

1 History of Economic Thought

The presentation of this section is heavily based on Niehans (1990). A bibliography is provided at the end of this handout.

THE CLASSICAL ERA

(ca. 1680 – 1830)

The **leitmotiv** of the classical era was the circular-flow-model **conception of a circular flow of income** of the economy as an **interdependent system**. Therefore, the main focus of the classical era is on macroeconomics.

François Quesnay (* 1694; † 1774)

first circular flow model
Tableau Economique

“The Tableau Economique (...) is an input-output model of the French economy as it would look with an efficient allocation of resources. (...) The outline of this model is most easily understood if it is represented as a circular flow diagram (...). There are three classes, namely the **productive class, the sterile class**, and the proprietary class or the landlords, including government, the army, and the church.” [Niehans (1990), p. 40.] Quesnay belongs to the so-called group of “physiocrats”.

focus on
agricultural
sector

Adam Smith (* 1723; † 1790) father of economists

His most famous contribution is the **Wealth of Nations** which was published in 1776. The complete title of the publication is: “An Inquiry into the Nature and Causes of the Wealth of Nations”. how can nations create wealth

Invisible hand and **competitive allocation of resources** in a growing economy

market mechanisms usually good way to allocate resources for good of society

The invisible hand is a force that **governs the self-interest of individuals to promote the general interest of the society**. It is the price mechanism that guides the resources in a competitive market economy.

invisible hand : egoistic behavior leads to what is best/good for society (price mechanism)

Division of labor much more productive when labour is split -> trade makes everybody better off

“Smith illustrates this with his famous pin-making example (...): While one unskilled worker can hardly make 20 pins a day (if any), ten workers, dividing the process into about 18 different operations, can make up to 48,000 pins, thus increasing labor productivity in a proportion of more than 240.” [Niehans (1990), p. 66]. This underlines

the importance of trade and exchange. Remember: Trade can make everyone better off (Mankiw's principle # 5).

David Ricardo (* 1772; † 1823) [international trade model](#)

“During the decades of the French Revolution and Napoleonic wars, the progress of political economy stagnated, though monetary policy, under the impact of inflation, rose to new heights. (...) A new impulse came after Waterloo when a London banker decided to shift mental energies from war finance to political economy. The banker was David Ricardo.” [Niehans (1990), p. 86].

“Whereas Adam Smith has sought to explain the size and growth of national income, Ricardo assigned economic science the primary task of determining the distribution of national income between landowners, capitalists, and workers.” [Niehans (1990), p. 88].

David Ricardo is probably most famous for his contributions to international trade theory. Niehans (1990) calls it “one of Ricardo's most brilliant achievements” [p. 100].

Principle of comparative advantage [if one country is better at both, and they concentrate on what they can do comparatively better, they will still profit](#)

Other authors had already noted that England would be better off if she produced more cloth and exchanged it for wine. “Ricardo's contribution was the development of .. rules for profitable foreign trade into a general numerical principle for the efficient allocation of production between two countries.” [Niehans (1990), p. 100].

Karl Marx (* 1818; † 1883) [founder of communism](#)

“With the exception of Buddha, Jesus, and Mohammed, the name of Karl Marx may be more often invoked than that of any other person who ever lived. (...) Clearly, his historical significance far transcends economics.” [Niehans (1990), p. 137.]

“At the most general level, Marx proposed a model of history. Often denoted by the term historical materialism, it is more accurately described as a dialectic model of history in the sense that history is interpreted as a sequence of economic revolutions.” [Niehans (1990), p. 140.]

The **Communist Manifesto (1848)** was written with Friedrich Engels and is the popular work on the **philosophy of history**. The role of Marx in **economics is determined by** his work **Capital (1867)**. The first volume was completed by Marx in 1867.¹ The volumes 2

¹ The Capital was first published in German. It was translated into Russian in 1872, into French in 1875 and into English in 1887. [Skousen (2007), p. 81.]

and 3 were published by Engels after Marx's death in 1885 and 1894, respectively. They are based on collected manuscripts.

Inevitability of the collapse of capitalism only productive source is labour/the worker

Marx is most famous for his prediction of falling profits and the **inevitability of the collapse of capitalism**. "The tendency of profits to fall in the course of capital accumulation was indeed one of the main themes of classical economics. Ricardo derived this tendency from the law of diminishing returns, and he saw it counteracted by technological progress. Marx refused to have any traffic with diminishing marginal returns and thus had to supply another explanation. (...) It is based on the notion that aggregate profits, since they depend only on labor inputs and wages, are independent of the amount of capital goods, at least in a first approximation. If more capital goods are held, aggregate profits do not therefore rise. It follows tautologically that an increase in capital goods lowers the rate of profits per unit of capital." [Niehans (1990), pp. 150–51.]

Marx also **developed a model of economic growth**. It is a **two-sector model of balanced growth**. Even though, according to his forecast of the collapse of capitalism, one might have expected him to develop a model of unbalanced growth.

