

THE CRISIS IN ECONOMIC THEORY

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Models and Reality in economic discourse, 4, pp.46 - 80

48 .. while the theoretical differences between^a Samuelson^b & Friedman are
49 distinct, and the/policy consequences are divergent, there is also the
question whether the theoretical framework that includes both is itself
adequate.

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- Up to 1890 "Political Economy", since then "Economics"
- from/ in order to detach/traditional context of moral activities
and to conceive economic exchanges in purely instrumental terms
an autonomous self-consistent realm; a system of structural relations;
in which economic activities followed from the postulates of the
system
- because liberalism wanted to regard human beings as individuals
detached from family clan class or nation, each independent and
self-determining, so that human relations were procedural not
morally substantive
- As art was for art's sake, law and morality were independent realms,
morals were private matter, law the formal general rules of public
conduct, so in economics each man properly pursued his own self-
interest.
- 48 Adam Smith: Theory of Moral Sentiments & Wealth of Nations
former on disinterested judgment, latter on self-interest
- Economic theory in England in first 75 years developed in context
of utilitarianism: the happiness of the greatest number was the
outcome, if not the object, of independent economic choices
- Economics conceived as a science:
an underlying set of invariant relations
a general set of equations governing their interconnections
applicable to any system of production and exchange
- Transition from political economy of historically related societies
to the neoclassical edifice of Alfred Marshall and the general
equilibrium of Leon Walras.
- 49 Classical economists from A Smith to J S Mill concerned with wealth
and economic growth
- Economic welfare measured by quantity of output, which in turn was
a function of quantity of labor and its productivity
- The 'real' measure of goods was was their "value" not their utility:
argued from "diamond-water paradox: water abundant and useful;
utility could not be a determinant of price
- For Smith the science of economics was the mode of augmenting
capital stock so as to expand the output of goods and thus wealth
The prenuse was that it does not pay a person to produce for himself
what he could obtain more cheaply from another
- Hence if each person took comparative advantage of his own resources
aggregate wealth would be maximized
- How to determine the maximum had to await Stanley Jevons and the
marginalist revolution. The utility of a good decreases as its
quantity increases
- 50 Marginal analysis made relative price and relative scarcity the
fulcrum
- Lionel Robbins: economics became the science of allocating given
quantities of scarce resources among competing claims to obtain
the most efficient or optimal use
- II A System of Equilibrium

Daniel Bell, "Money and Reality in Economic Discourse"

50 II. A system of equilibrium

Neoclassical behavioral assumption is the individual's utility maximization. Structural assumption: the criss-crossing of buyers and sellers effects a sorting-out which satisfies all those concerned.

Eric Bell: If.. we regard the economic system as an enormous conglomeration of interdependent markets, the central problem of economic inquiry becomes the formation of price.

Alfred Marshall was able to show, with his ingenious diagrams, how the costs of production on the supply side intersected with marginal utility on the demand side to determine relative price.

51 From price theory he derived the demand curve, the elasticities of demand and supply, the nature of consumer's surplus, the use of long-run and short-run analysis, partial equilibrium, and the other components of the "analytical engine" which he fashioned to understand the terms of trade.

He also provided the first nuanced analysis of the character of economic equilibrium. He refined Say's law of markets. He argued that a producer would never seek to offer a worker a wage greater than the value of the added output his labor could produce... John Bates Clark sought to show in his Distribution of Wealth that the same principle would apply not only to wages but to all the markets for all the factors of production, to rents and returns on capital (interest and profit) as well.

Given these millions of transactions in hundreds of different kinds of markets, where the aggregate of prices in a product market must match the aggregate of prices in a factor market, and where the prices paid out equal the incomes received, how is it all accomplished?

52 Leon Walras, Elements of Pure Economics (1874): The product prices and the factor prices are determined simultaneously, and by solving the simultaneous equations, one can determine the general equilibrium. Vilfredo Pareto added an additional criterion to obtain some degree of optimality: a welfare trade-off would be a point where no person was less well off and at least one person would be better off. After being neglected for many years, it was recalled by Abba Lerner in 1934, and today it is the foundation of welfare economics.

The Rational and the Real

53 Is general equilibrium a fiction, simply a normative standard by which to judge an actual economy, or is it a description of how exchanges (if unhampered) take place in accord with the laws of economics?

Adam Smith on the Price of commodities in Labor or in Money, was concerned not with purchasing power but with the question whether the individual enjoyed a reduction of the "trouble and trouble" of irksome labor.

Contemporaries ask whether there is an increase in the standard of living, an increase in real income, in the things we can buy.

