History of Economic Thought

Throughout history, we have had many explanations of how the economy works. Why people buy things, how things are valued, who generates wealth in the economy, how this wealth should be distributed and what the government should do to improve the standard of living for everyone.

In 1848, Karl Marx and Friedrich Engels published "The Communist Manefesto" which incorrectly argued that the value of something was what was put into it; and that labour controlled the means of production. We know that it is the intersection of demand and supply that determines the value (or price) of something and that is why entrepreneurs can make a loss. Also we know that enterprise is the factor of production that combines the other three to produce goods and services. It is for this reason that we say that enterprise controls the means of production. The theory of Communism has since been disproved, even still there are countries, like Venezuela, that try to adopt this failed ideology.

Before World War II, Keynesian economics became very popular, to the point where a later American President, Richard Nixon, said "We are all Keynesians now." Keynes argued for huge government expenditure during times of recession in order to stimulate the private sector into growth. Almost every government around the world in the 70's adopted this strategy.

As we moved into the 80's, the idea that Adam Smith talked about "The Invisible Hand of the Free Market" came very much into fashion. This called for as little government as possible and just allow the private interactions of consumers and sellers to occur; and it believed that this would increase the standard of living of the populace more than Keynesian, interventionalist policies. The American President, Ronald Reagan, tried to reduced the level of government involvement in the economy (however he increased government expenditure but removed many regulations which are the rules that govern certain sectors of the economy like the banking sector). This led to great prosperity in America in the 80's and was seen as the way forward.

The 2000's in America was a different story with economic stagnation and huge unemployment, and economists like Joseph Stiglitz, proposed that the economic recession of late 2001 was the result of the lack of regulation in the 80's and 90's and general economic attitude started to move away from Free Market principles.

The principles of Free Market Capitalism have been blamed for the recent financial crisis as they had come back into fashion in the late 1990's and early 2000's in this country.

We will now take a look at the development of economic thought throughout history and the main people that were associated with them.

The Mercantilists (1500 - 1780)

1) The Mercantilists believed that wealth consisted of precious metals like gold and silver.
2) They believed that countries should try to achieve a favourable balance of trade (export more goods than they imported) by increasing exports and lowering imports.
3) They thought that European countries should acquire colonies and steal natural resources (gold and silver) from these colonies, export it and achieve a more favourable balance of trade.
4) They thought that countries should try to become self sufficient (not rely on the imports of other countries). They thought that countries should achieve this by pursuing protectionist policies.
5) They felt that the government should intervene to try to achieve a favourable balance of trade.

Physiocrats (1750 - 1800)

1) They felt that agriculture was the main source of a country's income (wealth).
2) They felt that state interference made the economy worse off and as such wanted to keep state interference to a minimum. They promoted laissez - faire policies.
3) They felt that individual property rights was exceptionally important to achieve economic growth.

Classical School (1780 - 1800)

1) The Classical school is the birth of real modern day economics, which still lasts today and is being more and more promoted recently.
2) They believed that laissez - faire economic policies were the key to economic growth and as such wanted government involvement kept to a minimum.

3) They contributed to the idea of what is known as the Labour Theory of value. The incorrect assumption that the value of a commidity is the value of the labour (hourly wage X time taken to produce the good) that was put into it.
4) They believed that interest rates settled when savings equals investment. This is still true in the Long Run but John Maynard Keynes proved it untrue in the Short Run.
5) They believed that free trade (No trade restrictions like tariffs, quotas or embargoes) ensured a higher level of National Income.
6) The believed in the free market. The idea that the government should not interfere in economic policies. Let the price mechanism bring the market into equilibrium.

Marxists

1) They believed that there was a struggle between classes one which the workers would eventually win.
2) They believed that labour was the means of production, that produced and excess value which was taken by the capitalists (the owners of capital who were the owners of the company). This excess value was what capitalists called profits.
3) They believed that socialism and later communism would eventually replace capitalism around the world.

