

**Module 7**  
**Some Important Heterodox Thinkers**  
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**Topics**

**6.4 Some important heterodox thinkers:**

**The Quasi institutionalist Paradigm**

**6.4.1 Joseph Schumpeter (1883 –1950)**

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## Module 7

### Lecture 41

#### Topics

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##### The Quasi institutionalist Paradigm

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#### 6.4 Some important heterodox thinkers

##### The Quasi institutionalist Paradigm

The modern institutionalist school consisting of Veblen, Commons, Mitchell and their followers remained a tightly knit group. However, there are other economists who followed the institutionalist approach but their line of work is too individualist to fit them in any group. In this lecture we discuss three such economists: Joseph Schumpeter, Gunnar Myrdal and John Galbraith.

##### 6.4.1 Joseph Schumpeter (1883 –1950)

Schumpeter was never interested about the equilibrium focused approach of neo classical economics. He was concerned about the dynamic aspect of the economies. He became famous for his concept of *creative destruction*. The idea of creative destruction deals with the destruction of old technology and products with the creation of new ones. This idea has been extensively used in endogenous growth theories. Schumpeter found the abstract models of economics limiting. He criticized the use of static models by the neo-classical group. He was not a Marxian even though he acknowledged the power of Marx's vision. He declared his interest and supports for the orthodox paradigm comprising mathematics and econometrics, even though his own

work mostly did not use these techniques. His major books include *The Theory of Economic Development* (1912), *Business Cycles* (1939) and *History of Economic Analysis* (1954).

#### **6.4.2 Gunnar Myrdal (1898-1987)**

- His major criticisms of orthodox economic theory center on the role of value judgments, the scope and methodology, and the implicit Laissez faire bias of the orthodox theory.
- Myrdal concludes that attempts by orthodox Economists theorists to develop a positive science free of normative judgments have failed. He maintained that it is impossible to separate normative from positive. He said that the normative judgments are implicit in so called positive orthodox theories.
- He another major criticism against orthodox theory is that it is too narrowly defined. He also criticized economics for being so conversed about short run. Like Schumpeter he was also more interested about long run is economics where we can look at the development aspects of an economy.
- He said that orthodox economics is pre-occupied with equilibrium which is inappropriate for analyzing social outcomes.
- Myrdal was very critical of the way orthodox theories promote laissez faire as the best policy to follow. Myrdal believed that in the post-World War era western countries are going through welfare statehood. In this phase government takes welfare measures in piecemeal fashion to ease the pressure off the society. Hence there is a lack of coordination which can be remedied by overall planning of macroeconomic goals.
- Orthodox theory of growth is based on the logic of capital accumulation. In his study Myrdal found that orthodox theory is not very helpful for explaining situations in LDCs.
- He finds that labor efficiency in LDCs are very low. So that capital accumulation will not deliver the desired result.

### 6.4.3 John Kenneth Galbraith (1908- )

Galbraith was a major critique of the orthodox economics but did not provide any alternative theoretical structure.

His major work consists of three books: *Countervailing power*, *The Affluent society* and *the new industrial state*.

#### **American Capitalism (1952)**

- The main view expressed in this book is that Economics adopts a narrow approach as it does not account for power and economics.
- Standard economics takes competition as the benchmark case and imperfect competition as the aberrations. From American economy experience however, it's very clear that Monopoly and Oligopoly are not aberrations but essence of the economy.
- He said that when competition declined following the rise of large corporations, another power started rising out of the customers or suppliers of the big corporations. He calls this power the *countervailing power*.
- For example, growth of large corporation led to the growth of powerful unions. This countervailing power keeps a balance in the economy by restraining the existing power.

#### **The Affluent society (1958)**

- While American capitalism focuses on the efficiency of resource allocation in the private sector, in affluent society he concentrated on allocation of resources between private and public.
- He said that the orthodox price theory is good to explain allocation problem in a society which is concerned about providing basic necessities. A society such as the American one has solved that problem and now moving towards the production of low priority goods.
- He finds that with increase in GDP focus has shifted to producing even more. He contends that this is because of unequal distribution of income, individual

insecurity and recurring economic depression. Societies try to solve these issues by having ever growing output.

