CHAPTER ONE: INTRODUCTION TO HISTORY OF ECONOMIC THOUGHT

1.1. INTRODUCTION

- **Overview:**

Dear student! In your baby economics course you have learnt what economics is. And, in some advanced courses, I hope you have come across several economic theories and principles that are meant to describe economic phenomenon. These theories and/or principles did not evolve at a time. Rather, they have been through a series of discussions, arguments, and debates of hundreds of thousands of scholars of different times. In this course we look at the evolution of economic science via the growth and development of the theories and principles that constitutes the heart and the soul of the science.

- **Chapter Objective**:

The major objective of this chapter is to enable students of economics to

- Understand the growth of economic science
- Comprehend the characteristics of economic thought
- Learn and appreciate the causes of a given economic thought
- Know why we need to study history of economic thought
- Understand why economists hardly agree on economic ideas

- **Chapter Content**:

The remaining part of this chapter is organized as follows:

- Definition of history of economic thought
- Nature of economic thought
- Development of economic thought
- Do scholars always agree on economic ideas?
- Rationale of studying history of economic thought
- History of Economics Vs History of Economic Thought
- Chapter Summary
- Self Test Exercise

1.2. WHAT IS HISTORY OF ECONOMIC THOUGHT?

Dear student! What is economic science? What about economic thought? And what is history economic thought? Please, write your answer on the space provided below.

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Good! Compare your answer with the explanation given below.

Economic science is a result of accumulation of human knowledge and it includes doctrines and generalizations which deal with economic phenomena in social life. Economic thought generally covers the set of theories, doctrines, laws and generalizations, and analyses applied to the study and solution of economic phenomena and problems.

Definition: A history of Economic thought is a query in to the origin and growth of economic ideas. It is a historical account of the development of economic doctrines as also of their impact on economic institutions and activities (Hajala, 1994).

A study of economic thought covers study of development of economic science in static and stagnant economy as well as in a dynamic economy. A group of economists, whose work reflects a common intellectual orientation, are called as a '*School of Economics*.' Haney (1949)[1] defined study of economic thought as, 'A critical account of the development of economic ideas, searching into their origins, interrelations and manifestations.'

The history of economic thought deals with different thinkers and theories in the field of political economy and economics from the middle ages right up to the present. Changes in economic thought have always accompanied changes in the economy, just as changes in economic thought have propelled change in economic policy.

Economic thought has evolved through feudalism in the Middle Ages, through mercantilist theory in the renaissance, through modern political economy during the 'industrial revolution,' to the fractured economic schools of thought that dragged humanity into the twentieth century and a new globalised era of the twenty first.

[1] Cited in Hajela (1994)

1.3. NATURE OF ECONOMIC THOUGHT

Dear student! What is characteristic feature of economic thought? Please, write your answer on the space provided below.

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Good! Compare your answer with the explanation given below.

Economic thought is not a fixed set of theories or tools and techniques of analysis:

An economy is a dynamic phenomenon and, therefore, economic science is a dynamic one. With social changes new economic questions present themselves. The result is that economic science is always undergoing a change. Over successive time intervals, specific sets of economic ideas, theories, doctrines tools and techniques acquire recognition and acceptance implying thereby that in different contexts we have different systems of economic thought. The study of the history of economic thought, therefore automatically becomes a study of these various systems of economic thought. History of economic thought is not basically a history of ideas but that of economic proper. It is a body of economic ideas and generalizations which can be seen to belong to each other.

⇒ Economic ideas collectively become economic thought.

Economic thought is closely related to economic environment:

The role and growth of each significant theory, the set of theories and policy prescriptions provided by each school and even the significant contribution by individual economists must be viewed in the context of the prevalent economic environment. Therefore, economic doctrine or economic thought reflects the condition of the society it relates. *Economic thought is the product of time.*

Ideas on economic subjects and problems have been expressed at all times and in all ages.

The development of the systematic body of economic doctrine in the history of human thought may be recent but reflection and to a certain extent speculation on economic phenomenal must be as old as human thought itself. In ancient times economic doctrine were reflected from customs, laws and institutions and lacks scientific precision and coherence

Anybody of economic doctrine/theory has limited validity

Political thought throughout has been in large measure an attempt to explain how and what theory contemporary society is operating. Economic doctrines /principles / theories/ models are under continuous improvement and advances. But it should be remembered that no absurdity in the history of economic thought was in its time quite so absurd as it appears know *(⇒ they are not absurd when they are viewed at the time they are formulated).*

Hence, economic thoughts should be evaluated under the context of the socio-economic status when they were developed. We should also note that advancement of theories /doctrines don't necessarily mean castration of old ones. Old doctrines never die; they only fade away with a strong power of recuperation /reappearance in an appropriate environment.

1.4. DEVELOPMENT OF ECONOMIC THOUGHT

Dear student, when do you think did economic thought begin? And how did it develop? Please, write your answer on the space provided below.

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Good! Compare your answer with the explanation given below.

Economic ideas have been there since time immemorial, but it is only recently that they assumed the form of a system of thought which may be termed economic science or economics. Of course, it did not develop over night. Rather, like other sciences, it had to undergo a process of evolution and is the result of innumerable contributions by various thinkers. Although the views of these thinkers had a great impact upon the mounding of future patterns of economic thought, the role played by different thinkers in the process of evolution, relevance of their ideas toward the development of economic science and the resolution given to them has been uneven.

References to economic questions are scattered almost everywhere in old literature. In the early stages of human civilization, the share of economic problems in the totality of social life was small and therefore, there was not much to study by way of pure economics. The tendency to bring in non-economic factors in the study of economic problems slowed down the progress of economic science. Before the advent of capitalism, economic organization was a simple one.

There was no division of labor and the production was meant for self-consumption. Exchange and marketing problems were simple and of limited importance. Accordingly, the volume and importance of early economic thinking could be of only limited significance.

Lack of interest in social welfare and greater attention given by the rulers to non-economic factors such as fine-arts, music and the like retarded the growth of economic science, till the close of middle ages. The acquisition of wealth was considered more a matter of political power and conquest rather than that of economic relations.

However, with the passage of time, the forces that restricted the development of economics have given way to those which favor it. The expanding economic activities of modern governments played an active role in the development of economic science. Now-a-days, there has been an expansion in the profession of economists and knowledge of economics is more widely spread. The major factor that contributed to the development of economics as a separate science was the ever-growing importance of economic phenomena in social life.

History of economic thought is attempted in numerous ways:

i. One approach is to take up important strands of economic thought and pursue their development overtime. E.g. laissez-fair, economic welfare, etc.
ii. Another approach is to pursue the study of economic thought in terms of 'Schools.' E.g. Historical schools, Socialists, Institutionalism, Classical, etc.
iii. Third approach is to take up important personalities, that is, economists who made significant contribution to the advancement of economic science. E.g. Adam Smith, Alfred Marshall, John Maynard Keynes, etc.
iv. A blend of views in which due emphasis is accorded to the individual economists, to the 'Schools' and also to the development of important strands of economic thought.

1.5. RATIONALE OF STUDYING HISTORY OF ECONOMIC THOUGHT

Dear student! Does it really help us in our future thought? Please, write your response on the space provided below.

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Good! Students about to struggle over the difficult intellectual terrain ahead may well wonder 'why study economic theory? Why study its history?' why do we study history of ideas? Many answers come to mind. Two major reasons, other than the personal advantages that might be gained, justify the study of economic *theory*. First, such study allows us to gain an understanding of how an economy works; that is, what makes it hang together and function? Second, economic theory helps society reach the economic goals that it has selected for itself. Society can progress faster in achieving economic goals through knowledge of economics. Economic theory makes economic analysis easy and understandable. Economic analysis, on the other hand, helps us devise systems through which the common good can be individually and socially defined and through which people can pursue their own interests while simultaneously enhancing the well-being of others.

But, why study the *history* of economic thought? First, such a study enhances one's understanding of contemporary economic thought. Mark Blaug (1980)[2] said that "contemporary theory wears the scars of yesterday's problems now resolved, yesterday's blunders now corrected, and cannot be fully understood except as a legacy handed down from the past."

Second, the vast amounts of analysis and evidence that economists have generated over the decades can provide a closer check on irresponsible generalizations. This should enable us to make fewer errors than in the past when making personal decisions and when formulating national and local economic policies. Yet, numerous unsolved problems and unanswered questions remain in economics. Our understanding of past successes, errors, and dead ends will be useful in solving these problems and answering these questions.

[2] Cited in Brue & Grant (2007)

Finally, and above all, the study of the history of economic thought provides perspective and understanding of our past, of changing ideas and problems, and of our direction of movement. It helps us appreciate that no group has a monopoly on the truth and that many groups and individuals have contributed to the richness and diversity of our intellectual, cultural, and material inheritance. A study of the evolution of economic thought and the changing social background associated with it can light up changes in other areas of concern to us, such as politics, art, literature, music, philosophy, and science.

