**INTRODUCTION**

Suppose that a government introduces austerity, namely a policy adopted by the government where the main target is to equalize the government buys (realize equality). The total spending of the government must be equal to the tax revenues () and this is the target of a government introducing an austerity policy. So, a certain percentage of income (indicated by y) must be captured by the government and therefore tax rate (indicated by t) is proportional to total income. The problem behind this suggestion lies in the fact that it is very difficult to reach this target each year. In fact, there are different economic phases in a country’s economy, which alternates increases and recessions (large drop in the output of the economy), so if the government implements this policy during a recession it will face some economic aspects linked to this phase:

* Stock market prices drop
* Banks failure
* Reduction in employment

Given these aspects, every agent in the economy becomes pessimistic about future prospects, so both consumers and firms decide to reduce their spending, respectively consuming expenditure and investments. As a result, the total income of the economy goes down, in fact, the income of economy is given by consumption spending plus investments plus government spending:

y = c + I + G

I and c go down, so government can decide either to reduce or to maintain its spending, so the total income goes down. In this scenario, what happens if the government tries to realize austerity? The outcome is a situation of **government deficit**:

**G > ty**

If government wants to maintain the equality, it should not implement austerity during recessions, since the reduction of income implies that ty goes down during a recession. The optimum policy, instead, is not following strictly austerity but increasing government spending, deviating the course of austerity which aims at maintain or decrease G and increase ty. On the contrary, many economists suggest that the optimum solution is stimulating economy by increasing G.

Other scholars state that if G is not controlled even during recession an unbearable situation could occur. The government deficit accumulates in **government debt**, made up of the government deficit in each year.

represents the cost in terms of interests you have to pay to repair the debt. These scholars claim that even during recessions it is important to control by controlling G. If G increases, consumers may decide to wait to spend the additional income to realize some investments because they have a pessimistic attitude towards economy. These economists claim that this formula is more important than the equality between G and ty because it is necessary to control also the cost to repair the debts. Usually during recessions the interest rate goes up, so even maintaining fixed the debt could go up anyway.

The problems with economics in general is the fact that it is not a certain field, we cannot say *a priori* which is the best policy and this happens because economy is composed by agents (consumers, firms, financial investors) that make decisions and react to policies in a different way, so we cannot make predictions about their behaviour automatically. The main aim of economics is to provide the instruments to evaluate which is the most appropriate explanation of problems of this kind through the knowledge of the evolution of economic systems and ideas.

There are many economic factors that may have an impact on our life:

* **Austerity policy:** government may decide to reduce the funds for a certain institution (e.g. university) which has less money to implement its activities and may respond by increasing fees.
* **Deep recession:** during economic recessions, every purchase may entail problems with banks, which may decide to cut the funds to finance certain projects.
* **Functioning of economy:** the way in which the global output of economy is produced may have an impact of our lives because it may use sources for production that have an impact on the environment.
* **Global trade:** you may buy a product in your country or in another one and everyone can work in any country because everyone is free to move from one place to another.

**INTRODUCTION**

Economists, in general, study these situations and try to explain the effects of these economic questions. The problem in studying this aspect of the economy lies in the fact that **economy is complex**. Economy is composed by 200 countries and more than 7 billions of people with different cultures, institutions and organizations, a limited number of resources (e.g. food, oil, energy), so if we consider these aspects it is evident that the scenario is very complex. In addition, economists study an economy which is not static, yet changes continuously. Having these problems in mind, it is natural to observe that it is impossible to study economy and its functions in all aspects, yet economists try to isolate and focus on the key aspects of economy. This discourse opens the question of **economic methodology**, namely how to do economics: economists work in terms of economic theories, made up of their views concerning a certain aspect of economics. **Economic theories** are based upon **assumptions**, necessary to simplify reality. In forming economic theories from assumptions, economists have to use the so-called **logical accuracy**, the main passage needed to build a theory. Usually, logical accuracy is associated with the use of math. Assumptions are important because from wrong assumptions result wrong theories. Given the complexity of the object of investigation (i.e., a continuously evolving system), the economist has to use also the sensitivity needed to select those assumptions more close to the social reality (i.e., reliable assumptions). Differently, implausible assumptions result in erroneous conclusions. This mistake may translate in erroneous economic decisions affecting employment, economic growth, inflation dynamic, distribution of income, etc. Discussions about different theories of economic thought are based on these elements plus the **purpose** of economy.

