Marxian socialism, communism and syndicalism prefer a radical overthrow (revolution), while revisionism and guild socialism favour more gradual reform.
(d) *Are the interests of workers and business owners inherently conflicting, or are they potentially reconcilable?* The textbook's state socialism, anarchism, Marxian socialism believe that class struggle is inherent, while utopian socialists, Christian socialists, revisionists and guild socialists reject the inherent antagonism between classes.

Take note of the "communalities of socialism" (2013:165) [2007:153]. The prescribed textbook emphasises as the common elements shared by all shades of socialism: (i) class struggle, (ii) opposition to *laissez-faire* (iii) rejection of Say's law (the inherent macroeconomic instability of liberal capitalism), (iv) the perfectibility of man when the system is right, and (v) support for some form of collective action or public ownership.

Your lecturer wishes to suggest an alternative, arguably more insightful way of classifying the various forms of socialism. We distinguish five basic types:

(1) *Collectivism* or *dogmatic state socialism*. This type of socialism regards private ownership of business firms as the root of the problem. For that reason, collectivism advocates the complete abolition of private property in the means of production. All business enterprises are to be nationalised, that is, put in the hands of the state. No private business is to be allowed at all.
(2) *Pragmatic state socialism*. This type of socialism is not quite as dogmatic on private ownership of business firms being the root problem with capitalism. Accordingly, pragmatic state socialism allows some (smaller) business enterprises to remain in private hands. Nonetheless, in order to curtail the power of private business and to pursue social ends, it wishes to nationalise some key, strategic industries, like mining, banking, transport or communications, typically referred to as the "commanding heights of the economy".
(3) *Worker cooperative socialism*. The point of this type of socialism is that workers own and democratically run the firm. Because workers cooperatives are basically voluntary associations and, as such, are "liberal-capitalist" institutions, this type of socialism conflicts with "liberal" free enterprise principles only if government were to enforce worker cooperatives as the only allowable form of private enterprise, which is what syndicalists and guild socialists would advocate (2013:164–165) [2007:152–153]. But that has, up to now, never been the case. There are significant numbers of voluntary worker cooperatives in countries that are otherwise "liberal-capitalist" in outlook, such as the UK, Spain, France and Italy, although (with the exception of Spain's Mondragon Corporation) their contribution to total employment and output tends to be small as compared to that of conventional private corporations. Worker cooperatives can vary in their internal organisation, but the basic idea is that each worker gets a share in the firm which allows him or her to vote for manager representatives. Profits are retained or shared between worker-shareholders. The same applies to losses. It is indeed not uncommon for workers in

worker cooperatives to accept a wage cut in lean times in a bid to save the firm and their participation in it. Worker cooperative socialism should be carefully distinguished from unionism. Unions do not seek the power to manage the firm. They want to oppose management when it is perceived to act contrary to the interest of workers, but do not want to manage firms themselves. In principle, worker cooperative socialism would make unions redundant. What role is there for unions if workers own the firm? Share distribution schemes where workers are given some of the shares but not a controlling shareholdership in the company are, of course, also quite common in liberal-capitalist societies. But while there may be merit in such schemes, they do not really fall within this category of socialism whose basic idea is that workers substantially own and control the company for which they work.

(4) *Interventionist socialism*. This type of socialism does not seek to tackle the problems of capitalism at the level of ownership forms or the power to manage. For interventionist socialism, it does not matter whether firms are privately or publicly owned, worker-managed or owner-managed. Instead, what matters is that state institute laws forbid or prescribe certain behaviours on the part of business firms, with a view to protecting the interests of workers and consumers. Unionism falls within this category of socialism. It is due to interventionist legislation like the enforcement of collective bargaining, meaning that firms are obliged to negotiate with unions in decisions affecting the interest of workers.

(5) *Welfare state socialism*. For this type of socialism, it also does not matter whether firms are privately or publicly owned, whether workers have a significant say in its management or not, or whether firms are limited in their freedom by interventionalist laws or not. Welfare statism merely advocates that the state tax the profit and incomes generated by business enterprises to finance programmes to reduce poverty and inequality, like the provision of health care, education, housing, old-age pensions and unemployment and disability grants.

In this categorisation, there is only one opposite to socialism, namely a system where all production enterprises are privately owned, have full freedom to organise their production in any way they want, buy and sell what they want at the price that they want and pay a minimum of taxes on their profit. We could label this logical antipode to socialism *laissez-faire* (a French term coined by the physiocrats; see learning unit 1).

It is clear that modern "neo-liberal" capitalism mixes *laissez-faire* with fairly high doses of socialism varieties 2, 3, 4 and 5 above, although pragmatic state socialism (variety 2) is ostensibly on the wane given the inclination of modern states towards the privatisation (denationalisation) of previously state-owned enterprises. A degree of pragmatic state socialism, worker cooperative socialism (though small), interventionist socialism, and welfare state socialism has become integral to the modern liberal-capitalist ethos, while private enterprise and freedom of exchange obviously remain dominant. Hence, the only uncompromising form of socialism is collectivism/dogmatic state socialism (variety 1), because it is inherently antagonistic towards the private ownership of productive resources (private enterprise) and, therefore, irreconcilable with any degree of *laissez-faire*. Marxian socialism, the topic of this learning unit, is an instance of collectivism/dogmatic state socialism.

State enforcement of worker participation for all firms (syndicalism) would, interestingly enough, be equally disagreeable to both liberal capitalists and dogmatic state socialists/collectivists. The liberal-capitalist objection would be that it is difficult to make workers the (majority) owners of their firms unless they pay for their share in the ownership. And in so far ownership is not fully paid for, it would be less appreciated and, hence, less carefully managed. Productive efficiency would thus fall to the detriment of society as a whole. Worker participation is just as unpalatable for more radical communist-collectivists, because it means that power is divested from the state to the workers. And under collectivism/dogmatic state socialism, the state rules supreme, not the workers.

In order to understand why this is so, it is necessary to acquire a better grasp of dogmatic state socialism/collectivism, which is often poorly understood. It is interesting how Marxian collectivist ideas tend to impregnate the slogans of many a contemporary socialist, even if they do not necessarily propose to nationalise all business enterprises and merely prefer to throw more pragmatic state socialism, worker cooperative socialism, interventionism, and welfare statism into the neo-liberal capitalist mix. Collectivist slogans are attractive because they stir the crowds. But the question is: do they stir the crowds with truth. Let's pursue the issue.

In essence, Marxian collectivists do not trust private individuals with the economic power and freedom that capitalism (to varying degrees) gives them. There may, of course, have been good reason for this mistrust. Capitalist systems have regularly given (and may still give) too much power and freedom to particular sectors of society, such as the merchant, the king, the landlord or the corporate capitalist. This privilege has often led to abuse and the exploitation of economically weaker classes, in particular, the workers. Undoubtedly, the science of political economy ultimately aims to conceive of a system that is free of institutional bias and privilege (if such a system exists), meaning that economic power, opportunity and freedom are evenly spread over all members of society. Marxian collectivism, however, does not spread power, opportunity and freedom – it altogether removes them from the reach of private individuals (whether they be capitalists, landlords or workers) so as to invest them in the collective.

Now comes the crucial question: who is the collective? Is it the common people as a group of private individuals? No, because collectivism does not trust private individuals with the power, opportunity and freedom of private ownership. But if not a group of private people, who then is this collective to which all the power belongs?

Collectivist and communist systems of thought really have no answer to this question. The solution they come up with is really a subterfuge: they identify the collective with the state and its officialdom. That is how Marxian collectivism collapses into dogmatic state socialism. The will of the people becomes identically equal to the will of state officialdom. For that reason, government leaders who are inspired by collectivist-communist ideology will tend to claim to speak the will of the people, even when they simply speak their own private will as inspired by their own private interest, as the kings of old were inclined to do (see learning unit 1).

Because the will of the collective is regarded as absolute, and state officialdom is claimed to represent the collective, the position of state officialdom has thus become untouchable. Whoever contradicts the will of the government and its officials, contradicts the will of the people, which is the ultimate authority. Any opposition against government becomes treasonous by definition. Collectivist-communist ideology forces communist states to tolerate no dissent. And so Russia, Cuba, China and East Germany squashed political dissent with unparalleled ruthlessness (China and North Korea still do).

One may argue that parliamentary control by democratically elected representatives would be able to keep a check on the power of state officialdom under collectivism. But in practice collectivist systems have *never* managed to be democratic, and predictably so. Collectivism makes the benefit and privilege of controlling the state so great that the temptation simply to seize and retain control becomes virtually irresistible – the more so because control over the state is the only route to freedom and prosperity in a system where ordinary private individuals lack all opportunity for economic advancement. Control of the state provides the only access to the "good life". In addition, many communist leaders berated "bourgeoisie democracy" stating that democratic elections were unnecessary. As Fidel Castro used to say: "The people have spoken already", by which he meant "at the time of the Cuban Revolution". Because the collective gets equated with government officialdom and Castro represents that officialdom, he embodies the will of the people. Hence, according to collectivist logic, there indeed is no need to consult the actual people. It is ironic how extreme collectivism

degenerates into extreme individualism, namely the individualism of the autocrat, like Castro, who claims to represent the collective. At no time in history has the power of political leadership been so absolute as the power of the heads of Marxian communist states has been – with the possible exception of the pharaohs of ancient Egypt.

In short, the central naivety of Marxian collectivist thinking is contained in the idea that the collective is represented by the state rather than by the mass of ordinary private citizens. For example, traditional Marxism teaches that by nationalising all industries a "dictatorship of the proletariat" will be established, in which workers become owners of capital (2013:196–197) [2007:184]. But this is clearly not the case: state officials become the capitalists and workers remain workers, with as little power as before. Rather than a "dictatorship of the proletariat", Marxism establishes a "dictatorship of state officialdom".

Similarly, during the Russian and Cuban revolutions, the revolutionaries gained the much-needed support of the peasantry by promising them their own land. The peasants were betrayed in both cases. Land previously owned by the Cuban and Russian landlords was *not* distributed among peasants but nationalised. Instead of allowing peasants to run their own farms on their own land, which could have empowered them, they were forced to work for large, state-owned farming collectives. They simply moved from virtual servitude under the landlord to virtual servitude under state-run farming collectives, not gaining much in the process – neither in terms of civil liberty nor in terms of material betterment. When the peasants in Russia subsequently revolted against this betrayal, they were systematically murdered by the communist Russian state under Stalin – in their tens of millions, easily the biggest genocide the world has ever seen.

The point is: collectivist systems do not give power to the collective as a group of individual people but to the state and its officials. Intoxicated by misleading collectivist slogans, many followers of collectivist revolutions have misunderstood this, to their peril.

Another naivety of Marxian collectivism is contained in the suggestion that it is characterised by the virtues of cooperation and sharing, while capitalism is claimed to be characterised by the vices of competitive conflict and self-interest. And so the misleading suggestion is created that collectivism is merely about sharing, while capitalism is merely about the self-interest of the few. The suggestion is misleading on two levels.

1. As noted several times before, the point of liberal capitalism is not competition at the expense of cooperation, but the freedom to either cooperate/associate or compete/disassociate – both of which are potentially vicious and virtuous, depending on the goals and values of those involved. Capitalism allows for both competition/disassociation and cooperation/association. Collectivism, in contrast, permits only cooperation/association and of a kind, which is likely to be predominantly vicious, because it is coerced and comprehensive, covering all economic activities of all citizens. Because there is no freedom of disassociation/competition, everybody is wholly locked in ("no exit"). When the state becomes sole supplier of all goods and all jobs, state officialdom once more obtains absolute monopoly power in all markets over all people, which is bound to lead to abuse of power. As the old saying of Lord Acton goes: "Power tends to corrupt and absolute power corrupts absolutely."

   Hence, the increased bargaining power, which private individuals may gain by "standing together" for a common cause, is in conflict with collectivism. In communist nations like Russia, Cuba, East Germany and China, individuals were denied the right to form associations outside of the state. After all, Marxist ideology demands that the state is the only true collective, the only true representative of the will of the people which, therefore, permits no rivals. That is why former communist Russia, Cuba, East Germany and China did not allow the private formation of trade unions, churches or even sports clubs. All civil society was banned. For a similar reason, collectivist states will only recognise the virtues of sharing and self-sacrifice when they further the aims of the collective as represented by the will of government officialdom. Self-sacrifice and sharing

to further particular interests as determined by the people themselves are considered subversive. Private interest groups like trade unions are, paradoxically enough, a typical liberal-capitalist phenomenon, since only liberal capitalism gives people the freedom of association and disassociation. Vavi's Cosatu would not have been allowed to operate in Vavi's beloved Marxist Russia! Unionism is not compatible with dogmatic state socialism.

2. Similarly, while economic players under a capitalist system can be exclusively self-interested (and as such greedy), capitalism is not essentially based on self-interest, as noted in our discussion of Adam Smith too. Rather capitalism's essential philosophy is the maintenance of individual freedom (within certain important limits), whereby this freedom can be used to pursue either self-interest or sharing (if all is well, hopefully a bit of both). Once again, it all depends on the goals and values of the people themselves, although the modern corporate form of capitalism has probably magnified the drive towards profit making and in that sense made the system more greedy (see the articles mentioned in footnote 1). While capitalism allows for both self-interest and sharing, collectivism permits only sharing, which again is all-embracing and totally coerced. The state coercively gathers all income and wealth, and the state distributes it again to whom it pleases. The problem with this kind of coercive sharing is again that state officialdom, as the agent for the collective, inevitably obtains a large amount of discretionary power over how the wealth is to be distributed, which is likely to benefit them the most.

All this is not to say that there is no place for a degree of state-enforced cooperation and sharing under liberal capitalism. After all, there can be no *rule of law* without everybody agreeing to cooperate by obeying the law. Welfare state socialism, which is not irreconcilable with capitalism, is essentially enforced sharing: some of the wealth of the rich is taxed away to make financial provision for some of the schooling, health care and old-age pensions of the poor. Moreover, there may be a case to find mechanisms to share the benefits of a nation's natural resources, like its land, more evenly, while taking care not to compromise the productive use of that land. In this regard, the ideas of the above-mentioned Henry George may be worth some further investigation.

In certain forms of socialism (like the prescribed textbook's utopian socialism, Christian socialism, worker participation socialism and guild socialism) the cooperation and sharing may be voluntary, in which case the above-mentioned problems with collectivism do not apply. When a collective is voluntary, its members can always protect themselves against the collective representatives' abuse of power or mismanagement by leaving or refusing to join, just as you leave a church or soccer club when you don't like how it is run. Voluntary collectivism, in fact, presupposes a liberal-capitalist rather than a collectivist context, because only in a liberal-capitalist order is the freedom of association and disassociation respected. Again, the essential problem with collectivism is that its cooperation and sharing are completely coerced. "No Exit". People had to risk their lives to flee communist Russia, East Germany and China.

MARX

STUDY OUTCOMES

When studying this section, you should aim at gaining knowledge and understanding of the following:

- Marx's confusion between two opposites: collectivism *versus laissez-faire*, and industrial production *versus* handicraft production
- the influence of Ricardo, the utopian socialists, Darwin, Hegel and Feuerbach on Marx's thought
- the forces of production, the relations of production, and the internal contradictions of capitalism (class struggle), which inevitably lead to revolution
- the six stages of capitalist production, which eventually culminate in communism

- the similarities and differences between Marx's and Ricardo's labour theory of value
- the foundational idea of Marx's theory of exploitation: only labour is productive
- the degree to which capital, entrepreneurship and nature (land) can be regarded as unproductive
- Marx's concept of "socially necessary labour time", and its components
- Marx's concepts of "labour power" and "labour time", and how the value of labour power is determined
- the extraction of surplus value by capitalists: their power to set the length of the working day
- the fact that Marxian exploitation is not indicated by capital making excessively large profits because paying labour excessively small wages, but indicated by capital making any profit at all – however large or small
- the rate of surplus value, and the ability of capital to increase this rate by lengthening the working day or by reducing the value of labour power through raised productivity
- the determinants of the rate of profit
- the organic composition of capital as a measurement of the degree of capital intensity of production
- the transformation problem: the contradiction between equal profit rates in all industries and different profit rates between industries according to different degrees of capital intensity
- why, according to Marx, the profit rate falls when the degree of capital intensity rises
- why, according to Marx, capitalists may still have an incentive to mechanise even when the rate of profit falls
- how a falling rate of profit due to mechanisation can be temporarily offset by other forces
- the merits and demerits of Marx's arguments against Say's law
- Marx's views on the centralisation of capital: how large capital destroys small capital
- Marx's views on the intensification of class conflict and the inevitability of revolution: increasingly concentrated capital is confronted by increasingly concentrated and desperate labour
- Marx's accurate prediction of rising inequalities within countries as well as between countries
- Marx's accurate highlighting of the possibility of technological unemployment (machines replacing workers)
- Marx's accurate prediction of capitalism's proneness to cyclical instability, be it that the reasons, which Marx gives for this instability, are questionable
- Marx's inaccurate prediction of falling profits and wages
- the harmony as well as the conflict between labour and ownership
- the dangers of collectivism inherent in Marx's policy proposal
- the naïvety of Marx's ultimate communist heaven, which has no government and no private property

DEMARCATED READING

At this point you should read all of chapter 10.

CONTENT

The prominent historian of economic thought, Mark Blaug, once commented that "most of Marxian economics thrives in a cloud of terminological confusion ...".[4] As an introduction to the central terminological confusion underlying Marxian economics, consider the following opposites:

(1) *Collectivism versus laissez-faire*. The meanings of these terms were explained above and should already be familiar to you. In essence, this dichotomy describes opposite systems

4. Blaug, M. 1996; 2002. *Economic theory in retrospect*. 5th edition. Cambridge: Cambridge University Press:216.

of property and economic planning. Collectivism represents state ownership of all productive resources and centralised public planning, while *laissez-faire* is characterised by private enterprise and decentralised private planning.

(2) *Handicraft production versus industrial production*. ("Simple production" *versus* "extended production", in Marx's terms.) This dichotomy concerns opposite methods of production. Handicraft production is the method whereby most of the productive work is done by the hand of a single craftsman or craftswoman. As a result, handicraft production allows most workers to be self-employed, in which case there is no employer-worker relationship. Workers can be their own bosses owning their own firms. By contrast, industrial production means that the production process is highly mechanised, done by machines, which obviously presupposes a greater degree of labour specialisation than under handicraft production. Because mechanisation requires production on a large scale, society's needs for a certain product can only be served by a limited number of large production units. Hence, industrial production will inevitably lead to a situation where there are relatively few employer-owners of production enterprises and relatively many employee-workers. The owner-worker relationship is a typical manifestation of industrial production.

It is clear that *laissez-faire* is not essentially linked to industrial production. One can have *laissez-faire* with either handicraft or industrial production, just as one can have collectivism with either handicraft or industrial production.

The most important terminological confusion in Marx's economics can now be identified as follows: Marx does not make it clear whether what he calls capitalism refers to a mode of production (industrial production) or to a system of property (private ownership under *laissez-faire*). For example, you will discover shortly how Marx's theory of exploitation is based on the idea of capitalism as industrial production, that is, the inherently exploitative nature of the owner-worker relationship. But the owner-worker relationship has, strictly speaking, nothing to do with whether the firm is privately or publicly owned. If the firm is publicly owned, the state would become the exploitative employer according to the strict logic of Marx's theory. Still, Marx offers collectivism (public ownership of all firms) as the solution to the ills of industrial production – be it that he viewed collectivism as merely an interim solution (see our discussion of Marx's philosophy of history below). Marx's lifelong friend and collaborator, Friedrich Engels, seems to have been aware of this confusion, witness his remark that "the transformation [of the capitalist firm] … into state ownership … does not do away with the capitalistic nature of the productive forces", as quoted by Terry Bell in the Economics in Action section above. Engels locates the problem with capitalism in the inherently exploitative nature of the owner-worker relationship rather than in the inherently exploitative nature of private ownership. As a result, Engels is sceptical about whether nationalisation ("state ownership") can solve the problem. Interesting!

The above consideration can also help us understand the historical background to socialist concerns in general and Marx's concerns in particular, some of which are legitimate. Since the start of the Industrial Revolution around 1790, the mercantilist economy, dominated by commerce, agriculture and handicraft, was increasingly supplanted by an economy dominated by industrial manufacturing, which was a genuine revolution in the sense of creating real social upheaval. Among other things, it rapidly generated an underclass of urbanised, often unemployed poor, who had no safety net and very little bargaining power. Previously, a significant proportion of poverty had been rural, where a network of relatives or even the landlord regularly provided at least some sort of voluntary relief and many of the rural poor had access to small parcels of land to cultivate on the so-called "commons". In addition, governments had not yet worked out the necessary legal framework to protect the industrial workers, for example by setting standards on maximum working hours, minimum working age, safety of the work environment, as well as facilitating the formation of labour unions able to bargain for better wages and provide a minimum safety net. As a result, the

plight of the working classes in early 19th century capitalism was often (though far from always) deplorable. In that sense, the socialists and Marx were right.

With time, however, the working classes have come to be more effectively protected and their standards of living have significantly improved. In fact, it is in precisely those economies where industrialisation and capital accumulation have progressed the furthest that workers enjoy the highest standard of living and the fullest employment – in clear contradiction to Marxist theory. Nonetheless, this state of affairs is by no means solely a result of *laissez-faire* because interventionism and welfare statism have also played important roles in improving the lot of workers. One thing is clear: the increasing poverty and unemployment of workers predicted by Marx has simply not materialised, at least not in the most advanced industrialised nations.

While industrial capitalism has made major strides forward in eradicating absolute poverty in the most advanced industrial nations, it has not made any progress towards reducing inequality. In fact, as correctly pointed out by many communist sympathisers, the gap between rich and poor within nations as well as between nations has widened considerably, which is worrying. South Africa is in the unenviable position that both absolute poverty and inequality have hardly been reduced at all, which is even more worrying.

Take note of Marx's philosophy of history called "dialectic materialism" (2013:185–187) [2007:173–175]. Again, Marx uses somewhat odd terminology to describe his philosophy. There are what he calls the "material *forces* of production", which capture the techno-material side of production: the state of technology, the types of implements or machines used, workers' skills, raw materials required, and so on. These material forces are supposed to have an influence on the "material *relations* of production", which refer to the socio-economic system, that is, the extent of private property allowed, the degree of government intervention in the economy, the social classes these interventions favour or harm, and suchlike. Now, the material forces are supposed to be dynamic and, therefore, to continually put pressure for change on the material relations. More particularly, change in the material forces (the modes of production) creates internal contradiction in the existing material relations (the socio-economic system), which shows up in the form of class conflict. The material relations will be able to temporarily resist change because they are bolstered by a superstructure of science, culture and religion which, according to Marx, is inherently conservative, seeking to protect the interest of the prevailing ruling class. However, the class struggle will eventually put so much pressure on the socio-economic status quo that it will be overthrown by revolution. Thus classical slavery gave way to feudalism, feudalism to merchant capitalism, merchant capitalism to industrial capitalism, and industrial capitalism would finally be succeeded by "communism" in Marx's particular meaning of that term. History would then, according to Marx, have reached its final heavenly culmination, mainly because the need for a class struggle would have evaporated. We should not confuse this "communism" with the collectivism as practised by Marxian states like Russia, China and Cuba. To Marx, state ownership of all productive resources was only an interim phase, which was gradually to give way to "communism". Marx was vague and noncommittal about the precise nature of his "communist" heaven, so we are left in the dark as to how exactly class conflict was to have been avoided there. Although Marx was against religion ("the opiate of the people"), you notice how his philosophy of history carries a theme, which could easily be regarded as transcendental and religious: the promise of a final culmination of history when all wrongs are righted and all the hopes and aspirations of mankind are at last fulfilled.