1.6. DO SCHOLARS ALWAYS AGREE IN ECONOMIC IDEAS?

Dear student! Does the understanding of economic theory lead to a consensus on explaining economic problem? Do scholars always agree on economic ideas? Please, write your response on the space provided below.

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Good! Unfortunately the accumulation of knowledge and understanding does not *necessarily* lead to a universal agreement among the stakeholders. Even if all people were perfectly well-informed on economic matters, disagreements and conflicts would continue because of different ideas about what is good and what is bad, which goals should be adopted and which rejected, and what the priority of each goal should be. Even if we agree on the goals for the economy, we will disagree on their relative importance. In general, the following are the main reasons for lack of uniformity of conclusions and opinion amongst economists[3]:

i. Economics is a social science in which controlled experiments are not possible and accordingly there is always a possibility of differences of opinion regarding the choice of relevant causal forces and the process of their interaction.
ii. There are chances that differences would exist with reference to the assessment of facts, especially when they are mixed with each other.
iii. Economic analysis admits a wide variety of methods, which result in non-identical results.
iv. Differences also arise on account of the purposes for which an economic investigation is being undertaken.

[3] Nair, 2005. *Lecture Note on History of Economic Thought*, Department of Economics, AMU. (Unpublished)

v. Another reason for the divergence of opinion arises on account of the materialistic and idealistic attitudes of the economists.

1.7. HISTORY OF ECONOMICS VS HISTORY OF ECONOMIC THOUGHT

History of Economic Thought should not be confused with History of Economics and Economic History. Although, they are all studies of the constituents of History and Economics, they are separate branches of study having different subject matters and varying in emphasis on different aspects of the subject matter.

Economic History is an objective study of the development of economic life of a particular society. Economic History studies the origin and growth of commerce, manufacture, trade, banking, transportation and other economic phenomena and institutions. It deals with the ideas men have concerning economic facts and forces.

History of Economics is the history of the intellectual efforts that men have made in order to understand economic phenomena. It is a systematic record of the development of the science of economics.

History of economic thought, on the other hand, deals with the origin and development of economic ideas. It provides a historical account of how people viewed and understand economic phenomena, i.e. economic facts and tendencies.

In short, Economic History treats of facts. History of Economics and History of Economic Thought treats of the theory of these facts. It will thus be observed that History of Economic Thought has a much wider scope.

1.8. CHAPTER SUMMARY

- A history of economic thought is a query in to the origin and growth of economic ideas. It covers study of development of economic science in static and stagnant economy as well as in a dynamic economy.
- Economic thought is not a fixed set of theories or tools and techniques of analysis. Economy is a dynamic one and so does economic doctrines. Hence, Anybody of economic doctrine/theory has limited validity. It is also important to note that ideas on economic subjects and problems have been expressed at all times and in all ages.

- The study of economic theory allows us to gain an understanding of how an economy works. Studying economic thought on the other hand lends a perspective to the subject and enables the students to have a wider view of what he/she is studying.
- Economists do not always agree on explaining economic problems. One of the reasons is that economics is a social science in which controlled experiments are not possible and accordingly there is always a possibility of differences of opinion regarding the choice of relevant causal forces and the process of their interaction.
- Economic History treats of facts. History of Economics and History of Economic Thought treat of the theory of these facts. It will thus be observed that History of Economic Thought has a much wider scope.

1.9. SELF TEST EXERCISE

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of this chapter. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1) Distinguish between:
    a. Economic science, economic thought, and history of economic thought
    b. History of Economic thought, Economic History, and History of Economics.
2) List down the main characteristic of economic thought.
3) Why we study history of economic thought?
4) Do scholars always agree on economic issues? If not why?
5) Why does economics is said a dynamic science? What is its implication to the study of history of economic thought?
6) What is a school of economic thought?

CHAPTER TWO: ANCIENT ECONOMIC THOUGHTS

2.1. INTRODUCTION

- **Overview**:

Dear student! Recall that in the previous chapter we have discussed about the nature of economic thought and recognized the presence of economic ideas have been there since time immemorial. But it is only recently that they assumed the form of a system of thought, which may be termed economic science or economics. Therefore, the relevance of the past to study the present is not a matter of debate. To this end, let us explore economic thoughts in ancient times.

- **Chapter Objective:**

Dear student! Upon successful completion of this chapter you will be able to:

- Know the presence of economic ideas in antiquity;
- Understand the contribution of different ancient philosophers to the development of economic thought;
- Compare and contrast the economic thought of ancient Hebrews, Greeks, and Romans;
- Evaluate the relevance of ancient economic thoughts to the modern thoughts;
- Appreciate the depth of economic thoughts in antiquity.

- **Chapter Content:**

The remaining part of this chapter is organized as follows:

- The Hebrews
- The Greeks
- The Romans
- The impediments to economic inquiry
- Chapter Summary
- Self Test Exercise

2.2. THE HEBREWS

Dear student! From your history knowledge, who are the Hebrews? How did they contribute to economic thought? From where did their economic thought found? Please attempt them on the space provided below?

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Good! The Hebrew was a nation of ancient civilization whose history dates back to 2500 BC. The main source of their history and ideas is the writings of the Hebrew prophets. Their ideas are contained in the 'Rules of conduct'. The main theme of their education and the chief concern of government was the observance of these laws and commands. The 'Old Testament' is the most important and original source of information regarding their economic thought.

The economic ideas of the Hebrew prophets as expressed in their commands and laws can be summarized as follows:

1. **Usury or Interest:** Although the prophets did not use the term 'interest' they prohibited usury or anything that is lent up on 'usury'. If the thing accepted in return was more in value than what was given to the borrower, it was considered to be an act of usury.
2. **Commerce and Just Price:** There was hardly any place for middle men. The export of food was prohibited and at times of scarcity and famine, hoarding of food grains was not permitted. All these provisions aimed at safeguarding the interest of the poor. Thus, the Hebrews developed the basic concepts of 'just price' in its rudimentary form.
3. **Agriculture and Industry:** the Hebrews held agriculture and tilling of land in high esteem while they looked down up on trade. The saying goes that "he that tilleth the soil shall have plenty of bread." They did not encourage manufacturing of goods and commerce to any considerable extent. It is, thus, clear that their laws were conducive to the growth of agriculture while they discouraged industry and trade.
4. **Labor:** the Hebrews regarded all kinds of labor dignified, but the pride of place was given to the agricultural labor.

5. **Seventh and Jubilee Years:** the Hebrew prophets evolved a particular method of regulating and restricting the alienation of land by instituting the seventh and the Jubilee years.
    i. *The Seventh Year:* was one in which land lay fallow, i.e. after tilling it for six continuous years, the land was not to be cultivated for one year. They even attached some religious sanctity to this measure but it was mainly designed to conserve the fertility of the soil.
    ii. *The Jubilee Year:* meant the 5th year. According to this provision, the land transferred to some ones to revert to its first owner in the fifth year. Thus, sale of land really amounts no more than lease.
6. **On origin of State:** it is the outcome of natural instinct of man to associate with his fellow beings. Man is a social animal and the state is the creation of nature.
7. **Value and Exchange:** the value of a commodity depends up on its usefulness and/or intensity of wants. The greater the intensity of wants for a commodity, the more will be paid for it.
8. **Interest and Money:** while money serves as a medium of exchange it cannot be regarded as productive.

2.3. GREEKS

Dear student! Which country of our planet is considered as the source of knowledge? And what is the contribution of this nation to the development of economic thought? Please write your answer on the space provided below?

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Good! As you might have said, the Greeks are the pioneers in many branches of knowledge. In this regard it is not surprising if they are the beginners of economic theory. Economic literature recognized that it is in the Greek writers that theorizing on economic matters first explicitly emerged. But they did not contribute much to the growth of economic ideas. Economics was viewed as a minor subsection of ethics and politics and economic ideas were found in isolated fragments and mangled remains.

Dear student! Who do you think were the most important economic thinkers of the Greek? What was their individual contribution to economic thought?

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Well! Among the Greek writers which made some contributions to economic theory were Plato, Aristotle and Xenophobe. Let us see the contribution of these scholars to the development of economic thought.

A. Plato (427-347 BC)

Plato was born in Athens and was a pupil of Socrates. He was essentially an aristocrat and looked at democracy with disapprobation and derision. His views are expressed in the form of dialogues. His economic teachings are incidental to the theories of politics and ethics. The essence of Plato's thought is shortly summarized as follows.

- ***On state***: Plato traced the origin of state to economic consideration. According to Plato, "A state arises out of the need of mankind, no one is self-sufficing but all of us have many wants"
- ***On Division of Labor***: At the first time, it is Plato who states the division of labor. He attributed division of trade to the differences in nature and aptitude of human beings. His idea of division of labor emanates (originates) from his belief that 'there is diversity of nature among men and each should do what is natural to him.' It means that everybody should do what is natural to him and leave the others.
- ***On Communism***: It is Plato who state communism for the first time.[4] Plato was not a supporter of private property. In his earlier works, Plato espoused communism and has proposed a state based on communism. Even he advocated communism of wives and children. But later, he abandoned the idea to a more realistic approach to economic life.