Neo - Classical School

1) The contributed to the "Utility Theory of Value". The value of something in the short run is determined by it utility in the short run and its costs of production in the long run.
2) They thought that government could take positive economic action by preventing the growth of monopolies. Remember, monopolies are a form of market failure.
3) They introduced the idea of elasticity.
4) They promoted the MRP of Wages theory
5) Their main interest was on the household and the firm and as such the study of microeconomics began

Keynesian School

1) He suggested that national income could be in equilibrium (Aggregate Demand equals Aggregate Supply) without full employment
2) He opposed the Classical School idea that in a recession, wages would fall, the demand for labour would then rise and a recovery would follow. Keynes said that if wages fell, consumption would fall (as real income fell) which would lead to a worse recession.
3) Keynes favoured government intervention in the form of fiscal stimulus (lowering taxes and increase government spending) in order to try to stimulate demand. This became known as "spending your way out of a recession".
4) He was the one that introduced the idea of the Multiplier.
5) He opposed the Classical School theory of interest rate determination in the short run (Loanable Funds Theory) and came up with his own theory of interest rate determination in the Short Run. Liquidity Preference Theory. This states that interest rates in the short run are determined by the desire of people to hold their wealth in cash form.
6) Keynes proposed that the level of investment was influenced more by the expectations of business people than the rate of interest.

Monetarists

1) **Monetary Policy:** should be the main instrument used by the government to manage the economy and not fiscal policy. Increased government expenditure would only lead to higher prices and not increased output and employment as advocated by Keynes.
2) **Control of Money Supply:** Monetarists suggest strict control of the money supply so as to control inflation. Limiting credit availability, keeping interest rates high would control consumer borrowing.
3) **Inflation:** Reduction in inflation increases competitiveness which may lead to relatively cheaper exports, increased exports and job creation in the long run. Companies should keep wage increases to a minimum in order to avoid cost-push inflation.
4) **Laissez Faire Principles:** Monetarists favour a return to laissez faire principles: minimum state intervention; de-regulation of markets; privatisation of state bodies.
5) **Supply Side Policies:** Monetarists favoured any policies which improve market efficiency / boost supply/ reduce the ability of trade unions to interfere with the labour market.

Supply Siders

1) They agreed with Say's Law (we will look at this later), which said that supply creates its own demand. Therefore, they advocated an expansion of supply and not of demand as a solution to economic problems. Remember, it is the quantity and quality (or value) of what is produced in an economy that defines the wealth of a nation.
2) They advocated low taxes as they would encourage production (or at least remove a disincentive to produce goods and services) which would create employment.
3) They promoted the deregulation of markets (the removal of legal restrictions on how companies are allowed to act) and the privatisation of state companies.

Economist	Main Ideas
Thomus Mun	Encouraged Trade Surplus and Self Sufficiency
James Stuart	Government Intervention
François Quesnay	Agriculture is the source of wealth Tableau Économique - Similar to the Circular Flow of Income
Jacques Turgot	Law of Diminishing Marginal Returns as applied to agriculture Against Government Interference
Adam Smith	Division of Labour (Specialisation) Labour Theory of Value Against Government Interference Canons of Taxation
Thomas Robert Malthus	Population grows faster than food supply Iron Law of Wages

Economist	Main Ideas
David Ricardo	Law of Comparative Advantage (International Trade) Theory of Rent (Reward to the owners of land)
John Baptiste Say	Production created its own demand and therefore economic crises could not exist Identified Enterprise as the 4th Factor of Production
John Stuart Mill	Wages Fund Theory Advocated Free Trade
Alfred Marshall	MRP Utility Theory of Value Quasi Rent Elasticity, Consumer Surplus, Long and Short Run
John Bates Clark	MRP Theory of Wages The Accelerator Principle
John Maynard Keynes	Favoured government intervention in economic affairs by way of fiscal policy Liquidity Preference Theory National Income could be at equilibrium at less then full employment Multiplier
Milton Friedman	Advocated the use of Monetary Policy Control of Money Supply Prices will stabilise leading to an environment of economic growth.

David Ricardo

1) **Law of Comparative Costs:** Ricardo supported the idea of free trade and developed the law of comparative costs which states that a country should specialise in the production of those commodities in which it is relatively most efficient and trade for the remainder of its requirements.
2) **Theory of Economic Rent:** If population increased it was necessary to use inferior / more remote land. For use of this land rent was paid. As a result the price of food rose. Cost of producing on the best land was lower therefore food produced on this land earned a surplus over that produced on inferior land. This surplus led to an increase in rent payable for the use of good land.
3) **Accepted the Subsistence Wages Theory:** He believed that any increase in wages above the subsistence level would cause an increase in population which would in turn cause wage levels to fall.

