

*The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.*

*J.M. Keynes, The General Theory, [p 383]*

## **Chapter 1** **AN INTRODUCTION TO THE HISTORY OF** **ECONOMIC THOUGHT:** **AN OVERVIEW**

In every society it is necessary that there be a process to organize and coordinate choices regarding the **production**, **distribution** and **consumption** of **goods and services**. The need for this process arises because:

- our resources or inputs are finite at any moment in time,
- our technical knowledge constrains our ability to utilize these resources to produce goods and services,
- individuals, organizations, social institutions, business and governments may constrain output,
- in Western societies, wants or desires of individuals or groups are shaped by cultural or physical forces and often exceeds the availability of economic goods and services.

Ideally, these relatively scarce resources should be allocated to their “highest valued use.” A solitary individual who knows her/his preferences will typically use resources to satisfy those preferences to the greatest extent possible within constraints. This requires information, knowledge and choices about which goods and services should be produced and how to best produce them. Daniel Defoe’s [1659 (?60)-1731] *Robinson Crusoe* [1719] was a tale of a solitary individual, endowed with scarce resources, and the challenges he faced. When Friday enters the story, their lives and the allocation problem are altered. When individuals live in social groups it becomes necessary to distribute the goods among the individuals as well as choosing which goods and services to produce. In the jargon of the economist, it is necessary to decide

- What should be produced?
- What is the best way to produce it?
- Which individuals should get which goods and services?

Among the classics of literature are stories of the social and individual effects of the processes of allocation. Victor Hugo's [1802-1885] *Les Misérables* [1862] and many of the Charles Dickens [1812-1870] stories are examples.

The method that a society devises to answer these questions shapes the nature of society and influences the answers to the questions. There are many possible approaches to organizing economic activities of individuals living in social systems. Whatever method is chosen, it is necessary to coordinate or integrate the behavior of individual members of the society. The history of economic thought is a study of the more important attempts to analyze, describe and explain the relationships in actual or idealized economic systems. Knowledge of alternative explanations of economic processes provides a basis for evaluating the performance of industrial economies. It also provides a basis for critically evaluating economic theories and models that purport to describe modern industrial economies.

## ***ECONOMICS***

Economics is the study of how a society organizes the economic functions or processes. There are many definitions of economics. Jacob Viner is credited with defining it as, "*Economics is what economists do.*" This is correct but not a very useful definition. As one of the early architects of modern economics, Alfred Marshall defined economics as:

*"Political Economy or Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and use of the material requisites of wellbeing.*

*Thus it is on the one side a study of wealth; and on the other, and more important side, a part of the study of man."* [Marshall, p 1]

More recently, in a popular principles of economics text, economics was defined (as it is typically defined by most principles of economics texts) as:

*Economics is concerned with the efficient utilization or management of limited productive resources for the purpose of attaining the maximum satisfaction of human material wants.*

[McConnell, p 1]

The contrast of the definitions used by Marshall and McConnell suggest a difference in emphasis. Marshall focuses on economics as a social science and the role of the individual in a social system; it is "*a part of the study of man*" [humanity] in a social context. McConnell's definition is more narrowly focused on the allocative mechanism with respect to production, distribution and consumption of "material" wants; it seems to imply a study of "things" with relation to humans or individuals.

Human behavior is complex. Human interaction or social behavior is even more complex. Because of this complexity, it is necessary to abstract from reality. These abstractions are presented as **models**, analogies or metaphors. These models may be presented as narrative stories, mathematical systems [or equations], graphs or other representations of relationships among the relevant elements in the social and economic systems.

There are three fundamental reasons that economic behavior may be studied. First, as an academic discipline there is a desire to understand, describe and explain the world in which we live. Second, as a practical matter there is the desire to predict and control economic processes and their outcomes. Third, the method selected to describe, explain and predict economic processes shapes the perceptions and values that individuals in societies hold about those processes. Therefore, the values held by the members of society can be influenced by the theories, models or "stories" we believe and use. What we learn, teach and accept is the nature of our culture. Story telling is a mechanism for transmitting values and civilization. Economists are storytellers; their theories and models are stories that contribute to the character of society.

## *THE ECONOMY*

The process of integrating individual behavior has three important elements, all of which require the collection, interpretation and communication of information;

- the identification of objectives of the individual(s) and society,
- identification all possible alternatives that are feasible given the finite resources, social institutions and the current state of technical knowledge (technology),
- criteria to evaluate each possible alternative with respect to the objectives.

It is necessary to know the objectives or goals in order to make a rational choice. In a world with finite resources and technological constraints, individuals must choose among competing alternatives. They must know their preferences and objectives in order to make appropriate choices. In a social group the problem is more difficult, not everyone has the same preferences. Therefore, the preferences among individuals must be prioritized or assigned weighted values. The task is to establish criteria to identify the appropriate relative weights of values, or priorities, of the alternative uses of available resources among individuals as well as among different goods that could be produced. Is it more important for individual A to have a new car or individuals B, C, D and E each have a new refrigerator? Is it more important that individual A should have cigarettes or individual B have milk? The

weighting of values should consider relative scarcity of inputs and technology as well as social and individual objectives. Each society must devise processes to make choices about allocation of resources and the distribution of goods and services.

There is a continuum of approaches to the problem of allocation. At one end of the continuum, is the individualistic free market approach; individuals know their own preferences and then rely on a system of markets to signal information about the appropriate weights of individual preferences and establish incentives to coordinate their voluntary choices. At the other extreme of the continuum, the allocation process may be centralized and decisions are made through the authority of an individual or group; individual choices are not allowed. A third possibility is an economy where decisions are based on tradition; behavioral patterns that have seemed appropriate in the past become embedded in the system. While markets, command and tradition may be present in most societies, one approach is usually emphasized and determines the character of the economy.

In modern, Western, industrial societies, the process is called "the economy." Beginning in the mid 1700's with the Physiocrats and later Adam Smith, there has been an ideological bias and emphasis toward the use of markets as the primary allocative mechanism. Traditional solutions to some economic problems are present. There may be some economic activities and processes that are controlled by law, regulation or other forms of command. However, the dominant approach to the coordination of economic behavior and the allocation problem is the market.

The economy is one of many components, or sub-systems that work together to make up a social system. Using the reductionist approach of Western science, the social system can be thought of as many sub-systems including politics, religion, ethics, law, kinship, symbols, values, customs, mores and a variety of other processes and institutions. Other sub-systems might be identified such as the health care system, transportation system, educational system, legal system, industrial system, communications system, telephone system, etc. Each of these systems can be divided further. The health care system can be viewed as composed of an insurance system, medical education system, hospital system, and so forth. The transportation system is composed of a road system, trucking system, airline system, railroad system, system of navigable rivers, etc. All of these systems are interrelated and each influences the nature and operation of the others. As one component, the economy is related to each of the other components in society and influences and is influenced by each of the other components. The nature of political beliefs and the political system influences social perspectives and attitudes

about the operation of the economy. At the same time, the structure and performance of the economy is an important influence on the political system. This is true of law, religion, ethics, and other components of the social system. Individual attitudes about the direction and strength of these influences or relationships are an important factor that explains the existence of different approaches and schools of thought in economics.