54 Smith was concerned with the reduction of irksome toil by economic growth, by comparative advantage, specialization, the division of labor, it would extend the scope and scale of economizing (productivity).

Alfred Marshall cared for the advance of economic science which he conceived as the discovery and measurement of regularities in behavior.

The scope of economic science became coterminous with price theory.

Walras moved from determinacy of price in one market to determinacy in all markets. He assumed perfect competition and an absence of advance in technical knowledge (the latter would change the parameters). The theory is static but it makes possible the definition

55 of precise functional relations between quantifiable variables and the construction of geometric (later algebraic) models of economic behavior.

Since Walras, general equilibrium theory has been polished by Arrow, Debreu, Hahn; add the neoclassical formulations of Samuelson and Hicks, and we have a general system of theory to explain the relative prices of goods and services and of the factors of production, the allocation of these factors to various uses, the levels of employment, and the level of prices.

More precisely, there have been developed two general systems: one for relative prices and allocations, the other for levels of employment and price (micro- and macroeconomics).

A confusion of realms

56 Nature in Adam Smith implies a telos, which it is the task of men to realize; hence his Theory of Moral Sentiments. His world is individualistic (conscience rescues man from conformity) but not egoistic. Hence natural liberty in Smith is not Hobbes state of nature, which is a state driven by appetite and murderous self-interest.

Marshall: the moral impulses are also evident. His Principles are shot through with concerns to improve the well-being of men.

He proposes a "consumer's surplus", the difference between what a consumer actually pays and what he would have been willing to pay.

Still money and morals are sundered: economics is limited to phenomena that have a price measurement; prices are measured by human behavior, measured in terms of money, as men move about the "ordinary business of life, seeking the best advantage for themselves.

Economics deals with the maximization of utility, with welfare; such that wants are disregarded and needs alone are considered;

2) that social welfare is defined only in terms of individual welfare;

3) that every individual is the best judge of his own welfare;

4) that the welfare of individuals may not be compared.

57 Walras: his idea of tatonnement, of the groping of individuals in response to signals from an external environment is, unconsciously but perfectly, an image of the Darwinian world. For Menger society is an evolutionary system in which "spontaneous order" arises out of the mutual adaptation of individuals, and the whole is functionally integrated by natural processes, exactly similar to biological processes. Human calculation cannot anticipate and provide for the diversity which is the characteristic and the strength of creative natural forces, so that planning is inherently restrictive and self-defeating, limiting the ability of individuals to make their own adaptive responses.

Frederick Hayek: There is no such thing as "social" justice outside of individual desert; individual liberty is the necessary condition for individuals to respond to the unforeseeable and unpredictable onset of multifarious events, if a society is to maintain that capacity for spontaneous adaptation which would keep a social order viable. Economics, for Hayek, while integral to freedom, has little relation to virtue.

"General equilibrium" as perfected by Arrow, Debreu, Koopmans et al. is a jeweled set of movements, a celestial clockwork, in which perfect competition and optimal allocations operate as an Invisible Hand, except that the Invisible Hand is neither God, the principle of benevolence, nor the spontaneous adaptation of nature, but a Mathematical Theorem sublimely indifferent to the private ownership of the means of production or a decentralized price system of market socialism. It is a work of art.

58 Walras thought that the trading prices in actual markets would be the same as those which would solve the system of simultaneous equations. Yet the problem of equilibrium in different kinds of markets--such as labor markets--is too obviously a real-world problem. The conclusion is inescapable. There is no empirical guarantee that the groping of the market produces a set of "clearing" prices that are identical with the underlying set of equations. If the model as elaborated by Arrow, et al., has validity, it is only as a fiction--logical, elegant, self-contained, but a fiction none the less.

III Four bridges to reality

59 In relation to the debate on the viability of neoclassical theory, I wish to single out and discuss four such bridges.

1) The quantity theory of money

Aims to correct a) the view (traditionalist Catholics, young Marx) that money is a stealthy means to expropriate productive labor or the use-values it creates, and b) John Law and later American populists that money stimulates trade and that cheap money is the road to prosperity.

States: so long as quantity of money is stable, the general price level does not rise, though individual prices would adjust to each other as demand shifted. For the same reasons, Friedman believed that trade unions could not force up the general level of wages, so long as the general money supply was constant.