Of course, Marxian practice invariably got stuck in the penultimate stage of Marx's historical dialectic where the state, as an interim measure, nationalises all productive resources. Communist states like the Soviet Union, China or Cuba never moved beyond that stage towards the final "communist" heaven, which Marx described in vague anarchistic terms as having neither government nor private property: see 2013:163–164 [2007:151–152] for a fuller description.

In order to understand why, according to Marx, class conflict arises in industrial capitalism, you have to understand Marx's theory of exploitation. Before going into the detail of this theory, its foundational idea is simple: only labour is productive and only labour, therefore, deserves a reward. Entrepreneurship, capital and land are implicitly assumed not to make any productive contribution at all. Hence, whenever owners of business enterprises do make a profit, they more or less steal it from the workers, who are thus exploited to the full extent of the profit made. Marxian exploitation is, therefore, not indicated by excessively high profits at the expense of excessively low wages, but by the mere fact that capitalists make a profit at all – however much or little that profit may be.

There may be degrees of exploitation according to how large the profits of the capitalist are: they exploit much when their profits are large, and exploit little when their profits are little. Even so, the mere making of profit, much or little, is already sufficient to prove exploitation in Marx's eyes. For this reason, it would be wrong to suggest that, according to Marx, firms only start to exploit their workers when they earn "super-normal" or "excessive" profits and that they do not exploit their workers when they earn only "normal" profits. It is zero profit rather than just "normal" profit that prevents exploitation in Marx's eyes.

It is, however, clear that entrepreneurship, capital and land do make productive contributions, which would thus, in principle, merit a reward for entrepreneurs, capitalist and landowners. It may be useful to reiterate what these contributions are.

The contribution of entrepreneurship is twofold. First, it contributes the idea about a profit opportunity. Entrepreneurs recognise the original "gap in the market" with which all production initiative must start: a new or improved product or service, a better production technique, a better marketing approach and suchlike. Alternatively, in the case of going concerns, entrepreneurs check whether the status quo still optimally meets the needs of the market and that no "gaps in the market" are left for competing entrepreneurs to exploit. Second, entrepreneurship provides the necessary leadership to ensure that the promise of profit is indeed realised. Entrepreneurs mobilise and coordinate labour, material and implements in such a way that the eventual product can actually be sold at a profit. Without the contribution of entrepreneurship, there is no reason to suppose that the fruits of labour will be sold at a price, which more than covers cost. Contrary to what Marx contends, labour in itself does not create value; only labour whose fruits can be sold at a cost-covering price creates value. To produce stuff is not necessarily to create wealth; to produce stuff that can be sold at a cost-covering price is to create wealth. The skill and effort required to ensure that the fruits of labour can indeed be sold at a profit is contributed by entrepreneurship. It is obvious that the owners of a business enterprise must contribute at least some of that entrepreneurship. Marx implicitly regarded owners of productive enterprises solely as providers of capital, and not as providers of entrepreneurship too. In Marx's eyes, to be a business owner was merely to be a capitalist, that is, a provider of money. As we saw, the other classical writers similarly underplayed the productive role of entrepreneurship.

It is also evident that land (or nature in general) makes a productive contribution. While land yields its rewards only in cooperation with labour, these rewards cannot be attributed solely to labour. Nature also makes a productive contribution in its own right. As mentioned in learning units 2 and 3 when discussing the physiocrats and Ricardo, the unique attribute of land (or nature in general) is that it gives a reward to its owners, for which they have not laboured.

It also seems clear that capital makes a productive contribution. Viewed as "money capital", there is always risk involved in devoting capital to production. Because cost precedes benefit, one can never be sure at the time of incurring costs that future benefit will be sufficient to recoup these costs. Investors, at the moment of investing, cannot be sure that they get their money back. In case the capital is tied up in machinery whose payback time can stretch many years into the future, the risk is especially marked. Since nobody can be expected to risk his or her money for nothing, the provision of capital does seem to merit a reward. An important

aim of Marx was to disprove the classical notion of profit as a reward for contributing capital (waiting and risk taking, see (2013:190–191) [2007:178–179]). While Marx was right in that pro-fit is *not only* a reward for contributing capital (it is also a reward for contributing entrepreneurship and land), it certainly still contains an element of such reward. Obviously, at least part of the capital necessary to run a business enterprise must be supplied by the owners of the firm.

So the productive contribution of the owners-employers consists of the *labour* of entrepreneurship (white-collar workers are also tired in the evening), the provision and risking of money invested in the firm (capital) and sometimes some of the blue-collar labour as well – especially in smaller firms.

If it is agreed that owner-employers of business enterprises do make a productive contribution as entrepreneurs and capitalists, they do *not* necessarily exploit workers when they make a profit. Workers who have not paid for the machines, tools and buildings in the factory in which they work, who spend no time and effort making sure that what they produce gets sold at a profit, and who do not need to pay for losses when production does not get sold at a profit, do not deserve to get all the profits as wages. Workers deserve a fair and reasonable share in the surplus created but they do not deserve to get the total surplus as wages. Owners deserve at least some profit for their entrepreneurial effort and for the risk they take.

Viewed purely as a critique of industrial production rather than of *laissez-faire*, Marx's theory is, of course, not without merit. Nobody doubts that industrialisation has its drawbacks. As already mentioned, mechanisation caused the demise of handicraft production, which has made labour more mindlessly repetitive and "alienating" (although mechanisation has now progressed so far that relatively few workers are needed to operate the machines). Mechanisation also meant that incomes and economic power had become more unevenly spread. But as with just about all economic phenomena, there are both pros and cons. Things are seldom wholly good or wholly bad. Even so, there is obvious merit in the view that the world seems to have gone too far down the road of mechanisation, corporate bigness and extremely high levels of productivity – the inequalities and the concentration of economic power seem just too great. In the opinion of your lecturer, the corporate form of enterprise has something to do with this.[5]

As for the specifics of Marx's labour theory of value (2013:187–188) [2007:175–176], exchange value is determined by labour cost measured in labour time, just as in Smith and Ricardo. Because Marx assumed that capital and land (and entrepreneurship) do not make productive contributions, he saved himself the trouble of having to justify the exclusion of the cost of capital and of land use (and entrepreneurship) from the total cost of production – something that took up a great deal of Smith's and Ricardo's attention. Nonetheless, to justify measuring labour cost in labour time, Marx also had to take on board some of the same unrealistic assumptions as Smith and Ricardo did: one hour of labour time must represent the same amount of effort and skill; if not, wage rates would have to compensate perfectly for differences in effort and skill, so that the same wage would apply to a standard amount of labour ("socially necessary labour time"). Moreover, an hour of labour time had to be equally productive in all its applications, which meant that equal capital-labour ratios in all industries had to be assumed as well. The only important difference from Ricardo and Smith is that Marx intended to explain absolute rather than relative prices. For example, if a bicycle requires 10 hours of socially necessary labour time to produce and the wage rate is R3, then this bicycle should, according to Marx, sell for R30. Notice, however, that this R30 is, just as in Ricardo and Smith, a long-term natural price around which short-term market prices are allowed to fluctuate.

5. For more on this, see references in footnote 1.

Because Marx, like Smith and Ricardo, measures value in labour hours, he explains exploitation with reference to labour hours too. The profits which capitalists "steal" from the workers is then not measured as an amount of money but as a number of hours, namely the hours that are left (in, say, a working day) after workers have worked back their wages.

In order to illustrate this point, Marx once again introduces some off-beat terminology. "Labour power" is the *ability*, the *work potential* of a labourer for one day. It refers to labour as a traded commodity: that is, what the capitalist buys when he hires a worker for a day. The value of this commodity is obviously determined by its "cost of production" measured in labour hours: that is, the number of hours a worker must work to earn back the day's wages paid to him. This value must, however, be distinguished from the value of labour for the capitalist, which is "labour time". Labour time refers to the number of hours this worker is able to work for the capitalist. Incidentally, Marx sets wages at a subsistence level, not on account of overpopulation (as in Malthus and Ricardo) but on account of the continual unemployment created by capitalism itself (2013:189) [2007:177].

It may be reiterated that, in Marx's logic, the fact that workers receive only a subsistence wage may raise the degree of exploitation but does not cause exploitation. Even when workers earn significantly more than a subsistence wage, there would still be exploitation for as long as the capitalist makes a profit – however small or large. As stated several times by now, in Marx's logic, exploitation can be avoided only when capitalists earn zero profit, not when they earn just "normal" or low profit.

According to Marxist theory, surplus value (profit) is created when the value of labour power (the time a worker needs to work back his wage) is less than the labour time (the full working day he works for the capitalist). Hence, capitalists realise a surplus for themselves by buying the only commodity that can create more value than its own. In line with his labour-time theory of value, Marx does not describe exploitation in terms of capitalists paying their workers less than the value of their work, but in terms of capitalists letting workers work longer hours than they need to earn back their wages, as illustrated by figure 10-1 (2013:190) [2007:178].

The figure represents a single 12-hour working day, 6 hours of which are necessary for workers to earn back their wages (left column), leaving 6 hours for the capitalist to extract surplus value out of his workers (right column). It may seem strange on first inspection that both columns represent 15 shillings of value (their height is 15), while the value of labour power (the wages paid to workers) is only 3 shillings. The reason is that wages paid to current workers are not the only cost of production for the capitalist. During 6 hours of cotton-spinning, workers also use up 10 shillings' worth of raw material in the form of cotton and 2 shillings' worth of capital depreciation in the form of used-up spindles. While the cotton and spindles also represent labour time, it is "dead labour" expended in the past to produce the cotton and spindles, which were sold to the current capitalist at that price. Marx is, however, concerned only with the exploitation of "life labour" by the current capitalist, which is why the surplus value created during the latter 6 hours is not equal to the total value of production during that time (15 shillings) but only the value over and above the cost of "dead labour", embodied in cotton and used-up spindles (3 shillings). The figure, incidentally, measures labour hours in shillings, because it assumes a given wage rate in shillings and a given amount of labour time to produce the gold or silver in a shilling.

At this stage, Marx once more introduces somewhat strange terminology. The value of the "dead labour" invested in machinery and raw material he calls "constant capital" (c), while the value of the "life labour" is called "circulating capital" (v). As figure 10-1 also illustrates, the value of constant capital is directly transferred into the value of the final product without adding any value, as an expression of the fact that capital is unproductive. Only circulating capital adds value over and above its own cost in labour time (surplus value s), as an expression of the fact that only life labour is productive.

Marx calculates a number of ratios. First, there is the *rate of exploitation*: $s' = s/v$, which for our example would be $3/3 = 1 = 100\%$. For a given wage rate (1/2 a shilling in our example), the rate of exploitation expresses the ratio between the time workers need to work back their wage (6 hours in our example) and the remainder of the time left in the working day (6 hours in our example): $6/6 = 1 = 100\%$. Then there is the rate of profit: $p' = s/(c + v)$. Note that c refers to the depreciation on machinery and the cost of raw materials (spindles and cotton) *for the whole working day* (both columns), which is 24 in our example. The profit rate is then $3/(24 + 3) = 3/27 = 11{,}1\%$.

Now we come to the "transformation problem". The five points mentioned by the prescribed textbook (2013:192–193) [2007:180–181] are something of a simplification of the problem as Marx presented it. The essence of the problem is contained in point 5: when profit rates are uniform and capital-to-labour ratios differ among industries, commodities will not sell at their exchange price measured in labour time. We encountered more or less the same problem in Ricardo's theory of value. At the root of the problem lies the fact that only labour adds value to output in excess of its cost of production (surplus value), while capital cannot do so. Therefore, capital, in the sense of machinery, cannot create any profit, which seems somewhat unrealistic. In reality, we do see that a greater capital intensity of production (greater mechanisation) tends to create higher profitability.

This brings us to the next issue. The crucial starting point in Marx's views on capitalism's inexorable march towards self-destruction is that mechanisation leads to a reduced profit rate, which immediately raises the question why capitalists would wish to mechanise at all. Marx's answer (2013:193–195) [2007:181–182] is that mechanisation can be beneficial to the individual firm even though it will harm the industrial sector as a whole: it raises the profits of one firm at the expense of the profits of the whole sector.

Moreover, mechanisation can reduce the necessary labour time (the time workers need to earn back their wages), which creates greater scope for exploitation (a greater rate of exploitation). Note however the various offsetting forces, as mentioned by the prescribed textbook (2013:194) [2007:182], which may stave off a decline in profit rates for a time.

Marx then argues how capitalist accumulation will contribute towards the failure of Say's law (2013:195–196) [2007:182–183]. Marx claims that Say's law at best applies to a handicraft production economy, where production is done by self-employed artisans. In such an economy, households also function as production units (workers have their own businesses and are their own bosses), which Marx characterises as $C \rightarrow M \rightarrow C$. Artisan-households sell the commodities they produce for money ($C \rightarrow M$), which they then use to buy the commodities produced by other artisan-households ($M \rightarrow C$). Money income would thus get respent in full with the implication that there are no net leakages from the income-spending stream (no net hoarding of money) and that Say's law holds – if we assume there is no growth in production. Marx did not, however, claim that Say's law necessarily holds in a handicraft production economy; according to him, leakages from the income-spending stream (say, artisans hoard their money rather than spend it) could occur in a handicraft production too.

Even so, according to Marx, industrial production would significantly reduce the chances that Say's law holds. It leads to a divorce between households and business firms. Contrary to household-artisans, business firms buy in order to sell, rather than sell in order to buy again. Business firms aim to make money rather than to consume goods. As a result, their participation in the money economy can be represented as $M \rightarrow C \rightarrow M'$: money is spent to obtain commodity inputs into the production process ($M \rightarrow C$), after which the commodity outputs are sold again for money ($C \rightarrow M'$).

Marx then claims that, unless firms end up with more money than they started with ($M < M'$), they cannot make any profit. But this is not true. As explained in the section on Malthus, $M = M'$ does not indicate that profits are zero but that they remain unchanged relative to the

previous production round. In the same way, M < M′ does not suggest that profits start to become positive but that they are rising relative to the previous production round. As a result, Marx's claim that profits, as and when they occur, need to be squeezed out of workers need not be true either. If total production and profits remain unchanged relative to the past, wages can remain unchanged relative to the past as well. Only when profits have increased and productivity remains unchanged must wages fall. If productivity increases, there is even scope for both profits and wages to increase.

All this is, of course, not to say that Say's law is inviolable. As already mentioned in learning unit 3, there is significant scope for Say's law to fail in a modern economy, particularly due to an unstable net demand for credit (net money creation), unstable spending on non-recently produced goods, unstable passive money holdings (liquidity preference) and unstable international monetary flows.

As noted in the prescribed textbook (2013:195) [2007:183], Marx also claimed that increased investment would raise wage payment by firms, which would temporarily increase demand but ultimately contract demand and cause widespread business failure. The reason, according to Marx, is that the increased wage payment would ultimately lower profits and so cause a depression. There seems, however, little reason to suppose that increased investment would in itself cause a contraction in aggregate demand and in that way cause Say's law to fail (or to fail worse). Say's law fails (or fails worse) when there is a net leakage from the income spending stream: a net additional hoarding of money "under the mattress", a net reduction in the total money stock (money destruction), a net outflow of money from the economy, or a net increase in trade in non-recently produced goods. Why would an increase in investment spending lead to such net leakages? There seems no logical reason. Marx's claim that increased investment spending would reduce profits is solely based on his presupposition (inherent in his labour theory of value) that increased capital intensity and mechanisation makes no contribution to the profits realised by firms. While mechanisation may most certainly contribute to unemployment, it will almost always enhance profits. Such is indeed the dilemma of industrialisation.

The rest of the prescribed textbook's discussion on Marx (2013:197–202) [2007:184–190] should speak for itself. Note, once more, that Marx was mostly wrong in his predictions: increased capital intensity has led to increased rather than decreased profit rates, to increased rather than decreased real wages rates and also, although less obviously and with greater irregularity, to increased rather than decreased employment. Capitalism has definitely not impoverished the masses. But Marx was right on one important point: economic power has become more concentrated and income distribution has become more skewed under capitalism. While capitalism has made everybody better off, it has made some sections of society even better off than others.

Viewing South Africa's exceptionally high unemployment rate, one may be tempted to regard this as an instance of Marx's growing "reserve army of the unemployed". But remember that Marx's unemployment was due to the exchange of capital for labour (technological unemployment), while it is debatable whether South Africa's unemployment is solely or even mainly technological in nature – a case of people being pushed out of their jobs by machines. Moreover, in other more advanced capitalist countries, unemployment is generally quite low at between 4% and 6% (although it has been between 8 and 10% since the Great Recession of 2007–2008), much lower than South Africa's 30% unemployment rate.

LOOKING BACK ON ACTIVITIES 4.1 AND 4.2

Speaking in broad terms, the attraction of Marxist thought lies in the fact that it formulates some valid criticisms of capitalist practice. The problem of Marxist thought, and indeed its

danger, lies in the fact that it proposes an alternative that does not offer a real solution. For instance, Marxists rightly criticise capitalism for condoning an undue concentration of economic power in the hands of a few, but the Marxist alternative seems to make things worse in this regard. There is no greater monopoly than the monopoly of the state owning all productive resources. Similarly, Marxists rightly criticise capitalism for leading to unduly large inequalities, but, again, the Marxist alternative seems to make things worse in this regard. There is no greater inequality than that between the officials in charge of the communist state, which owns all productive resources and the common people, who own nothing and who have no civil liberties nor democratic rights to challenge state officialdom: no freedom of expression, no freedom of association, no freedom to start one's own company or to start a labour union, and no voting rights. In order to address the problems of economic power concentration and inequality in capitalism, we will have to look beyond traditional Marxism. There has to be a better way.

. . . .

RELEVANCE FOR TODAY: A

Socialist sympathisers in modern-day South Africa need to be asked the question: "Does your vision of a socialist revolution empower the people by giving them ownership and a personal stake in the production apparatus, or by nationalising all means of production (land and firms) so that the state virtually owns everything and the people virtually own nothing?"

The question is crucial, because communists have historically been less than entirely honest about this issue. It seems clear that the only way to empower people is to create opportunities for spreading the private ownership of the means of production as evenly as possible, and to educate people so as to give them the technical and business skills to seize these opportunities. Collectivist nationalisation does not give power to people but concentrates all power in the hands of the state. Where people may previously have been in virtual slavery to the capitalists, they will then be in virtual slavery to the state and its officials. It is a matter of debate which is worse.

Socialists may be justified in criticising current capitalism for failing sufficiently to spread the benefits of ownership – ownership in both firms and land. South Africa does need a social revolution of sorts, but a revolution, which truly spreads ownership and power, not one which concentrates ownership and power in the hands of the state and its few exceedingly privileged officials.

RELEVANCE FOR TODAY: B

While the private business sector can indeed be excessively and one-dimensionally profit-oriented in the modern world, especially when organised as impersonal corporate entities (see the articles mentioned in footnote 1), more state involvement need not necessarily serve the interest of the nation better.

To start with, state officials are not immune to greed and corruption either, especially when their power is unchallengeable, as it is under collectivist-communist systems.

And the profit motive plays an indispensable role as an incentive for productivity and efficiency, even if a degree of interventionism may be necessary to keep it within proper bounds. There is just less motivation for state officials to be productive and innovative as they do not personally receive the monetary rewards of productive success nor personally carry the monetary loss of productive failure. Instead, those losses are carried by the state, such as, for example, the recently sustained excessive losses of SAA and Eskom. Those losses come at a price to society, as the state could have used that money in alternative, more beneficial ways, such as to build schools, hospitals and upgrade roads.

To be sure, there are also negative sides to the profit motive.

It may, but need not always, degenerate into rank greed and selfishness (see our comments on Adam Smith in learning unit 2 above). If it does, the weak may indeed be victimised by being charged unacceptably high prices or being paid unacceptably low wages.

Moreover, if we rely exclusively on profit-driven private initiative, many a worthwhile but unprofitable project will not be undertaken. That is why the state often takes the initiative to build schools, hospitals and roads in poorer areas – areas, which may not be able to bear the cost themselves.

But it should be remembered that such state initiatives still remain dependent on the profit motive, because they still need to be financed by taxes, which ultimately come out from income of private people and institutions. If the private sector is not sufficiently profitable and productive, there may not be sufficient tax income to finance all the schools, universities, hospitals, infrastructure and social grants, which we, as a society, may find desirable to provide to our people, irrespective of their income.

After all, if ***all people*** were to look to the state for their means of existence, the state would obviously have nothing to give. The state has resources to give away only because there are private people who do not look to the state for their means of existence but make their own money, part of which is paid over to the state in the form of tax. Such people are able to pay taxes because they are motivated to create a surplus beyond their own needs – that is, they are driven by the profit motive. Although the state can contribute towards wealth creation by providing education and infrastructure, it is not a wealth creator itself; the state can only redistribute what private people have produced.

It is, all in all, difficult to dispense with the profit motive altogether.

RELEVANCE FOR TODAY: C

Always bear in mind that perfect equality of income is impossible and that a degree of inequality may even be desirable and beneficial, for various reasons.

Firstly, inequality is the inevitable correlative of giving those people with entrepreneurial talent and drive the incentive to create wealth and employment for many others besides themselves, which is in the interests of wider society. If we want a vibrant, growing economy with lots of jobs, we will have to allow those with entrepreneurial drive and skill to do more than averagely well for themselves; otherwise we won't have the growth and the jobs.

Secondly, the industrial mode has the advantage of being very productive. But that advantage has to be bought at the price of greater inequality, because the industrial mode can accommodate fewer production units whose owners must then earn above-average incomes, as already explained before.

Thirdly, some particularly unpleasant kinds of work deserve better remuneration, as do kinds of work requiring exceptional talent and skill. Otherwise people would have little incentive to do unpleasant work or to develop exceptional talent and skill. Where would Bafana Bafana or the Springboks be, if we did not allow exceptional rewards for exceptionally talented and skilful players?

Even so, it could still be argued that the present extent of inequality and concentration of economic power is unhealthy and excessive. Large-scale production and bigness have somehow gone too far, which is not to say that private property is all to blame and collectivism is the logical alternative. Collectivist systems have a poor track record. Somehow, we will have to be more creative and look for "third ways", although the recent trend towards globalisation leaves countries little room to manoeuvre. If we want an open economy and the benefits of trade, we have little choice but to follow the standard model of modern Western-style corporate capitalism.