The economic system has two related functions in all societies. One function is to contribute to the wellbeing of the individual and to promote the operation of society; to balance individual autonomy with the commonweal. The other function is to **allocate** or **ration** scarce resources among competing uses and among the members of society. The attainment of these functions is interdependent. The allocation process is more obvious and mechanical. Balancing individual wants with the social welfare is more difficult to observe and depends on an appropriate allocation process. The identification of two separate functions is to emphasize that the allocation process is not the end; rather it is a means to an end.

### ***INDIVIDUAL AND SOCIETY***

The most important task for any economy (or for that matter any social system) is to contribute to a balance between the autonomy of the individual with the commonweal or social wellbeing. The question about how to best insure the freedom and wellbeing of the individual within a just, stable and peaceful society is an issue that has been a common thread that has run through most of the important contributions to the history of economic thought. There are two extreme perspectives to this issue. The first is that there is a natural harmony of interests among the individuals in society or there are natural processes that result in a harmony of interests. The second view is that there is a conflict of interests among various individuals, groups or classes. A common element in both Classical and Neoclassical economics is that voluntary exchanges among individuals in a free market will resolve all or most conflicts. At the other extreme, Marxist economics is based on a belief that there are inherent conflicts among classes in the capitalist system, which result in its inevitable failure.

There are also different views regarding the direction and strength of the relationships of economics to the social system. At one extreme, the economic system may be seen as the primary determinant of most or all aspects of the social system. This view tends to hold that the economy is of greater importance than other aspects of society. One example of this position is Karl Marx [1818-1883] who uses the "modes or techniques of production" to explain the historical stages of

society and ultimate failure of the “**capitalist system**”. Alternatively, Austrian economists (Karl Menger [1840-1921], Ludwig von Mises [1881-1973], Fredrick Hayek [1899-1992], Murry Rothbard [1926-1995], et al.), public choice theorists (James Buchanan [1919- ], et al. ) and Neoclassical economists (Gary Becker [1930- ], Richard Posner [1939- ], et al.) explain the success of the **market system** because the rational decision making of individuals results in an optimal allocation of resources. Moreover they agree that the rational, individual economic behavior of individuals in a market setting creates the optimal structure of social institutions; the legal system, property rights, family and kinship relations and all other social institutions reflect economic forces and lead to optimal solutions of human and social problems. From this perspective, the economy is seen as the dominant aspect of society. As a result, this creates the perception that economics (economic theory) can explain most if not all human behavior. The belief that economic theory can be used to explain history, sociology, politics, religion, family life, sexual behavior and crime is referred to as “economic imperialism.” [Swedeberg, pp. 34-38]

The other view is that the social system determines (or should determine) the operation of the economy. Karl Polanyi [1886-1964] makes the argument in his book, *The Great Transformation* [1944], that there was a shift in mainstream thought from the perspective that the economy was an element to serve society to the view that society is an element to serve the economy and economic interests.

### ***ALLOCATION MECHANISM***

Modern principles of economics texts typically identify the economy as a process whose primary function is to allocate or ration resources [the inputs into the production process] among alternative uses. The allocation mechanism is required because of relative scarcity. Expanding on the allocation process mentioned above, there are 5 basic questions to be answered with respect to the use of resources:

- (1) What goods and services should be produced?
- (2) How many of each should be produced?
- (3) What techniques should be used in the production of the goods and services?
- (4) When the production or use of the goods and services take place?
- (5) Who should get the benefits of the use of each good or service?

The answers to these 5 questions are determined by a variety of factors including:

- the endowment of resources and the physical nature of the relationships among them,

- the level and nature of our understanding of those relationships, or technology,
- individual objectives,
- the objectives of society, (which reflect the organization of society and the institutions that coordinate the preferences and behavior patterns of individuals within society)
- information about alternative choices and the probable outcomes of alternative choices,
- perceptions of relationships among the individuals within the society
- values held by individuals, and
- the methods used to describe, analyze and identify potential alternatives and outcomes also shape the answers.

There are a variety of mechanisms that can be used by society to allocate economic resources, goods and services. **Exchange, reciprocity**, philanthropy, eminent domain (command), inheritance and theft are examples of rationing mechanisms that are possible ways of assigning and transferring **property rights** to things. These mechanisms may also be categorized as **exchange, tradition** and **command**. [Heilbroner, pp. 6-12] Modern mainstream economic theory tends to focus on exchange. The exchange mechanism takes place in the context of a social institution that is called a "**market**." A market is a social institution that allows (encourages) potential buyers or sellers of a good to engage in voluntary exchanges with other buyers and sellers. These voluntary market exchanges reflect the preferences of the individuals involved. Market theory is based on the assumption that the individuals know their preferences and will not behave in anyway that is detrimental to their interests (lower their utility). Every voluntary choice made by an individual in a market then represents an improvement in their welfare or no decrease in their welfare. Any voluntary choice represents an increase in individuals' welfare (or at least no decrease in welfare) since no one would voluntarily choose to make himself or herself worse off. Through this self-interested behavior in voluntary exchanges the interests of the individuals are brought into harmony and consistency with social wellbeing. The Utilitarianism of Jeremy Bentham [1748-1832] is the foundation of modern microeconomic theory and maintains that the utility of society is the sum of individual's utility functions.

The history of economic thought tends to be a study of alternative explanations about the perceptions of appropriate mechanisms to allocate resources and the proper relationship of the economy and economic behavior to society. There are many approaches to the study of any topic. In the instance of economics, there are two broad approaches; that of the absolutist and that of the relativist.

## ***ABSOLUTIST AND RELATIVIST POSITIONS***

The absolutist tends to believe that there are some objective, absolute “facts or truths” about the perceptions and patterns of economic behavior that cross cultural, temporal and social boundaries. These beliefs and patterns of behavior are perceived as universal. They are believed to apply in every society at all times in similar ways. From this point of view the study of the history of economic thought becomes a process of reading the works of economists that have contributed in the past and sifting out the grains of truth. Each generation of economists is seen as correcting errors made by their antecedents and adding new insights. Adam Smith corrects errors in the theories of the Mercantilists and Physiocrats and earlier works, synthesizes them and adds new insights to further economic knowledge. Alfred Marshall corrects mistakes in Smith and other Classical economists, includes new developments, tools of analysis and insights about microeconomics and improves the ability of economic theory to describe economic phenomena.

The relativist approach to the history of economic thought holds that what is “true,” or useful, in one time or place may or may not be useful in some other time or place. Economic theory is a product of its environment. What was “true” for Adam Smith in a “nation of shopkeepers” in the mid 18<sup>th</sup> century may or may not be useful or true in the early 21<sup>st</sup> century or for Alfred Marshall in the late 19<sup>th</sup> century. The relativist tends to believe that economic theory is shaped by technology, social and economic institutions.

