The Major Traditions in the Development of Economic Thought

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Abstract. Every economy in this world faces the problem of optimal allocation of resources among different human wants. This problem of choice arises because human wants are unlimited, resources to satisfy those wants are limited and resources have alternative uses. Economics teaches us various ways and means to allocate these resources in the best interests of the society. The science of economics has evolved through different phases which has been enriched by many economist of their times. An attempt has been made in this paper to discuss some important tenets of different schools of thought starting from mercantilists to the Keynesian system.

Key Words: Wants, Resources, Choice, Demand, Supply, Equilibrium, Mercantilist, Physiocrats, Classical, Neoclassical, Marginalists, Marxism, Keynesian.

Introduction

Economics is a dynamic science. With the development of human civilization this science has evolved to include within its ambit a vast range of topics concerned with human life. Every society on this earth faces three basic facts of human life:

- Human wants are unlimited
- Resources to satisfy these wants are limited and
- Resources have alternative uses.

Under such a situation a society cannot provide all its members everything they want. The society has to make a choice of wants to be satisfied in order of priority. Making such a choice is a highly difficult task. Here the science of economics comes to our rescue. Economics teaches us the ways and means to allocate scarce resources among different competing human wants so as to maximize the total satisfaction of our society. Further, the study of economics helps us to understand the intricacies of the world in which we live. There are many questions about the economy which spark off our mind and we want some concrete answers to these questions. Some of the questions that we face in our day to day life may relate to:

- Why do the prices of some commodities rise faster than others?
- Why some people are able to find work and others are unemployed?
- Why people are paid differently for different works they perform?
- Why is there inequality of income and wealth in an economy?
- Why some economies are rich and advanced while others are poor and backward?
- Why can't or why don't government keep prices stable over time?

The study of economics helps us to understand these and many other problems/questions that we face in our day to day life. For an individual person and the household the knowledge of economics helps to make decision regarding the choice of what particular profession/job, to take up? How to maximize income, how much and where to spend, save and invest? It is important for employees as well as employers to know about productivity and wages in their organization as well as in the whole economy. It is very helpful in maintaining cordial employer-employee relationships and overall industrial peace & progress. Economics is also important to businessmen and traders. If they understand the causes and consequences of the business fluctuations**,** they are better equipped during such periods to make intelligent decisions to maximize their gains. With a little knowledge of economics, farmers can maximize their returns. It may help in taking decision regarding raising different agricultural products in suitable quantities and at suitable time. It helps them to understand the problem of the "paradox of plenty". Knowledge of economics has a high practical significance to scientists and researchers who while perusing research studies can assess the economic and commercial viability of the outcome of their efforts and decide whether to continue it or pursue another line of action. Every citizen of a country should know how the economic system works. An appropriate understanding of various economic problems makes us enlightened citizens and voters. As a voter, the citizen of a country may guide the policy makers and the government about judicious and people friendly monetary, fiscal, agricultural, industrial, foreign trade and environmental policies to be adopted. Knowledge of economics is also essential for politicians and bureaucrats for good governance. Knowledge of economics is important for social reformers and NGOs who are interested to solve the problems of poverty, unemployment, illiteracy and environmental pollution.

Further, economics is an important branch of knowledge for improving the welfare of society. It provides us important tools not only for the best utilization of available limited resources but also the ways and means to augment these resources. Thus the study of economics and its understanding appears to be quite significant for economic development, political stability and social harmony in an economy.

Major Traditions in Economics

During the period between the last quarter of fifteenth and the last quarter of the eighteenth centuries several writers, thinkers and philosophers began thinking seriously about the working of an economy. Concepts like capital, labour, value, price, supply, demand, rent, interest and profit etc. were implicit in their intellectual pursuit, although in a chaotic and scattered manner. The most prominent group of thinkers of the period are known as Mercantilists and physiocrats. However, a discussion of their ideas is not relevant here.

The Mercantilists

The mercantilists' view of economics had suggested that maximising net exports is the best route to national prosperity and the only true measure of a country's wealth and success was the amount of gold that it had accumulated over time. If one country had more gold than another, it was necessarily better off. According to mercantilist thesis if an economy wants to enhance its level of prosperity and power it must increase the stock of foreign exchange and gold in the economy by maximising its exports and minimising imports. Being attracted by mercantilist ideas, countries such as Britain implemented policies which were designed to protect its traders and maximise income. The Navigation Acts of 16^{th} and 17^{th} centuries, which severely restricted the ability of other nations to trade between England and its colonies, were one such example.