RELEVANCE FOR TODAY: D

It has often been pointed out that anarchism, understood as the total absence of government, is workable only when there is superabundance of all goods.

As soon as there is scarcity of goods, some people get what they want only because other people do not get what they want. Scarcity necessarily implies rivalry. And this rivalry needs to be resolved through some institutional mechanism. In anarchic systems without any form of government (no law, no judicial system, no police, no army, only voluntary restraint), the rivalry over scarce goods is all too easily resolved through violence: the biggest bully gets what he wants. Non-anarchic systems use the coercive power of the state to institute mechanisms through which the rivalry is resolved.

Liberal capitalism uses the coercive power of government to allocate and protect private property rights – property rights in people's own labour (their body) as well as in productive resources like land or equipment. People subsequently use their labour and resources to produce goods and sell these goods to others for an income. Let's call this "market income" because it is generated through market exchange. Under liberal capitalism, it is people's market income, which enables them to lay claim to the scarce goods of their preference, through which those with the largest market income are able to acquire the largest share of the scarce goods – the implicit suggestion being that those with the largest market income have also roughly made the largest productive contributions.

Non-collectivist forms of socialism use the coercive power of the state to amend, in various ways, market incomes. Pragmatic state socialism does so by nationalising some strategic industries, interventionalism, for instance by regulating certain prices, and welfare statism by taxing market incomes and reallocating them to those deemed worthy of support.

Collectivism, by contrast, uses the coercive power of the state not to amend market incomes, but altogether to abolish them. The output of the nation is entirely appropriated by the government, with its officials deciding to channel that output to whom they favour.

Whatever the case may be, the mere existence of scarcity needs some way of resolving who gets what – if it is not the violence of the bully, then it must be some institutional arrangement backed up by the government's coercive power. Justice, it seems, means that the government uses its power in a just way, in accordance with just laws rather than the arbitrary whim of state officials. Anarchism as the absence of government appears to make justice impossible. There is only the law of the jungle.

RELEVANCE FOR TODAY: E

All this is, of course, not to claim that firm owners cannot exploit their workers. Wages may certainly be excessively and unreasonably low, especially because individual workers are often at a bargaining disadvantage vis-à-vis big corporate employers. The labour union movement came into being during the early 1900s precisely in order to address that imbalance in bargaining positions and allow labour to bargain on a more equal footing with business.

Labour unions can, however, also become so strong and powerful that the bargaining advantage starts to tilt in their favour rather. Labour unions can at times even become a menace to society at large. Their militancy can significantly disrupt the economy to the detriment of jobs and incomes for all. South Africa seems presently to enter a dangerous phase of high labour unrest and union militancy, which may merit state intervention. There can be no prosperous, thriving economy without a stable social environment where conflict is resolved in a rational and reasonable manner, without the lengthy disruptions, which benefit no-one.

As noted before, the strict logic of Marx's theory dictates that exploitation can only be avoided if workers receive the full value of their productive contribution in wages. But, in that case, there is no incentive to employ people at all! By implication, Marx removes all incentive to employ people, which is odd indeed. The fact that Marx ends up denying workers the advantage of jobs is understandable in terms of his belief that the interests of the economic classes are irredeemably in conflict with each other. In accordance with Marxist logic, workers cannot, therefore, benefit from cooperation with capitalists by exchanging their labour for an income.

The fact of the matter is: there is both conflict of interest and harmony of interest between workers and owner-employers. There is conflict over wage: the higher *ceteris paribus* the wage for workers, the lower the profit for business owners, and vice versa. But there is potential harmony too: workers need paying jobs, which business owners can give them, while business owners need labour, which workers can give them.

Without their cooperation both would be worse off: workers would have no paying job and business owners would have to do all the productive work themselves, which would obviously severely limit their productive effectiveness (everybody would be forced back into handicraft).

It remains, therefore, in the interest of both workers and employers not to push their demands so far that their potential cooperation is put in jeopardy, which would cause damage to both. During the hard bargaining over wage and working conditions, both unions and employers are usually careful to avoid such a situation. One suspects, however, that there is a new generation of hard-core Marxist unionists who in fact wish to "kill the goose which lays the golden eggs", because they imagine these eggs to be rotten!

LEARNING UNIT 4: SELECTED SELF-STUDY QUESTIONS

1. What are the contrasts between (a) syndicalism and anarchism and (b) Christian socialism and Marxian socialism?
2. Explain Marx's theory of history, relating it to the earlier ideas of Hegel and Feuerbach.
3. If workers are paid the value of their labour power, as Marx contended, then in what sense are they exploited?

LEARNING UNIT

5 The marginalist/neoclassical school, Marshall and Walras

MARGINALIST/NEOCLASSICAL SCHOOL

STUDY OUTCOMES

When studying this section, you should aim at gaining knowledge and understanding of the following:

- how the major tenets of marginalism/neoclassical economics are all the logical result of (1) the mathematisation of theory, and (2) its consideration of the demand side (utility) in the explanation of price
- rational economic behaviour: its meaning, realism and how it distorts Adam Smith's idea of self-interest
- microeconomic analysis (methodological individualism): its meaning and realism
- pure competition emphasis: its meaning and realism
- equilibrium approach: its meaning and realism

Special note: You will notice that marginalist/neoclassical economics is basically the microeconomics that you studied in your first and second year, so you should be familiar with this type of theory. On the other hand, you will also notice that the textbook discusses marginalist/neoclassical economics in a bit more depth than other schools, which may mean that you will need to put in a bit more effort to master this part of the work.

5.1

ACTIVITY

As an introduction to neoclassical economics, consider the following overview provided on the internet by the Open University in the UK.

The neoclassical school of thought and its rivals

Source: http://openlearn.open.ac.uk/file.php/2700/!via/oucontent/course/530/neoclassics.pdf (accessed on 15 March 2012).

Core neoclassical characteristics

One reason why neoclassical economics will seem to have something to say about everything is that it is in many ways more a methodological programme than a single theory that can be put to an empirical test. We can pick out four core features of neoclassical methodology: methodological individualism, rationality, equilibrium and the importance of the price mechanism.

Methodological individualism

This is the methodological position that aims to explain all economic phenomena in terms of the characteristics and the behaviour of individuals.

Because everything ultimately reduces to what individuals do, methodological individualism states that any theory of how the economy runs should be built up from an understanding of how the individuals within it behave. [The prescribed textbook's (2013:224) [2007:212] reference to "microeconomic emphasis" implies methodological individualism.]

Its commitment to methodological individualism means that neoclassical economics puts clear boundaries around what it is attempting to explain (since theories cannot explain everything). It does not want to look at the influence of the economy on the characteristics of individuals, on their tastes, for example. Rather, it is concerned with the influence of individuals on the economy. So neoclassical economists start their analysis by taking the fundamental characteristics of individual economic agents, such as their tastes, as given. This means that such characteristics are taken either to be fixed and unchanging or, if they do change, this is due to factors that lie outside the economic field of enquiry. In the terms of economic theory, these characteristics are said to be *exogenous*.

Margaret Thatcher's famous claim that there is no such thing as society, just individuals and families, can be seen as a classic statement of the politics, which is often seen to lie behind an approach based on methodological individualism. And just as she recognised families as well as individual people, neoclassical individualism embraces other individual units, specifically firms and households. Strictly, a methodological individualist would want to explain how households and firms behave by analysing the behaviour of the individual people who make up the household or firm. Institutionalists reject methodological individualism arguing that human behaviour, including economic behaviour, is fundamentally shaped by its environment, in particular the social and economic institutions of society, including social norms. Therefore, it does not make sense to talk of a pre-social individual and to see society as an aggregate of the behaviour of individual agents [see next learning unit on the institutionalist school].

Rationality

Neoclassical theory assumes that all individual behaviour is 'rational' according to a very specific definition of this term. Individuals are assumed to be self-interested and to have well-identified goals that they pursue in the most efficient way possible. To do this, they maximise something; usually consumers are assumed to maximise pleasure (utility) subject to what they can afford, and firms are assumed to maximise profits subject to what it is technically possible for them to achieve. Institutionalist theories criticise the assumption of rationality from different angles [see again next learning unit]. Evolutionary economists, for example, reject the notion that agents can maximise their goals, and see behaviour as aimed at the achievement of a satisfactory outcome through adaptation in response to previous experience rather than a conscious effort to maximise. Other institutionalist theories question whether we can see the goals of individuals as given, rather than being produced by the economy, while more interdisciplinary approaches suggest that values beyond pleasure and profit inform human behaviour; in particular, that people may also act out of habit, a desire for status, a sense of obligation or concern for others.

Equilibrium

In order to build models that reduce the complexity of the real world economy and are, therefore, manageable and easy to understand, neoclassical economics concentrates on the analysis of equilibrium. These are situations where whatever aspect of the economy is being modelled is at rest because no individual has any incentive to change what they are doing (unless external factors change).

A single market, for example, is in equilibrium when the market price is such that all buyers can buy as much as they want and all sellers can sell as much as they want at that price. This price is then the equilibrium price. In such a situation, no buyer or seller has any incentive to change what they are doing and the *status quo* persists, unless external forces alter anything.

Much of neoclassical theory is concerned with understanding the conditions under which a general equilibrium exists and whether it is unique and/or stable. A frequent next step is the method of comparative statics, which compares the equilibrium that results in two different situations, to see the effect of changing external conditions, say the cost of raw materials, on output and price within a particular market.

The importance of the price mechanism

The fourth main characteristic of the neoclassical school of thought is the central role it gives to the price mechanism in connecting economic agents. In neoclassical models the main, frequently the only, interaction between economic agents takes place through the price system. Decisions are based on prices alone: individuals do not have any other information in order to help them decide what to buy and sell. This means that neoclassical models assume that prices contain all the information needed by buyers and sellers, and that they provide agents with the necessary incentives to act (buy, sell, produce). In other words, the only information an individual has about the outside world is obtained through the market and the prices encountered there.

All economists would agree that the price mechanism is a very powerful institution that has a central role in markets. The neoclassical approach is distinguished by its almost exclusive focus on prices in the analysis of markets. This applies to all kinds of markets, irrespective of the goods and services traded and the type of exchange between buyers and sellers. Institutional economists, by contrast, believe that other social relationships and the characteristics of the good or service exchanged in a market affect how market processes work and the extent to which the price mechanism alone can co-ordinate a market [see, once more, the next learning unit]. In some markets, prices cannot carry all the information that agents would wish to have: for example, employers often do not know how productive employees they intend to hire will be. In these circumstances, there will be other non-market signals about other people's behaviour that agents take into account in deciding what to do. The institutional approach, therefore, has theories about these and other circumstances in which habits, trust, values and cultural norms inform and influence economic behaviour.

Another distinguishing feature of the neoclassical focus on the price mechanism is the attitude it takes to 'transaction costs', the costs that are associated with market transactions. There are a number of 'costs' that buyers and sellers incur in order to carry out a market transaction. Some of these, such as search and monitoring costs, are a direct consequence of the fact that agents do not have all the necessary information to carry out a transaction effectively. Other transaction costs include the costs of bargaining and arranging contracts and then enforcing them. Although many neoclassical economists would recognise that such costs exist in the real world, in order to make their models simple and usable they treat market transactions as costless. Many institutionalist economists feel that this simplification is too unrealistic and so build theories that are based on the existence of transaction costs [see again next learning unit].

There are some economists who have no quarrel with the other characteristics of neoclassical economics outlined above, but recognise that transactions are not costless and that the information transmitted by prices may be incomplete. These 'new institutionalists' have put forward theories to explain how institutions developed in market economies cope with the lack of full information and transaction costs.

These economists are referred to as 'new institutionalists', because they focus on institutions beyond the price mechanism, but unlike 'old institutionalists', they are similar to neoclassical economists in that they are methodologically individualist, assume rationality and focus on equilibrium, and they do not consider wider societal factors such as social values and norms [see next learning unit again].

Traditional neoclassical characteristics which are not core

In addition to the core features of the neoclassical approach, which have provided the main areas of contention between neoclassical theorists and their critics, there are also a number of additional non-core features that are often, but not always, present in neoclassical theories. Three of these non-core characteristics concern the extent of competition, the degree of knowledge economic actors can be assumed to have, and the use of formal modelling. The final one is the way that the different parts of neoclassical economics can be amalgamated in one overarching theory, known as competitive general equilibrium theory.

Competition

A strong assumption of neoclassical economics is that the power of individual economic actors is sufficiently small that they can take their environment as given, without thinking about the effects of their own actions on it. Specifically, given the neoclassical focus on the price mechanism, this assumption means that all agents are assumed to be price takers, reacting to prices, which the agents do not believe that they themselves can influence. In real world markets, many agents have much more power than this and can have significant effects on prices in the markets in which they buy and sell.

Agents' knowledge

Traditionally, in neoclassical theory the unrealistic assumption is made that all economic agents have perfect knowledge of anything in the past, present or future that might influence their decisions; in particular, that they know all future prices. There are now modified versions of neoclassical theory that allow for agents being uncertain about the future.

If the uncertainty about the future is about the decisions that other agents will take in the future, and choices and outcomes are interdependent, then agents have to act strategically in order to make the most of the situation. This happens, for example, in the case of asymmetric information, that is, when some agents know things that are not known to others. Situations where strategic behaviour is likely to occur are analysed using game theory.

The use of formal modelling

One of the characteristics of economics as compared with other social sciences is its systematic use of formal models, models that abstract from the complexities of the real world to concentrate on a few variables at a time, and then investigate very thoroughly the relationships between these variables, sometimes using mathematical techniques to do so. Neoclassical economics, in particular, uses a highly developed set of formal models. In developing such formal models, certain abstractions have to be made and theories often differ in what they see as the significant aspects of an economic problem. Because neoclassical theory uses mathematical modelling a great deal, some of its abstractions are designed to make the mathematics tractable.

Building up to competitive general equilibrium theory

As mentioned earlier, neoclassical economics should be seen more as a methodological programme of how to do economics than a collection of particular theories. The theory of competitive general equilibrium [see section on Walras in this learning unit] can be seen as the culmination of this neoclassical programme, building on all its features (both core and non-core).

Many economists would agree that it is the greatest achievement of the neoclassical approach.

In brief, competitive general equilibrium theory examines the conditions under which a decentralised market economy, in which economic agents follow their own interests, will reach an orderly outcome that is economically efficient. What is meant by 'orderly' is that all markets are in equilibrium, and by 'efficient' is that nobody's welfare can be improved without making things worse for someone else [Pareto efficiency].

Competitive general equilibrium theory represents the neoclassical school of thought in its purest form. Its requirements go beyond the four core characteristics of the neoclassical approach as it also needs the non-core assumptions of perfect competition and perfect knowledge, and it is usually presented using formal mathematical models.

Competitive general equilibrium theory has not only had a great impact on economic theory, but it also has strong policy implications. The result that, under some (admittedly restrictive) conditions, a decentralised market economy can be coordinated through the price system alone and achieve an outcome that is economically efficient is a very powerful statement in favour of market economies and leaving economic policy to 'the market'.

. . . .

Question: Having studied much of neoclassical economics in your first and second year studies, do you think the Open University article is unduly critical?

DEMARCATED READING

At this point you should read chapter 12: only the section "Overview of marginalist school".

CONTENT

The textbook, as well as the Open University's overview (in the Economics in Action section above), is quite comprehensive and mention many characteristics of this school of thought. As a result you may fail to see the wood for the trees as far as the essential nature of the marginalist/neoclassical school of thought is concerned. This school is basically about only two things:

(1) *The recognition that the demanders' valuation of a good (its utility) plays a key role in determining market price.* The early marginalists like Jevons and Menger (whom you don't have to study for the exam) reacted to the classical position, which one-sidedly emphasised the suppliers' valuation of the good (cost of production) as the main determinant of its price, by embracing the opposite one-sided position that regards demanders' valuation (utility) as the main determinant of price. That is why the prescribed textbook (2013:225) [2007:213] mentions "demand-oriented price theory" and an "emphasis on subjective utility" as main tenets of marginalism. However, the subsequent neoclassical theorists, Marshall in particular, combined cost and utility (suppliers' and demanders' valuations) in determining price. Be aware that marginalist/neoclassical theory is different from classical theory in that it wishes to determine the short-term market price, rather than the long-term natural price.

(2) *The mathematisation of theory.* Preceding classical theory was inclined to regard economic regularities (economic laws) as rough tendencies, in the style of "price tends to rise when demand increases", whereby the precise magnitudes of the increases in demand and price were ignored. Classical theorists did not intend to be specific and exact about numerical values, because they knew them to be irregular anyway: for a given increase in demand, price could sometimes increase a little and sometimes a lot. But the skeleton of the regularity – that price increases when demand increases – was considered to be generally applicable and, therefore, of theoretical relevance. By contrast, marginalist/

neoclassical theory did implicitly intend to be precise and specific about the numerical magnitudes in economic regularities. For example, it expresses economic regularities like “price tends to rise when demand increases” in mathematical language, like $P = aQ + b$. Although the parameters a and b in this supply function remain unspecified, they are still assumed to be at a given and fixed level so that theory can determine the precise numerical effect of Q on P.

Because neoclassical theory wished to be specific and precise about the numerical values in its demand and supply functions, it also had to be specific and precise about the expected utility that the acquisition of various quantities of good x will yield in the eyes of a demander or the expected profitability of its planned production in the eyes of a supplier. Only if there is complete certainty about these values on the part of agents can mathematically precise values of price and quantity be established. Agents must, therefore, possess perfect knowledge about their profit and utility opportunities, and they must be relentless maximisers of their profit or utility. It would be “irrational” to let known profit and utility opportunities go unexploited. That is where the marginalist/neoclassical assumption of “rational economic behaviour” (2013:224) [2007:212] comes from. Moreover, profit or utility maximisation is achieved when marginal cost is equal to marginal benefit (profit or utility), which explains the neoclassical “focus on the margin” (2013:224) [2007:212]. Demanders and suppliers make their consumption and production decisions at the margin, when they are presumed to change their consumption and production quantities by one unit at a time. And they change their consumption and production quantities by one unit at a time because their strict rationality forces them to be pin-point precise about their decisions. Utility/profit maximisation is achieved when cost equals benefit at the margin, because that equality indicates that all opportunities for increasing profit/utility by varying quantity demanded or supplied are already exhausted. And when all opportunities for increasing profit/utility are already taken advantage of, profit/utility must by definition be at their maximum level.

Be aware that the marginalist/neoclassical assumption of strict profit and utility maximisation turned Adam Smith’s concept of self-interest into something which Smith never intended: egocentrism and greed. Recall how Smith’s concept may be consistent with egocentrism and greed, but is not synonymous with egocentrism and greed. Smith’s self-interest degenerates into egocentrism and greed only if people are presumed to be *exclusively* concerned with their own needs. But such a relentless and uncompromising pursuit of personal gain at the possible expense of others is not necessary to Smith’s concept of self-interest at all. As noted in learning unit 2, Smith’s butcher, brewer and baker can strive to meet their own needs, even while being considerate of the needs of others too; they are not compelled to push their own interest to the absolute limit. But the neoclassical idea of the strict mathematical optimisation of profit and utility does exactly that, thereby distorting Smith’s idea.[6]

When rational behaviour is maintained and agents always maximise their profit or utility, they must find themselves on their demand and supply curves, which, in turn, requires that price must always be at the point of intersection between demand and supply curves. If price is not at the point of intersection between demand and supply curves, then either the demander or the supplier (or both) must be off their curve. Hence, the marginalist/neoclassical “equilibrium approach” (2013:225) [2007:213]. Furthermore, only in a purely competitive market, understood as the presence of many demanders and many suppliers in each market, will there be this tendency towards demand-supply equilibrium where price clears the market, which explains the marginalist/neoclassical “pure competition emphasis” (2013:224) [2007:212]. Finally, a numerically precise analysis of production is greatly simplified if it can assume only the two production factors of capital and labour, which is

6. We also noted in learning unit 2 how Smith’s concept of self-interest, while far from synonymous with altruism, is not inconsistent with altruism. It may even be regarded as a precondition for altruism: only those who have already provided for the minimum of their own needs are capable of caring for the needs of others.

why marginalist/neoclassical theory was inclined to regard land as a form of capital – the "merger of land with capital goods" (2013:225) [2007:213].

So you notice how just about all the "major tenets of the marginalist school" mentioned by the prescribed textbook (2013:224– 225) [2007:212– 213] follow from the above two characteristics: (1) recognition of the role of demanders' utility in price determination, and (2) mathematisation of theory. The first seems to have been an important step forward and the second an important step backward. The near-complete supremacy of the mathematical method in modern economic theorising is, in the opinion of your lecturer, unhealthy and damaging to the subject. It all started with marginalist/neoclassical economics during the second half of the 19th century, although Ricardo's abstract, deductive method can be interpreted as already betraying a certain bent towards the wish to be numerically precise and specific in its theoretical pronouncements. All this is not to say that mathematics has no role to play in economics. Mathematics is fine as long as there are no pretentions to numerical precision, which means that its usefulness is confined mainly to applied econometric analysis, which accepts the variability of its model structure and the instability of its parameter values, uses error terms and unashamedly adopts a pragmatic approach.

Carefully study the textbook's "Overview of the marginalist school" and keep its themes at the back of your mind when studying Marshall.

MARSHALL

STUDY OUTCOMES

When studying this unit, you should aim at gaining knowledge and understanding of the following:

- the law of diminishing marginal utility
- money as the measure of utility
- utility comparisons (of the same good between different persons, or between different goods for the same person) and the utility of money
- equimarginal principle and the law of demand
- ceteris paribus and the law of demand: movements along the curve *versus* shifts of the curve
- consumer surplus: meaning and measurement
- elasticity of demand: meaning and measurement
- supply in the immediate present, the short run and the long run
- producer surplus: meaning and measurement
- supply and demand as "the upper and the under blade of a pair of scissors that cuts through a piece of paper"
- the role of rivalry ("higgling and bargaining") between buyers and sellers in reaching the equilibrium price
- Marshall's concepts of "long-run normal price" versus "short-term market price"
- Marshall's theory of an optimal distribution of income: "At the margin of indifference between two substitutable factors of production, their price must be proportionate to the money value they add to total production"
- Marshall's theory of the wage rate: supply and demand curves for labour
- Marshall's theory of the interest rate: supply and demand curves for loanable funds (saving and investment)
- Marshall's theory of profit.
- Marshall's theory of rent (land = capital).
- quasi rent as the return on existing capital, which is fixed in the short run.
- Marshall's "representative firm": the sole proprietor typical of nineteenth-century manufacturing before the arrival of the joint-stock company (the limited liability corporation).
- the life-cycle of business enterprise (as sole proprietorship)

- internal versus external economies
- increasing versus decreasing returns to scale
- the difference between partial equilibrium analysis (Marshall) and general equilibrium analysis (Walras)

DEMARCATED READING

At this point you should read all of chapter 15, excluding “15-1 Past as prologue”, “15-2 Past as prologue”, “Elasticity of demand” and “Welfare effects of taxes and subsidies”.

