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Historical Origins and Development of Economic Rationalism

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Introduction

"[Economic rationalism's] generative axiom is that the free market should determine all economic transactions". Milton Friedman and Friedrich Hayek and most modern academic economists have supported the recent Australian terminological position known as *'Economic Rationalism'* (Carroll, 1992, pp. 7 - 9). The use of `rationality' in economic policy and practice implies a belief that economic decision-making needs to be 'rational' but this does not mean what many people assume viz. "*sane, sensible, not foolish, absurd or extreme*".

This paper traces the development of economic theory up till 'economic rationalism' became a household name. At each developmental stage factors leading to changes in economic theory are examined and leading protagonists and antagonists identified. Economic systems such as Mercantilism, classical economics, marginalism and neoclassical economics are embraced.

The advance of neoclassical liberalism was subjected to strong pressure during the Great Depression and the Second World War and this led to reliance on macroeconomic theory as explained by John Maynard Keynes. An economic time line has been developed and placed in the appendix of the full paper.

Early Economists and Economic Theory

A student of Socrates, Xenophon (c431BC), is regarded as the first Greek economist (Hunter, 1996, p. 185, Pomeroy, 1994, pp. 42, 46). In his book `The Economist (Oeconomicus)' he reports a talk between Socrates and Critobulus and also Ischomachus' discussion on 'profitable estate management' (Xenophon, c400BC). Aristotle (384-322 B.C.) endeavoured to portray the *'place of economy in society'*.

The Middle Ages – AD 476 – 1453

After about 1000 AD King William of England had problems with rebellious people and the care of the land. He created the 'Feudal' system in which organization was based on a system of contract and many kinds of political organization and social intercourse were derived from feudal contracts.

In the 13th century, Aquinas drew upon Greek philosophy in his European Renaissance writings and contributed to the development of economic thought in discussions on *"property, 'just' price, money and condemnation of usury"* (see Aquinas, 1955/1929). During the Middle Ages the Church guided the way in which economic transactions took place and decision making was intimately linked to faith and Church guidance.

Changes in Economic Thought after 1500 – The Early Modern Period

Tawney claims that the period from 1500 – 1700 saw the emergence of an objective economic science that lacked passion. The prevailing economic theory was `Mercantilism' and economic growth was measured by calculating increases in the total circulation of stock, such as silver and gold, under the control of the state (Tawney, 1938 [1926], p. 18). By the end of the early modern period in 1700 a `new science of Political Arithmetic' had replaced Christian economic value systems that linked economic transactions to a moral rule.

The 'Mid Modern' Period – 1700 – 1871 AD.

The eighteenth century and much of the nineteenth century saw the origin of economic theory, as we know it today. Many Scottish and English 'classical' economists developed economic theories between the time Adam Smith was born in 1723, and the death of John Stuart Mill in 1873.

Thornton claims that economic theory's historical origins can be traced to Richard Cantillon (1680-1734), a banker who emigrated from Ireland to France. Rothbard (1995) nominates Cantillon as "*the founding father of modern economics*" (see Thornton, 2007, Rothbard, 1995). Higgs grouped Cantillon with Adam Smith and others including Quesnay, Montchrétien, and Sully in the paternal group of economic thinkers (Higgs, 1892). Jevons indicates that Cantillon's *'Essai su la Nature du Commerce en Général'* (Cantillon, 1931[1755]), advances a theory of value superior to those promoted by economists a hundred years later (Jevons, 1881).

Cantillon's theories were part of a long line of economic thought extending into the modern era. Economists of this period included Adam Smith, Jean-Baptiste Say, Thomas Malthus and David Ricardo. Through the publication of Smith's *Wealth of Nations* (Smith, 1976 [1776]) came credit for the establishment of the first modern school of economic thought.

In *Treatise on Political Economy,* Say referred to theories promoted by other economists of his period and hypothesized about the cause of gluts (Steiner, 1999). His `1aw of markets' stated that the total demand in an economy must equal the total supply (Say, 1803, pp. 153, 178 - 179).