The physiocrats

Physiocracy was a theory of wealth. The physiocrats, led by Quesnay, believed that the wealth of nations was derived solely from the value of agriculture. Quesnay's understanding of value-added was focused on agriculture sector. He considered only agricultural labour to be productive as only they create surplus value in the words of Karl Marx. His views were rather primitive in the sense that he could not see, for example, the process and quantum of value addition in manufacturing sector. The physiocrats are most commonly known for these simplistic economic ideas. But this was not their most important contribution to economic thought. Rather, it was the physiocrats' methodological approach to economics that was considered their most significant contribution to this branch of knowledge.

The Classical System

The credit for bringing order into the chaotic state of economic enquiry goes to Adam Smith and David Ricardo. "To this order the name of the classical system has been given. Different schools of thought among later economist have chosen this name for different reasons. Sometimes the term 'classical' is applied to the doctrines of the system in order to describe the unquestioned and widespread authority which they possessed. Sometimes it is used to add a special significance to the consequences in the realm of policy which flowed from these doctrines." The classical system has mainly dealt with the working of the capitalist system, together with the historical development e.g. the industrial revolution and the rise of industrial capitalism which produced it. "It is not easy to define the chronological limits of the classical system. Some economists claim that the classical system never ended and its tradition has lived on through the work of the leaders of modern economics."[1] The chief tenets of the classical system can be found in the works of Adam Smith, David Ricardo, T.R. Malthus, J.S. Mill and J.B. Say.

The classical economists believed in the existence of an economy which is working automatically under perfectly competitive conditions and that there is no government interference in the day to day working of the economy. The economic system works through the forces of demand and supply which is called the price mechanism. It is the invisible hand of this price mechanism which allocates resources of the economy in such a manner that the national income is maximized. They regard capital accumulation as the main factor in economic progress. Only capitalists and landlords have the capacity to save because the working class gets only subsistence wages. Investment is induced by profit so the larger the prospect to earn profits, the greater the capital accumulation and investment. Profits do not increase continuously. They tend to decline due to competition among capitalists and the consequent increase in wages. Once profits start declining and become zero, population and capital accumulation stop increasing and the wage rate reaches subsistence level. According to Smith it is the scarcity of natural resources

[1] Roll, 1974, pp. 140

that finally stops growth and leads the economy to the stationary state. Malthus along with Ricardo and Mill, sees growing population and declining food supply and capital accumulation through the operation of law of diminishing returns, as the ultimate checks to economic development. The law of diminishing returns refers to a stage in production where total output of a commodity increases at a diminishing rate when quantity of a variable input is increased by an additional unit. Malthus argued that while population increases in geometric progression, food supply increases in arithmetic progression. The classical economists knew about business cycles but they viewed them as temporary and self correcting aberrations. The business cycle or trade cycle refers to the periodic upward and downward movement in the aggregate level of output and employment, relative to their long term trends. The famous Say's Law of markets states that supply creates its own demand, so general overproduction is impossible. Prices and wages are flexible so the economy automatically moves to the position of full employment stable equilibrium.

The above classical thought was greatly influenced by the socio-economic conditions prevailing in England and some parts of Europe at that time. It professed a rigid division of society between capitalist and landlords on the one hand and labourers on the other. It neglected the significant role of the middle class in the economic development of a country. It also neglected the role of the public sector. It wrongly assumed the level of technology to remain static overtime. Therefore, with the development technology and experiences of the western world the law of diminishing returns and the Malthusian theory of population have been severely criticized. Moreover, wages and profits do not tend to decline at subsistence and zero level respectively. Further, the Great Depression of the 1930s has invalidated the idea of the self correcting and automatic adjustment mechanism to reach full employment level in an economy as stated by Say's law of markets.

