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BA Economics Honours | Semester 3 | Calicut University

Evolution of Economic Theories

Course Code: ECO3CJ202 • Module 1

Module I: People and Markets – Market Mechanism, Competition, Price and Utility

The history of economic thought represents the intellectual evolution of human inquiry into the generation, distribution, and consumption of wealth. Economic doctrines do not emerge in an intellectual vacuum; they reflect the shifting material realities, philosophical worldviews, and institutional transformations of human societies. From early mercantilist statecraft to classical political economy and the neoclassical marginalist revolution, economists have unceasingly debated how markets coordinate decentralized human activity and determine value.

Unit 1: From Mercantilism to the Market Economy

Between the sixteenth and eighteenth centuries, the dominant European economic doctrine was **Mercantilism** (championed by Thomas Mun and Jean-Baptiste Colbert). Mercantilists viewed international trade as a fierce zero-sum conflict: one nation's enrichment was achieved exclusively through another nation’s commercial impoverishment. Wealth was defined strictly as the accumulation of metallic treasure (gold and silver bullion). Sovereign states pursued aggressive protectionist policies: high import tariffs, export subsidies, colonial monopolies (e.g., the English East India Company), and strict navigation laws to maintain persistent trade surpluses.

In mid-eighteenth-century France, the **Physiocrats**, led by physician François Quesnay (1758), launched the first systematic scientific revolt against mercantilist protectionism. In his celebrated *Tableau Économique*, Quesnay modeled the economic system as an interconnected circular flow of income and physical output, inspired by the biological circulation of blood in the human body. The Physiocrats coined the immortal slogan *"Laissez faire, laissez passer"* ("let it be, let it pass"), arguing that human economic society is governed by a benevolent **Natural Order** (*Ordre Naturel*). Crucially, the Physiocrats held that only agriculture was "productive" (yielding a genuine physical net product or *produit net*), while manufacturing and commerce were "sterile" because they merely transformed existing raw materials without generating biological surplus.

Unit 2: The Classical School: Adam Smith and David Ricardo

The publication of **Adam Smith’s** *The Wealth of Nations* in 1776 marked the birth of modern scientific economics. Smith dismantled mercantilist bullionism, demonstrating that true national wealth consists of the annual production of goods and services produced by labor. Smith identified two prime engines of economic progress:

- **Division of Labor:** Illustrated by his famous pin factory example, decomposing production into specialized operations multiplies worker dexterity, saves transition time, and fosters machinery invention.
- **The Invisible Hand:** In competitive markets, individuals pursuing their enlightened self-interest are led by price signals to advance the general societal welfare far more effectively than state planners.
- **Theory of Value:** Smith distinguished between *Value in Use* (utility of a commodity) and *Value in Exchange* (purchasing power over other goods), posing the famous **Diamond-Water Paradox**. In primitive societies ("the early and rude state"), exchange value was governed by labor embodied; in advanced societies with accumulated capital, price resolved into three factor components: wages, rent, and profit.

David Ricardo and Classical Deductive Analysis

David Ricardo formalized classical doctrine into rigorous deductive models in *Principles of Political Economy and Taxation* (1817):

- **The Labor Theory of Value:** Exchange value is determined primarily by the total quantity of direct and indirect labor embodied in production.
- **Ricardian Theory of Differential Rent:** Rent is that portion of the produce of the earth paid to the landlord for the use of the original and indestructible powers of the soil. Rent arises due to differences in soil fertility and geographical location (extensive margin) and diminishing returns from successive capital applications on the same plot (intensive margin). Marginal land pays zero economic rent; rent is price-determined, not price-determining ("Corn is not high because rent is paid, but rent is paid because corn is high").
- **Law of Comparative Advantage:** Nations gain from international specialization and trade whenever relative domestic opportunity cost ratios diverge, even if one nation holds an absolute advantage in all goods.

Unit 3: The Marginalist Revolution

In the 1870s, three economists working independently—**William Stanley Jevons** in England (*Theory of Political Economy*, 1871), **Carl Menger** in Austria (*Principles of Economics*, 1871), and **Léon Walras** in Switzerland (*Elements of Pure Economics*, 1874)—shattered classical supply-side cost-of-production theories by engineering the **Marginalist Revolution**.

The Marginalists established that:

1. Value is not determined by historical labor costs, but by subjective consumer valuation: **Marginal Utility**.
2. The Diamond-Water Paradox was definitively resolved: exchange value depends on the marginal utility of the final unit consumed, not total utility.
3. Walras pioneered **General Equilibrium Theory**, demonstrating mathematically via simultaneous equations that competitive markets can achieve multi-market equilibrium where all markets clear concurrently.

Unit 4: Alfred Marshall's Neoclassical Synthesis

In *Principles of Economics* (1890), **Alfred Marshall** synthesized classical cost-of-production theories with marginalist utility theory. Marshall famously resolved the historical value debate with his metaphor of the **two blades of a pair of scissors**: just as one cannot state whether the upper or lower blade of a pair of scissors cuts a piece of paper, one cannot say whether utility or cost of production alone determines price; both operate simultaneously.

Marshall introduced the operational concepts of **Elasticity of Demand**, the distinction between short-run (where utility dominates) and long-run (where cost of production dominates), **Consumer's Surplus**, and partial equilibrium analysis using the familiar supply and demand intersection diagram.

Intellectual Epoch	Primary Thinkers	Core Theory of Value	Role of the Sovereign State
Mercantilism (1550–1750)	Thomas Mun, Jean-Baptiste Colbert	Bullion accumulation via export trade surpluses.	Aggressive interventionist, protectionist, and colonial.

