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The market economy: theory, ideology and reality[1]

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Abstract
Malcolm Adiseshiah, whose 105th birth anniversary we observe today, is remembered in most parts of the world as the Deputy Director General of the UNESCO which had for long been something of a cultural forum of the affluent nations, but which became a powerful agency for development and education globally in the 1950s and 1960s thanks to his dynamic leadership. After he returned to India in 1970 he came to be known as the founder, along with his wife, Elizabeth, of the Madras Institute of Development Studies, then as Vice-Chancellor of the Madras University, member of the Rajya Sabha and pioneer of the adult literacy movement. But it is important to recall that he started his career as a college teacher, first in Calcutta and then after taking a Ph.D. from the London School of Economics in the Madras Christian College where he was noted for his academic scholarship. In his semi-autobiographical work, *Let My Country Awake* he has recorded that a great deal of his learning came from another source: "... the villages of Bengal and South India with their rural service centres where we worked out the economics of hand-pounded rice, hand-made paper, handloom textiles, crop rotation and rural credit, rural medicine and sanitation, adult literacy and curriculum reform. It was there that I found the testing ground for the many ideas and plans that I carried with me to UNESCO in Paris and from there to the four corners of the earth." Thus his learning was from two sources: academic centres and books on the one hand and from real life situations on the other. It is to remind us of these two sources of learning that I have chosen the theme: The market economy: theory, ideology and reality for this year's Founder's Day Lecture.

Let me start with something of a puzzle: I taught economics for a quarter of a century. When I came to the Madras Institute of Development Studies there was no teaching to do. One of my major responsibilities was guiding Ph.D. research. And I have worked with some 20 Ph.D. scholars. My policy was to let the scholar select his/ her area of research, but with one condition, that the selected topic must be about a real life situation. This meant that I was involved with a wide range of research themes – small-scale industries, urbanisation, fisheries, market conditions, agrarian transformation, handloom production and sales, labour relations, the millet economy and many more. And I used each one of these as a topic for my own learning. In order to be of help to the scholars, I was of necessity learning with them. What came as something of a surprise to me was that hardly any of them (including those whom I had taught) had used the "theory" they learned during their collegiate studies! That led me to ponder over what we teach and how we learn. Through this lecture I wish to share with you some of my thoughts on this crucial issue.

I take it that all learning is geared to the problem and process of understanding. This is true of learning at home (where all learning begins) in schools, colleges and universities and in the wider arena of life outside educational institutions. The aim of theory is, or must be, to serve as an aid to this understanding. Theory, certainly, is not and cannot be a true picture of life. Even if it were, how well can we understand a person from her photograph, or a country from

[1] This paper was the Founder's Day Lecture of the Madras Institute of Development Studies delivered on April 18, 2015, and it will appear in the next issue of the Institute's *Journal, Review of Development and Change*.

its map?[2] Because of this unavoidable lack of correspondence between theory and the reality it represents, there is always the possibility that theory can lead to *mis*understanding or *mis*interpretation. When it happens (deliberately or otherwise) this can become a tool for propaganda. Consequently, there has to be a non-theoretical (not necessarily *anti*-theoretical) procedure for understanding the topic, institution, or whatever it may be that one is after[3]. Taking the market economy or the market as the topic, I propose to examine the theory (theories) about it, the manner in which it lends itself to propaganda, and a way of having a more realistic understanding about it. I shall begin with an elementary theory of the market and the manner in which it has become a tool of propaganda in Section I. In Section II which is the main body of the Lecture, I shall suggest a procedure for a more realistic understanding of the market and the market economy. In Section III, I shall go back to the nature of market theory and consider why it often becomes the source for propaganda.

Section I. The theory of the market (the market economy) – an elementary exposition

The theory of the market and of the market economy taught in our colleges and increasingly even in our schools (as also in most parts of what may be described as the Anglo-American world) is the Neo-classical Theory which claims to have universal validity. It postulates the economy as consisting of individuals who are considered to be concerned about their own selfish interests, indeed as those who are trying, at least in the economic realm, to maximize their expected satisfaction. Each one is also considered to have some initial endowments, some of them in excess of their requirements. So they look around and see that those around them are also in similar situations, except that their bundle of goods is different. Each one, therefore, wishes to get rid of some of the excess goods and get some goods that they do not have or do not have enough. The individuals, therefore, can enter into deals with others, exchanging goods of which they have an excess and obtaining goods that they wish to have. If you can imagine a situation where there are only two individuals, A and B, and two goods, x and y, A having an excess of x and B and excess of y, it can be seen that the two will enter into a deal (after hard bargaining because each one is trying to maximize his expected satisfaction) to exchange a quantity of x for a specified quantity of y. The ratio of these quantities may be thought of as the rate of exchange or (relative) price of x for y. This, of course, is barter as practised by children when they exchange marbles for pencils (or whatever it is that they exchange these days!) or when countries exchange leather goods in return for military ware. It may, therefore, be concluded that satisfaction maximizing individuals will enter into exchange and exchange will establish prices. This basic principle applies even if there are more individuals and more goods and if one of the goods can be selected in terms of which relative prices can be converted into “prices”. According to theory that is how markets emerge, where there are many participants, many goods and some good in terms of which all prices are expressed.

[2] For a recent discussion of this theme see Stuart Birks, *Rethinking Economics: From Analysis to the Real World* (Springer, Singapore, 2014).

[3] Two economists I have found helpful in dealing with real life issues are Georgescu-Rogen and G.L.S. Shackle. On the procedure to analyse concrete life problems the former wrote: “Proudly accept the principle of practical opportunism with an appreciable dose of delicacy of touch…and arrive at a workable body of descriptive propositions for a given reality” in *Analytical Economics* (Harvard, Cambridge, 1966) pp. 110 & 112. Shackle added: "We have to strive for an insight which focuses informally and, if you like, non- logically a number of strands which in their formal aspects mutually repel each other" in *A Scheme of Economic Theory* (Cambridge, 1968) p. 2. I have frequently used the expression "analytical description" to deal with real life issues and it is this procedure that I use in Section II.