[4] *Communism is a social and economic system in which the state owns and controls the means of production on behalf of the people. It aimed to create a society in which every one is paid & work according to their needs and abilities.*

- ***On Value***: He considered value as inherent quality of the product. According to him a man should not attempt to raise the price, but simply ask the value.
- ***On Money and Interest***: Plato recognized the value of money as medium of exchange. As regard to interest, he thought that neither interest should be given nor the principal or a loan repaid.
- ***On wealth:*** He opposed accumulation of wealth on ethical grounds. According to him, 'Great riches and happiness are incompatible, for a rich man cannot be a perfect man, as part of his wealth must necessarily be acquired and expanded unjustly.'

B. Aristotle (384-322BC)

Aristotle was born at Stagaria and was a pupil of Plato. He went further than other thinkers in antiquity in the direction of detaching a separate science of Economics. Although he did not write any separate treaties on economics, many of his discussions were centered around economic problems.

The following are the theme of Aristotle's economic thoughts.

- ***On private property***: He did not fall in line with Plato in so far as the community of wives and property was concerned. Aristotle made a sharp attack against a common ownership of property. According to him, a system of communism would not work and that it violates natural human instincts. It was his belief that people pay most attention to their own private property.

  He argued that unity built on communism is in fact a delusion /illusion. The common purse leads to quarrels arising out of trivial causes (because human beings take care for their own property than they do for common property).

  ⇒ In contrast to Plato, he was for private property.
- ***On Slavery:*** Aristotle was the supporter of slave and he defended slavery. According to him, "the principle of rule and subjugation is inevitable and beneficial." He meant that 'Slaves are not only inevitable but also beneficial.'

  According to him, there were *natural slaves* and there were also legal slaves. By natural slaves he meant that those that are regarded by the society as naturally inferior. His legal slaves include those that are imprisoned or captives. But, he concentrates up on natural slaves.

- ***On Finance:*** His discussion on finance was related to the acquisition of wealth (method of wealth acquisition).Aristotle distinguished there kinds of finance: Natural (healthy) finance, Unnatural finance, Intermediate finance.
  i. *Natural finance*: refers to the acquisition of wealth through natural ways. According to him, the wealth through natural finance is a genuine wealth and has a limit. This limit is provided by the means of subsistence, by the needs of the household, and the state. His natural finance includes activities like farming, husbandry and bee keeping.
  ii. *Unnatural finance*: refers to the acquisition of wealth through those methods that do not have natural existence. Unnatural finance doesn't belong to domestic economy but natural finance belongs

  According to Aristotle unnatural finance is merely money making. It belongs to trade and this trade comprises commerce, usury and hired labor. Wealth acquired through unnatural finance doesn't have a limit.

  For Aristotle, *usury is the worst form of finance*. He said the function of money is merely for the exchange and nothing more. For him, money is sterile, unproductive and barren (not producing anything without success or useful result) Usury is condemned because it doesn't have any natural finance.
  iii. *Intermediate finance*: comprises something common to each of the others. This finance is concerned with the product of the earth such as wood cutting, and mining (extractive industries).

C. Xenophon (c434-c355BC)

Xenophon was the third in the chain of the great writers. Xenophon become a pupil of Socrates but preferred a military life to the quiet life of scholarly pursuit. In spite of his active military life, he could find time for composing literary works.

Dear learner! The main points raised by him that may be regarded as economic thought is summarized as follow:

- ***On Wealth***: Xenophon held that wealth like any other commodity had value for those who make adequate use of it. According to Xenophon, wealth is interpreted in relation to needs. To him, a man of simple tastes and little substance is wealthy in comparison with the man of greater processions on who excessive claims rest. The implication of

xenephone's argument is that even if a man possesses much wealth when compared to the society, if his needs are greater than his money, he is no more rich.

- ***On Agriculture:*** Xenophone wrote in praise of Agriculture. He considered agriculture to be the simplest art to learn, the source of all things and the quickest to yield returns. Emphasizing the importance of agriculture, he declared that "When husbandry flourishes, all the other arts are in good shape, but whenever the land is compelled to lie waste, the other arts of landsmen and mariners perish." This is to say that the base of an economy is agriculture.
- ***On Factors of Production:*** According to Xenophon, there were only two factors of production, labor and land. He said that agriculture supplies good things in plenty, but 'she suffers them not to be won without work hard'.
- ***Law of Returns:*** Xenophon showed an understanding of the operation of the law of returns. *He* held that agriculture was an industry subject to diminishing returns while silver mining yielded increasing returns.

  Regarding the diminishing return of agriculture, he said that the *landowners could tell you how many team and how many labors are required for their estate. If anyone employs hands in excess of requirements, it is reckoned as a loss.* Regarding the increasing return of silver mine, he said that *the greater the number of people employed, the more prolific becomes the ore.*

  Although he is not the first man to explain the law of diminishing returns, he approaches or seems to it in a fumbling way.
- ***On Joint Stock:*** In order to overcome the risks inherent in opening new silver mines, he suggested something approaching to a joint stock method of operation. He thought that joint stock companies are safer than the individual enterprises. In his opinion there should be a happy combination of public and private enterprises running with mutual cooperation and goodwill.
- ***On Public Finance:*** He saw foreign residents as a source of revenue. He said in peace time, wealth (revenue) is accumulated and in war time it is lost.
- ***On Division of Labor:*** Xenophon showed a definite advance over Plato's idea that division of labor arose from differences in the innate abilities of men. One can even discover the roots of the modern theory of division of labor in Xenophon. This will be evident from the following lines in his works:

And it is of course, impossible for a man of many trades to be proficient in all of them. -----. One man, for instance, makes shoes for men and the other for women; and there are places even where one man earns a living by only stitching shoes, another by cutting them out, another by sewing the uppers together, while there is another who performs none of theses operations but only assembles the parts. It follows, therefore, as a matter of course, that he who devotes himself to a very specialized line of work is bound to do it in the best possible manner.[5]

2.4. ROMANS

Dear student, what is the contribution of the Rome to the development of economic thought? Please write your answer on the space provided below?

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Great! As the record of social struggle, the history of Rome is of the highest importance. But the specific contribution of Romans to the development of economic thought is meager to the extent of being negligible.

Whatever contributions Rome made to theories is an echo of Greece. That is why the Rome writers were not considered as the original thinkers. But they are practical men. For instance, while the Greeks produced a philosophy which strengthened the moral and economic fiber of societies, the Romans shaped legal and political institutions with great finesse. Hence, Romans are known not for their theory but for their practice. Romans were not great thinkers and philosophers like the Greeks. But, this does not mean that they do not have philosophers. They had some but still the contributions of these writers were very small and most of it is the repetition of what is said by Greeks.

Dear student! Who are the most important economic thinkers of the Roman? What is their individual contribution to economic thought?

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[5] Cited in Hajela, 1994.

Good! The contribution of Rome to the discussion of economic topics falls under three groups. These are:

- The philosophers: Cicero, Seneca and Pliny
- The agricultural writers: Cato, Varro and Columella.
- The jurists: there are a host of people whose ideas have economic significance

Let us see the economic views of the aforementioned roman thinkers.

a) *Philosophers.*

Cicero (106-43 BC)

- Cicero attached great importance to agriculture as an occupation but conceded the value of wholesale trade.
- He strongly condemned usury and money lending. Usury was condemned not on any ethical or economic grounds but because it incurred ill-will.

Seneca (c4BC- c65AD)

- Seneca views money as root /source of all evils. He despised money lending and advocated simplicity of life. For him, envy and greed are the source of all injustice.
- He argued that some things have greater value than their price and hence utility should be the criterion for determining exchange value.
- He recommended geographical division of labor on the ground that various quarters of the earth are endowed differently with natural resources.

b) *Agricultural Writers.*

The agricultural writers (Cato, Varro and Columella) had the highest regard for agriculture. But they were concerned about all the technique of agriculture and less with the economics of agriculture. Although he has not used the term 'demand,' Varro has recognized its importance in the determination of the amount of goods to be produced.

c) The Jurists

The Roman jurists were the most original Roman thinkers and chiefly concerned with the framing of laws and evolving doctrines to regulate the commercial mechanism of Rome. In this regard, they produced a law which is popularly known as the Roman Law. In relation to the Roman Law. We can talk about two points.

Roman jurists recognized very well the importance of money as medium of exchange. They treated money like a commodity whose value was more or less changeable and essential to its function. In general they were opposed to interest taking, especially to usury. But no legislation could undo this evil.

To summarize, it can be concluded that the Romans added little to the stream of economic theory. But it might be admitted that their importance as a medium for such thought is great.

Overall, then, economic enquiry during antiquity did not grow fast as compared to its development in the recent era.