- He maintained that in a traditional, scarcity based society preferences is exogenous. But in an affluent society desire is constructed by the producers
- This requires a completely new consumer theory which does not presuppose consumer sovereignty.

### **New industrial state (1967)**

- Nine years after the publication of *The Affluent Society*, New Industrial State was published.
- In this book he mainly criticized the orthodox theory of firm.
- He observed that Modern technology → Large scale firm. Large scale firms have the following characteristics

→ Separation of ownership and control.

→ Planning which includes the management of consumer preference is now essential.

- Orthodox theory assumes sovereign consumers who reveal their preference through price signal. Accordingly firms produce
- Galbraith says this sequence is a myth.

→ Firms can construct preference.

→ Social attitudes are constructed by techno structures.

- Hence, in American society, according to Galbraith, the sequence is reversed. It is the corporations which to a large extent can influence/control consumer's attitude.

- Affluent society and new industrial society project a darker reality than American Capitalism.
- However, going through Galbraith's work reveals some inherent inconsistencies. In American capitalism he was optimistic about the restraining capacity of countervailing which is completely missing in the next two books. In *The Affluent Society* and *The New Industrial State*, the corporations are the most powerful which can create demand and then meet then with supply. This provides a rather simplistic description of the society. Essentially this ignores all the inherent contradictions in a society.

#### **6.4.4 Neo-Ricardian School – Piero Sraffa (1898-1983)**

- Piero Sraffa was one of the most prominent economists of the twentieth century who mostly followed the classical tradition in critiquing the neo classical theories. His three main contributions were providing a critique of the Marshallian partial equilibrium approach, critiquing Hayek's macro theories, and re-formulating Ricardo's analysis. He also indirectly contributed to the theories of imperfect competition developed by Joan Robinson.
- Sraffa's baccalaureate thesis examined the Italian inflation. In this thesis he meticulously outlined the corrupt and collusive behavior on the part of the banks and the states which led to high inflation regime in Italy. His thesis mainly looked at two issues: i) the choice between price stabilization at the post-war parity with gold, or revaluation of the currency to its pre-war gold value; and ii) the choice between domestic price stability or exchange rate stability. In his thesis he defended stabilization against reevaluation and preferred domestic price stability to exchange rate stability.
- Sraffa came in touch with J.M.Keynes in 1921 and Keynes was very much impressed by Sraffa's scholarship. This was hardly surprising as Sraffa's formulation of the monetary system was remarkably similar to that developed by J.M.Keynes. At the invitation of Keynes, Sraffa published two articles on the state of Italian banking system which detailed the incompetence and corruption of the system.
- Sraffa's first article on purely theoretical problems was published in 1925 where he critiqued Marshallian partial equilibrium framework. His critique was however

similar to those which gave rise to the general equilibrium framework. His critique mainly discussed why the assumption of *ceteris paribus* (all other things equal) is generally a flawed assumption. Because the equilibrium in market for X will have an effect on another market Y which in turn will have effect on the market for X. He also detailed the problems of accommodating increasing and decreasing costs within the framework of perfect competition.

- Sraffa extended this argument in his 1925 article “The Laws of Returns under Competitive Conditions”. In this paper, he attempts to show how value theory might go beyond the first approximation of constant costs in order to accommodate non constant returns. His main position was that increasing return can be accommodated by abandoning the competitive framework. This can be done by recognizing that an industry’s output is typically limited by the difficulty of selling larger quantities of a good without lowering its price. What then logically follows from this position is a departure from the competitive framework. Unlike the competitive framework, where each firm faces an infinitely elastic demand which allows them to sell any level of output without lowering the price, in this framework each firm has its own distinct market characterized by a downward sloping demand curve.
- This theoretical framework proposed by Sraffa in 1926 provided the inspiration for Joan Robinson’s “The Economics of Imperfect Competition” which was published in 1933.
- However, by 1928, Sraffa had already abandoned the above mentioned theoretical framework as he was moving towards a more classical treatment of value and distribution.
- Sraffa’s next major theoretical contribution came in 1932 when he wrote a critical review of Hayek’s *Prices and Production* published in the Economic Journal. Sraffa’s review attacked the foundations of Hayek’s Austrian Trade Cycle Theory. Hayek’s theory starts from the postulate that there exists a natural rate of interest which equates saving and investment. In his view, business cycle occurs because banks tend to hold their money rates below the natural rate, thereby creating distortions in the economy’s capital structure.

