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The Politics of Economics

Early economics

In earlier eras, human economic activity was pretty straightforward. You worked hard to produce the things you needed to survive. Powerful people (slave owners or feudal lords) took some of what you produced. You kept what was left. End of story.

As the economy became more complex, however, the relationships between different economic players became more indirect and harder to decipher. Economics was born, as the social science which aimed to explain those increasingly complex links. The first economists were called "political economists," in recognition of the close ties between economics and politics. They began to theorize about the nature of work, production, value, and growth just as Europe's economy was evolving from feudalism toward capitalism.

The first identifiable school of economics were the **Mercantilists**, based mostly in Britain in the 1600s. Their theories paralleled the growing economic power of the British empire, so not surprisingly they emphasized the importance of international trade to national economic development. In particular, they believed that a country's national wealth would grow if it generated large trade surpluses: that is, if it exported more than it imported. Mercantilists were also forceful advocates of strong central government, in part to strengthen colonial power and hence boost the trade surplus. Even today, the mercantilist spirit lives on (in modified form) in modern-day theories of "export-led growth" – such as those followed in recent years by the industrializing countries of Asia.

Across the English Channel and a century later, a group of French thinkers called the **Physiocrats** developed a very different approach to economics – one that also lives on in modern economics. They focused on the relationship between agricultural and non-agricultural industries (such as early artisans and workshops), and traced the flow of money between those different sectors. They likened this flow to the circulation of blood through the human body; indeed, the most famous Physiocrat was François Quesnay, a physician

to the French king. Their early efforts to trace the relationships between different sectors of the economy inspired modern theories of monetary circulation (which we will consider in Part Four). And they were the first school of economics to analyze the economy in terms of CLASS.

Adam Smith is often viewed as the "father" of free-market economics, but this stereotype is not quite accurate. Nevertheless, his famous *Wealth of Nations* (published in 1776, the same year as American independence) came to symbolize (like America itself) the dynamism and opportunity of capitalism. Smith identified the productivity gains from large-scale factory production and its more intensive division of labour (whereby different workers or groups of workers perform a variety of very specialized tasks). To support this new system, he advocated deregulation of markets, the expansion of trade, and policies to protect the profits and property rights of the early capitalists (who Smith celebrated as virtuous innovators and accumulators). He argued that free-market forces (which he called the "invisible hand") and the pursuit of self-interest would best stimulate innovation and growth. However, his social analysis (building on the Physiocrats) was rooted more in *class* than in individuals: he favoured policies to undermine the vested interests of rural landlords (who he thought were unproductive) in favour of the more dynamic new class of capitalists.

Defunct Economists

"The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist."

John Maynard Keynes, British economist (1936).

Smith's work founded what is now known as CLASSICAL ECONOMICS. This school of thought focused on the dynamic processes of growth and change in capitalism, and analyzed the often conflictual relationship between different classes. In general, classical economists accepted the idea that the value of a product was determined by the amount

of work required to produce it (what became known as the "labour theory of value"). After Smith, the most famous classical theorists were David Ricardo and Thomas Malthus. Ricardo developed a hugely influential theory of free trade known as COMPARATIVE ADVANTAGE. It claims that every country will be better off through free trade, even if *all* its industries are inefficient. (The theory is true, but only under very restrictive assumptions; we'll discuss it further in Chapter 21.) Meanwhile, Ricardo's friend Thomas Malthus developed an infamous theory of population growth which justified keeping wages very low. He argued that if wages were raised above bare subsistence levels, workers would simply procreate until their growing population absorbed all the new income. Therefore, wages should naturally settle at subsistence levels. Malthus was dead wrong: in fact, birth rates *decline* as living standards improve. Nevertheless, the classical economists (and Karl Marx after them) did accept the broad idea that workers' wages tended to stagnate in the long term (rather than rising automatically with economic growth).