2.5. IMPEDIMENT TO ECONOMIC ENQUIRY[6]

Dear student! What do you think were the reasons for slow growth of economic enquiry during antiquity? Weren't there barriers to economic enquiry during antiquity? Please, write your answer on the space provided below?

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Well! As you might have said, there were a lot of challenges to economic enquiry. The major impediments that hinder the emergence of economic enquiry in ancient times were:

i. **The dominance of the State:** Ancient thinkers had limited interest in economic matters. What was important for them was the focus on political matters and 'ideal state.' The dominant thinking was what they considered as 'a good life could be achieved through the City State. To the Greeks, for example, every aspect of daily life was connected to their discussion of 'City state.' They believed that individuals derived their

[6] Nair, 2005. Lecture Note on Labor Economics, AMU (unpublished)

importance from their relation with the city-state. It means that political matters primarily attracted the attention of the Greek thinkers. They were mainly absorbed by the origin and functioning of the ideal city state. The individual was subordinated to the state. This subordination limited the growth of economic thought. Thus, the emphasis of the State as an instrument to achieve optimal results prevented the development of the allocation of resources, in the absence of central authority directing the allocation.

ii. **The prevailing philosophy:** During the Greek and Roman period philosophers believed that human happiness is achieved only within the city-state, that is, the individual is inseparable from a self-sufficient city-state.

Stoicism was the prevailing philosophy, which transferred Greek philosophy to the Western (Roman) world. It is a philosophy on rational, systematic universe governed by the law of nature, that is, individuals should behave and live according to the law of nature in such a way as their actions conform to the dictates of natural necessity. Individual happiness is achieved by conforming (accepting rules) to inevitable law of nature. Therefore, this fatalicism philosophy (the acceptance of all that happens as inevitable) was not conducive to the encouragement in production and distribution of wealth. It was not conducive to the emergence of economic enquiry.

The disintegration of the Greek city-state led to the emergence of the Roman Empire; because of the search for the good life. It was no longer interwoven with the search for the good state. Thus began the divorce of politics from ethics and there began an appreciation of the individuals.

iii. **The attitude towards want satisfaction:** If economics was to emerge as a separate field of enquiry, the satisfaction of material needs should have become an acceptable goal of society. Wealth was regarded as with evil; because the pursuit of wealth was not encouraged. This means that absence of interest in economic ideas. Plato and Aristotle thought that a minimum amount of wealth was essential for a good life. Therefore, they supported production and storage of wealth. Nevertheless, they believed that retail trade or exchange for the purpose of making money is unnatural or a sin.

Within these frame work of ideas of the ancient period, economic enquiry could not develop. The development of economics had to wait till the period of reformation and the renaissance.

2.6. CHAPTER SUMMARY:

- Attempts to theorize on economic issues were started with the Hebrews. The main source of their history and ideas is the writings of the Hebrew prophets. The 'Old Testament' is the most important and original source of information regarding their economic thought. The Hebrew prophets cover a wide range of economic problems of their time. Although the prophets did not use the term 'interest' they prohibited usury or anything that is lent up on 'usury'. The Hebrews developed the basic concepts of 'just price' in its rudimentary form. The Hebrews held agriculture and tilling of land in high esteem while they looked down up on trade. They regarded all kinds of labor dignified, but the pride of place was given to the agricultural labor. The Hebrew prophets evolved a particular method of regulating and restricting the alienation of land by instituting the seventh and the Jubilee years. According to the Hebrews state is the outcome of natural instinct of man to associate with his fellow beings. The value of a commodity depends up on its usefulness and/or intensity of wants. While money serves as a medium of exchange it cannot be regarded as productive.
- The Greeks are the pioneers in many branches of knowledge. Economic literature recognized that it is in the Greek writers that theorizing on economic matters first explicitly emerged. Among the Greek writers which made some contributions to economic theory are Plato, Aristotle and Xenophobe.
- As the record of social struggle, the history of Rome is of the highest importance, But the specific contributions of Romans to the development of economic thought is meager to the extent of being negligible. Whatever contributions Rome made to theories is an echo of Greece. That is why the Rome writers were not considered as the original thinkers. But they are practical men. The contribution of Rome to the discussion of economic topics falls under three groups. These three groups are: the philosophers(Cicero, Seneca and Pliny); the agricultural writers (Cato, Varro and Columella); the jurists (there are a host of people whose ideas have economic significance)
- The major impediments that hinder the emergence of economic enquiry in ancient times were the dominance of the State, the fatalicism philosophy (the acceptance of all that happens as inevitable) and the attitude towards want satisfaction.

2.7. SELF TEST EXERCISE

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of the ancient economic thought. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1. Who do you think were forerunners in discussing of economic ideas?
2. Compare and contrast the economic ideas of the ancient Greek and Roman thinkers.
3. Which of the Hebrew's economic idea have lasting contribution to contemporary economic thought?
4. Which of the Romans economic idea have lasting contribution to contemporary economic thought? Why?
5. Evaluate the relevance of Greek economic thought to the modern thought.
6. Assess the importance of Aristotle in the history of economic thought.
7. What are the major impediments to economic thought during the ancient period?
8. What is the theme of Roman agricultural writers?
9. Did the Roman jurists add any value to economic ideas?
10. Why Roman thinkers are dubbed as unoriginal thinkers?

CHAPTER THREE: THE MIDDLE AGES

3.1 INTRODUCTION

- **Overview:**

Dear student! The period between 470AD to 1453AD, covering about ten centuries is generally known as the medieval period or the middle ages. It is believed that during these years, economic thought has moved at very slow speed. Nevertheless, the study of it is of immense value. Hence it is necessary to give due credit to the individuals and institutions of the period for their contribution of economic idea to the development of economic thought.

- **Chapter Objective:**

Dear student! Upon successful completion of this chapter you will be able to

- Know the presence of economic ideas in the Middle Age;
- Understand the contribution of different philosophers to the development of economic thought in the Middle Ages;
- Compare and contrast the economic thought of the middle age with that of the ancient;
- Evaluate the relevance of medieval period economic thoughts to the modern thoughts;
- Appreciate the depth of economic thoughts of the Middle Ages.

- **Chapter Content:**

The remaining part of this chapter is organized as follows:

- Characteristic of the Medieval Period
- Representatives of the Middle Age
- Significance of the Period
- Chapter summary
- Self Test Exercise

3.2 CHARACTERISTICS OF THE MEDIEVAL PERIOD

Dear student! From your previous history knowledge, what do you think are the main feature of the medieval period? Please write your answer on the space provided below.

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Good! As you might have said, feudalism and the dominance of the church were the two characteristic features of the medieval social structure which had cast and moulded the economic ideas of the middle age.

On the secular side**,** the middle ages are more or less synonymous with the feudal system.
The theory of feudalism in its essence implied a system in which society was held together by mutual obligation and services, so that each one had his place assigned to him, and his tenure of that place involved the giving and receiving mutual support and assistance. On the whole the accepted theory was that members of the society held their places on condition that they render/provide certain specific services to their fellows. There was thus a considerate element of status. Rank imposed obligations but it also conferred privileges.

To complete the picture on the secular side the middle age lived to the large extent in a natural economy. Here natural economy includes:

-the actual volume of trade was relatively small
- men lived in a small unit, which to a large extent were virtually self-supporting
- money transactions throughout Europe were limited.

On the religious side, the great all dominant fact was the church. The church sought to regulate all human relationships on the postulate that '*this earthly life is but a preparation for another, and that the only reality is eternal salvation.'* The church was in its very nature a cosmopolitan or metropolitan organization. It lay down principle not only for a certain nation, class or group, but for all -it is for international view. This nature of the church conferred/provided a certain unity on Europe before centralized nation found satisfaction in the misfortunes of their labor in later periods.

3.3 REPRESENTATIVES OF THE MIDDLE AGE

Dear student! Where do we get the economic ideas of the middle age? Who do you think are the representatives of the economic ideas prevailed during the Middle Age? Please, write down your answer on the space provided below.

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Good! The authoritative version of the medieval economic ideas is found in the works of St. Thomas Aquinas and Nicole Oresme. Let us narrate their ideas shortly in the following lines.

i. St. Thomas Aquinas (1225-1274)

An Italian born philosopher, St. Thomas Aquinas, was the most renowned scholastic philosopher. The views of the angelic doctor represent a synthesis of Aristotelian doctrine. St Thomas was prince of scholastic and the greatest exponent of scholasticism[7]. In general, it can be said that St. Thomas' view on all economic matters were highly influenced by Aristotle & Christianity.

The influence of Aristotle: Aristotle's views were chiefly influential with regard to

- nature and function of money,
- the inequity of money, and
- the principles which should govern exchange.

On much of these, St. Thomas clearly repeats Aristotle with added refinements from Christian sources.

The influence of Christianity: An important implication of Christianity is the principle that men are equal in the sight of God; (that is, all men are children of a common father, and hence brothers with immortal soul and of equal value in eternity.) This principle made it impossible to defend such institutions as slavery.