- In his critique, Sraffa's showed the existence of multiple natural rates which, unlike the structure proposed by Hayek, converge to single equilibrium. Sraffa considered an economy where loans are made in physical units. In such an economy the difference between the spot and forward prices can be seen as the rate of interest. But such difference would be sector specific giving rise to a set of sectoral rates of return which is natural for that sector. Such rates are not the result of any equilibrating mechanism as suggested by Hayek. Sraffa argued that they will exist even if goods are exchanged out of equilibrium.
- Sraffa then argued that the cyclical fluctuations cannot be attributed to the divergence of the money rate from the natural rate as there are multiple natural rates all of which will diverge from one another when the economy is not in equilibrium.
- The main objective of Sraffa's analysis was to counter the policy prescription of Hayek -- constant effective money supply (stock of money multiplied by the velocity). Sraffa, based on his analysis, suggested that constant money supply would lead to decline in money prices for a growing economy. He viewed deflation as a devastating outcome for an economy which was not unnatural in 1930s where everyone was concerned about depression. The rationale behind his critique of Hayek was to theoretically undermine Hayek's theory which suggests the policy of restricted money supply. Sraffa argued that the main weakness of Hayek's theory is its inability to accommodate the *store of value* function of money.
- In the early 1930s Sraffa started editing Works and Correspondence of David Ricardo – a Royal Economic Society commissioned project which would occupy him for over 20 years. While working this project he started adopting classical methodology for answering the questions of value and price determination and subsequent distribution.
- Even before working on this project, Sraffa realized that, unlike the neo-classical economics where value, output and distribution are determined simultaneously, in classical economics these things are analyzed into different logical stages.
- Sraffa attempted to re-formulate the value theoretic issues embedded in the Classical analysis. He looked at the Ricardo's attempt to refute Adam Smith's so called "adding up" theory of price which suggests that wage rate and profit rate

can move independently of one another. Ricardo showed that such independence is difficult to achieve in presence of the interdependence of price and distribution. Ricardo argued that change in wage alters the relative prices making some prices rise and some other fall according to their technical condition. Because profit rate is sensitive to changes in input prices. Therefore, even though this shows that wage and profit rate is not independent, the exact relationship between these two is difficult to pin down.

- Sraffa maintained that Ricardo tried to solve the problem by adopting the corn ratio argument. Ricardo assumed that in agriculture wages, inputs and output are all paid in the form of grain. Hence, in corn industry profit rate can be determined without reference to prices – making the identification of the relationship between wage and profit possible.
- Malthus objected to this idea saying workers spend their wages on things other than corn and corn production requires many capital goods other than corn. Ricardo admitted the validity of this criticism and in his *“Principles of Political Economy and Taxation”* (1817) he avoided the problem by assuming that the ratios of embodied labor time are close approximations to relative prices. However, Ricardo’s search for an invariable standard of value continued. Finally, Sraffa provided a solution in 1960 – in his book *“Production of Commodities”*.
- The fundamental data of Sraffa’s model are (i) the level and composition of the social product; (ii) the technical conditions of production and (iii) the profit rate (or alternatively the real wage). These conditions combined with the assumption that under competitive conditions market forces establish a tendency towards a uniform rate of return across sectors, determine relative prices and the remaining distribution variables.
- Sraffa defined standard commodity to substantiate Ricardo’s postulate that wage and profit cannot be determined independently.
- His book *Production of Commodities* emphasized the point that any commodity  $x_i$  is produced with number of other commodities  $x_j$ . Hence, it is not possible to classify any product as labor intensive because even if we can measure the use of direct labor, it is difficult to measure labor getting into its production in the

indirect route – being embodied in the inputs required to produce this particular commodity.

- This research agenda implies that it is possible to construct labor or capital demand curve faced by a firm as done in conventional economics. Even though the research program given rise by Sraffa is still in an early stage of development, it opens the gate for bringing in the role of history and institutions in determining the division of the social product.