Now, take this example a step further. Consider a large number of participants divided into two groups, one group called “households” or consumers and the other as “firms” or producers. Households own all goods, mainly their services (referred to as “resources”) which they hand over to firms and firms convert them into particular goods that the households want. A market thus emerges for a variety of goods, called “commodities” supplied by “producers” and demanded by “consumers”. It may, therefore be concluded that if consumers are satisfaction maximisers and producers are “profit” maximisers, the market will establish uniform prices for each one of the many commodities. According to another, and more familiar and visual exposition, taking price on the vertical axis and quantity on the horizontal axis, the producer supplies the good (represented by the upward sloping “supply curve”) and the consumer expresses his willingness to purchase via the downward sloping demand curve (because of “diminishing marginal utility”) the consumer and the producer together determine the equilibrium price. With large numbers of consumers and producers, the “market” where they all compete becomes the arena where prices get determined. And since the whole exercise is meant to satisfy the consumer, the consumer is said to be sovereign.

This theory, with all its circumscribing conditions, gets converted into the propaganda: The market is the forum where producers make public their cost of production to serve the consumers and the consumers indicate their preferences, and so: “In the Market Economy the Consumer is King”. This propaganda was required to lend support to a socio-economic order which was competing with another where an external agency called “the State” was alleged to be deciding what its members required and had its way of distributing it as it thought fit. In short: “Democracy vs Totalitarianism”[4]. In a different context where even within democracies an agency named “the State” is seen to be entering into economic decision making and action, the suitable propaganda becomes: “Leave it to the Market” (note the capital “m”). In both these cases, the propaganda is not initiated or sustained necessarily by those in the street or active in the market, but basically by internationally recognized and acclaimed academics who use philosophy, logic and high-brow mathematics to prove the point[5]. I shall return to these aspects in Section III.

Section II. The market economy: a reality check

Fortunately, the market is a familiar institution to most of us. Let me confess that I learned more about the market from life-long involvement with it, (including what I learned along with my Ph.D. students, all of whom dealt with some aspects of it) than from the class rooms and scholarly expositions in books and journals, although for long the two remained in two different segments of my brain! The early years of my childhood were spent in a small village in old Travancore, where I lived with my grand-parents and uncles (my father and mother being away in academic pursuits) in what was essentially a self-sufficient household. Most of the goods required were directly produced – paddy, a wide variety of vegetables and fruits, milk from cows owned. There was also a weaving shed that produced handloom clothing

[4] Those who are familiar with the debates of the 1930s on pricing will recall that the technical problem relating to the determination of relative prices was acknowledged to be to find solution to a set of simultaneous equations which a computer could solve. The practical issue was considered to be the appropriate institutional framework, decentralised decision making via the market (“democracy”) or centralised decision making ('socialist state'). See Oscar Lange, *On the Economic Theory of Socialism* in F.M. Taylor *ed.*, *On the Economic Theory of Socialism* (Minnesota, Minneapolis, 1938).

[5] For a clear exposition of this theme see Geoffrey Harcourt, *Markets, Madness and a Middle Way*, Ideas for Australia, 1992-1993 Program (Clayton, 1992). I am grateful to Harcourt for drawing my attention to this publication.

required for daily life. My recollection is that the household had everything other than cash which was very scarce, indeed. And yet, it needed goods that it was not producing – such as salt, dried chillies and molasses. What was done to secure these was to take some of its own produce, a bunch of raw bananas or some eggs, to a location about a mile away on a Wednesday or Saturday and where on those days the required goods would be available. Seldom was there direct barter. The active or hyper-active participants of the market were a few people who would buy our goods for cash which we would then use to buy the goods we required. These agents were called “merchants”. In my mind, therefore, the market is associated with a place and merchants. Even in Tambaram where the Madras Christian College was located, there was a place identified as the market to which I made frequent visits. There one could not find merchants who were buying and selling, but rarely did one buy anything directly from a producer either. Goods were sold in shops, temporary or permanent, and those who sold were taken to be merchants. Thus, the transaction was between the shop-keeper, the “seller” and me, not the consumer, but the “customer” I continued to do “marketing” even after we moved to Adyar, buying my requirements from the many shops along Sardar Patel Road, from the fruit vendors who had their temporary sheds between Sardar Patel Road and what was then First Main Road (which has now merged with Sardar Patel Road) and from vegetable shops in different parts of Gandhinagar. Once again, the transaction was between a buyer (a customer) and a merchant (a seller). There was no bargaining, certainly not in the shops which had fixed prices. The fruit sellers used to offer you “bargains”, in the sense that they would offer you a lower price per unit if you were to buy a dozen or more (bananas, oranges etc.) and occasionally you would reciprocate the bargaining. Am I right in claiming that everyday marketing is even now of this kind?

There are (and not surprisingly) differences between “markets as we know” and “markets in theory”. One has been noticed already. In theory, the market is a transaction between the producer and the consumer; in real life, the two parties are, respectively, sellers and buyers or customers. But there is a more important difference. In real life, the seller is rarely a producer. He/she is both a buyer and a seller, that is, a **merchant**. *A striking feature of the standard theory of the market is that it leaves out this crucial agent*. I shall enter into a discussion of the theoretical legitimacy of this exclusion in the next Section. In this Section I shall concentrate on what the real life implications of markets are whose active agents are merchants. Before I do that, however, let me touch upon a matter of pedagogic interest. I mentioned above that merchants offer larger quantities at lower prices. It appears quite reasonable as well. In other words, the merchant as supplier is a “rational” participant in the system. But then what is the nature of the “supply curve”?[6] It will be seen to be *downward sloping*. With also a downward sloping demand curve the intersection between the two may not easily take place, and if it does it will pose problems! It is not surprising therefore, that theory decides to eliminate merchants and sticks to the position that the supplier is the producer! *Be that as it may, let us note that the critical difference between the market in theory and the market in real life is that*