60 Neoclassical writers distinguished real and nominal value of money: real: what money can buy; nominal: the quantity assigned by the coin or note. Quantity theorists said that people maintain determinate real balances; changes in the relation of nominal to real value of money, led people to adjust nominal value to equal previous real value. Neoclassicals also held that sharp fluctuations of prices or purely monetary and nominal events could have real effects in the short run. They considered such fluctuations to be transient: underneath the 'top of the wave' turbulence was the real economy of capital equipment and labor. Hence, let them run their course since adjustments occur in the long run.

In Neoclassical theory a cut in money wages was the same as a cut in real wages if prices were flexible. When wages are too high, competitive pressure drives wages down and employers are enabled to hire again; if wages are sticky, an employer would not hire workers; then unemployment would be the trade-off (the partial equilibrium), but the general price level would fall.

Wicksell rounded out the picture of wage and product markets by showing the quantity of money and credit influenced interest rates, and interest rates influenced the flow of savings into investment. Interest rates became the equilibrating instrument for the supply of, and demand for, capital.

So there was a macroeconomics before Keynes: the quantity theory of money

2) The theory of monopolistic capitalism

61 Edward H. Chamberlin questioned the postulates of homogeneous products and interdependent markets that underlay the theorem of competitive equilibrium.

A firm which can establish product differentiation by "branding its product" gains a quasi-monopolistic advantage over its competitor and thus creates a special market enclave. Given branded products, consumers do not behave as if all similar products are alike.

61 Given the new kind of competition, each firm produces less than under conditions of perfect competition. Price does not equal marginal cost, and price and output are sloped along monopolist lines. Yet because of product competition, profits are lower than they would be under monopoly. Not only is Adam Smith's hand invisible; it is just not there. From the view of social beneficence and consumer optimality, there is only a waste land. Monopolistic competition provides the disadvantages of monopoly (i.e., higher prices than at a price-competitive level) and none of the benefits of competition (since entry into the market (which requires a new brand identification) is not easy. // These conclusions of Chamberlin, 50 years ago, are the basis for the more popular Galbraithian critiques of capitalist market practice.

62 Chamberlin had more than complicated the neoclassical view of competition. He had called into question some of the easy assumptions about price signals as the "switching mechanisms" between products and industries and, by questioning the interdependence of markets, he was implicitly calling into question the assertion that a 'general solution' or multi-market equilibrium was possible. While the 'realism' of Chamberlin's description of product markets rather than price markets was quickly established, the more unsettling implications of Chamberlin's arguments, coming as they did in the midst of the Depression, were put aside because of the macroeconomic problems posed by world-wide depression, unemployment, and social unrest.

62n5 Some of Chamberlin's work was obscured by the appearance the same year of Joan Robinson's Economics of Imperfect Competition. While the title of Mrs Robinson's book caught the 'gist' of Chamberlin's argument (though not the technical demonstration of a firm's quasi-monopolistic advantage), the two books really deal with different problems...

3) The Keynesian Revolution

Keynes' General Theory of Employment, Interest, and Money is a badly written book, poorly organized... abounds in mares' nests of confusions....

63 Though Keynes is popularly known for his ideas of deficit financing and "pump priming," these were not the concerns of the general theory. The book was an onslaught on Say's law, the argument that in the long run the "real forces" of the economic system would tend to full employment equilibrium. Thus Keynes' remark that, in the long run we are all dead.

Keynes made two arguments: One, highly technical, that even if Say's Law was valid in a static (i. e., self-contained) model, it could not show that a full-employment equilibrium was attainable/dynamically since the process of moving toward an equilibrium through time displaces the equilibrium itself [if a system is dynamic, it is undergoing change; to add the further change of moving towards employment equilibrium, is to change the system, and so to change the problem of moving it towards employment equilibrium].

The second, which received the most attention, was that in a depression a static equilibrium was impossible for three reasons; the inelasticity of interest rates as a means of stimulating investment (higher rates of interest do not change investors minds); a "liquidity trap," or the desire of savers (financial institutions or individuals) to hold ("hoard") money; and the stickiness of money wages and prices.

What Keynes was saying was that the nominal magnitudes, such as wage rates and interest rates, would not function as price signals, so that 'real wages' and 'real interest rates' could not come back into balance. With price levels relatively rigid, nominal magnitudes

