The 1st Chapter

Foundations of Economic History

&

The History of Economic Thought

Fifth Edition

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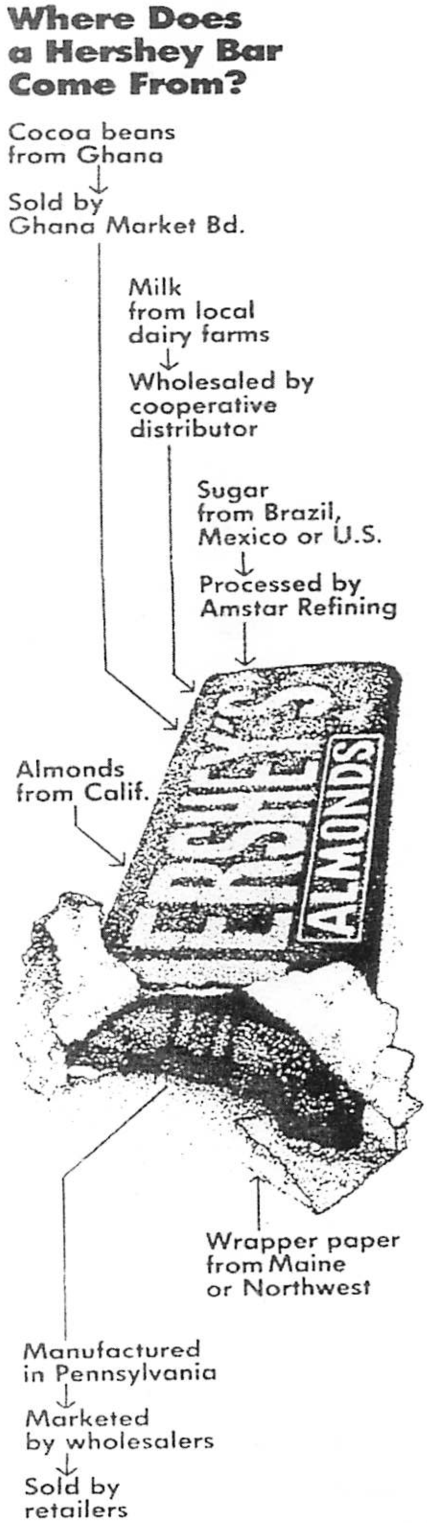


Introduction

What is economics?

"Economics" is not a fancy word, yet it is tricky to define. Economics looks at the way in which people organize their efforts to sustain life and enhance its quality by asking **four basic questions:**

1. **Who does the work?**
2. **Who controls the factors of production (the land, labor, raw materials, and physical capital such as tools, machines, and factories)?**
3. **How are the decisions made about production and distribution?**
4. **What are people's lives like?**

Factors of Production:

Include: **Land, Labor & Capital.** They are combined to produce goods and services.

Let us put these questions into practice by answering them for today's economic system in the United States.

1. Who does the work?

A majority of us work, that is we produce the goods and services needed in our economy. We teach, we flip hamburgers, we repair cars, we work as check-out clerks, we manage corporations–all paid forms of work. Other jobs such as cooking, cleaning our homes and taking care of children are unpaid–all work nonetheless is vital for the economy. However, this course, and most economics, limits itself to the study of paid work, although there is an important new field within economics that looks at how unpaid work is performed in the household.

According to the U.S. Census Bureau the population in the U.S. in 2009 was about **305 million people.**

About one-half are in the **paid labor force, over 150 million people**:

- **80 million** are men
- **70 million** are women
- **8 million** were counted as unemployed.
- **10 million** are self-employed

2. Who controls the factors of production?

In our economic system there is almost always a division between those who work and those who own the tools, machines, factories, land, labor, and natural resources or what economists call the "factors of

To economists:

Capital = man-made aids to production, such as tools, machines & factories

Land = Land and all natural resources used in production

Labor = all of the mental and physical work performed by people

production." A few people such as carpenters and doctors work independently with their own factors of production. But most of us work in an organization where we have no legal ownership of the tools, the buildings or the land. The owners of these factors of production typically are managers, stockholders, bankers, or other wealthy individuals. The distribution of ownership across society is an important topic of study in economics.

3. How are decisions made about production and distribution?

Two answers are necessary to this question. On the level of individual companies, decisions are almost always made by a small group of people, such as presidents and vice-presidents, or sometimes stockholders. But in looking at the economy as a whole, there is another answer. The ultimate success or failure of economic decisions is determined by an impersonal **market** rather than by a single person or company. The outcomes of our economic system–prices and levels of output, for example–are not pre-planned, but are instead the result of a large number of individual decisions regulated by competition. Certainly there are exceptions to this generalization: companies advertise to influence the market; some companies dominate industries so that there is little actual competition; and parts of the economy (such as publicly-funded colleges and universities) are dominated by governments that do not compete in a private marketplace. As we shall see, modern industrial countries differ considerably in the degree to which decisions are made by private organizations or by public governments.

4. What are people's lives like?

This is the most difficult question to answer in a short space. In the U.S. we produce over $14,000 billion (or $14 trillion) worth of goods and services each year, the largest economy in the world. Our economy produces one of the highest yearly amounts of output per person (over $45,000 in production for each man, woman and child.) Of course, this output is not equally distributed. The most well-to-do one percent of the population takes in about 17 percent of all income, and owns about 38% of total household wealth in America.

A Market:

Is anywhere buyers and sellers come together to exchange goods and services for money. The interaction of buyers and sellers in "markets" determines prices and ultimately how much of each good is produced.

In historical perspective, most U.S. citizens are extraordinarily well-off, compared to most individuals elsewhere in the world today. However, some countries can claim to have superior average standards of living for all their population because of more equal distribution of income and wealth and provision of decent health, child and retirement care to all citizens. Obviously this is a question that will require much further study in this course.

Ownership of Wealth in the U.S. (total value of existing assets: stocks, bonds, real estate, etc.):

- the richest **1%** owns **38%** of the wealth
- the richest **10%** owns **83%** of the wealth

Distribution of Family Income in the U.S. (yearly amount received in wages, salaries, dividends, etc.):

- the top **20%** receives **51%** of all income
- the top **1%** receives **17%** of all income

Poverty in other countries.
By any measure, much of the world's population lives in poverty. According to the World Bank, more than one billion people, about 15% of the world's population, live on less than $1 per day or $365 per year. Nearly 3 billion, about 40% of the world's population, must get by with less than $2 per day.

The U.S. Economic System

The economic system we have described for the U.S. needs a name. Most economists call it "capitalism;" sometimes it is called a "mixed economy." In summary, our four economic questions for this capitalist or mixed economy are answered as follows:

1. **Who does the work?** A majority of adults work for wages or salaries. A large number of adults also perform unpaid work in the home.

2. **Who controls the factors of production?** Most of the tools, machines, factories, land, and raw materials are owned by a relatively small number of managers, stockholders, bankers, and other wealthy individuals.

3. **How are decisions made about what is produced and how it is distributed?** The government sets rules about ownership, resolves disputes and provides about 20% of output while the vast majority of output (80%) is produced by private businesses.

4. **What are people's lives like?** Capitalism permitted the unleashing of unprecedented levels of material wealth. However, both wealth and income are unevenly distributed.

The Private sector: refers to economic activities of **firms and households.**

The Public sector: refers to the economic activities of **government.**

A digression on Capitalism, Democracy and Freedom

Sometimes the terms "capitalism," "democracy," and "freedom" are confused with one another. The U.S. has **economic capitalism** combined with **political democracy**. But the terms should not be used interchangeably. Countries such as South Africa under its former apartheid system and Hitler's Germany were capitalist systems, but neither was a democracy nor enjoyed basic freedoms. Other countries such as post-World War II Sweden, the Netherlands, Australia, and Jamaica have democracy *and* freedom, and at the same time have elected socialist political parties to run the government. On the other hand, there are countries that call themselves socialist, such as China and Cuba, that do not have political democracy.

We shall return shortly to look at varieties of capitalism and socialism that exist today. At this point, note that capitalism does not necessarily accompany democracy. And, socialism sometimes coexists with political democracy, while at other times it does not.

In **Section I**, we will study economic history, going back many centuries to learn about the origins of today's capitalist and socialist economic systems. Then, in **Section II**, we will study the history of economic ideas, looking at the different ways in which economists have tried to understand economic systems.

Capitalism and Democracy

Capitalism is an economic system based on private ownership of the means of production, the use of productive assets to maximize profits, and competition between business firms. Democracy is a governmental system in which authority derives from law rooted in the consent of the people. Not all capitalist economies are democracies, nor are democracies necessarily completely capitalist in their economic systems.

SECTION I: The Evolution of Economic Systems

Today's capitalist system has not always existed. In other words, the answers to our four basic questions on the previous page were quite different in the past. Consider the last question about peoples' lives. We all know past economies did not enjoy air-conditioning, computers, surf boards, or Coca-Cola. In previous years people did not have the advanced technologies to produce the goods and services we enjoy today. However, a visitor from past centuries coming to observe our society today would be shocked by the answers to the other questions as much as by our current goods and services. For example, anyone who lived prior to 1700 would be surprised that we buy and sell so many different items. For most of human history, people were self-sufficient for their food, clothing, and transportation, using money only for a few special items such as salt. Also, our visitor from the past would be surprised to learn that we obtain our current livelihoods by working for others and are paid a wage or salary. Again, until 300 years ago, most work was not based on the exchange of money. In order to understand these aspects of our economy that we take for granted–use of money for all purchases and working for pay–we need to go back in time to see how these developments came about. For convenience we will define four historical types of economic systems, or what economists call **"modes of production."** For each of these modes of production our four basic questions are answered in quite different ways.

> **Modes of Production:**
>
> is a technical term for "economic systems"; each with a unique set of relationships between the producers of goods and the other groups in society. We identify **four historical "modes of production":**
>
> 1. Primitive Communalism
> 2. Slavery
> 3. Feudalism
> 4. Capitalism

Primitive Communalism

For thousands of years prior to written history, humans lived in small tribal units. In order to improve the chances of survival, groupings of people worked collectively in their hunting and gathering economies. Although their tools appear 'primitive' to us, primarily spears, knifes, bows, arrows, baskets, and pots, they produced sufficient necessities and often enjoyed considerable "free" time. In many cases, economic decisions were made cooperatively for the good of the whole group, in some cases based on deference to a "chief" who distributed goods as needed, and in other cultures based on ritual exchange in which goods were distributed using traditions that maximized chances of survival of the group. Anthropologists study the

Social Class

In almost all human societies individuals belong to groups that perform different roles and have higher or lower social status. In some societies such as slavery, social classes are unmistakable and obvious to all members of the society. In a capitalist society, classes are more complicated, and some observers even argue there no longer are classes. However, the authors believe distinct social classes still exist in our society, including a small class that owns the factors of production, while a much larger class works for these owners. Additional small classes either work for themselves or live on the edge of poverty without regular employment. As a result there are large differences in wealth and power between individuals.

fascinating ways humans have chosen to organize themselves and arrange their material survival. Today primitive communalism survives only in a few very isolated regions of the world. Most of these groups have changed their mode of production, or they have been exterminated by more "advanced" groups.

Slavery

Over time, better tools paved the way for primitive agriculture, which along with the domestication of animals, allowed the nomadic tribes to settle in one place for longer periods and produce modest surpluses of goods. The evolution of weapons and the technology of waging war led some primitive societies to form confederations and armies in order to conquer and enslave their neighbors. In this class society, the means of production (land and capital), as well as the slaves themselves were owned by slavemasters, who also made all of the economic decisions for society. Ancient Greek and Roman empires are examples of such slave societies.

In slave economies, we see the production for the first time of a **"surplus"**, that is goods beyond those needed to feed and clothe those who do the producing. Of course these surpluses did not belong to the slaves, but were kept by the slave-holding and freeman classes, who were freed from the drudgery of everyday labor. These leisure social classes engaged in intellectual endeavors, producing great advances in language, mathematics, science, art and literature, at the expense of the slave class which suffered great hardships and cruelties.

Surplus:

Production of basic goods and services beyond the amount required to meet the subsistence needs of a society, allowing for the accumulation of wealth.

Slavery was found also in early Middle East, African, Asian, Central and South American economies. (Slavery in the southern United States during the 1700s and 1800s was a different system altogether because it was attached to a developing capitalist economy.) It is not often appreciated how much ancient civilizations relied on the slave mode of production; slaves built the Great Wall of China, mined the silver that supported Greek city-states, and millions of slaves constructed the monuments still standing in Rome and Egypt.

Feudalism

Aristocracy

A class of individuals in which power is attained by birth. Feudal landlords were aristocrats.