[6] Whether this is a supply curve will be contested by those who hold that “supply” is related to production. I am taking the line that it is the merchant who supplies what I want and that her/his price per unit will be lower for larger quantities. In that sense quite literally there is a downward sloping supply curve or sales curve. Others may argue that the phenomenon of the 'downward sloping supply curve' can be explained in terms of the transaction cost of the seller. The critical issue is that in real life there is usually an intermediary between the producer and the consumer and that if this role of intermediation is recognized, then changes will come in one’s understanding and procedures of analysis. The following link may be helpful: https://unlearningeconomics.wordpress.com/2012/12/11/whichever-way-you-paint-it-the-supply-curve-is-flat. This link was brought to my notice by Ashwin, a graduate student in economics and I am thankful to him.

in the latter it is a mediated process, whereas the former completely sets aside the mediatory role.

Let us move on. If the role of merchants is unavoidable to understand real life markets, so is the role of money. Let us recall the distinction that Marx clearly makes between barter which he represented as C-C (C standing for commodity) and transaction involving the merchant, that is designated as M-C-M'. That is, from the merchant's point of view the market is the arena where he converts money, M, into more money, M'.[7] To understand markets in real life, therefore, it is important to recognize that different participants enter into it with very different motivations. Further, it must be noted too that Merchants, Money and Markets constitute a triad such that no one of the trio can be understood without the other two. Let me be more specific. *While the theorist has the right to abstract from what she/he considers not essential, and thus exercises the right to leave out merchants from an exposition of the market, no one whose interest is in understanding how markets actually function can afford that luxury*. Let us go a step further. The theorist may claim that any one of the many goods that enter into transactions can serve as a *numeraire* to convert relative prices into absolute prices. However, when an active participant in the market is there to make money, how can it be left out? Let us note too that in real life situations few transactions will take place unless there is a commonly accepted medium of exchange backed by some equally accepted authority.[8]

On the basis of their historical research into the triad in ancient times, Karl Polanyi and his associates have documented how the triad relationship emerged over time. Their case studies lead to the conclusion that the forms of trade, use of money and market elements (each one independently evolving) differ widely across social institutions, but except in a "market economy" there is no particular relationship among these three elements. Early merchants could have been pirates who only wanted to trade their loot for some local product. Markets could have been a space where producers gathered to exchange their goods with different goods that others had produced. Early forms of money could have been a way of making a payment, instead of being a medium of exchange. But in a market economy "trade is directed by prices, and prices are a function of the market, all trade is market trade, just as all money is exchange money. The market is the generating institution of which trade and money are functions. In brief, *… trade, money and market form an indivisible whole*".[9] John Hicks in his *A Theory of Economic History* also emphatically states that it was specialization in trade that marked the beginning of the Market Economy.[10]

That being the case let us look at markets as the field of activity of the merchants who use money as the instrument of their profession. The professional role of the merchant is as a link. The link certainly can be between the producer and consumer, but not necessarily so. It could be between a merchant and the consumer, between a merchant and another merchant and so on. Indeed, in this sense a modern market economy is a *chain* consisting of several *intermediaries* of all sizes and shapes – not a very neat chain, for sure! In other words,

[7] Karl Marx, *Capital* (Progress Publishers, Moscow, 1976) Vol. I, pp. 151 ff.
[8] This is not to deny that there are local communities in different parts of the world that have their own currencies for purposes of transaction of the goods their members produce and services they render. See Bernard Lietaer and Jacqui Dunne, *Rethinking Money: How New Currencies Turn Scarcity into Prosperity* (BK Publishers, San Francisco, 2013) especially "Local Exchange Trading System" (LET) in a community close to Vancouver, Canada.
[9] Karl Polanyi *et al*, *Trade and Markets in Early Empires* (The Free Press, New York, 1957) p. 257, emphasis added. The studies included in the volume go back to the 17th century BC.
[10] John Hicks, *A Theory of Economic History* (OUP, Oxford, 1969).

markets in real life constitute a rough and rugged terrain. It is this very nature of a market economy that theory abstracts from to generate a neat and smooth theory of exchange.

a. **Merchants and their role:** Let us start with the merchants that most of us know and deal with, let us say the vegetable vendor who brings her wares to us in a cart every morning. Why does she do what she is doing? The answer quite simply is that she is making a living. The vast majority of merchants in our country are of this kind. She goes to the wholesale market early morning, pays money (to be sure borrowed money, but let us leave that aside for the time being) collects the vegetables and then sells them to you. There may be some bargaining there, not initiated by her, but by you! To use Marx's formulation, her activity is of the M-C-M' type. The extra money she makes (⊗M) she uses to buy rice and dhal for her family. Consider a second merchant, the owner of the shop from which we buy our stationery and similar requirements. Prices are marked on every item; so there is no bargaining. But there is a difference between the prices he paid to the merchant from whom he bought the goods (wholesale prices) and the sale price, the difference being his margin. But, again, it is of the M-C-M' format. But the chances are that he uses his ⊗M to expand his business, to buy some shares or whatever, i.e., to make more money. Think of a third intermediary, a very different kind indeed, Walmart in the USA or Waitrose in UK who are also merchants of the M-C-M' type, but who have direct contact with producers (from different parts of the world too!). So merchants may have direct dealing with producers and may sell to final consumers (as the chain grocery stores do). Merchants need not be big business people or corporates to link original producers and final consumers, but in general merchants' activity is to buy and then sell. So a market economy is dominated by a chain of sellers and customers. It is possible that in economies that are considered to be "developed" where the labour force is largely in the tertiary sector, rather than in the primary or secondary sectors, most of those who consider themselves as workers are indeed merchants selling goods and services.

