CHAPTER 4

Political Economy, Past and Present

"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." Thus did John Maynard Keynes (rhymes with "rains"), one of the great 20th-century economists, conclude his major work, *The General Theory of Employment, Interest, and Money.* He was careful to warn that economic ideas are often powerful whether they are right or wrong. He might have added that economic ideas can have a great impact even when their author's major works are so dense that they are impenetrable except to specialists in economics.

So it was with Keynes. His book was read by few and understood by fewer. And yet, less than a decade after Keynes wrote his *General Theory,* "Keynesianism" had become a battle cry of social movements, or an epithet to hurl at opponents, depending on one's opinions. So, too, had it been with Adam Smith, the prophet of capitalism, and Karl Marx, capitalism's great critic. In neither case were their major works well understood by many of their contemporaries, but in both cases their writings became controversial and had great impacts on the course of history.

Thus, economics was born in controversy and has grown in controversy. Someone once quipped that if you laid all the economists in the world end to end, they would not reach a conclusion. But because it is about the most ordinary and the most important of our daily activities, earning a livelihood, economics is hardly an irrelevant pursuit, even in the hands of those whom Keynes labeled "academic scribblers."

Near the beginning of the last chapter we warned against accepting any particular economic opinion as true without careful scrutiny. In this chapter we underline this warning by introducing six of the all-time great economists, each of whom has contributed to what we call the three-dimensional approach to economics. Had they met (they did not), they would have agreed on some things and strongly disagreed on others. But as you will see, they had complex ideas, and they often respected points of view that were at odds with their own; none of them was simply grinding an ax or trying to sell his own point of view. Marx, you may be surprised to find, lavishly praised capitalism for its massive increases in material output. And Smith worried greatly about what capitalism was doing to those who worked in its factories.

The crux of this chapter is that *political economy (three-dimensional economics) is a way of understanding capitalism that has evolved and changed along with capitalism itself.* This idea is expressed in the following points:

1. The primary contributors to political economy grappled not only with abstract theoretical issues but also with the concrete economic reality around them.
2. Adam Smith showed how markets can work as a system of coordination of private economic decisions.
3. Karl Marx contributed an understanding of classes, class conflict, and how economic systems change over time.
4. Joseph Schumpeter ("shum PAY ter") taught that innovation and technical change lead both to economic instability and to growth in living standards.
5. John Maynard Keynes explained why unemployment is a persistent problem and what the government might do about it.
6. Ronald Coase (rhymes with "snows") showed that bargaining among private individuals can sometimes solve problems that governments fail to address, and that firms are political as well as economic organizations.
7. Amartya Sen challenged the idea that people are entirely selfish, stressing the importance of ethical values in people's behaviors.
8. None provided wholly satisfactory answers to the questions they raised. Economists continue to seek new answers and to face entirely new questions as capitalism continues to evolve.

As long as there has been human life on earth, there have been *economies,* for the process of producing one's livelihood is a precondition for life itself. But *economics,* the study of economies, is relatively new, having originated barely 300 years ago. Like urbanization, technological change, population growth, mass migrations, increasing material abundance, and the other revolutionary changes of the modern era, economics came along with capitalism.

To help the reader relate the developments in economics (political economy) traced in this chapter to some of the major events in modern political, economic, and social history, we include here a timeline connecting the history of economists and their ideas with the broader history of the 18th, 19th, and 20th centuries. (See Figure 4.1.)

Before the capitalist epoch, the production of one's livelihood was so much an integral part of the rest of one's life that it did not seem separate enough to be studied on its own.

ECONOMY AND SOCIETY

mid–1700s: "Enlightenment" intellectuals in Europe challenge the divine right of rulers, question tradition, promote science

late 1700s: First Industrial Revolution and the the full development of capitalism in England, later in France and Germany

1776: United States "Declaration of Independence"

1789: French Revolution: "Declaration of the Rights of Man" and decline of aristocracy and autocratic rule in France

1820s–1840s: Voting rights extended to freeborn males in U.S.; Chartist movement seeks to expand voting rights in England; England adopts "free trade" and factory acts protecting workers

1848: Year of revolutionary ferment by urban workers, craftsmen, and intellectuals in Europe

1860–1864: Civil War in the United States; Emancipation Act ends slavery

1870s–1890s: Era of the "robber barons" in the U.S.; increase in agrarian protest; birth of the labor movement

1914–1918: First World War decimates Europe; Bolsheviks sieze power in Russia

1929: Great Depression begins in capitalist nations except fascist Germany and Japan

1933: Franklin Roosevelt introduces "New Deal" in U.S.

1939–1945: Second World War

1943: Great Bengal Famine kills two million people in India

1949: Chinese Revolution ushers in Communist rule in China

1948–1980s: End of European colonial empires; Cold War; Keynesian economic policies implemented in the capitalist nations; central planning in the Communist-ruled nations;

1980s–1990s: Berlin Wall falls; Soviet Union ends; Communist rule is terminated in Eastern Europe; information revolution accelerates; global warming becomes recognized problem

1700
1720
1740
1760
1780
1800
1820
1840
1860
1880
1900
1920
1940
1960
1980
2000

ECONOMICS / POLITICAL ECONOMY

1723: Adam Smith born in Scotland

1759: Adam Smith publishes the "Theory of Moral Sentiments"

1776: Adam Smith publishes "The Wealth of Nations"

1790: Adam Smith dies

1818: Karl Marx born in Trier, Germany

1800–1840s: The classical economics of David Ricardo, Thomas Malthus and John Stuart Mill flourishes in England, spreads beyond

1848: Marx and Engels publish "The Communist Manifesto"

1867: Marx publishes the first volume of "Capital".

1870s: Birth of neoclassical economics

1883: Marx dies; John Maynard Keynes born in Cambridge, England; Joseph Schumpeter born in Moravia (now part of Czech Republic)

1910: Ronald Coase born in Middlesex, England

1911: Schumpeter publishes the "Theory of Economic Development"

1933: Amartya Sen born in British India

1936: Keynes publishes "The General Theory"

1937: Coase publishes "The Nature of the Firm"

1942: Schumpeter publishes "Capitalism, Socialism, and Democracy"

1940s: Keynes and others create IMF and World Bank, Keynes dies

1960: Coase publishes "The Problem of Social Cost"

1965–present: Sen publishes works on famine, poverty, and democracy

1990s: Coase and Sen win Nobel Prizes

FIGURE 4.1 Timeline of society and political economy.

Most production, for example, took place in or near one's home and involved all the grown members of a family and usually children as well. Family and economy were not distinct. In fact, economic activities were just a part of family life and had little existence outside families. Markets, to take another example, were as much meeting places and sites for (sometimes raucous) entertainment as they were opportunities to buy and sell. Certainly they were not the specialized institutions for the exchange of goods that economists write about. How and when one worked, who one exchanged goods with, and at what price the exchange was made were affected by, or even dictated by, ancient customs, social values, and religious and governmental decrees.

