- Basically, orthodox is the mainstream and heterodox is the minority. If the mainstream sees little or no value in a group's views, we define that group as heterodox.

- A history of economic thought is a history of change, and what is heterodox in one time period can find a place in the mainstream in another.

- Economics does little to encourage heterodoxy and questions the legitimacy of heterodox views. Because of this, heterodox economists generally tend to focus on methodology, since through methodology they can question the legitimacy of the assumptions, scope, and methods that mainstream economists take as given.

- Heterodox economists are individualistic and are loners, they have little desire to compromise with their fellow professionals.

- The "competing research program" approach to methodology envisions various groups competing for students to further their research programs. The group that is most successful in competing becomes the mainstream, and groups that are less successful but do attract some researchers become nonmainstream.

- Nonmainstream schools (heterodox) play important roles in the evolution of a discipline: they pollinate the mainstream view and keep it honest by pointing out its shortcomings or inconsistencies. An example of the interaction between heterodox thinking and mainstream developments can be seen in the development of the economics of Alfred Marshall, who was able to find neoclassical economics by wrestling with the competing claims of historically oriented economists and abstract theorists.

Epistemology – Study of human knowledge

Economics as an Art and as a Science

1. ***Positive economics*** – concerns the forces that govern economic activity. It asks such questions as: How does the economy work? What are the forces that determine the distribution of income? The sole purpose of these inquiries is to obtain understanding for the sake of understanding. Focuses on facts and cause-and-effect behavioral relationships and includes the development and testing of economic theories.

- The methodology of positive economics is formal and abstract; it tries to separate economic forces from political and social forces.

2. ***Normative economics*** explicitly concerns questions of what should be. It is the philosophical branch of economics that integrates economics with ethics.

on the other hand, he advanced economics and all the social sciences by his use of abstract thinking.

- The significance of St. Thomas Aquinas's ideas lies in his fusion of religious teaching with the writings of Aristotle, which provided scholastic economic doctrine with much of its content.
- The most important contribution of Thomas Aquinas was Just price ("Justum Pretium"). This doctrine was based upon the concept of value. He recognized time and place utility. Just price was associated with utility or usefulness of the commodity. It was, however, believed that the exact determination of price was not possible.
- Charging of a higher price was justified if the seller was likely to incur a loss.
- The Medieval School believed that value should be equal to costs including the expenditure on labour.
- Aquinas distinguished between 'Just price' and 'market price'. Just price was determined by law.
- Lending money for earning more wealth was considered as the worst form of earning money. Like the Hebrews the Medieval church of fathers also prohibited the taking of interest. A high rate of interest was treated as the exploitation of the poor as there was absence of opportunities for the profitable investment of capital. But the lender was entitled for a compensation if the principal amount was not returned within the stipulated time. (Like Plato)
- St. Aquinas followed Aristotle regarding private property. There are two views, firstly, the power of acquiring and secondly the way of spending it. The power of acquiring the property gives the right to an individual. Private property leads to an increase in the production of wealth.
- The method of using the property was much more important than the right of ownership. According to Aquinas the estate – private property which was legitimately acquired should be distributed among the largest possible number of people and for the support of the poor also.
- Again, following Aristotle, Aquinas approved the regulation of private property by the state and accepted an unequal distribution of private property. However, in the spirit of Plato, he still advocated poverty and communal living as the ideal for those of deep religious commitment.
- He argued, private property was an addition to natural law, not a contradiction (naked, clothes)
- ***Scholastic usury-*** any taking of interest. Moreover, Aristotle had argued that the taking of interest on loans was unnatural, since money is barren. The scholastic view gradually moderated from a fairly strict prohibition of interest early in the period to its acceptance—at least for business purposes—later.

SUMMARY

- The Romans discarded the communal ownership of property. The jurists defined individual rights on property, and he was free to dispose of his property. Aristotle had limited the right of property; while the Roman law of private property showed unrestricted individualism which later provided the basis for the institution of capitalism.

SUMMARY

- The mercantilists and the physiocrats made useful contributions to economic theory, the most important of which was their recognition that the economy could be formally studied.
- The mercantilists achieved the first tentative insights into the role of money in determining the general level of prices and into the effects of foreign trade balances on domestic economic activity. The most significant contribution of the physiocrats was their concept of the interrelatedness of the various sectors of an economy.
- The mercantilists and the scholastics perceived a fundamental conflict in the economy, viewing exchange as a process in which one party gains at the expense of another. Therefore, both advocated intervention in the economy by either government or church.
- The physiocrats, on the other hand, perceived the working-out of the conflicts inherent in relative scarcity as basically harmonious. They called not for intervention in the economy but for laissez faire, and thus were an important influence on Adam Smith and the subsequent development of economic policy.