- 63 have a full effect on real quantities.
Keynes was seeking to recast economics--away from the quantity theory of money, to an emphasis on income and levels of employment as the determinants of equilibrium, and (the theme is so largely neglected in the popular image of Keynes) on the centrality of investment as the fulcrum of economic policy.
- The technical demonstration of Keynes' argument was worked out by Sir John Hicks--the IS and LM curves (i.e, investment savings and the demand for money) which now appear in all the textbooks, and which show the various equilibria at which different rates of interest and different demand schedules for money, intersect to achieve different levels of investment.
- 63n7 These curves were not new: Keynes had proposed them in a paper with Hubert Henderson in 1929; A C Pigou had put forth a rationale for public works in 1912.
- 64 In neoclassical theory, the rate of interest was a real, not a monetary phenomenon, determined by the demand for capital (at its marginal productivity) and the degree of savings in the community. But for Keynes, the two decisions are independent. The volume of savings is a function of the levels of income, and the degree of investment a function of the rate of interest. In a severe depression monetary policy is ineffective because of the liquidity trap whereby lenders prefer to hoard their cash and, unless the government becomes the leading lender, easy money in and of itself provides little inducement for investment.
- The third element in the tripod is ^wage rates. Keynes assumed that wages are sticky because workers are mesmerized by a monetary illusion. They bargain for and react to monetary wages, because they see only ^{their} immediate wage packet and have no means of knowing whether "real wages" (which would have to result from a fall in prices) would keep pace with the fall in money wages. Thus the labor supply responds to nominal wages and becomes inelastic. Since wages have become sticky, when business is bad employers lay off workers rather than cut their wages, and aggregate demand falls.
- What follows? In the US, the quick championing of Keynes by Alvin Hansen led to an emphasis on "compensatory finance" in which government intervention, through tax policy or government spending to raise aggregate demand, became the key policy prescription. In England, the expository essay by J. R. Hicks (in 1937) stressed that unemployment equilibrium was due largely to the disjunctions in the capital market and in the money markets. The liquidity preference schedule (LS) was seen as too interest-elastic, and the investment schedule (IS) was seen as too interest-inelastic, for the interest rate to function effectively to generate investment.
- The paradox is that in the Hicks version, Keynes was regarded as a radical, the champion of the necessary role of government as a permanent rider of the economy. In the Hicks version, the Keynesian and neoclassical views of aggregate economic behavior were assimilated into a unified economic model which re-established the idea of equilibria as the fulcrum of economic theory.
- 65 A concentration on the technical elements of Keynes' theories necessarily slights the larger, historical revolution which Keynes introduced. As against the Marshallian tradition, Keynes made macroeconomics the center of economic theory. As against the traditional concentration on individual decisions of firms and households, Keynes placed in the center of analysis the interrelation of aggregates such as investment and wages. And from the quantity theory emphasis

Daniel Bell, "Models and Reality in Economic Discourse," con'd.

65 on the money and price level, he shifted the focus to output, income, and employment, as these are coordinated in the markets for commodities, capital, and labor, as the fulcrum of concern.

What remains problematic--and it is the crux of the issue--is the question of equilibrium. Keynes was clear that no automatic adjustment of real economic forces toward the full utilization of productive resources was a realistic possibility in a modern differentiated society. But was disequilibria, and with it a long run tendency to stagnation, an endemic problem.

When Hicks wrote his reconciliation of Keynes with neoclassical theory --still the fons et origo of the standard interpretation, as Mark Blaug put it--Keynes wrote on his personal copy of that essay that he had "next to nothing to say by way of criticism." Yet year after the publication of the General Theory, Keynes wrote an article in the Quarterly Journal of Economics, a reply to four critiques by Taussig, Leontief, Robertson, and Viner in which he attributed the chronic cause for the underemployment of resources, and the inherent disequilibria in the economic system, to the inherent uncertainty of knowledge, the inability to know the consequences of our actions,, the impossibility of making forecasts, of knowing therefore what capital returns or discount rates of capital might be. "About these matters," Keynes wrote, "there is no scientific basis on which to form any calculable probability what ever. We simply do not know."

Marshall had assumed that through rational action and the law of large numbers, wherein individual variations are cancelled out, prediction was the great achievement of economic science. Yet if, as Keynes believed, economic behavior is ruled by uncertainty and indeterminacy, we are all adrift on the open sea.

4) The Phillips Curve

66 It may seem strange to group the Phillips curve--which began life as a prosaic statistical relation between wage rates and employment in the United Kingdom from 1862 and 1957, first noted by a New Zealand economist, A. W. Phillips, at the London School of Economics--with such grand concepts as the quantity theory of money, or monopolistic capitalism, or the Keynesian revolution, as one of the bridges from the rarefied purlieu of abstract theory to the messy marketplace of haggling and higgling.

* Solow: "Notice that [Phillips] was comparing the rate of changes of wages, a nominal quantity, with the percentage of the labor force out of work, a real quantity. If there were no long-run connection between real events and nominal events there ought to be no relation these two time series...