CONTENT

Even though this chapter about Marshall basically covers the same material as second-year microeconomics, students tend to find it difficult. We will, therefore, try to provide some additional explanation. Occasionally we will also indicate paragraphs that you can ***ignore***, because they are unnecessarily obscure. Do try to get to grips with this chapter, though. It still contains important and useful insights.

Take note of the difference between marginalism and neoclassicism as described by the prescribed textbook (2013:293) [2007:275]. The basic methodology of the two schools is the same, namely the mathematical mode of analysis. Neoclassicism only extended marginalist analysis in a few more directions. It is of course ironic that Marshall, who contributed significantly to the mathematisation of economics, was sceptical about its value (2013:294) [2007:276].

In connection with the law of diminishing marginal utility (2013:295–297) [2007:277–279], Marshall implicitly regards marginal utility as the change in total utility resulting from an *infinitely small* change in the number of goods consumed, precisely so as to facilitate its use in mathematical optimisation (utility maximisation). But this strictly mathematical view of marginal utility is not indispensable for the law of diminishing marginal utility. That law can also be stated with reference to a kind of “marginal” utility, which merely expresses a change in utility resulting from the final addition to (or subtraction from) the number of goods consumed, whereby this final addition (or subtraction) does not necessarily need to be infinitely small. So even if we remove its mathematical application, the law of decreasing marginal utility can remain a valid and useful theoretical device. Something similar applies to the law of diminishing marginal returns in connection with marginal productivity and marginal cost. Note Marshall’s two qualifications of the law of diminishing marginal utility, which show some of its limitations (2013:295–297) [2007:277–279].

In the section entitled “Marginal Utility” (2013:295–297) [2007:277–278], the third paragraph starting with “The utility approach of the Marshallian system …” to the end of the section ***can be ignored***. These paragraphs unnecessarily complicate a simple issue, namely that utility can be measured with money. In its stead, the following paragraphs will attempt to explain, hopefully more simply, how money can be used to measure the utility of goods.

Utility is obviously a subjective concept. It refers to subjective feelings and expectations, more particularly an agent's subjective expectation about a good’s ability to meet a certain need in him or her. For example, a loaf of bread has utility for me, because I expect it to have a nice taste and to be able to satisfy my hunger. I estimate how this loaf can meet my needs for a nice taste and for relieving my hunger sensation and I accordingly assign utility to it, depending on how strongly felt these needs are and the extent to which this bread is expected to meet them. The needs that a good can satisfy do not have to be only physical, but can be psychological as well. A fancy Mercedes has extra utility for people over and above its usefulness as a reliable mode of transport, because it also has a certain snob value, which meets some people’s needs to be esteemed and looked up to (see the discussion on Veblen in learning unit 5). Daimler-Benz knows this and can, therefore, ask a higher price for its cars.

The question is: Given that utility is subjective and immeasurable, how can it ever be regarded as influencing price, which is objective and quantitatively measurable?

The solution to this riddle lies in the fact that price is a ratio of two subjective valuations – concerning the utility that an agent assigns to a unit of good x and the utility that he or she assigns to a unit of money spent to procure x. While the utility of good x is purely subjective and as such unquantifiable, its subjective dimension can be concealed by expressing it as a multiple of the equally subjective utility of having command over a unit of money. This is effectively what happens whenever monetary value is assigned to a good. For example, when my wife declares that a mountain bike is worth R1 000 to her "and not a cent more", what she is actually saying is that, in her estimation, the utility of a mountain bike is a thousand times greater than the utility of one rand spent to acquire it. Hence, by expressing value as a dimensionless ratio of two utilities (that of the good traded and that of the unit of money spent to acquire it), value can be objectified without having to deny the subjectivity of its constituent utilities. This is what Marshall recognised as well (2013:295–297) [2007:277–278].

Marshall, furthermore, suggested that if two people are willing to pay the same amount of money for a certain good, say both John and Tandi value a mountain bike at R1 000, the utility they assign to possessing a mountain bike is roughly equal. But this suggestion is valid only if John and Tandi's utility of one (marginal) rand spent to acquire the bike is roughly equal, which need not necessarily be so. The utility that people assign to their money differs, among other things, according to their income. Generally wealthier people assign less utility to their incremental money units spent than poorer people. That is why a wealthier person will decide to buy a Mercedes and a poorer person will not, even though both may assign equal utility to owning and driving a Mercedes. The utility of money spent on a Mercedes is determined by the utility of the goods foregone that could alternatively be bought with that amount of money, which is much higher for the poorer than for the richer person. After all, the poorer person, when buying a Mercedes, is likely to have to forego life's necessities (food, clothing and shelter), which have a very high utility, while the richer person's needs for food, clothing and shelter are not at risk when spending money on a Mercedes.

The utility of money is likely to be roughly the same for the same person, although the money may be spent at different times under changed circumstances. That is why Marshall suggested that if a person, say Lindiwe, is willing to pay the same amount of money for two goods whose consumption yields different kinds of pleasures (say R1 000 to buy a mountain bike or R1 000 to go on a pleasure cruise), the utilities of these different pleasures are probably rated the same by Lindiwe. Marshall also suggested, which is perhaps more questionable, that we can assume the same utility of money for whole sections of society with roughly the same income, or even for society as a whole. Marshall's underlying reasoning is that differences in preferences more or less cancel out for a larger group of people, so that some sort of stable average set of preferences applies. If the utility of money can be viewed as roughly the same for the whole of society, the amount of money spent on certain goods becomes a reliable indication of how society values these goods.

The subsequent section on "Rational Consumer Choice" (2013:297) [2007:279] merely establishes the fact that consumers maximise their utility. The section after that ("Law of Demand", (2013:297–300) [2007:279–282] discusses how Marshall employed the equimarginal principle to explain how consumers reach maximum utility. According to this principle, a person maximises his utility, when the utility per unit of money spent on the various goods available (A, B, C, etc) is equal: $MU_A/P_A = MU_B/P_B = MU_C/P_C$ and so on (2013:297) [2007:279].[7] The equimarginal principle is just a particular way of expressing the profit/utility maximisation condition (marginal cost = marginal benefit). It is applicable to circumstances in which an agent spends a given amount of income over a limited number of goods. Spending one rand more on good A will then require spending one rand less on any other

7. Recall that nominal prices (P_A, P_B, or P_C) are amounts of money: R4, R121 or R0.60. Therefore, MU_A/P_A, MU_B/P_B or MU_C/P_C indicate the utility of 1 rand spent on good A, B or C.

good, say good B. If the utility of this rand spent on A and B differs, say $MU_A/P_B > MU_B/P_B$, the agent could increase his utility by taking one or more rands away from B and re-allocating them to A. The loss of utility by withdrawing money from B will be more than compensated for by the gain in utility when that money is rather spent on A. Hence what the equimarginal principle, in effect, tells us is that all opportunities to increase total utility by re-arranging a given amount of total income over various spending options have already been exhausted, so that utility is maximised. If the textbook doesn't help you understand this, go back to your first-year or second-year prescribed book for microeconomics.

Note that the equimarginal principle presupposes that our agent exhaustively spends all his income, exhaustively considers all spending options (goods available) at the same time and has exhaustive and precise knowledge of the expected utility of all these options, which of course rather takes things to the extreme. We do not walk around a shopping mall simultaneously considering the utility and price of all goods available in all shops and calculating a utility of the marginal rand spent on all of these items. To the extent that the equimarginal principle describes something real, it obviously does so only very roughly and approximately. It is true that we do very roughly equalise value for money on our purchases (think about that). But, as said, because neoclassical theory wanted to be exact about numerical values, it had to be exact and exhaustive about utilities and prices on all goods. Moreover, agents do not necessarily spend ALL their income over a period. They may save a bit for later, in which case the utility of future goods during future spending trips would need to be considered too, which further complicates the neoclassical endeavour to be quantitatively exact about buying behaviour.

Marshall then uses the logic of the equimarginal principle to derive an individual consumer's demand curve, say his demand curve of good A. When the price of good A increases (P_A now represents more rands), the utility of one rand spent on good A (MU_A/P_A) falls. If we assume that the utility of one rand spent on all other goods (MU_B/P_B, MU_C/P_C, et cetera) remains unchanged, the consumer will have an opportunity to increase his total utility by spending less money on good A and more on other goods (B, C, et cetera). As the consumer buys less of A and more of the other goods, the law of diminishing marginal utility dictates that MU_A rises and the MUs of the other goods fall. This process goes on until the MUs of all goods are brought back into equality again: $MU_A/P_A = MU_B/P_B = MU_C/P_C$, et cetera. The same applies the other way around: when the price of good A falls, the consumer will have reason to buy more of A and less on other goods. This is the logic on which Marshall bases the negatively sloped demand curve according to which an increase in price causes a decrease in quantity demanded, and vice versa.

But you will notice that the demand curve, thus derived, assumes that only the price of good A (P_A) changes, while the marginal utility of good A (MU_A) as well as the marginal utilities and prices of all other competing goods (MU_B/P_B, MU_C/P_C, et cetera) remain unchanged. And it also assumes that the total income of this consumer remains unchanged; it was emphasised above how the equimarginal principle presupposes a given amount of income. That is why the *ceteris paribus* ("all other things equal") assumption plays such an important role in Marshall's derivation of the demand curve. When one of these "other things" do change and the *ceteris paribus* clause is violated, the curve shifts. For example, when the consumer's income or the utility which he or she assigns to good B (MU_B) changes, the demand curve of good A shifts. Only a change in the price of A (P_A) causes a *movement along* its demand curve; a change in any other variable causes a *shift of* the curve. The language of the second paragraph of the section entitled "Law of Demand" (2013:297) [2007:279] starting with "Marshall illustrated the law of demand …" may be a bit complicated. But this is its essential, fairly straightforward message.

Marshall's use of the equimarginal principle in deriving his demand curve obviously also assumes that the utility of one rand spent on the various goods (the utility of money) remains the same. In the subsequent paragraph starting with "In formulating his theory of demand …" (2013:300) [2007:280–282], the prescribed textbook notices that the utility of one rand may,

however, be influenced by changes in the price of good A. This happens when the consumer's spending on good A takes up a large proportion of his total income. In that case, changes in A's price will significantly affect total income available to spend on other goods, which is then also likely to affect the utility of one rand spent on the other goods. If you grasp this, you can ***otherwise ignore*** that paragraph. It deals mainly with the distinction between the substitution effect and the income effect, which you may still remember from your second-year microeconomics.

In the section "Consumer surplus", the prescribed textbook (2013:300–302) [2007:282–283] refers to "the Austrians" and to the "paradox of value". These Austrians are Menger, von Wieser and von Böhm-Bawerk, whose ideas you ***do not have to study*** for the exam. In the context of Austrian economics, the textbook also discusses the paradox of value; you ***can also ignore*** that issue for purposes of the exam.

While the section on consumer surplus may appear somewhat complicated, the concept should not be overly difficult to grasp. Recall from our introductory comments on price theory in learning unit 2 on Adam Smith, that the demander's valuation of good A is a *maximum cut-off price*. If the market price of A rises above this price, the demander is not interested in buying an (extra) unit of A because an (extra) unit of A would cost him more than what that unit is worth to him. If the market price of A falls below this price, the demander will buy an (extra) unit of A because the (extra) unit costs him less than what it is worth to him. The difference is consumer surplus: demander's valuation (maximum cut-off price) of a unit of A *minus* its market price. When the market price of a unit of A is equal to its demander's valuation, the demander is indifferent between buying or not buying (more of) A. The demander does not add to his consumer surplus.

The individual consumer's demand curve of good A is really a collection of his valuations (maximum cut-off prices) of good A as he changes his quantity demanded. Under the influence of the law of diminishing marginal utility, his valuation of successive units of A falls as he demands more of good A (the curve slopes downwards). Hence, as the actual market price falls and the consumer buys more of A until the point where market price equals maximum cut-off price, the intra-marginal units of A (the units of A bought prior to the last one) start to earn him a surplus: they are worth more to him than what he paid for them. Only the last bought unit (the marginal unit) will not earn him a surplus because market price equals maximum cut-off price. If you add up all the surpluses on the intra-marginal units bought, you get the total consumer surplus. Graphically it is the area below the demand curve bordered on the South side by the horizontal line representing the market price: see figure 15-1 (2013:306) [2007:287].

Conceptual problems with the idea of consumer surplus arise when one moves from the individual consumer's demand curve to the market demand curve of all consumers of good A, which is a horizontal addition of all individual consumers' demand curves (see your first- and second-year microeconomics). Calculating the market's consumer surplus in the same way as the individual's consumer surplus presupposes that all consumers assign not only the same utility to the marginal one rand of their income, but also to all the money units spent on A. All "one rands" spent on A must carry the same utility for all consumers. Otherwise one cannot add up the money valuations of good A on the part of all the consumers. This problem is discussed by the textbook in the last paragraph of the section starting with "A second problem associated …"

You ***can ignore*** the second last paragraph of the section on "Consumer Surplus" starting with "Marshall purposely selected …".

The section on the "Elasticity of Demand" (2013:302–303) [2007:283–284] is ***not prescribed***, mainly because it is really straightforward second-year microeconomics content, with which you should already be familiar. Just know that the concept comes from Marshall.

The same applies to Marshall's theory of supply (2013:303–304) [2007:284–286] and his theory of equilibrium price and quantity (2013:305–307) [2007:286–288]. But we left them in because these topics are foundational to Marshall's price theory.

In the context of the theory of supply, do take note of the definition of the market period and the shape of the supply curve in the "immediate present", the "short run" and the "long run" respectively. Brue and Grant (2013:307) [2007:288] comment on Marshall's treatment of time is worth emphasising:

> *As a general rule, . . ., the shorter the period of time, the greater the influence of demand on value. The reason is that the influence of cost of production takes longer to work itself out than does the influence of changes in demand . . . In the long run, therefore, the cost of production is the most important determinant of price and value. In a stationary state . . . cost of production would govern price and value. In a changing world, however, with adaptations to change that are imperfect and gradual, both demand and supply are important.*

The logic of producer surplus is completely analogous to that of consumer surplus. The supplier's valuation of an (extra) unit of good A is really a *minimum cut-off price*. A market price below it will cause the supplier not to produce an (extra) unit of A (he would make a loss on it), a market price above it will cause him to make a surplus profit on it (which is producer surplus) and a market price exactly at it will cause the supplier to be indifferent between producing or not producing (more of) A. The producer will make a surplus profit on the intra-marginal units produced, while this surplus is zero on the marginal unit (the last unit produced before total profits start to decline). If we add all these surpluses, we get the total producer surplus for a given producer of good A, which can be graphically represented by the area above his supply curve bordered on the north by the horizontal line representing the market price (see again figure 15-1 (2013:306) [2007:287]. Producer surplus, of course, carries a strong resemblance to Ricardo's rent, which is also earned on intra-marginal land. Similar conceptual problems arise when a producer surplus is calculated for all suppliers of good A, using its market supply curve. Such calculation similarly presupposes that all suppliers assign the same utility to one rand earned in producing and selling good A.

It is important to realise that, even if we may criticise the marginalist/neoclassical way of providing theoretical underpinnings for the market demand and supply curves, these curves may still be useful theoretical devices to explain the behaviour of price in a competitive market. The planned quantity demanded for a given good will often vary inversely with price, just as the planned quantity supplied will often vary positively with price. When factors like income change, which causes the whole demand curve to shift, the amount traded and the price will often change in the way predicted by Marshallian demand-supply theory. The same applies to changes in factors, which shift the supply curve, provided that the relevant market is reasonably competitive – in other words there are many demanders and suppliers in the market.

Marshallian and classical theories of distribution (2013:307–311) [2007:289–292] are similar in that both assume that factor prices (wage rate, profit rate, interest rate and rent rate) determine income distribution. However, Marshall's theory of income distribution is also a significant departure from classical theory on the topic, in at least two ways.

First, in classical theory, factor prices and the resultant factor distribution do not influence total productive output: how the cake is carved up does not influence the size of the cake. But factor prices do influence total output in Marshallian theory: how the cake is carved up does influence its total size. The correct pricing of factors ensures that they are optimally used. Any deviation of factor prices from their competitive equilibrium levels harms total output.

Marshall uses something like the equimarginal principle to determine the optimal distribution of income. Firms minimise their costs when the price and productive contribution of the various factors are equal to each other at the margin. And they achieve this when the marginal one unit of money (say one rand) spent on the various factor inputs

contributes the same marginal addition to total income. In symbols: $P_O.MP_L/P_L = P_O.MP_K/P_K$, assuming only two factors, labour (L) and capital (K), whereby P_O is the price of output, MP_L and MP_K the marginal products of labour and capital, and P_L and P_K the wages rate (price of labour) and interest rate (price of capital) respectively. As Brue and Grant (2013:307–308) [2007:289] remark:

> *At the margin of indifference between two substitutable factors of production, their prices must be proportionate to the money value they add to the total product.*

In other words, one rand spent on various production factors yields the same addition in nominal output, which ensures that total nominal output is maximised for a given total cost or, what amounts to the same thing, total cost is minimised for a given total output. In your second-year microeconomics text, this is the point where the isoquant touches the isocost curve.

The crucial implication is that factors (labour and capital) are rewarded according to the value of their productive contribution, which provides an obvious defence for the justice of market incomes. Note, however, that neoclassical/Marshallian theory of income distribution assumes that factor and output markets are perfectly competitive and that factors are completely substitutable for each other, which is, of course, seldom the case. Most markets in modern capitalism are oligopolistic and factors are very imperfectly substitutable. One cannot always substitute labour for machines, or land for entrepreneurship, or machines for land.

Second, contrary to classical theory, Marshall's theory employs demand and supply curves for the relevant factor inputs to determine their price. Hence, factor price is influenced not only by factor cost to the supplier of the factor but also by factor profitability (or contribution to profitability) to the demander of the factor.

The demand for labour curve is downward sloping because of the decreasing marginal productivity of labour (MP_L), as you should recall from your second-year microeconomics. The prescribed textbook (2013:308) [2007:289] suggests that Marshall assumed a vertical labour supply curve indicating the size of the total labour force, which implies that the supply of labour remains the same irrespective of the wage rate. The wage rate is then determined at the intersection of the supply and demand curves. You ***can ignore*** the section on the determinants of the wage elasticity of labour demand (2013:308–309) [2007:289–290]. It is ***not prescribed***.

Something similar applies to Marshall's demand and supply curve of new capital (investment), by which the interest rate is determined (2013:309–310) [2007:290–291]. The demand curve for new capital (investment) is downward sloping because of the decreasing marginal productivity of capital (MP_K). The supply curve of new capital (saving) is upwards sloping because, *ceteris paribus*, the higher the interest rate the more inclined people will be to postpone consumption and lend out saved funds. The interest rate is obtained at the point of intersection between both curves.

Marshall treats land as capital. Rent is accordingly simply a return on money invested, that is an interest rate. Land (or nature more broadly) is, however, unique among production factors and unlike capital in a number of respects. Unlike machinery, land is in fixed supply, land is not man-made but a gift of nature, and land values are partially socially determined by the value and usefulness of surrounding land. We mentioned this earlier in our discussion of Henry George.

Because profit contains the reward for investing capital ("interest"), labour ("the earnings of management") and entrepreneurship ("the supply price of business organisation") (2013:310) [2007:291], it cannot similarly be viewed as determined by the demand and supply curve of some single production factor. Marshall treats profit in a distinctly classical fashion by assuming that it tends towards some stable ("normal") level in the long run. Long-run

"normal" profit is then defined as that level at which capitalist entrepreneurs do not wish to enter or leave an industry.

Marshall's rent theory is distinctly Ricardian, since he similarly assumes that rent does not influence price. In Ricardian rent theory, rent cannot influence price because price is determined at the point where price equals marginal cost while rent is not treated as part of marginal cost.

Marshall argues that, in the short-run, the stock of existing real capital (machinery) is in fixed supply. In that sense, it is like land, which is also in fixed supply. In the short run, therefore, the return on the stock of real-capital is determined in the same way as rent on land. Marshall thus calls it "quasi-rent". In the longer term, however, the supply of capital goods is variable, which means that its return is no longer determined in this way, but as the interest rate obtained by the interaction of the demand and supply of investible funds (money capital, that is savings and investment).

The prescribed textbook's (2013:312– 315) [2007:294– 296] discussion of "The life-cycle of business enterprises", "Internal versus external economies" and "Increasing and decreasing returns to scale" should be accessible enough. These Marshallian concepts are still useful and worth studying. Note, however, that Marshall took the 19th century sole proprietorship as the typical form of business enterprise (the representative individual firm), which was already becoming outdated in Marshall's lifetime. From the early 1900s onwards, the limited liability corporation increasingly became the preferred form of the manufacturing business enterprise, which had a profound influence on capitalist practice. As noted in learning unit 1, before the late 1800s incorporation had to be done by special state grant and was conferred only on account of the enterprise serving some clear public interest, such as public utilities (e.g. railroads). After 1870, any private business firm could incorporate itself irrespective of whether it served some public interest, the state automatically granting permission subject to certain minimal conditions.[8]

WALRAS

DEMARCATED READING

At this point you should read chapter 18: only the section "Leon Walras".

CONTENT

Walras is neoclassical and Marshallian in all respects except one: he relinquished a partial equilibrium approach or method (2013:226) [2007:214] in favour of a general equilibrium approach. Instead of studying one market at a time, the aim of Walrasian general equilibrium analysis is to emphasise the interrelatedness of markets, for the purpose of which all markets are considered simultaneously. Once again the textbook's discussion of Walras is lucid enough, thus needing no additional explanation. You should be aware of the fact that the most sophisticated contemporary theory takes the shape of Walrasian general equilibrium rather than Marshallian partial equilibrium analysis.

LOOKING BACK ON ACTIVITY 5.1

What do you think? After having read through the prescribed readings for this learning unit, has this changed your opinion of the Open University article? Whatever the case, do make a

8. For more information on these issues, see the references as given in footnote 1.

point of reading the Kohn article under the next heading, which is even more critical of neoclassical theory and its effect on current economic theory and policy.

. . . .

RELEVANCE FOR TODAY

The Impasse in Economic Theory

Excerpt from Kohn, M. 2004. Value and exchange. *Cato Journal* 24(3):303–307 (accessed on 14 March 2009).

To understand the current difficulties of economic theory, we need to understand the goals of the research programme that guides it. That programme has its origins in the work of two great [neoclassical] economists – Paul Samuelson and John Hicks – and its goals grew out of theirs.

Samuelson's goal was to reformulate economic theory in the language of mathematics ... He believed that this would promote greater clarity and precision. And he hoped that mathematisation would lead to a formal unification of the whole of economic theory. He believed this possible because he thought that all of economics could be formalised using essentially the same mathematical approach.