b. **Markets and ownership:** Let me turn to another aspect that has not received the attention it deserves. What the merchant sells is what s/he owns. In the case of the vegetable vendor it is obvious. She sells the vegetables she has bought. The vegetable she sells are hers as long as they are with her. And they become yours when you pay for them. The same is true of all who sell for the simple reason that only what is *owned* (not merely held) can be alienated. As Hicks puts it: "When he sells an article he must be able to assure the buyer that the thing is his to sell; he must be able to prove his property in it, if he is challenged".[11] If so the merchant can be thought of as one who specialises in transferring ownership, and the ⊗M that he makes may be considered as payment for this important service he renders. *It also means that the market must be thought of as a place of constant juggling of ownership, perpetually in motion, never in a state of equilibrium!* This is seen most clearly in the financial market to which we will soon be turning.

c. **The merchant as a source of information:** The merchant is not only in possession of goods, s/he also stores information s/he gathers. S/he certainly knows (makes an effort to know) what her/his customers are interested in (that that is why s/he stores them) but also of what s/he sells. That being the case, a market economy cannot be one where all buyers and sellers have the same information. The merchant as an intermediary will also have information about her/his clients that s/he can use for her/his own advantage. That

[11] John Hicks, *A Theory of Economic History* (OUP, Oxford, 1969) p. 34.

is, it cannot be assumed that information is symmetrical in a system where there are activities of buying and selling. *In other words, the market economy must be considered as one characterised by* **asymmetry of information**. I cannot but recall that Joseph Stiglitz, George Ackerlof and Michael Spence who were awarded the Nobel Prize in Economics a few years ago were recognised for showing that asymmetry of information must be taken seriously! Also, they have acknowledged that they received enlightenment by coming into contact with real life, Stiglitz in Kenya and Akerlof in India.

d. Inter-locking markets: A closely related aspect of real life markets is that merchants who are actively involved in them are responsible for inter-locking them. We can claim credit that this is a widely recognised theoretical contribution of Indian economists, Amit Bhaduri and the late Krishna Bharadwaj. It became a theoretical contribution because theory postulates that the act of selling and buying each good must be treated as a function of its own price and nothing else. But look at buying and selling from the point of view of the merchant. S/he is in competition with others in the market, and will succeed only to the extent that one way or the other s/he carves out a market of her/his own. *Tying up different markets is thus an important and intrinsic aspect of the market economy and it is achieved by dealing with and bringing together (tying up) a specific set of buyers and sellers s/he deals with and convincing them that s/he is offering each of them a special deal, but without any one of them knowing the details of her/his deals with others in the loop.* It will be seen that interlocking of markets is closely associated with asymmetry of information and is not confined to the rural agricultural sector.

e. Expansion and segmentation of markets: It is important to recognise that merchants are constantly striving to carve out markets of their own. There are different ways of achieving this objective. Your vegetable vendor may claim your street as her exclusive territory. Your shop keeper may “cultivate” you by offering to have your requirements delivered to your residence, or by allowing you to make payment for your purchases on a monthly basis instead of every time you buy something. Big intermediaries have their own brand names. The idea is to get a set of “attached” customers, thereby making a protected market, something that provides an element of monopoly power. Product differentiation, real or just visual, assisted by advertising plays an important role in this process. Real life markets, therefore, have features of competition and monopoly, resulting in monopolistic competition, rather than “free” competition. A major consequence of this process is that real life markets always tend to expand (resulting from the relatively easy entry of new merchants who create new markets) and get differentiated or segmented (resulting from each merchant's effort to establish a protected market). The built-in tendency of markets to expand has been recognised by writers, both of the past and more recent, Adam Smith, Karl Marx, Rosa Luxemburg, Karl Polanyi, Joan Robinson and John Hicks, for instance.[12] Segmentation of markets has received recognition only in the immediate past. But the two have seldom been seen as happening simultaneously resulting from the activities of merchants. A special kind of segmentation deserves some attention. It is a kind of natural segmentation based on the income (or purchasing power)

[12] There is a relatively new phenomenon of “disintermediation” of producers attempting to “throw out middlemen” and going directly to the consumers. The internet is the medium through which this is achieved with the producers going directly to the consumers. For details see the link, http://en.wikipedia.org/wiki/Disintermediation. I am grateful to Stuart Birks for bringing this link to my notice. It may be note, however, that big middlemen like Amazon may be using the same platform to weed out small middlemen.

of the customers. This is seen most prominently in the case of hotels, where the segmentation is officially recognised by the "star" status (five-star, four star…and no star), but is, indeed, very wide-spread, in the spheres of entertainment, transportation, medical care, and even education. We may recognise this as a vertical segmentation of markets.

f. **The key role of money:** Whatever may be the role that theory assigns to money in the exchange process, markets in real life cannot function without money. Paradoxical as it may sound, the most successful form of money for purposes of transaction is money that is intrinsically worthless. Compare some precious metal like gold used as money on the one hand and paper money on the other. The former can be used for other purposes, but the latter mainly for exchange. It may appear strange that what is worthless or has no value measures the value of everything else! However, that is something of a "money illusion". For, worthless money has a role and a very prominent role in economic and social life because it is backed by a powerful authority, the State (via its designated agency). Paper money is accepted for transactions because it carries the statement by the representative of the State: "I promise to pay the bearer the sum of…" In other words, paper money is based on authority and promise, and is thus an IOU, and the trust that users have in that authority and its ability to pay. Apparently those who ask the State to keep its visible hands off the market economy run by the Invisible Hand are just parroting some slogan that they have picked up somewhere. Let it be affirmed that markets in real life function because there is an authority backing them.