The economist must have: **observation power**, **intuition**, **logical accuracy**. The discussions among economists are based on: the logical coherence of various theories, the realism of assumptions, purposes of the economy.

enice)

**METHODS**

To build a theory, you can use either a **deductive** or **inductive** method of reasoning.

A **deductive** method (***from general to particular***) of reasoning is also called **analytical**, **abstract** or **prior** and is characterized by the fact that an observer **starts** from very **general** **assumptions** or general truths and, basing upon them, builds an economic theory.

e.g. *All businessmen are interested in realizing profits* 🡪 *businessmen buy cheap products and sell them at higher prices in the market.*

The main steps involved in this method are:

* **Observation of reality** and **forming assumptions** based upon the observation of a determined behaviour.
* **Deductive reasoning:** it is necessary to use logical accuracy and build your **final** **hypothesis**, which is the result of deductive reasoning.
* **Hypothesis testing:** once built a hypothesis, it must be validated by methods that confirm its reliability (e.g. statistical method or direct observation).

**Deductive method** has advantages and disadvantages.

The **advantage** is the fact that it has a very close relation with reality (**efficacy**), since it starts from observing reality without filters (no experiments and data analysis 🡪 less expensive and time-consuming, i.e. efficient). Another advantage is its **accuracy** (clarity), due to the use of mathematical formulations.

The main **disadvantage** of deductive method is the fact that the **conclusions** (hypotheses) **are valid only if assumptions are valid**: if generalizations are wrong since the beginning, the results will be wrong since they follow initial assumptions. The second disadvantage is the fact that a very high level of **abstraction** must be employed, isolating very few elements from reality to build a theory (“intellectual toys” with little connection to reality). Moreover, the validity of assumptions may be **state-and-time-contingent** (not universal): it may change over time and among different places.

**Classical** and **neoclassical** school use deduction; the difference between them is not a matter of degree, but the fact that one sets out from **aprioristic** hypotheses (neoclassical school), while the other is **historic** and part of a sequence of observed facts (classical school).

enice)

Deductive method employed by the classical and neoclassical economists often led to many facile conclusions due to reliance on imperfect and incorrect assumptions.

Sharp reaction began against this method from the German historical school of economists. They advocated a more realistic method for economic analysis known as inductive method.

enice)

**Inductive method** (*from particular to general*)

of reasoning is also called **empirical** method and is characterized by some aspects: it **starts** from **particular** **facts** and then arrives to build general statements through the crucial **employment** of **statistical** **method** and experiments in the **building process**. On the contrary, the deductive method employs them only at the end, in the validation process.

e.g. *195 out of 200 people in the market decide to buy cheaper products, 4 people decide to buy domestic/local products and 1 person buys products randomly* 🡪 *almost everyone prefers buying cheap products, with few exceptions* (considered outliers and therefore not considered)*.*

The conclusion is implicitly driven by statistical method because, in forming this statement, we are considering the ratio between people buying cheap products and the total of people participating in the market.

The main steps in using the inductive method are:

* **Observation of reality** in order to identify the facts under investigation (no assumptions needed).
* **Data collection:** by observing certain behaviours, it is necessary to collect information about the number of people behaving in a certain way or in another.
* **Data analysis** using appropriate statistical methods to draw conclusions.
* **Generalization of conclusions:** the results of the analysis based on a limited sample must be generalized to the entire population (n > 1), validating the results by repeating the experiment.

The **advantage** of this method is the fact that the results are based on data and therefore empirically validated (**accuracy**), avoiding error. The **conclusions** reached (economic laws), however, are not static but **dynamic**, so they depend on time and place of the experiment. Furthermore, inductive method may be used to validate the results of other methods of reasoning, such as the deductive one. This means that the inductive method is **complete**, differently from other that are incomplete.

The main **disadvantage** is the fact that this method needs lots of data and experiment to be validated and requires elaborating a large number of data: it is very **time-consuming** and expensive. Another disadvantage is the fact that **data collection** is **difficult**. Finally, the generalizations are valid only if the experiment can be repeated (**large dataset**).