Embedded economy is a description of the economy of the precapitalist epoch, which was so fully integrated into the whole society that it did not have a separate or specialized existence.

The anthropologist Karl Polanyi expressed the integration of the economy in the whole social order by saying that the precapitalist economy was *embedded* in society. Not surprisingly, at the time people did not regard "the economy" as a separate realm. They did not see economic activities as separate from other activities. The economy was there, of course, but people did not see it.

For economics to be recognized as distinct, the economy would have to become both more separate from society and more specialized. Work would have to be done in places specialized for work—factories, offices, plantations. Buying and selling would have to become the sole functions of markets. And the pursuit of economic gain—more than custom, moral scruple, or religious dictate—would have to become the guiding principle of economic life.

Capitalism brought about all three changes, and as a result the economy became *disembedded.* It was still part of society, but it had become separate enough and specialized enough to warrant a distinct type of investigation. The birth of economics awaited only minds creative enough to sense the new realities. In the 18th century a number of thinkers moved in this direction, but Adam Smith turned out to be the most perceptive.

ADAM SMITH

The first in the lineage of political economy is Adam Smith, whose great book, *The Wealth of Nations*, was published in 1776, the same year as the U.S. Declaration of Independence. *The Wealth of Nations* is the most influential book on economics ever written. In it Smith expounds the idea that rather than to try to direct the economy, the government should leave well enough alone. This is roughly the meaning of the French expression *laissez-faire,* which has ever since been associated with Smith's thinking.

Laissez-faire is an approach to economic policy that advocates a very limited role for the government, confining its activities to national defense and the enforcement of laws and contracts.

Adam Smith was a pioneer in understanding markets and in studying how whole economies composed of many markets work as integrated systems. Since every school of economics regards the workings of markets as important, Smith is widely regarded as the founding father of the discipline. Smith and the leading economists in the two generations that followed him are called the "classical economists." Three of Smith's ideas are key to the development of political economy.

First, Smith identified the basic challenge of economics: how can society *coordinate* the independent activities of large numbers of economic actors—producers, transporters, sellers, consumers—often unknown to one another and widely scattered across the world? This problem of coordination arises because no person is self-sufficient: everyone's livelihood requires a multiplicity of goods and services produced by others. Thus, Smith focused his attention on the *division of labor,* the fact that in all economic systems some people produce certain things while others produce different things, all the different outputs being necessary for the livelihood of all and everyone being economically interdependent with everyone else.

Second, Smith developed the idea—a very radical position to take in his day—that society could leave the coordination of the division of labor up to the individual self-interest of the economic actors themselves. This idea was radical because it asserted that a rational order might arise without any person or institution consciously attempting to create or maintain order. Earlier philosophers such as Thomas Hobbes, an English writer a century before Smith, had advocated a powerful government as the only means by which the self-seeking activities of large numbers of people could result in order rather than chaos. Smith argued that markets, or rather systems of markets, could do the job as long as two conditions were in place. Property rights would have to be well defined, so as to make it clear who owned—and therefore could exchange—what. Also, there would have to be enough competition among the many economic actors that no market was monopolized. We will explore his reasoning on these points in later chapters.

Third, Smith explained how a system of competitive markets could translate the self-interested actions of individuals into results beneficial for society. This was, again, a truly radical departure since it came at a time when selfish behavior was regarded as immoral. Smith argued that while the self-interested activity of the farmer or the barber may be based on greed, the pursuit of that greed will—under the right conditions—benefit all. Thus, socially beneficial results will be produced by well-defined property rights and competitive markets behind the backs of the people who make up the economy, even if most people care little or nothing for the well-being of their neighbors. Smith coined the phrase *the invisible hand* to refer to the tendency of markets to guide the economy toward the best use of its human and natural resources.

In Smith's view, then, markets would regulate the economy and harness self-interest to achieve material progress for the whole society. He warned the government against taking on inappropriate tasks, in particular the direction of individuals in their economic activities.

Smith's idea of limiting government's role in the economy was far from one-sided, however. He repeated the usual arguments that government should protect the nation from external enemies and assure internal justice with police and a system of courts; he also advocated government investments in bridges, roads, canals, and other "public works" (such as free education for all children) and proposed the imposition of taxes on alcohol to discourage drunkenness.

In other words, Smith saw that there were many valid exceptions to his general argument for minimal government intervention in the economy. He was also acutely concerned with the sometimes negative human consequences of the pursuit of economic gain. He worried, for example, that England might turn into a country of mindless robots if something were not done to alleviate the oppressive and mind-numbing conditions in its factories.

Moreover, Smith often took the side of the poor against the rich. In his chapter on wages in *The Wealth of Nations,* he wrote: "No society can surely be flourishing or happy, of which the far greater part of the members are poor and miserable. It is but equity, besides, that they

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ADAM SMITH: PROPHET OF CAPITALISM (1723–1790)

There was nothing particularly routine or normal about Adam Smith's life. At age four he was kidnapped by gypsies (and later returned to his family). At age 14 he enrolled at the University of Glasgow. It is said that he once left home sleepwalking in his pajamas and traveled 15 miles before waking up. Another time he fell into a tanning vat while walking with a colleague, deep in conversation.

What was most unusual about Smith, however, was the range of his intelligence and his bent for radical ideas. He held the chair of moral philosophy at the University of Glasgow and lectured his students on "natural theology, ethics, jurisprudence, and expediency," in that order, the latter being his term for economics. While earlier philosophers had attempted to tame the selfish side of people, Smith sought to put their self-interest to good use: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner," he wrote, "but from their regard to their own interest."

Though his advocacy of laissez-faire has made Smith quite popular today, contemporary proponents of business-friendly policies often neglect to mention Smith's criticisms of capitalism. The advice of businessmen to governments, he warned, "ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined . . . with the most suspicious attention. It comes from an order of men, whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even to oppress the public." Moreover, the pursuit of self-interest does not always benefit society as a whole: "People of the same trade seldom meet together," he wrote, "but the conversation ends in a conspiracy against the public."

Perhaps most telling was Adam Smith's concern that the rise of the factory system, which he hoped would lead to a more affluent future, might, in fact, bring about the degradation of human labor. Pointing out that division of labor results in specialization of tasks, and noting that peoples' intellectual capacities "are necessarily formed by their ordinary employments," Smith concluded as follows: "The man whose whole life is spent in performing a few simple operations . . . has no occasion to exert his understanding. . . . He naturally loses, therefore, the habit of such exertion, and generally becomes as stupid and ignorant as it is possible for a human creature to become."