g. **Financial markets:** Let us now turn to one of the special real life markets, the financial market which these days has become "the Market". It deserves special attention for a variety of reasons. First and foremost, if what used to be referred to both in everyday conversation and in professional discourse as 'international' has now become 'global' it is because of the manner in which the financial market has moved into every part of the world and the exponential growth it has been making during the past few decades. What needs to be noted, however, is that the working of the financial markets brings out some of the essential features of real life markets so much so that John Hicks claimed that the financial markets are the places where the market system is at home. And why? First because the commodity that they deal with is claims to ownership (shares) where cost of production is low. Second, it is in the financial market that a major feature of markets as trading of ownership is clearly seen. And third, nowhere does the significance of the mediatory role of markets and of traders and the associated asymmetry of information become as evident as in the financial market. In that sense the financial market is where the nature of the real life market can be observed most clearly. Indeed finance is intermediation raised to the n^{th} degree.[13] Surprising as it may appear at first, the financial market does not function according to its own criteria; nor is it free from "external" interferences. Big Brother is always alert and intervenes when considered necessary via changes in the rate of interest which is the most effective price in the market for credit. Let us note too that the (global) financial market does not function solely on the basis of finance and its features. It involves legal agreements, both national and international, regulatory agencies and the like and makes its impact felt on the balance of payments of the countries concerned, on property rights and living conditions of ordinary people who may have nothing to do with finance, as shown by the recent experience of Greece.

[13] See my *Wealth and Illfare: An Expedition through Real Life Economics* (World Economics Association Books) Ch. Five.

h. **Some larger issues:** Without going into details I would like to flag a couple of issues relating to the financial market that deserve critical scrutiny. First, with credit playing the major role in the financial market, markets are now making significant inroads into the future which means that future participants will be confronted with *fait accompli*, thus reducing their own choices and decision making power. Second, using claims as proxy the financial market is dealing with wealth as such; it is concerned with transactions of ownership of wealth. The profit that the owner of wealth and her/his agent makes through the transaction is part of current income; over time whatever is saved of it becomes addition to wealth. As the activity of the financial sector increases in a country's economy it would, therefore, mean that income generation and wealth accumulation are increasingly through trade rather than through production. Some re-examination of our notions of capital formation and growth will be called for to take into account this reality. This change resulting from the spread and intensification of the financial market also has profound social consequences. If incomes are increasingly generated through financial transactions, those who are already wealthy are at an advantage; their incomes and wealth are likely to increase more than the average. If so, as more capital is formed and more growth takes place inequality will also increase. Is this happening globally and in our country? [14]

i. **Production and trade:** In concluding this section let me briefly touch upon the relationship between production and trade and more specifically the producer and the merchant. Historically production and trade were possibly independent activities, but with what may be described as large-scale (industrial) production, the two have been closely associated. Large-scale production, of course, is meant for the market. The producer, motivated by profit, realizes it only after the merchant (who is also motivated by profit) takes the product, finds the buyers and sells the product. The common pursuit of profit led to a mutuality of relationship. In the early stages with large-scale production the producer may have had the upper hand. However, traders also have ways of scaling up their activity (recall that the early joint-stock companies were those of traders) and so there has been a changing scenario. Shrewd merchants had ways of marketing in their name products made by small producers and thus capturing markets and growing big. We are now in a stage where the market is controlled by the big distributors, Walmart, Amazon and others globally, Reliance, Spencers and similar big names in our country. The multinational corporations (MNCs) combined production and trade, but the trend currently appears to be for producers, distributors, bankers et al to focus their activities on the finance sector in spite of the recently experienced problems and collapse in that segment. What counts today is being big and going global (that is what finance does) with the assurance that the Big will not be let down by the State – the Wall Street-Washington alliance or the Dalal Street-Delhi alliance!

[14] Amit Basole writes about the Indian experience: "… [I]nequalities steadily decreased in the planning period, driven by the fall in real incomes at the top of the distribution. This decline reversed itself in the 1980s. The 1990s saw an increasing divergence between the rich (top 1 per cent) and the rest of the country". ('Dynamics of Income Inequality in India, Insights from World Top Incomes Database', *Economic and Political Weekly*, October 4, 2014).

Section III. Theory, ideology (propaganda), reality

Having provided an account of the market in real life, I wish to return to theory asking the question why theory which is meant to be to enlighten reality turns out to be a distortion of reality, at least as far as markets are concerned. Let me repeat what I had stated earlier: I think I am right in saying that in the economics of the Anglo-American variety there is no theory of the market. Marshall's familiar Supply-Demand diagram and Walras's less familiar General Equilibrium Theory reworked in the middle of the twentieth century by Arrow-Debreu, Koopmans, Lionel McKenzie and others have entered into class room teaching, the former at the undergraduate level and simplified versions of the latter at the graduate level.[15] These are not theories of the market; they are at best *theories of prices*. The difference is crucial.

If a sweeping generalization may be made of the 118th century writers on political economy, hardly any of them claimed to be concerned with theory as such. They were trying to understand and interpret the economic reality that they saw around them. Adam Smith's writings on trade and markets must be seen against the mercantilists' restrictions on domestic trade. There was something of a long-standing theoretical discussion, the relationship between "use value" and "exchange value", which remained unresolved. This theme was taken up by the trio considered to be the initiators of Neo-Classical Economics, Jevons, Menger and Walras. In pursuit of their objective they turned to the physical sciences for a procedure to be adopted. In the Preface to his *The Theory of Political Economy* (1870) Jevons wrote: "All the physical sciences have their basis more or less obviously in the general principles of mechanics, so all branches and divisions of economic science must be pervaded by certain general principles. It is to the investigation of such principles – to the tracing out of the mechanics of self-interest and utility, that this essay has been devoted."[16]

Walras who had the same objective had started as a mining engineer and according to Schumpeter, couldn't make a living and so decided to apply his mathematics to political economy in which he had some interest.[17] His major work was on the use value/ exchange value nexus. And he did not hide the fact that his aim was to convert economics into a 'physico-mathematical science'. In his *Elements of Pure Economics*[18] he sets up a universe of discourse to demonstrate the interaction between sellers and buyers in economics. Some

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[15] At the graduate level whether the General Equilibrium Theory is directly dealt with or not, because of the link it has with Modern Welfare Economics, Pareto Optimality, Duality Theorem etc., the concept as such is not unfamiliar. Much work has been done on the theory in the second half of the past century. For a review of the literature see Frank Ackerman, *Still Dead After All These Years: Interpreting the Failure of the General Equilibrium Theory* (G-DAE Working Paper No. 99-01, November 1999, Global Development and Environmental Institute - Working Paper No.00-01). Ackerman's conclusion is: "The mathematical failure of general equilibrium is such a shock to the established theory that it is hard for economists to absorb its impact", (http://ase.tufts.edu/gdae/publications/Working_Papers/stilldead.pdf, p.5). This reference was passed on to me by John Kurien and I am grateful to him. Though dead, the General Equilibrium Theory will be around because it is the most popular theory of pricing. See End Note for my past involvement with it.