After the fall of the Roman Empire during the 300s, a new economic system slowly arose in Europe. By about 700 A.D., most of Europe had a **feudal** mode of production. From literature you may be familiar with the warriors of this period who were called knights. However, the majority of the population under feudalism worked the land, a social class called serfs. Unlike slaves, serfs could not be bought or sold; instead serfs and their offspring belonged to a feudal manor. (The system is also called "manoralism.") The ruler had authority over almost all affairs of the manor andwas called a lord. He most often was an independent landholder who sometimes was a church bishop or a knight who was rewarded for his success. However the relationship between lord and serf usually followed tradition. The serf and his children could not be removed from the manor; the serf had access to the "common land" for firewood and hunting; and the lord received a

By courtesy of the University of Illinois at Urbana-Champaign.

Punishing Serfs. This seventeenth century illustration from Olearius's famous Travels to Moscovy suggests what serfdom really meant. The scene is set in eastern Poland. There, according to Olearius, a common command of the lord was, "Beat him till the skin falls from the flesh." *(The University of Illinois, Campaign)*

Noted historian H.S. Bennett describes typical conflict within feudalism in his book *Life on the English Manor:*

Let us start with the village mill. We may safely assume that every village (and almost every manor) had one... These mills were either the property of the lord, or had been so at some earlier date, until he found it worth his while to accept a yearly rent for them.

The mill therefore became a valuable part of his income... Since the mill was of such financial importance it was necessary for the lord to see that its business was ample and that it was not threatened by any rivals...Despite all manorial injunctions men were constantly failing to bring their corn to the lord's mill, and in due time found themselves accused in the Manor Court. Here they usually received short shifts, and were fined, sometimes for grinding at another's mill, sometimes for grinding at home with a small hand-mill...

The greatest difficulty that faced the lord, however, was how to deal with the secret milling that went on in the peasant's own home...The lord tried to prevent this, and wherever possible fined those found in possession of hand-mills.

Let us turn from these obligations of mill...to other forms of oppression. As have already noted, (the peasant) could not indulge in many of the most common actions without first obtaining his lord's leave, and this was usually given only as a result of a money payment. The fish in the rivers and the game in the woods were not at his disposal.

sizable proportion, often nearly one half, of the crops grown by the serf.

While the serf to lord obligation was the key feudal economic relationship, supplying the surplus on which the economy depended, other groups existed, including artisans, religious orders, monarchs and merchants. Artisans merit attention because they transmitted skills through the Middle Ages, and in some locations such as today's Belgium and The Netherlands, formed powerful Guilds that set rules for the production of cloth, ships and other goods. Today, only a few workers, those who own their own means of production and sell directly to customers, can be called artisans. Merchants were another small group, also located primarily in today's low countries and Italy, important because they brought back knowledge from their travels to the east, and a source of acquired wealth for the eventual building of factories.

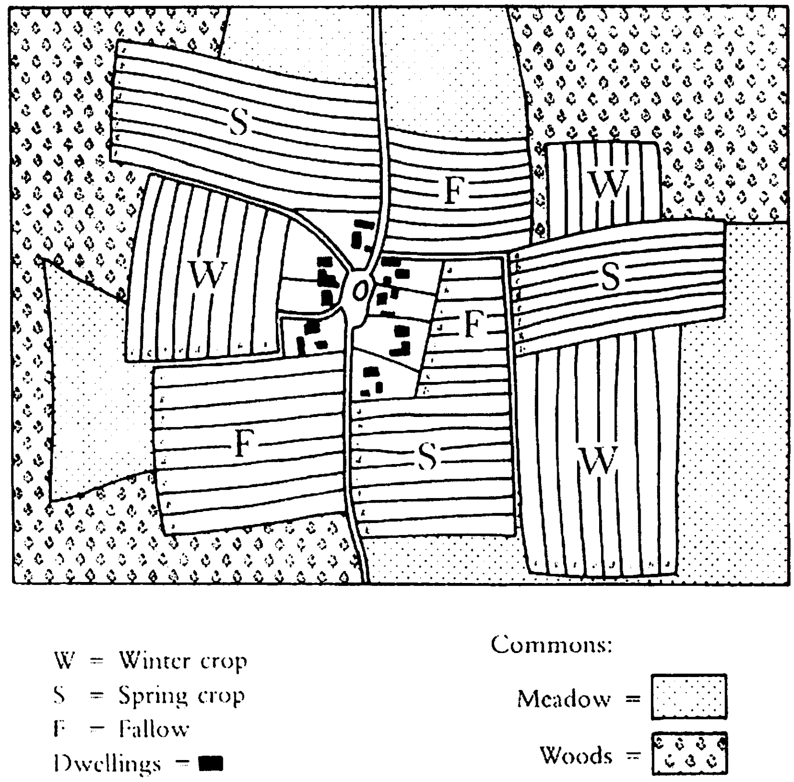
This form of traditional feudal agriculture spread throughout Europe between 600 A.D. and 1200 A.D., and continued in Eastern Europe until the 1800s. Economic systems similar to Europe's feudalism existed elsewhere, most notably in Asia, where traditional relationships between landowners and peasants persisted into this century.

Discussion Question:
Where has feudalism survived in the modern world?

No observer of history would pick Europe in 1000 AD as the place in the world from which a new economic system called capitalism could ever evolve. In many ways Western Europe was far behind much of the world in its intellectual achievements, because it had not yet learned of important developments in Africa, the Middle East and Asia. Also its agricultural methods were quite primitive, relying primarily on human-force instead of animals, wooden, not iron plows, and little fundamental scientific knowledge such as crop rotation. Overall living standards were poor, both in comparison to much of the rest of the world, as well as by what we experience today. Therefore it was surprising that capitalism began its development in Europe at this time.

Typical Feudal Land Use

Note: crop rotation and commons (later enclosed)



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Why Europe changed so quickly during the next few centuries is a much debated historical question. One theory is that precisely because Europe was so backward, no single monarch or ideology was able to control the entire region. As a result, a few independent towns emerged in what today are Italy, Germany, Belgium, and the Netherlands. In these towns, artisans and merchants could produce and trade without being subject to the control of monarchs. (Whereas monarchies controlled trade in most of the Middle East, China, and India, and Africa.) Thus, in relatively backward Europe, merchants initiated worldwide trade, bringing back knowledge as well as gold, silver, spices, and many other products. This widespread trade paved the way for the

The Enclosures. One reason peasants left the countryside is described by economist Robert Heilbroner in, *The Making of Economic Society:*

Starting as early as the thirteenth century, the landed aristocracy, increasingly squeezed for cash, began to view their estates not merely as the ancestral fiefs, but as potential sources of cash revenue. In order to raise larger cash crops, they therefore began to "enclose" the pasture which had been previously deemed "common land." Communal grazing fields, which had in fact always belonged to the lord despite their communal use, were now claimed for the exclusive benefit of the lord and turned into sheepwalks. Why sheepwalks? Because a rising demand for woolen cloth was making sheep-raising a highly profitable occupation.

The enclosure process in England proceeded at an irregular pace over the long centuries; not until the late eighteenth and early nineteenth centuries did it reach its engulfing climax. By its end, some ten million acres, nearly half the arable land of England, had been "enclosed."

Merchants

Individuals who make profits by buying and selling a product rather than producing it.

emerging capitalist system by improving the quality of roads and the reliability of axles, and by encouraging the development of new navigational and shipbuilding skills.

Capitalism

In retrospect we can see that new methods of production and new classes were being born during the late stages of European feudalism. But the process of developing today's capitalist economy was long and full of conflict. One key feature was a change in the traditional relationship between lord and serf. Beginning about 1000 A.D., lords more frequently rented their land to peasants rather than taking a portion of the crop from serfs. One reason was the rise of farming in Eastern Europe where there was a shortage of labor. A second reason was the increase in taxes that feudal manors were required to pay. The peasant farmworkers could now leave the manor, but were no longer guaranteed the tradition of passing farming rights to their children.

Feudalism

An economic system dominated by agriculture in which the most important economic relationships are determined by tradition. In Europe, where feudalism lasted from about 600 A.D. until 1800 (in Russia), the predominate form of organization was a manor controlled by a lord, on which serfs worked, giving part of their crop or work-time to the lord.

Mercantilism

The economic system, based on trade between regions or nations, that introduced the capitalist era. (Approximately 1500 - 1700.) The traders attempted to maximize wealth for their nation by making certain that export sales were greater than import purchases and by making sure their nation always maintained the upper hand over their trading partners.

Capitalism

An economic system that arose first in Western Europe after about 1700, and now is the dominant economic system in the world. In a capitalist system most products are bought and sold with prices set by a market mechanism. The commodities bought and sold include the factors of production: capital, land, and labor. An individual's need to sell his or her ability to labor is unique to capitalism.

The increased demand for products led merchants to look for new ways of making items such as cloth for sale. The newly freed peasants became a major source of labor in the **"putting out"** system. Peasant families were loaned raw materials, and machinery such as wool, spinning wheels and looms to make finished products such as cloth. Later the merchant would return to purchase the final goods, which of course they sold for large profits.

The putting-out system proved unsuccessful in part because there was no guarantee that the peasants would do the promised work–or even that the wool and loom would be there when the merchant returned. Also the putting-out system was too fragmented and unpredictable to meet the increased demand for processed goods. Consequently, merchants built the first factories, placing workers and machinery all under one roof, and the watchful eyes of the first supervisors. With the development of water power, mechanized equipment was introduced, greatly expanding the quantity of output and productivity per worker. By the 1700s, widespread use of factory production replaced many of the traditional artisan workshops. The majority of the population became city dwellers, so that wage workers in factories replaced peasant farming as the principle occupation, creating a large industrial working class and a smaller capitalist, business-owning class. This transition was a slow process, beginning during the 1700s in England, and not completed in most of the world until recent years.

Discussion Question: Where does a system similar to "putting-out" still exist today?

Conditions in early factories are difficult for us to envision. The work was tedious; the hours were long–often 12 or 14 hours; the work week lasted six days; conditions were often harsh, cold, dirty, and unsafe; and typically entire families, including mothers and children worked side-by-side. Probably factory life can best understood from novels of this period by Zola and Dickens that portrayed the abject condition of working classes.

There were social classes other than factory workers and capitalists. In a few parts of the economy, artisans continued to make things and provide services on an individual basis, owning their own tools and selling directly to customers. In some countries such as Italy, the church was an important group, owning much wealth, producing goods, and providing an income for many individuals. In many countries, the aristocracy owned much land that was passed from one generation to the next through inheritance. In the U.S., independent farmers constituted a large group that did not exist in other countries.

Over time, all of these other social classes–artisans, church leaders and aristocrats–became less powerful than the capitalist class. Ownership of the means of production proved more important for economic power than ownership of land or labor power. Those who worked became concentrated in a single class of wage and salary workers, while fewer people worked independently as artisans or farmers. Today, artisans and farmers, constitute less than 10 percent of the U.S. workforce, leaving the capitalist class and working class as the two largest classes.

Market: When goods and services are allocated by prices that fluctuate depending upon supply and demand.

Command: When goods and services are allocated through decisions made by a central authority such as a government-owned enterprise.

Cooperative: When goods and services are produced and distributed based on individual abilities and needs.

Economic systems today

The widespread buying and selling of things in what economists call "markets" dominates the capitalist mode of production. Nonetheless every day each of us encounters other non-market economic relationships. For example, in your family there are relationships similar to primitive communalism. Jobs are done-the children are cared for-and resources are allocated-food is taken out of the cupboard-on the basis of individual need and individual ability to provide. Other examples of cooperative economic relationships in your life may include religious or social groups in which everyone shares responsibility for work.

Probably the best-known visionary of future societies was Karl Marx, an economist who we will study in depth shortly. Marx described a possible future communist form of society that would combine the cooperation and fairness of primitive communalism with the advanced productivity of a capitalist economy. In other words, **communism, for Marx, was a distant goal** in which the economy would provide "from each according to his ability, to each according to his needs." After analyzing the four historic modes of production Marx speculated that capitalism would first be replaced by **socialism**, and much later socialism would be replaced by communism. In simple terms Marx envisioned these systems as follows:

Marxian Socialism:
An economic system with public ownership of the factors of production and state control of economic decisionmaking, with wages paid according to work done.

Communism:
A society in which production and human nature are so highly developed that there are no longer social classes. Government and the market are no longer needed because decisions about production and distribution are based on people's needs and desires.

In Figure 1 (page 13) the three corners of the triangle represent the relative use different economic relationships in today's economy. We place family relations in the corner marked "cooperation"-but not quite in the corner. In most families decisions about who does the work and who receives the resources are not shared equally as in a totally cooperative relationship. If one person or group of people makes the decisions, then the economy has a command orientation. Finally, there is a third option: in some families there is also a market system, perhaps when an adult family member pays rent.

One example of a command economic relationship in a modern economy is a typical job in which the employer tells the employee when to come to work and what to do when he or she arrives. Also, government rules and regulations are considered a "command" economic relationship, although there is a degree of cooperation if they take place in a democracy. Nonetheless, legal structures under which businesses operate, such as incorporation, bankruptcy and property rights are all commands that each business must follow. Similarly, as consumers and workers we face safety regulations, union organizing and other government rules that everyone must follow.