Marx developed a two-sector of balanced growth 2x2 model (e.g. households and companies)

OTHER CLASSICAL ECONOMISTS:

- **David Hume** (* 1711; † 1776)
- **Jacque Turgot** (* 1727; † 1781)
- **Thomas Robert Malthus** (* 1766; † 1834)
- **Jean-Baptiste Say** (* 1767; † 1832) Saysche gesetz --> jedes Angebot schafft sich seine Nachfrage
- **John Stuart Mill** (* 1806; † 1873)

developed because they wanted to ask, how can we explain the growth/wealth of nations

THE MARGINALIST ERA

(ca. 1830 – 1930)

microeconomic focus

after the french revolution; aufklärung

consumer optimum

The leitmotiv of the marginalist era is **individual optimization**. This brought about a shift from macroeconomic focus to microeconomics. “With the rise of marginalism, the macroeconomic insights of the classical era did not disappear. They were revealed not as false but merely as incomplete. What was missing was an explicit analysis of the microeconomic calculus by which households and firms optimize their decisions. This analysis was the collective achievement of the marginalist era.” [Niehans (1990), p. 12.]

Johann Heinrich von Thünen (* 1783; † 1850)

Von Thünen was **a German farmer and estate owner who studied agronomy and economics**. His main intellectual achievements were on resource allocation and location for many goods. “By applying his optimizing approach to several factor inputs, Thünen became one of the originators of the marginal productivity theory of distribution.” [Niehans (1990), p. 170.]

Diminishing marginal productivity mehr arbeitnehmer bis er genau so produktiv ist, wie ihm bezahlt wird. dann nicht mehr

Profit-maximizing **entrepreneurs will increase the use of labor until the marginal product of the last worker equals the wage** that he or she will be paid. (Lecture in 2nd semester.)

Concentric rings perishable products are produced nearer to the place of the market and less perishable goods are produced further away

“It is generally evident that close to the city there must be cultivated products that weigh a great deal or take up much space relative to their value, and whose transportation costs to the city are so considerable that they cannot be supplied from distant regions. They may also be products that spoil easily and have to be consumed fresh. With increasing distance from the city, the land will be used more and more for the cultivation of products that require lower transportation costs relative to their value. For this reason alone there will be formed around the city rather sharply delineated concentric circles, in which one or the other product will be the main output.”

[von Thünen (1842–63), part 1, § 2, quoted and translated by Niehans (1990), p. 169.]

Hermann Heinrich Gossen (* 1810; † 1858)

Diminishing marginal utility

“The magnitude of a given **pleasure decreases continuously if we continue to satisfy** this pleasure without interruption until **satiety is ultimately reached**.” [Gossen (1889), p. 4f.,

(1983), p. 6, quoted and translated by Niehans (1990), p. 189.] This is Gossen's first law or the property of **diminishing marginal utility** as presented in Part II, Section 2, of the lecture.

Wasser-Beispiel

Antoine Augustin Cournot (* 1801; † 1877) famous

cournot-point: point where it is optimal for the monopolist to produce that amount and want that price

Systematic analysis of profit maximization by firms based on differential calculus

Cournot wrote the book "Researches into the Mathematical Principles of the Theory of Wealth" which was published in 1838. This book "opened a new chapter in the history of economics, namely the **systematic analysis of profit maximization** by firms based on differential calculus. The **contemporary economists, however, did not recognize the pioneering quality of this contribution.** (...) The main reason, however, was that **economists did not understand calculus.**" [Niehans (1990), p. 177.]

The **condition for the optimum** is: **Marginal cost = marginal revenue! (MC = MR)**

derivative of cost = derivative of revenue

marginal cost cannot be lower than the marginal benefits

Alfred Marshall (* 1842; † 1924)

Principles of Economics (1890)

"Towards the end of the nineteenth century, political economy became rapidly professionalized and, in particular, professorialized. (...) The professors, however, still lectured and wrote largely for audiences without academic training. The graduate school, where present professors teach future professors, had only just been invented (the first was Johns Hopkins University, founded in 1873). (...) The problem for economists was to translate the results of their research, sometimes based on highly specialized training and quite abstract analysis, into language readily understood by their Victorian public. The personification of this phase of economics was Alfred Marshall." [Niehans (1990), p. 236–37.]

"**Marshall was the Adam Smith of his age.**" [Niehans (1990), p. 246.] most influential of his era

Concepts that **Marshall developed or to which he contributed:**

- **Marshallian Cross** (supply and demand analysis)
- **Elasticity of demand** (see Part IV, Section 4 of the lecture)
- **Consumer surplus and producer surplus** (see Part IV, Section 5 of the lecture)
- **Partial equilibrium** (from general equilibrium to partial equilibrium) how are different market sectors kept in equilibrium

OTHER ECONOMISTS OF THE MARGINALIST ERA:

- **William Stanley Jevons** (* 1835; † 1882)
- **Léon Walras** (* 1834; † 1910)
- **Vilfredo Pareto** (* 1848; † 1923) pareto prinzip, pareto optimal
- **Irving Fisher** (* 1867; † 1947) fisher-equation, interest-rates and interest parity; financial economics