Both methods are needed in economy to build theories, no one can be used exclusively: as Alfred Marshall stated, *inductive and deductive methods are needed in economy as the right and the left foot are needed in walking*.

**DEFINITIONS OF HoET**

There are lots of definitions of economic thought. One is the ones given by professors **Haney** and **Schumpeter**: the latter states that economy is an assembly that studies the evolution of economic thought, whereas the former states that economics is a complex issue and this field of economics studies the **development** of various **economic ideas** and their **interrelationship**.

*“A critical account of the development of economic ideas, searching into their origin, interrelations and manifestations”* (Prof. Lewis H. Haney)

*“Economic thought is the sum total of all the opinions and desires concerning economic subjects especially concerning with public policies of different times and places”* (Prof. Joseph Schumpeter)

enice)

Schumpeter says that economic thought is the sum of all opinions and especially those concerning public policies, yet his approach is static rather than dynamic. According to these definitions, there is an idea of **evolution**, defining history of economic thought as a dynamic science that studies how ideas evolve in time and their linkages.

Economic history and history of economics seem similar to history of economic thought, yet they study different objects. Economic history is interested in studying economic aspects of one country, such as the history of its commerce, industrial organization ecc. Instead, history of economics studies economics as a science rather than economic ideas. These three fields of economic research have something in common, yet their objects are different, since HOET studies the evolution of economic ideas introduced by various economists over the years.

There are two views with regard to the importance of study of history of economic thought: one group of economists believed that there is no need to study the history of economic thought because it is a history of errors, whereas another group believed that one cannot possess knowledge of any economic doctrine until one knows something of its history.

enice)

History of economic thought may be broadly divided into two parts: the first part deals with the origin and the development of economic ideas before the development of economics as a science. This part comprises all pre-classical theoretical contribution (i.e., before Adam Smith). The second part deals with the economic ideas after the development of economics as a science. This part comprises all theoretical contributions after Adam Smith.

enice)

History of economic thought can be studied through different approaches:

* **Chronological approach:** it presents the various economic ideas of different economists year-wise following a timeline and enables to see the linkage among different schools of thought. Different phases can be recognized: **ancient world** (300 BC – 1500 🡪 Greek philosophers, Roman church fathers, scholastics), **pre-classical school** (1500 – 1700 🡪 mercantilism, physiocrats, social philosophers), **classical school** (1700 – 1800 🡪 Smith, Ricardo, Marx), **neoclassical school** (1800 – 1900 🡪 Jevart, Merger, Marshall), **historical school** (1850 – 1900 🡪 Weber, Schumpeter), **monetary school + Keynesian** (1950 – 1980s 🡪 Keynes, Pigou) and **new Keynesian school** (1980s – 2000 🡪 Lucas).
* **Conceptual/ideological approach:** economic ideas are presented as organized in different topics without a timeline. Therefore, it deals with the development of different economic concepts and their interrelation. For example, we can find **ethical** aspects of economics (moral behaviour an economic agent has to follow when decides to consume or invest regarding usury, exchange, just price, slavery ecc), aspects related to **property rights** (heart of the economic system, pivotal in ancient world, feudalism and in capitalistic world, for example alienation for Marx), aspects related to the **price theory** (which is the fair value of a good, concept present in the ancient world and in classical economic schools with the labour theory of value of Smith, Ricardo and Marx, as well as in neoclassical schools with diminishing marginal utility), aspects related to **money lending** and **interest** (fair value of interest rates, again related to usury), aspects related to **public finance** (taxation, government spending, austerity, management of government balance), aspects related to **business cycle theories** (reasons lying behind short run trends and economic phases such as recessions, peaks of growth ecc) and aspects related to **economic growth** (long run trends and dynamics of economics 🡪 Schumpeter and Solon). Other aspects are related to **international trade** (focus on mercantilism, comparative advantage theory of Ricardo) and to **population and environment** (evolution of population with respect to land studied by Malthus).