As the example of a market in the triangle we use a yard sale because in this case the buyer and seller come face-to-face to determine the price of the product depending on supply and demand. But you also take part in a market when you buy gas for your car, although in this case your purchase is such a tiny fraction of the total demand that you can't see its effect on price. Thus we have everyday experiences with market, command and cooperative relationships.

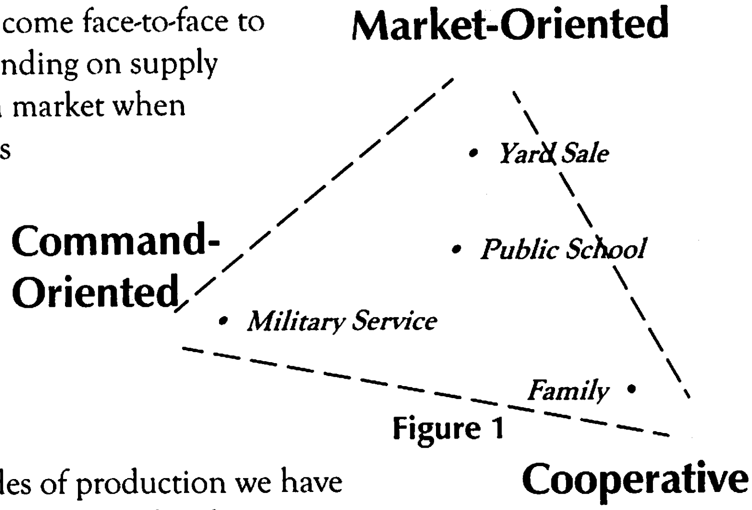


Figure 1

In Figure 2, we place the economic modes of production we have studied in the command-market-cooperation triangle. Slavery is primarily a command relationship between slave and master. Primitive communalism lies in the cooperation corner, but not quite in the corner because there were some command relationships, for example tribal leaders. Also some primitive communal groups engaged in market-like trading with other groups. Feudalism was a command relationship between lord and serf, but not entirely in the command corner because, as we have seen, there were cooperative relationships among artisans within the guilds. Also, recall that under feudalism a few isolated Western European cities, a small merchant class that bought and sold products in markets.

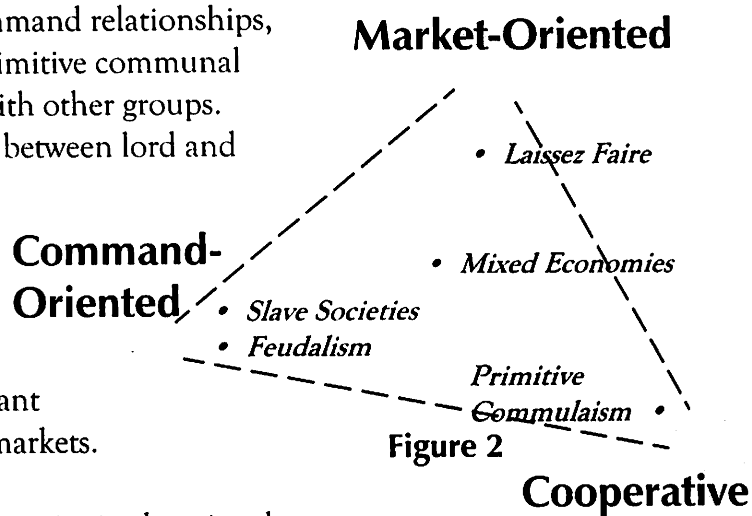


Figure 2

Finally, in Figure 3 we place modern countries in the triangle according to how much of each characteristic they possess. No country relies entirely on the market; we place Hong Kong closest to the corner because so much of the economy takes place in the market with little government involvement. The United States is slightly distant from the market corner because various levels of governments produce and allocate many goods and services, totalling about one-third of the economy. These products include the military, roads, most education and many other services that are paid for by taxes and allocated on the basis of need rather than by a price system. Because U.S. governments are democratic in principle, we place the U.S. slightly toward the cooperative corner.

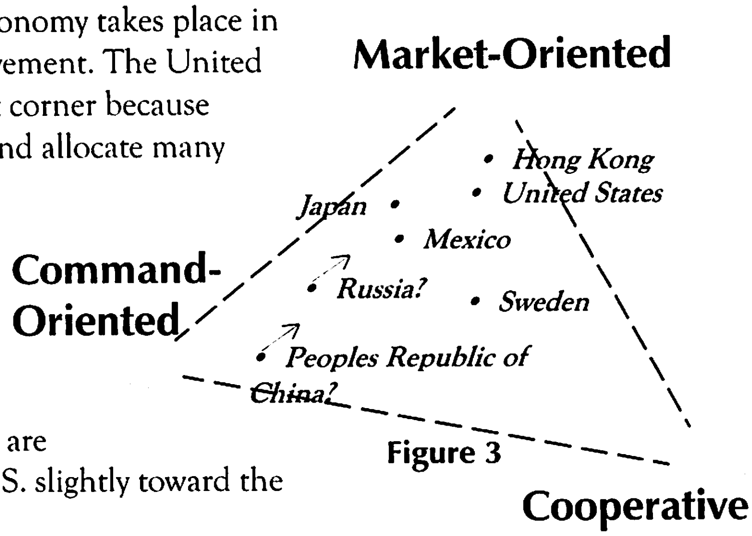


Figure 3

European countries are placed closer to the cooperative corner because they offer a broader array of government services than those available in the U.S. In most of the industrialized economies—except for the U.S.—there is publicly-provided health care, day care, financial stipends for all college students, sizeable pensions for all retirees, and time-off with pay for new parents. Economic systems such as Sweden that provide a comprehensive set of social services generally are called "welfare socialism."

A second variation on the market economy is government ownership of selected industries referred to as state-owned enterprises. For example, in Mexico, the oil industry has been owned by the government and in Germany, the railroad system and telephone company are state-owned and operated. When there is a large degree of such government ownership, while most industries are privately-owned, the country is placed toward the center of the triangle.

Japan, South Korea, and other newly industrialized Asian countries are primarily market economies because most businesses are privately owned. But government is involved in helping businesses to coordinate their plans. For example, several years ago Korean government leaders, in consultation with business leaders, decided that automobile production and computer assembly would be the major exports. Laws were passed that guaranteed special treatment such as low interest loans, to businesses who would help the country export cars and computers. We put Japan slightly toward the command corner because government central planning helps direct investment and subsidized business loans. Plans by other Asian economies, such as South Korea and Indonesia, have at times included violent suppression of unions and democracy.

Finally, there are countries with relatively few markets. Today, China and Cuba have economies with central planning in which governments decide how much will be produced, and the price at which these products will sell. Such plans are imposed by central governments, so we place them in the command corner, and call such systems "state socialism." However, both China and Cuba increasingly are using markets, following the lead of

Welfare Socialism: An economic system in which most industries are privately owned, but a large government sector provides services such as child care, education, health care, and pensions.

State Socialism: A planned economy in which levels of production and prices for most goods and services are determined by a central government.

Mixed Economies: Economic systems that include a combination of market, command and cooperative characteristics. Frequently this includes some private ownership of businesses and some government involvement in economic decision-making.

Russia, which is moving at a fast pace to dismantle its former command economy and replace it with more market relations.

The reality is that advanced industrial nations are essentially "mixed economies," employing their own unique combination of market, command and cooperative orientation. There is no pure capitalism that is 100% market oriented.

What comes next?

Even though capitalism is the dominant economic system in the world today, the study of history suggests that the capitalist mode of production may not last forever. It is difficult for an observer within an economic system to envision what will eventually replace it. Certainly no thinkers during the feudal era could describe the capitalist system that would replace it. Nonetheless, it is useful to think about types of economic systems that may exist in the future.

What will the future hold for the world? In recent years the trend appears to be moving toward greater reliance on market mechanisms. Not only is the former Soviet Union moving in this direction, there are also parts of the U.S. economy that are relying more on the market. Child care is a striking example. Thirty years ago, day care centers were rare, and most child care was the responsibility of parents or extended families. Today, day care is a booming industry including nationwide chains in which prices fluctuate with supply and demand.

To take one example: the U.S. health care industry faces a crisis in which costs are escalating so that more excluded from care, and the country falls further behind in terms of average longevity and other measures of well-being. Is the answer more markets, command through greater government involvement, or more cooperation? These are hotly debated economic questions on which you will be asked to vote in future political elections. As a first step in helping you to develop your own well-informed point-of-view, we will review how economists of the past looked at these issues.

SECTION II: The History of Economic Thought

The earliest economists

Economics is a relatively new field of study. The first experts began studying what we now call economics during the 1600s. For most of human history, up until approximately the last 200 years, the economy was inseparable from the family, religion, and the government. However beginning during the 1700s, some thinkers, mostly philosophers at universities, attempted to understand remarkable changes in Western Europe. New methods of production were being introduced, quickly expanding the quantity and types of items available. By 1800 the production of iron in England was 20 times its level in 1700, while the use of cotton increased 60 times. This was not the first time that production had taken place on a large scale; in many respects, Western Europe was catching up with already-advanced Asian and African cultures. But one feature was entirely new: unlike highly developed cultures elsewhere in the world, European production was taking place outside the control of government, the church and the family. For the first time, social scientists could begin to study the economics separately from political science, religion, and sociology.

One of the first problems tackled by these early economists was the question of why some countries were wealthier than others. Particularly puzzling was the rise of England, replacing Spain as Western Europe's leading economic power. Two competing schools of thought emerged to explain this situation. One group, that today we call the "mercantilists," argued that nations gain wealth and hence power through the accumulation of national treasure. Although this wealth can be gained through simple acquisition, as in the case of Spanish theft of gold and silver from the Native American cultures, in the long run it is only trade that enables a country to become wealthy. However, according to mercantilists, this happens only if your country sells more to other countries than it buys from other countries. Or, simply put, earnings from exports must exceed the wealth used to pay for imports to create a positive flow of wealth into your country.

Mercantilists

A group of economists who wrote during the 1600s and 1700s, primarily in England. This perspective argued that wealth was based on the accumulation of gold or silver. In the mercantilist view, the best way to increase this wealth was for a nation to sell as much as possible to other nations in return for gold, and to buy as little as possible, thereby keeping the gold at home.

Physiocrats

A group of economists who wrote during the 1700s, primarily in France. The physiocrats argued that national wealth came from agriculture which produced a surplus that permitted the survival of other groups such as merchants, aristocrats, and capitalists.

The mercantilist philosophy had a major influence on government policy, including the limits England placed on trade with its colonies, one important cause of the American revolution. Trade by England to the rest of Europe also was restricted, most importantly the importing of grain, grown at much less expense on the European continent. These ideas may sound familiar in a modern context as the basis for restricting trade. You have probably heard someone argue that a country loses power when it buys more from another country than it exports to them (a trade deficit). This is modern-day mercantilist thinking.

Professor Smith in his study.

Original artwork drawn by Micheal Coomes, Glendale, CA, 1992. Reprinted with permisssion.

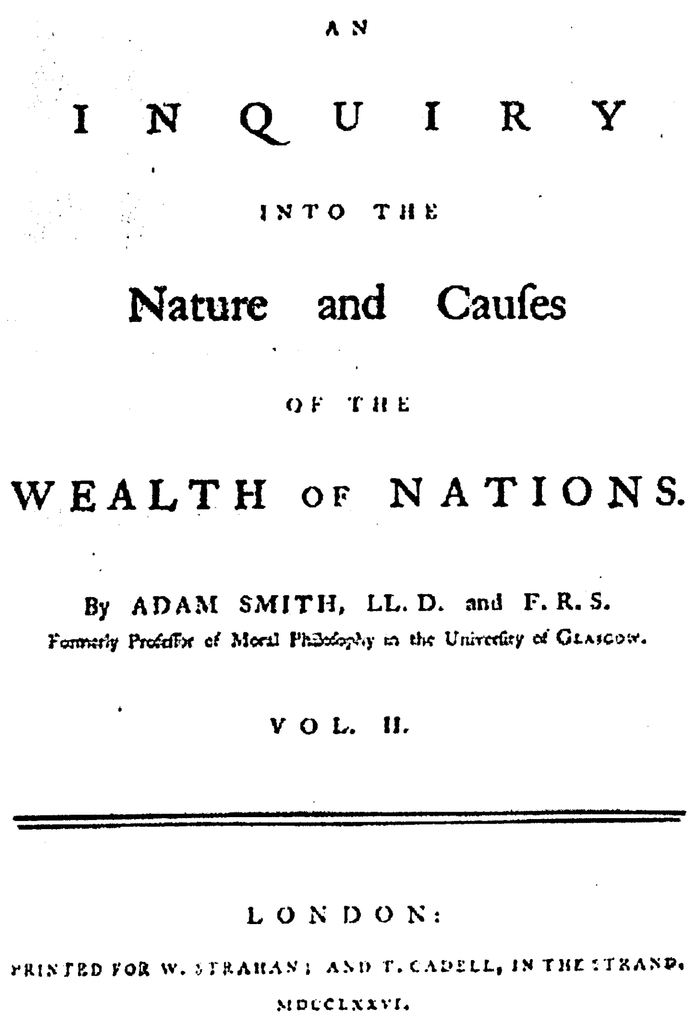
A second school of thought in opposition to the mercantilists arose in France where agriculture was dominant over manufacture. Today we call these economists "physiocrats". These early French economists opposed restrictions on the grain trade, arguing instead that agriculture was the most important part of an economy and agriculture should be promoted, even at the expense of other sectors. Their emphasis on agriculture was based on the argument that to create wealth an economy needs to produce a **surplus** of goods above that which is needed for survival. Only when agriculture produces an abundance–far above what is necessary to keep agricultural workers alive–will there be enough to support merchants, industrial workers, capitalists or other sectors that will make a country rich and powerful. By this way of thinking, agriculture is the basis of the economy requiring special government support, including trade practices enabling them to sell grain across national boundaries. Perhaps you have heard agricultural representatives argue that they are the backbone of the economy, worthy of special consideration in terms of water allocation. This is modern-day physiocratic thinking.