Both the absolutist and relativist positions have attractive features. Perhaps a position somewhere between the extreme relativist and absolutist positions is more reasonable. There may be universal patterns of economic beliefs and behavior that span all societies. However, cultural features, technology and other factors influence our perceptions, values and behavior. Mark Blaug writes;

*"No assumptions about economic behavior are absolutely true and no theoretical conclusions are valid for all times and places, but would anyone seriously deny that in the matter of techniques and analytical construct there has been progress in economics? [Blaug, 1985, p 3]*

The history of economic thought is a critical investigation of the criteria that have been used to decide which economic ideas are relevant and to identify which direction “progress” might lie.

The structure of society, technology and the economy are interrelated: each influences the nature and structure of the other. The appropriate forms of technology, society and the economy and their interrelationships have long been the subjects for debate. Different perspectives about these relationships and the

relative importance of each element in the social system are the grist for the mill of history. The direction of causation is one source of debate. Does technology primarily determine economic or social systems? Or, do the economic and social forces determine the nature of technology?

Different perspectives regarding the interrelationships of technology, economy and society also influence the methods used to analyze and describe the relationships. In turn, the description of the relationship may alter the course of technology, economic and social systems. The technology of the industrial revolution and conditions of the workers was an influence on Karl Marx. At the same time, Marx's analysis and assessment of capitalistic societies was an influence on the course of history. The economies of China and the former Soviet Union were influenced by various interpretations of Marxist economics. The very existence of these systems has influenced, not only those countries, but also the rest of the world community.

Economic theory is constructed by economists who are members of society. Their perspectives of relationships and events are products of the society to which they belong. Some economists construct theories that represent the views of smaller, sometimes disenfranchised social groups. Generally, only those theories consistent with the prevailing and/or dominant social values will displace earlier theories. However, theories that represent the disenfranchised may influence the mainstream economics that represents the society at large. Economic theory is both a determinant and reflection of the society of which it is a part.

The methods, theories and perspectives are like lens. As we view economic behavior and processes through these lenses, our perceptions are shaped. To critically evaluate the economic processes in society we need to understand the nature of the lens that influence, focus or distort our interpretation of the "facts."

### ***IDEOLOGY, THEORIES AND POLICY***

Three fundamental components of human perception and action to be included in a study of history of economic thought are ideology, theory and policy choices. The outcomes of the policies is a fourth item which should be included since it interacts with the first three. While outcomes of economic choices and policies are the subject of applied micro and macro economics, they are also important in a study of the history of economic thought because they are interrelated to the other components. It is possible to just study the chronology of economic theories or of policies and their outcomes. However, one of the reasons to study the history of economic thought is to understand how we have come to believe what we believe

and why we interpret some economic ideas as knowledge. The interaction of ideology, theory, policy and their outcomes contributes to the explanation of our beliefs.

### *Ideology*

Joan Robinson comments that ideology is much like the proverbial elephant, it is difficult to define but we know one when we see it. [Robinson, p 2] Ideology is a complex concept that arises from many sources and takes many forms. It influences our perceptions of the world about us and alters our behavior patterns. The word "ideology" can be used in a variety of contexts. There are political and epistemological issues associated with ideology. [Eagleton, pp. 8-12] Ideology consists of values, attitudes, beliefs, and perspectives that are held in common by a social group. It is often difficult to specify the exact nature of ideology although we can identify specific ideas that are contained in the ideology. Joan Robinson says;

*"What then are the criteria of an ideological proposition, as opposed to a scientific one? First, that if an ideological proposition is treated in a logical manner, it either dissolves into a completely meaningless noise or turns out to be a circular argument. ... (Robinson seems to use ideological and metaphysical as synonyms) The hallmark of a metaphysical proposition is that it is not capable of being tested. ... Yet metaphysical statements are not without content. They express a point of view and formulate feelings which are a guide to conduct."* [Robinson, pp. 2-3]

This ideology influences what we choose to observe as important and the interpretations we make of those observations. It also alters the criteria we use to evaluate phenomena and judge the morality of choices and behavior.

Ideology is a fundamental aspect of a culture. The dominant ideology shapes the rules that establish what is acceptable and unacceptable behavior patterns. It is also a guide and the criteria that are used to evaluate "right and wrong." It is the foundation of our system of morality and ethical behavior. From a political perspective, ideology may establish the distribution of power within a society. The dominant ideology is typically associated with a system of implicit and explicit rules and rewards for those whose behavior and views are consistent with those of the prevalent ideology. Smaller groups within a society may have an ideology that is inconsistent to the dominant ideology. Ideology is also present in the individual. Each individual accepts, consciously or unconsciously, a set of values and principles that shape their perceptions and guide their choices. Adherence to ideologies that are inconsistent with the principles and values expressed in the dominant ideology may lead to disenfranchisement of an individual or group.

From an epistemological perspective, ideology is a strong influence on perceptions of important phenomena. It identifies which phenomena are relevant to our values and it shapes the interpretation of those phenomena. A superficial view of history suggests that the ideology shifts over time. The foundation of the Greeks' ideology (Athenian) included beliefs which valued discourse, rhetoric, democracy, nature (including a view of the nature of humans), interaction of humans with nature (or gods) and the appropriate roles for classes and gender. The Romans' ideology stressed many of the aspects of the Greeks but less emphasis was placed on democracy and more on domination and war. The Scholastics placed value on the importance of the human mind, and its ability interpret and reconcile the scripture with Aristotelian philosophy. The renaissance and the rise of science are related to a shift in of ideology (from an epistemological perspective) to observation, measurement and categorization of phenomena in order to identify atomistic, mechanical relationships among all natural and social phenomena. In recent years, a pecuniary facet has been added. In addition to empirical observation and quantification of physical phenomena, the market system has strengthened the importance of the measurement of monetary or pecuniary values. These monetary, pecuniary or market values are proxies for human values as demonstrated through the ability to pay in a competitive, market context.

The sources of ideology are varied. Story telling and theory are two important ways in which ideology is created, transmitted and embedded in a culture. In most societies, fables and stories are used to express and reinforce ideology. Aesop's fables, fairy tales and nursery rhymes often have ideological content. A classic example is the story of "The Little Red Hen" which stresses the importance of hard work and cooperation. Theories too rationalize and justify particular choices and behavior patterns. In the words of Joan Robinson,

*"It was the task of the economist to overcome these sentiments and justify the ways of Mammon to man. No one likes to have a bad conscience. Pure cynicism is rather rare. Even the Thugs robbed and murdered for the honour of their goddess. It is the business of economists, not to tell us what to do, but to show why what we are doing anyway is in accord with proper principles."*

[Robinson, p 21]

A theory of markets that is based on individual pursuit of self-interest justifies behavior that is based on self-interest. A person living in a society explained by theories that stress individual self-interest feel justified in pursuing their self-interest. If the ideology and resulting theories ignore forces (ethics, duty, morality, sympathy etc.) the individuals feel justified in behavior that ignores or is

devoid of those same forces. Problems may arise, not so much for what the ideology includes, but for what it leaves out. John Locke [1632-1704], Adam Smith [1723-1790], Jeremy Bentham [1748-1832] and the other philosophers who helped to frame our individualistic, mechanical market ideology, included sympathy, empathy, morality, ethics, law and social values as well as self-interested individual motives. In a more simplistic interpretation of their work, self-interest is often seen as the isolated motive that guide and justifies human behavior. A study of the history of economic thought should create an awareness of the richness and complexity of our ideological heritage.