The Marxist Doctrine

Karl Marx worked in the classical tradition but he was a revolutionary who used the study of political economy as an instrument in political struggle.[2] The Marxian analysis is claimed to be the most exhaustive examination of the processes of capitalist development. Marx predicted the inevitable fall of capitalism and emergence of socialism and it was on this

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[2] Ibid, pp. 251

prediction that the superstructure of communism was built in the Soviet Union, China and other communist countries. Marx for the first time provided the economic interpretation of history. He argued that all historical events are influenced and determined by the economic forces which in turn determine the entire social, cultural, legal and institutional structure of the society. The history of all existing societies is the history of class struggle. There has always been a clash of interest between the classes of haves and have-nots, which is known as class struggle in the Marxist literature. This class struggle ultimately overthrows the whole social system. Marx uses his theory of surplus value as the economic basis of the class straggle under capitalism. Class struggle is simply the outcome of accumulation of surplus value in the hands of few capitalists. The surplus value leads to capital accumulation. Capitalists try to accumulate more and more capital in three ways: (i) increased working hours of labourers, (ii) Reduction in wage rate below subsistence level, (iii) By increasing the productivity of labour. But since every capitalist is engaged in introducing new labour saving and cost reducing devices, the ratio of labour and hence surplus value to total output falls. Rate of profit falls and production becomes unprofitable in longer run. Consumption falls as unemployment increases because of increased mechanisation of production processes. As machines displace men so the industrial reserve army expands. In this capitalist crisis small firms become bankrupt and ultimately disappear. There is general overproduction and recession in the economy. Unemployment and wage cut further worsens the condition of working class. There may be some revival and recovery from the above situation but the process is again reversed towards the crisis. Thus Marx provides the economic explanation of the necessity and inevitability of the decay of capitalism and emergence of the socialist society.

However, Marx's theory of surplus value is unrealistic. The evolution of socialist societies has not been in line with Marxian doctrine. Contrary to Marxist belief, technological progress increases employment in the long run. Falling tendency of profit is also not always correct. Moreover Marxian theory is not applicable directly to underdeveloped countries.

The Neoclassical Economics

In the last quarter of the 19th c. the addition of so called marginal analysis by Austrian, British and American economists led eventually to the substitution of the term neoclassical for classical economics. The essence of the neoclassical system is that individuals using their income derived mainly from their own productive activities express their desires by the way they distribute their income for the various goods and services available to them in the markets.[3] The tendency is to distribute the income on various commodities in such a way as to maximize the satisfaction. This tendency is passed on to the producers through price signals who are motivated by the maximization of profit. Thus production is ultimately at the command of the consumers. The market was considered to be highly competitive so that no individual consumer or producer could exercise any influence over the price of the commodity. By the nineteen thirties the assumption of competition by many small firms had become untenable. The neoclassical model was modified to embrace the case of markets shared by a few large firms. Between the competition of the many and the monopoly of the single firm there emerged the oligopoly of the few, especially with the publication of the work of Piero Sraffa, E.H. chamberlin and Joan Robinson. Thus oligopoly came to be accepted as a new form of market structure. Under oligopoly the firm has got the power to set the price of the product. Prices are higher and output, investment and employment are smaller than would be ideal. But due to existence of motivation of profit the consumer remains supreme. Until the great Depression of nineteen thirties the economic system was regarded in all neoclassical attitude as being self regulating and self correcting. The neoclassical equilibrium between demand and supply was supposed to be established at full employment level as per the Say's Law of market. But with the publication and wide acceptance of Keynes's General Theory the system was no longer assumed to be self regulating. State intervention was considered necessary to keep the economy at or near full employment and ensure its steady growth. Although the neoclassical system has been refined a lot since then, it has not affected the central substance of the discipline.

The Marginalist School

"Classicism, it was said, emphasized production, supply and cost; modern theory is mainly concerned with consumption, demand and utility. The Marginal utility concept was introduced to affect this shift of emphasis and has since dominated academic thought with unchallenged authority."[4] Therefore, this school needs a separate space. The first generation of modern marginal utility theorists consists of celebrities like Jevons, Menger and Walras. But before these economists developed the concept of marginal utility it was Gossen who first propounded the concept. "Gossen begins by stating that the aim of all human conduct is to