Adam Smith and the Wealth of Nations

Mercantilist and physiocratic ideas paved the way for the first great economist, Adam Smith, who sought to combine the best elements of both philosophies. His most important book, *The Wealth of Nations*, was published in 1776.

Adam Smith was a university lecturer in "Moral Philosophy" (again, there was no field of economics for him to teach) at Scotland's University of Glasgow. Smith's lifetime, 1723-1790, was a period of rapid change in England. As described above, the first factories were built, although at this early stage primitive industry predominated and most people still worked in agriculture much as they had for previous centuries. In this sea of change about him, Smith wrote *The Wealth of Nations*. It is a long book, quoted more often than read, even by those who claim the *Wealth of Nations* as the origin of their beliefs. As we will see, the writing style in *Wealth of Nations* is not difficult; instead the main impediment to the book is its sometimes tedious investigation of every aspect of a problem. But remember, Smith was a scientist in the sense that he wanted to find the underlying laws that organized the economy, which meant examining the world in all its detail in order to unravel what lay underneath.

Title page from Smith's most important book, reprinted with permission from ????


AN

INQUIRY

INTO THE

Nature and Cauſes

OF THE

WEALTH OF NATIONS.

By ADAM SMITH, LL. D. and F. R. S.

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VOL. II.

LONDON:

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MDCCLXXVI.

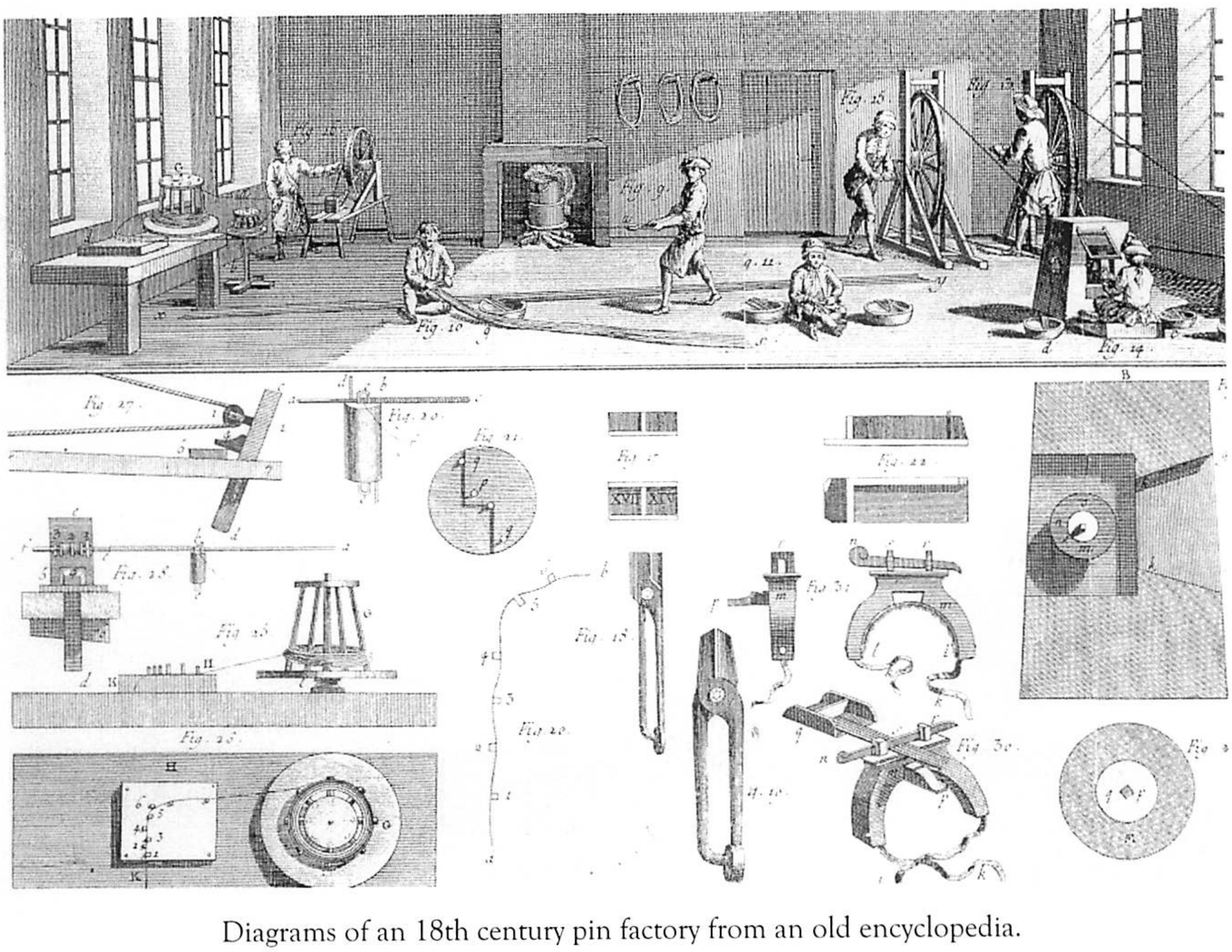
The main question Smith asks himself in the *Wealth of Nations*, and in his earlier writings was: how does the economy work when every individual strives only for self-interest? Or, to use modern language, if we each do our own thing, how can we have an economy that seemingly requires increasingly careful coordination to produce its vast array of products? In answering this question, called the "Adam Smith problem" by his contemporaries, Smith was influenced by natural science of his day which was developing laws to explain physical occurrences ranging from the motion of the planets to the pressure of boiling water. Thus it was not surprising that a philosopher would try to extend the concept of natural laws to the operation of human activity as well as these physical phenomena.

In examining Smith's work, we will focus on **three basic issues** and then compare his answers to two other economists who followed Smith.

A. How is wealth created?

Smith's answer to this first question was based on his reading of the physiocrats and mercantilists, whom he believed to be one-half right and one-half wrong. From the physiocrats, Smith borrowed the idea that the production of surplus mattered for a nation's wealth more

Diagram of an 18th century pin factory, from The Time/Life Syndicate. Reprinted with permission.



Diagrams of an 18th century pin factory from an old encyclopedia.

Discussion Question: Is the productivity of modern industry still the result of the division of labor?

than the mercantilist emphasis on accumulation of national treasure by exporting more than importing. But Smith disagreed with the physiocratic emphasis on agriculture. Looking around England and Scotland with its quite poor farming base, Smith could not ignore the production of wealth in nonagricultural forms. Here Smith borrowed from the mercantilists and their emphasis on the importance of trade. A surplus can be created in manufacturing as well through what Smith called the **division of labor**. The origin of Smith's insight is best summarized in his own words, from *The Wealth of Nations*, after he visited a pin factory of his day (shown on the previous page):

> *To take an example ...from a very trifling manufacture... the trade of the pin-maker; a workman not educated to this business ...could scarce, perhaps with his utmost industry, make one pin in a day...But in the way in which this business is now carried on ...it is* ***divided into a number of branches****...One man draws out the wire, another straights it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; it is even a trade by itself to put them into paper...in this manner,...I have seen a small manufactory of this kind where ten men only were employed ...when they exerted themselves, make among them... upwards of* ***forty-eight thousand*** *pins in a day.*

Notice that Smith is describing a quite primitive workplace as shown in the accompanying picture of a pin factory that Smith might have visited. Capitalism was still in its infancy as a mode of production in the middle of the 18th century. The high level of production was achieved without electricity or any machinery other than might have existed in any workshop long **prior** to the 1700s. Also, note that there is no assembly line in the modern sense. Instead, each worker sits independently doing his craft much as an artisan might have done for hundreds of years.

According to Smith, the secret of increased wealth is the division of tasks among individuals so that each can specialize and greatly increase his individual output. Later Smith expands this concept to division of labor **between** workplaces. He uses as an example, the following description, also from *The Wealth of Nations*:

> *"The woolen coat ...which covers the day laborer, as coarse and rough as it may seem, is the produce of a great multitude of workmen. The shepherd, the sorter of the wool, the wool-comber or*

carder, the dyer, the scribbler, the spinner, the weaver, the fuller, the dresser, with many others must all join their different arts in order to complete even this homely production. How many merchants and carriers besides, must have been employed..how much commerce and navigation..how many ship builders, sailors, sail-makers, rope makers...

According to Smith, even a peasant was able to enjoy new products, based on the industry of widespread individuals, all because of the division of labor.

B. Who gets the wealth?

Smith did not assume that everyone would automatically benefit from this increased wealth. Long sections of *The Wealth of Nations* explore who gets the wealth. According to Smith the wealth of a nation is divided between three major groups, capitalists, landlords, and workers, who receive respectively, profits, rents and wages. Consider first who is missing. Although both the aristocracy and the church were still quite

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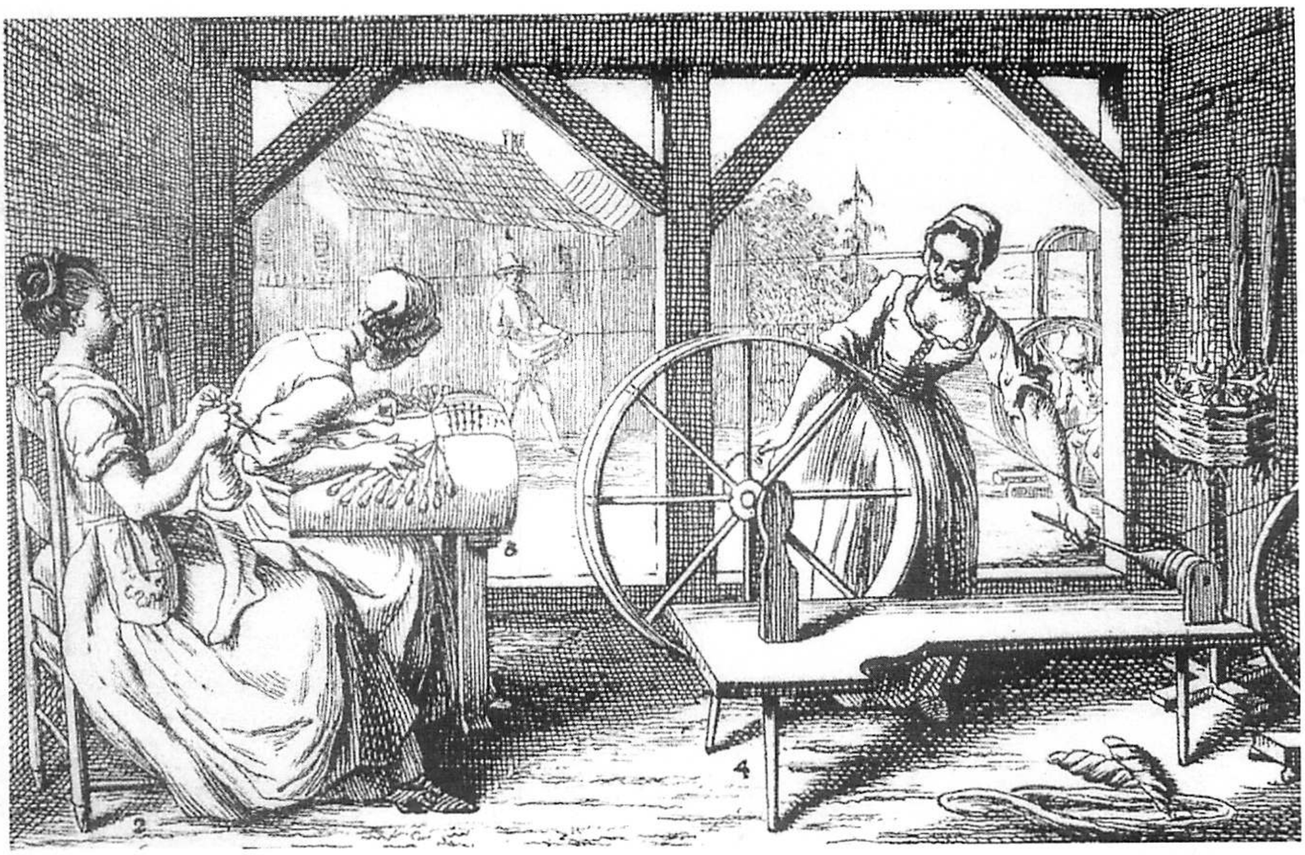


Working Women. This mother and her daughters may well be knitting, lace-making, and spinning for some mercahnt capitalist. The close ties between cottage industry and agriculture are well illustrated in this summer scene. *(The University of Illinois, Campaign)*

Smith's Invisible Hand

Free, unrestrained, and invisible market forces of demand and supply would channel the selfish and greedy motives of individuals and firms into consistent, mutually beneficial activities, that, without intending to, would promote the welfare of all society at the same time it rewarded the individual.

powerful during his day, Smith chose not to focus on them. As individuals both royalty and the church were often quite wealthy, especially if they were landlords receiving rent. But as **economic actors**, Smith limited himself to groups who could be thought of as being directly involved in the production of the surplus. Other groups missing, although important in terms of numbers during the 1700s, were servants and artisans, individuals who produced items individually, selling directly to their customers. Smith identified these groups as not important for the production of the surplus; indeed they have been reduced in numbers dramatically during the last two centuries.

