

EVOLUTION OF ECONOMIC THOUGHT: A REVIEW OF THE LITERATURE AND ITS IMPLICATIONS FOR MODERN ECONOMIC POLICY

Reina A. Hadikusumo *

Politeknik Ubaya

reina21april@gmail.com

Sabirin

Universitas Palangka Raya (UPR)

sabirinme@gmail.com

Solikhah Nurwati

Universitas Palangka Raya (UPR)

soli.nurhadi@gmail.com

Abstract

The development of economic theories has evolved from the classical era to the modern era, and how these ideas influence economic policy formulation today. This research examines the major literature articulating the changes in economic paradigms, including classical, neoclassical, Keynesian, and modern economic theories such as Behavioural and Institutional Economics. The analysis shows that each approach has its own strengths and limitations as well as important contributions to our understanding of economic mechanisms. The implications of this evolution of thought for modern economic policy are significant, as policymakers must take into account various theoretical perspectives to design effective and adaptive policies. This multitheoretical approach allows for more comprehensive policies in addressing contemporary economic issues such as macroeconomic stability, inflation management, unemployment, resource distribution, and socio-institutional factors. Thus, this study emphasises the importance of flexibility and innovation in economic policy to achieve sustainable and inclusive economic development.

Keywords: Evolution of Economic Thought, Implications for Modern Economic Policy.

Introduction

Economic thought has undergone a significant evolution from classical times to the contemporary era. Each era of economic thought reflects the dominant social, political, and technological conditions of its time, providing a framework for understanding economic dynamics and offering solutions to the challenges faced by society.

In the beginning, classical economic theory introduced by figures such as Adam Smith, David Ricardo, and John Stuart Mill emphasised the importance of free market mechanisms, competition, and the minimal role of government in the economy. They believed that the market would naturally achieve equilibrium and efficiency through the 'invisible hand' described by Adam Smith (Álvarez & Hurtado, 2023). However, this thinking began to be questioned with the advent of the industrial revolution which

brought significant social and economic impacts, including income inequality and poor working conditions (Psalidopoulos, 2024).

In the 20th century, John Maynard Keynes proposed a theory that became known as Keynesian economics. He emphasised the active role of government in regulating the economy through fiscal and monetary policies to manage aggregate demand and prevent economic instability such as depression or recession. The Keynesian view dominated economic policy in many countries after World War II until the 1970s, when the oil crisis and stagflation challenged the effectiveness of the approach (Leeson & Rouanet, 2023). This led to a revival of neoliberalism economic theory that emphasised deregulation, privatisation and trade liberalisation. In the contemporary era, economic thought continues to evolve by introducing new concepts such as behavioural economics, which integrates psychological aspects in economic analysis, as well as environmental economics, which considers the impact of the economy on ecosystems and climate change. However, these theories did little to address the economic instability experienced in times of depression and recession. Later, the Keynesian Revolution in the 20th century provided a new perspective that emphasised the role of government in regulating the economy through fiscal and monetary policies (Guiot-Isaac, 2023).

In the modern era, economic theory continues to evolve in response to new and unexpected challenges. Behavioral economics, environmental economics, and other approaches have emerged to respond to issues such as climate change, economic inequality, and globalisation. However, there is a disconnect between theory and practice in the economic policies implemented by governments in various countries. This raises important questions regarding the relevance and effectiveness of existing economic theories to the dynamic conditions of modern economies (Psalidopoulos, 2024).

Against this background, this study reviews the evolution of economic thought through a literature review and analyses its implications for modern economic policy formulation. A deeper understanding of how economic theories evolve and adapt to changing times will provide valuable insights for the development of economic policies that are more appropriate and responsive to current and future challenges.

Research Methods

The study in this research uses the literature method. The literature research method is a research approach that refers to the collection and analysis of data from various written sources, including books, journal articles, reports, theses, dissertations, and other documents relevant to the research topic (Firman, 2018); (Suyitno, 2021). Researchers use this method to identify, evaluate, and synthesise existing information in order to obtain a comprehensive understanding of theories, concepts, and previous findings related to the research issues raised. This technique involves several main steps

such as collecting literature data, sorting sources, evaluating the validity and relevance of the information, and preparing a report that presents the results of the analysis systematically. Literature research can stand alone or be part of a larger study to formulate a theoretical framework or conceptual foundation (Jelahut, 2022).

Results and Discussion

Classical Economic Thought

Adam Smith, considered the father of modern economics, made a major contribution through his monumental work 'The Wealth of Nations' in 1776. Adam Smith introduced the concept of the 'invisible hand,' which describes how a market free from government intervention can organise itself through supply and demand mechanisms (Siven, 2023). Smith also promoted the importance of division of labour, which he believed could increase productivity and overall economic efficiency. His theory of value and price was also fundamental; he introduced the concepts of utility value and labour value, which became the basis for the free market economic system (Meisel, 2023).