Malthus argued for a reduction in the bullion price of corn to enable price parity with imported corn. Such reductions would affect the price of labour and improve the supply of agricultural products (Malthus, 1814). When the 1815 Corn Laws were being debated Ricardo accurately developed the `Classical' system of political economy that constituted economic thinking throughout the 19th Century. He argued that the agricultural sector was an avenue to establish profit and rents rates as wage and profit rates established in this sector would be equal to rates in the industrial sector (see Ricardo, 1815).

In *Principles of Political Economy and Taxation* Ricardo regarded utility to be essential to exchangeable value but, except for scarce goods, did not measure it (Ricardo, 1821). By 1805 scholars began using the term 'political economy' to indicate the study of economic pursuits by individuals as distinct from government.

Based on the `labour theory of value', Marxist economics considers that capitalism exploits the working class and that the price paid to labour is always lower than its full value. About the time of Marx, Western European economists commenced to reason about marginalism and opportunity costs. For instance, in 1862 Jevons presented a paper outlining a theory of exchange (Jevons, 1871/1888, Ch. 1) .

The Modern Period – 1871 to the Present

Writing almost two centuries after Adam Smith wrote *Wealth of Nations* Joan Robinson declared that there were political and technical reasons for neoclassical economics adding "a *Theory of Value"* to classical economic analysis (Robinson, 1956/1971, p. v). However, Menger's *`Grundsätzeder Volkswirtschaftslehre,* (Menger, 1994/1871), Jevons' *Theory of Political Economy*` (Jevons, 1871/1888) and Walras' *`Elements of Pure Economics'* (Walras, 1874) formed a trilogy and, outlining a new principle of marginal utility, commenced a new period in the development of economics (Hayek, 1994, p. 12). Even though Walker claims that von Böhm-Bawerk and Wiezer were students of Menger (Walker, 2007), von Mises asserts they learnt Menger's economic theory through studying the *Grundsätze* (von Mises, 1984). The Austrian School's rejection of economic modelling, and the emphasis on economic subjectivism was developed by Menger, Ludwig von Mises and Friedrich Hayek.

The Cambridge Neoclassicals ("Marshallians") were founded in 1890 when Alfred Marshall published his *Principles of Economics* (Marshall, 1890/1961) and a Cambridge Professor, John Neville Keynes, best known as the father of John Maynard Keynes published *The Scope and Method of Political Economy* (Keynes, 1890/1999).

Weber attributed the 'capitalist spirit' to the influence of Protestantism on the economic ethic. The term `economic rationalism' was utilized on at least three occasions by Weber in his *Protestant Ethic* (Weber, [1904-5]1971, pp. 26, 40, 75). Tawney's (1938[1926], p. 18) description of the development in European economic thought, as *"passionless economic science"* suggests that a similar description could be given to the development of economic rationalism following the Marginalist Revolution and the institution of neoclassical economics.

Back in England after leaving the Versailles Peace Conference prematurely on a matter of principle, John Maynard Keynes wrote *The Economic Consequences of the Peace* (Keynes, 1919). Keynes' publications during the depression include *The Means to Prosperity* (Keynes, 1933) and *`A General Theory of Employment, Interest and Money'* (Keynes, 1936/1970). It is claimed that this latter work *"revolutionized economic theory"* (Bruner, 2007). However, not all economists agree with Keynes about the cause of the depression.

A different economic situation arose with the outbreak of World War II. This war had caused Keynes to acknowledge that *"in war we move back from the Age of Plenty to the Age of Scarcity"* (Hayek, 1940, pp. 321 - 322). Financing the war necessitated real borrowing and increased taxation. His idea was to employ low interest rates to finance the war effort.

After the war many countries adopted Keynesian economic polices in their reconstruction programs. The Bretton Woods agreement established a system of fixed exchange rates and heralded a Golden Age of economic growth that lasted for 25 years. Setting their exchange rates to the US dollar coupled with demand management of domestic policy after the Keynesian model, saw developed countries *"[enjoy] their longest period of strong economic growth and full employment"* (Macfarlane, 2006, p. 5).

Not every economist was a supporter of Keynesian economics at this time and some drew the link between economic theory and public opinion that is often related to economic activity fluctuations. For instance, Friedrich Hayek's *The Road to Serfdom* (Hayek, 1944) provided a very influential and popular exposition of libertarianism and classical liberalism. It provided a political ideological model that was employed significantly in the administrations of Margaret Thatcher (1979-1990), in the United Kingdom, and Ronald Reagan (1981-1989) in the United States.