Sources: Robert Heilbroner, *The Worldly Philosophers* (New York: Simon & Schuster, 1999), Ch. III; Andrew S. Skinner, "Adam Smith" in John Eatwell et al., eds., *The New Palgrave: A Dictionary of Economics* (London: Macmillan, 1987); Emma Rothschild, *Economic Sentiments: Adam Smith, Condorcet, and the Enlightenment* (Cambridge, Mass.: Harvard University Press, 2001); Adam Smith, *The Wealth of Nations* (New York: Random House, 1937), Book I, Chs. II, VIII, X, XI; Book IV, Ch. IX; Book V, Ch. I.

who feed, clothe and lodge the whole body of the people should have such a share of the produce of their own labor as to be themselves tolerably well fed, clothed and lodged." However, in another part of the book he observed: "Wherever there is great property, there is great inequality. For one very rich man, there must be at least five hundred poor, and the affluence of the few supposes the indigence of the many." Not one to shy away from hard facts, Smith went on to say: "Civil government, so far as it is instituted for the security of property, is in reality instituted for the defense of the rich against the poor."

KARL MARX

The second major contributor to political economy was the 19th-century economist and philosopher Karl Marx. If Smith was capitalism's prophet, Marx was its critic. His contribution was to reformulate the classical economists' theories in such a way as to provide the original version of what in this book is called the three-dimensional approach to economics, or political economy.

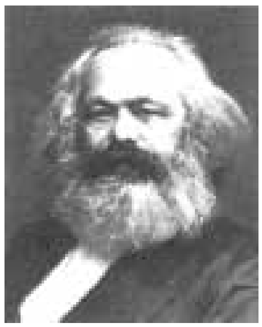
Marx first mastered the theories of the classical economists—Adam Smith, David Ricardo, and others—and then developed a criticism of their ideas and an alternative way of looking at capitalism. While the classical economists writing at the time of the birth of capitalism had believed that the emerging capitalist economy would work for the benefit of all, Marx and his frequent coauthor, Friedrich Engels, had seen enough of the real history of capitalism to have a different view. They saw the immense productivity of modern industry juxtaposed with the grinding poverty and economic insecurity of England's new industrial towns. Marx argued that there were three elements that needed to be emphasized in, or added to, the classical economists' models.

First, there is conflict as well as harmony when it comes to economic interests. When two individuals trade with each other in a voluntary exchange, both benefit—otherwise why would they trade? This is the lesson of neoclassical economics, for which economics is mostly the study of exchange (or competition). But not all exchanges result in equal benefits for all the parties to them. Marx noted that the conditions under which people make trades—remember the robber's terms, "Your money or your life!"—affect the outcomes of those trades. He argued, moreover, that the exercise of power, coercion, and force (what we call "command") is a significant factor in most economic systems.

With regard specifically to capitalism, Marx observed that some people (employers) own the productive assets such as land, factories, and office buildings, while most people (workers) do not own these types of assets. The result is that there are differences in power as well as income, and these differences shape the economic relationships among the different classes of people in a capitalist economy.

Second, Marx expanded on Adam Smith's ideas about self-interest by observing that groups as well as individuals may act together to defend and advance their interests. Conventional economic textbooks focus on competitive market relations and on individual economic actors or agents. But people often act cooperatively in groups, and an approach that focuses exclusively on individual competitive behavior will miss this important aspect of human interaction.

KARL MARX: CRITIC OF CAPITALISM (1818–1883)



Few scholars have been as revered or as hated as Karl Marx. Though he was born in Germany and began his career as a journalist there, he spent a good part of his early years on the run. His newspaper, *Rheinische Zeitung,* was closed by the government because in it he advocated freedom of the press and other democratic rights unpopular with the autocratic rulers of the day. Seeking a more tolerant environment, he moved to Paris but was soon expelled for writing articles exposing poverty and economic injustice and advocating radical solutions to these problems. In 1848 he moved to London with his wife and family, often barely making a living by writing articles for such newspapers as the *New York Daily Tribune.* (His mother once commented, "Karl, I wish you would *make* some capital instead of just writing about it.") He remained in England, writing *Capital* and working with his friend and sometime coauthor, Friedrich Engels, until his death in 1883.

Capitalism, according to Marx, is an economic system that constantly expands the potential of society to harness science and human labor so as to meet the needs of people. In *The Communist Manifesto*—probably the most widely read pamphlet ever published—Marx and Engels wrote: "The bourgeoisie [meaning the capitalist class], during its rule of scarce[ly] one hundred years, has created more massive and more colossal productive forces than have all preceding generations together."

Marx dedicated the latter half of his life to a study of the capitalist economy. But he believed that an alternative to capitalism—he called it communism—could continue or even speed up the growth of the economy's productive potential while at the same time making better use of this potential. However, of the thousands of pages that Marx wrote, only a handful outlined his vision of a post-capitalist society. His main interest was in understanding how capitalism worked, not in designing an alternative to it

Marx advocated democratic reforms that were considered radical at the time, including the direct election of political leaders by universal suffrage, and he termed the American Civil War and the end of slavery "the one great event of contemporary history." But as Marxism became the official dogma of communism following Marx's death, these democratic ideas fell by the wayside. The leaders of the Soviet Union, China, and other Communist nations imposed forms of dictatorship far more oppressive than those Marx had criticized as a young journalist. As these countries abandoned their Communist systems starting in the late 1980s, the official dogmas bearing Marx's name fell into disuse. In spite of this

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(or perhaps because of it), many of Marx's ideas, including the importance of the economy as a factor in historical change, the division of societies into classes, and the contribution that conflict sometimes makes to progress, have become widely accepted even by people who might be surprised to know the origin of their ideas.

Sources: David McLellan, *Karl Marx: His Life and Thought* (New York: Harper & Row, 1973); John Cassidy, "The Return of Karl Marx," *The New Yorker,* October 20/27, 1997, pp. 248–259.

Of course, there exist many different groups, and these groups may be of different sizes, may have overlapping memberships, may be tightly or loosely organized, and may have different purposes. Thus, there are football fans, steel manufacturers, corn farmers, blacks, and Catholics, to mention just a few examples. Marx emphasized the importance of *economic classes* such as workers and employers or slaves and slave owners. Within such classes, he argued, people often act together to promote their common interests while also taking care of, or possibly even advancing, their own individual interests. We define and flesh out the concept of class in the chapters that follow.

Marx argued that capitalism itself is an obstacle to the full development of a society's productive potential. This is because, in his view, the conflictual owner-worker relationship at the heart of a capitalist economy blocks the adoption of many advances in technology and knowledge that, even though they would increase productivity, would also reduce the rate of profit of certain companies or eliminate jobs in a particular industry and would therefore be resisted by the companies involved or the unions representing the workers who would be displaced. Examples of these problems might include the opposition by oil companies to the development of alternative energy sources, the resistance (in the past) of dockworkers' unions to the introduction of container shipping technology, and music companies' attempts to design "copy-proof" systems of sound reproduction. More generally, in a capitalist society the pursuit of private economic gain, in Marx's view, consumes human intelligence and energy that might otherwise be directed toward meeting human needs.

Third, Marx emphasized that economic systems change over time, especially in response to their own operations. Rather than thinking of an economic system as a fixed set of relationships (for example, competitive markets and voluntary exchange), he insisted that the operation of an economic system itself tends to change the conditions within which economic activity is carried on. Marx argued specifically that capitalism fuels economic change, leads to the growth of cities, propels increases in material abundance, induces global migrations, fosters changes in family life, and will ultimately bring about its own destruction.

