**PRE-CLASSICAL THOUGHT**

This period covers a long time span and comprehends the Renaissance period (1400-1650) and part of the Enlightenment (1650-1800).

The dividing line between the two periods (pre classical and classical) is the contribution of Adam Smith (1723 - 1790), who is the founder of the classical school in economics some consider him as the father of economics in general.

**Passage from Feudalism to Mercantilism**The new economic system can be defined as **mercantile system**, which is the first stage of capitalism and market-based economy. There are **big nation-states** and the evolution of the manors into **farms**.

**[1]** During mercantilism we witness the passage from **manors** to farms:

* They were not complex systems, everybody knows their place and what to do  the study of this kind of system is NOT a big issue for intellectuals.
* They were usually enclosed by hedge and are born from an economic arrangement between a lord and his serfs.
* They had a well-defined structure and are self sufficient; commerce and trade are poor as well as roads and infrastructures.

The political economy is born (when human actions ≠ spiritual ends), together with theories of economic policy, to study the problem of accumulation and management of wealth of a State.

These big nation-states controlled the economy and their main aim was **accumulating** **wealth** and **power** through **international trade policies**.

**[2]** The passage from feudalism to mercantilism is due to two main factors:

1. **innovation technology** (**scientific discoveries**, e.g. heliocentric theory, Galileo’s law of fall, refracting telescope, laws of planetary motion, circulation of the blood, Boyle’s law, law of universal gravitation, crop rotation system, caravel, Mercator projection map, foundation of modern hydraulics), which changed the way educated people looked at the world,
2. **long-distance trade** (**colonization** **policy**).

The former brings to the **evolution** of the concept of **natural law** and to the application of a **new method of reasoning**.   
In the Middle Ages, natural law represented a moral order related to God and inspired by God’s reasoning: only the wise man was able to interpret God’s reasoning.   
According to this new current of thought, **natural law** was inspired by **human reason** (basic, permanent characteristic of men) and this was related to scientific discoveries: human mind was trusted as considered able to understand what happens in the world in terms of natural phenomena and to deduce universal and self-evident rules for human behaviour.

**Empiricists:**   
Science in the middle ages was aimed at understanding God rather than the world and it was unconceivable to examine the universe outside the realm of religion.   
In the ancient world the method of reasoning was deductive, whereas in this new context a group of scholars called **empiricists** suggested the use of the bottom-up or **inductive method**, from particular to general. Two important philosophers of this group are **Bacon** and **Locke** (also a social philosopher)

They stated that **human knowledge** derives from **sensory** **experience** and consists of three steps:

* Observation of a number of cases,
* Discovery of a common pattern among them
* Inference that the pattern holds for all things of the relevant type.

**Bacon** advocates that new knowledge has to be acquired through an **inductive**, or experimental, reasoning process called empiricism. Bacon **rejects the medieval view** of knowledge based on tradition, and believes instead that it is **necessary to collect data**, **observe**, and draw conclusions.

**Locke** posits that the **mind** is a **tabula rasa**, or blank slate, at birth. There are **no innate, or God-given, ideas** in the mind, only the **capacity to have them** (an innate capacity to reason). All of our **knowledge** must come from **experience of the physical world**, through **sensory perception**

With the Renaissance, man is placed at the centre of the universe and philosophy had emancipated from the influence of the Church.

The Renaissance also led to the beginning of that great process of intellectual emancipation known as the “scientific revolution”. In Renaissance period we observe a big expansion of European universities. The basis of modern economic thought laid down in this climate of cultural revolution.   
  
The birth of economic science is the result of two processes:

* **Abandonment of the idea that economics is a sub-product of ethics and politics:** it is the result of two factors occurred after the second half of fifteenth century: **the formation of nation-States and the huge increase of international trade**. In the Middle Ages the manor, not the village, is the basic unit of organization. A manor consists of a manor house, one or more villages, and up to several thousand acres of land divided into meadow, pasture, forest, and cultivated fields. The manor is usually enclosed by a hedge. The manor system is an economic arrangement between a lord and his serfs.   
  The manorial system is not complex: everyone knows their place and what they have to do. Each manor has the same well-defined structure and is self-sufficient. Commerce and trade are poor as well as roads and infrastructures. At that time, and with the above-mentioned organization of society, the study of the “manor system” (i.e., the management of the manor) is not a big issue for intellectuals.

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* **Secularization (laicization) of science**: the birth of political economy occurs only when human action is no longer motivated by spiritual ends. When public choices are no longer legitimated by God, but only by the ends of men and the nation, it is possible to study them scientifically.

Moreover, in this period we witness the fundamental **passage** from feudalism to mercantilism. During Middle Age, there where many small units with local rulers who claimed tolls. On the other hand, mercantilism worked **for centralization** and **against the political fragmentation** to create big Nation-States.