Smith investigated the distribution of wealth between capitalists, landlords and workers in order to anticipate which group would fare well. Of particular concern to Smith was declining living standards for workers, a situation he bemoaned, but for which he saw little solution. At higher levels of society, Smith saw a struggle over distribution of wealth, for which he suggested policies quite different from those put forward by most previous economic thinkers. Smith opposed special assistance to the agricultural sector as proposed by physiocrats, or limits on imports as proposed by mercantilists. In place of government intervention, Smith advocated the dramatic new idea of trusting "market interactions" to distribute the nation's wealth. He envisioned the interactions of buyers and sellers in markets regulating the amount of profit each firm receives, the amount of rent each landlord acquires, and the wage of each worker.

C. How does the economy reproduce itself?

Recall Adam Smith's problem: how can society be functionally effective despite the pursuit of goals by individuals that quite often are in direct competition with one another. This issue can be restated as the problem of "reproduction." No economy will last long if it cannot maintain itself over time, a goal seemingly at odds with the market system in which you attempt to out-maneuver everyone else before they out-maneuver you. Smith's answer was that a market system not only coordinated itself, but did so in a manner that put the economy on a course for faster growth than could be otherwise achieved. These goals would be achieved only if the market were allowed to exist in the first place.

Smith explained this idea in a passage from *Wealth of Nations* that contains his most famous phrase:

> *He (the laboring individual) intends only his own gain, and he is led by* ***an invisible hand*** *to promote an end which was no part of his intention ...By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.*

The "invisible hand" appears in this single place, on page 432 of *The Wealth of Nations*. But more than any other phrase it summarizes Smith's idea that the market economy operates according to rules that we cannot see, much in the way natural scientists describe the workings of the physical world. In earlier economies there was a *'visible'* hand of the feudal lord or slave-owner controlling everything from how much grain was planted to access to the common lands for gathering wood. By contrast, a market economy was controlled by the invisible forces of demand and supply, generated by buyers and sellers. Quite simply, shortages of any product will cause higher prices and thus more production, while surpluses will cause lower prices and thus less production. In this manner prices act as **signals** to the economy, telling it to speed up or slow down production as needed. Because of this unseen coordination by the Invisible Hand, Smith concluded that the economic system would be **self-correcting** to any problems of over- or under-supply.

The beneficial effects of the invisible hand led Smith to oppose government policies that interfered with the market. For example, he argued against the large number of restrictions that had been set up on trade between countries, including control over trade with the Americas and trade in grain with Europe. On the European continent restrictions were even more rigid, causing textile manufacturers to produce cloth only with specific thread counts. If the invisible hand was to operate, it was necessary for there to be free trade.

Failure to rely on the invisible hand would lead to three problems: 1) prices would not change as the market dictated, so excess inventories and shortages would persist; 2) suppliers of labor, capital, and land would not receive the proper signals to give forth their factor of production; and 3) most destructive in the long run, these inefficiencies would cause the surplus to be too small. As a result there would be less investment in new forms of capital, thereby preventing the economy from

Discussion Question: What would Adam Smith say about the economic policies of the current U.S. president?

growing as much as it would if the invisible hand were permitted to operate.

This philosophy of leaving the coordination of the economy to market forces is called "*Laissez Faire*", a French term used by the physiocrats, meaning "leave it alone." This approach to economic problems was the most important legacy of *The Wealth of Nations*, although it was slow to be adopted. The book was first quoted in the British Parliament only in 1784, and then by a member who admitted he had not actually read the book. But the book gained support from capitalists who wanted to be able to operate without government regulations. Smith's argument was used to oppose restrictions on trade, then later restrictions on child labor, the length of the working day (which had grown to 14 hours, six days per week), and later in the twentieth century, to oppose government restrictions on business mergers and acquisitions. Smith himself was pessimistic about the well-being of the working class, but for different reasons. In Smith's view, the invisible hand would operate on the supply of labor causing any temporary increase in wages to be quickly offset, as follows: higher wages would lead to increased births and a future excess of workers. This oversupply of labor would ultimately cause wages to fall back to their original low level, keeping workers impoverished.

The use of *The Wealth of Nations* by modern economists to oppose government regulation of big business is a curious legacy for Smith. A careful reading shows that Smith believed relatively evenly matched competition among a number of small firms to be the force behind the invisible hand. Smith wrote that industrialists "generally have an interest to deceive and even to oppress the public," and "people of the same trade seldom meet together but the conversation ends in a conspiracy against the public, or in some diversion to raise prices." He favored many small firms competing against one another, each striving to make better products at lower prices in an effort to attract greater sales and larger profits. Smith viewed the consumer as benefiting from this continuous competition to produce high-quality, low-priced goods. Smith knew nothing of the modern factories or huge market-dominating corporations—these developments came 100 years later. Consequently, it is not far-fetched to argue that he would have favored restrictions–even government regulations–if he witnessed the huge size of the modern corporation.

Three Basic
Ideological Perspectives
in a nutshell:

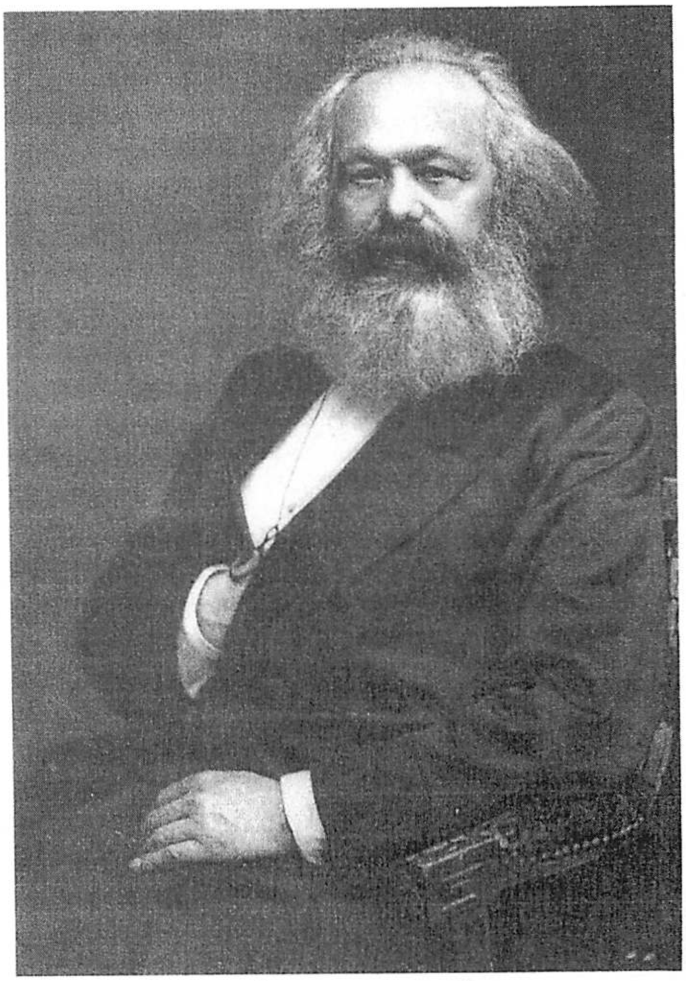
- **Conservative:** rely on private markets
- **Liberal:** expanded role of government and public sector
- **Radical (or Progressive):** greatly expanded role of government and public sector

Smith as a Conservative

Smith can be claimed as the father of much modern economics. Nonetheless his ideas are most in agreement with one branch of current economic and political thinking, traditionally called "conservative." Like Adam Smith, there are modern-day economists and political leaders who argue against government intervention in economic matters. The most successful advocates of these beliefs have been Republican presidents, Ronald Reagan, George H. W. Bush and George W. Bush. Milton Friedman, a famous conservative U.S. economist and one of President Reagan's personal advisors, specifically traces his ideas to Adam Smith in his popular economic writings. For example, Friedman in public presentations, would hold up a pencil to show the remarkable division of labor it contained (wood from Canada; rape seed from Indonesia used to make the eraser, and so on).

The conservative point of view is in fact more complex than simply laissez faire. Indeed, critics point out that the conservatives favor quite active government intervention when it comes to the military or the use of force to protect the property rights of private corporations. One might also add that a careful reading of Adam Smith shows him to be skeptical about the power of these large corporations. Nonetheless, as with many famous thinkers, what counts is what people remember, more than what the original person actually wrote. In the case of Smith, his importance in economics is based on his insights about the role of markets in regulating a capitalist economy.

Karl Marx, from the Granger Collection, New York. Reprinted with permission.



Karl Marx at age 49.

Karl Marx

Karl Marx is the best known of the economists we will study. He is also the economist about whom many people have strong opinions, both favorable and unfavorable. Even among those who call themselves "Marxists," there are many different points of view. In fact, Marx himself late in his lifetime attended a conference at which speakers claimed to be Marxists, but presented ideas so much at odds with what Marx believed that Marx

Marx on Class Struggle:

In Marx's scheme social classes are determined by an individual's relationship to the productive process and to the ownership of the factors of production. To Marx, the conflict between the central two social classes of any era, largely determine the history of that period as demonstrated in this selection taken from *The Communist Manifesto* (1848):

> ***The history of all hitherto existing society is the history of class struggles,*** *Freeman and slave, patrician and plebeian, lord and serf, guildmaster and journeyman, in a word, oppressor and oppressed, stood in constant opposition to one another. ...The modern bourgeois [capitalist] society that sprouted from the ruins of feudal society has not done away with class antagonisms. It has but established new classes, new conditions of oppression, new forms of struggle in place of old ones.*

According to the Marxist perspective under capitalism, history is shaped by the relationship between the capitalist class (owners) and the working class.

responded he was "no longer a Marxist." Clearly we have some work to do in order to disentangle the contradictory threads of Marx's legacy.

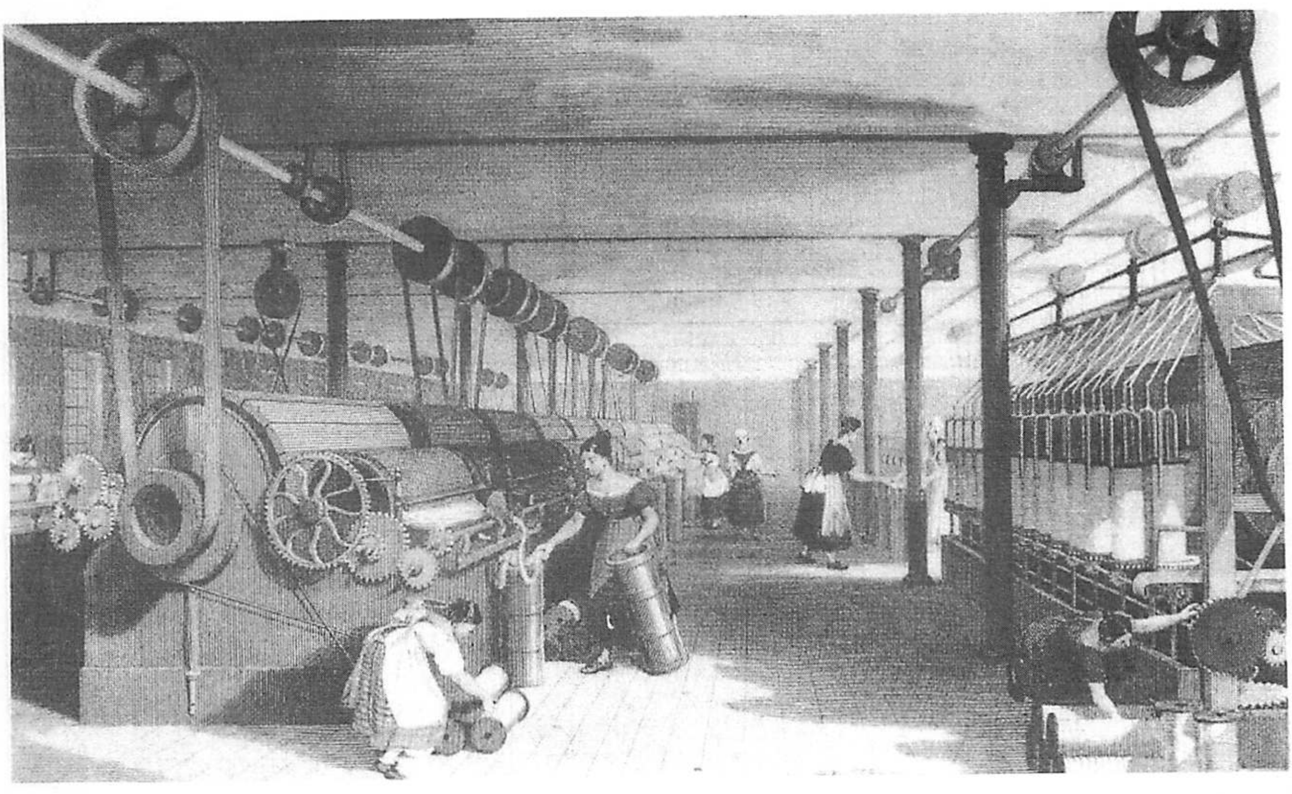
Marx was born in 1818 in what today is Germany. He died in 1883, so that his lifetime included the middle of the industrial revolution when the modern factory system arose in Western Europe. After receiving a university degree in philosophy, Marx worked as editor of a newspaper known for its outspoken point of view. However, Marx's editorship lasted only five months, after which the newspaper was closed down for opposing the aristocracy. For example, the newspaper supported the rights of peasants to gather firewood in the forests, a right they enjoyed since ancient times, but withdrawn by landowners who wanted to sell the wood for a profit. After losing his newspaper job, Marx moved on to France and later Belgium, where he wrote *The Communist Manifesto* with his friend Friedrich Engels.