JOSEPH SCHUMPETER

A third great contributor to political economy was Joseph A. Schumpeter, an early 20th-century lawyer, financier, businessman, and economist who was born in what is now the Czech Republic, spent much of his life in the European academic and business worlds, and, from 1932 until his death in 1950, was a distinguished professor of economics at Harvard University. Schumpeter tackled the big problems in economics. The title of his most

JOSEPH SCHUMPETER: ADVOCATE OF "CREATIVE DESTRUCTION" (1883–1950)

The aristocratic and the modern were inextricably combined in Joseph Schumpeter. The paradoxes of this great economist, who also served as minister of finance in the post–World War I government of Austria, are suggested by the fact that at his first teaching post, he challenged the university librarian to a duel to win freer access to books for the students.

Perhaps Schumpeter was attracted to the big issues because he himself witnessed drastic changes in society. He was raised in pre–World War I Vienna, a city dominated by a glittering aristocracy made rich by the immense wealth of triumphant late 19th-century capitalism. The city was a center of splendorous art, music, opera, palaces, and balls. Yet there was an air of impending doom in Viennese high society. The propertied classes were imbued with a sense that this privileged and beautiful life could not last. Poor working people crowded the industrial districts of the city, and the whole Austrian empire, of which Vienna was the capital, tottered. Bourgeois life seemed like an overripe fruit ready to drop as soon as the tree was shaken. Although Schumpeter identified with the aristocracy and valued its culture, he could see that capitalism was an enormously dynamic system, one that was continually changing society and disrupting established (and by Schumpeter cherished) institutions.

Although Schumpeter was a staunch defender of capitalism, he had a gloomy view of its future. Just after World War II and a year before his death, he warned the American Economic Association of what he termed "the march into socialism." He believed that capitalism would solve the production problems of society, but he also thought that its success would sow the seeds of its own demise. Specifically, he anticipated that large organizations, because of their bloated bureaucracies, would destroy the climate for innovation, and he also predicted that the intellectual classes would turn against the system, removing its cultural and ideological legitimacy. Thus, after beginning his speech to his economics colleagues saying "I do not advocate socialism," he went on to suggest that he was not hopeful about the future of capitalism: "Capitalism does not merely mean that the housewife may influence production by her choice between peas and beans; or that the youngster may choose whether he wants to work in a factory or on a farm; . . . it means a scheme of values, an attitude toward life, a civilization—the civilization of inequality and of the family fortune. This civilization is rapidly passing away."

Unlike so much of what Schumpeter wrote, this assessment has not been borne out by history—or at least not yet. The decades following Schumpeter's warning were in many ways a golden age for the capitalist economy in America, Europe, and elsewhere.

Sources: Robert Loring Allen, *Opening Doors: The Life and Work of Joseph Schumpeter,* 2 vols. (New Brunswick, N.J.: Transaction Publishers, 1991); Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper & Row, 1942), pp. 83, 416, 419.

famous book, *Capitalism, Socialism, and Democracy*, indicates the range of his intellect and interests. He added to our understanding of capitalism in three ways.

First, he deepened Marx's argument that capitalism creates change, once saying that "Capitalism is by nature a form or method of economic change and not only never is, but never can be stationary."[1] For Schumpeter, change—our time dimension—had to be central to any economic theory. Among his many novel ideas, the most powerful are his theories regarding innovation, on the one hand, and disruptive change, on the other. He called the connection between the two "creative destruction" and applied the term not only to technological innovation but to organizational and social change as well. Capitalism, he wrote, constantly revolutionizes economic institutions and creates new ones. For progress to occur, old methods of doing business must be disrupted in a creative burst. The idea of creative destruction is that old ways must be destroyed to create the basis for new leaps forward.

In Schumpeter's view the important thing about competition is not what is presented in conventional economics textbooks: price competition taking place among small firms under unchanging circumstances. Rather, for him the significance of competition lies in the incentives it provides for firms to achieve monopolies and breakthroughs based on continuous profit seeking and innovation. For Schumpeter, then, it seemed appropriate to explain competition not with mechanical analogies but rather with references to military strategy and counterstrategy.

Second, Schumpeter argued that innovations combined with the competitive edge conferred by advantages of large-scale production result in a tendency for large businesses to dominate small businesses in a capitalist economy. His views on innovation and creative destruction brought Schumpeter to see large-scale enterprises in a novel way. Whereas conventional economics textbooks usually present big businesses as impediments to competition and hence as a source of inefficiency and misallocation of resources, Schumpeter argued that such companies make possible the concentration of resources required for making big innovative jumps. Whereas the conventional textbooks focus on the negative effects of a monopoly at a particular moment in time, Schumpeter envisioned the dynamic potential inherent in concentrations of economic power. We consider this point further in a later chapter.

Third, Schumpeter looked at the broad history of capitalism and wrote about what have come to be called "long waves," or "long swings," in economic activity. A long swing, also known as a "Kondratieff cycle" in memory of the early 20th-century Russian economist who first noticed it, is an extended period of prosperity, or boom, that lasts perhaps for 20 or 30 years and is followed by a lengthy period of stagnation, or economic hard times.

JOHN MAYNARD KEYNES

Considered by many to be the greatest economist of the 20th century, the Englishman John Maynard Keynes was another very important contributor to political economy. Combining theory with practice, he gave advice to the British government before and during World War II and also played a major role at the 1944 Bretton Woods (New Hampshire)

[1] Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper & Row, 1942), p. 82.

conference that established the institutional framework, including the International Monetary Fund and the World Bank, for the postwar global economy.

Keynes greatly influenced both neoclassical economics and political economy. However, the version of Keynesian theory that appears in conventional economics textbooks today—Keynes's collaborator Joan Robinson termed it "bastard Keynesianism"—does not accurately convey the ideas of this great economist.

Keynes's main contribution to political economy was to provide a model of the capitalist economy as a whole. Pioneering what is now called "macroeconomics," Keynes observed that in a modern capitalist economy there are often unemployed people looking for work while at the same time there are underutilized factories. He concluded that government intervention is needed to overcome chronic unemployment.

In neoclassical economic theory, unemployment exists only as a temporary problem as people move between jobs. Before Keynes many economists reasoned as follows: in a competitive labor market the wage will settle at the level at which the supply of labor by workers will be exactly equal to the demand for labor by employers—hence the presence of unemployment is only a sign that some workers are asking for a wage that is too high. In the neoclassical model, then, unemployment is either *temporary* or *voluntary unemployment,* brought on by workers themselves asking for a higher wage than the one that would equalize the supply of and demand for their labor. Accordingly, all but temporary unemployment could be eliminated if workers would only agree to work for a lower wage. (We explain in Chapter 8 how "supply" and "demand" interact in markets.)