While Samuelson's goal was formal unification, Hicks's goal was substantive unification. Hicks believed that much of economics could be understood in terms of the theory of value – the part of economics that seeks to explain the pattern of relative prices in an economy and the resulting allocation of resources … The construction and refinement of the theory of value had been the principal project of economics since Ricardo, and its major components were largely in place by the time of the marginalist revolution of the 1870s [the subject matter of this learning unit]. Its most ambitious formulation was the general equilibrium theory of Walras and Pareto that addressed simultaneously all of the markets of an economy and their interconnections. It was within this Walrasian framework that Hicks hoped to unify much of economic theory.

Samuelson's goal and Hicks's, while different, proved highly complementary. Samuelson's approach was to reformulate a piece of economic theory as a set of equations that jointly determined the economic variables of interest. It was essential to his method that this set of equations could be interpreted as describing an equilibrium of the system in question. The theory of value was especially amenable to this method because the concept of equilibrium was at its very core. Given the relative ease of mathematising the theory of value, it was then only natural to attempt to mathematise other parts of economic theory by reformulating them as extensions of the theory of value. It turned out that advancing Hicks's goal was a natural way to advance Samuelson's …

Increasingly, then, adherents of the Hicks-Samuelson research programme came to see the theory of value as *being* economics: they saw the two as identical and indistinguishable. This view, which has come to dominate economic theory, goes far beyond the ideas of Hicks and Samuelson themselves. I will call it the *value paradigm*.

The Hicks-Samuelson research programme today is in trouble. Of course, in terms of its dominance of economic theory, it has been an unqualified success. The "job description" of an economic theorist today is the elaboration of mathematical models. Arguments not couched in mathematical terms are dismissed as lacking in intellectual rigor.

The devotion to mathematics and the adherence to the value paradigm have not been without cost. Mathematisation has promoted a kind of sterile armchair theorising. Many theorists see little need to be acquainted with the details of real-world economies: almost exclusively, they study each others' models. Both mathematisation and the value paradigm have induced a significant narrowing of the theoretical agenda: economic phenomena that do not lend themselves to mathematical treatment or that are impossible to reconcile with the assumptions of the theory of value have become "uninteresting."

While the costs of the Hicks-Samuelson programme are clear, its benefits have been elusive. It is difficult to see the payoff to this huge intellectual effort beyond some successes in the theory of asset pricing (which really falls within the theory of value proper). In such areas as money, fluctuations, and growth, the mathematical theory of value has contributed confusion rather than illumination.

Most disappointingly, the Hicks-Samuelson research programme has done virtually nothing to assist in the formulation of economic policy. On the great issues of the day, it has been virtually silent. The major improvement in the management of the domestic monetary system that occurred in the 1980s was the result of trial and error on the part of practitioners: economic theory contributed virtually nothing. On transition [the transition from command to market economies, which the former communist countries had to undergo] and economic development, modern economic theory has again had nothing useful to say ... This is not to suggest that economists as individuals have made no contribution. However, their advice has relied more on economic common sense than on high theory. It is difficult to see how a 19th century economist, or even one from the 18th century, would have made a less useful policy adviser than a tooled-up modern theorist.

The failings of the Hicks-Samuelson research programme have hardly gone unnoticed. The principal response of mainstream economics has been increasingly to turn away from this programme in favour of an entirely different one – the application of econometric methods. While econometrics was developed originally to test or to estimate the models devised by theorists, today's applied econometrics is largely atheoretical. Applied econometrics rather than mathematical theory is today the high-status field in the best graduate schools and the one that attracts many of the best minds.

Because the applied econometrics programme is firmly empirical it has been much more fruitful. Some interesting work has focused on an area particularly refractive to the Hicks-Samuelson approach – the causes of economic growth and development. Shleifer and Levine and their respective collaborators have used cross-country comparisons to explore the significance for growth of legal and financial institutions. This work is highly suggestive, but it is ultimately limited by its atheoretical nature. Yes, financial and legal institutions matter – but why? For an answer, we need a theoretical understanding of the processes at work. More generally, as this example shows, atheoretical applied econometrics avoids the problems of economic theory but it does not solve them.

LEARNING UNIT 5: SELECTED SELF-STUDY QUESTIONS

1. Review the list of major tenets of marginalist thought and determine which of them apply to the writings of Marshall.
2. What is Marshall's law of demand? How does it relate to (a) the equimarginal rule, (b) the law of diminishing marginal utility, and (c) consumer surplus?
3. Explain Marshall's theories of wages, profit and rent.

LEARNING UNIT

6

The German historical and institutionalist schools, Veblen and Galbraith

THE GERMAN HISTORICAL SCHOOL

STUDY OUTCOMES

When studying this section, you should aim at gaining knowledge and understanding of the following:

- the meaning of the historical school's evolutionary approach
- the historical school's nationalism as opposed to the classical school's individualism
- the historical school's positive view on the role of government as opposed to the classical school's broadly negative view of government
- the historical school's inductive-historical approach as opposed to the classical school's (Ricardo's) abstract-deductive approach
- the historical school's way of counteracting socialism through moderate reform

6.1

ACTIVITY

As an introduction to the historical and institutionalist schools, consider an interesting contemporary perspective on the role of institutions in economic development by Harvard economist Dani Rodrik. The article is somewhat dated (from 1999), but should still be worthwhile reading for South African students. Read it through very briefly before starting your reading for the German historical school and then again more thoroughly after completing your reading for the Institutional school.

Institutions For High-Quality Growth: What They Are and How to Acquire Them (excerpt)

Dani Rodrik,

Harvard University. October 14, 1999.

Source: http://www.imf.org/external/pubs/ft/seminar/1999/reforms/rodrik.htm, 20 March 2012.

I. Introduction

The comparative experience with economic growth over the last few decades has taught us a number of important lessons. One of the more important of these is the importance of private initiatives and incentives.

All instances of successful development are ultimately the collective result of individual decisions by entrepreneurs to invest in risky new ventures and try out new things. The good news here is that we have found *homo economicus* to be alive and well in the tropics and other poor lands. The … notion that the private sectors in developing countries would fail to respond quickly to favourable price and other incentives … has been put to rest by the accumulating evidence. We find time and again that investment decisions, agricultural production, or exports turn out to be quite sensitive to price incentives, as long as these are perceived to have some predictability.

The discovery that relative prices matter a lot, and that therefore neoclassical economic analysis has much to contribute to development policy, led for a while to what was perhaps an excessive focus on relative prices. Price reforms – in external trade, in product and labour markets, in finance, and in taxation – were the rallying cry of the reformers of the 1980s, along with macroeconomic stability and privatisation. By the 1990s, the shortcomings of the focus on price reform were increasingly evident. The encounter between neoclassical economics and developing societies served to reveal the institutional underpinnings of market economies. A clearly delineated system of property rights, a regulatory apparatus curbing the worst forms of fraud, anti-competitive behaviour, and moral hazard, a moderately cohesive society exhibiting trust and social cooperation, social and political institutions that mitigate risk and manage social conflicts, the rule of law and clean government – these are social arrangements that economists usually take for granted, but which are conspicuous by their absence in poor countries.

Hence, it became clear that incentives would not work or generate perverse results in the absence of adequate institutions. …

The question before policy makers, therefore, is no longer "do institutions matter?" but "which institutions matter and how does one acquire them?" …

II. Which Institutions Matter?

[T]he market economy is necessarily "embedded" in a set of non-market institutions. … The rest of this section discusses five types of market-supporting institutions: property rights; regulatory institutions; institutions for macroeconomic stabilisation; institutions for social insurance; and institutions of conflict management.

A. Property Rights

While it is possible to envisage a thriving *socialist* market economy in theory, as the famous debates of the 1920s established, today's prosperous economies have all been built on the basis of private property … It stands to reason that an entrepreneur would not have the incentive to accumulate and innovate unless he/she has adequate *control* over the return to the assets that are thereby produced or improved.

Note that the key word is "control" rather than "ownership." Formal property rights do not count for much if they do not confer control rights. ... Legislation in itself is neither necessary nor sufficient for the provision of the secure control rights. In practice, control rights are upheld by a combination of legislation, private enforcement, and custom and tradition. …

Moreover, property rights are rarely absolute, even when set formally in the law. The right to keep my neighbour out of my orchard does not normally extend to my right to shooting him if he actually enters it. Other laws or norms – such as those against murder – may trump property rights. Each society decides for itself the scope of allowable property rights and the acceptable restrictions on their exercise. … All societies recognise that private property rights can be curbed if doing so serves a greater public purpose. It is the definition of what constitutes "greater public purpose" that varies.

B. Regulatory Institutions

Markets fail when participants engage in fraudulent or anti-competitive behaviour. They fail when transaction costs prevent the internalising of technological and other non-pecuniary externalities. And they fail when incomplete information results in moral hazard and adverse selection. Economists recognise these failures and have developed the analytical tools required to think systematically about their consequences and possible remedies. Theories of the second best, imperfect competition, agency, mechanism design, and many others offer an almost embarrassing choice of regulatory instruments to counter market failures. Theories of political economy and public choice offer cautions against unqualified reliance on these instruments.

In practice, every successful market economy is overseen by a panoply of regulatory institutions, regulating conduct in goods, services, labour, asset, and financial markets. … In fact, the freer are the markets, the greater is the burden on the regulatory institutions. …

It is important to recognise that regulatory institutions may need to extend beyond the standard list covering anti-trust, financial supervision, securities regulation and a few others. This is true especially in developing countries where market failures may be more pervasive and the requisite market regulations more extensive. … The experience of South Korea and Taiwan in the 1960s and 1970s can be interpreted in that light. The extensive subsidisation and government-led coordination of private investment in these two economies played a crucial role in setting the stage for self-sustaining growth (Rodrik 1995). …

C. Institutions for Macroeconomic Stabilisation

Since Keynes, we have come to a better understanding of the reality that capitalist economies are not necessarily self-stabilising. Keynes and his followers worried about shortfalls in aggregate demand and the resulting unemployment. More recent views of macroeconomic instability stress the inherent instability of financial markets and its transmission to the real economy. All advanced economies have come to acquire fiscal and monetary institutions that perform stabilising functions, having learned the hard way about the consequences of not having them. Probably most important among these institutions is a lender of last resort – typically the central bank – which guards against self-fulfilling banking crises. …

D. Institutions for Social Insurance

A modern market economy is one where change is constant and idiosyncratic (i.e., individual-specific) risk to incomes and employment is pervasive. Modern economic growth entails a transition from a static economy to a dynamic one where the tasks that workers perform are in constant evolution and movement up and down in the income scale is frequent. One of the liberating effects of a dynamic market economy is that it frees individuals from their traditional entanglements – the kin group, the church, the village hierarchy. The flip side is that it uproots them from traditional support systems and risk-sharing institutions. …

The huge expansion of publicly provided social insurance programmes during the 20th century is one of the most remarkable features of the evolution of advanced market economies. … Despite a considerable political backlash against the welfare state since the 1980s, neither the U.S. nor Europe has significantly scaled back these programmes. …

Social insurance legitimises a market economy because it renders it compatible with social stability and social cohesion. At the same time, the existing welfare states in Western Europe and the United States engender a number of economic and social costs – mounting fiscal outlays, an "entitlement" culture, long-term unemployment – which have become increasingly apparent. …

E. Institutions of Conflict Management

Societies differ in their cleavages. Some are made up of an ethnically and linguistically homogenous population marked by a relatively egalitarian distribution of resources (Finland?). Others are characterised by deep cleavages along ethnic or income lines (Nigeria?). These divisions hamper social cooperation and prevent the undertaking of mutually beneficial projects. Social conflict is harmful both because it diverts resources from economically productive activities and because it discourages such activities by the uncertainty it generates. …

[Unresolved social conflicts] can be thought of as instances of coordination failure in which social factions fail to coordinate on outcomes, which would be of mutual benefit. Healthy societies have a range of institutions that make such colossal coordination failures less likely. The rule of law, a high-quality judiciary, representative political institutions, free elections, independent trade unions, social partnerships, institutionalised representation of minority groups, and social insurance are examples of such institutions. What makes these arrangements function as institutions of conflict management is that they entail a double "commitment technology:" they warn the potential "winners" of social conflict that their gains will be limited, and assure the "losers" that they will not be expropriated. They tend to increase the incentives for social groups to cooperate by reducing the payoff to socially uncooperative strategies.

III. How Are "Good" Institutions Acquired?

As I argued in the preceding section, a market economy relies on a wide array of non-market institutions that perform regulatory, stabilising, and legitimising functions. Once these institutions are accepted as part and parcel of a market-based economy, traditional dichotomies between market and state or *laissez-faire* and intervention begin to make less sense. These are not competing ways of organising a society's economic affairs; they are complementary elements that render the system sustainable. Every well-functioning market economy is a mix of state and market, *laissez-faire* and intervention.

A. Accepting Institutional Diversity

A second major implication of the discussion is that the institutional basis for a market economy is not uniquely determined. Formally, there is no single mapping between the market and the set of non-market institutions required to sustain it. This finds reflection in the wide variety of regulatory, stabilising, and legitimising institutions that we observe in today's advanced industrial societies. The American style of capitalism is very different from the Japanese style of capitalism. Both differ from the European style. And even within Europe, there are large differences between the institutional arrangements in, say, Sweden and Germany.

It is a common journalistic error to suppose that one set of institutional arrangements must dominate the others in terms of overall performance. …

The point about institutional diversity has in fact a more fundamental implication. ... There is no reason to suppose that modern societies have already managed to exhaust all the useful institutional variations that could underpin healthy and vibrant economies. Even if we accept that market-based economies require certain types of institutions, as listed in the previous section, such imperatives do not select from a closed list of institutional possibilities. … We need to maintain a healthy scepticism towards the idea that a specific type of institution – a particular mode of corporate governance, social security system, or labour market legislation, for example – is the only type that is compatible with a well-functioning market economy.

B. Two Modes of Acquiring Institutions

How does a developing society acquire functional institutions – functional in the sense of supporting a healthy, sustainable market-based system? An analogy with *technology transfer* is helpful. Think of institution acquisition/building as the adoption of a new technology that allows society to transforms its primary endowments (land, raw labour, natural resources) into a larger bundle of outputs. Let us call this new technology a "market economy," where we understand that the term encompasses all of the non-market institutional complements discussed previously. Adoption of a market economy in this broad sense moves society to a higher production possibilities frontier, and in that sense is equivalent to technical progress in economist's parlance.

But what kind of a technology is a market economy? To oversimplify, consider two possibilities. One possibility is that the new technology is a general purpose one, that it is codified, and that it is readily available on world markets. In this case, it can be adopted by simply importing a *blueprint* from the more advanced economies. The transition to a market economy, in this vision, consists of getting a manual with the title "how to build a market economy" (a.k.a. the "Washington Consensus") and following the directions: remove price distortions, privatise enterprises, harden budget constraints, enact legal codes, and so on.

A different possibility is that the requisite technology is highly specific to local conditions and that it contains a high degree of tacitness. Specificity implies that the institutional repertoire available in the advanced countries may be inappropriate to the needs of the society in question – just as different relative factor prices in LDC agriculture require more appropriate techniques than those that are available in the rich countries. Tacitness implies that much of the knowledge that is required is in fact not written down, leaving the blueprints highly incomplete. For both sets of reasons, imported blueprints are useless. Institutions need to be developed locally, relying on hands-on experience, local knowledge, and experimentation.

The two scenarios are of course only caricatures. Neither the *blueprint* nor the *local-knowledge* perspective captures the whole story on its own. Even under the best possible circumstances, an imported blueprint requires domestic expertise for successful implementation. Alternatively, when local conditions differ greatly, it would be unwise to deny the possible relevance of institutional examples from elsewhere. But the dichotomy – whether one emphasises the blueprint or the local knowledge aspect of the process – clarifies some key issues in institution building and sheds light on important debates about institutional development. …

Although my sympathies in this debate are with the experimentalists, I can also see that there are dangers with experimentalism.

First, one needs to be clear between self-conscious experimentalism, on the one hand, and delay and gradualism designed primarily to serve privileged interests, on the other. The dithering, two steps forwards, one step backwards style of reform that prevails in much of the former Soviet Union and in many Sub-Saharan African countries is driven not so much by a desire to build better institutions as it is by aversion to reform. This has to be distinguished from a programmatic effort to acquire and process local knowledge to better serve local needs. …

Second, it is obviously costly – in terms of time and resources – to build institutions from scratch when imported blueprints can serve just as well. Experimentalism can backfire if it overlooks opportunities for institutional arbitrage. Much of the legislation establishing a SEC-like watchdog agency for securities markets, for example, can be borrowed wholesale from those countries that have already learned how to regulate these markets the hard way – by their own trial and error. The same goes perhaps for an anti-trust agency, a financial supervisory agency, a central bank, and many other governmental functions. One can always learn from the institutional arrangements prevailing elsewhere even if they are inappropriate or cannot be transplanted …

C. Participatory Politics as a Meta-Institution

The blueprint approach is largely top-down, relying on expertise on the part technocrats and foreign advisors. The local-knowledge approach, by contrast, is bottom-up and relies on mechanisms for eliciting and aggregating local information. In principle, these mechanisms can be as diverse as the institutions that they help create. But I would argue that the most reliable forms of such mechanisms are participatory political institutions. Indeed, it is helpful to think of participatory political institutions as *meta-institutions* that elicit and aggregate local knowledge and thereby help build better institutions.

It is certainly true that non-democratic forms of government have often succeeded admirably in the task of institution building using alternative devices. The previously mentioned examples of South Korea (with its "embedded" bureaucratic autonomy) and China (with its decentralisation and experimentalism) come immediately to mind. But the broad, cross-national evidence indicates that these are the exceptions rather than the rule. Nothing prevents authoritarian regimes from using local knowledge; the trouble is that nothing compels them to do so either.

The case of Mauritius illustrates nicely how participatory democracy helps build better institutions that lay the foundation for sustainable economic growth. … Mauritius found its own way to economic development because it created social and political institutions that encouraged participation, negotiation, and compromise. That it did so despite inauspicious beginnings and following a path that diverged from orthodoxy speaks volumes about the importance of such institutions. The following section presents some cross-national evidence suggesting that democracy tends in fact to be a reliable mechanism for generating such desirable outcomes.

IV. Participatory Political Regimes Deliver Higher-Quality Growth

In policy circles, the discussion on the relationship between political regime type and economic performance inevitably gravitates toward the experience of a handful of economies in East and Southeast Asia, which (until recently at least) registered the world's highest growth rates under authoritarian regimes. These countries constitute the chief exhibit for the argument that economic development requires a strong hand from above. The deep economic reforms needed to embark on self-sustaining growth, this line of thought goes, cannot be undertaken in the messy push and pull of democratic politics. Chile under General Pinochet is usually exhibit no. 2.

A systematic look at the evidence, however, yields a much more sanguine conclusion. While East Asian countries have prospered under authoritarianism, many more have seen their economies deteriorate – think of Zaire, Uganda, or Haiti. Recent empirical studies based on samples of more than 100 countries suggest that there is little reason to believe democracy is conducive to lower growth over long time spans. Neither is it the case that economic reforms are typically associated with authoritarian regimes (Williamson 1994). Indeed, some of the most successful reforms of the 1980s and 1990s were implemented under newly elected democratic governments – think of the stabilizations in Bolivia (1985), Argentina (1991), and Brazil (1994), for example. Among former socialist economies too, the most successful transitions have occurred in the most democratic countries.

In fact, the record is even more favourable to participatory regimes than is usually acknowledged. This section provides evidence in support of the following assertions:

1. Democracies yield long-run growth rates that are more predictable.
2. Democracies produce greater short-term stability.
3. Democracies handle adverse shocks much better.
4. Democracies deliver better distributional outcomes.

The first of these implies that economic life is less of a crapshoot under democracy. The second suggests that, whatever the long-run growth level of an economy, there is less instability in economic outcomes under democratic regimes than under autocracies. The third finding indicates that political participation improves an economy's capacity to adjust to changes in the external environment. The final point suggests that democracies produce superior distributional outcomes.

Taken together, these results provide a clear message: participatory political regimes deliver higher-quality growth. I would contend that they do so because they produce superior institutions better suited to local conditions. …

The bottom line is that living under an authoritarian regime is a riskier gamble than living under a democracy.

Our interest in democratic institutions in this context derives from the idea that such institutions provide ways of regulating and managing social conflicts through participatory means and the rule of law, and, hence, dissipate the adverse consequences of external shocks. …

These results are perhaps surprising in view of the common presumption that it takes strong, autonomous governments to undertake the policy adjustments required in the face of adversity. They are less surprising from the perspective articulated above: adjustment to shocks requires managing social conflicts, and democratic institutions are useful institutions of conflict management. …

More participatory regimes produce greater equality not only within the modern (manufacturing) sector, but throughout the economy. And they do so … without cost to economic growth and while producing greater stability and resilience overall.

V. Concluding Remarks

Institutional reform has become the buzzword of the day. Policy advisors and international financial institutions (IFIs [the IMF, the World Bank and the like]) find it tempting to extend their advice and conditionality to a broad range of institutional areas, including monetary and fiscal institutions, corporate governance, financial and asset market supervision, labour-market practices, business-government relations, corruption, transparency, and social safety nets. While such efforts have the basic diagnosis right – the development of a market-based economy requires a heavy dose of institution building – they suffer from two weaknesses.

First, it is not clear whether the IFIs can overcome their bias towards a particular, "neo-liberal" social-economic model – a model that is approximated, if not fully replicated, in the real world by the United States. … This model is not only untested, it forecloses some development strategies that have worked in the past, and others that could work in the future. … [A]n approach that presumes the superiority of a particular model of a capitalist economy is quite restrictive in terms of the range of institutional variation that market economies can (and do) admit.

Second, even if the IFIs could shed their preference in favour of the neo-liberal model, there would remain an organisational bias towards providing similar, even if not identical, advice to client governments. It would be difficult for institutions like the World Bank and the IMF to adopt a "let a hundred flowers bloom" strategy, as it would appear that some countries are being treated more or less favourably. The result is likely to be at best unfriendly to institutional experimentation on the part of client governments.

To be sure, some institutional convergence can be useful and proper. No one can be seriously against the introduction of proper accounting standards or against improved prudential supervision of financial intermediaries. The more serious concern with regard to IFI conditionality is that such standards will act as the wedge with which a broader set of institutional preferences – in favour of open capital accounts, deregulated labour markets, arms-length finance, American-style corporate governance, and hostile to industrial policies – will be imparted to the recipient countries.

My focus on the importance of local knowledge, and on participatory democracy as a meta-institution for eliciting and aggregating it, suggests that conditionality is perhaps better targeted at basic political freedom. I have shown in this paper that democracies perform better in a number of dimensions: they produce less randomness and volatility, they are better at managing shocks, and they yield distributional outcomes that are more desirable. One interpretation of these results, and the one that I have emphasised throughout, is that democracy helps build better institutions. While I am a great believer in institutional diversity, I see no argument that would make it appropriate for some governments to deny their citizens basic political rights such as freedom of speech, the right to vote and stand for political office, or freedom of association. If there is one area where institutional conditionality is both appropriate and of great economic value, it seems to me that this is it.

References omitted

. . . .

Question: After having studied the historical and institutional schools, can you identify which institutions in South African culture aid growth and employment, and which institutions in that culture impede them?