[16] William Jevons, *The Theory of Political Economy* (Edited with an Introduction by R.D. Collison Black, Penguin, London, 1970).

[17] I am relying on Walras because he spells out his theoretical method fairly clearly which shows how restricted is the application of his theory to real life situations. Many overlook this crucial aspect of theory and pick up just the conclusions. This is one reason for theory becoming an ally of propaganda. See Note 17 also.

[18] Walras had spelt out the procedure he was adopting: "From real-type concepts, these sciences abstract ideal-type concepts which they define, and then on the basis of these definitions they construct a priori the whole framework of their theorems and poofs", *Elements of Pure Economics*, p. 71. In my *On Markets in Economic Theory and Policy*, R.C. Dutt Lectures, 1990 (Orient Longman, Calcutta) there is a more detailed account of Walras's method and conclusions.

"laws" of a general nature can also be seen as holding within this universe which, therefore, can be claimed to be "universal". In the physical sciences such constructions are used as a prelude and aid to probe the real thing. This is what Walras claimed he was doing. His intention was to understand wealth, social wealth to be accurate, which for long had been recognised as the field of enquiry of economics. In Lesson 3 of *Elements* he first defined social wealth as "all things material and immaterial that are scarce", that is to say, useful on the one hand and available in limited quantity on the other. Useful things, limited in quantity, are appropriable. Appropriable things are exchangeable. Useful things limited in quantity are assigned value by exchange, and social wealth is the sum value thus assigned to useful things limited in quantity through exchange. Thus, a universe of discourse consisting of the inter- related concepts of social wealth, utility, scarcity, appropriation and exchange is set up.

But this was only one of the universes that Walras dealt with. The other universes that he took note of were the universe of production, or industry where the multiplication of useful things limited in quantity takes place, and the universe of property which deals with the appropriation of such things. He warned against the tendency to study simultaneously social wealth from all these points of view and decided to concentrate on the universe of exchange which, according to him, had not received enough attention. To do this he would leave out (abstract from) the other two. Thus *there is no one to one correspondence between theoretical structures and real life situations* and those who fail to recognise this fact may use theoretical conclusions as basis for policy recommendations or for purposes of propaganda. This is the most charitable explanation that can be given for that wide-spread mental disorder.

A second explanation for the gap between theory and reality is that theorists may abstract too much from the reality in their attempt to interpret reality. Staying on with Walras and those who have followed him, we may ask how valid it is to convert all decision makers, even within the limited realm of economics, as those only interested in their own expected satisfaction and are indeed trying to maximise it. With reference to exchange, this procedure is frequently justified by invoking isolated passages from Adam Smith, partly because he is considered to be the founder of economics (not a true claim at all) and also because he is accepted as a philosopher who should, therefore, be acknowledged as an authority on human nature. Isolated passages from his writings are then quoted, such as:

> "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our necessities but of their advantage".[19]

That appears to be a very clear statement about self- love in the context of exchange. Those who invoke this passage, however, forget that it is preceded by another passage which reads:

> "In almost every other race of animals each individual, when it is grown up to maturity, is entirely independent, and in its natural state has occasion for the assistance of no other living creature. *But man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only*. He will be more likely to prevail if he can interest their self-

[19] *Wealth of Nations*, Vol. I, Ch. II.

> love in his favour, and show them that it is for their own advantage to do for him what he requires of them".[20]

Wicksteed, writing a century later gave a different, and almost opposite interpretation of the logic of exchange:

> "We get our own purposes through a network of exchanges in which we are doing the things others want done, in order that we may get others to do what we ourselves want done".[21]

Is exchange motivated by self-love or an expression on the mutuality of our relationship with fellow human beings? Much can be said on both sides, the more said the better!

One more point needs to be added, in defence of those who consciously seek "theoretical" explanations for problems they consider important. Their intention is not to link theory and real life. On the contrary, and as already mentioned above and more will be said about how Walras handled it, they jettison a lot that is considered to be "real" to concentrate on the problem they have chosen. It is this procedure that is referred to as *abstraction*. The role of theory to them is to throw light on *(enlighten)* what they have decided, after careful consideration, as important. Thus, if it is considered that the rational allocation of scarce resources is the central issue in the science of economics, then whatever is necessary to centre stage that has to be done. "**If this…, then that**" is the nature of the postulational method on which economic theorists, especially Neo-classical theorists have relied. Kenneth Arrow and Frank Hahn who made very significant contributions to general equilibrium theory had this to say:

> "The immediate 'common sense' answer to the question 'What will an economy motivated by individual greed and controlled by a very large number of different agents' look like is probably: There will be chaos. That quite a different answer has long claimed to be true and has indeed permeated the economic thinking of a large number of people who are in no way economists is itself sufficient ground for investigating it seriously".[22]

The problem that they wish to tackle has been clearly formulated, whatever conditions are required to find a solution have been specified, and an answer to it has been proposed. Questions may and should continue to be raised about the procedures of the theory and its implications. That is one of the ways in which science grows. The physical sciences then turn to the real world to see whether new theories are supported by facts; in economics the position appears to be that if a theory is not supported by facts it is because of some 'imperfection' in the real world!