Some economists today analyze employment and unemployment in the same way that they explain why lowering the prices of automobiles will clear a car dealer's lot of unsold inventory. They believe that in every market there is an *equilibrium price* that equates supply to demand. The proposition is applied to the labor market by treating the wage as the "price" of labor. Thus, if the supply of labor is equal to the demand for labor, everyone who wants to work (that is, to supply labor) should be able to find a job. If there is unemployment, it can be eliminated in the same way the car dealer would move his unsold supply of cars out of the lot, that is by lowering the "price" of labor until the supply of it is equal to the demand for it.

Keynes rejected this reasoning. He argued that unemployment results not from wages being too high but from the demand for the goods that labor produces being too low. And if the problem is insufficient demand for output, said Keynes, the cure might be to raise rather than cut wages. His reasoning was that since wages pay for the goods people consume and thus make possible a large part of the demand for the output of the economy, higher wages might lead to an increase in demand that, in turn, would lead to an expansion of output, increased employment, and less unemployment.

Keynes's theory demonstrated (a) that capitalism has no automatic mechanism for eliminating unemployment and (b) that unemployment in a capitalist economy may well be *involuntary unemployment,* that is, unemployment that would not go away even if wages were lowered. Published in 1936, shortly after the Great Depression had driven the rate of unemployment in the U.S. up to 25 percent, Keynes's most important book, *The General Theory of Employment, Interest, and Money,* took the economics profession by storm. In his book Keynes challenged Adam Smith's view of the economy as a self-adjusting mechanism and advocated a type of government intervention in the economy that would regulate total demand for output in order to reduce unemployment.

JOHN MAYNARD KEYNES: SAVIOR OF CAPITALISM (1883–1946)

John Maynard Keynes was born in the same year in which Karl Marx died. Keynes was no revolutionary, but his ideas revolutionized 20th-century economics.

Keynes spent much of his career at Cambridge University, first as a student and then as a teacher, as an editor of a professional journal, and as a writer of numerous articles and books on economics. He was also a leading member of the elite English literary circle known as the Bloomsbury Group, and the story of his personal life includes a number of serious romantic and sexual relationships with men as well as a long-lasting and passionate marriage to the famous Diaghilev ballerina Lydia Lopokova.

Keynes served both as a director of the Bank of England and as the financial adviser to Cambridge University's King's College, where he had been a student and subsequently became a highly regarded member of the faculty. His speculations in financial markets increased the assets of King's College 10-fold. In reward for his important service to the British government, Keynes was appointed to the House of Lords by the king of England.

Because some think that Keynesian policies prevented a second Great Depression, Keynes is often credited with having saved capitalism. If so, it was not out of love for the capitalist system. In 1933 he wrote: "The decadent international but individualistic capitalism, in the hands of which we found ourselves after the [First World] War, is not a success. It is not intelligent, it is not beautiful, it is not just, it is not virtuous—and it doesn't deliver the goods. In short, we dislike it and we are beginning to despise it. But when we wonder what to put in its place, we are extremely perplexed."

Though he favored a larger role for government and advocated policies to reduce unemployment, he did not think of himself as a socialist or as an ally of the working class: "When it comes to the class struggle as such," he wrote, "my [own] personal patriotisms . . . are attached to my own surroundings . . . [and] the class war will find me on the side of the educated bourgeoisie."

Sources: Robert Skidelsky, *John Maynard Keynes,* 3 vols. (New York: Viking Penguin, 1986, 1994, 2001); J. M. Keynes, "National Self-Sufficiency," *The Yale Review,* vol. 22, summer 1933, pp. 755–769; J. M. Keynes, "Am I a Liberal?" (1925), in *Essays in Persuasion* (New York: Norton, 1963), pp. 323–338.

Keynes explained that the process of investment and growth in a capitalist economy depends on a precarious balance between what are now called the cost conditions affecting investment and the demand conditions affecting investment. Left to its own devices, he argued, a capitalist economy is not likely to achieve this balance in such a way as to provide jobs all the time for all who seek them. For this reason Keynes urged the adoption of policies that, when necessary, would increase the government's demand for goods and services. Such policies, he argued, could help to maintain a level of total demand (including also that of consumers and businesses) sufficient to ensure both full employment and adequate profits.

Because he supported the idea of more government involvement in the economy, Keynes's theories were initially regarded as "dangerously radical" by some business groups. But what came to be known as Keynesian economics gradually became the accepted basis of government policy. John F. Kennedy, a Democrat elected in 1960, is considered to have been the first Keynesian president, but it was a Republican president, Richard Nixon, who proclaimed a decade later: "We are all Keynesians now." Partly as a result of the spread of Keynes's ideas in the advanced capitalist countries, major depressions have been avoided in the post–World War II era, and unemployment rates have been generally lower than they had been before the war.

RECENT DEVELOPMENTS

During the last half of the 20th century, economics, which had long since ceased to be called political economy, became a unified but increasingly narrow field of study strongly influenced by Adam Smith's "invisible hand" metaphor and, to a lesser extent, by the work of John Maynard Keynes. In economics courses students rarely encountered the ideas of Joseph Schumpeter, and those of Karl Marx were hardly taught at all. Thus, the workings of markets became the main focus of economics. The "creative destruction" occasioned by technical change and economic progress and the class conflicts arising from economic inequalities were thought to be of little interest. Of the three dimensions of what we term three-dimensional economics—competition, command, and change—only the first was seriously studied. Command and change were relegated to political science, history, or other disciplines. The "one-dimensional" approach, described in the previous chapter as *neoclassical economics*, eclipsed its rivals, except in the Communist countries, where a crude version of Marxian economics ("bastard Marxism") dominated the curriculum.

However, as the mainstream of 20th-century academic economics moved further and further away from the ideas of Schumpeter and Marx, the real-world problems that had stimulated their thinking stayed around in one form or another. As described in Chapter 1, the global economy continued on its lurching course, buffeted by rapid technological developments, climate change, and a widening gulf between the world's haves and have-nots. Conflicts within and between nations continued unabated, and the role of hierarchy—command—in economic life was at least as prominent at the end of the 20th century as it had been a century earlier.

It is not surprising, then, that a series of innovations occurred in the discipline of economics in the final quarter of the 20th century, some of which are now widely accepted and commonly taught in economics courses. A few of the new ideas were set forth earlier in the century but came to be fully appreciated only in recent decades. For example, game theory, the study of how individuals interact strategically (buying, selling, bargaining, threatening, commanding, and submitting), was developed just after World War II by several scholars, including John Nash (played by Russell Crowe in the film *A Beautiful Mind*). Only recently, however, has game theory become widely studied and practiced in economics. It is introduced in Chapter 9 of this book with accounts of "the prisoner's dilemma" and "the tragedy of the commons."