DEMARCATED READING

At this point you should read chapter 11: only the section “Overview of the German historical school”

CONTENT

This is a short section, which is important mainly because the German historical school is a precursor to American institutionalism. Here you will find just about all the themes of the American institutionalists: the evolutionary approach, the emphasis on the positive role of government and the inductive/historical approach. The irony is, of course, that the German historicists were predominantly right-leaning and conservative while the American institutionalists were, and are, predominantly left-leaning and progressive. It just goes to show how careful one needs to be with labels. Note that Germany (more particularly Prussia) was a monarchy at the time, and that the historicists were often against its democratisation. Germany only became a fully-fledged democracy after World War I during the highly unstable time of the Weimar Republic, which lasted only a few years and gave way to Hitler’s Third Reich in 1933.

The main theme in the controversy between classical/neoclassical economics and the historical school concerns the nature and usefulness of theory. The historicists argue that classical/neoclassical theory is not very useful, because it is unrealistic, static and ahistorical. It is unrealistic because it replaces real flesh-and-blood people with an abstract concept of “economic man”, who is a mathematical profit/utility maximiser; it is static because this “economic man” has a set of choice options and preferences, which do not change within a given period; and it is ahistorical because the theory does not show how these options and preferences are shaped by the social circumstances of the day, that is by institutions. Institutions are organisational structures or behavioural patterns, which have acquired a

certain degree of persistence. Because they are persistent, they become part of the social environment, which can systematically shape human behaviour in the economic sphere.

The historical school was basically anti-theoretical, because its supporters believed that institutions continually change too. As a result, according to the historicists, there are no universal economic laws applicable to all times. Instead of formulating abstract logical theory, economists should rather study history so as to try to discern contingent evolutionary patterns, which could teach us valuable lessons for the present and the future.

The criticism of the historical school seems to have a great deal of merit: classical and neoclassical/marginalist theory is often unrealistically abstract, static and ahistorical. But it does not follow that we should, therefore, entirely give up on theory, as the historical school was inclined to do. Classical and neoclassical/marginalist theory is not the only type of theory there is. While institutions change, they possess a degree of persistence too – as already indicated. Their ability to shape behaviour can, therefore, be used to explain economic regularity, which is the aim of theory. Real people do not try to maximise their economic benefit to the absolute ruddy limit, if only because they lack the perfect foresight to gauge what the precise numerical value of the economic benefit of all their choice options is going to be. Nonetheless, real people still tend to be significant pursuers of economic benefit, in the marketplace. A softer, more realistic kind of "economic man" (*homo economicus*) may be sufficient to explain behaviour patterns in the marketplace.

THE INSTITUTIONALIST SCHOOL, VEBLEN AND GALBRAITH

STUDY OUTCOMES

When studying this section, you should aim at gaining knowledge and understanding of the following:

- the institutionalist school's holistic, broad perspective
- the meaning of institutions and their role in economic explanation
- the institutionalist school's evolutionary approach: how institutions change
- the institutionalist school's rejection of aspects of neoclassical economics: normal equilibrium, pleasure-pain psychology (as inherent in "economic man"), and *laissez-faire*
- the institutionalist school's emphasis on conflict of interest between sections of society, and the need for government arbitration
- the institutionalist school's rejection of Marxism in favour of democratic reform
- Veblen's theory of the leisure class: that class's conspicuous consumption, propensity to avoid useful work, and conservatism (beneficial changes being blocked by its sheltered, privileged position)
- Veblen's specific attacks on neoclassical economics: its assumption of consumer sovereignty, its staticness, its assumption of an "economic man", who is driven by hedonism and who is a completely rational ("lightning") calculator of pleasure and pain; its justification of the current distribution of wealth and income, and its neglect for the fact that most markets are not perfectly competitive
- Veblen's instinct for workmanship and how it conflicts with the neoclassical view of work
- Veblen's criticism of the firm's increased inclination "to make money" for itself rather than "to make goods" for society
- how all Veblen's criticism of the business world seem to presuppose the *corporate* form of business organisation
- how, according to Veblen, difference in access to bank credit creates an advantage for big business against small business
- how Veblen was wrong in arguing that credit expansion (money creation) cannot increase total output
- the basic elements of the credit-driven business cycle

- how, according to Veblen, technicians and engineers ("the soviet of technicians") could save corporate capitalism from itself
- Galbraith's criticism of neoclassical theory for being obsolescent
- Galbraith's criticism of consumer sovereignty
- the meaning of the "technostructure" and Galbraith's ideas about its purposes
- Galbraith's policy proposals to counter the excesses of corporate capitalism.

DEMARCATED READING

At this point you should read all of chapter 19, excluding "19-1 Past as prologue" and "Wesley Clair Mitchell".

CONTENT

The institutionalist school has both a theoretical side and a political economy side to it. On the theoretical side, it criticises neoclassical/marginalist economics along very much the same lines as the historical school. The "holistic, broad perspective", "focus on institutions", "Darwinian evolutionary approach" and "rejection of pleasure-pain psychology" (2013:396–398) [2007:370– 372] are all criticisms of neoclassical/marginalist theory and method. The holistic perspective and rejection of the pleasure-pain psychology emphasise that market behaviour cannot be solely explained in terms of the profit/utility maximising behaviour of "economic man". Other motives play a role as well, so that the explanation of market phenomena should be multidisciplinary. The focus on institutions draws attention to the fact that behaviour is often shaped by state laws, organisational structures, habits and culturally determined customs, which show a degree of persistence over time. Hence, institutions cause human behaviour to display a certain regularity, a certain predictability. While human behaviour is never completely predictable, it does display some broad patterns. The evolutionary approach highlights how institutions are, nonetheless, also subject to evolutionary change, and that there is a certain logic and predictability to how they change.

On the political economy side, it criticises corporate industrial capitalism. The two adjectives "corporate" and "industrial" should be distinguished. Industrial capitalism – Veblen called it "machine industry" (2013:409) [2007:383] – has existed from the start of the Industrial Revolution, dating from 1790 in Britain and a bit later in other European countries. It is not necessarily linked to the corporate form of enterprise – for example in the early 1800s most industrial companies were not yet corporations but still non-corporate proprietorships or partnerships. Nonetheless, some industrial companies, like public utilities, railway companies and banks, had already acquired corporate status; they had become "chartered companies" as the term was then. But this was the exception. Business firms did not yet have the right to incorporate themselves and incorporation was still a special privilege granted by the state rather than a right. The negative side-effects typical of the industrial mode of production, like increased inequality of income, were important issues for institutionalists as well.

The dominance of capitalism by the corporate form of enterprise dates from after the 1870s, when firms acquired the right to freely incorporate themselves (see learning unit 1 and the references given in footnote 1). Institutionalists like Veblen sharply criticised the corporation in particular ("absentee ownership", "separation of ownership from control"), arguing that it intensifies industrialisation, leads to monopoly and creates a decisive bargaining advantage of producers over consumers and of employers over employees. Notice how "the age of monopoly may be said to have begun in the 1870s" (2013:396) [2007:369], which is roughly the time the corporate form of enterprise started to dominate capitalism too. By increasing the power and size of the firm, corporate capitalism thus intensified the potential conflict of interest between the classes in society, which is why institutionalists emphasised "clashes of interest" (2013:398) [2007:372]. The corporate form of business also bolstered the profit motive, because it causes the corporate firm to be ruled by a dispersed mass of anonymous

shareholders for whom profit has become the "lowest common denominator" of all their motives. The profit motive is also bolstered by the fact that corporate management is under continual threat of being dethroned by corporate takeover, which it can avoid only by relentlessly pursuing profit to the absolute limit. The dominance of the corporate firm over capitalism has thus made "economic man" a somewhat more realistic abstraction.

Moreover, by intensifying industrialisation, corporate capitalism also intensified both the negative and the positive spin-offs of industrialisation: greater inequality ***and*** greater wealth creation. Corporate industrial capitalism had become so productive as to lead to excessive luxury and waste, themes emphasised by Veblen as well.

Instead of doing away with free incorporation, institutionalist authors preferred to rely on "liberal democratic reform" (2013:398) [2007:372] to contain the excesses of corporate capitalism. Institutionalists were keen to expose the inconsistency in nineteenth-century US government policy of being decisive in intervening in the market mechanism to protect the interest of corporate big business but being very shy in doing the same to protect the interests of the working classes.

The reforms proposed by institutionalists boil down to throwing more pragmatic socialism, worker cooperative socialism, interventionalism and welfare statism in the liberal-capitalist mix. Institutionalists are generally not Marxian socialists; Veblen did not endorse Marxian labour value theory nor did he advocate an all-out nationalisation of all firms (dogmatic state socialism). But institutionalists were (and still are) strongly critical of corporate industrial capitalism.

The section on Thorstein Veblen should be easily accessible as well as entertaining to read. It is difficult not to like Veblen in spite of all his weaknesses and eccentricities.

Veblen appears to overstate his case at times. There's certainly plenty of "conspicuous consumption" in South Africa and the Western world in general, but not necessarily mainly by a "leisure class". Most wealthy South Africans maintain their "conspicuous consumption" at the cost of a great deal of stress and hard work – in fact, often too much stress and hard work. A strictly non-working leisure class would seem small, both in South Africa and elsewhere in the world. In addition, while the consumer is certainly not sovereign and has a great deal less economic muscle and power than the big corporate producers, the consumer is most certainly not entirely powerless. The big corporates still cannot force people to buy their products, however big their advertising budgets – consider how many products flop and how many advertising campaigns fail.

Veblen's views on the "instinct for workmanship" are interesting (2013:406–407) [2007:380–381]. It seems certainly true that people do not consistently experience their work as "irksome", that is, as having a negative utility – as assumed by neoclassical economics. Provided they are not overworked, people do generally "want to work and to do it well". Not for nothing do the unemployed generally experience huge frustration about their idleness. Moreover, we do find satisfaction in providing for our offspring, and somehow allowing them to build a better life than we had. To be sure, large-scale machine production dominated by the corporate form of business is hugely more productive than small-scale handicraft production ever was. We are all much better off than we were a century and a half ago (provided we do have work). But something has also been lost in the process: pride in work, a slower pace of life, care for people beyond their economic value, personal identification with what is produced, and the like. The enhanced power of the profit motive under corporate capitalism has somehow squashed other, equally important values.

Veblen's emphasis on the role of credit in modern capitalism (2013:407–409) [2007:381–383] is interesting and merits some attention. Bank credit is, in essence, lending by a commercial bank, which gives rise to money creation. The reason why commercial banks create money when providing credit is that they do not need to finance their lending with deposited cash.

Instead, they can simply issue the borrower with additional deposits by way of a bookkeeping entry. Credit, according to Veblen, tends to favour big business over small business because the former have a larger and safer balance sheet, which contains better collateral than the latter. Because they can consequently obtain credit more easily, big business can invest in the latest technologies more quickly, which gives them the edge over smaller business with less ready access to finance.

Veblen also argued that credit merely raises prices without stimulating real production. While credit creation can indeed be inflationary, this is not necessarily the case. It depends on factors such as what we today refer to as the "output gap": when there is a significant output gap, credit creation will tend to stimulate real output but leave prices roughly unchanged, and when the economy operates close to full capacity, credit creation will tend to push up prices but leave output largely unchanged.

It seems obvious that, broadly speaking, the modern credit-money system has facilitated a much-accelerated real growth by boosting both real production and the public's ability to buy that production. It has boosted real production by allowing firms to increase their investments beyond society's savings – their own savings as well as the savings of households. Firms can augment their finance by borrowing from banks, which banks can finance with money creation rather than with the savings of depositors. Similarly, consumers can augment their spending beyond their current income plus savings by borrowing from banks, which amounts to money creation. As the prescribed textbook (2013:408) [2007:382] correctly observes in criticism of Veblen:

> *Veblen's strictures on credit would be valid only if the supplies of the factors of production and final products were perfectly fixed and, therefore, could not be readily expanded.*

The paragraph beginning with "Veblen's views on credit led him directly into …" (2013:408) [2007:382] until the end of the section with the title "Credit and Business Cycles" (2013:409) [2007:383] may be somewhat obscure to some students. You ***can ignore*** these paragraphs if you find them inaccessible. Instead consider the following broad explanation of the business cycle which covers the same type of issues.

There is a fair degree of consensus among modern economists that the business cycle is indeed closely related to the credit-money system.[9] In that regard, Veblen has broadly been vindicated. The best known contemporary economist who espouses this view is Charles Kindleberger who took his ideas on this issue from Hyman Minsky.[10] The following steps in the typical credit cycle are usually identified:

1. Future optimism soars.
2. Producers and consumers take up more bank credit to finance their increased investment and consumption spending.
3. The money stock increases.
4. Incomes and spending increase.
5. Asset prices (mainly real estate and financial assets) increase.
6. Balance sheets of firms and consumers improve, which appear to raise their creditworthiness.
7. Optimism soars even further, which feeds back into 2 and the upward spiral starts all over again.

But as the money stock keeps on increasing, the level of bank indebtedness of the public keeps on increasing too. At some stage, the public's bank indebtedness will rise to such a level that it makes the public more nervous. If some bad news story then comes up, the

9. The credit-money system is a system where most money in circulation consists of bank deposits created when banks grant credit to nonbanks.
10. See Kindleberger, CP & Aliber, R. 2005. *Manias, panics and crashes: a history of financial crises*. 5th edition. Hoboken (NJ): John Wiley & Sons.

public will start to worry about its ability to meet its debt-servicing obligations (payment of interest and repayment of principal). The same cycle will then start to operate in reverse:

1. Future pessimism sets in.
2. Producers and consumers start to repay rather than take up bank credit.
3. The money stock shrinks (or grows less).
4. Incomes and spending fall (or grow less).
5. Asset prices fall (or rise less).
6. Balance sheets of firms and consumers deteriorate, which lowers their creditworthiness.
7. Pessimism soars even further, which feeds back into 2 and the downward spiral starts all over again.

Usually, the government will at some stage step in to counter the fall in spending by raising its own spending and financing its raised spending with credit from the banking system, until such time as optimism recovers and the public is prepared to take up more bank credit again. The government will then slowly reduce its bank indebtedness again to create scope to counteract the next cyclical downturn. Such is the classic Keynesian remedy (see next learning unit). If you wish to pursue these issues, you should do a course in *monetary economics* or *money, banking and financial markets*, either at undergraduate or at honours level.

Finally, Veblen's discussion of "the soviet of technicians" should be accessible enough and requires no clarifying remarks. The idea that a revolt of technicians and engineers can save corporate capitalism from itself is interesting but also seems somewhat naive.

Then we move to Galbraith who is the best known of the more recent institutionalists.

His themes are very similar to Veblen's. He also criticises neoclassical theory and corporate industrial capitalism. Galbraith's criticisms of neoclassical theory – see the heading "Conventional wisdom" (2013:415–416) [2007:388–389] – are entertaining for their sharp wit. You should have little difficulty following them.

Galbraith's criticisms of corporate industrial capitalism are contained in the sections "The Dependence Effect" and "Galbraith's Theory of the Firm" (2013:416–419) [2007:389–392].

In the former section, he criticises the neoclassical idea of consumer sovereignty, that is, the idea that consumers, through their buying decisions, determine what corporations produce ("dollar democracy"). Galbraith turns this around, arguing that big business through advertising creates the wants in consumers. Take note of the policy implications of this view.

In the latter section, Galbraith argues that big corporations (the "planning sector") are not necessarily motivated by profit alone. A basic characteristic of the corporate form of business is that ownership is divorced from control. Because ownership (shareholders) does not actually own the assets of the corporate firm, it has little control over how the firm is run. That control is exercised only indirectly, via its ability to appoint management. Management, by acting as the agent for the corporation as a legal entity in its own right, does have control over the firm's assets thereby enjoying a large degree of autonomy from owners/shareholders. Galbraith's point is that, while shareholders may be predominantly motivated by profit, the motivation of management (the technostructure) is more complex and multi-faceted. He distinguishes the protective purpose (the survival of the technostructure) and their affirmative purpose (the growth in the firm's size and thus in the power and prestige of the technostructure), which partially overlap with profit maximisation but also partially conflict with it.

You can fill in the detail by studying the relevant sections yourself.

As some of the policy implications of Galbraith's views, the textbook mentions the futility of anti-trust legislation (the stuff of the Competition Commission in our country), the need for more government control over wages and management salaries, and the need for centralised planning of production (2013:419) [2007:391–392]. In other words, Galbraith once again relies

on government interference to counter the negative side-effects of corporate capitalism rather than repealing the right of private individuals to incorporate their business concerns.

Read the prescribed textbook's (2013:419) [2007:392] criticisms of Galbraith carefully.

Take careful note of *Past as Prologue* 19-2 on Douglass North (Brue and Grant 2013:420–421) [2007:393–394], which introduces *new institutionalism*. Dani Rodrik's article in the Economics in Action section would be an instance of new institutionalism. The approach of new institutionalism could be a fruitful way of conducting abstract theorising while giving recognition to both the role of institutions and a form of economic rationality. The new institutionalism of Douglass North in particular assumes what seems to be a more realistic form of economic man: an economic man that pursues profit and utility, but without necessarily being a relentless mathematical maximiser. Douglass North's (1990) *Institutions, institutional development and economic performance* is still a worthwhile, quite accessible, read.

LOOKING BACK ON ACTIVITY 6.1

The main weakness of old institutional economics is that it has not yet been able to come up with a credible alternative to neoclassical theory. There is no body of institutionalist theory rigorous and realistic enough to challenge the neoclassical supremacy, although all the necessary tools seem available. The power of institutions in explaining economic phenomena is plain. For instance, cultures are different and these differences can powerfully influence economic outcomes. Perhaps, the approach of the new institutionalists provides a fruitful way of conducting economic theory.

RELEVANCE FOR TODAY

In light of the dominance of the neoclassical school over current economic theory, and taking into consideration the criticisms of it as contained in the Open University and Kohn readings, especially the criticism that it fails to take proper account of institutions, it appears that both the German historical school as well as the latest developments in the Institutional school (e.g. Galbraith, Geoff Hodgson) are highly relevant to attempts to improve current-day economic theory and explaining why institutions matter.

SELECTED SELF-STUDY QUESTIONS

1. Refer to the list of tenets of the classical school and indicate which of these principles the historical economists would reject. Explain.
2. Explain Veblen's distinction between making money and making goods.
3. Explain Galbraith's theory of the firm.

LEARNING UNIT

7 The Keynesian and Chicago schools, and some concluding thoughts

THE KEYNESIAN SCHOOL: KEYNES

STUDY OUTCOMES

When studying this section, you should aim at gaining knowledge and understanding of the following:

- Keynes's rejection of Say's law, and how that causes him to engage in macroeconomic analysis, to focus on demand rather than supply, and to emphasise instability in the macroeconomy
- the main reason why, according to Keynes, total demand was erratic and the macro-economy unstable
- "Wages are a source of demand as well as a cost of production."
- why, according to Keynes, reductions in the wage rate may be ineffective in stimulating employment, and possible criticisms of that view
- how Keynes sought to stimulate and stabilise the macroeconomy, and possible negative side-effects of these measures
- the main elements of Keynes's analysis: the consumption function and the marginal propensity to consume; the savings function and the marginal propensity to save; the investment function and the marginal efficiency of capital (mec); the unstable expectations (animal spirits) underlying the mec; the liquidity preference theory of the interest rate; the multiplier; and monetary and fiscal policy (This list is just to refresh your memory. You should already know all these elements from you second-year macroeconomics. If not, revisit the relevant sections as well as your second-year text.)
- possible criticisms of Keynes's view about the economy's long-term trend towards stagnation

7.1

ACTIVITY

This learning unit is mainly about macroeconomic stability and its contribution towards growth and employment. The schools of thought discussed (the Keynesian and Chicago schools) differ mainly on what is necessary to achieve macroeconomic stability: the attainment and maintenance of Say's law.

As an introduction to this learning unit, consider the following excerpt from the New Growth Path as introduced in 2010 by the South African government. We have included fairly large sections that do not deal directly with macroeconomic issues, because they provide important background knowledge of the South African economy. You should still find them interesting.

THE NEW GROWTH PATH: THE FRAMEWORK (excerpt)

1. INTRODUCTION

… There is growing consensus that creating decent work, reducing inequality and defeating poverty can only happen through a new growth path founded on a restructuring of the South African economy to improve its performance in terms of labour absorption as well as the composition and rate of growth. To achieve that step change in growth and transformation of economic conditions requires hard choices and a shared determination as South Africans to see it through. The Government is committed to forging such a consensus and leading the way by the following:

1. Identifying areas where employment creation is possible on a large scale as a result of substantial changes in conditions in South Africa and globally.
2. Developing a policy package to facilitate employment creation in these areas all through the following:
   (a) A comprehensive drive to enhance both social equity and competitiveness
   (b) Systemic changes to mobilise domestic investment around activities that can create sustainable employment.
   (c) Strong social dialogue to focus all stakeholders on encouraging growth in employment-creating activities. …

Achieving the New Growth Path requires that we address key trade-offs. Among other decisions, government must prioritise its own efforts and resources more rigorously to support employment creation and equity; business must take on the challenge of investing in new areas; and business and labour together must work with government to address inefficiencies and constraints across the economy and partner to create new decent work opportunities. Some key trade-offs include the following:

- Between present consumption and future growth, since that requires higher investment and saving in the present.
- Between the needs of different industries for infrastructure, skills and other interventions.
- Between policies that promise high benefits but also entail substantial risks, and policies that are less transformative and dynamic but are also less likely to have unintended consequences.
- Between a competitive currency that supports growth in production, employment and exports and a stronger rand that makes imports of capital and consumer goods cheaper.
- Between the present costs and future benefits of a green economy.

2. THE CONTEXT

This section first reviews the extent of joblessness and inequality, which makes employment creation our top priority. It then outlines changes in global and national conditions that generate new challenges but also immense opportunities for overcoming the legacy of inequality and exclusion that still shapes our economy.

2.1 The core challenge: Mass joblessness, poverty and inequality

For most of the '00s, South Africa enjoyed relatively strong economic growth. As a result, despite the volatility of the 1990s, overall economic expansion between 1994 and 2008 approached 4%, more or less the same as other upper-middle income countries. In contrast, from the late 1970s to the early 1990s, South Africa's economic growth lagged its peers, running at just over 1% a year. Despite improved growth, the economy remained one of the most inequitable in the world. In the mid-'00s, some 40% of the national income went to the richest 10% of households. Deep inequalities were associated with extraordinarily high levels of joblessness.