Marx and Engels were among the first economists to examine the economy with historian's eyes: how did the capitalist economy come to be? and, where is it going? Marx and Engels had a view of the world in which classes struggle to create the future. In other words, the direction the economy would move depended on how each class was able to organize itself to press its own interests.

Marx and Engels combined their work as intellectuals with activism; Engels wrote *The Condition of the Working Class in England in 1844*, an indictment of the terrible condition in English slums at the time, and Marx served as a leader of the early union movement for much of his life. At the same time, these two thinkers argued that political activity by itself could not create a better world. In addition to action, one needed to understand how the current system worked. Otherwise the would-be activist becomes a Don Quixote, tilting hopelessly at windmills, but unable to affect the real world. Marx criticized those who would create the ideal world overnight, a tendency Marx called "idealism." Thus we now turn to the theoretical side of Karl Marx, and his attempt to develop a new scientific basis for his criticism of the capitalist system.

Marx and Engels participated in a revolutionary movement that swept across Europe in 1848 attempting to replace the powerful aristocracy with more democratic forms of government. (Some historians have argued that this revolution was not complete until 1989 when the democracy movement finally was successful in Eastern Europe.) When the 1848 revolution failed and its leaders faced imprisonment, Marx moved to London, where he spent the next three decades studying economics. Sitting day after day in the reading room of the British Museum took its toll on Marx's health, in particular on his underside, but left us with what is probably the most far-reaching attempt by one person to understand capitalist economies. Marx's writings filled dozens of volumes, some of which are still being translated into English. For the most part they are commentaries on the work of previous economists, most importantly Adam Smith. Marx set himself the task of writing a comprehensive analysis of capitalism in several volumes, but during his lifetime he completed only Volume One of *Capital: A Critique of Political Economy*. Volumes Two and Three were edited by Engels and published after Marx's death.

Cotton Mill-Workers, from The Time/Life Syndicate. Reprinted with permission.



Cotton Mill Workers Family members often worked side by side in industry. Here women and children are combing raw cotton and drawing it into loose strands called rovings, which will then be spun into fince thread. *(The Mansell Collection)*

As you might guess from the title, *Capital* is a criticism of the current system; however, Marx makes no attempt to describe how it might be replaced by socialism, communism or any other system in this work. If Marx had taken the time to describe in detail what he thought would replace capitalism, there might have been much less debate today about which economic system actually represents his ideas: is it China? is it the Soviet Union? is it Sweden? or some other system entirely?

In any case we can use Volume One of *Capital* to summarize Marx's answers to the three questions posed earlier.

Alienation of Labor

Marx argued that the most fundamental evil of capitalism was **not** the material impoverishment of the working class. Rather, it was the fact that capitalism systematically prevented individuals from achieving their potential as human beings. Capitalism diminished people's capacity to give and receive love and thwarted their emotional, aesthetic and intellectual development.

According to Marx technological developments in the productive process were introduced for only one purpose, increased profit. Work, in conjunction with ever newer machines became more repetitive and degrading as the opportunity for creativity was eliminated. Relations between worker and owner were exploitative in nature.

Marx used the term **alienation** to describe the condition of individuals who were isolated and dehumanized having to sell their labor for money in impersonal markets. Moreover they felt divorced from their own work, unable to feel pride of accomplishment about their work. Marx predicted that the alienation of the working class would lead to psychological problems, such as alcoholism and the breakdown of family life.

A. How is wealth created?

To a surprising degree Marx agreed with Adam Smith in that wealth is produced by the effort of labor. By the mid-1800s when Marx was writing *Capital* this trend toward industrialism was well established in England. Thus, like Smith, Marx emphasized factory production–rather than trade or agricultural surplus–as the main source of wealth.

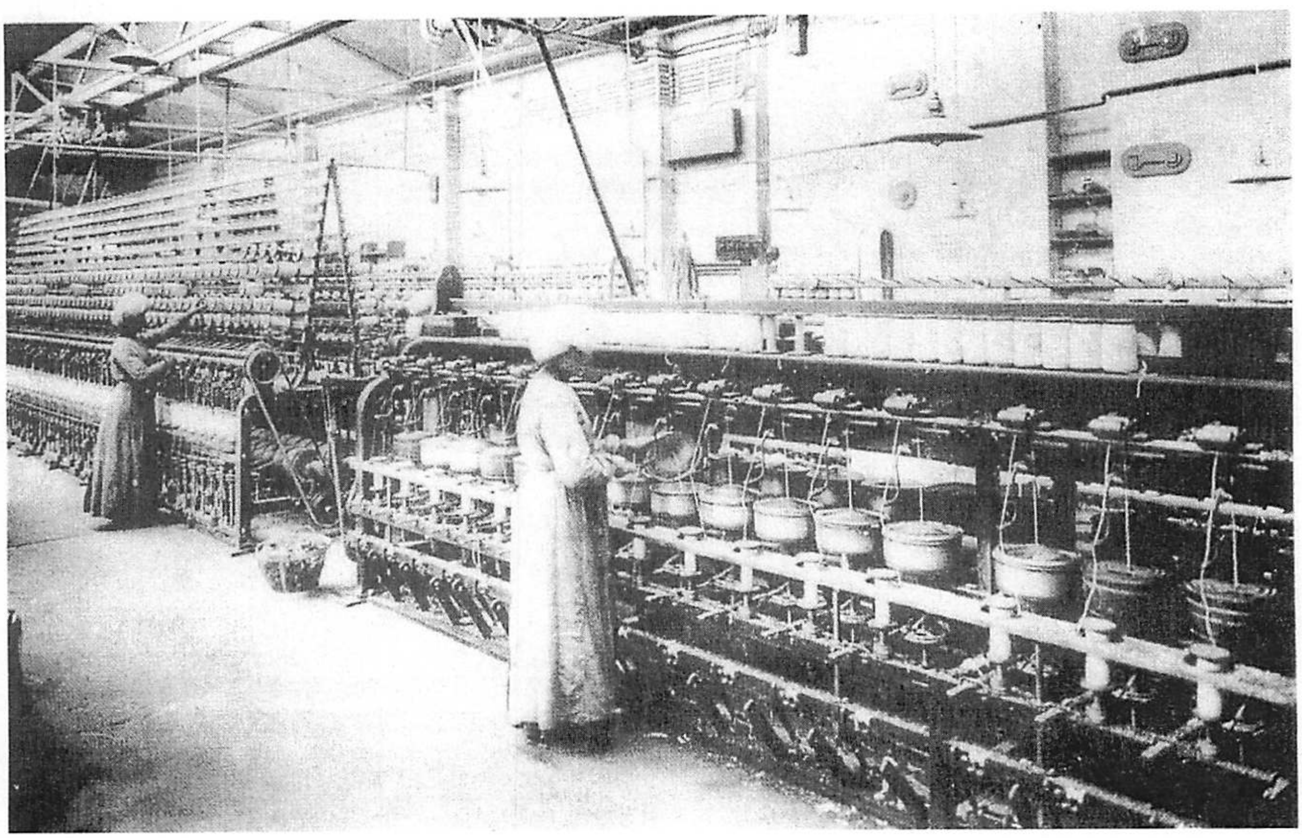
What Marx added to Smith's analysis was a new way of looking at the division of labor. According to Marx, the way in which the economy divided tasks could indeed increase productivity–but often at a terrible cost. Marx described at length the way in which English factories molded men, women and children to fit the machines in jobs with dangerous, repetitive tasks, performed 14 hours a day, six days a week.

In this view, the division of labor is not only a technical problem to increase production, but also a **social** problem, in which capitalists and workers struggle about how work will be performed. Although today's factory work conditions are often better than 100 years ago, modern Marxist economists attribute this improvement to the ability of working people to organize unions and other means to protect their well-being. Present-day economists have used Marx's insights to analyze changes in modern offices and other workplaces where managers and employees continue to struggle about the division of labor. For example, the introduction of computers has eased the burden of some jobs, but has also allowed employers to keep track of an employees' every keystroke and restroom break, thereby making some work more stressful despite the use of what should be "labor saving" technology.

B. Who gets the wealth?

Karl Marx followed Adam Smith's use of three main categories–wages, profits and rents–for the distribution of a country's output. But Marx added a twist: those who receive wages, profits and rents **may not actually produce the wealth**. Most importantly, workers' labor effort was not measured by the wages they received. In a workday of 12 hours during Marx's time, the value of the wages paid to the worker would typically be paid in 6 hours, leaving 6 hours of labor to he distributed as profits and rents to capitalists and landlords. Marx called this latter part of the workday the "surplus value" because it did not go to workers in the form of wages, but was kept by the owners.

Cotton Textile Workers in Germany, from The Time/Life Syndicate. Reprinted with permission.



Cotton Textile Workers in Germany Factories become larger, faster, and more efficient in the nineteenth century. Compare this cotton mill with that of the early Industrial Revolution on page 27, where women and children are working together.

> **Surplus Value**
>
> Karl Marx's method for measuring the amount of surplus in a capitalist economy. According to Marx, a large part of the output produced by workers is not paid back to them in wages or salaries. This extra amount, or surplus value, is retained by the owners of capital and land, and is usually called profits, rents, or interest.

What do capitalists and landlords do with the surplus value? To an extent it enables them to live far better than the working classes. But most surplus value will not be totally consumed because doing so would cause the individual capitalist to lose out in the competitive battle between firms. Instead, most surplus is reinvested in new capital (tools, equipment, factories and technology). According to Smith any such addition to capital was a good thing because it caused the economic system to expand and increase the productivity per worker. But Marx pointed out that the expansion of capital can also mean greater exploitation. For example, new machinery can replace skilled labor, thereby lowering wages and making workplace tasks more repetitive. In this way Marx attempted to explain an apparent paradox of the 1800s: as capitalism expanded and countries as a whole became wealthier, the well-being of many working people worsened. Or, as Marx described it:

> *"Accumulation of wealth at one pole is therefore, at the same time accumulation of misery, agony of toil, slavery, ignorance, brutality, mental degradation, at the opposite pole"*

Is the solution to this problem simply to take the surplus value away from the capitalists and landlords and give it to workers? When such ideas were presented during the 1870s, Marx ridiculed them as failing to understand basic economics. Marx pointed out that turning over surplus value to workers would not solve the basic economic problem of how to pay for raw materials, how to maintain the machinery used in factories, or how to plan for future production. In other words, exploitation was not just a matter of the amount of surplus value taken by the capitalist, but also the issue of who will control the surplus. Recall that under market-oriented economies decisions affecting surplus are made by the capitalist class (firm owners). Again, Marx left no comprehensive blueprint for a future "good" society, but he did point out that control over the surplus value would be a critical concern.

Control over surplus value is perhaps the most controversial part of Marx's analysis. Various countries claim to be following Marx's legacy through their different ways for controlling the surplus. In China, and in the Soviet Union until 1991 the surplus has been controlled by the central government, a condition which traditional Marxists in those countries claim to be a way to take control of the surplus away from capitalists and place it in the hands of government which represents the majority or working class. (However critics point out that a new government elite has replaced the capitalist elite.)