67 "what Phillips found was pretty astonishing. The simple bivariate relation, relating only one real and one nominal variable, help up very well over a long time during which the nature of British industry and labor changed drastically."

Gordon, Macroeconomics pp 210-212 (2nd edition)

68 A continuous increase in aggregate demand causes continuous inflation. Most of the discussions of the Phillips curve have obscured two very different kinds of issues. One is a movement along the Phillips curve, which posits a trade-off between a specific percentage increase in the rate of inflation in exchange for a specific decrease in unemployment (vice versa). The other is a shift in the slope of the curve itself, in which the relation is more nearly vertical, so that one could have a rise in employment without inflation, or a drop in inflation without cutting jobs.

Solow: .. in the inflation of the 1970's each of the Phillips curves in the family is relatively flat, so that you have to accept a lot of unemployment to push the economy down any one of those curves.

Daniel Bell, "Models and reality in Economic Discourse," con'd.

68 [Solow] Most of the serious estimates suggest that an extra 1% of unemployment maintained for one year would reduce the rate of inflation by something between 0.16% and 0.5%. That trade-off is not very favorable. We also know that the inflationary process itself involves a great deal of inertia; that is, it takes a long time for
69 the economy to pass from one member of Philipps curves to a lower one, at least under normal circumstances. E. g., an extra 1% of unemployment maintained for three years would reduce the rate of inflation by something between 0.5% and 1.75%. (An extra point of unemployment for three years costs the economy about \$180 billion of production, which makes this a very expensive way to reduce the inflation rate.

We know those two things, albeit in a tentative and gingerly way. What we don't know... is why the inertia is so great, why those Phillips curves are so flat. That is, we don't what bits of our social and economic structure would have to be changed to change those relationships.

IV Impasse

The golden age of economics, from 1947-1973, arose from the confluence of empiricism and theory. On the one hand was the towering work of Simon Kuznets who constructed the macroeconomic identities of national income and national output, and the aggregation, into a system of national accounts. On the other was the synthesis of Keynesian and enoclassical economics into a formal mathematical model and a set of policy tools to manage the economy. The combination of the two produced a new growth industry of econometrics, and a spate of forecasting models to chart the movement of economic activities and predict the direction and magnitude of their interactions.

69n11 The Brookings model of 1965 had 18 major components, such as labor force, consumer demand, residential construction, etc., in 36 producing sectors, and made its forecasts through the use of 300 equations. Project Link, which made its forecasts on the world economy, has 1,178 simultaneous non-linear equations in the set of 12 national models, plus several hundred equations to cover trading relationships in the rest of the world.

But there are two fundamental problems--one might even say fallacies--in the utilization of economic models to understand the ups-and-downs of economic activities. One is that economic theory, pace Marshall, is not a generalization about human behavior but, following Pareto, derives from an ideal types of one kind of action, so-called logical actions. And these may well be a minority of economic significant actions.

70 // The other is that and conomic system is not an economy; it is an analytical abstraction, an ideal, closed world where resources low freely in response to price, where comparative advantage dictates a shift of resource utilization, where labor is not people but units of skill (or lacks thereof), where there are no political // boundaries, and where machinery, capital, and commodities distribute themselves to the maximum benefit of mankind. It is a utopia, a utopia imagined by John Locke and Adam Smith, and even by manchester liberals such as Richard Cobden and John Bright who thought that the rational

70 advantages of productivity and free trade would make war and exploitation--indeed even political boundaries--only a memory of the dark past of mankind.

In short, economic theory is a convenient fiction, an "as if," against which to measure the habitual, irrational, logical, egoistic, self-interested, bigoted, altruistic actions of individuals, firms, or governments-- but it is not a model of reality. But even as a fictional ideal, it is inherently problematical.

Modern economic theory is based upon two specific assumptions about human behavior and its social setting. One is the idea of utility maximization as the motivational foundation for action, the other is a theory of markets as the structural location where transactions take place. The assumptions converge in the thesis that individuals and firms seek to maximize their utilities (preferences, wants) in different markets, at the best price, and that this is the engine that drives all behavior and exchange. It is the foundation for the idea of a comprehensive equilibrium. The reform of neoclassical theory has to begin with these two postulates of utility and markets.

The maximization of utility

Paul Samuelson has noted that many economists would "separate economics from sociology on the basis of rational and irrational behavior, where these terms are defined in the penumbra of utility theory." Utility is identified egoism or self-interest, and rationality is defined as consistency--that is, that preferences are transitive (if x is preferred to y , and y to z , then we would have to assume, in predicting behavior that x would be preferred to z).