### *Theories*

A theory is an intellectual construct that consists of a set of consistent, coherent propositions that explains a particular class of phenomena. This set of propositions cannot include all aspects of a phenomenon. A theory must, of necessity, abstract from the real world and identify the most relevant features and aspects of a phenomenon. It is a simplified perception of reality. It provides a framework to identify which "facts" are relevant and a guide to interpret what the facts might mean. Without theory, facts are simply data without context or meaning.

Theories are expressions about expected or perceived relationships among things or phenomena. There is frequently a causal relationship that is expressed in a theory; event A "causes" event "B." Causation is difficult to access, as we shall see in the chapter, "*A Problem of Knowing*." A more precise statement is that events "A" and "B" are correlated, or event "B" tends to happen when event "A" happens and there is some reason to believe (theory of a relationship) that events "A" and "B" are causally related.

Theories are typically presented as "models." The word, model, has many meanings. In one sense, it is an abstract or simplified representation or standard that can be used to demonstrate, judge or compare phenomena. In economics, a model can be thought of as an abstract, simplified system that identifies and characterizes a set of phenomena and their relationships. A model usually begins with a set of **axioms** that provide the foundation for the relationships among the phenomena.

Models may be constructed and presented in several different formats. A model may be presented as a story or narrative. It may be a visual model that takes the form of a picture, sculpture or graph. Models that express causal relationships in economics often are mathematical models that are expressed as

equations, systems of equations or graphs that represent mathematical relationships between a dependent variable and a set of independent variables.

Our expressions about perceived relationships are influenced by our ideology and in turn, influences our ideology. The axioms, that are "truths" that are accepted as self-evident propositions or are assumed true without testing, are determined largely by our ideology. These axioms then become the foundations and determinants of theories. Peter Lichtenstein comments;

*"It is essential, therefore, to point out at the very outset that economic theory has a very subjective, ideological aspect to it."* [Lichtenstein, p 4]

A theory or set of theories that is accepted as "the way the world works," or as "true," rationalizes the ideology that provides the axioms and foundation of the theories. In economics, an ideology that includes human behavior that is mechanical, individualistic, reductionist, and self-interested, contributes to a system of theories that explain the operation of individual choice in the context of a market system. This system of theories about the market system then justifies and reinforces the ideology of individualistic, self-interested behavior. An economy explained by market theories that are based primarily on individual, self-interested behavior justifies and encourages self-interested behavior.

These theories and models are an image of how the world works. The function of science is to develop and test the validity of these theories. The testing of these theories provides "knowledge" about the relationships and phenomena in the real world. Theories are not the real world; they are representations of reality. The issue of "what we know" depends on the methods we use to test the validity of theories and the confidence that we place in the methods and tests of theories. The evolution of Western approaches to "knowing" and epistemology are discussed in more detail in the chapter "[A Problem of Knowing](#)."

Theories represent what we think we know about the relationships among relevant phenomena. The more confident we are about the certainty of the knowledge expressed in the theories, the more likely we are to use our presumed knowledge as a basis for making choices and policy.

### ***Policies***

Individuals living in societies must make decisions about their interaction with nature and other humans. One of the most important functions in any society is the coordination and integration of individuals' behavior in a manner consistent with the operation of a society. Policy may be implicit or explicit. At the social level, policy is an agreed upon course of action encouraged by a set of rules that

constrain or encourage particular actions within a social setting. In a sense, policy is an important part of the "rules of the game." Individuals make choices within the social policies. Traditions, customs, mores and culture form implicit rules or policy. Social institutions define and enforce these implicit rules. Noncompliance with these implicit rules will (or may) result in social sanctions. Laws, orders and both private and public regulations constitute much of explicit policy. Generally, explicit rules can be thought of as the rules or policies that are consciously created and explicitly stated by social groups, corporations, organizations and governmental units.

Mark Blaug describes the relation of policy and theory:

*"It may be granted that, even in its purest form, economic theory has implications for policy and in that sense makes political propaganda of one kind or another. This element of propaganda is inherent in the subject and, even when a thinker studiously maintains a sense of Olympian detachment, philosophical and political preferences enter at the very beginning of the analysis in the formation of, as Schumpeter would have it, his 'vision': the preanalytical act of selecting certain features of reality for examination.*

[Blaug, 1985, p 5]

Policies are the result of what a society or individual thinks they know about their natural, social and built environment. The notion of rational behavior suggests that policies must be consistent with theory. Rationality may be thought of as using knowledge to choose among alternatives to best achieve desired objectives. To make choices counter to what we think we know would be irrational.

### ***Outcomes***

Choices have consequences. The Newtonian, mechanical perspective that forms the model for science in Western industrial societies is based on the notion that events are causally related; for each choice there is an outcome or set of outcomes. Modern Western economics is predicated on the idea of a finite world with limited resources that may be used to satisfy unlimited human wants. The selection of any alternative implies that other alternatives were not selected. The alternative selected has effects on other variables; if an institution in society chose to increase the money supply, there are effects of that choice. The effects that flow from that choice might include an increase in monetary prices that include interest rates. An increase in interest rates may have the effect of reducing expected returns from endeavors that use borrowed money; this in turn, may have the effect of reducing the willingness to borrow money to invest in such endeavors. This expected chain of causes and effects depends on our theory and observations of

previous events. The actual chain of causes and effects may (or may not) be independent of our expectations that were formed based on our theories.

Policies and choices are made on the basis of our expectations of specific outcomes of particular actions. Modern economic theory maintains that choices are made based on **opportunity cost**; a comparison is made between the effects that will result (or we expect to result) from a choice and the expected outcomes of the next best choice. Theories form the expected results of each alternative action. In a modern, scientific, rational world, theories and "knowledge," are the bases for our choices. Choices may be made based on intuition, feelings and emotion, however these are not regarded as "scientific" in Western industrial societies.

### ***CONSISTENCY OF IDEOLOGY, THEORY, POLICY AND OUTCOMES***

The relationships among ideology, theory, policy and outcomes are multi-directional and multifaceted. Each influences and is influenced by the others. In an ideal world, the relationships might be viewed as a flow diagram. Ideology is the foundation that provides the axioms and nature of the theories that are used to explain the ways that the world works. At an individual level, the ideology is influenced by a variety of forces; peer groups, family, religion, social position, education, training, ethnicity, gender and a multitude of other factors contribute to an individual's ideology. At the social level, the ideology consists of the values, principles, attitudes, beliefs and perspectives that are held in common by a group. At this level, ideology is integrally related to religion, education, the legal system, philosophy, and all the other components of society. Ideology is transmitted and reinforced by stories and the theories that are accepted by the group. The theories and ideology must be consistent. The theories, based on ideology, are expressions and explanations about the nature of things and their relationships. Theory provides the framework to interpret observed facts about the real world. This "knowledge" about things and relationships among things provides a basis for making choices and establishing policy. Each policy and choice have outcomes. These outcomes are evaluated against the expectations that theory suggested. If the outcomes are not consistent with theory and policy then it may be necessary to reevaluate the theory and the accompanying policies. Outcomes may also be evaluated by comparing outcomes with the values, attitudes and beliefs expressed by the prevailing ideology. If outcomes are inconsistent with the expectations of theory or the values expressed within the ideology, it may be necessary to modify the theories and/or the ideology. The theories may change with greater ease and speed.