[7] *Scholasticism* may be defined as the system of thought that combined the teaching of Christianity, dictates of the church and the philosophy of Aristotle. It can not be treated as a science because for it did not aim at explaining the cause and effect of economic phenomenon.

Although St Thomas himself showed inclination to accept what Aristotle said about slave, this principle is not as such easy to be understated. Christianity's belief that this world is the preparation to another world led St. Thomas to state that *even a slave may enter the kingdom of Heaven.*

The fact that *this world is a preparation for the other* would have led for an attitude of *tolerance*. This attitude led to accepting inequality as part of the arrangement ordained by the Almighty and viewing life in relation to the light of eternity.

Christianity has challenged the traditional Greek view with regard to the dignity of work, which in the period of Greek was considered as a mark of slave. The New Testament indicated *work with your own hands,* and this led people to conclude that *if any one wouldn't work, neither should he eat.*

The views of St. Thomas were, therefore, the admixture of the teachings of the Bible and the philosophy of Aristotle. The views of St. Thomas Aquinas in particular and the scholastic writers in general, can be briefly stated as follows:

Role of the state: State was likened to private economy and the office of the rulers was considered as private property. According to him, the State was for the maintenance of population, provision of the poor, establishment of safe and free roads, and regulation of currency. The regulation of currency was thought necessary because a slight change in its quantity might affect its price (which was later/in the modern era developed as the quantity theory of money).

On sectors: St. Aquinas regarded every profession leading to public service as noble. Even private gain was good if it was used for public service.

On private property: He holds that "possession is natural to man". Private property is not contrary to the natural law; rather it is added to natural law by a further creation of human reason. Having justified possessions, St. Aquinas distinguished the two kinds of rights which men may have in things:

1. the right to acquire and administer property – private
2. the right to use – communal

To him, if property was used in the interest of the community it was good, otherwise not. Here, things are to be regarded as common, ready to be shared with others in need. Thus, while the right of property remains, the harshness of the Roman conception has gone. The existence of private property leads to the question of exchange rule. In this connection, he underlined that human relations should be governed by justice and hence the central conception is that of the *just price*.

On just price: The Scholastics preached the concept of 'just price'. The two cardinal economic doctrines of the middle ages are found in the notion of just price and the prohibition of usury. A just price is the price equivalent to that the producer needs to live according to his rank; that is a price that suitably supports the producer according to his rank. This is because they believed that each person has a rank in life (that is, a pre-ordained place). The idea of just price emanates from the understanding that we are brothers and should behave as brothers, respecting each other‘s right and positions of life; hence each should receive that to which he is entitled. No one, under any circumstances, should take advantage of his neighbors.

It was, however, believed that accurate determination of price (just price) was not possible and that it could be subject to variation. Slight variation in the 'just price', according to the market fluctuations, was considered desirable. Therefore, he admitted that there must be a certain margin allowed with regard to the just price since it cannot be fixed with complete certainty/accuracy.
This principle of just price includes the idea of just wages – payment for service renders, as “the laborer was worthy of his hire”. By just wage was meant that the rate of remuneration (compensation) which was required to enable the worker to live decently in the situation of life in which he was placed.

On exchange: He regarded trade as neither good nor natural. It was unnatural and graceless. It could be justified only 'If the merchant sought to maintain his household and when the objective of trade was to benefit the country. Trade could be permitted if goods were exchanged at a price which was 'just' both to the seller and the buyer, that is the commodity given and the commodity received were of equal value. In this connection St. Thomas underline that human relation should be governed by justice and hence the central conception is that of just price. Justice

consists in rendering to each one what belongs to him- it implies equality. Therefore, there should be equality in exchange.

On wealth: He didn't think that wealth was natural or good. It was like other imperfections and weaknesses of this earthly life, which could not be avoided, but their use could be made as good as possible.

On value: St. Thomas did not clearly show how to determine the value of a thing. He seems to assume that we know what it is rather than explaining how in any given case we may determine it. He simply state that value is known by customary price. *Just price= value= customary price.*
But, St. Thomas admitted that there can be certain factors that can change the just price. And, he said that there must be a certain margin allowed with regard to the just price. He indicated that it cannot be fixed with complete certainty (accuracy). Therefore, within a limit certain slight variations (up or down) need not be regarded as impairing the equality which justice demand.

Prohibition of usury: Of course this concept was explicitly started in the Aristotle's period but has also borrowed ideas from the teachings of Christianity. The bible teaches that a Christian should lend hoping for nothing again. Despite such statement, the attitude of the church was not so rigid at first as it become later. When the question first emerged, usury was forbidden only to clerics or clergy; it was not till relatively late that the prohibition was made general and usury becomes offence.
In the hands of St. Thomas Aquinas, the objection to usury becomes more deeply grounded and by reasoning of his own, he demonstrated that usury involves an offence against justice. His argument rests on the distinction between those items for which use and consumption cannot be separated and those for which they can be separated.

Dear student! Do you know items whose use and consumption can be separated? Please write your answer on the space provided below.

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Good! These are some examples used to explain conditions under which use and consumption are identical and different.

- ***Wine & Bread***: use and consumption are identical. If you give bread for some body, it means he is allowed to eat. Ownership is transferred immediately
- ***Car & House***: Use and Consumption are different. If you rent a house use is taken out, but consumption is still of you. You can sell its use and you can sell its consumption.
- ***Money:*** use and consumption cannot be separated. In money borrowed, ownership is transferred. It is paid for the holder.

⇨ In the case of bread, there cannot be use without consumption. In the case of a house, it is possible to sell a house and it is possible to use the house since they are destined.

⇨ In the case of money, he argued, use and consumption are inseparable. St. Thomas further argues that a loan of money is in fact bound to be a sale (a change of ownership); you can't sale the use of money.

As it is inadmissive to sell bread to a man and simultaneously charge him for the use of it, so it is inadmissible to sell money and charge also for its use. The proper price is the return of the same money; the additional charge for its use is of the nature of swindle.

Dear student! Why usury was so offending during the medieval period? Please write your answer on the space provided below.

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Good! it is mainly because people were so religious and accepting something extra than lent was considered as sin. In the words of St. Thomas, the offence of the usury may be expressed as:

- Either he/she is selling something that doesn't exist
- Or, he/she is charging for the same thing twice
- Or if the lap of time is considered, he/she is selling time which belongs to God.

Certain modifications on Usury

Dear student, did they stick to the view that taking interest is always injustice? Please write your answer on the space provided below.

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Good! as you might have said, it is not always true that taking usury/interest is injustice. Since the main consideration was that of justice, St Thomas underlined that both the borrower and the lenders should be viewed in relation to justice and the lender should not suffer by lending. The restoration of the original capital (money) would not be enough if the lender had to suffer as a result of his lending.

Accordingly, the following four exceptions which provide the possibilities of an extra payment were made:

i. If the lender could prove that, arising out of the loan, he had suffered a definite loss. This exception was named ***damnum emergens***
ii. If as the result of loan, the lender can show that a source of gain had dried up. This was known as ***Lucrum Cessans***.
iii. if the borrower agreed on the return of money on a certain date with a penalty in case of delay and if the borrower fails to return on the specified date. This was known as ***Poena Conventionalis***
iv. A payment to cover the risk inherent in the possibility of the money not being paid. It is paid with interest (usury) not because the borrower is using it but the lender is suffering loss risk. This is known as ***periculum sortis***.

Dear student! How do evaluate the relevance of the modifications made on usury? Please, write your comment on the space provided below.

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Good! From the discussion made above two conclusions are evident.

First, these exceptions are no exceptions in principle. Taking interest where there is no risk, no loss incurred, no inconveniences suffered, still remained evil in the eyes of the medievalists. The payment for the use of money continued to be illegitimate.

Second, in practice these various modifications were sufficient to break down the prohibition of usury. Especially, with the development of industry & finance, it would be increasingly possible for a lender to demand either a damnum emergence or a lucrum cessans.

ii. Nicole Oresme (A.D. 1320- 1382)

Oresme was the most influential churchman of his time. He was chiefly influenced by Aristotle and Buridan. His main concern was the study of the origin of money and the use of the precious metal. He gave a detailed description of the origin of money and enumerated the qualities of good money. In this respect, he was the forerunner of the later monetary theorists.

He defined trade and advocated protection of the merchant class against the oppressive practices of the King, which none of the thinkers before him ever thought.

3.4 SIGNIFICANCE OF THE PERIOD

Dear student! What did you learn from this period? What is the significance of the period to the development of economic thought? Please write your answer on the space provided below.

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Good! Notwithstanding its having been dubbed by historians as the 'Dark Age,' the period is of great significance in the evolution of economic thought. In simple statement, it can be concluded that the concept of value as being absolute and depending upon cost was prevalent during the Middle Ages. Economic decision making was outside the scope of individual action; that is, individual action was suppressed. This was incompatible with the development of economics as an analytic science. It was a period of transition. The influence of the church also declined and this resulted in the separation of economics from morals.