THE ERA OF ECONOMIC MODELS (since 1930)

came to end, probably, nowadays more econometric models (putting statistic models on economic problems)

„The era had begun in which scientists interpreted their activity as model building. (...) David Ricardo used models to prove theorems, Karl Marx struggled with models, and the core of marginalism consisted of optimization models. Irving Fisher had referred to the importance of models in mathematics and physics as early as 1892 (...), and he actually built hydraulic machines as models of the economic system. Nevertheless, up to the 1920s, much of economic theory could not be easily quantified or expressed in symbols that lent themselves to logical manipulation. (...) Arthur Cecil Pigou (in his youth), Joseph Schumpeter, and John Maynard Keynes still presented their reasoning with hardly a graph or symbol. (...) Even Irving Fisher, despite his mathematical investigations of value and interest and his many suggestions for macroeconomic models, limited his formal macroeconomic analysis to the equation of exchange. (...)

After World War I the complexion of economics began to change. The generation born around the turn of the century established different analytical requirements. Many of its members had an extensive training in mathematics, statistics, and physics and looked at the economic world with the eye of scientists. (...)

As in earlier eras, historical events and economic conditions provided powerful external motives for economic research. The Great Depression made unemployment and economic stabilization the most important research problem, attracting brilliant young minds into economics. The war effort and postwar reconversion and recovery stimulated work on planning and optimization, one outgrowth of which was operations research. Postwar prosperity and development directed the minds of many economists to long-run economic growth. The cycle of inflation and stagflation beginning in the early 1960s made monetary policy the focus of debate and controversy. The limits to growth imposed by exhaustible resources, accentuated by successive oil crises, provided economics with a new agenda.” [Niehans (1990), p. 313–15.]

“World history of the 1930s was, directly or indirectly, largely shaped by the Great Depression. Among its legacies was the conviction that mass unemployment is one of the great problems of mankind.” [Niehans (1990), p. 345.] This provided the historical background for the work of

John Maynard Keynes (* 1883; † 1946)

General Theory (1936)

The full title of his most famous book is **General Theory of Employment, Interest and Money**. Concepts that Keynes developed and to which he contributed:

- **Stabilization policy** keep stable during recession US-became most influential economy
- **Demand-side economics** try to increase demand
- **Multiplier** if one earns income, they spent it therefore 2 group has more money as well, and so on

Keynes is example for economics being a social science.
General Theory : based on experiences in great depression (1929); governments should have implemented stabilization policy --> should have increased spending

stabilization policy infrastructure and employment programs to create income and therefore create consumption --> demand side economics

“The American Keynesians (...) tended to regard economic policy as a sequence of discrete measures each of which was historically unique. This was the perspective from which they advocated the Phillips curve as an instrument of monetary policy. However, if similar measures are taken routinely under similar circumstances, they begin to be expected in advance, which in turn will often change their effect. As seemingly noninflationary growth degenerated into stagflation in the course of the 1960s, this aspect, long known but theoretically unexplored, became the focus of macroeconomic attention. (...) An early champion of rules was Milton Friedman.” [Niehans (1990), p. 498.]

Milton Friedman (* 1912; † 2006) opposing to keynes
because politician react to slowly

monetarism

Concepts to which Friedman contributed and that he championed:

- **Supply-side economics**
- **Monetary macroeconomics** (**monetarism**) leave economics by itself and just create conditions
- **“Rules rather than discretion”** try to smoothen crisis

An economist who is famous for his work in the field of entrepreneurship is Joseph Schumpeter. He belongs to the so-called **“Austrian school”** of economics. Schumpeter was born in Moravia and **emigrated to the United States** in 1932.

Joseph Schumpeter (* 1883; † 1950)

Important concepts that he worked on are

- **“innovative entrepreneurship”**
- **“creative destruction”** related to creative destruction; something has to be destroyed so that something new can take its place (e.g. vinyl to cd to mp3 to streaming); (e.g. Smartphones; tastensmartphone were destroyed by smartphone; other industries are destroyed by innovation if you're not adapting fast enough)

OTHER ECONOMISTS OF THE ERA OF ECONOMIC MODELS:

- **Arthur Cecil Pigou** (* 1877; † 1959)
- **John Hicks** (* 1904; † 1989)
- **Jan Tinbergen** (* 1903; † 1994)
- **Wassily Leontief** (* 1906; † 1999)
- **Paul Samuelson** (* 1915; † 2009)
- **Robert Solow** (* 1924)
- **Kenneth Arrow** (* 1921)
- **Robert Lucas** (* 1937)

See also the **list of laureates of the Sveriges Riksbank Prize in Economic Sciences** in Memory of Alfred Nobel on the official website of the Nobel Foundation http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/ more contemporary economists and the biographical information on contemporary economists and their contributions to economic science and political discussions in Putnoki/Hilgers (2007) and Tichy (2012).

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[introduction to famous economists; more light reading](#)
[erschien auch in der wirtschaftswoche](#)