Ideology is slow to change. The changes in ideology may be in response to changes in theories.

The classic example of theory changing faster than ideology is the story of the "Copernican Revolution." The Copernican Revolution began as a change in the theories that explained the observed orbits of planets. The theory evolved over time through the work of Nicholas Copernicus [1473-1543], Tycho Brahe [1546-1601], Galileo Galilei [1564-1642] and Johann Kepler [1571-1630]. The Copernican theories were published in 1543. The heliocentric theory of the system of planets and their relation to the sun were in conflict with ideology that was primarily an expression of the Church. The observations and predictions of the Copernican model were more consistent with the new theories than the Ptolemaic system. The theory changed quite rapidly; in 1543 Copernicus' system was published, in 1609 Kepler published *New Astronomy*, and in December of 1610 Galileo verified that Venus orbits the sun, thus showing that the Copernican system was a more accurate theory (explanation) than the Ptolemaic system.

By 1611, the Jesuits at *Collegio Romano* had verified Galileo's astronomical observations and honoured him. The ideology related to the theories of planetary movement changed more slowly. It is also in 1611 that the Inquisition decided to investigate Galileo. In 1613 Galileo responded by writing a letter on the relationship of his findings to the scripture, and by 1615 Galileo went to Rome to defend himself. In 1633 he was questioned by the Inquisition, detained, and threatened with torture and imprisonment. Ultimately he was placed under house arrest and died in 1642, almost 100 years after Copernicus' publication. The basic ideology had resisted change in the face of empirical evidence. Overtime however, the ideology was modified to produce a consistency with the theory and observed outcomes.

The evolution of economic thought is also a story of ideology, theory, policies and outcomes. Neoclassical microeconomic theory of the late 19<sup>th</sup> and early 20<sup>th</sup> centuries focused on explanations of a self equilibrating market economies that always returned to full employment equilibrium. The policies it fostered were free market polices. Yet the outcomes of the "great depression" [1929-1941] were inconsistent with the theories and the ideological values that were held. The result in this case was a shift in the theories; Keynesian economic theory replaced, at least for a time, the neoclassical models.

## *Economics as an Academic Discipline*

While the economic process is an integral part of society and the social system, economics as an academic discipline, like most disciplines, has become more and more specialized.

The Greek philosophers and medieval scholars who pondered and wrote about economic problems did not see economics as separate from other issues in society. Questions of ethics, social and natural phenomena were interrelated. The **Mercantilists** in the 1500's and the **Physiocrats** in the mid 18<sup>th</sup> century began to distinguish between economic events and phenomena and other aspects of society. Economics, however, was seen as a part of the natural order of things and a component of society. **Adam Smith** [1723-1790], writing in the last half of the 18<sup>th</sup> century was a "moral philosopher." Moral philosophy was what we might now call "social science." Smith tried to explain economic relationships [*An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776] within the context of a society with a moral system [*The Theory of Moral Sentiments*, 1759] and a legal system [*Lectures on Jurisprudence*, 1762-3 and 1766].

The term "political economy" appears in the title of David Ricardo's [1772-1823] "*Principles of Political Economy and Taxation* [1817] and later in John Stuart Mill's [1806-1873] "*Principles of Political Economy, With Some of Their Applications to Social Philosophy* [1848]. David Ricardo's work was an important factor in the development of economics as an abstract, analytical discipline.

During the middle of the 19<sup>th</sup> century the discipline of economics began to focus more exclusively on economic behavior. The writers were aware of the social context of economics but were unable to consider all aspects of social behavior. The titles of the major contributions chronicle this trend. In 1838 Augustin Cournot [1801-1877] published *Researches into the Mathematical Principles of Wealth*. William Stanley Jevons [1835-1882] in his 1871 *Theory of Political Economy* used the term political economy. In the same year Karl Menger [1840-1921] used the title *Principles of Economics* and Leon Walras' [1834-1919] contribution was titled *Elements of Pure Economics*. It is Alfred Marshall [1842-1924] who provides the foundation for Neoclassical economics with *Principles of Economics* [1890]. From the Greeks to the end of the 19<sup>th</sup> century, the trend was from philosophy to social analysis to "political economics" to "economics." The changes in the titles of important works reflect the development of economics as a separate, distinct discipline. It is a move from an element in philosophy that considers ethics as well

as human's relationship to technology and the natural environment to a concern with the pecuniary implications of an allocation of things within a market system.

Marshall reflected on the importance of ethics and social institutions in understanding economic process [Marshall pp. v, 17, 21] and warned about the improper use of mathematics [Ibid. p ix]. The construction and understanding of economic theory and explanations requires the use of mathematics, but as a tool to understand the relationships. In a reference to the works of Augustin Cournot, Marshall states that:

*"And though Cournot's genius must give a new mental activity to everyone who passes through his hands, and mathematicians of calibre similar to his may use their favourite weapons in clearing a way for themselves to the centre of some of those difficult problems of economic theory, of which only the fringe has been touched; yet it seems doubtful whether any one spends his time well in reading lengthy translations of economic doctrines into mathematics, that have not been made by himself. A few specimens of those applications of mathematical language which have proved most useful for my own purposes have, however been added in an Appendix. [Marshall, p ix]*

However, modern economic theory has increasingly used more sophisticated mathematical methods to construct and communicate models. As economic methods have evolved, the discipline has also become increasingly more specialized. The use of mathematics has encouraged this specialization. To express economic ideas as equations or systems of equations requires simplification and abstraction. Mainstream economic theory is more concerned with "purely economic behavior" rather than the relationships of economic behavior to the social system. It is difficult to measure and quantify many social relationships.

By the late 1800's economics had emerged as a separate academic discipline. It was during the **Victorian era** and the early 1900's that many of the other social sciences such as anthropology, sociology and psychology, emerged and matured as separate disciplines.

### **"Fields" in Economics**

Not only has economics become more specialized as a social science, but within economics there is greater specialization. Currently, economics is a discipline that covers a large and growing number of topics or "fields." The *Journal of Economic Literature*, a major journal in the field of economics lists 17 categories used to classify new books. These include: *General Economics and Teaching; Methodology and History of Economic Thought; Mathematical and Quantitative Methods; Microeconomics; Macroeconomics and Monetary Economics; International*

*Economics; Financial Economics; Public Economics; Health, Education and Welfare; Labor and Demographic Economics; Law and Economics; Industrial Organization; Business Economics; Economic History; Economic Development, Technological Change, and Growth; Economic Systems; Agricultural and Natural Resource Economics; Urban, Rural, and Regional Economics; and Other Topics.* Each of these categories is then divided into more specialized fields. As an example, *Urban, Rural, and Regional Economics* is divided into *General, General Spatial Economics, Household Analysis, Production Analysis and Firm Location, Transportation Systems, and Regional Government Analysis.* Within each of these divisions there may be further specialization. The practicing economist may specialize in a narrow topic such as the economics of railroads, trucking, health insurance or the economics of the pharmaceutical industry.

