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## Economic Theory and Economic History

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Economics has a very difficult methodology, complicating the relationship between economic theorising and empirics. Below, I set out my view of why economics is in this dismal state. Subsequently, I discuss, as part of a possible remedy for this problem, how economic theorising could relate more productively to (economic) history. On the one hand, analytic narratives can be used to explain the particular economic aspects and recorded behaviours of a historical episode. Conversely, history can provide insights into human economic endeavours to help us formulate better general theories of economic phenomena and to advance political economy in general. Particularly, I focus my discussion on historical entrepreneurial activities and how these could contribute to formulating economic theories of entrepreneurship. This illustrates the relationship between economic history and economic theorising.

### Understanding the Current State of Economics

Economics studies the human condition, which makes this pursuit dangerously fraught with significant problems. The cause for this is the very nature of the human condition. But from this, we can also understand how to alleviate these significant problems and to achieve a more functional and productive study of economic phenomena.

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At the foundation of the problems in economics is the fact that humans operate in a dual reality (Harari 2014): On the one hand, human actions concern the objective reality made up of the physical substance of the human environment; on the other hand, humans collaborate and create economic wealth through fictional narratives that engender a fictional reality. Our human ability to collaborate is characterised by our ability to believe these fictional narratives blindly—as if they were of the same substance as the objective, physical environment in which we exist. The latter is the main subject of study in the social sciences—including economics—and the humanities—including history.

The physical and natural sciences—from biology to physics, chemistry and the medical sciences—concern themselves primarily with the study of the objective reality. They are endowed with relatively strong methodologies of how to conduct scientific investigations and analysis founded on a strict relationship between the empirical measurement of the natural environment and the formulation of theories that explain the observed phenomena. This methodology was set out most profoundly by Popper (1968), although his precursor Kuhn (1962) and his critic Lakatos (1978) addressed methodological issues that put doubt on the validity of the Popperian methodological perspective.<sup>1</sup>

As the social sciences and humanities concern themselves with the human condition itself, their perspective requires the incorporation of both sides of the dual human reality: The physical objective reality as well as the human fictional reality of socio-economic institutions and politics. This makes pursuits in economics and history fraught with inconsistencies and serious problems. This is most profound in economics, since it explicitly pursues understanding how human involvement converts objective physical substance into human “use value”. In particular, in contemporary economics, this has resulted in the strict dichotomy of theoretical economics and empirical economics.

## The Dichotomy of Economic Theory and Empirics

The main objective of economics is to investigate how human collaborative effort converts natural resources as well as human labour and ingenuity into economic wealth or “value”. Theorising about an ever-evolving dynamic pro-

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<sup>1</sup> Even the natural sciences can get carried away by their adherence to the fictional narratives that form the foundation of their theories (Smolin 2006).

cess of human collaboration is complicated due to the feedback from this theorising on these processes; economists' subject matter is not objective but part of the human fictional reality itself. Therefore, economic theorising has become burdened by the economists' embeddedness in their own theories and narrative perspectives. Consequently, the development of economic theory has become propelled solely by the theory itself, without a proper empirical component.

On the other hand, empirical economics cannot be strictly Popperian since it is impossible to appropriately falsify economic theories. As a consequence, empirical economics has become more and more data-driven, without a proper theoretical component. This is further complicated by the perception that empirical economists seem insufficiently aware that empirical observation of human economic activities is actually theoretical in nature. Indeed, the measurement of seemingly objective economic phenomena is actually founded on theoretical constructs such as the demand and supply of commodities, income levels and unemployment. Thus, empirical economic measurement is informed by a certain (political) perspective of the economy.<sup>2</sup> There is no truly *objective* measurement of these economic phenomena possible.

Another consequence of the indicated problems with economics is that there evolved a long history of self-reflection and -doubt in economics centred on the difficulty of its subject matter—the “economy”—and its own necessarily ideological nature (Backhouse 2010; Foley 2006; Keen 2011; Sutton 2000). After the Great Financial Panic of 2008 and the following “Great Recession”, there emerged a large, popular as well as academic literature on the state of economics and its inability to properly explain the state of the contemporary twenty-first-century global economy (Hodgson 2008; Kirman 2010a, b; Mirowski 2010; Schlefer 2012).