In the late '00s, less than half of all working-age South Africans had income-earning employment, compared to an international norm of almost two thirds. Inequalities and joblessness were also associated with the legacy of apartheid geography. In the mid-'00s, around a third of the population lived in the former Bantustans. Fewer than one in three adults there was employed. Over half of all households in the former Bantustans depended mostly on remittances or grants, compared to under a quarter in the rest of the country. The position was worst for young people, largely because too few jobs were created to absorb the large numbers of new entrants to the labour market. In the first quarter of 2010, the unemployment rate for young people aged 16 to 30 was 40%, compared to 16% for those aged 30 to 65. Amongst the employed, many workers had poorly paid, insecure and dead-end jobs. In the third quarter of 2008, half of all employed people earned less than R2 500 a month and over a third earned under R1 000 a month, according to Statistics South Africa. The informal sector, agriculture and domestic work contributed a third of all employment, but two thirds of working people earning under R1 000 a month. Moreover, one in five employed African women was a domestic worker. The share of wages in the national income dropped from 50% in 1994 to just over 45% in 2009, while the share of profits climbed from 40% to 45%. In short, the economy has not created sufficient employment opportunities for many of our people over the past three decades. Creating more and better jobs must lie at the heart of any strategy to fight poverty, reduce inequalities and address rural underdevelopment.

2.2 The changing global and national context

At the global level, the New Growth Path responds to the severe economic downturn from late 2008 as well as accelerating technological change. Nationally, it results from the insufficient job growth of the '00s and the need to accelerate employment creation, income growth and a decline in poverty.

The global economic crisis means that South Africa must re-think historical patterns of trade and investment. In the past two years, slow growth in our traditional partners in the global North has been offset by the rapid recovery of growth in China, India and Brazil. Africa's importance has also grown in recent years, as a source of resources and a potential market with one billion consumers as well as one of the fastest-growing regions in the world. Shared development across our region is a pre-condition for sustainable prosperity in South Africa.

Global economic turmoil has also opened up new policy space for developing economies to go beyond conventional policy prescriptions. Our strategic objective must be to forge a consensus on the new opportunities within South Africa, across the continent and globally, and how these can be seized to achieve socially desirable and sustainable outcomes. The government has a critically important role to play in accelerating social and economic development including through effective regulation of markets. The world economy faces far-reaching changes as a result of efforts to reduce global warming. While efforts to control emissions will impose heavy costs – especially on relatively carbon-intensive economies like South Africa – they also lay the basis for major new industries. More broadly, accelerating technological change promises to transform the world economy in the coming years, with new job opportunities in areas such as biotechnology and nano-technology.

The New Growth Path also responds to domestic developments. The transition to democracy emerged when the economy was already undergoing considerable structural change. Reintegration with the world economy as well as changes in mining and agriculture saw extensive job shedding. In the late 1970s, around two thirds of all working-age South Africans were employed – just on the international norm. By the early 1990s, in contrast, fewer than half had employment.

Despite substantial improvements in employment creation from 1994, in 2010 South Africa still ranked amongst the ten countries with the lowest level of employment in the world.

The upswing from the early '00s to 2008 built on South Africa's traditional strengths, as booming international commodity prices combined with high global liquidity to foster significant short-term inflows of capital. One consequence was that this enabled the country to spend more than it earned; another was that it increased the nominal value of the rand. It also resulted in what has been described as consumption-led growth that was not underpinned by a strong production base, with rapid growth in retail, the financial sector and telecommunications and comparatively slow expansion in manufacturing, agriculture and mining.

While the '00s saw relatively rapid employment creation, many jobs were poorly paid and insecure. Most new jobs emerged in retail, security and other low-level business services, and housing construction. Finance and telecommunications did not create much employment, despite their rapid growth, and mining and agriculture shed workers. Security guards alone accounted for one in 14 new jobs created between 2002 and 2008, with 150 000 new security guards employed in this period. The strong rand permitted reductions in the interest rate, contributing to rapid credit creation, as well as cheaper imports, but it also contributed to lower profitability and competitiveness in manufacturing, agriculture and other tradable-goods sectors. It generated a consumption boom that was largely restricted to South Africans in the upper income group. Deep inequalities in incomes and wealth meant that working people saw only limited improvements, as the richest 10% of households captured around 40% of the national income and around three quarters of new credit creation. According to the Organisation for Economic Co-operation and Development (OECD), wages for lower paid workers fell in the '00s.

The global economic downturn ended this pattern of growth abruptly with a 3% fall in the GDP from the third quarter of 2008 to mid-2009. Job losses were still more severe, as employment dropped by a million jobs from the end of 2008 to the middle of 2010. As a result, the employment ratio fell back from a high of 45% in 2008 to 41% in 2010 – virtually the same level as in 2002, before the economic boom started. In addition to high unemployment, the growth phase in the '00s pointed especially to the following fundamental bottlenecks and imbalances in the economy:

- Dependence on the minerals value chain, including smelting and refining, which used huge amounts of electricity, leading to high emissions intensity.
- Weaknesses in the state's use of commodity-based revenue for economic diversification and skills development.
- A persistent balance-of-trade deficit funded with short-term capital inflows (essentially foreign investment in equities and in 2009/10 increasingly in interest-bearing assets), attracted largely by interest rates that were high by international standards. In effect, the country borrowed abroad to sustain government spending, investment and household consumption, which remained heavily biased toward the well-off. Both investment and domestic savings remained below the levels required for sustained growth.
- Bottlenecks and backlogs in logistics, energy infrastructure and skills, which raised costs across the economy. A particular concern arose from energy shortages that resulted in part from weak investment in new generation capacity as well as high demand spurred by low prices for much of the '00s.
- Continued economic concentration in key sectors, permitting rent-seeking at the expense of consumers and industrial development.

The New Growth Path responds to emerging opportunities and risks while building on policies advanced since the achievement of democracy 16 years ago. …

3 THE NEW GROWTH PATH

The New Growth Path starts by identifying where employment creation is possible, both within economic sectors as conventionally defined and in cross-cutting activities.

It then analyses the policies and institutional developments required to take advantage of these opportunities. In essence, the aim is to target our limited capital and capacity at activities that maximise the creation of decent work opportunities. To that end, we must use both macro- and microeconomic policies to create a favourable overall environment and to support more labour-absorbing activities. The main indicators of success will be jobs (the number and quality of jobs created), growth (the rate, labour intensity and composition of economic growth), equity (lower income inequality and poverty) and environmental outcomes.

To achieve profound changes in the structure of savings, investment and production, the government must steadily and consistently pursue key policies and programmes over at least a decade. Moreover, the state must coordinate its efforts around core priorities rather than dispersing them across numerous efforts, however worthwhile, that do not contribute to a sustained expansion in economic opportunities for our people. These are the core characteristics of a developmental state. …

Long-term structural change also requires phasing to establish the preconditions for success over time. In the case of employment, for instance, the steps that the state can take vary over time:

1. In the very short run, the state can accelerate employment creation primarily through direct employment schemes, targeted subsidies and/or a more expansionary macroeconomic package.
2. Over the short to medium term, it can support labour-absorbing activities, especially in the agricultural value chain, light manufacturing and services, to generate large-scale employment. Government can provide effective inducements to private investment in targeted sectors principally by prioritising labour-absorbing activities for the provision of appropriate and cost-effective infrastructure, regulatory interventions that effectively address market and state failures, measures to improve skills systems, and in some cases subsidies to production and innovation.
3. In the longer run, as full employment is achieved, the state must increasingly support knowledge- and capital-intensive sectors in order to remain competitive. This inherent phasing means that in the medium term the state must focus on facilitating growth in sectors able to create employment on a large scale. But it should not neglect more advanced industries that are crucial for sustained long-run growth. Government must encourage stronger investment by the private and public sectors to grow employment-creating activities rapidly while maintaining and incrementally improving South Africa's core strengths in sectors, such as capital equipment for construction and mining, metallurgy, heavy chemicals, pharmaceuticals, software, green technologies and biotechnology. These industries build on our strong resource base and our advanced skills and capacity in some economic sectors. South Africa needs to re-industrialise off the back of the opportunities identified in the growth path. But this is more than simply identifying sectors and product niches. It also requires markets. In this context, South African businesses need to do more to find opportunities in the fast-growing economies of China, India and Brazil. This requires more active pursuit of exports to, and investment from, these emerging centres of economic power.

This strategy comes with challenges, for example in the composition of the trade relationship. … The growth path emphasises supply-side needs. A critical requirement, however, is simultaneously to improve demand. In all successful economies, the domestic and regional market has been a critical factor in long-term growth. This points to the importance of production aimed at meeting basic needs within the national economy. In South Africa, however, the domestic market is relatively narrow due to the relatively small population, low employment levels and deep inequalities.

The growth path therefore proposes strategies:

- to deepen the domestic and regional market by growing employment, increasing incomes and undertaking other measures to improve equity and income distribution; and
- to widen the market for South African goods and services through a stronger focus on exports to the region and other rapidly growing economies. The measures in the New Growth Path, taken together, constitute a key means to address the income inequalities in our society. They place decent work (more and better jobs) at the centre of the fight against inequality but also include measures such as skills enhancement, small enterprise development, wage and productivity gain-sharing policies, addressing the excessive pay gap between top and bottom, progressive taxation and support for the social wage, meaning public services targeted primarily at low-income households. …

3.1 Jobs drivers

If we can grow employment by five million jobs by 2020 (around three million more than the anticipated growth if we extrapolated from 2002 to 2009), over half of all working-age South Africans would have paid employment and narrow unemployment would drop by 10 percentage points from 25% currently to around 15%. Achieving this goal will be the key target that informs the annual employment and growth targets that will be set. We can reach this target if we focus consistently on areas that have the potential for creating employment on a large scale – what we term "jobs drivers" – and securing strong and sustainable growth in the next decade. Most of the projected new jobs will come from the private sector. …

Two key variables will affect the target of five million new jobs: the rate of economic growth and the employment intensity of that growth – that is, the rate of growth in employment relative to the rate of growth in GDP. In effect, we need both to maximise growth and to ensure that it generates more employment, mostly in the private sector, in order to reach our target. The employment intensity of growth must be kept between 0,5 and 0,8, while the rate of growth in GDP should rise to between 4% and 7% a year. The following box explains this relationship. Supporting the jobs drivers through appropriate measures is important to encourage more employment-intensive growth. …

The rate of growth required to achieve the target of five million jobs over the next ten years depends on the employment intensity of growth – that is, the relationship between the growth in employment and the growth in the GDP. The actual employment intensity of growth in South Africa is the subject of debate both because of difficulties with the data, especially before 2001, and because of annual fluctuations. …

The jobs drivers we have identified are the following:

1. substantial public investment in infrastructure both to create employment directly, in construction, operation and maintenance as well as the production of inputs, and indirectly by improving efficiency across the economy
2. targeting more labour-absorbing activities across the main economic sectors – the agricultural and mining value chains, manufacturing and services
3. taking advantage of new opportunities in the knowledge and green economies
4. leveraging social capital in the social economy and the public services
5. fostering rural development and regional integration

3.2 A development policy package for growth, decent work and equity

The work done for the New Growth Path indicates that our goal of growing employment by five million new jobs over the coming decade is achievable. It cannot, however, be achieved with only a single policy instrument. It needs a package of interventions that addresses a range of challenges in the economy and that balances competing policy concerns while mitigating unintended consequences. …

We outline below the details of a developmental package consisting of macroeconomic strategies, microeconomic measures and stakeholder commitments that can lead our society to a new growth trajectory and achieve a higher, sustainable expansion in decent work opportunities and in output based on our common efforts.

The macroeconomic section of the package entails a careful balancing of more active monetary policy interventions to achieve growth and jobs targets, *inter alia* through a more competitive exchange rate and a lower cost of capital, with a more restrained fiscal stance and repriorisation of public spending to ensure sustainability over time. The microeconomic section in the package involves targeted measures to control inflationary pressures and support competitiveness and increased equity, which in turn makes the macroeconomic strategy sustainable and viable. It includes reforms in policies on skills, competition, industry, small business, the labour market, rural development, African integration and trade policy. …

3.2.1 The macroeconomic package

In terms of the macroeconomic stance, for the foreseeable future government will be guided by a looser monetary policy and a more restrictive fiscal policy backed by microeconomic measures to contain inflationary pressures and enhance competitiveness. The package entails the following:

1. The monetary policy stance will continue to target low and stable inflation but will do more to support a more competitive exchange rate and reduced investment costs through lower real interest rates. This will be accompanied by measures proposed below to contain inflationary pressures and build competitiveness.
2. Additional and larger purchases of foreign currency flowing into South Africa, as a result of foreign direct investment and portfolio inflows, in order to counter appreciation of the rand as required. An African development fund will be established to invest in African infrastructure, as outlined below. A further set of tools to address the competitiveness of the exchange rate is being explored, including measures to address the negative effects of short-term capital inflows. These tools will take into account global agreements to deal with imbalances.
3. Greater restraint in fiscal policy to slow inflation despite easier monetary policy. A counter-cyclical fiscal stance through the business cycle will manage demand in support of a more competitive currency while achieving critical public spending goals. The MTEF foresees real growth in expenditure of just over 2% a year for the next few years.
4. Mobilisation of resources to finance growth path priorities, particularly jobs, skills and infrastructure. The new fiscal policy will require vigorous prioritisation and improved value for money, with reductions in less important areas while protecting priority public services. Spending proposals need to be subjected to a clear and rigorous prioritisation process, corruption and waste eliminated, and remuneration growth moderated to avoid squeezing crucial developmental programmes.

Source: http://www.moneyweb.co.za/mw/action/media/downloadFile?media_fileid=9594 (accessed on 16 March 2012).

Question: What, in your estimation, is the role of macroeconomic stability in the achievement of a high growth and high employment levels? What do you learn from the Keynesian and Chicago schools about what is necessary to achieve macroeconomic stability? What more besides macroeconomic stability is needed to realise greater employment growth for South Africa?

DEMARCATED READING

At this point you should read all of chapter 21, excluding "21-1 Past as prologue".

CONTENT

Modern mainstream economics consists of neoclassical microeconomics and Keynesian macroeconomics. You studied the historical roots of microeconomics in learning unit 5. Now you will study the historical roots of macroeconomics, which are mainly found in one book written by one author. The author is John Maynard Keynes and the book is *The general theory of employment, interest and money*, commonly shortened to the *General theory*.

The *General theory* was published in 1936 during the height of the Great Depression of the 1930s, when around 25% of the labour force of the Western world was unemployed. Such an unemployment rate may seem mild to South Africans, who have been accustomed to unemployment rates of 30% and beyond. But in the most advanced Western countries where unemployment rates normally fluctuated between 4% and 6%, this was an unheard-off disaster. While it is controversial whether Keynes's ideas are applicable only to exceptional situations of crisis, it is undoubtedly so that the Great Depression stimulated these ideas. Once again there is a theoretical side and a political economy side to Keynes's ideas as contained in his *General theory*.

As for the theoretical side, Keynesian theory is characterised by a "macroeconomic emphasis", a "demand orientation", an emphasis on "instability in the economy" and "wage and price rigidity" (2013:456–457) [2007:428–429]. Let's briefly explore these characteristics. The macroeconomic emphasis means that Keynes theorised in terms of relationships between aggregate amounts (total income, total consumption, total investment, the general interest rate, the general price level), whereby these relationships were not always derived from the benefit-maximising behaviour of an individual consumer or producer. This applies in particular to Keynes's consumption function, which he explains by way of a "fundamental psychological law", according to which most people on average do not spend all their income. However, Keynes's investment function does seem to be microeconomic in that it is still grounded in the profit-maximising behaviour of an individual representative firm. Something similar can, perhaps, be said about Keynes's employment and liquidity preference function. The moral of this story is that Keynes's macroeconomics was still to a significant degree influenced by Marshallian microeconomics.

The demand orientation of Keynesian theory is simply the result of Keynes's rejection of Say's law. Refer to our discussion of Say's law in learning unit 3. When Say's law does not necessarily hold and "supply does not always create its own demand", the sale of aggregate production can be constrained by insufficient aggregate demand, which then acts as a drag on sales and eventually on production as well. In other words, the failure of Say's law makes demand the bottleneck, which then comes to determine income and production.

More particularly, Keynesian theory emphasised that "wages are a source of demand for goods as well as a cost of production" (2013:458) [2007:430]. The classical remedy for unemployment was, of course, to allow wages to fall, which would decrease the cost of labour and so stimulate employment. Keynes disagreed, among other things, because a drop in wages would curtail demand for goods which would limit the profitable expansion of employment. Note, however, that the reduction of wages, ceteris paribus, causes the incomes of workers to fall but the incomes of business firms (profits) to rise. Whether total demand falls will then depend on the extent to which businesses would re-spend their increased incomes following the reduction in wages, which will be discussed below. The argument against wage reduction popularly advanced by South African trade unions is also that a reduction in wages shrinks the demand for goods and is thus detrimental to the economy. But, again, the argument is strictly speaking false. The direct effect of price changes is to not to change total income but merely to redistribute it. In the case of a wage decrease, firms gain and workers lose income. The effect on total spending will then depend on whether the liquidity preference (the propensity to keep money idle rather than to spend it) is different among workers than it is among firms.

In the context of falling wages the prescribed textbook (2013:459) [2007:430–431] also remarks how, according to Keynes, a decrease in nominal wages is inadvisable because it may lead to deflation, which tends to worsen economic depression. Let us see why this is the case. First, deflation raises the "real burden of debt", as money has to be repaid in money units (rands or dollars) of increasing real value. Since firms are normally debtors, their profitability would consequently fall. Second, deflation directly reduces profits, simply because producing and selling take time and the incurring of costs, therefore, always precedes the recoupment of costs from sales. When prices continually fall, it is likely that the fall in output prices will lag behind the fall in input prices, which lowers profit margins. All this further depresses economic activity and employment creation, as indeed happened during the Great Depression. Finally, bear in mind that Keynes's opposition to reducing wages as a way of remedying unemployment presupposes a closed economy. In order to improve the competitiveness of a country's exports on the international market it may, however, be beneficial if its production cost, including labour cost, were to fall. This may be particularly important for an open economy like South Africa's.

Keynes's emphasis on the instability of the economy is similarly related to his rejection of Say's law, because that instability is caused by the instability of total demand, in particular investment spending by businesses (2013:457) [2007:429]. Since investment is unstable, it regularly falls below the level necessary to compensate for the reduction in spending due to household saving (the so-called "savings gap", which follows from Keynes's consumption function). When investment is insufficient in this regard, production and employment will eventually fall. The destabilising effect of investment spending on total spending is also related to the industrial form of capitalism. Because the benefit of investment lies, by nature, fairly far into the future, these benefits are particularly uncertain. As a result, the level of investment spending is highly sensitive to entrepreneurs' and investors' volatile moods and confidence levels, to which Keynes referred, somewhat disparagingly, as "animal spirits". The more industrialised an economy is and thus the greater the proportion of total spending, which goes toward investment and intermediary goods, the more unstable total demand will be.

It is also in the nature of the modern credit-money system that it makes spending levels more unstable relative to the traditional commodity-money system. As noted before, a credit-money system is a system where money consists mainly of demand deposits created when banks grant credit to their clients. In such a system, the total money supply is highly flexible and adapts itself easily to demanders' spending plans, especially when these demanders have direct access to bank credit as do most large businesses and investors. By contrast, a traditional commodity-money system is a system where money predominantly consists of precious metals or notes and deposits fully convertible into precious metals. Such a system makes the money supply much less flexible in the short run, with the result that a limited availability of funds becomes a more important determinant of the level of total spending. Because a modern credit-money system thus renders a limited availability of funds less important and unstable future expectations more important, as determinants of investment decisions on the part of investor-entrepreneurs, it adds to the instability of investment spending. If you want to know more about these things, do one of our third-year or honours courses in *monetary economics* or *money, banking and financial markets*.

Lastly, the Keynesian assumption of wage and price rigidity is similarly related to institutional factors such as the industrial mode of production and the corporate form of the business firm. As we saw in chapter 20 of the textbook, these institutions make for a large and powerful corporate business firm, which, therefore, has the market power to control prices. The greater power of the modern trade union movement has similarly caused the wage rate to be rigid as well, seldom if ever allowing it to drop.

It thus transpires from all the major tenets of Keynes's economics that he implicitly criticised corporate-industrial, credit-money capitalism. Even the inherent instability and speculativeness of stock markets, which Keynes regarded as not "one of the most outstanding triumphs

of *laissez-faire* capitalism" (2013:460) [2007:432], he attributed to the corporate form of private business firm:

> *With the separation of ownership from management [i.e. the corporate firm] which prevails today and with the development of organised investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but sometimes adds greatly to the instability of the system.*[11]

Recall how the institutionalists, Veblen in particular, also directed their attack at corporate-industrial capitalism and the modern credit-money system. The only difference between Keynes and Veblen in this regard is that Keynes focused his attack more narrowly on the inherent instability of corporate capitalism and chose to employ neoclassical theory for his purposes, while Veblen criticised corporate capitalism more broadly and was, of course, more consistently opposed to the neoclassical method. This brings us to the political economy side of Keynes's ideas.

Keynes did not advocate cutting back on industrialisation or doing away with the corporate business form and the credit-money system. Instead, he preferred to correct the negative side-effects of modern corporate capitalism by way of government policy. Keynes believed that public works programmes, a degree of wage and price control as well as careful monetary and fiscal policy making could stabilise total demand at a level somewhere round where full employment is obtained. In that way, Say's law could be made to hold. It has to be admitted that the Keynesian medicine has been amazingly successful in many Western countries. Largely inspired by Keynesian-style policies, Western industrialised nations have enjoyed unparalleled economic prosperity over the last fifty-odd years since the end of World War II, with the exception of a few periods of relatively minor recession, such as during the 1970s and the early part of the 1980s. In the light of this, Keynes is often regarded as capitalism's saviour. The financial crisis of 2007–2008 has, of course, underlined the potentially severe instability of contemporary capitalism and dented confidence in the ability of government to manage that instability.

Still, not all Keynesian policies are necessarily "mild, safe and sane" (2013:458) [2007:430] and they can have serious negative side-effects. For example, stimulation of the economy by way of demand can lead to inflation, which can destabilise the economy by creating extra uncertainty among other aspects. Uncertainty, as you should know by now, is the enemy of industrial capitalism. The extensive involvement of government in the economy through public works can, furthermore, lead to inefficiency and waste of resources, which is partly why many nations have since opted for the privatisation of state assets. Moreover, even if Keynesian demand management is scrupulously applied and there is little government inefficiency, serious problems with corporate-industrial capitalism remain. While it has in the main generated sufficient levels of employment in developed nations, it has been singularly unsuccessful at generating anything like sufficient employment in most developing nations, including South Africa. The trend towards the concentration of power in the hands of a few big corporations proceeds unabated, both in South Africa and the world at large. Financial markets (stock exchanges and foreign exchange markets, in particular) remain highly volatile and unstable, which is especially disruptive for vulnerable developing economies like South Africa's. Furthermore, the natural environment continues to be damaged by an immoderate drive towards wealth creation. Keynesian-style policies, even with optimal planning and implementation, can provide no solution to such negative side-effects. Keynes could not completely save capitalism.