### **Nature of Work in Economics**

James Cochrane suggests that the work of economists can be divided into three categories: [Cochrane, p 1-2]

- descriptive economics,
- analytical economics, and
- applied economics.

#### **Descriptive Economics**

*"In descriptive economics one collects together all the relevant facts about particular topics; for example, the agricultural system of Basutoland, or the Indian cotton industry."* [Ibid.]

The descriptions are often narratives about particular features of the institutions or descriptive statistical measures. William Petty [1623-1687] is an example of an early writer that tried to describe economic phenomena. In his *Political Arithmetik* [completed about 1676; see Spiegel, p 124] he tried to estimate national wealth and national income. In a complex world it is impossible to categorize and measure all phenomena. Consequently, it is necessary to make choices. The choice of which variables to describe determines the nature of the story that is told.

#### **Analytical Economics**

*"In economic theory, or economic analysis as it is often called, one gives a simplified explanation of the way in which an economic system works and of the important features of such a system."* [Cochrane, p 2]

Analytical economics is the process of trying to explain general relationships between events. It is based in the notion of "cause and effect." (Cochrane refers to

this estimation of causes as applied economics. For purposes of this manuscript we will define applied economics differently.) A key characteristic of analytical economics is the use of theory and models. These models may be narrative in form, but in modern economics they are most frequently expressed as equations or systems of equations. Graphical representations of these models are typically used for heuristic purposes.

### *Applied Economics*

Here we are defining applied economics as the application of descriptive and analytical economics to the process of identifying problems and selecting among alternative solutions. Applied economics is the use of analytical economics to select among alternatives, it is used for policy purposes. If the elements of the monetary system are described and the general relationships among the various elements are known, this knowledge can be used to suggest or prescribe policies. What is the money supply? What is "the" interest rate? What is the level of employment (or unemployment)? What is the level of prices? How are these elements related? If we can describe these elements and know the relationships it may be possible to alter one variable to achieve desired changes in another.

### ***Microeconomics***

The methods of economics may focus on the relationships and behavioral patterns of individuals, firms, or industries. Modern, orthodox microeconomics tends to focus on exchange relationships in a market setting. These exchange relationships are simplified and are usually related as monetary costs and benefits. More specifically as **marginal costs** and **marginal benefits** measured in monetary terms. Each agent, acting in its self-interest, attempts to optimize some objective or goal. Consumers are usually characterized as "utility maximizers" while firms are often "profit or sales or market share maximizers." This focus on the market as a mechanism to coordinate individual choices and behavior is called methodological individualism. The interactions of the agents in markets, *exchange relationships*, are usually summarized and represented as price and quantity relationships. As a result of the concern with monetary prices, non-market values are often omitted or considered only in a tertiary way.

The general structure of microeconomic analysis involves three steps:

- identify the objective,
- identify all feasible alternatives (choices that are feasible),
- develop a criteria to evaluate each feasible alternative with respect to the objective.

Microeconomics emerged as a separate branch of economics in the late 1800's. Alfred Marshall's *Principles of Economics* [1890] is the foundation of microeconomics as it is currently structured. His work is a synthesis and extension of the earlier ideas of the Classical School and the marginalists. Neoclassical economics is the core of modern microeconomics. Most economists believe that the theories in Neoclassical microeconomics are universal; they are applicable among all cultures at any time. Because of this perception, there is a dominant **ideology** expressed in the methodology of microeconomics. Modern microeconomics tends to support the ideology of market systems.

Greek philosophers were among the first to develop microeconomics. Xenophon [430-355 BCE] was soldier, historian and student of Socrates. Among his writings he expresses views on the division of labour and the allocation of resources within the *latifunda*. He referred to the management of these large, self-sufficient estates as *oeconomicus*. Plato [427-347 BCE], another student of Socrates developed the notion of specialization as a criteria of justice and the basis for the existence of the city-state. He believed that justice was each person doing that for which they were best suited. Once each person specializes, there is a mutual dependence that requires exchange, hence, the growth of the city-state. [Plato, pp. 165-232] Aristotle [384-322 BCE] divides economics into *oikonomiks* and *chrematistiks*. *Oikonomiks* is much the same as Xenophon's *oeconomicus*. Aristotle limits *oikonomik* to the provision of real and necessary goods and services. *Chrematistiks* is the process of moneymaking and exchange to accumulate monetary wealth. He was interested in value and justice of exchange. Aristotle regarded *oikonomiks* as natural and necessary while *chrematistiks* was unnatural behavior.

During the period of the Roman Empire and middle ages, much of the thinking about economics dealt with justice, exchange, usury, just price and other microeconomic topics. During the Renaissance [approximately 1350 or 1450 to 1700], economics began to include more macroeconomics. During the period of the Mercantilists [approximately 1500-1776] there was an interest in the development of nations and the growth of national economies. Classical economics continued the emphasis on macroeconomic issues. Microeconomics was of interest primarily because of its relation to the growth of national wealth. From about 1850 until the "Great Depression" in 1929 microeconomics, [primarily Neoclassical economics] was fashionable.

## ***Macroeconomics***

Macroeconomics is the branch of economics that focuses on the whole economy. The overall performance of the national [or world] economy is the primary concern of macroeconomics. In macroeconomics, the role of descriptive economics is to measure or quantify National income accounts [Gross Domestic Product, National income, etc.], overall levels of employment [or unemployment], price levels and interest rates. **Economic stability** [or instability] and **economic growth** are also important issues in macroeconomics.

Analytical macroeconomics develops models to explain and/or predict the forces that affect the aggregate measures of economic activity. The conclusions and models developed in macroeconomic theory are used to design and defend policy prescriptions. Because of the close relationship of macroeconomics to policy choices, competing ideologies offer different solutions to the perceived problems.

Like microeconomics, the approach and nature of macroeconomics depends on the objectives. In the case of macroeconomics, the objective may be an economic variable [level of employment, inflation, growth, etc.] or the policy that theory seeks to support or defend ["free markets," intervention, planning, etc.]. At one level macroeconomic policy may be to achieve particular levels or changes in employment, incomes, income distribution, interest rates or price levels. At another level, macroeconomics may be used to defend or attack ideological perspectives.

As mentioned in the previous section [Microeconomics], the development of macroeconomic theory was related to the growth of the nation state. While the Greeks' experience was with city-states, Xenophon [430-355 BCE] did consider ways to increase the revenue of Athens. However it was the Mercantilists, Physiocrats and Classical economists who speculated on forces that would increase the wealth of particular societies or nations. Their focus was on macroeconomic relationships. Microeconomics was considered primarily as it related to macroeconomic goals.