*Why do we need to study HoET? The study of history of economic thought clearly shows that there is a certain unity in economic thought that connects us with ancient times. The study of economic thought will help us to understand the origin of economics. Economic ideas have been instrumental in shaping the economic and political policies of different countries. Economic ideas are conditioned by time, place and circumstances. A study of economic thought provides a broad basis for comparison of different ideas. It will enable a person to have a well-balanced and reasonable judgement. Through the study of economic thought the student will realise that economics is different from economists. The study of the subject helps us to avoid the mistakes committed by earlier economic thinkers. The study of history of economic thought will enable us to know the person responsible for the formulation of certain important principles.*

enice)

enice)

*History of economic thought is selective and interpretative in nature: authors select those topics in which they are interested. If authors leave out certain important facts and emphasize others, their judgements are biased. For example, “A History of Economic Doctrines” — written by Gide and Rist leaves out discussions on ancient economic ideas, medieval economic thought and the contributions made by mercantilists. Further, complete history should deal with modern economic thought also. That means it should include the contributions made by Marshall, A.C. Pigou, J.M. Keynes etc. In this respect it can also be said that Alexander Gray’s “The Development of Economic Doctrines” is incomplete.*

enice)

The evolution of economic thought is related to the **evolution of economic systems**, since economists form ideas which follow from the economic systems of their times. All the economic thinkers reflect the evolution of the economic systems. A society needs an economic system to organize its life.

IN SHORT: **ECONOMIC SYSTEM EVOLUTION**

**Hunting/gathering economic system:** it is the earliest economic system dating back to the prehistoric era, when people needed to provide food, which was pivotal to this kind of economy based on **survival**. This kind of society was organized in terms of hunting, the most important activity in this kind of economy, and the most important aspects of this system made up of a small number of members are **cooperation**, **redistribution** and **reciprocity** (**group-oriented**). Members of the group had to work together and help each other and this organization was based on and driven by the idea of **interest of the group** rather than self-interest which grants equilibrium. In every economic system, people are interested in reaching a **high social status** and even such a simple economic system presents this feature: social status was related to the capacity of finding a large amount of food, so reaching the top of the social scale depended on **hunting skills**.

**Agricultural system:** the breaking point of the previous system was innovation through agriculture, leading to a society made up of lots of members that needed to better organize society also in other aspects than surviving. The central element of this system was **surplus product**, the amount of output produced in a quantity that is larger than that needed to survive. In this case, there is the opportunity of employing this part of product in other innovative activities, such as making animals and plants grow. The surplus product is linked to **property rights**, since the attribution of a owner to this residual part is problematic: everyone wants to have it and there is a kind of **warfare** among communities to conquer it. This opens the problem of **allocation** and **control**: even once the owner has been identified, the question is how to use the surplus product. In more complex economic systems, the problem is how to organize the allocation of surplus product. The control of surplus product in these more complicated systems is attributed to **kings**, **emperors**, **lords** and similar figures that are at the **top** of the **society**. The consequence of this is that with the surplus product we observe the **division** **of** **society** **in** **social classes** and in particular into **unproductive classes**, which controls the surplus product but do not produce, and **productive classes**, made up of land workers, slaves and all the people who are at the bottom of social scale and produce output controlled by the unproductive class. There is an **evolutionary passage** from a group formed to survive to a society divided into two classes (upper and bottom), where **individualism** and **self-interest** prevail. The upper class is interested in maintaining their power and the bottom class aims at gaining power. In this context, an **army power** is needed to safeguard order, threatened by the rebellions of the productive class. In this system the **government** has the role of organizing army power and defend the property rights of the upper class.

In the **Ancient Greece** government officials, philosophers and thinkers composed the upper class; foreigners living in Greece without being born there were a sort of middle class, with some rights but not as many as the upper class; former slaves that had exited slavery and become free constituted the freedom class; slaves were the lowest and most numerous (50% of society) class, being totally subjected to the authority of the lords. The government was needed to defend the position of the upper class and organize military power to control external attacks. Ancient Greece was characterized by the presence of many city-states, each of which was self-sufficient and capable of organizing their lives without trading or cooperating with the others. Therefore, the trade was limited to luxury goods, namely those which are bought by upper classes.