The term "socialist" is also used by countries other than China and the Soviet Union. For example, in recent years, socialist parties have been in power in countries as diverse as Sweden, the Netherlands, Australia, Haiti, Nicaragua, Jamaica, Chile, and Greece. In some countries, a few industries were taken over by the government, but for the most part these economies have remained under the control of private capitalists. Instead of public ownership of the factors of production, the socialist parties in these countries have called for increased government services such as medical care, old-age pensions, and child care for all citizens. Often these services are called "welfare socialism" and the countries' political system is called "democratic socialism."

Would Marx approve of this mixture of a privately owned capitalist economy and publicly-provided government services? Some Marxists argue that this form of economy, which has created living standards arguably better than in the U.S., is a stepping-stone toward actual socialism.

In most Western European countries, as well as Japan, New Zealand, Canada and Australia, the government offers health care, child care and educational services far more generous than those in the U.S. While additional taxes are needed to pay for these services, they cost far less than the same services purchased privately by well-off individuals in the U.S. In all these countries, corporations remain in private hands, although the distribution of income and wealth is more equal than in the U.S.

Impoverishment of the Working Class

Why would anyone work for 12 hours while being paid for only six hours of labor? Marx's answer was that this occurs through the market. As described by Adam Smith, pay levels are regulated by demand and supply. In the case of labor, there is a "going" pay rate that depends on how much capitalists need workers (the demand for labor), and how many workers need jobs (the supply of labor.) But, according to Marx, even though this market is based on the invisible hand, it is unfair because the capitalist owns all the factors of production and the worker has nothing to sell but labor. Typically not all workers who want jobs will find them, leaving an excess supply of unemployed workers—Marx called them the `reserve army'—who are ready to take a job from anyone who is unwilling to work at the wage set by the market.

Like Adam Smith, Marx was pessimistic about the plight of the working class under capitalism. Indeed there was little cause for optimism in the grueling workday and poverty-level wages of 19th century factories. But conditions are considerably better for most workers today, so critics of Marx argue that Marx was wrong. Supporters of Marx answer that it was precisely the ability of workers to organize unions and political parties that forced capitalists to pay higher wages and provide better working conditions.

C. How does the economy reproduce itself?

For both Smith and Marx the economic surplus created the possibility of an expanding economy. However, Marx added to Smith's analysis by pointing out that expansion was not a certainty; economic decline was also a likely outcome. By the mid-1800s there had been several downturns in the economy during which economic expansion not only stopped, but disastrous recessions occurred, where wealth appeared to disappear for capitalists, and living standards dropped dramatically for the working class. These episodes which we know as recessions or depressions continued into the next century, culminating in the worldwide depression of the 1930s.

Marx devoted long sections of *Capital* to understand the origin of the ups and downs in capitalism. He identified several trends that he called contradictions in which the expansion of the capitalist system carried the seeds of its own destruction. For example, when capitalists expand their profits, a necessity under the cut-throat competition of capitalism, they also reduce the percentage of the economy going to wages. Because these wages are a major source of demand for goods and services, the system is in danger of decline when there are insufficient funds to buy what is produced. In addition, constant technological progress and reinvestment in new capital added to the system's ability to produce ever greater quantities of all goods. The combined effect was re-occurring economic downturns, triggered by overproduction of goods and under-consumption by a working class whose purchasing power was continuously eroded.

Recession and Depression

When the total output of a country stops increasing and actually starts to fall, it is called a **recession**. Usually economists call such downturns a recession only if they last for at least six months. A severe reduction in production that lasts for many years is called a **depression**.

Every decade since the Civil War there has been at least one recession in the U.S. The last depression occurred during the 1930s.

Predicting the severity and frequency of capitalist recessions and depressions was important for Marx because these were time periods when oppression of the working class was at a maximum. Would it cause workers to revolt? During the 1930s Depression many observers believed the U.S. to be close to a revolutionary situation. Why did a revolution fail to occur? Some Marxists argue that capitalist countries postponed the impending downfall of capitalism by expanding the system into other countries to take an advantage of inexpensive raw materials, cheap labor, or new markets for products that cannot be sold at home. This process, called imperialism, is also seen as the cause of wars when competing imperialist interests run into one another in their effort to control other parts of the world. In summary, few would fault Marx for his emphasis on the ups and downs of the capitalist economy. The experience of the early-2000s is evidence for the continued roller-coaster ride of capitalism. Similarly, there is evidence for the increased conflict brought about by international capitalism. But we must wait to see what these trends mean for the future of capitalism.

Marx as a Radical

By some standards Marx was surprisingly moderate. For example, the list of recommended changes in the 1848 *Communist Manifesto* includes what are today such commonplaces as free public education and government operation of transportation. Also, despite Marx's reputation as a revolutionary, above all he was a scientist, counseling his labor union comrades to understand how the capitalist system worked. Nonetheless, Marx weighs in as a radical, that is someone who works for major changes in the existing system.

The word radical means the "root." And Marx's economics was radical in this sense because he wanted to dig down to understand the underlying workings of capitalism in order to change it. Thus for Marx, and for many who call themselves Marxists or radicals today, the problems of capitalism will be solved only when the system itself is unearthed and changed. In this view, moderate reforms such as government services may be desirable, but they will not offset the tendency of the system to regenerate the same problems all over again.

Another obvious reason for categorizing Marx as a radical is that his name has been used as the philosophy behind revolutions in the Russia, China and elsewhere. Although these revolutions created systems that called themselves "socialist", Marx may not have supported them or much of what the world now associates with his name. The current fastpaced change in the Russia, Eastern Europe, and China is causing Marxists everywhere to reconsider the nature of Marxism. For some, the failure of the economic system in the Russia is evidence for the failure of Marxism. For others, the former Soviet Union was, from the start, a faulty form of Marxism whose failure may help the development of democratic types of socialism, perhaps along the lines of Western Europe.

Crisis of Capitalism

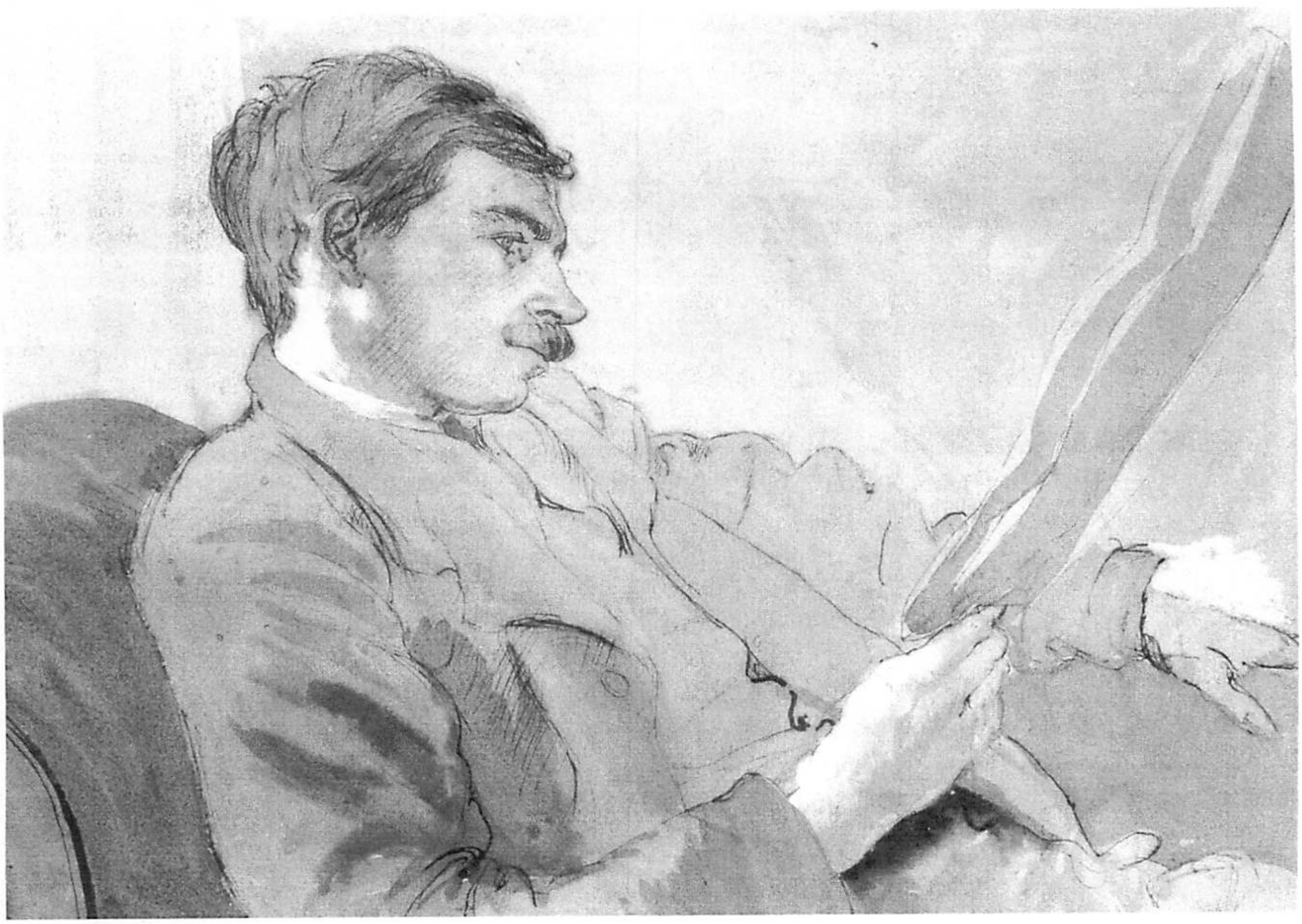
Marx believed that the capitalist system contained the "seeds of its own destruction". He predicted that capitalism would be plagued by re-occuring recessions and depressions triggered by continously expanding output over-production) combined with insufficient purchasing power in society because of depressed wages (under-consumption). This fundamental imbalance would be made worse when mergers and buyouts accelerated the concentration of capital. These trends would make the capitalist system increasingly more vulnerable to the revolutionary establishment of socialism by an enlightened, class-conscious workers movement.

John Maynard Keynes

With our third economist we move to the 20^{th} century. John Maynard Keynes (his name rhymes with "rains") wrote during the 1920s and 1930s in a style that sounds modern to our ears and about problems that will be more familiar to the reader today. Keynes' impact on today's economy becomes obvious when we observe contemporary political leaders often adopting policies Keynes recommended 60 years ago.

Keynes was born in 1883–coincidentally the same year Karl Marx died–to a decidedly upper class family. His father was an economist, and young John Maynard quickly displayed his own talents. He won a scholarship to the elite Eton School, attended Cambridge University, and then placed near the top in the government civil service examinations. His lowest score came in economics to which he responded, "The examiners presumably knew less than I did."

John Maynard Keyes, by courtesy of the National Portrait Gallery, London. Reprinted with permission.



John Mayard Keynes. A drawing by Gwen Raverat.

Although typically immodest, the remark soon proved to be true.

> **Discussion Question:**
> Why is Karl Marx's economic analysis less well known than his political activity?

Keynes worked his way up in government service so that he soon became a key advisor on economic matters for the 1919 Peace Conference following World War I. However the resulting Versailles Treaty so dismayed Keynes that he resigned his job and wrote a stinging critique called *The Economic Consequences of the Peace*. In retrospect this book, written in 1919, is remarkable for predicting the course of world events twenty years later. Keynes argued that the penalties charged against Germany would cause economic collapse in Germany (it did), that England and France would therefore not be repaid (they weren't), and that a despot would likely arise during the chaos (Hitler came to power). Keynes own words demonstrate his flair for language and the depth of his feelings in this quote from *The Economic Consequences of Peace*:

> *The danger confronting us, therefore, is the rapid depression of the standard of life of the European populations to a point which will mean actual starvation for some... Men will not die quietly .... And ...in their distress (they) may overturn the remnants of organization, and submerge civilization itself...*

By the mid-1920s, Great Britain was already in an economic depression, a decline that would hit the U.S. in 1929. By the mid-1930s, economic collapse was worldwide. In 1935 Keynes set to work on his major economic work, *The General Theory of Employment, Interest and Money*. Typically Keynes wasted no time on modesty, claiming his economic theory would "largely revolutionize-not I suppose at once, but in the course of the next ten years-the way the world thinks about economic problems." Much of what you will study in macroeconomics was influenced by *The General Theory*. We can summarize Keynes' ideas in this book based on the three questions used to understand the ideas of Smith and Marx.

A. How is wealth created?

Writing in the midst of the worst depression ever experienced by the capitalist system, Keynes set himself the task of understanding what went wrong. He accepted as self-evident the fact that capitalism had the potential for creating wealth, but clearly under some circumstances, the system also had the potential for severe contraction, and if left to itself might even collapse.