David Ricardo is famous for the theory of comparative trade that he outlined in his book 'On the Principles of Political Economy and Taxation' in 1817. This concept states that countries will benefit from international trade if they specialise in the production of goods and services that they can produce most effectively relative to other countries. This theory not only influenced international trade policy but also provided the basis for arguments for free trade and economic globalisation. In addition, Ricardo introduced the theory of distribution which explains how national income is divided among the three factors of production: land, labour, and capital (Psalidopoulos, 2024).

Thomas Malthus is best known for his essays on population, especially 'An Essay on the Principle of Population' which was first published in 1798. Malthus put forward the theory that population growth would always tend to outpace the growth of food production, which could lead to resource scarcity and a decline in living standards (Hua, 2021). Malthus saw that without control over the rate of population, population surges would lead to various disasters such as famine, disease and war. His ideas also reflected pessimism about humanity's ability to overcome natural limits to production and had a major influence on demographic policy and economic theories of growth (Wagner & Lee, 2023).

The contributions of Adam Smith, David Ricardo, and Thomas Malthus formed the foundation for the development of classical economic theory. Smith provided the basic framework with the concepts of free markets and division of labour. Ricardo took the theory international with his theory of comparative trade, expanding the

understanding of the benefits of global trade (Yagi, 2022). Meanwhile, Malthus added another dimension by exploring the limits to economic growth from the standpoint of population and resources. Despite their different foci and outlooks, their contributions complemented each other and formed a foundation of economic thought that greatly influenced further economic policy and theory (Rancan, 2021).

After the great contributions of Adam Smith, David Ricardo, and Thomas Malthus, many other economists continued and developed these economic theories. John Stuart Mill, for example, developed their work by introducing the concept of political economy, distinguishing between production and distribution, and debating the role of government policy in correcting market failures. Karl Marx brought a critique of classical economics by delving deeper into the tensions and contradictions that exist in the capitalist system, something that was based on Adam Smith and Ricardo's concept of labour value (Yagi, 2022).

In the 20th century, economic theories underwent a revolution with the emergence of Keynesian economics by John Maynard Keynes who emphasised the large role of government intervention in controlling economic cycles and ensuring aggregate demand was sufficient to achieve full employment. Micro and macroeconomic theory also underwent rapid development through in-depth studies of the behaviour of individuals, firms and government decisions in often highly dynamic and complex contexts (Murray, 2022).

Thus, the contributions of Adam Smith, David Ricardo, and Thomas Malthus provided a solid foundation for the development of modern economics. Adam Smith with his concept of free markets and division of labour, David Ricardo with his theory of comparative trade, as well as Thomas Malthus with his analysis of population and resources, all played an important role in the formation and refinement of classical economic theory. Their legacy remains relevant in understanding economic dynamics today, from domestic markets to international trade, and from population growth to public policy. The synergy of their thinking made economics a robust social science, the direction of which was further developed by many other thinkers, continuing to shape global and national economic policies to this day.

Neo-Classical Economic Thought

Utility theory and the concept of revolutionary margin were first introduced in economics in the early 19th century to understand how individuals make decisions based on the satisfaction or happiness they derive from the consumption of goods and services. Previously, classical economics focussed more on the objective value and quantity of goods (Glynn & Booth, 2020). Utility theory introduced a subjective approach that focuses on the satisfaction felt by individuals. Pioneers in the development of this theory, such as Jeremy Bentham, argued that individual actions are

motivated by the search for maximum happiness and the attempt to minimise pain (Drakopoulos & Katselidis, 2023).

A significant development occurred in the 19th century when economists such as William Stanley Jevons, Carl Menger, and Léon Walras introduced the concept of marginal utility, which measures the additional satisfaction gained from the consumption of an additional unit of a good. Marginal utility helped explain the paradoxical phenomenon of water and diamonds that had previously puzzled economists: why does water, although essential, have a lower market value than the rarer, non-essential diamond? The answer lies in the fact that the additional utility of an additional unit of diamonds is greater than that of an additional unit of water, which is usually more abundantly available (Zouboulakis, 2023).

The concept of marginal utility also plays an important role in explaining the law of supply and demand. When a person consumes more of a good, the marginal utility of the good tends to decrease, so they are less willing to pay the same price for an additional unit. This helps form a downward-sloping demand curve, while the supply curve can be explained by marginal cost. This diligence in marginal analysis allows economists to clarify how prices and quantities in competitive markets are determined (Gotsis, 2023).