The **Romans** observed a similar social structure, with the patrician families at the top (land owners who lived in large houses and had lots of political power), then plebeians (working class and peasants) and finally slaves (prisoners of war) at the bottom of the social scale. The Roman Empire conquered a large amount of territory and needed a strong military power to defend and control the empire. There was an important network in communication, with lots of roads built to facilitate communication and transportation: it is an important added value because they were capable of linking different cities and territories. Trade was again focused on luxury goods and economy was based on the work of the slaves (**slavery economy**) and on sources obtained by colonies. When the slaves started to rebel and sustaining the government became difficult, the Roman Empire entered its decreasing phase. At the end of the empire, the networks of communication disappeared and the society evolved into **feudalism**.

**Feudalism** starts at the end of the Roman Empire (476 AD) and finishes in 1450s. After 476 there is a chaotic period due to the collapse of the roman organization, when there was no government to control the trade rules: the result is that **cities** become **isolated**.

Cities have to survive and cannot use the sources imported from other cities because the trade was made impossible, leading to a recession in society in terms of organization and communication.

The society is organized as a pyramid scale with the king at the top, controlling the activity of the lords, who controlled territories called **manors**, where serfs worked. The lords paid taxes to the king, so some of the surplus product goes back to the king in terms of fiscal control.

The towns were out of this scale, being aggregations of people composed by groups of merchants and artisans (guilds), constituting the centre of the town. They traded luxury goods with the society. Manors were the main economic centre and were based upon agreement between lords and serfs. The serf worked the land inside the manor and, in exchange, received some food and some portion of the land. On the contrary, slaves worked with nothing in exchange. Moreover, the serfs had no intention to rebel to the lord, differently from slaves, because they received food and protection (sort of remuneration) from the lord. In this economy, the lord was more important than the king, who was only an institution but did nothing to move the economy and realize surplus. The role of the market in the town was very limited and managed only by guilds, which produced luxury goods devoted to the lord, but were not essential to him since the economy of the manor was **self-sufficient**. The problem with this kind of organization is the **lack of space for innovation**, since the goods produced by artisans were luxury goods which cannot bring any innovation. If there is no innovation, there is no space to evolve and this is why this system survived for such a long time.

After the feudal system we can find the so-called **mercantilism**, the first stage of capitalism or **market-based economy**. The market became central to this kind of society: the trade and the role of the merchants were very important.

Mercantilism is characterized by the presence of a **big nation-state** which controls the economy with ad-hoc trade policies with the aim of **increasing wealth**. How did this passage happen? The first way was **technological innovation**:

1. First of all in agriculture: the **crop rotation system** of agriculture was pivotal to this change because it opened new possibilities for the economy to evolve. In particular, the **increased productivity** implied that there were more sources of food for people and this resulted in a **demographic increase**. Accordingly, there were **big towns**.
2. New means of transportation allowed people to be involved in **long-distance trade** and goods to be bought from distance places. **New trading opportunities** and **new markets** opened and in this situation the role of the **merchant** became very important, exiting the system of guilds and using their knowledge to organize this new kind of trade (cheap importation and expensive exportation, rising profits): this figure stays at the centre of mercantilist economy.
3. The second point that can help explaining the passage to this economic system is the **Crusades**, whose official aim was defending the Church and freeing the Holy Lands from non-Catholics occupiers. However, the real aim of the crusades was economic: western European countries entered into contact with eastern or Latin American countries, having the opportunity of trading some important commodities (e.g. importation of gold, silver and slaves).
4. The rise of the **nation-states** was possible thanks to the **collaboration** between the **king** and the **merchants**: the king acknowledges that the world is changes and that there are new trading opportunities, so he decides to make an agreement with the merchant, attributing him the role of organizing the trade and using the revenues to buy new territories and enlarge his power.   
   The king uses the knowledge of the merchant and the merchant uses the money of the king. To maintain their power, nation-states needed lots of money, useful both to create and maintain them.   
   This kind of policy can be seen in the exploration of new territories by Vasco De Gama, Christopher Colombo and others who received money from the king to discover new regions and markets and collecting new sources.
5. The search for new markets brings to the formation of the so-called **colonialism**, result of the contact between western European countries and new regions, whose resources are collected by the invaders. There was an **asymmetric trade** and total control of the Europeans over the newly discovered countries with the exploitation of their resources.

What about the lord in this kind of economy? The lord wants to maintain some power and decides to use the free common land outside the manor for his private purposes. To do this, he uses the money received by the king to sell the manor in order to build a new manor, not only based upon the agricultural system but also upon some animals: there is a passage from manors to **farms**.

