CHAPTER 19, “History and Schools of Economic Thought,” FROM THE BOOK:

The Science of Economics

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In studying economics, we encounter different schools of thought regarding phenomena such as business cycles, national income, markets, and international trade. Students will also encounter their names and theories. It is therefore worth while to see what these schools teach and how they are different.

1. Mercantilism

During the 1500s through the 1700s, the mercantilist school predominated in Europe. **The main object of trade was said to be the acquisition of bullion - gold and silver - for the national treasury**. Such riches would enable a country to have a strong military and also use this wealth for domestic investment. Mercantilists also promoted domestic industry with government protection and aid. To acquire precious metals, a country needed to either possess mines, as did Spain in its Latin American colonies, or to have an export surplus which would be balanced out with an importation of metals.

One problem with such a mercantilist policy is that one country's trade surplus implies deficits in other countries, so all countries cannot together succeed. As Adam Smith was to argue in his ***Wealth of Nations***, when all countries restrict trade, the result is less wealth overall.

2. Physiocracy

In reaction to mercantilist policy, a school of though arose in France during the 1700s, the first to call themselves "economists." They called their school "physiocracy," which means "the rule of natural law." The most prominent of the Physiocratic economists was **Francoise Quesnay**. Physiocratic theory emphasizes free trade as removing barriers which harm consumers.

In physiocratic theory, nature provides a "net product" which is a surplus beyond the payment to labor and the provides of capital. This is equivalent to what we now recognize as land rent. Instead of taxing industry, the physiocrats theorized that the net product could be an "impot unique" or "single tax" that could provide for all government revenue. Much of this revenue could then be invested in infrastructure and other capital investments, which would further increase productivity, increasing rent or the net product even more, thus putting into effect an upward spiral of economic development. The Physiocrats thus had the first model of the circular flow of an economy and a model of economic development which was to be successfully applied by Japan and Taiwan.

3. The classical school

Also in reaction to mercantilist economics, and influenced by the physiocrats, **Adam Smith** in 1776 began the school which was to be called the "classical." As noted above, Smith showed how free trade would increase the "**wealth of nations**." His book, a major systematic treatise on economics, showed how the general welfare was increased by persons acting out of self-interest in a free market. Smith emphasized the productivity caused by a division of labor. Classical economists believed in the "labor theory of value," that the value of goods comes from the labor used to produce it, a view refuted by later economists. Also a moral philosopher, Smith's book, ***The Theory of Moral Sentiments***, showed how people are not just self-interested but also can act out of sympathy with others or some cause.

David Ricardo in the early 1800s expanded the though of Smith to analyze the effects of growth on land rent. Population growth would push production to less productive land, thus increasing land rent while keeping wages at a subsistence level. Ricardo also furthered the theory of international trade with the concept of comparative advantage, showing how trade was mutually advantageous.

John Stuart Mill was another major classical economist as well as philosopher and the author of the famous essay ***On Liberty***. Writing in the mid 1800s, his text was a widely used benchmark in economics. The classical school theorized that free markets provide for maximum prosperity, and that land rent is an especially suitable source of taxation. However, social problems, labor unrest, and continuing poverty raised doubts among some about the virtues of markets. Some economists, including Mill, turned to various degrees and types of socialism for remedies.

4. Socialist economics and Marxism

Karl Marx was a German philosopher and economist who settled in Great Britain and collaborated with Friedrich Engels in much of their work, including The Communist Manifesto. Marx's main book, Das Kapital or **Capital,** in three volumes, was as much a critique of so-called "capitalism" or market economies as a treatise on the socialist alternative, which was not described in much detail. Marx divided society into two main classes, capitalists who owned property and the proletariat workers.

Basing his analysis on the labor theory of value, Marx held that revenues of production belonged to labor, and the surplus value, or profits, properly belonged to workers. For that reason, and due to an army of unemployed workers which keeps wages low, capitalists exploit workers. Eventually, however, as capital goods accumulate, the rate of profit will fall, and industry will become more concentrated in ownership. Eventually, the proletariat would revolt and own the means of production, sharing the product according to need.

Modern Marxist economists follow Marx's general line of thought, with various modifications. Despite the failure of socialist systems and the theoretical criticism of Marxist thought, Marxists continue to believe that the market process is inherently flawed and needs much fixing.

5. Geo-classical economics

Henry George was an American classical economist, but was also very critical of much of classical thought and presented alternative theories. His major work was ***Progress and Poverty***, written in 1879. Thus he and his Georgist followers form a school of their own, which I call "geoclassical," the term "geo" standing for both George and for land. It has elements in common with both the Physiocrat and the classical school. But George rejected the classical notion of Malthus that population will tend to outrun production, and he also argued against the classical "wages fund" theory that wages are paid from some fixed amount of capital fund.