It was also found that a transition was made from an economy in which manufacturers and trade were looked down up on to one in which they were fostered; from one in which money was

despised to one in which it gained a dominant position. The whole economic philosophy of the Middle Ages might be summed up in the doctrine of 'just price,' which aimed at protecting both the buyer and borrower from exploitation by subjecting economic motives to ethical appraisal under a sort of system of rate regulation.

3.5 CHAPTER SUMMARY

- The period between 470Ad to 1453AD, covering about ten centuries is generally known as the medieval period or the middle ages. It is believed that during these years, economic thought has moved at very slow speed. Feudalism and the dominance of the church was the two characteristic feature of the medieval social structure which had cast and moulded the economic ideas of the middle age. The authoritative version of the medieval economic ideas is found in the works of St. Thomas Aquinas and Nicole Oresme.
- St. Thomas' view on all economic matters was highly influenced by Aristotle & Christianity. Aristotle's views were chiefly influential with regard to nature and function of money, the inequity of money, and the principles which should govern exchange. An important implication of Christianity is the principle that men are equal in the sight of God. The views of St. Thomas were therefore the admixture of the teachings of the Bible and the philosophy of Aristotle.
- The two cardinal economic doctrines of the middle ages are found in the notion of just price and the prohibition of usury. A just price is the price equivalent to that the producer needs to live according to his rank; that is a price that suitably supports the producer according to his rank. The concept of probation of usury was explicitly started in the Aristotle's period but has also borrowed ideas from the teachings of Christianity. In the words of St. Thomas, the offence of the usury may be expressed as: either he/she is selling something that doesn't exist; or, he/she is charging for the same thing twice; or if the lap of time is considered, he/she is selling time which belongs to God.
- Since the main consideration was that of justice, St Thomas underlined that both the borrower and the lenders should be viewed in relation to justice. Accordingly, the following four exceptions which provide for the possibilities of an extra payment, were made: damnum emergens, Lucrum Cessans, Poena Conventionalis, periculum sortis

- Another important representative of this period was Nicole Oresme. He gave a detailed description of the origin of money and enumerated the qualities of good money. In this respect, he was the forerunner of the later monetary theories.
- Notwithstanding its having been dubbed by historians as the 'Dark Age,' the period is of great significance in the evolution of economic thought. The concept of value as being absolute and depending upon cost was prevalent during the middle ages.

3.6 SELF TEST EXERCISE

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of the medieval economic thought. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1. Explain the major characteristic feature of the medieval economic thought.
2. What is just price? Explain.
3. How did Christianity affect the economic thought of St. Thomas Aquinas?
4. Which of Aquinas's economic thought is his lasting contribution to economic thought?
5. Evaluate the significance of Oresme's economic idea.
6. What are the justification of the medieval economic thinkers especially St. T. Aquinas to condemn usury?
7. What were the major amendments made on usury? What was the reason for the amendment? Did it really help to attain the objective?

CHAPTER FOUR: MERCANTILISM

4.1. INTRODUCTION

- **Overview:**

Dear student! In the preceding three chapters, we saw only the economic idea of different thinkers that belongs to different discipline. By then, there was no economic science and hence no economic professional. It was towards the beginning of the 15th century that definite sign of a growing science could be traced. Indeed, that period marked the beginning economic theorization. But, it took nearly three centuries for economics to come in to its proper shape. And, during these centuries, quite unlike the ancient and the medieval ages, the economic factor gained an upper hand in politics and in the formulation of state policies. The ideas that prevailed during this period have been grouped together and named as *mercantilism*.

In this chapter, we will briefly see the economic thoughts prevailing the period of mercantilism.

- **Chapter Objective:**

Dear student! Upon successful completion of this chapter you will be able to

- Define what mercantilism is and explain its essence;
- Understand the background mercantilism and factors giving rise to it;
- Know the period when mercantilism was dominant;
- Compare and contrast the economic thought of the mercantilism with that of the middle age and the ancient;
- Evaluate the relevance of mercantilism to the development of economic thoughts;
- Distinguish between economic ideas of mercantilists of different countries;
- Appreciate the depth of economic thoughts of the Middle Age.

- **Chapter Content:**

The remaining part of this chapter is organized as follows:

- Historical background of Mercantilism
- Period of Mercantilism
- Factors giving rise tom mercantilism
- Major tenets of mercantilism
- Colbertism and Cameralism
- Representatives of Mercantilism
- Evaluation of Mercantilism
- Chapter summary
- Self Test Exercise

4.2. HISTORICAL BACKGROUND OF MERCANTILISM

Dear student! Do you remember the socioeconomic conditions prevailing in the Middle Age? Please jot them down on the space provided.

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Good! Mercantilism was a revolt against the medieval ways of life. Some regard it as a battle against hampering medieval thought and practice during the middle ages.

In the middle age, warier classes gained strength and settled down as lords & vassals; and priest had been occupying a predominant position in the political, social and economic life of the period. But later, around the end of 14th c

- In the political sphere, the concept of national government (as opposed to local government) and absolute monarchy started gaining strength. That is why that mercantilism was regarded by some as an economic counterpart of political nationalism.
- In the economic sphere, trade and commerce began gaining importance and a new class, known as merchant was born.

The interest of both the monarch and the merchant, however, came to be identical. The monarch requires power and wealth, not only for himself but also for promoting the wealth & welfare of his subjects. To the king the wealth obtained from international trade was more important than the wealth acquired from the natural economy. To this purpose, trade was considered to be the best device. It breaks the barriers of localism. Hence, mercantilism was considered as the ideological justification of commercial capitalism.

4.3. PERIOD OF MERCANTILISM

Dear student! When do you think was Mercantilism dominant? What were its beginning and ending points? Please write your idea on the space provided below.

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Nice! Basically, mercantilism doesn't represent a period of time in history as in case of middle age. It is the view of people. Hence it is not easy to state with any definiteness the year or century in which mercantilism come in to existence and died out. However, we can refer to some events indicating the period where mercantilism is dominant. Politically, mercantilism grew with the rise of absolute monarchy and died out with its extinction. In its economic aspect, it developed with the growing importance of commerce and trade especially foreign trade.

Adam smith named mercantilism for the economic view which prevailed during the period falling roughly between the end of the middle ages and the beginning of the American Revolution. To sum up, mercantilist was dominant between 15th c – 18th c, from end of middle age to the first half of 18th.

4.4. FACTORS GIVING RISE TO MERCANTILISM:

Dear student! What do you think are the factors that give rise to mercantilism? Please, write your answer on the space provided below.

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Good! Theories of the past cannot be properly understood or their validity fairly estimated, unless they are taken in connection with the actual phenomenon that were at the time attracting attention and mould people's view. To understand properly the main tenets of mercantilism, it is necessary to study the social, economic, political cultural and scientific conditions and the changes that were taking place during the 13th & 14th C in Europe.

1. *Economic Factors*:

The period of middle age is superseded by the Renaissance. *Renaissance means age of reason, age of inquisitiveness*. Towards the end of 15th century, stupendous changes were taking place in the economic setup of the society.

In this period:

- Agriculture was yielding place to manufacturing economy;
- Internal as well as foreign trade were fast developing;
- Self sufficiency of the feudal system gave way to merchant capitalists;
- Feudalism as a method of organizing agricultural production was losing ground, due to modern changes in farming methods.
- the use of money was extending by laps and boundaries;
- The merchant capitalist become the key figure in the world of business;
- National states were rising and the most powerful of them acquire colonics and increase their sphere their shake commerce;
- Economic competition (rivalries) between states sates were intensified [the idea of justice which were seen in the period of the middle age were harshed. People want to get the benefit of the other and to become stronger than their neighbors);

In general, strong state (omnipotent state) was in demand and the mercantilists were concerned with the means where by the state could be made strong. It was a devise adopted by the nationalist states to consolidate and strengthen themselves. That is why some writers called it as "state making" on the economic side.

2. *Religious factors*

The supremacy of the Roman Catholic Church and the authority of the pope in religious and political matters which was explicit during the middle age becomes the fact of the past. Protestantism gives a more national meaning to Christianity and points out the importance of money, economic efforts and thrift in man's life as opposed Catholism which preached total detachment of man from material wants. The concepts of individual and personal freedom were also inherent in Protestantism.

3. *Cultural changes*

Culturally too, Europe has undergone a sharp change. The renaissance gave a new light and learning to the people. According to the teaching of the middle ages the miserable life on this earth was not to be the source of worry, as it will be compensated by the pleasures in heaven. But under the impact of the reformation and the renaissance, people were made to realize that this life was important than the life of the other world.