71 Yet the crucial question is whether the obverse of the rational is the irrational rather than the non-rational, and whether or not non-rational non-rational motivations can provide a valid assumption for an // understanding of economic behavior-- i.e., the behavior which seeks to enhance the wealth and welfare of mankind. As Amartya Sen, who has raised the question in an acute form, has written:

The primary concern ... is not with the relation of postulated models to the real economic world, but with the accuracy of answers to well defined questions posed with pre-selected assumptions which severely constrain the nature of the models that can be admitted into analysis.

As against egoism, for example, Sen proposes the idea of "commitment," which would require the reformation of welfare economics models, particularly in the area of public goods. On the basis of "egoism theory" people are expected to avoid their share of costs on the expectation that, if it is to be a public benefit, it would in any case be extended to all. Such a theory proceeds from a theorem of Bentham's that the community is a fiction and that in effect there is no such thing as a "social" point of view apart from one's own self-interest. Yet the radical individualism that underlies this assumption and that has shaped the models of economic behavior, flies in the face of the large variety of traditional and ideological attachments which often shape an individual's action into collective form.

71n13 [ad fin.] ... this hedonic calculus is itself the most narrowly-bound interpretation of human behavior, ignoring the large areas of traditionalism on the one hand and of moral reflection on the other.

~~In fact, it is assumed that not only individuals but firms are utility maximizers. In it is also assumed that not only individuals but firms are utility max-~~

Daniel BELL, "Models and Reality in Economic Discourse," con'd.

71 It is also assumed that not only individuals but also firms are "utility maximizers." In fact, it was often assumed that, while individuals, responding to habit custom, or to impulse, may be irrational, the firm subject to the discipline of the bottom line, acts //
72 in pure "rational" ways, and so becomes the primary agent in "clearing all markets." In recent years, an entire literature has arisen that disputes that simple-minded idea. In this issue, Harvey Simon expounds his theory of X-efficiency, which undercuts some of the traditional assumptions of microeconomics. And Herbert Simon has won the Nobel Prize in economics, in part, for his theory that firms operate not as profit-maximizing but as satisficing institutions. Sir John Hicks a propos of Keynes on sticky wages: suggests that (apart from a few rather abrupt periods of rapid slide) wages and unemployment [for the past 70 or so years] tended to be sticky because neither employers nor unions wanted to disrupt traditional relationships. "The 'stickiness' is not a matter of 'money illusion; 'it is a matter of continuity." ... "Wages rise, whether or not there is labor scarcity; so they rise in slump as much or nearly as much as in booms...."

So in this crucial area of utility theory it is sociology ("irrational action"?) that seems often to provide more adequate basis for explanation than standard economic theory.

What does government spending maximize? The older German school of public finance, with typical German thoroughness, states that governments maximize utility for something called the State. Anglo-American economic theory, since its premises are individualistic, ignores the problem completely.

8 Since governments, even in market societies, account for between 20% and 60% of all economic transactions, what does the government maximize?
73 But none of these suggestions tells how collective decisions are made or ought to be made. An economist might reply that this is a matter for political theory. But it remains for the economists a problem of understanding how the judgments are or should be made.

Modern economic theory developed from classical liberalism. But that liberalism was anti-political; that is the meaning of laissez-faire. Adam Smith did not look to government to set the boundaries of individual actions; he looked to civil society, that network of family, clan, and neighborhood, parish and church, to set the general standards of moral conduct. Liberalism sought for the autonomy of realms, not only the distinction between Church and State as temporal powers, but the division between economic and politics as autonomous activities... A qualitative difference in the ways in which individuals behave in these two realms. Hence Carl Schmidt: Once an economic action becomes political, it becomes inextricably bound with the State and implicitly accepts the power of the state to adjudicate the validity of these actions.

74 The state is an ad hoc instrument evolved out of the functional necessity that some central body manage the interdependence and complexity generated by the new scales of the communications and technological revolutions of modern society. Since it is a political body having to manage economic institutions, whom is it intended to serve? Economic theory, even as a technical instrument to analyse the consequences of such decisions, is highly limited unless it attempts some answers to these questions.

74 Markets, free and otherwise.

The question of markets has been a recurrent topic since the time AS remarked that merchants habitually come together over a pint of bitters, among other things, to fix the price of their product. Shop talk is price talk.

References to market imperfections or market failures are as frequent in economic literature as the obeisance to the other obligatory caution, caeteris paribus. And the sticking point in any empirical theory of equilibrium is why there persistent disequilibria in certain markets--as in the labor market.

In his 1973 lectures Sir John Hicks distinguished fixprice and flexprice.