[3] ibid page 11-12.
[4] Roll, 1974: pp. 368

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maximize enjoyment. From every day observations Gossen derived certain laws of human enjoyment of which two, now known as Gossen's first and second laws, are the most important."[5] Based on utility analysis Jevons produced a comprehensive theory of value, exchange and distribution. Jevons being a statistician believed that empirical studies (Use of statistics and mathematics) were an essential part of total economic studies. Economics had to be as mathematical in character as the physical sciences. "Menger's contributions to economics fall into three main classes: methods, money and pure theory. Manger insists that economic method must rest on an individualist foundation."[6] He believed that the economic phenomena of society are only the resultant of the conduct of individuals. He explained the functions of money in the process of exchange and in the formation of price. His contribution in the field of theory of value and marginal productivity theory of distribution is noteworthy. As the last of the founders of the marginal utility school, Leon Walras uses mathematical method more thoroughly to explain theory of market equilibrium.[7] He worked mainly in two areas first dealing with the theory of exchange and the other with the theory of production. "After the passing of its founders, the marginal utility analysis becomes the accepted basis of economics theory. What follows later on is almost entirely a process of refinement which might be called the second generation of marginal utility school. In the second generation of marginal utility school three broad groups may be distinguished: The English, The Austrian and that of Laussane. They represent three versions of common doctrine rather than three separate schools of thought. The English school is represented by the work of Marshall."[8] He formulated the theory of value and distribution based on the concept of marginal utility and marginal cost. He inserted time element in his analysis of market equilibrium. Consumer's Surplus is one of the most important concepts propounded by Marshall. Although he used the Partial equilibrium analysis to study the behaviour of different economic agents and variables, yet his concepts proved very fruitful for subsequent economic analysis and evolution of practical aids to statesmanship.

The Austrian school is represented by the works of wieser and Bohm-Bawerk (the two great disciples of Menger). Their writings do not contain any fundamental change in the views of their master; however their achievement lies in the theory of cost, distribution, capital and

[5] ibid pp. 374-375
[6] ibid pp. 385-386
[7] ibid pp. 391
[8] ibid pp. 394 -395

interest. The last of the great writers of the second generation is Pareto belonging to Laussane School. He was interested in the use of mathematics in economics and use of statistical techniques in empirical studies. With the help of mathematics, Pareto like walras showed the general inter- dependence of all economic quantities and the determination of general economic equilibrium. Pareto believed that utility was not measurable. It is purely an ordinal concept which is sufficient to formulate a theory of choice.

The American Contribution

The contribution of American economic thought in the field of economic analysis flows mainly from the writings of economists live J.B. Clarke, F.H. Knight and Thorstein B. Veblen. The principle of marginalism was independently evolved here and applied in the field of production and distribution. American economics has significantly contributed in the statistical and descriptive branches of the subject as a process of the interplay between the Universities, Business and Government. The rise of special research institutions and the endowments for empirical work in economics are, in some ways, the outstanding features of the present state of economics in the United States.[9]

The Keynesian system

"Though thoroughly grounded in the Marshallian version of neoclassical economic doctrine, Keynes's own theories showed almost from the beginning, a strongly original, not to say heterodox, tendency. Keynes's ideas can be seen as a continuous process of renovation and reformulation of established doctrines and, in the end, of their transformation into something wholly new. Therefore it is treated as a separate school of economic doctrine though not completely divorced from the neoclassical ideas."[10]

Classical political economy, Keynes argues, was concerned with the distribution of the national product rather than the forces which determine the level of income, employment or economic activity in general. Keynes theory is built upon the rejection of the classical assumptions, although he, like classicals, was also concerned with the aggregates of an economy. According to Keynes, the equilibrium level of income, output and employment is determined at the point where aggregate demand is equal to aggregate supply. Aggregate demand consists of consumption demand plus investment demand. Consumption demand depends on level of

[9] ibid pp. 454
[10] ibid pp. 480

income and propensity to consume. Investment depends on the marginal efficiency of capital and the rate of interest, the marginal efficiency of capital in turn depends on supply price of capital and the profit expectation of the investor. The rate of interest is a function of the demand for money (Liquidity preference) and supply of money. During the time of depression income, output and employment has a tendency to fall because profit expectations decline and the system does not correct itself automatically. Under such situation Keynes advocated for an active intervention from the state and using suitable monetary and fiscal tools to revive the economy from the state of depression. He argued that full employment equilibrium is a rare case while underemployment equilibrium is a general case.

Later on the followers of Keynes developed the theory of relation between multiplier and principle of acceleration which connects changes in consumption with changes in investment. The pioneering work in this field was produced by P.A. Samuelson. They also propounded theory of foreign trade multiplier. A new branch of economic study called macroeconomics emerged during this period leading to a much better understanding of how to combat periodic economic crises and how to stimulate long- term economic growth.

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