Macroeconomics became somewhat less important during the period from about 1850 to 1929. Neoclassical economics had discovered equilibrium and believed that markets would tend toward full employment equilibrium. The macroeconomy was a self-equilibrating mechanism that optimally allocated resources. Mainstream, Classical economists regarded unemployment, panic, recessions and depressions as temporary aberrations. It was the Great Depression that began in 1929 that generated a renewed interest in macroeconomic theory and policy. John Maynard Keynes [1883-1946] published the *General Theory of*

*Employment, Interest and Money* in 1936 beginning the “Keynesian” revolution that reconsidered macroeconomic theory and policy.

In a recent years, both micro and macro theory have been included. Usually an economist will focus on either microeconomic theory or macroeconomic theory. Some work has been done on the microeconomic foundations of macroeconomics. Other economists have worked on the macroeconomic foundations of microeconomics.

## ***SCHOOLS OF ECONOMIC THOUGHT***

Economists and critics of economics have all heard the story that President Harry Truman wanted a one armed economist; so that after rendering an opinion or recommendation they couldn't say, “*On the other hand!*” Other one liners about economists include:

- If all the economists in the world were laid end to end they still wouldn't reach a conclusion.
- If all the economists in the world were laid end to end they wouldn't point in the same direction.
- If you ask four economists a question you will get five (or six) different answers.

Jokes about economists, like all stories and jokes, often have a grain of truth and influence the perceptions of those who hear them. One of the common perceptions about economists is that they never agree. There is some credibility in this perception, but there is more agreement than is commonly believed. One of the factors that contributes to the perception of disagreement is that there are different “schools of economic thought.” George Stigler defined a school of thought as;

*“A school within a science is a collection of affiliated scientists who display a considerably higher degree of agreement upon a particular set of views than the science as a whole displays. It is essential to a school that there be many scientists outside it or the school would have no one with whom to argue.”*

[Stigler, p 116]

The history of economic thought record the development and evolution of many different schools of thought. One of the first schools was a group of French writers who were led by François Quesnay [1694-1774] and called themselves “the economists.” They became known as the Physiocrats. Adam Smith [1723-1790] began what is now known as the Classical economics. Alfred Marshall [1842-1924] is often considered the founder of Neoclassical economics and Karl Marx [1818-1883] is the obvious leader of Marxian economics. John Maynard Keynes' [1883-1946] writings

resulted in the Keynesian school emerging during the great depression of the 1930's.

"Mainstream economics" is the term used to describe the body of theory that is most widely accepted at a given time. The modern body of mainstream economics is represented by Neoclassical and Classical economics. In addition to these "mainstream" schools, some of the others that are important include:

- Austrian school
- "Old" and "New" Chicago schools
- Monetarists
- "Old" Institutional and "New" Institutional
- Public Choice
- Marxian
- Keynesian and Post-Keynesian

This list is not exhaustive. There are other schools that are important. In many cases the schools may overlap on many issues.

Some of the characteristics of a school that are identified by Stigler are;

- "A school must have a leader." [Stigler, p 116]
- the school may be united by "*substantive scientific views*"
- "*If the school is united on methodology rather than substantive doctrines, its life will be longer.*" [Ibid.]
- "A school may be based on policy views rather than upon economic analysis or scientific methodology." [Ibid.]

In *A Modern Guide to Economic Thought*, Mair and Miller present a summary statement about several important schools of thought. The summaries are divided into topics such as world view, values, goals, methodology, criteria (to evaluate theories) "hard core," concepts, agenda and themes. [Mair, pp. 68-69]

One of important differences between different schools is their view of "human nature." There are two important ways of classifying human nature that influence perspectives of different economic schools of thought. First, is whether humans are viewed as basically "good" or "evil." If humans are basically good there is little need for social institutions to constrain behavior. William Godwin [1756-1836] is an example of an anarchist who believed that humans were basically good and social institutions encouraged them to be "bad."<sup>1</sup> Alternatively, if humans are basically bad, it is necessary to constrain their behavior. Much of Western

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<sup>1</sup> Godwin's daughter, Mary Wollstonecraft Shelly wrote *Frankenstein* [1816] that tells the tale of technology and individuals' relationship to society in which a man created by Frankenstein, who was basically good, became bad after mistreatment by society.

religion accepts the doctrine of original sin. Humans are by nature born with evil tendencies and some method of altering behavior is necessary.

The second, is whether "human nature" is fixed by nature (genetics or...) or is the result of the environment. Thomas Malthus [1766-1834], the first person employed as an economist, is well known for his view of the nature of humans with respect to population growth. Human behavior is the result of natural traits and cannot be altered by welfare, working conditions or other factors. Alternatively, Robert Owen [1771-1858] risked his fortune investing in New Lanark and later New Harmony to show that individuals who are treated well will change.

It is the ideological underpinnings that shape perceptions of economic processes. It is differences in ideology that produce different schools of thought in economics. The history of economic thought attempts to identify these schools and to determine the forces that contribute to their creation, evolution and ultimate "success" or "failure" an intellectual construct that explains, predicts or justifies the world we have created.

### ***REASONS FOR STUDYING THE HISTORY OF ECONOMIC THOUGHT***

The economic process that evolves in any society is a complex matrix of individuals, organizations, rules, and relationships. This matrix is the product of perceptions, values, beliefs, knowledge and technology. The economic process is embedded in society and is related to all aspects of the culture. An understanding of the economic system and economic theory requires an awareness of the social, historical and philosophical context in which they are developed. It is possible to train individual economists to apply economic tools, such as benefit/cost analysis without an understanding the historical and philosophical context of the tools. It is also possible to train an individual to fire and clean a firearm without considering the context of its alternative uses. This is the difference between training and education, between knowledge and wisdom. Both are needed.

The history of economic thought is a study of alternative perspectives and explanations of how the economic processes function. An important aspect of the study of economic thought is to identify the factors that encourage different perspectives of the economy. It is also important to trace the evolution of the tools used for analysis and understand how the different perspectives and conditions encourage the use of different tools. Mark Blaug writes:

*"The task of the historian of economic thought is to show how definite preconceptions lead to definite kinds of analysis and then to ask whether the analysis stands up when it is freed from its ideological foundation. It is doubtful whether Ricardo would have*

*developed his theory of international trade without a strong animus against the landed classes; but this theory survives the removal of his prejudices.* [Blaug, 1985, pp. 5-6]

An understanding of the different approaches to economics, the causes for those differences and how they have evolved over time provides a historical and philosophical context that encourages a more critical analysis of current economic tools and their applications. This critical approach has three advantages. First, it provides a more complete understanding of the current state of economic analysis and second, it may suggest alternative perspectives that will extend, improve or alter the tools and analysis. Third, through an increased awareness of our own perspective of the economic process, it encourages a degree of humility and respect for others.

Most importantly, the study of the history of economics thought can be fun and reveal many things about ourselves.

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# *Glossary*

## *Chapter 2*

### *Introduction to History of Economic Thought*

**allocate-** the act of identifying a resource, thing or place for a specific use.

**axiom-** is an unproven proposition that is accepted as true for the purposes of studying the consequences that would follow from it if it were true. Axioms are accepted as self evident "truths."