Keynes began by arguing that capitalism was not as self-regulating as assumed by many economists of his day. This belief in self-regulation can be traced back to Adam Smith (although of course it was not accepted in the Marxian tradition.) According to Keynes the adjustment process of capitalism does not work smoothly. His explanation for how markets fail to generate economic growth is described in depth in macroeconomics; for the moment it is sufficient for us to understand simply that Keynes believed they will not always work properly. Or, to use an analogy created by a modern-day Keynesian, the economy is less like a boat with automatic stabilizers that keep it upright in a storm–the Smithian or classical view– but more like an elevator that can go up and down, and sometimes gets stuck in the basement.

We can appreciate the flavor of Keynes' writing by looking at his analysis of the stock market. He was a quite successful player in the stock market, earning himself a personal fortune. It is said he made his stock decisions over breakfast every morning, leaving the rest of the day free for more important endeavors. Despite his private success in the stock market, Keynes was quite cynical about the role of the stock market in the overall economy. He wrote:

> *For it (the stock market) is, so to speak, a game of Snap, of Old Maid, of Musical Chairs–a pastime in which he is victor who says Snap neither too soon nor too late, who passes the Old Maid to his neighbor before the game is over, who secures a chair for himself when the music stops...*
>
> *Or, to change the metaphor slightly, professional investment may be likened to those newspaper competitions in which the competitor have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view...*
>
> *There is not clear evidence from experience that investment policy which is socially advantageous coincides with that which is most profitable...*
>
> *Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the*

> *bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.*
>
> *The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism–which is not surprising, if I am right in thinking that the best brains of Wall Street have been in fact directed toward a different object.*

"Believe me, the whole economy profits. We rob somebody of five grand. Then we buy some stuff from a fence. He gives a cut to the mob. They pay off the cops..."

In other words, although one person may be able to play the stock market game successfully, that does not imply that the stock market is beneficial to the economy as a whole.

In order to remedy the problems of the stock market and other parts of the economy that do not work properly, Keynes called for intervention by the government. In particular, he wanted government leaders to sit down with business leaders to make decisions about investments. Such planning ran quite counter to the tradition in most capitalist countries of leaving investment decisions to the stock market and the actions of private capitalists. But according to Keynes, "capitalism is too important to leave to the capitalists," a condescending attitude that did not make Keynes popular with many capitalists. In response, Keynes took care in the last chapter of *The General Theory* to point out to his critics that he favored a capitalist economy. In fact, he claimed that his remedies were the only way to save capitalism from forces within the system that would lead to its demise.

Keynes' call for economic planning went unheeded during his lifetime. However the capitalist countries such as Korea, Japan and several European industrial nations have used such government-corporate planning quite successfully in recent years as a way to insure that investments worked well. In the U.S., railroads, air travel, and banks all have significant government regulation.

In addition, Keynes urged that governments intervene to make certain that the economy kept growing. In his view, aggregate demand was sufficient to purchase current output only if there was government intervention, perhaps government purchases, lower taxes, or incentives to encourage businesses to invest and consumers to spend.

And finally, Keynes advocated that government use taxes and social programs to redistribute income from high to low income groups, in order to promote social justice and stimulate consumer demand.

B. Who gets the wealth?

Keynes' study of the distribution of goods and services in the economy was also oriented toward understanding **why** it was possible for a depression to occur. Although he is remembered primarily for his solutions for economic slowdown, Keynes' major contribution to economy theory was his analysis of a possible shortfall in demand in an economy compared to the level of production in the economy. Keynes divided the economy into three basic sectors, consumers (Personal Consumption (C)), business (Investment in Capital (I)) and government (Government Purchases (G)), and then showed why the total demand of these three sectors would not always be sufficient to purchase all of the currently produced products. If the shortfall in demand was severe, then a serious recession with massive unemployment could occur.

Once again Keynes' analysis was not popular with mainstream thinkers. One way in which insufficient demand could occur in an economy would be for incomes to be distributed too much in favor of those who were already well–to–do, and likely to save rather than spend large portions of their income. These individuals were less likely to spend this income, thereby providing too little demand for products. In this view, a more equal distribution of income could increase the demand for products by shifting incomes from the wealthy toward those individuals more likely to spend them.

The suggestion of redistributing income from the rich to the poor may sound odd coming from an individual as wealthy as Keynes. However once again, his goal was to save the system, including the privileged position of those with high incomes, which paradoxically was being undermined by the insufficient buying power of those with low incomes. This policy recommendation was not accepted during Keynes' lifetime, but is widely used in some modern industrial economies. There is evidence, for example, that countries such as Japan have succeeded by creating a home market in which there is relatively even distribution of incomes.

Keynes also argued in favor of government intervention in the financial sector including banks, stock and bond markets that, in his view, could destabilize the entire economy. Here, too, he did not believe that capitalists were exploiting the working class, as did Marx, but rather that individual capitalists did not act in the interest of the capitalist system as a whole. When banks or investors acted in their own self-interest, as advocated by Smith, by cutting back on loans during an economic slowdown, for example, the result could be a downward spiral in which the slowing economy caused even less lending. Consequently, bank, stock and bond market regulation was needed, and indeed was adopted by the U.S. during the 1930s.

C. How does the economy reproduce itself?

In terms of actual government policy, Keynes' major contribution is in decisions about government spending and taxation. To this day policies that advocate the adjustment of spending and taxation in order to regulate the economy are called "Keynesian economics." After the 1930s Great Depression ended with the onset of World War II, many economists thought that Keynes' ideas could be used to keep the economy going at

Keynes' Three Prescriptions for Capitalism's Crises

In *The General Theory*, J.M. Keynes suggested three specific remedies for the economic depression. Each would have greatly increased the role of government in the economy.

1. **economic planning** by government in cooperation with private industry, in particular to increase investment in new capital and infrastructure

2. **redistribution of income** by government from the rich to middle and low income groups, through progressive taxation, spending on social programs, and transfers

3. government spending programs to provide jobs, even if the government would need to spend more than it collected in taxes (**deficit spending**)

an acceptable rate of growth. Instead of reproducing itself with periodic business cycles of alternating growth and recession, it was hoped that Keynes' insights would allow for steady economic growth.

The current state of the economy shows that Keynesian theory has not pointed the way toward an easy elimination of up and down cycles in the economy. Nonetheless, the Keynesian idea that government can affect the growth rate of the economy is accepted by most economists. Often the debate is about which type of government spending or tax cuts would be best. On this question Keynes was typically acerbic, as he described how government spending of even a ridiculous sort could save a sick capitalist economy:

> *If the Treasury were to fill old bottles with bank notes, bury them at suitable depths in disused coal mines which are then filled up to the surface with town rubbish ...there would be no more unemployment... It would, indeed, be more sensible to build houses and the like; but if there are practical difficulties in the way of doing this, the above (burying bank notes) would be better than nothing.*

In other words, Keynes favored government activism of almost any sort, as long as it corrected the shortage in demand in the private, capitalist economy.

Keynes as a Liberal

The philosophy of government intervention places Keynes as a liberal on the political spectrum, especially compared to Smith's *Laissez Faire* vision. He was not as optimistic about the ability of the capitalist economy to rectify its own shortcomings as was Adam Smith and the conservative economists who believed in laissez faire. On the other hand, Keynes found less fault with capitalism than Karl Marx, believing instead that it was readily correctable through reforms instituted by the government.

> **Discussion Question:** What would Keynes have to say about today's problems in the stock market and banking system?

As a relatively recent economist, Keynes writings have directly influenced U.S. politics. At the height of the Great Depression, Franklin Roosevelt met with Keynes and was impressed with his ideas. However it took the U.S. entry into World War II and the subsequent tremendous increase in government spending to spur the

U.S. out of the depression. The apparent success of Keynesian policy to stimulate economic growth during the Democratic administrations of Kennedy and Johnson during the 1960s, persuaded Republican President Nixon to declare during the 1970s that "we are all Keynesians now."

Aggregate Demand

Total social expenditures for all goods and services, called **Aggregate Demand (AD),** can be expressed as a simple formula, which is explained at length in our textbook:

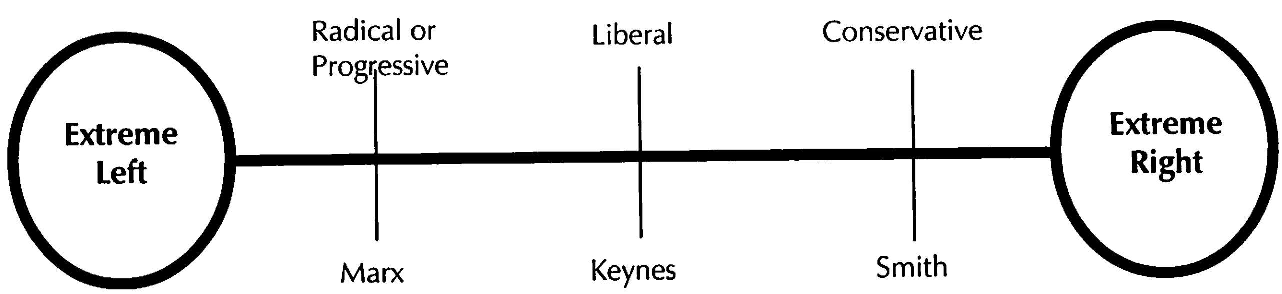
AD = C + I + G

The Keynesian triumph was short-lived when the combined forces of inflation and recession hit the U.S. economy after 1974. In 1980, Republican Ronald Reagan was elected on a platform that called for reversal of Keynesian ideas; in particular Reagan argued for dramatic reduction in the size of government services and reduced personal and corporate income taxes. By the 1990s, the pendulum had swung back in favor of Keynes. Problems of the Federal debt, bank defaults, declining productivity, recession, the growing gap between rich and poor, and the persistent trade deficit called into question the wisdom of the conservative approach of the 1980s.

The first decade of the 21st century showed a strong split in the U.S. politics between conservatives and liberals. The George W. Bush presidency called for Reagan-like reductions in government regulation and spending (except for the military), while Democrats called for more government involvement, in particular in response to new problems that emerged in housing, energy prices, and the environment. Radical, or now more commonly called "progressive" policies are infrequently discussed because of the focus on the conservative-liberal debate.

Conclusion

Are you a conservative? a liberal? a progressive? During the study of economics it is common to examine these points of view in greater depth. One goal for you might be for you to find the connection



Macroeconomics

The study of an entire economy, focusing on problems such as unemployment, inflation and economic growth that affect the whole economy.

Microeconomics

The study of the individual parts of an economy, focusing on the behavior of individual people and businesses, and problems of prices, wages and salaries that affect parts of the economy.

between your beliefs and long-standing economic philosophies. John Maynard Keynes has the last and typically eloquent words, on the subject. He concludes *The General Theory*:

> *...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 influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interest is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians, and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil.*

In this quote, Keynes argues for the careful study of economic ideas. We are, he believed, more influenced by ideas than we often realize. You may have not yet studied what he calls the "academic scribblers" or "defunct economists," but you may use their ideas without knowing it. One benefit of studying economics is that you may learn the origins of your own beliefs.

Introductory economics is divided into two complementary courses: Microeconomics and Macroeconomics. In macroeconomics the focus is on the economy as a whole, looking at how the entire system works. Topics include unemployment, inflation, and economic growth, problems that affect the whole economy. Microeconomics looks at smaller, or "micro" units of the economy, studying prices, quantities, profits, wages, and various types of market structures, problems that affect primarily individual people or individual businesses in the economy.

Discussion Question: Do today's politicians (in the U.S. or other countries) use Keynes' recommendations?

In more advanced courses you will learn that various modern thinkers who are critical of the simple Classical or Keynesian approaches to studying the economy. There are many points of view such as New Classical, New Keynesian, and Post Keynesian perspectives. These perspectives have taken elements from the three economists summarized in *The First Chapter*. We hope that this pamphlet will serve as a useful beginning in your study of economics.

Recommended Sources

1. Economic history

The presentation here owes much to Robert L. Heilbroner's lucid introduction to economic history, *The Making of Economic Society*. Also helpful is E.K. Hunt's *Property and Prophets*. More specialized accounts include: *The Oxford History of the Classical World*; *Cambridge Economic History of Europe*; H.S. Bennett's *Life on the English Manor*; and E. Power's *Medieval People*.

2. History of economic thought

The three major works described in the text are: Adam Smith, *The Wealth of Nations*; Karl Marx, *Capital (Volume One)*; and J.M. Keynes, *The General Theory of Employment, Interest and Money*. For an introduction to these works, the most readable summary is Robert Heilbroner's *The Worldly Philosophers*.

Modern-day works from the different economic perspectives described here include:

- From the conservative perspective: R. and M. Friedman, *Free to Choose*; web site: www.heritage.org; Blog: http://www.becker-posner-blog.com
- From the liberal perspective: Paul Krugman, *The Conscience of a Liberal*; web site: http://www.cepr.net/; Blog: http://delong.typepad.com/sdj/
- From the radical (progressive) perspective: Robert Pollin, *Contours of Descent*; web site: http://www.dollarsandsense.org/; Blog: http://www.dollarsandsense.org/blog/