Adam Smith

1) **The Pursuit of Self Interest:** This best benefited the individual and hence best benefited society.
2) **Division of Labour:** Increased productivity and a country's wealth. His example - the manufacture of pins illustrated the benefits of the division of labour.
3) **Labour Theory of Value:** The value of an item was equal to the amount of labour that went into producing the product.
4) **State Protection of Property Rights:** Encourages the accumulation of personal wealth.
5) **Invisible Hand of Competition:** Allows a self regulating market to operate thus ensuring economic progress is achieved.
6) **Perfect Competition:** Free entry into markets; profits sufficient to reward entrepreneurs; inefficiency penalised and price would be based on the cost of production. Monopolies would not persist.
7) **Laissez-Faire:** No justification for government intervention in the economy except for defence/justice.
8) **Canons of Taxation:** To fund the state's defence/justice systems taxation was necessary and he devised the four principles of a fair tax system: equity, economy, certainty and convenience.
9) **Paradox of Value:** He distinguished between 'value in use' and 'value in exchange'. Some items had a vast utility (air, water) but are not

exchanged, while others (diamonds) possessed little utility but could command a great value in exchange.

10) **Free Trade:** He advocated international free trade unhindered by the imposition of tariffs so that markets could operate effectively and allow the gains from trade to be spread between nations.

Alfred Marshall

1) **Theory of Value:** The value of a commodity was determined in the short-run by its utility and demand and in the long-run was determined by its cost of production.
2) **Distribution of Wealth:** The return to each of the factors of production was determined by their marginal productivity.
3) **Competition Regulated Economic Activity:** Government intervention and inter-business co-operation could regulate economic activity and enhance economic freedom.
4) **Growth of Monopolies could be Prevented:** Regulation by government; consumer information; increased number of small investors/more accountability.
5) **Quasi Rent:** The economic rent earned by factors of production in the short run when demand exceeded supply.
6) **Developed concepts of price-elasticity of demand / consumer surplus / how markets adjusted to changes in D & S over time:** quantifying buyers' sensitivity to price; the surplus value or utility a consumer enjoys; Market period, short period and long period.

John Maynard Keynes

1) **National Income at Less than Full Employment:** Keynes observed that national income could reach equilibrium without reaching full employment and hence he suggested government intervention to help create jobs when required.
2) **Output is Demand Determined:** The size of national income depends on expenditure i.e. $C = I + G + X - M$
3) **Favoured Government Intervention in the Economy:** The job of the government is to manage the economy. The government can use fiscal policy to create full employment.
4) **Investment Decisions by Entrepreneurs:** He stated that investment by entrepreneurs depended more on businessmen's expectations than on the rate of interest.

5) **Investment could be less than Savings:** This could result in a leakage in spending which decreases national income and employment.
6) **New Economic Concepts – The Multiplier:** He developed new tools to explain his theories including the multiplier: Any initial increase in spending will cause a greater much greater increase in GNP due to the fact that one person's expenditure is another person's income. He developed concepts such as: - MPC, MPM, etc.
7) **Liquidity Preference Theory:** People may prefer to hold their wealth in money form for three reasons: transactionary; precautionary and speculative reasons.
8) **Managed system of Exchange Rates:** He favoured a system of foreign exchange rates which could be 'managed' by the state rather than the gold standard.

Milton Friedman

1) **Monetary Policy:** Should be the main instrument used by the government to manage the economy.
2) **Control of Money Supply:** Monetarists suggest strict control of the money supply so as to control inflation.
3) **Reduce Inflation:** This increases competitiveness which may lead to increased exports and job creation in the log run..
4) **Laissez Faire Principles:** He favoured a return to laissez faire principles - with minimum state intervention; de-regulation of markets; privatisation of state bodies.
5) **Supply Side Policies:** He favoured any policies which improved market efficiency / boosted supply: de-regulation of markets; reducing the ability of trade unions to interfere with the labour market.

Karl Marx

1) Marx argued that workers were paid subsistence / minimum wages by their employers.
2) The value of the goods produced by a worker was more than the wages paid to the worker. (The difference between the two he called the 'surplus value' or profit to the employer). This illustrated that workers were exploited and in time would be replaced by capital resulting in their unemployment.

Thomas Robert Malthus

1) Malthus stated that population increases in a geometric progression (i.e. 2, 4, 8, 16 etc) while food supply increases in an arithmetic progression (i.e. 2, 3, 4, 5 etc).
2) Population would outgrow the means of subsistence. The outcome would be famine, disease etc.

No

His theory is not relevant today

POPULATION

1) Extensive population control measures are in place worldwide which are helping control population growth.
2) Some countries impose strict population controls e.g. China's 'One Child Policy'.

FOOD PRODUCTION

1) Because of the development of high yielding crops /Genetic modification means that food production is being increased.
2) The availability of cheaper imports from developed nations (EU; North America) is helping the distribution of food worldwide.