Some of the late 20th-century innovators in economics won Nobel Prizes. Recent honorees include Douglass North and Robert Fogel, who focused mainly on economic institutions and their history; Gary Becker, who expanded the scope of economics to include analyses of the family, schooling, addiction, and crime; Kenneth Arrow, who is at once one of the greatest contributors to neoclassical economics and one of its most trenchant critics; Joseph Stiglitz and George Akerlof, who challenged the neoclassical economists' theory of how markets work; and Daniel Kahneman and Herbert Simon, whose contributions were in the psychology of individual behavior (they were not even economists by training). Also among the Nobel Laureates who have made major contributions to contemporary economics are Ronald Coase and Amartya Sen, both of whom advocate taking an interdisciplinary approach to the study of economic problems. It is an irony as well a tribute to his intellect that Coase is considered to be a conservative even though one of his most important ideas is an extension of some of Karl Marx's thinking. It is equally ironic that Amartya Sen, usually considered a progressive economist, derived much of his inspiration from some long-ignored ideas of Adam Smith.

RONALD COASE

This great 20th-century thinker made two important contributions to political economy. First, he showed that, with its exclusive focus on market interactions, neoclassical economics cannot explain some very important aspects of a modern economy unless its approach is broadened. Second, he found a way to specify precisely the conditions under which a completely unregulated market economy would achieve efficient (if possibly unfair) solutions to problems.

At the age of 27 (in 1937), Coase posed a question that shocked many economists: if market competition is as good as Adam Smith and his successors claim it is, why do we have anything *other than* markets? In particular, why do we have entities called "firms," ranging in size from dozens to hundreds of thousands of people, that are organized not by exchange relations but by command relations, with some people (supervisors, executives) giving orders to other people (workers)? In his pioneering and now classic article "The Nature of the Firm," Coase made the following statement: "It is important to note the character of the contract into which a [worker] enters [when he or she] is employed within a firm." With regard to the "character" of such an employment contract, Coase went on to say that the worker "for certain remuneration . . . agrees to obey the directions of an entrepreneur [employer]."

Having introduced the concept of obedience to authority, Coase proceeded to define the firm with reference to its *political,* not its market, structure: "If a workman moves from department Y to department X, he does not go because of a change in prices but because he is ordered to do so . . . [T]he distinguishing mark of the firm is the suppression of the price mechanism." Coase then observed, quoting one of his contemporaries, that firms are to the market like "islands of conscious power in this ocean of unconscious cooperation[,] like lumps of butter coagulating in a pail of buttermilk."[2] Writers after Coase have referred to the authority structure of the firm as a "visible hand" that works in combination with Smith's invisible hand. The everyday fact that employers exercise power over their employees—not news to most employees—had been a central theme in Marx's economics, but it was (and generally continues to be) overlooked by most neoclassical economists.

Early in his studies Coase noted the similarity between the hierarchical organization of capitalist firms, with their reliance on command relations, and the then-existing system of centralized economic planning in the Communist countries, where production was carried out in accordance with orders from higher authorities and where market competition played little role. This similarity intrigued Coase because most economists, then as now, believed that economies based on command relations do not work very well.

Coase stated the issue as follows: "How [does] one reconcile the views expressed by economists on the role of the pricing system [markets] and the impossibility of successful central economic planning with the existence . . . of these apparently planned societies, firms, operating within our own society?" Answering his own question, he first noted that there are costs of carrying out exchanges—for example, finding someone to exchange with, haggling over prices, and making sure that a contract is fulfilled—and he called such costs *transactions costs.* Using this novel concept, he then went on to argue that for some kinds of activities, at least, the cost of running things from the top down is less than the cost of getting them done with reliance only on market exchanges. His conclusion was that firms exist because the transactions costs of organizing what they do by command are less than the transactions costs would be of organizing the same activities by market exchanges.

Coase's idea had the ring of truth about it. Imagine how much time and effort would be wasted if, instead of being organized in a team with a boss, workers on a production line were all independent contractors, each contributing to the completion of a product, pausing to sell it to the next person on the line, and then turning to the person "upstream" to buy another less complete product. Alternatively, imagine the cooks at a fast food restaurant selling cooked burgers to the wait staff, who then sell them to the customers.

The idea of transactions costs has become central to our understanding of how markets work, why they do not work well in certain situations, and when nonmarket organizations such as families, firms, and governments may do a better job of organizing production. Where transactions costs are substantial—and Coase believed that this is just about everywhere—neoclassical economics falls short. He summarized his critique as follows: "In an economic theory which assumes that transactions costs are non-existent, markets have no function to perform and it seems perfectly reasonable to develop the theory of exchange by an elaborate analysis of individuals exchanging nuts for apples in the edge of the forest or some similar fanciful example."

In the real world, economic activities take place not only in markets but also in institutions such as firms and families. And nonmarket transactions differ in important ways from market exchanges. As we explain in later chapters, the employment of labor, the

[2] The quotations from Ronald Coase here and in the preceding paragraph are from Ronald Coase, "The Nature of the Firm," *Economica*, vol. 4, 1937, pp. 386–405, as reprinted in Louis Putterman and Randall Krozner, eds., *The Economic Nature of the Firm: A Reader*, 2nd ed. (New York: Cambridge University Press, 1996), pp. 89–104.

taking out of loans, and even purchases of new computer systems are hardly the same as buying and selling nuts and apples. The varieties of capitalism in the world today are distinguished from one another by how they govern transactions in firms, markets, governments, and other institutions.

Coase's other big idea was to point out that one does not necessarily need the invisible hand of the market to make a completely decentralized laissez-faire economy work; unimpeded private bargaining might do the trick.

A classic argument against the invisible hand and in favor of government regulation focuses on situations in which the activities of one person (or firm) impose costs on another (or others). In these situations, such as environmental pollution, for instance, there are what economists call *spillover* effects (or externalities). (These were defined in Chapter 3 and are discussed at length in Chapter 9.)

Taking the now-quaint example that Coase himself used, suppose that a railroad passes through farming country and that the grass in fields adjacent to the tracks is occasionally set on fire by sparks from passing engines (the trains he was referring to were still pulled by coal-fired steam engines). Before Coase it was taken for granted that railroads should be held liable in a court of law for any such damages done to farmers' fields. Alternatively, it was held that the government should simply require the railroad to install "spark-free" engines.

Coase's response to the problem was both surprising and ingenious: the engines should be redesigned only if the damage they imposed on farmers was greater than the cost to the railroad of redesigning the engines. But if this were really the situation, the farmers would presumably offer the railroad a sufficient sum to motivate it to retire the offending engines. In this case, both parties might come out ahead: the farmers would end up with more value in their fully-grown crops than it cost them to pay the railroad, and the railroad would be better off with whatever amount of cash the two parties had agreed on than it would have been if it had been sued in court for the entire amount of the damages or if its incendiary engines had been banned by the government.

In this case there seems to be no need for government regulation: a satisfactory solution to the problem is available privately by means of bargaining between the farmers and the railroad over the appropriate payment in return for the redesign of the engines. However, such a solution is possible under only two conditions. The first is that both parties have clearly established property rights to whatever is involved in the conflict. (This condition does not exist in many spillover situations, such as environmental pollution, when the air or water affected belongs to nobody in particular.) The second condition is that there be no impediments hindering either party's ability to bargain with the other party. This would be the case only in situations in which there are no transactions costs.

