History of Economic Thought

Ordinary Exam 16.12.2025

Outline of solution

The answer to each of the questions should take the form of a short essay touching upon the points stated below:

1. (a) In the writings of Keynes, the Classics should be understood as the mainstream economists at his time, including the neoclassicals, with specific regard to contemporary theorists Pigou and von Hayek . The fundamental difference between Keynes and the Classics is the approach to the short run balancing of savings and investments, which in the classical theory was performed by changes in the interest rate, whereas Keynes proposed that equilibrium is achieved through changes in income. The inability of the price mechanism to secure short-run equilibrium effected also other markets, in particular the labour market.

(b) An attempt to reconcile the two different approaches was made in the form of the neoclassical synthesis, whose main proponent was Samuelson: In the short run, prices are not flexible enough to achieve equilibrium, which then must be secured by suitable increase of aggregate demand, but in the longer run, prices will adapt and equilibrium prices will restore the balance.

(c) The Keynesian macroeconomic theory was challenged from several holds, initially from the Classics with von Hayek as the main figure, and later by the monetarists following Friedman. The Classics later reappeared as New Classical macroeconomy emphasizing the role of expectations in the behaviour of economic agents, leading the the rational-expectations school of macroeconomics. Also the Keynesian school of thought underwent considerable changes, with the New Keynesian school adapting a considerable part of the arguments put forward by the New Classicals.

2. The historical survey may start with early authors mentioning the concept of demand, but demand *functions* were introduced first by Cournot and shortly afterwards by Dupuit. In the early versions, the demand functions were thought as assigned to a given quantity the price at which it could be sold in the market, and this interpretation was kept by several later authors. Demand functions were used by several authors (Rau, von Mangoldt, Jenkin) in the years immediately before and after the marginalist, and with Marshall it became a standard part of economic theory.

Demand functions are used in the context of welfare economics mainly as defining the consumer surplus, a concept which was used already by Dupuit under another name but was more thoroughly introduced and analysed by Marshall.

The notion of utility has been used by economic authors for centuries, and its systematical use in the analysis of economic decisions goes back to Bentham. With Dupuit there were several hints of a connection between demand and utility, but it become explicit only with Marshall who showed how the demand function can be derived fro utility maximization under budget constraint.

3. Adam Smith and indeed all the classical economists including Mill viewed capital as an outlay forwarded by the entrepreneur consisting of goods necessary to carry out the production of the final commodities, including raw materials, tools and goods for feeding the workers. The last part, concerning the workers, constituted the wage fund, playing a fundamental role in the reasoning of the classical economists. Given that the wages are kept at subsistence minimum, the size of the wage fund determines the number of workers employed. The subsistence minimum wage derived from writings of Malthus and the theory of rent as introduced by Ricardo give rise to a theory of distribution, as capitalists will compete for profitable uses of the capital so that the surplus eventually will end with the passive owners of resources (land).

With the neoclassical writers, in particular Clark, capital as physical commodities are used as input together with labour. Introducing production functions one may identify factor prices as the marginal products of the inputs. Profit then appears as a residual, provided that there is one, and as shown by Wicksteed, it disappears if the production function admits constant returns to scale.

In the 20th century, the concept of capital has played a less important role but has kept figuring in the contexts of growth models, through which it became the object of the Cambridge capital controversy related to the impossibility of measuring a profit rate independently of the equilibrium prices on commodities.