Intellectual Epoch	Primary Thinkers	Core Theory of Value	Role of the Sovereign State
Physiocracy (1750–1770)	François Quesnay, Turgot	Agricultural *produit net* (biological reproduction).	Laissez-faire; single tax on agricultural land rent.
Classical School (1776–1870)	Adam Smith, David Ricardo, J.S. Mill	Labor embodied / Cost of production.	Minimalist state (defense, justice, public works).
Marginalist School (1870–1890)	Jevons, Menger, Léon Walras	Subjective Marginal Utility.	Free market optimization; price mechanism efficiency.
Neoclassical Synthesis (1890+)	Alfred Marshall, Pigou	Dual scissor synthesis (Demand/Utility & Supply/Cost).	Market-friendly regulation; corrective Pigouvian taxes.

Advanced Theoretical Formulations and Empirical Frameworks (Analytical Division 1)

The theoretical structures established in this module carry far-reaching implications for empirical economic research, institutional policymaking, and dynamic market equilibrium. In contemporary economic analysis, economists employ sophisticated econometric models, institutional diagnostic frameworks, and comparative historical evaluations to rigorously assess the validity of core assumptions and their real-world outcomes across developing and advanced economies.

Empirical Methodology, Identification Strategies, and Econometric Estimation

Empirical validation of economic models necessitates the rigorous treatment of endogeneity, omitted variable bias, and measurement error. Whether analyzing consumer behavior, firm cost structures, fiscal multipliers, or monetary transmission mechanisms, applied researchers utilize instrumental variables (IV), difference-in-differences (DiD), synthetic control methods, and regression discontinuity designs (RDD) to isolate causal relationships from mere statistical correlation.

Consider the structural estimation of policy impacts across decentralized economic agents. When evaluating macroeconomic interventions or microeconomic regulatory changes, parameters estimated from observational datasets must account for expectations formation and structural parameter stability in accordance with the Lucas Critique. Consequently, contemporary applied economics bridges micro-foundations with aggregate macroeconomic phenomena through dynamic stochastic general equilibrium (DSGE) modeling and micro-econometric panel estimations.

Comparative Institutional Analysis, Market Failures, and Policy Governance

Economic outcomes are fundamentally mediated by institutional architectures, legal property rights regimes, and regulatory governance. In emerging market economies such as India, market imperfections—including asymmetric information, transaction costs, infrastructural bottlenecks, and credit constraints—often necessitate nuanced policy interventions that differ substantially from textbook laissez-faire predictions.

Analytical Dimension	Orthodox / Classical Perspective	Heterodox / Institutional Framework	Empirical Policy Manifestations in India
Market Efficiency	Markets clear instantaneously; price	Markets are prone to structural failures,	Targeted regulatory oversight, public investment in

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	mechanism allocates resources optimally without systemic friction.	information asymmetry, and coordination coordination failures.	infrastructure, and social safety nets.
Behavioral Motivation	Hyper-rational agents maximizing expected utility with complete cognitive computational capacity.	Bounded rationality, behavioral heuristics, loss aversion, and institutional anchoring effects.	Choice architecture, behavioral nudges (NITI Aayog initiatives), and consumer financial protection mandates.
State Intervention	State role restricted to core public goods, contract enforcement, and national defense (minimalist state).	State acts as developmental catalyst, risk-absorber of last resort, and promoter of equitable distribution.	Strategic industrial policy (PLI schemes), counter-cyclical fiscal intervention, and universal public services.
Distributional Equity	Factor rewards reflect marginal productivity; distribution is secondary to allocative efficiency.	Power asymmetries, bargaining power, and historical wealth accumulation shape distribution.	Progressive fiscal transfers, land reforms, and affirmative human capital investments.
Technological Progress	Exogenous technological shocks arriving randomly (Solow neoclassical growth model).	Endogenous technological innovation driven by R&D, human capital, and intellectual property institutions.	National Innovation Foundation, Startup India, and public digital infrastructure (India Stack / UPI).

Comprehensive Empirical Analysis: The Kerala Model and Sub-National Development

In the context of the Indian economy and sub-national development paradigms, the Kerala Model of Development provides a seminal empirical case study illustrating the complex trade-offs between social development and economic growth. Characterized by high physical quality of life indicators—including near-universal adult literacy, high life expectancy, and low infant mortality rates comparable to advanced Western economies—achieved despite historically modest per capita state domestic product, Kerala demonstrates the transformative power of public social expenditure, agrarian land reforms, and decentralized local governance (Panchayati Raj institutions).

However, contemporary economic analysis also highlights structural challenges confronting this development paradigm: high educated unemployment, fiscal constraints stemming from escalating public debt servicing and pension obligations, and heavy reliance on external remittance inflows from migrant workers in the Persian Gulf. Sustaining this high-welfare equilibrium necessitates transitioning toward a knowledge-driven economy, incentivizing high-tech manufacturing, and mobilizing sustainable sub-national fiscal resources.

Policy Synthesis and Analytical Evaluation

Policy formulation in dynamic economic environments must therefore synthesize foundational deductive reasoning with robust inductive empirical inquiry. Economists must continuously evaluate the balance between market incentives and regulatory governance, ensuring that institutional frameworks promote both productive efficiency and distributive social justice.

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Distributional Equity	Factor rewards reflect marginal productivity;	Power asymmetries, bargaining power, and	Progressive fiscal transfers, land reforms, and affirmative

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	distribution is secondary to allocative efficiency.	historical wealth accumulation shape distribution.	human capital investments.
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