Let me now turn specifically to the theory of exchange as expounded by Walras and followers to show that no explanation of markets can be deduced from it. The strategy used by Walras was to show that value in use and value in exchange coincide in barter. Two parties enter into barter because each perceives use value in what the other has to offer, conventionally

[20] *ibid*, italics added.
[21] Wicksteed, *The Common Sense of Political Economy*, with an Introduction by Lionel Robbins (Routledge, London, 1935) p. 165.
[22] Kenneth Arrow and Frank H. Hahn, *General Competitive Analysis* (North-Holland, Amsterdam, 1970) p. vii.

referred to as "the double coincidence of wants". There may or may not be bargaining in their transaction. And the quantities of the two goods that they agree upon for the transaction reflect an exchange (price) ratio. If several parties are involved, and all are bargaining for exchange transactions, then it follows that rates of exchange for all goods will be established. So runs the argument. Conditions apply, of course. When n number of participants with m number of goods bargain, no actual transaction can take place till everyone is satisfied with every rate of exchange. It may be that this condition will be satisfied via the Invisible Hand alone. So introduce an Auctioneer who does not bid, but has the power to cancel all bids so that the *tatonement (groping)* continues till (relative) exchange values of all goods are established and no participant has an incentive to bid – general equilibrium is established, that is. There is also the need to express the relative exchange values arrived at as price. No problem. Select a good, any one, and use it as *numeraire* in terms of which all relative ratios are expressed and you arrive at prices. I have, of course, oversimplified, but I think this is enough for our purpose.

What are the short-falls in the Walrasian exposition? Let me touch upon two that I consider significant. The first is that while the numeraire may succeed in establishing prices in general for the theorist, unless the good selected is generally acceptable, most participants may not accept exchange as a matter of everyday living. This is where the absence of money in the Walrasian general exchange system turns out to be a problem. True, in the past several goods have been used to facilitate exchange; but we know also that under such conditions exchange was an occasional activity, and few entered into it. In any real life situation participants will need money (even if it is an IOU) backed by an accepted authority to enter into trade. Walras's Auctioneer does not have such authority.

Second, and more important is that Walras goes too far in claiming that barter establishes any rate of exchange except as between the two goods, the two participants and for that specific occasion. On this issue Marx certainly has a more correct analysis. According to him each act of barter (C-C) is a process of use value changing places and hands, and is "extinguished" when that transaction between two commodities and two parties is over. In other words, through barter it is not possible to arrive at generalized transactions. Ronald Coase was right when he stated in his Nobel Prize Acceptance Speech in 1992 that such theories of exchange that dominate Neo-classical Economics are fit only for the analysis of "lone individuals exchanging nuts and berries on the edge of the forest".[23] To generalise transactions it is necessary to have merchants and money; that is, the M-C-M format which, as we have already seen will naturally turn into the M-C-M' mode. Hence the claim that is made by Schumpeter and others that Walras was dealing with "multi-commodity barter" is not valid at all. In my view, "Multi-commodity Barter" is an oxymoron.

The truth of this claim is brought out by an analogy that Joan Robinson popularised based on an example that R.A. Radford had initially used.[24] They compared the Walrasian system to a prisoner- of war camp. The men are kept alive by official rations, but occasionally receive gift parcels from the Red Cross. The contents of the parcels are not tailored to the tastes of the individual recipients, so that it is possible for each one to gain by swapping what he wants less for what he wants more. The camp official takes the place of an Auctioneer and announces exchange ratios in terms of one of the goods picked from the parcels and lets the prisoners of war enter into exchange contracts. But the contracts are valid only if at the

[23] Quoted by Ha-Joon Chang in *Economics: The User's Guide* (Pelican, New York, 2014) p. 127.
[24] Joan Robinson, *Economic Heresies* (Macmillan, London, 1971) and R.A. Radford, "The Economic Organization of a P.O.W. Camp", *Economica* (November, 1945)/

announced prices the amount offered of each good is equal to the demand for it. If not, the tentative contracts are cancelled and the game starts again and is played till the two conditions are simultaneously satisfied, viz, the announced prices lead to satisfactory contracts for all participants and at these prices in all markets quantities supplied and demanded are matched.

The comparison of the "free" market economy with a P.O.W. Camp experience may not be fair. But it brings out an important aspect, the initial endowment of the participants. Walras had recognized this and took the commodities that the participants bring to the market as their endowments. Any endowment beyond that (property, for instance) he considered to be extraneous to the exercise on the determination of prices. But some initial endowment sufficient for the survival of each of the participants was required for the model to become robust. Arrow and Debreu referred to it, but according to Koopmans did not find a satisfactory procedure. Koopmans himself dealt with it as the "survival problem" and conceded that "the hardest part in the specification of the model is to make sure that each consumer can both survive and participate in the market, without anticipating in the postulates what specific prices will prevail in an equilibrium". It may be noted that among the alternatives that he put forward was what he described as the "hard-boiled" one, "to assume instantaneous elimination by starvation of those whose resources prove insufficient for survival…" He certainly was not recommending it, and finally decided to concede that the model "would be found best suited for describing a society of self-sufficient farmers who do a little trading on the side".[25] If that is the case, then the model cannot claim to be applicable to all situations, although the claim usually made about it is that it has "universal" applicability.

An important implication of the initial endowment condition is that entry into the market is not "free"; there is something of a "*fee*", to enter the market, that is, you must have purchasing power if you want to be a player in the market economy. What signals the market is not so much the preferences of the consumers as such, but their differential ability to back their desires by their resource endowments. Look around and see the prolific increase in the sale of motor cars and luxury apartments after we turned to the "free market" in the early 1990s while the production of consumer goods required by the vast majority of the people, including basic needs like food and shelter, lag behind. Or reflect on the decisions that we make. We know, for instance, that we cannot afford food served in all hotels, or treatment given in all hospitals or training in all educational institutions. We avoid embarrassment by selecting markets where we can afford the fee (mentioned in **Section II E** as the segmentation of the market on the basis of levels of income). But we know of people who cannot afford to buy even the basic necessities of life. The situation is more pathetic for another section of our citizens, even our neighbours, who are desperately eager to sell the only saleable thing they possess, their labour power, but for which there is no "market". How can a theory that recognizes the critical role of resource endowments for the survival of the participants and ensures it via appropriate assumptions – "hard boiled" or "soft boiled" – claim to be "universal"? And how relevant is it to countries like ours where we know the survival conditions of the vast majority of the people? Those who champion the cause of the "free market" are either unaware of its distributional aspect or are callously indifferent to it. All that they need is the assurance that the "Invisible Hand" works miracles!