Coase did not argue that the farmers (not the railroad) should actually pay for the redesign of the coal-fired engines: the question of who pays is an entirely different issue. He simply pointed out that *in the absence of transactions costs,* the spillover problem can (theoretically) be solved in many situations without government regulation. The extent to which transactions costs hinder the bargaining is something that must be factually determined on a case-by-case basis. If there were just a single farmer, for example, bargaining would be a lot less costly than if there were a thousand, and the situation would be more complicated if there were some farmers with fields near the rail line and some whose fields were more distant from it.

RONALD COASE: THE INVISIBLE HAND AND THE VISIBLE HAND (1910–)

When Ronald Coase received the Nobel Prize at the age of 81, he recalled that while growing up in England at the time of World War I, he was "often alone [but] never lonely." "When I learnt chess, I was happy to play the role of each player in turn." A taste for solitude would serve him well, for he was to be a maverick: his first published article, "The Nature of the Firm," written in his mid-20s, was ignored for decades.

Both of his parents had left school at the age of 12, and both worked at the Post Office. Coase's own education was somewhat haphazard, with a false start in chemistry ("the mathematics was not to my taste"). That he won the Nobel Prize in Economics, he explained at his award ceremony, "was the result of a series of accidents." One such "accident" had to do with the origin of his most famous article, "The Problem of Social Cost." A group of professors at the University of Chicago—among them some of the leading exponents of conservative laissez-faire economics—had read a paper by Coase and considered it to be mistaken. They invited him to dinner to correct his error, but it was Coase who prevailed, and they then persuaded him to repeat his reasoning in print. It was this paper that made the so-called Coase Theorem famous and, more than anything else, won him the Nobel Prize. There is actually no theorem—there is not a single equation in the article (remember his math aversion)—but one of his dinner partners that night thought it would be catchy to call the idea a theorem, and the term caught on. Shortly thereafter he was offered a professorship at the University of Chicago Law School, where he taught until his retirement in 1979.

Because the so-called theorem appeared to advocate a limited economic role for government, Coase became a hero of many conservative economists and business groups. But, in fact, he was a critic of the then-dominant neoclassical approach to economics. Eschewing the highly abstract and mathematical approach of most economists, he urged others "to write about the way in which actual markets operate and about how governments actually perform." He chided his fellow economists for knowing little about the institutions of a capitalist economy and for giving bad advice to other countries, especially those that had rejected communism in the early 1990s: "Without the appropriate institutions no market economy of any significance is possible. If we knew more about our own economy, we would be in a better position to advise them."

Sources: Ronald Coase, autobiography, published on the Nobel Prize website: http://www.nobel.se/economics/laureates/1991/coase-autobio.html; Ronald H. Coase, "The Nature of the Firm," *Economica*, vol. 4, 1937, pp. 386–405; Ronald H. Coase, "The Problem of Social Cost," *Journal of Law and Economics*, vol. 3, no. 1, 1960, pp. 1–44; Ronald H. Coase, "The Institutional Structure of Production," *American Economic Review*, vol. 82, no. 4, 1992, pp. 713–719; Ronald H. Coase, *The Firm, the Market and the Law* (Chicago and London: University of Chicago Press, 1988).

Art Source: From Mark Blaug, *Great Economists since Keynes: An Introduction to the Lives and Works of One Hundred Modern Economists* (Cambridge University Press, 1985).

The key assumption—the absence of transactions costs—is crucial, and it is often ignored by advocates who use Coase's work to support their arguments against government regulation of business activities, such as those that degrade the environment or result in other spillovers. Coase himself made the implications of his work clear: "Of course it does not imply, when transactions costs are positive, that government actions . . . could not produce a better result than relying on negotiations between individuals in the market. Whether this would be so could be discovered not by studying imaginary governments but what real governments actually do. My conclusion: let us study the world of positive transactions costs."

AMARTYA SEN

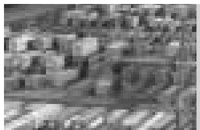
Like Ronald Coase, Amartya Sen is also motivated by concerns about the world as it really is, but Sen's contributions are of an entirely different nature. Addressing deep philosophical issues and often using advanced mathematical techniques, Sen has taken up precisely the questions of fairness that Coase set aside in his famous "theorem."

What does it mean to say that someone is "well off" or " better off" than another person? How can we measure these things? And how can policies help to establish conditions that allow most people to be well off? Sen begins his paper "The Economics of Life and Death" with the following statements: "Economics is not solely concerned with income and wealth but also with using these resources as means to significant ends, including the promotion and enjoyment of long and worthwhile lives. If, however, the economic success of a nation is judged only by income . . . the important goal of well-being is missed." Well-being, to Sen, requires more than *having* things; it requires *being able to do* things, or what he terms *capabilities*. Of course, the goods and services that income can buy are crucial to well-being in Sen's sense, but they are a *means* to well-being, not ends in their own right. More than income is required.

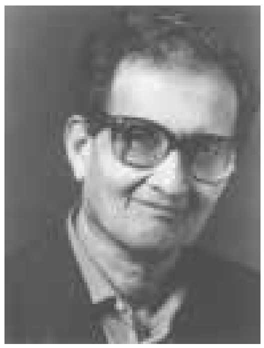
Sen points out that some very poor people—for example, the populations of China, Sri Lanka, and the Indian state of Kerala—are much healthier on average than are poor people in countries five times richer (by the standard of average income) such as Brazil and South Africa. The difference is due to two things. First, income is very unequally distributed in Brazil and South Africa, so the poor in those countries suffer severe deprivation of nutrition and other necessities. Second, Kerala, China, and Sri Lanka have adopted public health policies that address many of the needs of the most vulnerable members of their populations.

Rather than measuring the economic development of nations by such indexes as average income and then devising policies to raise income levels, Sen proposes that we make our concept of well-being explicit. He begins his book *Development as Freedom* with these words: "Development can be seen . . . as a process of expanding the real freedoms that people enjoy. . . . If freedom is what development advances, then there is a major argument for concentrating on that overarching objective rather than some particular means." Sen goes on to say that "Development requires the removal of major sources of unfreedom," including poverty, poor economic opportunities, systematic social deprivation, intolerance, neglect of public facilities, tyranny, and repressive states.[3]

[3] Amartya Sen, *Development as Freedom* (New York: Random House, Anchor Books, 2000), p. 3.



AMARTYA KUMAR SEN: FREEDOM AND FAMINE (1933–)



Amartya Sen was born on a university campus in Santiniketan, near Calcutta, and wrote in his autobiography: "I . . . seem to have lived all my life in one campus or another." He has taught at Harvard, Oxford, and Cambridge Universities, the Delhi School of Economics, and the London School of Economics, and he has also served as president of the American Economic Association. Yet his contributions to economics extend from the highly abstract to the very practical. There are few economists about whom one can say with confidence "this person's research has saved lives." In the case of Sen one could say "millions of lives." Two childhood experiences shaped his career.