* **Labour** becomes a **factor of production** and the merchants are able to use a lot of labour because of the demographic increase (work supply > work demand). Another important factor of production is **land**, implied by the passage to the farm system: land can be used for agricultural purposes, for animals or for renting 🡪 land is a business.
* All this economy is market-based: market is pivotal both at the nation-state and at the farm level.
* The important feature of capitalism is the fact that the means of production can be bought and sold: **property rights** enter this scenario and a large part of the population needs to work, so this kind of economic society is driven by **self-interest** (enlarging property and raising money).

The next phase is **industrial capitalism** (1700s – 1850s), born as the evolution of the previous one. The passage is driven by the introduction of new machinery in the farms: some important merchants or lords controlling the farms decided to introduce an automatic method of production through the introduction of **machinery** (new technology) in the production process, resulting in the passage from farms to **factories**. The **capital** (amount of machinery, buildings and equipment needed to produce a given good) is the centre of the economic activity, so the **ownership of capital** represents the source of **power**. This society is characterized by a huge **increase in profits** for the capitalists, resulting from demographic increase and from the law of demand: if many people need to work (high supply), the demand will be lower than the supply and the cost of the labour will be very low. The cost of production of other commodities needed to produce a given good is low as well, so the profits (amount of total income obtained by capitalists) are very high.

From 1850s, we observe the dark ages of capitalism, when the capitalists had a lot of power with respect to the workers and the bargaining power of the latter was very low, so they accepted any kind of salary, even if very low. Marx observed this situation and basing on this formulated his idea of revolutionary economy.

The working conditions improved only at the beginning of 20th century with **labour laws**.

Nowadays, since the end of 20th century, we are living in **finance capitalism**, an economic society governed by the financial sector, to be intended as the banking sector. For example, if a firm does not have the funds to buy equipment, it can obtain them from the bank (**debt financing**). Alternatively, it could sell part of its ownership, using an **equity** policy: selling its ownership in the stock/share market, this portion of equity is bought by various agents in the market. Those who want to buy have 3 options: buying part of this ownership, buying treasury bonds issued by government or depositing their sum in a bank deposit. These 3 options are the result of a well developed financial structure.

We can observe a new kind of innovation technology (automatization) which is very costly for the firms and the emergence and development of the new class with lots of money to invest (middle class: merchants, farmers, renters) brings to the formation of the financial sector. With these new instruments, firms and consumers are able to satisfy their needs of investment of their savings.

The result of this **financialization** of the economy is that economy becomes very unstable and this means that the economic phases (booms and recessions) are very persistent. The reason of this instability is the fact that, in financial markets, all **agents** – firms and consumers – behave according to a sort of **animal spirit**, in a sort of **irrational** way: they are over-optimistic or over-pessimistic depending on the economic phase they are living in.

For example, during a period of boom and economic growth the firms want to buy new machinery and introduce new technology because they observe a growing economic phase that makes them optimistic. At the same time, the consumers may decide to invest buying new share in the stock market and, observing that they are in a growing phase, they may decide to invest more in the financial market. As a result, growing patterns of output are amplified. During recessions, on the contrary, both consumers and firms become more pessimistic, since the latter may had decided to invest in new machinery but the negative trend of the output could lead them to freeze or drop the investment project. At the same time, consumers may decide to maintain the saving instead of buying share or treasury bond.

In this situation, the output of the economy continues to decrease because of the behaviour of consumers and firms, which amplifies the decreasing pattern of the economy. So, in a financial economy the role of the financial sector is the **amplification of economic phases**, so society is very sensitive to little changes in economy and therefore unstable. Outcomes of this pattern are crises such as the Great Depression in 1929, the recession of 1980s and 1990s, the @com bubble in 2001 and the Great Recession in 2008.

**Global capitalism** is an evolution of financial capitalism and is characterized by the fact that world economies are linked by **capital movement** and by the so-called **internet** era. The recessions mentioned before are the result of global capitalism because they have an international nature: international movement of capital causes recession born in one country to spread in the others. In particular, the last two are the result of the internet era: the first is linked to the internet industry and the second was born in the USA and spread through internet connection. Studying the recession periods we are able to identify the contributions of various forms of capitalism in economic growth.