**Mercantilism**  
Mercantilism is a **market-based system** based on the presence of a **big nation-state** (a process of unification started after the end of Holy Roman Empire and completed in the second half of fifteenth century in UK, France, and Spain) **controlling** the **economy** with the aim of **increasing** their **power** (accumulation and management of wealth) through international trade policies.

It is the application of the mercantile system into economic thought. In this context, **the expansion of trade**, especially long-distance commerce, adds complexity in the investigation of economic functioning of the nation-State.

The nation-state is pivotal to this system and its authority was justified by **social philosophers**, who introduced the concept of **social contract**.

**Social contract**During this period social philosophers developed the theory of the social contract: with the term social philosophers we consider all the XVII century theorists of social contract such as Grotius, Hobbes, Pufendorf, Locke, Rousseau, Kant.

The social contract concerns the **origin of society** and the **legitimization** of the authority of the **state** over the individual as the result of a **morally justified and** **voluntary agreement among individuals**. Individuals decide to recognize the power of the state and they agree that it has to **control economy**, which is its main function together with the **protection of individuals**.

Therefore, the social contract is **based** upon **natural law**, which in turn is the result of human behaviour, so the authority of the nation-state is the result of this social contract which gives it power. The social contract obliges citizens to respect and obey the state, in exchange for stability and security that only a system of political rule can provide.

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**Social philosophers: Hobbes.**  
The social contract of Hobbes (1588—1679) start from the concept of **man in a primitive state** (the so-called state of nature) **without political authority**. He considers that such a **stateless autonomous condition** may be overcome only if men accept the social contract.

Hobbes argues that the State is made up by individuals who **recognize** that only the establishment of **sovereign power** may safeguard them from the **insecurity of the state of nature.**

In this context, States or other sovereign entities could only have **validity** and **legitimacy** if their laws were **consistent** with these natural laws. Natural law is defined as the **way in which a rational human being**, seeking to survive and prosper, **would act.**

In general, mercantilism is not a coherent branch of economic thought, since inside it we can find different branches: the **German mercantilists** were interested in studying **public finance**, the **French mercantilists** investigated **domestic industries** (how to support and increase their productivity), the **Spanish mercantilists** focused on the **acquisition of precious metals** (gold and silver) and the **British mercantilists** studied the **balance of payment** (exports and imports) of the country.

The **power of the state**   
It was considered to be **proportional** to the **wealth** **accumulated**, so what are the factors that favour this accumulation? There are two factors: (1) **International trade** and **protection policies** on the one hand and (2) **quantity** of **money in circulation** in the country.

* Mercantilists focused on international trade because it implies an **inflow** of **precious commodities** (gold and silver). Therefore, they thought that internal commerce was not able to increase wealth because the quantity of precious metals inside the national economy does not change. In international trade, exports refer to the goods sold and paid in terms of gold and silver, so exports lead to inflow of precious metals. The mercantilists suggested to increase exports and decrease imports (**exports > imports**). So if this is the suggested policies, given that international trade is necessary, the policy focuses on the highest possible reduction of imports by means of **tariffs**, an idea born from French mercantilism, which stated that reducing imports stimulates domestic industry.
* Also the higher the quantity of money in circulation the more the trade and employment were stimulated.

This idea of favouring exports in spite of imports was criticized by **Ricardo** in 18th century: in fact, he stated that there is a **reciprocal advantage** in international trade. Only when both countries have a reciprocal advantage that increases their wealth, then we can talk about international trade. The inflow of gold and silver is generated by a surplus of external trade, so the point is understanding how to increase the quantity of gold and silver in a different way. The **quantity theory of money** explains the mechanism through which an **increase** in **gold** and **silver** **leads** to an **increase** in **wealth** and **output** of the economy. This theory can be divided into two versions:

* **Old version**, introduced by Jean **Bodin** (16th century), who stated that the effect of the increase in gold and silver is just an increase in the quantity of money in circulation, which translates into an increase in price levels. This mechanism is the result of **colonialist policies** that led to the import of great amounts of precious metals from colonies. This way, demand increases but supply is fixed and not stimulated, so prices go up.   
  ↑ Gold/Silver = ↑ money = ↑ price levels. Demand is greater than supply → colonialism policies.
* **New version**, dating back to 17th and 18th century, when inflows of gold and silver from colonies were very low and therefore could be obtained only by international trade with exports outweighing imports. In this case, the increase in demand is balanced by an increase in supply, resulting in increased output. In fact, the theory is based on the equation , where M = quantity of money in circulation, V = velocity of circulation of money, p = price and y = output. The left part of the equation is the total expenditure and the right part is the total receipts: the two must be equal in a given period of time. According to these scholars, V and P are fixed (constant over time): if this is true, if the quantity money in circulation goes up, so does output 🡪 **direct effect**. In fact, if exports > imports, then there is a surplus and therefore the quantity of money increases, translating into an increase in output, always given that V and P are fixed.