In his childhood home of Dhaka (now in Bangladesh), religious intolerance was rampant, and tensions ran high between Hindus and Muslims. One afternoon a man came to Sen's parents' home screaming in pain. He was a poverty stricken Muslim who had been seeking work in the mostly Hindu neighborhood. He had been stabbed in the back by a mob of Hindus. His wife had warned him not to seek work in a Hindu neighborhood, even though their family was in dire straights. Sen's father rushed the man to the hospital, but he died there of his wounds. "The experience devastated me," Sen later wrote in accepting the Nobel Prize; "it alerted me to the . . . fact that economic unfreedom, in the form of extreme poverty, can make a person a helpless prey in the violation of other kinds of freedom."

The second formative experience for Sen, also occurring before he was a teenager, was the Bengal famine of 1943. Though 2 to 3 million people perished, he later wrote: "I had been struck by its thoroughly class-dependent character. I knew of no one in my school or among my friends and relations whose family had experienced the slightest problem during the entire famine; it was not a famine that afflicted even the lower middle classes—only people much further down the economic ladder, such as landless rural laborers."

Not surprisingly, Sen's life work has addressed questions of poverty, inequality, freedom, and intolerance, reaching far beyond the usual confines of economics. In an article in *Scientific American* he showed that life expectancy is not only lower for African Americans than for European Americans, it is lower for African Americans even than for the people of China or the state of Kerala, one of India's poorest. He also documented the fact that in much of the world including India, Bangladesh, China, Pakistan, and the Middle East, female children do not have equal access to health care and nutrition. The result, he calculated, is that there are more than 100 million "missing women"—girls who did not survive their relative deprivation.

Continued . . .

In India Sen is a powerful voice for religious tolerance and for addressing the health and educational needs of the poor. Regarding antiglobalization protests, he has said: "Insofar as [the] protesters focus on the huge inequities of the world, they deserve a careful hearing, not a roughing up by [the police]." But he is for the most part a scholar, not an advocate: "I am used to thinking of the word 'academic' as meaning 'sound' rather than . . . 'unpractical,'" he remarked when accepting the Nobel Prize.

Sources: Amartya Sen, autobiography, published on the Nobel Prize website: http://www.nobel.se/economics/laureates/1998/sen-autobio.html; Amartya Sen, "The Economics of Life and Death," *Scientific American*, May 1993, pp. 40–47; Amartya Sen, "Addressing Global Poverty" in Dudley Fishburn, ed., *The World in 2002* (London: *The Economist Publications*, 2002), p. 50.

Art Source: Amartya Sen, *Development as Freedom* (New York: Alfred A. Knopf, 1999).

Given his concern for such values as freedom and tolerance, it is hardly surprising that Sen has explored the role of ethical norms in our individual behaviors. In contrast to the self-interested and amoral economic man that is the behavioral foundation of much of conventional economics, Sen observes that while selfish behavior is common, people also regularly act out of a concern (sympathy) for others, even for strangers. We also honor commitments to uphold moral norms even in circumstances in which we could benefit from violating them. (In Chapter 2 we presented evidence in support of this position.) In a paper titled "Rational Fools," Sen declares: "The purely economic man is indeed close to being a social moron."

In one of his most influential works Sen asked the very practical question: why do famines occur? The conventional answer was simple: too little food and too many mouths. But Sen showed that lack of food is rarely the cause of famine. For example, the 1974 famine in Bangladesh occurred despite the fact that per capita food availability was higher that year than it had been in the previous two years or was in the next year. The cause of the famine was massive unemployment caused by a weather-related disruption of planting activities that usually provided employment for vast numbers of poor landless workers. Without wages, the unemployed could not buy the available food, and as a result thousands starved. Moreover, as starvation spread, more affluent people began buying and hoarding large amounts of food, driving up its price and making it even further out of reach for the poor.

Thus, Sen showed that the famine resulted not from a lack of food but from an extremely uneven distribution of food caused by a very unequal distribution of income. The famine could easily have been averted had government policies been used to support the buying power of the poor. A contributing factor was that U.S. food shipments were held up during the famine (due to a dispute about Bangladeshi exports to Cuba), but the main failures were those of the government of Bangladesh. The fundamental problem, Sen argued, was governmental indifference to the plight of the very poor: "Famine is entirely avoidable if the government has the incentive to act in time. . . . No democratic country with a relatively free press has ever experienced a major famine."

The following table summarizes the contributions of these six great economists to the development of political economy.

TABLE 4.1 The Key Ideas of Six Great Economists

Adam Smith (1723–1790)	Labor is the basis of wealth; satisfaction of human needs is the measure of the wealth of a nation. The division of labor implies economic interdependence. Markets are self-regulating systems for the orderly coordination of the division of labor. The individual pursuit of self-interest in competitive market interactions has socially beneficial effects (that are brought about by "the invisible hand").
Karl Marx (1818–1883)	All known economic systems have divided societies into "haves" and "have-nots"—or "dominant" and "subordinate" classes. Members of classes work together in the pursuit of their common interests. Technical progress, the growth of knowledge, and conflict among classes all foster perpetual change. Capitalism as an economic system is irrational in the sense that it does not allow full use of modern science and technology to meet human needs.
J. Schumpeter (1883–1950)	The key to progress is innovation, and capitalism above all other economic systems fosters innovation. The operation of a modern economy is determined by a relatively small number of large-scale organizations—businesses, unions, and governments—rather than by a large number of small businesses and individuals. The growth of the capitalist economy is uneven: periods of prosperity and stability alternate with periods of stagnation and instability.
J. M. Keynes (1883–1946)	The market system is not self-regulating: left to its own devices the market system fails to make sensible use of our productive potential. Unemployment is a chronic problem in a capitalist economy. Government intervention in the economy can reduce unemployment and instability.
Ronald Coase (1910–)	Bargaining among private individuals can often solve problems that governments or market exchanges cannot solve. Government policies should facilitate these private bargains. Firms are mini-command economies based on the giving and following of orders rather than on market exchange. Capitalism is a mixture of competition and command.
Amartya Sen (1933–)	Economic policy should seek to promote freedom, tolerance, and well-being. Famines are not the result of shortages of food. Rather, they result from shortsighted government policies and unequal distributions of income. Democratically elected governments are more likely to pursue policies that address problems of poverty.

Smith, Marx, Schumpeter, Keynes, Coase, and Sen (and many others) have all contributed to the development of political economy, or what we call the three-dimensional approach to economics. In the chapters ahead we do not always label a particular idea Smithian, Marxian, Schumpeterian, Keynesian, Coaseian, or Senian, in part because modern-day political economy builds on, integrates, and changes many of the ideas of these great economists in light of current realities. But you will no doubt recognize the general themes that these thinkers first introduced.

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