Needless to say, the oppressive working and living conditions of the Industrial Revolution, and the glaring contrast between the poverty of the new working class and the wealth of the new capitalist class, sparked abundant economic and political turmoil. Workers formed unions and political parties to fight for a better deal, often encountering violent responses from employers and governments. An economic underpinning for this fightback was provided by Karl Marx. Like the classical economists, he focused on the dynamic evolution of capitalism as a system, and the turbulent relationships between different classes. He argued that the payment of profit on private investments did not reflect any particular economic function, but was only a *social* relationship. Profit represented a new, more subtle form of EXPLOITATION: an indirect, effective way of capturing economic surplus from those (the workers) who truly do the work. Marx tried (unsuccessfully) to explain how prices in capitalism (which include the payment of profit) could still be based on the underlying labour values of different commodities. And he predicted the ultimate breakdown of capitalism, in the face of both economic instability (the ongoing boom-and-bust cycle) and political resistance. Marx's ideas were very influential in the later development of labour and socialist movements around the world.

Neoclassical economics

After Marx, the capitalist economies of Europe continued to be disrupted by regular interludes of revolutionary fervour. Gradual economic and political reforms were achieved through the nineteenth century in response to these upheavals: limited social programs and union rights were introduced to moderate the worst inequalities of industry, and democracy was gradually expanded (at first, workers were not allowed to vote since they didn't own property). And it was in this context that a whole new school of economics arose.

Following an especially strident wave of revolutionary struggles in Europe (including the first attempt to establish a socialist society in Paris in 1871), NEOCLASSICAL ECONOMICS strove to justify the economic efficiency and moral superiority of the capitalist (or "free market") system. The neoclassical pioneers included Léon Walras (in Switzerland), Carl Menger (in Austria), and Stanley Jevons (in Britain); Walras was ultimately the most influential.

These theorists seemed to start from the precepts of their market-friendly classical predecessors (in fact, "neoclassical" simply means "new classical"), but in fact they made important changes to the classical approach. First, they focused on individuals, not classes. Second, they focused on the existence of market EQUILIBRIUM at any particular point in time – like a snapshot of the economy – rather than on the evolution and development of an economy over time. Third, they began to apply mathematical techniques to economic questions. And they adopted a more abstract approach to theory: instead of explaining concrete, visible realities in the economy, neoclassical theory uses abstract logic to build complex economic theories on the basis of a few starting assumptions, or "axioms."

Neoclassical theory still dominates the teaching of economics in developed countries, although there are many cracks in its walls. The key premises of the neoclassical approach include:

- Every individual starts life with some initial "endowment" of one or more of the FACTORS OF PRODUCTION (labour power, skill, wealth, or other resources). The theory does not concern itself with explaining how that initial endowment came about.
- Every individual also has a set of PREFERENCES which determine what goods and services they like to consume. Again, the

theory does not concern itself with explaining how those preferences evolve.

- Technology determines how those various factors of production can be converted into useable goods and services, through the process of production. Initially, neoclassical theory did not try to explain technology; more recent neoclassical writers have begun to study how and why technology evolves.
- Through extensive market trading (in both factors of production and produced goods and services), the economic system will ensure that all factors of production are used (including all labour being employed) in a manner which best satisfies the preferences of consumers. Important and unrealistic assumptions about the nature of markets and competition are required to reach this optimal resting point – a market-determined economic nirvana.

If supply equals demand in all markets (both factors of production and final goods and services), then the system is considered to be in GENERAL EQUILIBRIUM. Walras was the first to describe this situation, and the theory came to be known as *Walrasian general equilibrium*. Modern neoclassical thinkers have tried to prove mathematically that this general equilibrium is in fact possible; they have failed repeatedly, and today general equilibrium theory has fallen out of favour with many academic economists. Even in theory, the model depends on incredibly extreme and unrealistic assumptions (regarding perfect competition, perfect information, and perfect rationality). The theory has almost no practical applications. Nevertheless, the policy conclusions of the Walrasian view remain very influential, even though their logical underpinning is weak. Here are the key neoclassical conclusions:

- Left to its own devices, the economy will settle at a position of full employment, in which all potential economic resources (including labour) are used efficiently. For this reason, the economy is SUPPLY-CONSTRAINED: only the supply of productive factors limits what the economy can produce.
- This works best when private markets are allowed maximum leeway to operate. Attempts to regulate market outcomes (such

as by imposing minimum wages or taxes) will reduce economic well-being by interfering with market forces. Governments should limit their role to providing essential infrastructure and protecting private property rights.