Keynes can, furthermore, be criticised for implicitly regarding the satisfaction of Say's law (effective demand sufficiency) as a sufficient condition for the achievement of full employment by contending that Say's law amounts to "the proposition that there is no

11. Keynes, JM. 1936. *The general theory of employment, interest and money.* London: Macmillan:150–151.

obstacle to full employment".[12] The implication is that unemployment is solely the result of insufficient aggregate demand. The caricature thus created is not harmless as it provides the theoretical rationale for the kind of macroeconomic populism, which indiscriminately applies expansionary monetary and fiscal policy to all instances of unemployment. Especially for developing economies with typically large structural unemployment levels (caused by supply-side constraints on growth), such a policy stance may spell serious macroeconomic destabilisation, as practice has unfortunately borne out all too often.

The prescribed textbook (2013:461– 469) [2007:433– 441] ably sums up the particularities of Keynes's theoretical system, with which you should already be familiar from your second-year studies in macroeconomics. There is, therefore, no need to add extra explanation, which should not be taken to mean that this theoretical system is in any way less important. It is important and needs to be studied carefully.

THE KEYNESIAN SCHOOL: POST-KEYNESIANS AND NEW KEYNESIANS

To spark your interest in those economists today who argue that Keynes's message has been misinterpreted by the dominant neoclassical school, you may choose to listen to a video clip by Robert Skidelsky, a prominent authority on Keynes, entitled 'Economics and Political Power during the Crisis' accessible either through the INET site or directly through googling and YouTube.

STUDY OUTCOMES

When studying this section, you should aim at gaining knowledge and understanding of the following:

- The major tenets of the post-Keynesian school, with particular emphasis on mark-up pricing, endogenous money, macroeconomic instability (already a Keynesian theme) and the need for incomes policy to combat inflation.
- The importance of endogenous money and the relevance of cost-push factors in the inflationary process – as emphasised by the post-Keynesians.
- The major tenets of the New Keynesian school, and their emphasis on the downward rigidity of relative prices and wages as the cause for unemployment.
- The questionable view, underlying New Keynesian economics, that price and wage flexibility would have ensured full employment and full capacity utilisation.
- Possible reasons why prices and wage may be inflexible downwards: menu cost, formal and implicit contrasts, efficiency wages and insider-outsider theory.

DEMARCATED READING

At this point you should read chapter 22 only the sections "The post-Keynesians" and "The new Keynesians".

CONTENT

We purposefully left out the textbook's discussion of the IS-LM framework ("The Hicks-Hansen synthesis", at the start of chapter 22), with which you should already be familiar. The formalisation of Keynes's economics by way of the IS-LM model is often called the "neoclassical synthesis", because it is believed to be an eclectic mix between Keynes's ideas and neoclassical, mathematically oriented analysis. Essentially, the school of thought called post-Keynesian believes that the essence of Keynes's message got lost when too many of his ideas were forced into the neoclassical mould. But because Keynes himself made extensive use of neoclassical analysis, it seems the problem is a matter of degree rather than principle.

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12. Keynes, JM. 1936. *The general theory of employment, interest and money.* London: Macmillan:26.

The general problem with Keynes's theoretical system is that its various elements (his theory of consumption and investment spending, his theory of employment, his theory of interest rates and prices, his theory of money, etc) are difficult to combine into a single integrated whole, without doing violence to at least some of them. Moreover, there are things about Keynes's system, like his emphasis on uncertain profit expectations, which are difficult to model at all.

The post-Keynesian school wishes to wrestle Keynes's theory free from its neoclassical entanglements, so that its essential message can come out more clearly, especially concerning the inherent instability of capitalism and the inability of the price system automatically to maintain full employment. At times, the message is remoulded in Ricardian terms, whereby a cost-of-production theory of value is endorsed, like Sraffa's theory (2013:495) [2007:464–465]. At other times, this message is remoulded in more institutionalist terms, through which the modern capitalist institutions of the corporate form of enterprise and credit money are blamed for the inherent instability of total spending, the inherent instability of the banking system, and the high levels of inequality of income.

Two important aspects of the post-Keynesian perspective are, furthermore, worth mentioning, because they can easily be recognised as valid, even if one chooses to remain sceptical about the broader intent of post-Keynesian economics.

Firstly, the post-Keynesians can be credited for being the first to emphasise the predominantly endogenous nature of the money supply (2013:496) [2007:465]. Conventional theory had assumed that money is exogenously determined, meaning that it is fully controlled by the central bank and treated as given by private agents. But it seems obvious that in a credit-money system, most money is created in the process of banks granting credit to their clients. If so, the demand for credit by the private sector is the most important driver of the money supply. The primary way in which the central bank can influence the money supply is then by influencing private credit demand, which it achieves by manipulating the cost of bank credit through the interest rate. And this is exactly what happens in practice. The actions of private sector agents thus play an important role in determining the money supply, which is therefore not exogenous in the sense of being fully controlled by the central bank without the involvement of private sector actions. These themes are developed further in our third-year and honours courses in *Monetary Economics* or *Money, Banking and Financial Markets*.

Secondly, post-Keynesians rightly emphasise that inflation is not purely and solely caused by excess demand for goods, even if they may be wrong in advocating an incomes policy to combat inflation (2013:496) [2007:466]. Inflation can most certainly also be caused by cost or profit push factors, such as when the rand cost of imported inputs rises when the exchange rate falls, as is happening at the time of writing. The problem with cost-push inflation is that the government cannot *directly* combat it by way of Keynesian demand management. But demand management (a restrictive monetary policy) can still *indirectly* combat cost-push inflation. By restricting total demand for goods, the bargaining power of demanders vis-à-vis suppliers is enhanced. Suppliers are thus encouraged to absorb inflationary cost increases rather than pass them on to demanders in the form of higher prices. In that way, restrictive demand management can slowly squeeze inflation out of the system, even if an excess of demand did not originally cause the inflation. This is essentially what the South African Reserve Bank is presently trying to achieve as well, although you will realise that such an anti-inflationary policy goes at the expense of lower profit margins for business (which may slow down production and employment creation), if labour does not simultaneously limit its wage demands.

Experience all over the world has shown that an incomes policy to control inflation, if it means that prices and wages are artificially frozen, does not work and has serious detrimental side-effects. It leads to the development of black markets, reduces supply if the fixed price does not allow sufficient cost recovery (all the shops go empty, as happened in Zimbabwe), it stifles competition and it cannot do anything about the prices of imported

goods. Moreover, its inflation-dampening effect tends to be short-lived, nullified by accelerated inflation once the price controls are lifted again. However, if an incomes policy means some kind of social contrast among labour, business and government, it can potentially be highly effective. Business, labour and government could sit around a table and work out a compromise on allowable price/wage/tax increases, so as equitably to share the necessary sacrifices to squeeze out inflation, which is precisely how many European countries got rid of their inflation in the 1980s. But such a strategy would require a degree of willingness to sacrifice sectional interest for the sake of the interest of the country as a whole, which may not be present in South Africa. The antagonism and mutual distrust between business, labour and government is probably too strong in South Africa for such a cooperation to materialise.

So much for the post-Keynesians and now for the new Keynesians (we hope you are not yet thoroughly confused by the profusion of labels), who are an altogether different breed. While the post-Keynesians operate more on the fringes of mainstream economics, the new Keynesians operate right in the middle of it, in that they employ the mathematical-neoclassical style of theorising. New Keynesians latch on to one of the characteristics of Keynes's analysis, namely the assumption of downwardly inflexible prices and wages. They then impose inflexible relative wages and prices on a standard neoclassical Walrasian general equilibrium model, so as to make it generate unemployment. Unemployment is thus attributed mainly to inflexibility and other such market failures, whereby it is implicitly suggested that there would have been full employment had relative prices/wages been perfectly flexible and had other market imperfections been absent, which in a developing world context like South Africa’s, where a large percentage of the unemployment is structural, is somewhat debatable. You will notice that menu costs, formal and implicit contracts, efficiency wages and insider-outsider theory are all explanations for downward relative price/wage inflexibility.

THE CHICAGO SCHOOL: OVERVIEW

STUDY OUTCOMES

When studying this unit, you should aim at gaining knowledge and understanding of the following:

- the emphasis of the Chicago school on neoclassical economics’s basic method (economic man, microeconomic orientation, mathematical analysis) and political philosophy (limited government)
- the view of the Chicago school that monopoly power abuse is fleeting and self-correcting
- the view of the Chicago school that monetary policy, by controlling the money stock, could ensure that Say’s law holds, and that total demand would be neither insufficient nor over-sufficient

DEMARCATED READING

At this point you should read chapter 24: only the section “Overview of the Chicago school”.

CONTENT

Basically, the Chicago school of thought is a reaction to Keynesianism, its theoretical and political economy underpinnings. This reaction should be seen against the backdrop of the economic situation of the 1970s when some of the negative side-effects of Keynesian policy became especially pronounced: high inflation combined with high unemployment (stagflation), excessive union power and high government inefficiency. The Chicago school goes back to some of the basic theoretical and political economy suppositions of classical and neoclassical economics. As for theory, they employ the Walrasian variety of neoclassical

theory (just as the new Keynesians, except that the new Keynesians impose inflexible relative prices on the Walrasian system), which the new classical economists in particular have taken to new heights of mathematical sophistication. In spite of this sophistication, the basic and simple classical suppositions of the model remain intact: belief in the validity of Say's law (aggregate demand is always more or less sufficient to buy up total aggregate production) and belief that markets are sufficiently competitive for prices to be relied on to clear markets. The abuse of monopoly/oligopoly power by firms is not a problem; new firms will spontaneously come up to challenge existing monopolies/oligopolies, which will thus dissipate of themselves. This leaves Chicago school economists with only the following causes for the existence of unemployment and instability in modern capitalism: inappropriate government policies, temporary disruption due to technological innovation and a reduced propensity to work (people are unemployed because they want to be). Now these factors, especially the first two, may certainly contribute towards unemployment, but it is unlikely that they can sufficiently explain unemployment in most countries, especially not in South Africa. South Africa's macroeconomic policies are extremely responsible and restrained (close to "textbook-perfect"), temporary disruption due to technological innovation cannot be great and people definitely want to work here. Yet we sit with an unemployment rate of around 30%!

As for the political economy side of their system, Chicago school theorists believe in minimal government, leaving the economy as free as possible almost to the point of pure *laissez-faire*. While Keynesians may in the past have relied too heavily on demand stimulation leading to inflation, while they may have overemphasised public projects to stimulate employment leading to inefficiency and waste of public resources, and while they may have over-regulated the economy leading to inflexibility, it would seem to be equally misguided to go back to an almost perfect *laissez-faire* system (which has never existed anyway). There is a role for Keynesian demand stimulation provided it is carefully applied, there is a role for selective public projects provided they are carefully managed, and there is a role for regulation provided it does not become too stifling. Implicit in Chicago school theory and policy seems to be a view of the economy, in which most markets are highly competitive because populated by a multitude of small businesses of the proprietorship and partnership type, in which the banking system is inherently stable and there is never too much or too little money creation, and in which the ownership of land and capital is well spread out over the whole population. But it is not so. In the modern capitalist economy, markets are dominated by huge corporations many of whom have strong monopolistic/oligopolistic powers; the credit-money system is inherently unstable needing careful central-bank oversight and control; financial markets are highly volatile and globalised; and the ownership of capital and land is highly concentrated in the hands of a few, in the light of which some Chicago-school policies seem naïve indeed. But this is only the opinion of your lecturer. Feel free to disagree.

The prescribed textbook (2013:531–532) [2007:495–496] notes the interesting point that the minimalist government doctrine of the Chicago school cuts both ways: it is not only against government regulation of private business, but also against government protection of private business, which can be extensive indeed. It is not uncommon for United States (US) or European Union (EU) governments to prop up and subsidise ailing industries with billions of dollars or euros. In both the United States and the European Union agriculture is also extensively subsidised and protected by the government, not so much for strategic reasons but simply because the farmers are a very powerful political lobby. The Chicago school would be opposed to such protection, which may be a good thing. In this context, it is worth mentioning that a significant proportion of any country's economy depends on state spending. For example, many construction and engineering companies depend on state spending on infrastructure, such as roads, railways, and dams. Also the whole complex of armaments and related industries, which makes up a sizeable proportion of the US and EU economies, depends on defence spending by their own as well as foreign governments. Although such spending is evidently not a subsidy, it does highlight that powerful private-sector interests are often bound up in the size and direction of government spending, which

explains why so much questionable lobbying (if not corrupting) is going on in the world's capitals.

THE CHICAGO SCHOOL: FRIEDMAN AND LUCAS

STUDY OUTCOMES

When studying this unit, you should aim at gaining knowledge and understanding of the following:

- Friedman's view that "inflation is always and everywhere a monetary phenomenon", and possible weaknesses of that view
- Friedman's modern quantity theory of money, and the role of the "monetary rule"
- the Phillips curve
- the meaning of Friedman's adaptive expectations
- Friedman's short-run Phillips curve: the effectiveness of expansionary fiscal/monetary policy to raise employment above its natural level in the short run
- Friedman's long-run vertical Phillips curve: the ineffectiveness of expansionary fiscal/monetary policy to raise employment above its natural level in the long run
- the meaning of Lucas's rational expectations
- Lucas' long-run vertical aggregate supply curve: the ineffectiveness of *anticipated* demand stimulation to boost employment and output, in both the short run and the long run
- Lucas' short-run aggregate supply curve: the effectiveness of *unanticipated* demand stimulation to boost employment and output in the short run – but still not in the long run
- how Lucas' model presupposes Say's law

DEMARCATED READING

At this point you should read all of chapter 24, excluding "24-1 Past as prologue", the "Consumption Function" and "Gary S. Becker".

CONTENT

As for the particulars of Milton Friedman's economics (2013:533– 540) [2007:497– 504], the prescribed textbook should be clear enough and needs little extra clarification. You ***can ignore*** the section "The demand for money" (2009:535–536) [2007:498–499].

Friedman proposes that the demand for passive money holding is relatively stable (though not static), which implies that the income velocity is stable (though not static). Moreover, Friedman's restatement of the quantity theory of money proposes that the money supply can be exogenously determined by the central bank; compare our remarks on endogenous money above. The upshot of these two propositions is that total spending can be controlled by way of the central bank's control over the money supply. In other words, Say's law can be made to hold and inflation can be avoided, if the central bank keeps the growth in the money supply roughly equivalent to the growth in the real economy – see "the monetary rule" (2013:539) [2007:503]. We now know, however, that the demand for money is not very stable (and, in fact, has recently become increasingly unstable) and that the money supply cannot be perfectly controlled by the central bank, unless it accepts highly volatile interest rates which would be seriously destabilising. All in all, Friedman's monetary rule would be wonderful if it could work; but it is just not practicable. With that, his critique of Keynesianism and his belief in the inherent macroeconomic stability of the economy is undermined.

Friedman's claim that inflation is "always and everywhere a monetary phenomenon" is true in the sense that inflation cannot occur without the money stock increasing. If real income is not to fall drastically, the higher general price level and the resultant higher nominal volume of trade needs to be financed by more money. But that does not mean that inflation is purely

a demand-pull phenomenon which can be controlled by controlling the money stock. As we noted above in our discussion of the post-Keynesians, inflation is also a cost-push phenomenon.

To understand the prescribed textbook's (2013:537–539) [2007:501–503] discussion of the long-run vertical Phillips curve, first study the normal Phillips curve (2013:490–492) [2007:460–461]. Friedman's theory about the long-run vertical Phillips curve is also important because it drew attention to the role of expectations in economic theory. Friedman argued that workers' labour-supply decisions are determined by expected rather than actual real wages. Under these circumstances, when policy makers cause inflation by stimulating demand and that inflation remains unanticipated by the workers, expected real wage remains the same, but actual real wage drops. Under these circumstances, employers will be inclined to offer more jobs and produce more goods. But as soon as workers realise that their real wage has fallen, they will start anticipating the higher prices and demand higher nominal wages to restore their original real wage, which will bring production and employment back to its original level. The moral of the story is that unemployment can only be forced below its "natural" level, when policy makers cause unexpected inflation by expansionary monetary or fiscal policies, which would trick workers into believing that their real wage is higher than what it really is. But this trickery will obviously only be temporary. As soon as workers wise up to the situation, real wage rises again and employment again falls to its long-term "natural" level. A vertical long-run supply curve of goods thus emerges. We may call this *adaptive expectations*.

Robert Lucas, of the new classical school, took this idea a step further (2013:540– 545) [2007:504– 508]. He argued that economic agents have *rational expectations*, meaning that expansionary monetary or fiscal policy cannot even temporarily stimulate production and employment, because the inflationary effects of these policies would have been anticipated by the workers, who would accordingly adapt their nominal wage demands as soon as the policies were noticed. Only if the expansionary policy is *unanticipated* can it temporarily stimulate the economy, but this would mean that the monetary or fiscal authorities would have to be erratic and unforeseeable in their policy application, which would be destabilising anyway. Hence the rational expectationists concluded that monetary or fiscal policy cannot stimulate the economy; its effects are only inflationary.

Although Lucas and the new classical school seem right in pointing out that the anticipation of a policy action can influence its effectiveness, the total ineffectiveness of policy seems to depend on other assumptions as well. Most importantly, it depends on the assumption that the economy always finds itself at its "natural rate" of employment and production. The natural rate of employment and production (2013:537– 539) [2007:501– 503] is the level of employment and production where all markets clear, and where the only remaining unemployment (that is, the natural rate of unemployment) is frictional. Because demand and supply are presumed to be equal in all markets, a stimulation of the total demand would have to be inflationary. However, if we assume that Say's law does not always hold and that demand can fall short of supply, a stimulation of demand can have real expansionary effects in the medium to longer term, without prices necessarily having to rise.

Nonetheless, *rational expectations* has become an important concept in modern macroeconomic theorising. Just as agents in neoclassical models are supposed to maximise their utility in their spending and production decisions, they are also supposed to maximise their utility in their information-gathering efforts so as to form rational expectations. Rational expectations theory, however, not only assumes that agents gather all relevant information but also that they develop a correct understanding of the workings of the economy in the process. As a result, the gathered information gets translated into averagely correct expectations of the event concerned. In this context, it is popularly said that the rational expectations approach presupposes that agents possess "the correct model of the economy". While the approach does not exclude the possibility that expectations are wrong, expectational errors are assumed to be normally distributed around a mean value, which is

the correct expectation. Moreover, as already mentioned, the rational expectations approach postulates that the "correct model of the economy" is a neoclassical Walrasian model in which Say's law always holds, employment and real income are a function of real wage/price only and markets always clear. As a result, workers need to correctly forecast only the future price level, in order to be certain about the real value of their currently negotiated money wage. Unless the parameters of the labour demand and supply functions change, real wage will thus always be at the market-clearing level. That is why employment is fixed at what is called the natural rate of unemployment.

LOOKING BACK AT ACTIVITY 7.1

Several lessons can be learnt from the discussion in this learning unit. To start with, macroeconomic stability (stable and sufficient growth in aggregate effective demand – the maintenance of Say's law) is not enough to guarantee full employment, for several reasons. The first is that growth can be constrained by both insufficient demand and insufficient supply. The latter can be result of a lack of profit opportunities for entrepreneurs or a lack of productive inputs required to exploit these opportunities, which requires addressing issues like inadequate real and financial infrastructure, inadequate skills levels, and socio-political-legal uncertainty. The second is that the degree to which growth in output translates into growth in employment depends on the capital intensity of the sector in question. Increasing capital intensity in a sector may neutralise the employment-creating effects of growth in that sector. The third is that macroeconomic stability focuses mainly on local aggregate demand. But if foreign demand for our goods is to be stimulated, we also need to look at stimulating foreign demand which is a matter of raising the competitiveness of local manufacturing in both local and foreign markets. The latter requires a conscious strategy involving all stakeholders: government, private business and the unions. However, while it may be important to concentrate on export-led (and import-replacement) growth, significant employment gains can also be made from growth in activities in the local non-tradables sector, in particular services and construction, the latter mainly through large infrastructural works and tourism (although tourism can also be regarded as an export tradable). Concentrating on local growth has the added advantage of being less dependent on the vagaries of the world economy, which at the time of writing seems to enter a particularly unstable phase. See the New Growth Path for more detail.

RELEVANCE FOR TODAY

This last learning unit is the unit most relevant to current economic theory and policy. From around 1950 to around 1980 the Keynesian school dominated the economic theory and policy of the time. From around 1980 onwards, due in part to the (mistaken) view that the world-wide inflation and 'stagnation' of the 1970s was the result of Keynesian policies, macroeconomic theory and policy has been dominated by the Chicago school. In the wake of the 2008 world financial crisis there has been a partial revival of the influence of Keynesian remedies in the form of massive fiscal and monetary packages (notably quantitative easing') and widespread acknowledgement that it is these Keynesian policies that have prevented the world economy from slipping into another 'great depression'. Nevertheless the influence of the Chicago school has made itself felt via the arguments for 'fiscal austerity', most dramatically felt in the case of Greece.

SELECTED SELF-STUDY QUESTIONS

1. Contrast the major tenets of the Keynesian school with those of the marginalist school.

2. At what points do the new Keynesians disagree with the Post Keynesians?
3. Explain Lucas's distinction between short-run and long-run aggregate supply.

SOME CONCLUDING THOUGHTS

DEMARCATED READING

At this point you should read all of chapter 25.

CONTENT

This chapter speaks for itself, so here are just a few additional thoughts from your lecturer.

The prescribed textbook's remark (2013:560) [2007:522] that "new ideas seldom lead to the total abandonment of the existing heritage" is important. What its authors are actually saying is that schools of thought, whether they be classical, Marxian, socialist, neoclassical or institutionalist, all contain valid ideas. Economics ideas, if wrong, are seldom totally wrong. It's more likely they are some sort of half-truth. As a result, one should never totally discard the ideas of defunct and out-dated schools of thought, as one may thus miss out on some of the half-truths that are validly highlighted.

The prescribed textbook (2013:562) [2007:524] notes a certain danger of mathematical economic theory, namely that "the tools at hand often dictate which jobs are undertaken". In other words, the dominance of mathematical theory leads economists to tackle only those economic phenomena that easily lend themselves to mathematical modelling. But that is only half the problem. The way in which these phenomena are explained is also dictated by the mathematical tools. As such, the danger exists that economic reality is adapted to suit the tools, rather than that the tools are adapted to suit reality. There is the old joke about the economist who rebuked the data when they refused to confirm his model.

FINAL THOUGHTS

After completing chapter 25, you may like to listen to a few more video clips. These may help to crystalise some of your responses to what you have learnt in the module. They should also serve to help relate what you've learnt to what is happening in economics today. Once again, they are not examinable. I suggest you listen to two:

Philip Mirowski on 'Why is there a Nobel Prize in Economics?' as well as Sanjay Reddy on 'Fact and Values are entangled: deal with it'. Both are available via INET or directly via googling and YouTube. If you have some spare time the INET clip entitled 'John Shattuck interviews Axel Leijonhufvud' is worth watching, at least for the first few minutes when Axel explains that the modelling culture learnt especially at (American) graduate schools forms such a powerful lens that it prevents successful students from looking at the economy in any other way.

We hope you enjoyed this course and that it stimulates you to further reading in the history of economic thought.