CLASSICAL ECONOMIC THOUGHT AND ITS CRITICS (1776-1867)

- The three major treatises of the classical period were *Inquiry into the Nature and Causes of the Wealth of Nations* (1776) by Adam Smith, *On the Principles of Political Economy and Taxation* (1817) by David Ricardo, and *Principles of Political Economy* (1848) by John Stuart Mill. (represents the end of the classical period)

- Malthus and Marx are more significant as critics than as adherents of classical economics.

- The economic ideas of the scholastics, physiocrats, and mercantilists were the basis of a more or less unified system of the classical economists.

- The classical vision of a mostly harmonious economic system sharply contrasted with the mercantilist and scholastics belief that the market is characterized by disharmonies calling for intervention.

- The view that markets automatically provide harmonious solutions to the conflicts was first significantly advanced by the physiocrats who followed that the government should adopt a general policy of non-interference – laissez-faire.

- Scholastics, on the other hand considered it appropriate for the church to adjudicate the morality of economic activities and the mercantilists advocated government intervention, the classicals, like the physiocrats, favored free, unregulated markets and maximum individual freedom. (economic freedom leads to efficiency)

2 broad developments relating to the concept of harmony in the economic system:

1. Orthodox: accepts the basic premise of a harmoniously operating economic system.

2. Heterodox: denied the harmony accepted by classical economics, saw conflicts that needed major changes in the institutional structure for resolution (Marx).

Karl Marx:

- The foremost critic of classical economics, and the person who coined the term classical. The most important economist who influenced Marx was Ricardo.

- Although the classical found in the economy a basic harmony that led them to advocate a governmental policy of laissez faire, they also found a number of conflicts. One was the conflict between landlords and capitalists. Marx pointed to the economic clash between capitalists and laborers. He adapted the classicals' labor theory of value to support his view that labor was exploited by the capitalists. à Marx wanted to show how exploitation was embedded in a system in which labor did not own the means of production.

- The classicals found that the profit motive of the capitalists led to an efficient allocation of capital in the economy and to saving, which promoted growth and wealth.

- Marx saw the activities of the capitalists as ultimately harmful to the proletariat and the society.

- Classical economics was an ode to capitalism; Marx wrote an ode on the faults fo capitalism.

ADAM SMITH

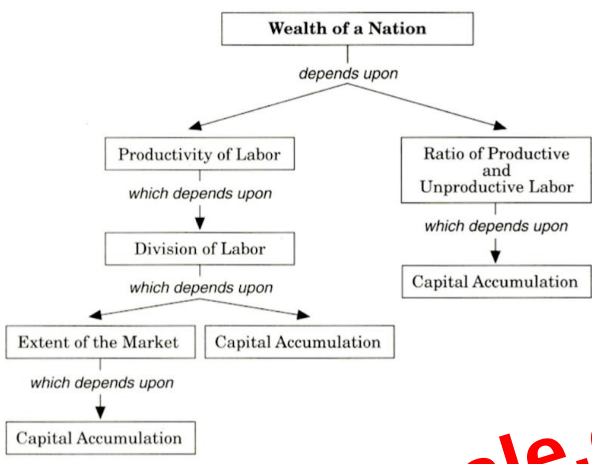
- Smith was influenced by his teacher, Francis Hutcheson (1694-1746), and by David Hume (1711-1776). Smith shared Hutcheson's strong disapproval of the ideas of Bernard Mandeville (c. 1670-1733), whose satirical style had given his presentation of the mercantilist position wide currency.

- Mandeville and Smith started with the same assumption regarding the egoistical nature of humans but reached opposite conclusions. Mandeville maintained that the pursuit of individual self-interest would generate many undesirable social and economic consequences, and therefore he built a case for government intervention in the economy.

employed. Labor employed in producing a vendible commodity is productive labor, Smith held, whereas labor employed in producing a service is unproductive.

- According to Smith, the larger the share of the labor force involved in producing tangible real goods, the greater the wealth of the nation. Capital is required to support the productive labor force; therefore, the greater the capital accumulation, the larger the proportion of the total labor force involved in productive labor.

Figure 4.1 Determinants of the Wealth of a Nation



- Furthermore, an unequal distribution of income in favor of the capitalists is of tremendous social importance. Smith insisted that the highest rates of economic growth would be achieved by distributing large incomes to the capitalists, who save and invest, and low incomes to the landlords, who spend for menial servants and "who leave nothing behind them in return for their consumption."

- Furthermore, because economic growth is inhibited by government spending for unproductive labor, it is better to have less government and, consequently, lower taxes on the capitalists so that they may accumulate more capital. Without an unequal distribution of income, economic growth is not possible. Individual self-interest coupled with the accumulation of capital leads to an optimum allocation of capital among the various industries.

- For Adam Smith there was no question that capital accumulation required an institutional framework of free markets and private property. In a system of free markets operating without government direction, a given level of investment spending would be allocated so as to ensure the highest rates of economic growth. In a system of private property, a further requirement for high rates of capital accumulation is an unequal distribution of income.