- Expanding trade (including international trade) will always expand the total economic pie, and this creates the *potential* for improving the economic outcomes of everyone in society.
- The profit received by investors reflects the real "productivity" of the capital that they own, and hence profit is both legitimate and economically efficient. Proving that profit is economically and morally justifiable, rather than the result of exploitation, has been a central preoccupation of neoclassical economics.

Economics after Keynes

The development of neoclassical theory reflected the debates and conflicts of industrial capitalism. The capitalist economy continued to develop through the nineteenth and twentieth centuries in fits and starts, with periods of vibrant growth interspersed with periods of sustained stagnation and recession. But with the Great Depression of the 1930s, it became very obvious that neoclassical faith in the economy's self-adjusting, full-employment equilibrium was painfully misplaced. In reality, capitalism was visibly unable to ensure that all resources (especially labour) were indeed employed.

A new era of thinkers arose to explain both the failure of capitalism to employ labour, and advise what could be done about it. The most famous was John Maynard Keynes, who worked in Britain between the two world wars. Just as important but lesser known was Michal Kalecki, who was born in Poland but also worked in Britain. Working separately, they developed (at about the same time) the theory of EFFECTIVE DEMAND. In general, they found, an economy's output and employment were not limited only by the supply of productive factors (as believed in neoclassical theory). The economy can also be DEMAND-CONSTRAINED by the strength of aggregate purchasing power. If purchasing power is weak for some reason (due to financial or banking problems, pessimism among consumers or investors, or other factors), then unemployment will exist. Worse yet, there is no natural tendency for that unemployment to resolve itself.

To deal with this problem, Keynes advocated proactive government policies to adjust taxes, government spending, and interest rates in order to attain full employment. Kalecki went further than Keynes, and showed that effective demand conditions also depend on the distribution of income (and the distribution of power) between classes; he advocated socialism as the ultimate solution to the problem of unemployment.

As it turned out, massive government military spending during World War II did indeed "solve" the Great Depression. Then, during the vibrant postwar expansion that followed, neoclassical economics uncomfortably tried to digest a watered-down version of Keynesian ideas. The leading economists of this era (such as America's Paul Samuelson and Britain's John Hicks) tried to construct a "synthesis" of neoclassical and Keynesian approaches. They concluded that unemployment and depression could only occur under very particular conditions. In most cases, however, they felt that the basic neoclassical model was still valid.

Eventually even this limited departure from key neoclassical commandments was abandoned. Global capitalism experienced growing instability and stagnation in the 1970s, as the Golden Age drew to a close. A new group of hard-nosed neoclassical thinkers – led by Milton Friedman and his colleagues at the University of Chicago – attributed this instability to misplaced government intervention. They resuscitated the core neoclassical policy framework (according to which government should provide a stable, market-friendly environment, and do nothing else), and hence provided the intellectual foundation for neoliberalism. This approach has become dominant in economics in most countries.

There is still much debate and controversy within economics today – although not nearly as much as there should be. In particular, economics instruction in English-speaking countries conforms quite narrowly to neoclassical doctrine.

Some economists, however, reject neoclassical assumptions and methodology. For example, **Post-Keynesians** have worked to develop the more non-neoclassical aspects of Keynes' work – emphasizing the economic importance of uncertainty and the particular nature of money. (Keynes himself never fundamentally broke from neoclassical thinking, and this has caused great confusion and controversy in subsequent years about what he "really" meant.) Other economists, known as radical or STRUCTURALIST thinkers, have branched out from

Kalecki's work, emphasizing the connections between power, class, demand, and growth. Some economists continue to work within the Marxist tradition, and others in a broad stream of thought known as INSTITUTIONALIST economics (which emphasizes the evolution of economic and social institutions).