Some economists have thrown up their hands and argued that economics is nothing more than telling intelligent stories, either as cleverly constructed narratives or as mathematical theories (McCloskey 1983; Rubinstein 2006, 2012). Rubinstein even seems to argue that economics is just not of much interest at all. I think that this perspective is too negative. Only very few contributions such as Backhouse (2010) really enlightened the relationship between economic theorising and empirical observations.

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<sup>2</sup>An example is that of the unemployment rate. Throughout the past century, this figure has been (re)constructed from government data of unemployment benefits and related registrations. In the past decades, the unemployment rate has been redefined habitually by government agencies for the political benefit of political parties that are in government.

## Empiricism, Analytic Narratives and Economics

Understanding the human condition is important and should be pursued vigorously. This can be accomplished by making its methodology subordinate to this goal. Theoretical economics ought not be concerned with proliferation of mathematical theory for its own sake, and empirical economics ought not to be solely data driven. We ought to strive for the unification of theoretical and empirical economics and unburden economic reasoning from its heavy methodologies.

I believe that historical events, cases and phenomena give us an empirical as well as an analytical test bed for economic theorising. Indeed, economic history is mainly concerned with past economic activities, which can be measured empirically as well as investigated through analytic narratives. Both perspectives of the past provide economists with evidence to construct better theories to understand the creation and allocation of economic wealth. Below, I focus on entrepreneurial activities and economic theories of entrepreneurship to illustrate the relationship between history and economic theorising.

### Beyond Analytic Narratives

The contributions in the volume edited by Bates et al. (1998) introduce analytic narratives as theories that explain historical economic phenomena, using economic decision and game theory. This methodological conception explicitly focuses on using economic theories to explain historical processes. These analytic narratives “rationalise” past behaviour by constructing applied theories—such as the models developed and used in Greif (1993, 2006) to explain the historically observed contracting practices of tribal traders.

The above refers to the use of general economic theories—such as game theory—to investigate and explain historical economic phenomena. Thus, these general economic theories are specified and calibrated for application to the historical phenomenon in question and serve only to explain the observed economic aspects.

The second use of historical economic phenomena is to inform and support the formulation and design of general economic theories in political economy and economics. Hence, a generally applicable theory can be designed based on historically observed behaviour, events and processes. The theorising process is, therefore, reversed: Instead of explaining an explicit historical episode with the application of a general economic theory, multiple historical episodes are used to design a general economic theory that can explain these

historical episodes through appropriately formulated analytic narratives based on that particular economic theory.

It should be noted that there is a long tradition in economics to formulate general economic theories based on such observations of historical phenomena. In particular, I refer to the general use of casual observations of historical events and processes by economists throughout the past two centuries.<sup>3</sup> I illustrate this with a more elaborate discussion of economic theories of entrepreneurship, some of the historical cases that inspired and framed these theories, as well as some historical cases that can be understood through application of these general theories in explanatory analytic narratives.

## Case: Economic Perspectives on Entrepreneurship

Entrepreneurship plays a critical role in the development of the capitalist economy. The explanation of entrepreneurship and the related economic development has traditionally been based on the study of historical and contemporary entrepreneurial activities. This has resulted in the rise of general economic theories of entrepreneurship. I discuss the relevant economic literature in Gilles (2018, chap. 5), which I summarise here.

Schumpeter (1934, 1942) developed a very comprehensive, qualitative perspective on economic entrepreneurship in the context of his general perspective on the economy. He proposes that entrepreneurs disrupt the economy through the creation of innovative production technologies and new economic goods. These entrepreneurial actions result in the destruction of existing economic processes through the obsolescence of production technologies and of existing commodity markets. One refers to this as the Schumpeterian theory of *creative destructionism*.<sup>4</sup>

Burt (1992, 2004, 2005) developed an alternative perspective founded on a sociological, non-market view of the economy. He argues that entrepreneurs are exceptional networkers, who build new connections—or “bridges”—between disparate parts of the existing (trade) networks. These bridge builders

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<sup>3</sup>An example of this is the formulation of the theory of money and debt founded on the historical intervention of nation states from the nineteenth century through the monopolisation of monetary instruments, the regulation of banking and the establishment of national central banks to regulate the monetary and financial system. This has resulted in the economic theory of *fiat money* and its derivatives (Menger 1892; Mitchell 1944; Sargent and Velde 2002).

