

Economic Schools of Thought

The word "economics" is derived from *oikonomikos*, which means skilled in household management. Although the word is very old, the discipline of economics as we understand it today is a relatively recent development. Modern economic thought emerged in the 17th and 18th centuries as the western world began its transformation from an agrarian to an industrial society.

Despite the enormous differences between then and now, the economic problems with which society struggles remain the same:

- * *How do we decide what to produce with our limited resources?*
- * *How do we ensure stable prices and full employment of our resources?*
- * *How do we provide a rising standard of living both for ourselves and for future generations?*

Progress in economic thought toward answers to these questions tends to take discrete steps rather than to evolve smoothly over time. A new school of ideas suddenly emerges as changes in the economy yield fresh insights and makes existing doctrines obsolete. The new school eventually becomes the consensus (generally accepted) view, to be pushed aside by the next wave of new ideas.

This process continues today and its motivating force remains the same as that three centuries ago: to understand the economy so that we may use it wisely to achieve society's goals.

Mercantilists

Mercantilism was the economic philosophy adopted by merchants and statesmen during the 16th and 17th centuries. Mercantilists believed that a nation's wealth came primarily from the accumulation of gold and silver. Nations without mines could obtain gold and silver only by selling more goods than they bought from abroad. Accordingly, the leaders of those nations intervened extensively in the market, imposing tariffs on foreign goods to restrict import trade, and granting subsidies to improve export prospects for domestic goods. Mercantilism represented the elevation of commercial interests to the level of national policy and the growth of political nationalism during the era.

Physiocrats

Physiocrats, a group of 18th century French philosophers, developed the idea of the economy as a circular flow of income and output. They opposed the Mercantilist policy of promoting trade at the expense of agriculture because they believed that agriculture was the sole source of wealth in an economy. As a reaction against the Mercantilists' numerous trade regulations, the Physiocrats advocated a policy of *laissez-faire*, which called for minimal government interference in the economy.

Classical School

The Classical School of economic theory began with the publication in 1776 of Adam Smith's monumental work, *The Wealth of Nations*. The book identified land, labor, and capital as the three factors of production and the major contributors to a nation's

wealth. In Smith's view, the ideal economy is a self-regulating market system that automatically satisfies the economic needs of the populace. He described the market mechanism as an "invisible hand" that leads all individuals, in pursuit of their own self-interests, to produce the greatest benefit for society as a whole. Smith incorporated some of the Physiocrats' ideas, including laissez-faire, into his own economic theories, but rejected the idea that only agriculture was productive.

While Adam Smith emphasized the production of income, David Ricardo focused on the distribution of income among landowners, workers, and capitalists. Ricardo saw a conflict between landowners on the one hand and labor and capital on the other. He posited that the growth of population and capital, pressing against a fixed supply of land, pushes up rents and holds down wages and profits.

Thomas Robert Malthus used the idea of diminishing returns to explain low living standards. Population, he argued, tended to increase geometrically, outstripping the production of food, which increased arithmetically. The force of a rapidly growing population against a limited amount of land meant diminishing returns to labor. The result, he claimed, was chronically low wages, which prevented the standard of living for most of the population from rising above the subsistence level.

Malthus also questioned the automatic tendency of a market economy to produce full employment. He blamed unemployment upon the economy's tendency to limit its spending by saving too much, a theme that lay forgotten until John Maynard Keynes revived it in the 1930s.

Coming at the end of the Classical tradition, John Stuart Mill parted company with the earlier classical economists on the inevitability of the distribution of income produced by the market system. Mill pointed to a distinct difference between the market's two roles: allocation of resources and distribution of income. The market might be efficient in allocating resources but not in distributing income, he wrote, making it necessary for society to intervene.

Marginalist School

Classical economists theorized that prices are determined by the costs of production. Marginalist economists emphasized that prices also depend upon the level of demand, which in turn depends upon the amount of consumer satisfaction provided by individual goods and services.

Marginalists provided modern macroeconomics with the basic analytic tools of demand and supply, consumer utility, and a mathematical framework for using those tools. Marginalists also showed that in a free market economy, the factors of production -- land, labor, and capital -- receive returns equal to their contributions to production. This principle was sometimes used to justify the existing distribution of income: that people earned exactly what they or their property contributed to production.