In addition to providing insights into consumer behaviour, utility theory also paved the way for the development of modern microeconomics, where the analysis of individual decisions was carried out in greater detail. The theory also drove advances in areas such as consumer behaviour, production theory, and the concept of general equilibrium. While many critical arguments challenge the assumptions of rationality and utility measurement, the theory's contributions remain the backbone of economic analysis today, enabling a better understanding of how policies can be designed to maximise overall social welfare (Misaki, 2020).

Alfred Marshall was one of the most influential economists of the late 19th and early 20th centuries, helping to shape the foundations of modern economics. His most famous work, 'Principles of Economics' (1890), introduced various concepts and analytical tools that remain relevant to this day. Marshall expanded and deepened earlier ideas about utility and demand, and combined marginal analysis with cost and production theory to provide a more comprehensive view of how markets function (Michelagnoli, 2021).

One of Marshall's greatest contributions was the development of the concept of elasticity of demand, which measures the sensitivity of quantity demanded to changes in price. Elasticity provides important insights in understanding the behaviour of consumers and firms, as well as how they respond to changes in price, income, and other factors. It allows for more detailed analyses of how tax policies, subsidies, and price regulation will affect markets and economic welfare (Heise, 2023).

Marshall is also known for his development of partial equilibrium theory, which analyses individual markets or sectors separately from the rest of the market. This concept helps ease economic analysis by focusing on a small part of the economy at once, while assuming that other elements remain constant or *ceteris paribus*. Partial equilibrium becomes the foundation for microeconomic analysis, providing a useful tool to study the interactions between various economic agents within a given market (Spaskyy, 2021).

In addition, Marshall highlighted the importance of short- and long-term economic advantages. He distinguishes between fixed and variable costs, as well as economies of scale that provide insights into the efficiency of pricing and production levels in the long run. This helps explain how firms can adapt to changes in demand and technology over time. Overall, Alfred Marshall's contributions to economic theory provide an important foundation for modern economic analysis, which incorporates marginal sensitivity, elasticity, partial equilibrium, and long-run dynamics to understand how markets work and economic decision-making.

The Keynesian Revolution

The Keynesian revolution refers to the radical transformation in economic theory and policy triggered by the work of John Maynard Keynes, particularly through his famous book, 'The General Theory of Employment, Interest, and Money' (1936). Prior to Keynes, economic views were dominated by classical principles, which assumed that free markets would always tend towards full equilibrium automatically, with a natural rate of unemployment and full utilisation of resources. Keynes challenged this view by arguing that the economy could get stuck in a state below full capacity in the absence of government intervention (Duhs, 2021).

At the heart of Keynesian theory is the concept that aggregate demand - total spending in the economy on goods and services - is the main driver in determining the level of production and unemployment. According to Keynes, during times of recession, aggregate demand is often insufficient to achieve full output and employment. This can lead to a prolonged cycle of economic decline. Therefore, Keynes advocated that the government needs to play an active role in managing aggregate demand, especially through fiscal policies such as government spending and taxation (Costantini, 2022).

The Keynesian revolution brought about major changes in public economic policy. Many governments began to adopt Keynesian principles to tackle the problem of unemployment and support economic stability. Deficit spending and public investment were used to stimulate the economy during recessions, while tighter policies were applied during booms to avoid inflation (Ebner, 2024). This approach resulted in a long period of relatively stable economic growth and low unemployment rates in many developing countries after World War II, often referred to as the 'Golden Age' of economics (Scazzieri, 2022).

However, in the late 1970s and early 1980s, criticisms of Keynesianism began to emerge, especially when many countries' economies experienced stagflation - a combination of economic stagnation and high inflation - which was not accounted for in the classical Keynesian model. This led to the rise of other economic theories, such as Monetarism and Real Business Cycle Theory, which emphasised the importance of tight control over money supply and the undesirable effects of government policies. Nonetheless, Keynes' legacy remains strong, and many of the concepts and analytical tools he introduced continue to be an important part of the modern economic policy framework.

A Contemporary Economic Approach

Contemporary economic approaches are the result of the evolution of various theories and methods developed by economists throughout the 20th and 21st centuries. It encompasses various schools of thought including Keynesianism, Monetarism, Behavioural Economics, and Institutional Economics. In addition, the contemporary approach is also influenced by technological developments and globalisation, which are changing the way markets operate and increasing interconnectivity between national economies. This approach emphasises the need for flexibility and adaptation to dynamic and rapidly changing economic conditions (Pomini, 2021).