Industrial markets control the quantity of their product and accordingly like a single fixprice for each product and vary the output to suit the demand.

Staple markets have to dispose of the quantities that nature currently provides, and it suits them to vary the price to make the best of the opportunities that exist. Similarly, speculative and financial markets prefer flexprice to fixprice.

Fixprice leads to price rigidities. Market power can inhibit flexibility but it gives stability. In periods of shortages it is more often the large corporation that will eschew large price increases for established customers in order to maintain long term relations. In periods of unemployment, it is the basis of the "implicit contract" when employers, bound by traditional relationships, or even some residual obligation, hold on to a labor force as long as they can.

How far all this traditionalism, these rigidities, these fixprice markets extend we do not know. But it is clear that price signals are not the the shunting or switching mechanisms of standart economic theory which create equilibria or optimal distribution of resources in the society. And if institutional and political factors become more important than market determinants, all these raise crucial questions for public policy,

75f Several illustrations of these questions are set forth, but the comment is that standard models of economic theory give us little help in answering them.

V Rationality or time?

76 At the beginning of the 20th century the central question that concerned socioogy, as psoed by Max Weber, was: Why did rational capitalism develop in the West rather than in China or other parts of the non-Westen world?

His anŝwer was that capitalism had been abetted by a new set of legitimations (principally religious in orientation) that tore down traditonal relationships (guilds, parishes, clans), fostered individualism, and made all resources (such as land and labor) mobile, subject to the market.

Yet at the close of the 20th century, the emergng sociological question seems to be why capitalism has been so successful in Japan, which has maintained traditional relationships (and even converted the traditonal village structres into factory structures), emphasized communalism and consensus, and provided long-term if not life-time employment for its wokers.

77 The economic theory that has developed in the West in the last 200 years is impotent before such questions. It has been ahistorical and abstractly analytical. But that is precisely the rub. Economic

77 theory, by and large, is based on the model of classical mechanics and operates in the image of the natural sciences. The model leads to the idea of an equilibrium in which natural forces seek to reassert themselves and restore economic relations to a balance, the fulcrum of which is "perfect competition." The result is a basically mechanistic view of human behavior, and when disordinances occur, there ensues a series of separate and twisted efforts to square the nominal magnitudes (i.e., the irrational) with the real magnitudes (the rational) that underlie the system. How Hegelian!

But this enterprise ignores a crucial distinction. Classical mechanics is constitutive of nature; it seeks to discern the intrinsic order which is hidden in the properties of the system. Economics is not constitutive. It is a constructed logic, at best an "as if" model of how some resource distributions would be made if individuals acted in some specified "logical" way. But there is no single underlying structure to a society. Since men act variously by habit and custom, irrationally or zealously, by conscious design to change institutions or redesign social arrangements, there is no intrinsic order, there are no "economic laws" constituting the structure of the "structure" of the economy; there are only different patterns of historical behavior. Thus, economics and economic theory cannot be a closed system. The social sciences necessarily are partial prisms selecting out different facets of behavior in order to understand the causes of change and their meanings. And what sets their boundaries is not the essential properties of a subject matter, but the different questions they ask, which is why they are permeable.

BL: Dimensions of Meaning, Collection pp 252-67
Method in Theology, Meaning 57-99; Religion, 101-120; Interpretation, 153-173; History, 175-234; Dialectic, 235-266.
Insight, ch. 6, 7, 10, 11.

78 Keynes himself, it may be recalled, had raised doubts about the possibility of predicting human behavior, especially when such // behavior is based on variable expectations. To put the issue more formally, as G. L. S. Shackle does in his book, Epistemics & Economics, the economic theorist can choose either rationality or time. The theory that rejects time can set forth propositions such as subjective marginalism, partial or general equilibrium. But the introduction of time not only introduces uncertainty; it also necessitates understanding the non-rational behavior if it is to deal with the choices that human beings make.

An "interpretative" economic theory

What are the roads to reconstruction? What ultimately provides direction for the economy, as Veblen pointed out long ago, is not the price system but the value system of the culture in which the economy is embedded. The price system is a mechanism for the relative allocation of goods and services, not in accordance with human nature (or utility maximization), but within the framework of the existing distribution of income and cultural patterns of social wants. Accordingly economic guidance can only be distributive as equitably as the cultural value system which shapes it.

Daniel Bell, "Models and Reality in Economic Discourse," con'd.