It will be essential in coming years to nurture these various "heterodox" streams within economics ("heterodox" refers here to any economist who breaks away from neoclassical orthodoxy), in order to provide some badly-needed diversity and balance within the profession.

Impure Science

"Economics has three functions – to try to understand how an economy operates, to make proposals for improving it, and to justify the criterion by which improvement is judged. The criterion of what is desirable necessarily involves moral and political judgements. Economics can never be a perfectly 'pure' science, unmixed with human values."

Joan Robinson and John Eatwell, British economists (1973).

The economy, economics, and politics

This extremely condensed history of economics reveals a couple of important lessons:

- The development of economics has paralleled the development of the economy itself. Economists have tried to keep up with real-world economic problems, challenges, and conflicts. The theories of some economists have supported those seeking to change the economy; the theories of others have justified the status quo.
- Consequently, economics is not a "pure" science; it never has been. Economists have worked to try to understand the economy and how it functions. But they have also had views – usually very strong ones, and often hidden – about how the economy *should* function. In the jargon of economics, the pure study of the economy is called "positive" economics; it is supposed

Table 4.1 **Economics and Politics Through the Ages**

Theory	*Time*	*Economic Context*	*Political Context*
Mercantilists	Seventeenth century	Expansion of European colonial empires	Support for centralized state political and military power
Physiocrats	Early eighteenth century	Expansion of non-agricultural industries	Defend agricultural surplus against undue expropriation
Classical	Late eighteenth century, early nineteenth century	Birth of industrial capitalism	Favour ascendant capitalists over landlords; promote expansion of markets
Marx	Mid-nineteenth century	Consolidation, expansion of capitalism	Explain and criticize exploitation of workers; describe socialist alternative
Neoclassical	Late nineteenth century, early twentieth century	Consolidation, expansion of capitalism; democratic and social reforms	Reaction against European revolutions; provide justification for private profit
Keynes/ Kalecki	Post-1930s	Great Depression; WWII; advent of "Golden Age"	Policies to restore full employment, expand social security
Monetarism, neoclassical resurgence	1970s to today	Breakdown of "Golden Age"	Describe failure of "Golden Age" policies; intellectual justification for neoliberalism
Modern heterodox*	Today	Consolidation of neoliberalism	Describe failures of neoliberalism; advance alternative policies

* Includes Post-Keynesian, structuralist, institutionalist, Marxian.

to be separate from the advocacy of particular policies, called "normative" economics. But in practice, these two functions get mixed up all the time.

- The theories of economists have always been spurred by real world debates, politics, and interests (see Table 4.1). The Mercantilists celebrated the power and reach of empire. The Physiocrats tried to protect farmers against undue expropriation of their produce. The classical writers were concerned to celebrate (and hence justify) the innovative and growth-inducing

> behaviour of the new capitalist class. Marx's analysis of conflicts in capitalism was tied up with his vision of radical political change. Early neoclassical economics justified the payment of private profit and the dominance of markets. Keynes grappled with the destruction and lost potential of the Depression, while the subsequent resurgence of neoclassical doctrines both reflected and assisted the parallel reassertion of private-sector power under neoliberalism.

Today, economics continues to display its inherently political character. There is no economic policy debate which does not involve trade-offs and conflicting interests; discussions of economic "efficiency" and "rationalism" are therefore never neutral. When a blue-suited bank economist appears on TV to interpret the latest GDP numbers, the reporter never mentions that this "expert" is ultimately paid to enhance the wealth of the shareholders of the bank. (On the rare occasions when a *union* economist is interviewed, the bias is usually presumed, by both the reporter and the audience, to be closer to the surface.)

And when economists invoke seemingly scientific and neutral terms like "efficiency," "growth," and "productivity," we must always ask: "Efficiency for whom? What kind of growth? And who will reap the benefits of productivity?"