International Trade: (trade isn't a zero sum game)

- Smith argued for unregulated foreign trade, reasoning that if England can produce a good at lower costs than France, and if France can produce another good at lower costs than England, the it is beneficial to both parties to exchange these goods, with each trading the good it produces at lower costs for the good it produces at higher costs. ← Absolute advantage argument for foreign trade. (Also applies to trade within a country as well)

MARGINALIST REVOLUTION AND NEOCLASSICAL SCHOOL

Marginalist Revolution and Neoclassical School: (1870 – 1930) (Following Marx's Das Kapital)

- In 1871 Jevons and Menger attacked classical theory's almost exclusive emphasis on supply. The policies arising from classical theory were also under siege. Laissez faire, for example, seemed hardly appropriate in light of the poor living and working conditions of the growing population of English factory workers.
- The period that followed Ricardo, especially from 1870 to 1900, was full of criticism of classical economic theory and the capitalist system by humanists and socialists. The period was also characterized by the questioning of the classical assumption that laissez-faire was an ideal government policy and the eventual demise of classical economic theory and the transition to neoclassical economics.

Main Figures:

1. William Stanley Jevons – Theory of Political Economy
2. Carl Menger – Principles of economics
3. Alfred Marshall – Principles of economics (1890)
4. Leon Walras - Elements of Pure Economics (1874)

- In 1870, the Marginal revolution brought the prevailing classical view of value theory to an end. Their main idea was that value, or price of a commodity depends on upon the marginal utility of the commodity to the consumer.
- Marginalism Seeks to explain economic phenomena through mathematical functions. By the 1890s, several economists, realizing that this tool could be applied to the forces that determined the distribution of income, developed the concept of the marginal productivity of factors. → Orthodox economic theory from 1870-1930 focused on microeconomic theory.

The three main Marginalist theorists:

1. **William Stanley Jevons:**

- Considered a co-founder of Marginalism and Theory of utility.
- Jevons and Marginal utility theorists had elaborated a theory of value based on the idea of maximizing utility, holding that value depends on demand.
- Jevons looked for simple causal relations, but it was not correct.
- It is incorrect to view the process of price determination as a simple chain of causal relationships in which utility determines demand, which then determines price, or cost determines supply, which then determines price. Nor do marginal values, whether on the side of utility or on the side of cost, determine prices. We go to the margin to examine the forces at work and to improve our understanding of them, but when we go to the margin, we find that utility, cost, and price mutually determine one another's values and that simple causal chains do not exist.
- In the classical analysis of the forces determining relative prices, prices were commonly assumed to depend upon the cost side or the supply side in the long run. Jevons, Walras,

Commented [OA1]: Jevons, Menger and Walras contributed plenty to the development of economic theory by their expansion of the use of marginal analysis. However, they exclusively focused on demand and ignored supply.

Commented [OA2]: 1.Utility was measurable in cardinal units, such as monetary units
2.The utility function is additive and separable
3.They all use the Gossen's laws
Gossen's Laws:
first law: "The magnitude of a given pleasure decreases continuously if we continue to satisfy this pleasure without interruption until satiety is ultimately reached", thus implying diminishing marginal utility.
second law: "The magnitude of each single pleasure at a moment when it's enjoyable is broken off shall be the same for all pressure" which means that maximum satisfaction will be achieved when *goods* and needs are allocated and they provide the *maximum utility*.

Keynes	Friedman
Monetary policy is ineffective in the traps (liquidity trap)	Fiscal policy is ineffective due to the crowding out effect
Fiscal policy is always effective	Monetary policy is effective in the short run, but it should not be used due to lags

- Monetary policy cannot fix the real interest rate in the long run or have an impact on unemployment in the long run.
- Monetary policy can prevent money from causing disturbances, maintain a stable basis for the economy, and prevent other, more serious problems.

New Classical School (1970s)

- Originated in the early 1970s; emphasizes the ability of a market economy to cure recessions by downward adjustments in wages and prices. The new classical economists of the mid-1970s attributed economic downturns to people's misperceptions about what was happening to relative prices.
- Robert Lucas developed the rational expectations (individuals form expectations about the future based on the information available to them and that they act on those expectations).
- During the 1970s, it became clearer that an analysis incorporating the supply side was an essential part of macroeconomics and some economists turned to an entirely new way of looking at macroeconomic issues.
- They started with a focus on individuals and their decisions. The new approach aimed at an analysis of how individual choices would affect the entire economic activity.
- Like classical economics, NCM focuses on the determination of long-run aggregate supply and the economy's ability to reach this level of output quickly. The NCM economics puts mathematics tow work in an extremely complex way to generate from individual behaviour to aggregate results.
- Regarding policy making, the NCM believes that no government intervention concerning demand is beneficial for the economy, not even in the short run. They argue that government can promote growth and stabilize the economy only through supply-side policies.
- Rational expectations hypothesis also states that people respond strategically to fiscal and monetary policy changes; not passively as previous models such as the adaptive expectations assumed.

$$x_t = E_{t-1}x_t + \varepsilon$$

- The value of *x* today will be the value that we expected it to be plus an error term.