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[25] For details see T.C. Koopmans, *Three Essays on The State of Economic Science* (McGraw-Hill, New York, 1957) pp. 59 to 63.

I started the Lecture referring to the propaganda about the free market where the Consumer is claimed to be King. *In reality the Consumer is* **not** *King,* **not** *Queen, but a mere pawn*.

Post script

I trust that an important query that arises from the Lecture is how we must introduce economics in the class room. There are two clear options. The first is the prevailing pattern, that is, via presentation of "theory" which most teachers have no experience of and students swallow because it is a condition for them to receive the degree. The second option is to guide the students through an expedition of real life economics. I have raised this question and tried to provide an answer favouring the latter option in my *Wealth and Illfare*, (as cited in Note 12) and in my paper "Abstract and Substantive Reasoning in Economics" in World Economic Association's Newsletter, Vol.4, Issue 6, December 2014 (http://www.worldeconomicsassociation.org/files/Issue4-6.pdf).

My claim is that in terms of ownership, intermediation, authority and asymmetry of information, and relying on substantive reasoning it will be possible to probe into the working of real life economies. However, it calls for a conviction and agreement on what economics is all about. A moment of reflection will show that we usually start with an unexamined assertion that economics is about the use of scarce resources and its optimal allocation. Is that really so? Or should economics be considered as part of the study of the society in which we live, more specifically as the study of arrangements that human communities make to ensure their material requirements and progress? That will make the subject a much broader enquiry – into history, politics and many more aspects of social realty – in which management of resources will have a legitimate place. Wasn't that the procedure adopted by the "Classical" writers on the subject? I hope those who are engaged in teaching of economics and research in economics will seriously consider this matter. If there are comments, they may be passed on to me: ctkurien@gmail.com.

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End Note

I may give a brief account of my own involvement with the General Equilibrium Theory which included exchanges with Kenneth Arrow, my teacher at Stanford University and discussions with T.C. Koopmans at Yale University where I was a Visiting Fellow in 1968-69. The background was my doctoral dissertation (1962) which was essentially on the much discussed topic of those days, "surplus labour" in "overpopulated underdeveloped economies" such as India. While most writers, including Arthur Lewis were concerned with showing how an economy with "unlimited supply of labour" would grow, my eagerness was to understand what surplus labour meant. I knew that technically it was a case of “excess supply “of labour and Linear Programming models relying on General Equilibrium Theory had shown that goods in excess supply would have zero price in equilibrium. Three noted economists had gone to the extent of saying that such goods would exist like “sand in the Sahara” (R. Dorfman, P.A. Samuelson and R.M. Solow (*Linear Programming and Economic Analysis*, Mc-Graw Hill, New York, 1958) Ch. 13. I could not accept that surplus labour would exist like that. I argued that the manifestation of surplus labour was the tendency for the inseparable use of labour and non-labour resources (land, capital) because the joint returns would be more than the sum of the separate returns to labour itself and the non-labour factors. I argued too that consequently various forms of self-employment, even when they could be shown to be technologically “inefficient” would be prevalent where the equilibrium price of labour tended to be zero. The dissertation was titled: “Factor Market Structure and Technological Characteristics of an Underdeveloped Economy – An Indian Case Study”.

After I got back to India, my main academic concern was to give a formal statement of my argument. I made use of what had come to be known as “The Walras – Cassel General Equilibrium Model” and presented a paper with the title “Some Problems of Factor Allocations in an Underdeveloped Economy” at a UGC sponsored Seminar in 1964. I shared the paper with Arrow and he responded enthusiastically saying: “I think you have put up a most interesting discussion in elucidating, with the aid of modern resource allocation theory, the nature of the dual economy”. However, he felt that an additional assumption of a minimum (subsistence) wage rate was necessary to complete the argument. I insisted that if it was accepted that surplus labour would resort to ways of survival, the model would not reach equilibrium. After a few exchanges, Arrow finally conceded the point and said:

> “I have puzzled for a long time on the question of the dual economy and I do not know that any theoretical coherent explanation exists. That does not mean of course that we cannot simply assume some imperfection in the competition and try to examine its consequences as you did in your dissertation and has been done by Lewis and earlier by Rosenstein-Rodan”.

I was not sure that imperfection of competition and a dual economy were the real issues. In the Father Carty Endowment Lectures of the Madras University in 1965 I re-examined the problem, retaining all the competitive assumptions of General Equilibrium Analysis, but introducing the “survival” condition of labour. That resulted in a broader framework representing the Indian Economy of which the perfectly competitive model (of the Arrow-Debreu, Koopmans kind) and the Arthur Lewis “Dual Economy” were shown to be special cases. These Lectures, further revised, later appeared as my *A Theoretical Approach to the Indian Economy* (Asia Publishing House, Bombay, 1970). It was the typed version of this publication that I shared with Koopmans. He not only validated my approach and conclusion, but encouraged me to do further work on the topic. But my interest and commitment were not to theory as such, but rather to the survival problem of millions of our fellow citizens. Consequently, I turned to searching for a clearer understanding of the problem of mass poverty and the conditions of living of the millions in our land. Those who wish to have a more detailed account of my intellectual journey may look up my *Rethinking Economics*, (Sage, New Delhi, 1996) Ch.2.

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