**Capitalism, capitalist system-** an economic system that is characterized by (strong) property rights that are held by individuals or corporations. Of particular importance is the ownership and control of the means of production. Because property rights are held (or tend to be held) by individuals and corporations, markets tend to be the dominant allocative mechanism. The social, political and legal systems must be consistent with the needs of the capitalist system.

**Command-** command is defined by Heilbroner as "*the method of imposed authority.*" The authoritarian method of resource allocation requires some person or group of persons to be in command. The basis of the person or group's authority may be based on religion, military position, business position, political power, nobility, technical expertise or wealth. It might be expected that the political system would correlate to the economic system; a theocracy [based on religion], fascism [industrial leaders], oligarchy [few], aristocracy [nobility], technocracy [technical knowledge], plutocracy [wealth]

**consumption-** the process of using existing goods and services to satisfy wants. These goods and services may be altered in the process of consumption; they may or may not be used up completely; there may be residuals that remain.

**corporation-** a hierarchical organization given, by government, limited liability in addition to the rights of an individual. As a creation of the state, the corporation is unlike an individual in that it has a continuous life, limited liability, and there may be a separation of ownership and management.

**distribution-** is the process of dividing or apportioning a good, service, or resource and giving rights to use or ownership among the members of a group.

**economic growth-** in its most simplistic form, economic growth is an increase in the aggregate measures of an economy's performance; gross or net domestic product, national income, etc. It is an increase in the output of goods and services. **Economic development** is an improvement in the standards of living for the members of an economy. Economic growth and economic development may be an increase of output levels of currently produced goods and services or a change in the nature and mix of goods and services produced.

**economic stability-** is a condition where significant economic variables that reflect the performance of an economy are not subject to undesired change. The variables may be price levels, interest rates, employment, investment (capital formation), output levels, etc. If the representative variables are changing gradually in a desired direction, the economy may still be regarded as "stable." Stagnation implies something different from stable.

**exchange-** an agreement between two (or more) agents (people or organizations) giving a specified item in return for some item of equivalent value; a *quid pro quo*. The items exchanged are clearly specified and the agreement has characteristics of a contract. In a market setting it is important that all exchanges be voluntary actions of the parties involved and that there be exclusive property rights to avoid non-market effects on others (third parties, externalities, etc.) The persons engaged in an exchange might be strangers; in fact, the market may work better if the participants do not know each other. Some exchanges, where trust is important (diamond trade), will have lower transaction costs when there are significant customs, mores, or social connections among the participants.

**goods-** are regarded as things that satisfy wants of humans, things which have positive utility. Economic goods are goods that are scarce relative to the desires, i.e. people would prefer more to less. Good can be used to represent both goods and services.

**ideology-** is the set of values, beliefs, myths or doctrines common to a group or movement.

**marginal benefits-** the change in benefits associated with a change in the level of consumption or activity. In calculus the change in the level of consumption or activity approaches 0; it can also be the change in benefits associated with a one-unit change in consumption. Typically, but not necessarily, most marginal benefit functions decline as the activity is increased or are negatively sloped when graphed.

**marginal costs-** the change in costs associated with a change in the level of production or other activity. In calculus the change in the level of production or activity approaches 0; it can also be the change in benefits associated with a one-unit change in production. Typically, but not necessarily, most marginal cost functions increase as production is increased, or are positively sloped when graphed.

**market-** is a social institution that facilitates the interaction of potential buyers and sellers of a good (or related goods) for the exchange of property rights to goods. A market may be represented by demand and supply functions; the demand function represents the set of equilibrium conditions for the potential buyers given incomes, preferences, etc; the supply function represents the equilibrium conditions for the potential sellers given technology, factor prices, taxes, etc. The nature of the goods exchanged, geography, the nature of buyers, etc may determine the boundaries of markets.

**market system-** or market economy is an economic system that relies predominately on the use of interrelated markets to allocate resources,

goods and services. A free market system is one characterized by allocation by an almost exclusive use of markets where individuals engage in voluntary exchange with little or no interference by government.

**Mercantilism**- an economic system grew out of the rise of the nation states.

Mercantilism is a collection of ideas that were developed in the period from the late 1400's to the late 18<sup>th</sup> century that is associated with statecraft and the rise of a merchant class. The ideas were diverse but tended to be for the purpose of justifying policies that benefited the state and the merchants. Gold and silver (specie, bullion) was regarded as wealth, therefore the policies of the states were to use all manner of activities and regulations to increase the inflow of specie into the country. In economic activity the regulations were intended to promote a "favorable balance of trade" (the value of goods exported was to be greater than the value of the imports). These ideas and policies were called mercantilism in England, kameralism in Germany, and Colbertism in France. The Netherlands, Spain and Portugal were other nations that followed mercantilist policies.

**model**- a representation, formal or informal, that abstracts and simplifies a process, relationships, system or thing in the real world for the purpose of understanding and/or communicating. In economics models are usually representations of processes or relationship between relevant economic variables, e.g. a model of a "demand" relationship would include the price of the good, prices of related goods, income and number of buyers and the quantity that will be purchased.

**opportunity cost**- opportunity cost is the cost associated with making a choice. It is defined as the value of the next best alternative that was sacrificed as the result of a choice of another alternative.

**Physiocrats**- a school of economic thought (perhaps the first school of thought in economics) that emerged in about 1750. François Quesnay [1694-1774], personal physician to Louis XV, became the intellectual leader and published an article on economics in 1756 and the *Tableau économique* in 1758. The Physiocrats ceased to exist as an active school by about 1776 when Anne Robert Jacques Turgot [1727-1781] was dismissed as the Minister of Finance under Louis XVI. Smith's *Wealth of Nations* included some of the ideas and the spirit of the Physiocrats was published in 1776. They believed that man made law should be consistent with the law of nature, emphasized individual rights, opposed Colbertism, were system builders but, tended to advocate *laissez-faire, laissez-passer* [phrase attributed to Jean Vincent de Gournay [1712-1759]]

**production**- the process of altering inputs (or resources, land) to increase their ability to satisfy human wants. The alteration may be a change in physical characteristics, place, time available for use, or ownership.

**ration**- is the process of allocating or distributing resources, goods or services on the basis of a relevant characteristic. The price mechanism in a market system rations goods and services on the ability to pay. Discrimination is

an allocation process based on irrelevant characteristics such as race, gender, or...

**reciprocity**- a transfer of property rights based on "obligatory gift giving." Farmer Brown helps farmer Smith or gives her a bale of hay; farmer Smith then is "obligated" to repay Brown in some way. Unlike an exchange, the payment is not specified and depends on a personal relationship, society or sense of community

**relative scarcity**- is the result of two factors; first, the good or resource is finite and second, the desire or want for the good exceeds the available finite amount. Relative scarcity may also be used to characterize the amounts of one good relative to another; diamonds have a greater relative scarcity than emeralds. Prices in Neoclassical microeconomic theory are supposed to reflect relative scarcity.

**services**- the word service is used in economics to denote tasks or activities that provide utility are performed for a price.

**tradition**- the economic decisions of what to produce, how to produce and who gets it are based on habitual patterns of behavior that are enforced by social or community connections.

**Victorian era**- The Victorian era is the period from 1840-1900 and is related to the reign of Queen Victoria.