

# **Schools of economic thought**

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This powerpoint serves as a study material for the students of the course Introduction to economics (MEB435/MEBn5035) at FSS MU in Fall 2019. Using this presentation for other purposes without consent of the author is prohibited.

# Introduction

- Theory
  - A construct of thought that abstracts the relevant information and relationships from the reality
  - A tool that enables us to recognize the essence of the problem
  - A tool to organize our thoughts
  - And finally a tool that gives us solutions to the problem at hand
- Positive vs normative theory
- Economics has gone through a turbulent development with several paradigmatic shifts
- Apart from the dominant neoclassical theory there are several recognized schools of economic thought

# Mercantilism

- International trade is a zero-sum game
- 16th-18th century
- Widespread economic policy (in Europe)
- Key concepts
  - Money is wealth
  - Positive balance of payments should be the goal of government economic policy
  - Added value – governments should try to locate productions with highest value added to their territory
- Relevance and shortcomings

# The Classical School

- The market keeps all producers alert through competition, so leave it alone
- Late 18th – late 19th century
- A. Smith, D. Ricardo
- Key concepts
  - Invisible hand – market coordination is spontaneous
  - Say's law – supply always finds sufficient demand
  - Comparative advantage – international trade is beneficial
  - Class analysis and labor theory of value
- Relevance and shortcomings

# The Neoclassical School

- Individuals know what they are doing, so leave them alone – except when markets malfunction.
- Since late 19th century
- L. Walras, A. Marshall
- Key concepts
  - Rational individuals
  - Subjective theory of value (utility)
  - Marginal analysis
  - Pareto criterion

# Internal divisions among NC economists

- Various labels (saltwater vs freshwater, new Keynesian vs new classical etc.), the basic model, different additional assumptions (or frictions)
- Liberal (Krugman, Stiglitz)
  - Market failures, externalities, asymmetric information, oligopolies, sticky prices
- Conservative (Friedman, Lucas)
  - Rational expectations, efficient market hypothesis, government failures, flexible prices
- Relevance and shortcomings

# The Marxist School

- Capitalism is a powerful vehicle for economic progress, but it will collapse, as private property ownership becomes an obstacle to further progress.
- Since the second half of 19th century, K. Marx
- Key concepts
  - Labor theory of value and exploitation
  - Historical materialism (modes of production; base × superstructure; forces × relations of production)
  - Class conflict, economic crises and communist revolution
- Relevance and shortcomings

# The Developmentalist Tradition

- Backward economies can't develop if they leave things entirely to the market.
- Very old, important after the Second World War
- A. Hamilton, F. List
- Key concepts
  - Focus on practical problems of development
  - Production capabilities
  - Infant industry argument
- Relevance and shortcomings



# The Austrian School

- No one knows enough, so leave everyone alone.
- Late 19th century
- C. Menger, L. Mises
- Key concepts
  - Uncertainty
  - Spontaneous order
  - Free markets
  - Strong anti-government bias
- Relevance and shortcomings

# The (Neo-)Schumpeterian School

- Capitalism is a powerful vehicle of economic progress, but it will atrophy, as firms become larger and more bureaucratic.
- First half of the 20th century, J. Schumpeter
- Key concepts
  - Innovations (creative destruction)
  - Role of the entrepreneur
  - Bureaucratization of the economy
- Relevance and shortcomings

# The Keynesian School

- What is good for individuals may not be good for the whole economy.
- Since 1930s, J. Keynes
- Key concepts
  - Full employment
  - Uncertainty
  - Animal spirits (liquidity preference)
  - Demand management
- Relevance and shortcomings

# The Institutional School

- Individuals are products of their society, even though they may change its rules.
- Old – since late 19th century, T. Veblen
- Key concepts
  - Formal and informal institutions
  - Conspicuous consumption (importance of status)
- New – since 1980s. D. North
- Key concepts
  - Transaction costs
  - Property rights
- Relevance and shortcomings

# The Behaviouralist School

- We are not smart enough, so we need to deliberately constrain our own freedom of choice through rules.
- Since late 20th century, H. Simon, D. Kahneman
- Key concepts
  - Bounded rationality
  - Heuristics
  - Altruism
- Relevance and shortcomings