Keynesianism still finds a place in contemporary approaches, especially in fiscal and monetary policies used to manage economic cycles. Nonetheless, Keynesianism has been adjusted and expanded to address modern issues such as globalisation and international economic integration. One important development is 'New Keynesian Economics', which combines the basis of the traditional Keynes model with modern microeconomic concepts such as rigid price theory and asymmetric information (Konstantinidis & Vlachou, 2023).

On the other hand, Monetarism, led by figures such as Milton Friedman, is also still influential, especially in terms of monetary policy. This approach emphasises the importance of controlling money growth to control inflation. Central banks in many countries adopt an inflation target-oriented policy framework, which guides them in setting interest rates and managing money supply. Increased policy transparency and communication are also key elements of this approach, which aims to maintain price stability and support economic growth (Dow, 2023).

In addition, the emergence of Behavioural Economics and Institutional Economics has brought a new dimension to our understanding of economic decisions. Behavioural Economics incorporates insights from psychology to explain how factors such as cognitive biases, heuristics, and emotions affect individuals' economic decisions. Meanwhile, Institutional Economics emphasises the role of institutions - the rules, norms, and organisations in the economy - in shaping economic behaviour and performance. Both approaches highlight the importance of social interactions and

institutional structures in understanding contemporary economic dynamics. As such, contemporary economic approaches have become more holistic and interdisciplinary, seeking to address the complex challenges faced by today's globalised economy.

Conclusion

The development of economic theory over time has enriched our understanding of market mechanisms and macro- and microeconomic interactions. From early classical and neoclassical thinking that emphasised free markets and equilibrium, to Keynesianism that paid attention to the role of government in stabilising the economy through fiscal and monetary policy, as well as more modern approaches such as Behavioural and Institutional Economics that take into account psychological and structural factors. This evolution shows that no one approach is completely dominant, but rather a blend of various theories that complement each other in providing the basis for the formulation of economic policies that are adaptive and responsive to changing global economic conditions.

The implication for modern economic policy is the importance of integrating the views of various schools of thought to create a comprehensive and multifaceted policy. The establishment of effective economic policies should take into account aspects such as macroeconomic stability, management of inflation and unemployment, efficiency of resource distribution, as well as social and institutional factors that influence economic behaviour. Therefore, policymakers should strive to maintain flexibility and openness to new approaches and continue to analyse the dynamics of an increasingly complex and integrated economy in order to achieve the goal of sustainable and inclusive economic development.

References

- Álvarez, A., & Hurtado, J. (2023). *A History of Colombian Economic Thought*. Routledge. <https://doi.org/10.4324/9781003289241>
- Costantini, O. (2022). Inequality, Economic Policy, and Household Credit in the USA: The Roots of Unsustainable Finance. *Springer Studies in the History of Economic Thought*, Query date: 2024-11-12 15:19:00, 177–190. https://doi.org/10.1007/978-3-030-86753-9_10
- Dow, S. (2023). Keynes on Theorising for Policy. *Economic Policy and the History of Economic Thought*, Query date: 2024-11-12 15:19:00, 173–188. <https://doi.org/10.4324/9781003228097-11>
- Drakopoulos, S., & Katselidis, I. (2023). *Economic Policy and the History of Economic Thought*. Routledge. <https://doi.org/10.4324/9781003228097>
- Duhs, L. A. (2021). Iceland: Evolution of a small resource-based economy. *Economic Analysis and Policy*, 69(Query date: 2024-11-12 15:19:00), 574–584. <https://doi.org/10.1016/j.eap.2021.01.007>