78 con'd An "interpretative" economic theory might have to consider that that its own analysis only makes economic sense when joined to sociology. For the hard-nosed economist, this is a fate feared worse than the pox, yet one finds, pleasantly, that even so rigorous a theorist as Robert Solow, in his presidential address to the American Economic Association (December 1979), seeking to formulate a theory of wage stickiness to fill the chinks in Keynesian theory, resorts to explanations such as "social conventions" and "modes of good behavior enforced by social pressure" to explain "the persistence of disequilibrium in the labor market." And he concludes, "Economic man is a social... category." That too is a modest start toward the reconstruction of economic theory.

78n16 As a static feature, a full-employment equilibrium is theoretically possible within a closed and timeless system, but the process of moving toward equilibrium through time displaces the equilibrium point itself, so that one may simply be chasing a will of the wisp.

78n17 I use the term "interpretative" in accordance with a growing usage in the social sciences to define a mode of inquiry which is not positivist but defines inquiry in relation to the meanings of actions of individuals rather than just the "observable behavior" itself.

78 An economic theory has to understand its underpinnings not only in relation to politics but to political theory. The great paradox of //
79 all modern social theory is that political philosophy, going back to Machiavelli, Hobbes, and Rousseau, saw men as being ruled by appetite, passions, or will, while economic theory defined actions as rational behavior--albeit such rationality is defined in purely instrumental and functional terms. Only Max Weber, among modern theorists, has sought to sketch a theory of social action that takes into account the rational and the non-rational, and to look at economics and administration, politics and religion, in terms of the two modes.

Within that context economic theory has to integrate political practice within its body of understandings. Price theory is distributive. Resources flow to the most profitable (or least costly) places. Necessarily, some persons lose; what Schumpeter has called "creative destruction," or more recently, Lester Thurow has called the zero sum game. But political practice is redistributive, responding to the weights (votes, money, power) of the different interest, functional, ethnic, advantaged, and disadvantaged groups in the society.

80 And finally economic theory has to return to time (in the logical sense) and to history (in the empirical fact) in order to be responsive to the complex new social arrangements that derive from the widening of scales and the new arenas of economic and social actions. The world of Adam Smith was one of thousands of small family firms, of visible merchants and customers, so that Smith could look to civil society, not government, as the arena in which competition would be regulated by custom and ethics, rather than by contract and law. A post-industrial order is one in which economic // innovation is ruled by the codification of theoretical knowledge, yet contemporary economic theory, rooted in a world of agriculture and industry, has no means of measuring the "output" of science, of little, even, of technological change. Yet without such understandings, how effective can economic theory be as guidance, let alone as a "model" of economic reality?

The crux of my argument is an epistemological one. Economic theory, unlike physics, is not constitutive of a single underlying reality. None can it be, pace Alfred Marshall (and Gary Becker), timeless generalizations about human behavior. In consequence, economics cannot

80 be, as its model in classical mechanics, a "closed system" which ignores change or the effort to discern specific patterns of change. Does this mean the abandonment of the powerful logical engine of rationality and equilibrium, of maximization and markets, to vagaries of sociology and the unrestrained whims of politics? Not at all. "At least from the time of the physiocrats and Adam Smith" Paul Samuelson has observed, "there has never been absent from the main body of economic literature the feeling that in some sense perfect competition represented an optimal situation." We have also seen in recent years the growth of a large body of literature in welfare economics which, deriving from Pareto-optimality, defines a set of optimal outcomes for allocations of resources and distributions of incomes. But this is a divergence, and a necessary one, from the positivist tradition which has ruled economic theory. The corollary of all this is that economic theory should be taken as a "model" or template of how human beings behave, for these will always be inadequate, but as a "Utopia", a set of ideal standards against which one can debate and judge different policy actions and their consequences. That, it seems to me, is the meaningful role of any social "science" in theorizing about human affairs.

79n19 Mancur Olson cites evidence (from the findings of the monetarist Philip Cagan) that the tendency of prices to fall during recessions diminished steadily over time. And as he writes, in an unpublished essay, "An Evolutionary Approach to Macroeconomics":

Obviously something is accumulating or progressing over time such as changing policies, structures, or institutions, which is changing the character of the macroeconomic problem. We know both from the tendency for real output to vary more with changes in aggregate demand and from observation of the prices themselves, that stickier prices and wages are crucial to the change that is taking place. But we do not explain the change by referring to sticky prices, any more than we explain anything like the ad hoc assumptions like "rigid wages" or merely descriptive concepts like Phillips curves. The cause of the fact that prices and wages were less flexible in the interwar years than in the nineteenth century, and still less flexible in these stagflationary times, must be found. That cause in turn must play a leading role in our macroeconomic theory.