4. *Scientific and technological changes.*

In the field of science and technology, great advancement and invention were made which helped in strengthening mercantilist philosophies and policies. Among the major scientific and technological changes the following are evident:

- Innovation of printing press: This helped in the spread of new ideas and knowledge
- Innovation of mariner's compass made navigation easier which led to:
  - ✓ discovery of new continents: e.g. in 1492 Columbus discovered America
  - ✓ New route was discovered; e.g. 1498 – new see route to India
  - ✓ New market, great variety of raw material and a wider field of specialization
  - ✓ The great geographical discoveries expanded the sphere of commerce
  - ✓ the reduction of cost of transportation
- The discovery of gold in the western (American) hemisphere. This facilitated the increased volume of trade.

5. *Political Factors*

In political aspect, feudalism was replaced by nationalism which was itself superseded by absolute monarchy. The rise of a free labor class and the decay of feudalism led to the growing importance of the merchant. Do you know why importance of trade was emphasized? It is because it creates a favorable balance of trade so that enough money will be accumulated to maintain the standing armies of the monarch.

On the political environment, Niccolo Machiavelli and Jean Bodin had profound impacts on the development of mercantilist.

N. Machiavelli (1469- 1527) is an Italian political philosopher. In his book, *The Prince*, he advocated a centralized sovereign state (a strong prince). He wants to see a very strong state. His is known for his argument of "the end justifies the means". This means the end is more important than the means. If you achieve your end (objective), whatever way you go is correct. The implication is that the prince should do what he deems appropriate and end should be attained,

Jean Bodin (1530-1596), on the other hand, is French political philosopher. He argued that there should necessarily exist a supreme power in each state. It is necessary to have a supreme power that can achieve a strong state.

Both of them advocate centralized supreme power in a state. Consequently, *mercantilism is regarded as an economic equivalent of Machiavelli and Badin.*

4.5. MAJOR TENETS OF MERCANTILISM:

The main principles of mercantilism can be summarized as follows.

1. **Gold and Silver as the most desirable form of wealth.** Mercantilists tend to equate the wealth of a nation with the amount of gold and silver bullion it possessed. A few early mercantilists even believed that the precious metals were the only types of wealth worth pursuing. All of them value bullions as the means by which power and rich could be achieved
2. **Nationalism.** Mercantilists promoted nationalism. Nationalism was the pivot on which their main ideas were centered. In contrast to the theory of individualism, the emphasis was on the national strength & prosperity. Of course all countries could not

simultaneously enjoy a surplus of export. Therefore, one's own country should promote export and accumulate wealth at the expense of its neighbors. Only a powerful nation could capture and hold colonies, dominate trade routes, win wars against rivals and competes successfully in international trade. According to this static concept of economic life, there was a fixed quantity of economic resources in the world; one country could increase its resources only at the expense of another. Mercantilists' nationalism quite naturally leads to militarism; they want to see their country militarily strong. That is why mercantilism is regarded as the economic counterpart of political nationalism.

3. **Foreign trade as the only means for acquiring Gold and Silver**. Mercantilism considered foreign trade as the only means for acquiring Gold and Silver and hence the ordinary means to increase wealth & treasure. A surplus of exports from a country was, therefore, necessary if payments were to be received in hard money (bullion)
4. **Regulation of business.** Mercantilism favored a strong regulation of internal business. Mercantilist writers and practitioners recognized that tolls and taxes could throttle business enterprise and drive up the price of the country's exports. They advocate a grant of monopoly privileges to companies engaged in foreign trade. Free entry in to business at home was restricted in order to limit competition.
5. **Protectionism.** Mercantilism advocates duty-free importation of raw materials that could not be produced at home, protection of raw materials and manufactured goods that could be produced at home and export restriction on raw material. This emphasis on exports and reluctance to import has been called 'the fear of goods'. The interest of merchants took precedence over those of the domestic consumers. Merchants receive gold and silver for their exports that supposedly enhancing the country's wealth and power. Prohibition against the outward movement of raw materials helped keep the prices of finished exports low.
6. **Colonization and monopolization.** Merchant capitalist favored colonization and monopolization of colonial trade. They want the colonies eternally dependent upon subservient to the mother country. Any benefits that spilled over to the colonies from the home country's growth and military power were an accidental by-product of the policy of exploitation.

7. **Strong central government.** A strong central government was needed to achieve goals discussed previously: nationalism, protectionism, colonialism, and international trade. It is also needed ensure a uniform national regulation.
8. **Large and hard working population.** Mercantilists favored a large and rapidly increasing population. Not only would a sizable, industrious population provide an abundance of soldiers and sailors, but also it would keep labor supply high and wage, therefore, low. They believed that cheep and abundant supply of labor would help to compete successfully in the world market.

   The low wage would lower prices on export, and reduce idleness and promoting greater participation. Some of the mercantilist went even to the extent of advocating freedom of immigration and granting of equal rights to the immigrants mainly because this would bring wealth and enrich the country.

   Mercantilists need hard workers they don't want beggars & monks, priests and nuances. Idleness and begging by able-bodied people were dealt with mercilessly, and thievery was severely punished. Although mercantilism promoted wealth for the nation, it did not encourage wealth for the majority of its population.
9. **Multiple tax system:** Mercantilists approach taxation in a scientific way. They favored a multiple tax system based on the basic principle of each should pay according to the benefits received from the state.
10. **Intrinsic and extrinsic value:** In the Mercantilist literature, one comes across two types of value:

    Intrinsic value- depending on human needs and desires and the power of the commodity to satisfy human wants.

    Extrinsic Value- depending upon cost of production.

    Earlier writers regarded value as the intrinsic worth of a commodity (the subjective aspect-utility). The latter writers regarded value as an extrinsic phenomenon and called it artificial or exchange value.

With regard to interest, however, mercantilists did not agree. Some of them are justifying the charging of interest on the ground that money lending provided capital to the poor merchant. The others are opposing it on the ground that interest is unearned income. The fact, however, remains that the mercantilist writers were not clear about the function of money and capital.

Most of them were not able to understand the functional relationship between productivity of capital and interest.

4.6. COLBERTISM AND CAMERALISM

Mercantilism has been known by different names in different countries. It was known in France as Colbertism and in Germany as Cameralism.

Colbertism:

In France, Mercantilism was known as Colbertism following Jean Baptist Colbert (1619- 1683). Colbert was the heart and soul of French Mercantilism. He was the French Minister of Finance (1661-1668). He believed the importance of gold & silver and in favor of exports. He was an arch-nationalist and militarist. He favored government regulation of business.

Colbert favored large hard-working and poorly paid population. During his time, France had a rule that says 'if a man married in his child age, he is exempted from tax; if a father has more than 10 children, he is exempted from tax. Colbert wants France to be self-sufficient and free from foreign goods. He regarded *money as the only weapon for making the state powerful.*

Cameralism:

Cameralism is the German counterpart of mercantilism. Cameralism has slight difference from its France and Britain counterparts because at that time German was relatively poor. But the main idea is almost the same. The word camera refers to r*oyal treasure room.* As the name indicates the interest of Cameralism was to fill the royal treasure. The manse of filling it is by collecting more taxes (revenue).

Hence, Cameralists want to see prosperous/rich population and they want to see broad circulation of money and capital. They were in favor of dense population basically to get abundant labor supply, to get large military personnel and to collect more revenue. In relative term, Cameralists accorded less importance to balance of payment. They are not against positive balance of trade but it is not their primary objective – more importance to the royal revenue. That is, they want to get more revenue from internal resources; however they want to get revenue from surplus export.

4.7. REPRESENTATIVE MERCANTILIST WRITERS

Dear student! We shall now give in brief the views of some important mercantilist of different countries. What do you think is the need of studying this kind of view? Please write your idea on the space provided below.

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Great! As you might have said, it may help the reader in finding out the trend of thought in different countries and also in having a comparative idea of the mercantilist concepts and practices evolved in different parts of the world.

Some of the most influential writers of the mercantilist era includes: Philip. W. van Hornigk (1638-1712), Antonoi Serra (1580- 1650), Thomas Mun (1571-1641), J. B. Colbert (1619- 1683), Sir William Patty (1623- 1687) and Antoine de man Chrétien (1576- 1621- one who first used the term political economy in his work. "traicted demonic politique"

Among these, we will see the economic idea of the following thinkers.

i. W. von Hornigk (1638-1712)

Hornigk was born at Mainz in Austria and is, therefore, a representative mercantilist form Austria. He is a lawyer in profession. In 1684 he published a book *Austria above all, if only she will.*

The main points of his economic ideas are summarized as follows:

1. The most is to be made of a country's soil, not a lamp (a price) of earth is to be unconsidered.
    - Every form of plant is to be experimented and if possible gold and silver to be discovered.
    - If only there is a scarce of labor, they import labor: this implies that they were not interested in colonies.
2. Commodities have to be manufactured in the country. Recommendation to industrialize the economy.
3. Population is to be encouraged and people turned from idleness. They should be trained in various skills and activities.