Another branch of the quantity theory of money states that there is another effect operating through **interest rates** channels: if the quantity of money goes up, it results in a fall in interest rates (cost of raising loans), because more money can be used for raising loans and this implies a reduction of the cost of the loans, namely a reduction in the cost of interest rates. This stimulates investments and increases the output of the economy 🡪 **indirect effect**.

If Exports>Imports = ↑ Gold/Silver = ↑ money = ↑ output(Y).   
Both demand and supply have to increase.

**Total Expenditure = Total receipts from sale of final goods/services**: “M x V = P x Y” → Y and P (central letters) are fixed, so if M increases also Y (output) increases.

M is money  
V is the average number of transactions  
P is price (The difference from the old is that here P is fixed)  
Y is output

To sum-up:

- if Exp>Imp(surplus) → an increase in G/S means ↑ M = ↑ Y (Direct effect given V,P fixed)

- if ↑ M = ↓ Int. rates = ↑ Investments = ↑ Y (Indirect effect). +ù

**William Petty**

An English scholar, called **William Petty** (1623-87), is sometimes considered a mercantilist and sometimes a forerunner of classical school because of different aspects of his theory. He is the founder of **political arithmetic**, namely the application of **quantitative** **methods** in the analysis of economic phenomena. This method was influenced by Francis **Bacon** and empiricist school and implies that, to study economic phenomena, it is necessary to collect and process data to obtain economic laws (close to the inductive method). This theory is related to the concepts of money, fiscal systems, natural values and surplus.

* **Money** is important because it facilitates trade: this view is close to the mercantilist one, yet Petty suggests that there is an **optimal level of money** in the economy, since too much money can be harmful for the economy. Therefore, it can be considered a critique to the mercantilist view of increasing surplus to increase money.
* Also **fiscal systems** are important for an efficient functioning of the economy and they have to ensure **uniformity** through a **proportional taxation** applied **on consumption** rather than on production (T x C rather than T x y), where T = taxation and C = consumption. In fact, he thought that consumption rather than production is an **indicator of wealth**.
* The **market** **price**, namely the observed price in a market for any commodity, fluctuates around an **optimal** level called **natural price**, depending on the technology level and on the workers’ subsistence (level of wage guaranteeing the subsistence of all the workers in the economy). If these two factors increase, natural price goes up.
* As for **surplus**, it is the additional value of the land with respect to a series of costs and, for Petty, surplus is equal to the value of land products minus the yield obtained on this land without the usage of labour, plus the wages paid to the workers. This quantity is more or less equal to the rent of the land. In fact, output is equal to rent plus wages plus profits 🡪 y = r + w + π, so r = y – (w + π).

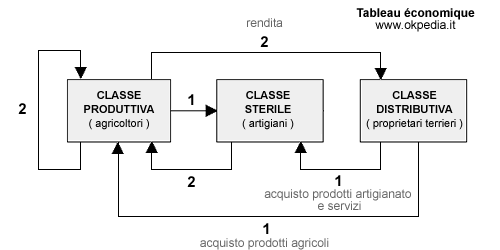
**Physiocracts**   
It was a group of French economists whose leader was Francois Quesnay (1694-1774). Physiocracy means “**power of nature**” and suggests the presence of a natural order in economy; physiocrats want to eliminate State regulations on market 🡪 natural order should be restored.  
Natural order comes from Natural Law which, as Social Phy said, defines how a rational person should act.  
They thought that agriculture (first sector) was the only one able to produce surplus.

**Quesnay**

He was a surgeon and he translated his medical background in economics and, in particular, applied the functioning of human body to the functioning of economic systems. In human body, organs are interconnected and arrive to a sort of equilibrium without any kind of external force intervention.

According to him, also economic systems work like this: their different sectors work together without external intervention. His main writing is “*Tableau economique”*, where he considers the various economic activities as a circular process, where each class has a specific role and work together to find equilibrium.  
Interconnection: In this process Quesnay said that classes are interconnected. Each sector is allowed to reintegrate the initial endowments of means of production and of subsistence..

Society is composed by **three classes/sectors**: the **landowners** (**unproductive class**) that consume all economic surplus without producing, the **manufacturing** class (**sterile class**) that consume exactly how much they produce (input employed in production = output consumed) and the **agricultural** sector (**productive class**) that produces a net output (surplus) larger than the value of the inputs employed.

Quesnay refers to a period *t*, divided into six sub-periods   
(*t.1*, *t.2* ... *t.5*). The generic *t* is our starting situation and the first five sub-periods refer to the **circulation process**, where an exchange of goods and money among different economic sectors occurs.   
In period *t.6* the **production and consumption process** occurs.