Instead, George theorized that wages are set at the margin of production, where the best free land is available, and production of better land, after paying wages and capital yields, constitutes land rent. Land rent is increased and wages lowered by land speculation, which pushes the margin to less productive land. The remedy for the resulting poverty is the collection of land rent for public revenue and the abolition of the taxation of labor and capital. This will not only increase the margin to more productive land, but also remove the stifling effects of taxing and restricting labor. George also advocated free trade just as the classicals and physiocrats did.

Hence, while socialists advocate the replacement of markets with central planning and redistribution, the geoclassical school recognizes that markets are not truly free if restricted and taxed, and it is these interventions that cause unemployment and poverty. Prosperity can be attained by removing these barriers, not erecting others.

6. The Austrian school

In 1871, **Carl Menger**, an economist in Vienna, Austria, wrote ***The Principles of Economics*** in reaction to German economists who based their though on historical studies, without the need for any general abstract theory and also in reaction to some classical concepts. In contrast to the classical labor theory of value, Menger recognized that value and utility are entirely subjective, independent of labor and other inputs. The value of land, labor, and capital goods are base on the values and utility people place on consumer goods.

Besides **subjectivism**, Menger's theory included **marginal analysis**, in which the value and market price of a good is based on the utility of the marginal or extra increment of the good obtained. This marginal utility diminishes with increasing amounts of the good. Trade is beneficial because people exchange goods of lower marginal utility for those of higher marginal utility. Menger also developed a theory of money based on its origin in exchangeable commodities.

This analysis began a new school of thought, called the Austrian. Other economists in the school included Boehm Bawerk, who worked out a theory of capital and interest. **Ludwig von Mises** also wrote on this theme, recognizing that interest rates depend on time preference (see Chapter 5). Mises' main treatise, ***Human Action***, written in 1949, is a staunch defense of the market process. Mises and another Austrian, **Friedrich von Hayek**, argued against socialism, saying that economic calculation required the competitive enterprise of markets, so socialism would be ineffective.

Austrian thought emphasizes the importance of basing theory on individuals and their subjective values. Besides marginal analysis, Austrian theory emphasizes the spontaneous order of market processes, the uncertainty of the future, the importance of the heterogenous aspects of capital and money creation, and the decentralized nature of knowledge. Austrians such as Hayek have further developed the theory of capital, and modern Austrians have pioneered the theory and study of the history of free banking. Austrians also have a theory of the business cycle emphasizing the role of money creation and interest rates. Contemporary Austrians are now world-wide.

7. The neoclassical school

Besides Menger, two other economists, **Stanley Jevons** in Great Britain and **Leon Walras** in France pioneered **marginal utility theory** and thus sparked a revolution in economic thought that converted most economists from classical to neoclassical analysis. In neoclassical thought, the value of goods derives not from labor but from their marginal utility. The classical differentiation of land and capital became blurred, as neoclassical theory became described in mathematical terms. Land became treated as part of capital.

Walras pioneered the theory of general equilibrium, with a model of an entire economy where all production is interrelated in an equilibrium setting all prices and quantities. **Alfred Marshall** in Great Britain developed the theory of supply and demand, including the geometrical conventions of the curves. In Sweden, **Knut Wicksell**, influenced also by Austrians, further developed theories of capital, interest, and public finance. Favorable to taxing land, Wicksell originated the concept of the natural rate of interest in a free market.

8. The institutional school

While most economic theory is based on abstract supply and demand, factors, and expenditure, the institutional school points out that organizations also influence economic activity. The American economist **Thorstein Veblen** was a key theorist in this approach. Government, large corporations, banks, labor unions, and social organizations certainly affect the outcomes of economies, and institutionalist economics is important in the understanding of economic history and current economic life. The theory of institutions is also part of basic economic theory. Both the Austrian and geoclassical schools have included institutional concepts in their theories, including the role of central banks in Austrian monetary theory and the role of land tenure in geoclassical theory.

9. The interventionist school and Keynesianism

During the great world-wide depression of the 1930s, many neo-classical economists came to doubt the full-employment claims of neo-classical macroeconomic theory, although Austrians and geoclassical economists recognized that the economies of the early 20th century had many interventions which had led to the depression. **John Maynard Keynes** in Great Britain published the book ***The General Theory of Employment, Interest and Money*** in 1936, claiming to overturn many neo-classical concepts, although microeconomic neoclassical theory was not questioned.