- Ebner, A. (2024). Innovation in economic evolution: Reintroducing Schumpeterian thought to current advances in economic sociology. *Current Sociology*, Query date: 2024-11-12 15:19:00. <https://doi.org/10.1177/00113921241271850>
- Firman, F.-. (2018). *PENELITIAN KUALITATIF DAN KUANTITATIF*. Query date: 2024-05-25 20:59:55. <https://doi.org/10.31227/osf.io/4nq5e>
- Glynn, S., & Booth, A. (2020). Economic policy. *Modern Britain*, Query date: 2024-11-12 15:19:00, 304–327. <https://doi.org/10.4324/9781003071372-16>
- Gotsis, G. (2023). Economic Policy in the Prehistory of Economics. *Economic Policy and the History of Economic Thought*, Query date: 2024-11-12 15:19:00, 13–33. <https://doi.org/10.4324/9781003228097-2>
- Guiot-Isaac, A. M. (2023). Becoming Economic Experts. *A History of Colombian Economic Thought*, Query date: 2024-11-12 15:19:00, 133–155. <https://doi.org/10.4324/9781003289241-9>
- Heise, A. (2023). Fiscal Policy after the Crisis. *Economic Policy and the History of Economic Thought*, Query date: 2024-11-12 15:19:00, 245–264. <https://doi.org/10.4324/9781003228097-15>
- Hua, T. (2021). Merchants, Market and Monarchy. In *Palgrave Studies in the History of Economic Thought*. Springer International Publishing. <https://doi.org/10.1007/978-3-030-77189-8>
- Jelahut, F. E. (2022). *Aneka Teori Dan Jenis Penelitian Kualitatif*. Query date: 2024-05-25 20:59:55. <https://doi.org/10.31219/osf.io/ymzqp>
- Konstantinidis, C., & Vlachou, A. (2023). Karl Marx. *Economic Policy and the History of Economic Thought*, Query date: 2024-11-12 15:19:00, 89–108. <https://doi.org/10.4324/9781003228097-6>
- Leeson, P. T., & Rouanet, L. (2023). Austrian Economics and Economic Policy*. *Economic Policy and the History of Economic Thought*, Query date: 2024-11-12 15:19:00, 159–172. <https://doi.org/10.4324/9781003228097-10>
- Meisel, A. (2023). Between the Hedgehog and the Fox. *A History of Colombian Economic Thought*, Query date: 2024-11-12 15:19:00, 194–209. <https://doi.org/10.4324/9781003289241-12>
- Michelagnoli, G. (2021). The modern Italian debate on the Walrasian theory of capitalization (1960-1971). *HISTORY OF ECONOMIC THOUGHT AND POLICY*, 1, 131–155. <https://doi.org/10.3280/spe2021-001006>
- Misaki, K. (2020). English Translation Series: Japanese Historians of Economic Thought 〈11〉 Eiichi Sugimoto, The Explication of Modern Economics Translated by Robert Chapeskie and Kayoko Misaki. *The History of Economic Thought*, 62(2), 26–66. https://doi.org/10.5362/jshet.62.2_26
- Murray, M. J. (2022). Economic method, public policy, and society: Adolph Lowe's political economics. *The European Journal of the History of Economic Thought*, 29(4), 600–618. <https://doi.org/10.1080/09672567.2022.2058046>
- Pomini, M. (2021). Interpreting the path of Italian economic thought: The contribution of Eraldo Fossati. *HISTORY OF ECONOMIC THOUGHT AND POLICY*, 1, 21–39. <https://doi.org/10.3280/spe2020-001002>
- Psalidopoulos, M. (2024). *A History of Modern Greek Economic Thought*. Query date: 2024-11-12 15:19:00. <https://doi.org/10.4324/9781315413419>

- Rancan, A. (2021). Econometric modelling in Italy: From economic planning to academic research. *HISTORY OF ECONOMIC THOUGHT AND POLICY*, 1, 63–82. <https://doi.org/10.3280/spe2021-001003>
- Scazzieri, R. (2022). Instability and Structural Dynamics in the Macroeconomy: A Policy Framework. *Springer Studies in the History of Economic Thought*, Query date: 2024-11-12 15:19:00, 249–265. https://doi.org/10.1007/978-3-030-86753-9_14
- Siven, C.-H. (2023). Bent Hansen's theory of fiscal policy. *The European Journal of the History of Economic Thought*, Query date: 2024-11-12 15:19:00, 1–31. <https://doi.org/10.1080/09672567.2023.2172196>
- Spaskyy, I. (2021). FIXED CAPITAL THEORY IN THE EVOLUTION OF ECONOMIC THOUGHT: METHODOLOGICAL ASPECTS. *Economic Analysis*, 31, 70–79. <https://doi.org/10.35774/econ2021.02.070>
- Suyitno. (2021). METODE PENELITIAN KUALITATIF KONSEP, PRINSIP DAN OPERASIONALNYA. Query date: 2024-05-25 20:59:55. <https://doi.org/10.31219/osf.io/auqfr>
- Wagner, G. A., & Lee, H. J. (2023). Does broadband affect local economic outcomes less than we thought? Micro evidence from Louisiana. *Contemporary Economic Policy*, 42(1), 68–93. <https://doi.org/10.1111/coep.12628>
- Yagi, K. (2022). Early Socialism and Social Policy from the 1900s to 1920s. *Modern Japanese Economic Thought*, Query date: 2024-11-12 15:19:00, 65–81. <https://doi.org/10.4324/9781003081319-5>
- Zouboulakis, M. S. (2023). Economic Policy in Marginalist and Early Neoclassical Economics 1871–1920s. *Economic Policy and the History of Economic Thought*, Query date: 2024-11-12 15:19:00, 109–122. <https://doi.org/10.4324/9781003228097-7>