In the starting situation, the production and consumption process of the previous period has just completed; here there is a total output corresponding to a certain amount of **goods** produced by **agricultural** sector plus a certain amount of **manufactured goods** produced by the manufacturing sector.   
Moreover, there is a quantity of **money** owned by the agricultural sector. It is possible to represent this situation in a table format.

**Starting situation (period t):**

|  |  |  |
| --- | --- | --- |
| **Agriculture** | **Manufacturing** **sector** | **Landlords** |
| 5 units | 2 units | - |
| 2 money | - | - |

In the following five sub-periods, these three sectors exchange goods for subsistence and for production purposes. What are the rules of this exchange? 1 unit of output can be exchanged with 1 unit of money. This means that the value of agricultural and manufactured goods is the same. When the circulation process has finished, the three sectors start the production and consumption process.

In **t.1**, the agricultural sector pays 2 units of money of rent to landowners, so there is only a **money transfer**.

|  |  |  |
| --- | --- | --- |
| **Agriculture** | **Manufacturers** | **Landlords** |
| 5 units | 2 units | - |
| - | - | 2 money |

In **t.2**, there is a double exchange: landlords buy 1 unit of agricultural output for subsistence and 1 unit of manufactured output for luxury consumption purposes. Therefore, there is both transfer of goods and money (the latter in opposite direction).

|  |  |  |
| --- | --- | --- |
| **Agriculture** | **Manufacturers** | **Landlords** |
| 4 units | 1 units | 2 units |
| 1 money | 1 money | - |

In **t.3**, the manufacturing sector buys 1 unit of agricultural output for subsistence purposes

|  |  |  |
| --- | --- | --- |
| **Agriculture** | **Manufacturers** | **Landlords** |
| 3 units | 2 units | 2 units |
| 2 money | - | - |

In **t.4**, the agricultural sector buys 1 unit of manufactured output as input for the production process, with an opposite flow of goods and money.

|  |  |  |
| --- | --- | --- |
| **Agriculture** | **Manufacturers** | **Landlords** |
| 4 units | 1 unit | 2 units |
| 1 money | 1 money | - |

In **t.5**, the manufacturing sector buys 1 unit of agricultural output from the agricultural sector as an input for production.

|  |  |  |
| --- | --- | --- |
| **Agriculture** | **Manufacturers** | **Landlords** |
| 3 units | 2 units | 3 units |
| 2 money | - | - |

The circulation process is completed and all the sectors are ready to start the production and consumption process, after which there is a new identical starting situation. The accumulation process starts again and repeats circularly.

The agricultural sector, in the final stage, has 2 units of agricultural output and one of manufactured goods: 1 unit of agricultural output is used for subsistence and the others are used as inputs for production. But since agricultural and manufactured goods have the same value, the total can be expressed as 3 units of agricultural output. But, since the total output is 5, the surplus for this sector can be expressed as output minus inputs, so 5 – 3 = 2. [POSITIVE]

The manufacturing sector uses 1 unit of agricultural product for subsistence and 1 as input for production. In terms of agricultural output, it means that the value of the inputs is equal to 2 units of agricultural product. Inputs and outputs are identical, so surplus is equal to 2 – 2 = 0 🡪 sterile sector because net output = 0.

The landlords use 1 unit of agricultural output for subsistence purposes and 1 unit of manufacturing output as luxury consumption, so this sector consumes 2 units of agricultural product and produces 0 output. Therefore, surplus is equal to output minus inputs 🡪 0 – 2 = -2. Therefore, landlords consume all surplus in the economy. [NEGATIVE]

Some points should be emphasized:

1. Reproduction 🡪 2 money have returned to the farmers, and agriculture and manufacturing have both recovered their advances so that a new production cycle can begin again
2. Net Product and Taxes 🡪 Surplus is entirely consumed by the nobility and clergy (who do not produce anything) and are able to buy agricultural or manufactured products only because of the rent they are paid. Consequently the government should take taxes from the rent that landlords receive.
3. Interconnections 🡪 all different sectors and social classes are interconnected, the distribution of the product among the different social classes takes place simultaneously with the process of exchange (that allow each sector to reintegrate resources)

The economic table is based upon a circular idea of exchanges among sectors to realize production and consumption purposes.

In each period, the economic system is able to reacquire the initial resources. The system works well and reaches **equilibrium** **without** any kind of **external** **intervention**, so goods and money exchanged must flow freely.

This statement is a critique to the mercantilist view of state intervention in economy, which states that it is necessary to introduce trade policies: in his view, the state must support a ***laissez faire***policy.   
There is no growth in this simplification of economy, since the surplus is assumed to be consumed entirely by landlords.

The contribution of Adam Smith constitutes the dividing line between preclassical and classical school.