<sup>4</sup>Historical examples for this theoretical perspective are, for example, the case of Henry Ford’s introduction of the semi-automated production of his T-model car and the case of the introduction of the compact disk to replace vinyl music recordings.

bring together disparate ideas to innovate the economy and to create new economic wealth.<sup>5</sup>

Baumol (1990, 2010) introduces an institutional perspective on entrepreneurship and contests Schumpeter's perspective on the entrepreneur as a driver of economic development through generating waves of creative destruction. Baumol instead observes that the distinct form of entrepreneurship within a society is determined by the institutional structures of that society and, thus, integrates institutional structures into the analysis of entrepreneurial action. Baumol suggests that some institutional environments and arrangements have historically been more compatible with productivity increasing technological innovations than others. He concludes that institutional arrangements allow a Schumpeterian entrepreneur to be more or less successful. However, Baumol also notes that entrepreneurship has historically not always been of the Schumpeterian variety. Hence, institutions tend to determine both the level and type of entrepreneurship.

In Sims (2017) and Gilles (2018, chap. 5), this Baumolian line of reasoning is extended to its logical conclusion and fully integrated with the Schumpeterian and Burtian perspectives. Based on several historical cases, we conclude that entrepreneurial activity is only relevant as far as it affects the institutional matrix that guides economic behaviour. Innovation of production technology and the introduction of new commodities only have economic impact if it affects the institutional structure of the system of commodity markets; bridge building is similarly effective only if it creates innovative network architectures; and activities that modify the institutional matrix of the economy are obviously entrepreneurial as well.<sup>6</sup> All these phenomena refer to institutional features of the economy.

## The Entrepreneurship of the House of Medici

One historical episodic era stands out as a unique case that combines all of these three categories of entrepreneurial activity and supports the theorising of entrepreneurial activity from all of these perspectives. This concerns the rise of the Medici bank and the establishment of the Medici family as the ruling house in the plutocracy of Renaissance Italy.<sup>7</sup>

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<sup>5</sup> A prime example of such entrepreneurship is the case of Microsoft under the leadership of Bill Gates, using acquired software to provide IBM with an operating system for its *Personal Computer* in 1980.

<sup>6</sup> This general perspective on institutional entrepreneurship allows one to consider political agents as economic entrepreneurs if their actions indeed affect the institutional foundations or matrix of the economy—such as is the case for Gaius Octavianus Augustus, Napoleon Bonaparte and Margaret Thatcher.

<sup>7</sup> I refer to Sims (2017) and Gilles (2018, chap. 5) for details of the following conclusions and insights.

First, the historical entrepreneurial activities of the Medici family in Florence support the Schumpeterian perspective for the innovative financial products and bookkeeping practices introduced by Giovanni di' Bicci de' Medici in his international banking network in the early fifteenth century.

Second, Giovanni's son and heir, Cosimo di' Giovanni de' Medici, placed himself and his family at the centre of the Florentine political power structure by building an elaborate marriage network with other ruling families in early fifteenth century. Cosimo's network has been formalised by Padgett and Ansell (1993) and Jackson (2008) to test several measurement tools from social network analysis to determine positional power.

Third, Giovanni was able to build his European-wide banking network based on innovative management of international branches, referring to innovation of the institutional behavioural rules that governed the international banking networks at that time. This contributed to a prolonged period of significant economic success for the Medici bank that lasted for a century, only coming to an end under the weak leadership of Piero "the Gouty" de' Medici. It also affected banking practice in Europe, in general, that paved the way for the rise of capitalism in the eighteenth century.

The case of the Medici shows that historical episodes and cases can contribute significantly in the development of qualitative, general economic theories. This goes well beyond the standard perspective on economic history founded on analytic narratives and cliometrics.

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