Modern day economic rationalists are strong advocates of the free market system. If the total national output rose then it was considered that economic policy had resulted in 'allocative efficiency'. Economic rationalism's contribution to declining social cohesion and increasing pursuit of self-interest, has interfered with social life with some being winners and others losers.

Coleman and Hagger attribute the first Australian use of the term `economic rationalism' to a paper written in 1979 by A. S. Watson, an agricultural economist (Coleman and Hagger, 2001, p. 9). According to Watson the Australian Labor Party's agricultural policy at that time was based firstly, on a strong tradition supporting government intervention in agriculture; and secondly on a strand of Labor agricultural policy that could be described as `economic rationalism' (Watson, 1979, pp. 164 - 165).

This would appear to imply that Watson considered *`economic rationalism'* is '*leaving economic problems to the market'* rather that relying on government intervention for a solution. Watson offered no formal definition of `economic rationalism'. Although the term had not been in general use in Australia prior to the 1990s, it was used by Glen Withers in his paper *`Economic Rationalism and Wage Indexation'* (Withers, 1986). Prior to 1990 the term, `Economic Rationalism', was not employed to attack economics or economists. According to Coleman and Hagger (2001, pp. 11 -12) this all changed in 1991 with the publication of Michael Pusey's *Economic Rationalism in Canberra: A Nation Building State Changes Its Mind* (Pusey, 1991).

Four principal reasons support Pusey's belief that economic rationalism is wrong as a policy and as a way of understanding Australian society. To Pusey, economic rationalism is arrogant in its assumption that "*economics, markets and money can always deliver better outcomes than states, bureaucracies, and the law*". However, when good economic rationalists search for alternatives to government programs, they become interested in assessing arguments and evidence about the net benefits of such programs. A more technical and narrow definition regarded the principal concern of economic rationalism to be with economic management and efficiency in resource allocation. In the case for market deregulation, positive economics is not value free and thus "*has led economists to claim the full support of their discipline for statements that reflect their own values*". Most economic rationalists may not be imperialistic, or believe that the market is the only legitimate allocator of goods and services, as some opponents of economic rationalism have proposed. Thus opposition to economic rationalism could have been based on the rationalistic concept of the supremacy of the market with little thought for income distribution. Nevile (1993, p. 3) claims that some economic rationalists argue that "*unequal distribution is important to create the right incentives*". Economics may be regarded as "*a tool kit of ways of solving economic problems*" and, as such, might not possess unchangeable scientific laws (Nevile, 1993). Therefore, economic rationalistic conclusions do not evolve from some mysterious scientific law. The Reverend Warren Clarnette was censorious of churches that criticised economic rationalism (Clarnette, 1993). Prior to 1990 enquirers had to `read between the lines' to understand what users of the term `Economic Rationalism' meant. This changed with the publication of Pusey's book when the labelling of people as adherents of `Economic Rationalism' became, on occasions, a term of abuse.

Conclusion

This paper has considered a concept referred to as '*economic rationalism*' and traced a long line of economic systems that have been adopted from the time of Xenophon and Aristotle till the present day. The economic historical line progressed through the middle ages in which the political and economic systems were based on a system of contracts. With the onset of the early middle ages a passionless economic science emerged and the period of the 16^{th} to 18^{th} century was mainly subjected to an economic theory that related a nation's prosperity to its supply of capital. A challenge came to this theory with the onset of classical economics as the result of the writings of Adam Smith and Cantillon.

About a hundred years after the onset of classical economics a marginalist revolution occurred and with the publication of work by Jevons, Menger and Walras neoclassical economics emerged during the years 1871 – 1874. Neoclassical economics was developed in a number of schools of economics by academics and social scientists who had commenced to advocate a `rational' approach to economic policymaking. The Great Depression and the Second World War forced a rethink of economic policy and Keynesian economics and adopted a macroeconomic approach to the management of the economy that became the dominant policymaking resource. This changed, however, when neo-liberalism advocated by economists such as Hayek began to influence political thinking and *`Reagonomics'* and *`Thatcherism'* became popular concepts promoted by social scientists and journalists in the 1980s.

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