Keynes argued that wages would not automatically or swiftly adjust to a lower supply/demand juncture, but can remain stuck at a high level, reducing the demand for labor and creating unemployment. Also, Keynes disagreed with the classical and neoclassical concept that investment increases with lower interest rates. To Keynesians, markets do not necessarily work well, and they are not always self-correcting when unemployment rises and output declines. Government intervention is needed to boost demand. Whereas classical theory states that the supply side determines output, since factors are paid the full amount of the product, and since prices adjust to equilibrate supply and demand, Keynesian interventionists claim that prices and wages don't in fact adjust, and that in a money economy, the total demand for products can be insufficient, since people don't necessarily spend enough.

Keynesian policy thus emphasizes increasing demand during a depression by increasing the money supply, by increasing government spending, raising the money supply, and reducing taxes to increase private spending. During a boom, the government can reverse these policies to reduce inflation. Interventionists have restored some mercantilist policies, some arguing for protectionist measures.

Critics of such interventionist policies point out that the interventions, first of all, do not necessarily work in the long run. Inflating the money supply eventually raises prices and stops raising output, aside from distorting prices and production. Also, these policies attempt to treat the effects of economic problems without analyzing the root causes, which turn out to be interventions rather than the market process itself.

In response to these critiques, a **New-Keynesian school** has developed, with more sophisticated theories of how markets fail and how intervention can correct them, so the debate continues.

10. The new-classical macroeconomic school

In reaction to interventionists, especially in money and banking, the monetarist school restored the classical theory of money that emphasizes the role of the quantity of money. High money expansion in the long run leads to inflation rather than increasing output. A key **monetarist** has been **Milton Friedman** in the United States. Monetarists point out that government does not have the knowledge to respond to every twist and turn in the economy, so instead of discretionary policy, it is better to have some rule that will be followed by central banks. Monetarism is not a complete macroeconomic theory, but is a school within macroeconomics, especially for monetary economics.

More comprehensively, some economists have argued against intervention as the "new classical" school. A key concept in this school is that of "rational expectations," which states that people create judgements about future economic variables such as inflation using past information and some model or theory of the economy, by which they will avoid systematic mistakes. The New-Keynesian school has accepted rational expectations, so it is not an exclusively new-classical principle, but it is used to rebut some interventionist policies, since the new-classicalists state that people will recognize and respond to expected policy.

11. The post-Keynesian school

A new macroeconomic school of thought based on Keynesian thought, expanded by the work of the Polish economist **Michael Kalecki**, has been called "post Keynesian." They follow Keynesians in believing that markets don't always clear and that individuals don't always perceive the correct market signals. They also have adopted some institutionalist thought and a Marxist emphasis on the different economic classes, the workers and capitalists. Post-Keynesian thought has also been influenced by the work of the Italian-British economist, **Piero Sraffa**, who restored some Ricardian classical theory, where prices are determined by the costs of production.

12. Foundational economics

The foundational school of economics encompasses all economic theory, micro, macro, and institutional. It seeks a comprehensive theory of economics, synthesizing the thought of all other schools in an integrated, systematic way, with a foundational based on a set of axiomatic propositions that apply to all people, times, and places. Pure theory is derived from these propositions using deductive logic. Specific theory about particular events, cultures, and economies is based on pure theory and the institutions and facts about the particular phenomena, derived using hypotheses tested by data as well as deductively. The foundational school integrates moral and economic concepts, since it recognizes that pure markets follow moral rules.

The macroeconomic model is that of a pure market economy on which interventions are imposed. Pure markets work well, providing for prosperity and full employment. In accord with the physiocratic and geoclassical schools, foundational economics agrees that land rent is the efficient source of revenue for public goods and services. In accord with classical theory, it agrees with the principles of free trade. Its trade theory combines geoclassical and Austrian elements for an integrated theory with real and monetary aspects. It also accepts the Austrian theory of interest rates based on time preference and its theory of banking.

Foundational theory encompasses neoclassical marginal analysis and price theory, but retains the classical differentiation of the three factors of production. Socialist and interventionist views are not accepted, since these are flawed or lacking axiomatic foundations.

Foundational economics is open to theory from any school or approach so long as its pure theory can be derived from the axiomatic propositions or has specific theory founded on pure theory. It can therefore potentially create a synthesis from the other schools as a comprehensive and unified theory of economics.

Conclusion

Most economists today are neoclassical in micro-economics and interventionist or monetarist/new-classical in macroeconomics. This author and text are foundational, drawing much from geoclassical, Austrian, and neoclassical theory. Which school do you find makes the most sense?