Marxist School

The Marxist School challenged the foundations of Classical theory. Writing during the mid-19th century, Karl Marx saw capitalism as an evolutionary phase in economic development. He believed that capitalism would ultimately destroy itself and be succeeded by a world without private property.

An advocate of a labor theory of value, Marx believed that all production belongs to labor because workers produce all value within society. He believed that the market system allows capitalists, the owners of machinery and factories, to exploit workers by denying them a fair share of what they produce. Marx predicted that capitalism would produce growing misery for workers as competition for profit led capitalists to adopt labor-saving machinery, creating a "reserve army of the unemployed" who would eventually rise up and seize the means of production.

Institutionalist School

Institutionalist economists regard individual economic behavior as part of a larger social pattern influenced by current ways of living and modes of thought. They rejected the narrow Classical view that people are primarily motivated by economic self-interest. Opposing the laissez-faire attitude towards government's role in the economy, the Institutionalists called for government controls and social reform to bring about a more equal distribution of income.

Keynesian School

Reacting to the severity of the worldwide depression, John Maynard Keynes in 1936 broke from the Classical tradition with the publication of the *General Theory of Employment, Interest, and Money*. The Classical view assumed that in a recession, wages and prices would decline to restore full employment. Keynes held that the opposite was true. Falling prices and wages, by depressing people's incomes, would prevent a revival of spending. He insisted that direct government intervention was necessary to increase total spending.

Keynes' arguments proved the modern rationale for the use of government spending and taxing to stabilize the economy (fiscal policy). Government would spend and decrease taxes when private spending was insufficient and threatened a recession; it would reduce spending and increase taxes when private spending was too great and threatened inflation. His analytic framework, focusing on the factors that determine total spending, remains the core of modern macroeconomic analysis.

A more recent rejection of the Keynesian School has been supported by economists such as Milton Friedman. Friedman was an economist at the University of Chicago who argued that monetary policy being responsible for the Great Depression. The best way to deal with the economy is actually free market monetarism

Austrian School

Carl Menger, an Austrian economist, who wrote "Principles of Economics" in 1871, is considered by many to be the founder of the Austrian School. Menger explained in his book that the economic values of goods and services are subjective in nature. That is: what is valuable for you may not be valuable for your neighbor. Menger further explained that with an increase in the number of goods, their subjective value for an individual diminishes. This valuable insight lies behind the concept of what is called diminishing marginal utility. Over the years, the basic principles of the Austrian school have given rise to valuable insights into numerous economic issues like the laws of

supply and demand, the cause of inflation, theory of money creation, and operation of foreign exchange rates. On each of the issues, the views of Austrian school tend to differ from other schools of economics.

The Austrian school holds that prices are determined by subjective factors like an individual's preference to buy or not to buy a particular good, whereas the classical school of economics holds that objective costs of production determine the price. Many theories developed by "first wave" Austrian economists have been absorbed into mainstream economics. These include Carl Menger's theories on marginal utility, Friedrich von Wieser's theories on opportunity cost,, and Eugen von Böhm-Bawerk's theories on time preference, as well as Menger and Böhm-Bawerk's criticisms of Marxian economics.

Economist Paul Krugman has stated that because Austrians do not use "explicit models" they are unaware of holes in their own thinking. In February 2013, Krugman further criticized Austrian School economists on their failure to revise their theory of inflation in light of their incorrect prophecies of government-induced inflation following the 2008 financial crisis.

Summary

Economic theories are constantly changing. Keynesian theory, with its emphasis on activist government policies to promote high employment, dominated economic policymaking in the early post-war period. But, starting in the late 1960s, troubling inflation and lagging productivity prodded economists to look for new solutions. From this search, new theories emerged:

Monetarism updates the Quantity Theory, the basis for macroeconomic analysis before Keynes. It reemphasizes the critical role of monetary growth in determining inflation.

Rational Expectations Theory provides a contemporary rationale for the pre-Keynesian tradition of limited government involvement in the economy. It argues that the market's ability to anticipate government policy actions limits their effectiveness.

Supply-side Economics recalls the Classical School's concern with economic growth as a fundamental prerequisite for improving society's material well-being. It emphasizes the need for incentives to save and invest if the nation's economy is to grow.

These theories and others will be debated and tested. Some will be accepted, some modified, and others rejected as we search to answer these basic economic questions: How do we decide what to produce with our limited resources? How do we ensure stable prices and full employment of resources? How do we provide a rising standard of living both for now and the future?