4. Gold and Silver, once in the country, are under no circumstances to be hoarded but are to remain in circulation.
5. The inhabitants should get long with their own domestic products and do without forcing products as far as possible. Consumption of imported goods(especially luxury) should be avoided
6. When absolutely essential to obtain goods from the foreigners, they should be obtained in exchange for other wealth, and not by the payment of gold and silver.
    - Necessary imports should be paid in terms of exports & not in precious materials;
    - To get imports at minimum price, they should be purchased directly from the producing country rather than from intermediates.
7. No imports should be allowed whenever there is a sufficient supply of the related commodity in the country even if the home article is of inferior quality and of high price.

ii. Antonio Serra (1580-1650)

Serra is an Italian mercantilist. He expressed the importance of gold & silver by saying 'a very important country is the one which has gold & silver in abundance.' After expressing the importance of gold & silver, he found two sources for acquiring gold and silver.

1. *either a country has its own mines or*
2. *through collateral factors (other factors for acquiring gold & silver)*

His collateral factors include: quantity of industry, quality of the population, extensive trading operation, the regulations of the sovereign, geographical location of trading area, surplus of products in excess of needs.

Serra (and even all mercantilists) gives preference to industry over agriculture. This is because:

- In industry profits are certain (provided labor is expended) while in agriculture they are uncertain because the latter is governed by the conditions of weather.
- In industry production can always be multiplied manifold with less than proportionate increase in the cost of production
- The produce of industry can be presumed for longtime. It can be exported and retained till a better market is available but the agricultural output cannot be preserved for long (they are perishable).

Regarding the quality of production, he said that people of a country must be industrious and hard-working. They must be zealous and anxious to develop trade, domestic as well as foreign. Serra argued that if money is exported for whatever purpose, it must return with a profit in to the kingdom form which it was sent. By and large, Serra is an earliest Mercantilist devoted his attention to the importance of metals for a country and did not say anything regarding the balance of trade.

iii. Sir Thomas Mun (1571 – 1641)

Sir Thomas Mun was born in England. A merchant by profession, he was one of the most prominent writers of his time. Around 1630, Mun wrote his famous exposition of mercantilist doctrine in his book entitled 'England's Treasure by Foreign Trade.'
Mun's economic idea is briefly explained as follows.

On wealth: In relation to wealth, he proposed more realistic idea. He defers from those mercantilists who believe wealth is only gold and silver. He said, however, these are uncertain and of small considerations. He said, "Wealth of a country consists of those things which are needed for a civilized life."

On balance of Trade: he has clearly enunciated the theory of balance of trade. According to him, the fundamental rule of international trade should be to sell more to strangers than we consume of theirs in volume. Mun advocates accumulation of wealth (to some extent) to defend itself from foreign power & avert war. According to Mun, accumulation of wealth could be possible by chopping off the imports and encouraging exports. He did not favor the idea for accumulating money to a limitless extent for, he thought, it would result in high prices and ultimately affect the balance of trade adversely.

Mun suggested imposition of heavy import duties on goods meant for domestic consumption and moderate duties for goods meant for export. He does not want to allow all kinds of bounty and pomp to be avoided for he was afraid that if the English people do not use foreign commodities then who would purchase theirs? But he finally restates and come back to the idea of the surplus balance of trade as an important source of money.

iv. Sir William Petty (1623-1687)

Petty was a mercantilist who offered some new ideas that foreshadowed classical economics. He was regarded as the founder of political Economy by Marx. Before he was sixteen, Petty had mastered Latin, Greek, French, mathematics, astronomy, and navigation. The son of a poor clothier, he achieved great wealth, fame, and honor. During his busy life, Petty was a sailor, a physician, a professor of anatomy, an inventor, a surveyor, a member of Parliament, a promoter of iron and copper works, an experimental shipbuilder, an author, a statistician, and a large landowner. We shall first discuss Petty's mercantilist views and then those of his ideas that anticipated Adam Smith's.

His Mercantilist Views:

Petty favored freer foreign trade than many of the mercantilists, partly because he felt it would circumvent the widespread smuggling that was occurring. He wanted imported goods taxed so that they "may be made somewhat dearer than the same things grown, or made at home, if the same be feasible." Imports of raw materials ought to be lightly taxed.

As did other mercantilists, Petty favored a large population. But Petty based his position on the concept of increasing returns to government, which would reduce unit costs of governing a larger population.

Petty felt that those out of work should be employed by the state working on roads, dredging rivers, planting trees, building bridges, mining minerals, and manufacturing various goods. In this sense, he was a predecessor to those contemporary economists who advocate public service employment to reduce structural and cyclical unemployment. How would these public works be financed? For Petty, it was by taxes. Because people were concerned with their relative incomes as compared with their neighbors', a proportional tax would not matter so long as the money was spent within the country.

Petty as a Forerunner of Classical Economics:

Petty was a pioneer statistician. Instead of using only comparative and superlative words, and intellectual arguments, petty favored expressing ideas in terms of numbers. Today, statistical analysis is a significant feature of the discipline of economics.

Petty stated in fragmented form several other ideas that classical economists later developed in detail. These included the notion of velocity, the division of labor, rent as the surplus from land, the importance of capital goods, and a labor theory of value. Let's briefly examine each.

- *Velocity:* Petty recognized that the velocity of circulation (the rate at which money changes hands) can be as important as the quantity of money. If payments are made weekly rather than quarterly, less money will do the same work.
- *Division of labor:* Although not developing this idea in detail. Petty recognized the economies associated with the specialization of labor and division of tasks. For instance, he stated that "cloth must be cheaper when one cards, another spins, and another weaves . . . than when all the operations above were clumsily performed by the same hand." Adam Smith later discussed and developed this idea in great depth.
- *Rent theory.* Petty arrived at a primitive theory of rent. He said, rent is the surplus from land. This was an advance in economic thinking. But, Petty did not separate the return to capital from the return to land—an error easy to commit in the 1600s when capital investments in tools and fertilizer were insignificant. Nor did he show rent to be a differential return arising at the extensive and intensive margin of cultivation. But, Petty did realize that land near the market yielded a higher rent because the cost of transporting the produce was lower.
- *Importance of capital.* Petty emphasized on the importance of capital in production which would increasingly become appropriate with the emergence of the industrial revolution in the 1700s.
- *Labor theory of value.* According to Petty, labor is the father, and lands the mother, of wealth. He argued that the value of a bushel of corn will be equal to that of an ounce of silver if the labor necessary to produce each is the same.

4.8. EVALUATION OF MERCANTILISTS

Dear student! From the discussions made above, what do you conclude about mercantilism? Can we say it is a scientific outlook? Please write your comment on the space provided below.

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Nice! As you might have said, there were strengths and weakness that can be shortly summarized as follows.

- Mercantilism was not a scientific system of thought because a scientific outlook is said to exist when conclusions are not modified and arguments are not twisted to suit certain objectives. Cameralists come much near to this goal, but mercantilists do not pass this test in many ways.
- British mercantilists were mainly philosophers and men of political affairs – they emphasize a large dense population, abundant money and foreign trade with a surplus balance.
- Their science of economics is yet in state formation
- Each mercantilist was covering only a limited number of problems by inadequate understanding of the economic phenomenon
- It is argued that all countries cannot have a surplus balance simultaneously – This is true of course, but the mercantilists were never interested in viewing this issue from the global point of view. *They are accused of a static approach in which gain of one state could be only at the loss of the other*.
- They were not clear about the relationship between money, price & demand. They had a rudimentary idea of quantity theory of money, and were finding that increased quantity of money led to higher price.
- They believed that money was needed for expanding commerce and trade (even if money was not wealth itself, the fact which some of them realize).
- Being trader in outlook, they need adequate funds for expanding trade activity without caring much for inflationary activities. They said, "if increasing price raised profits, it was not a step against welfare of the poor but a step for the good of trade and industry."
- Mercantilism was both a dynamic and illogical system.

  Dynamic: - successive writers took note of the changing circumstances and advance the analytical framework and policy prescriptions.

  Illogical: - because it still bears a static outlook.
- Mercantilism was not an academic system and, therefore, we should not expect a pure scientific approach in its treatment. It was bound to exhibit an imperfect understanding of economic phenomena and contradictions here and there. But it had an immense practical value & quite a few lessons may be learnt from it even now.

- As an economic policy mercantilist system lacked universal application and as a body of doctrine it could not provide right guidance to the statesmen of the time.
- They laid too much stress on gold & silver and neglected the importance of other commodities. They confused the means & the ends by over emphasizing the importance of bullion as if it had such great magic power as to make it the only worthy end of national policy.
- They exaggerated the importance of commerce and undermine the usefulness of agriculture and other branches of human industry.
- They erred in believing that a favorable balance of trade was the only source for bringing prosperity to the country.
- Their belief that the gain of one nation was necessarily the loss of another was erroneous as shall be elucidated by Ricardo and Smith later.
- Their ideas regarding value and utility were vague & abstruse.
- Their ideas about capital and interest were imperfect.

Broadly, Mercantilists are grouped in to Bullionists and Mercantilism Proper.

Bullionists: are early mercantilists. They were against imported goods and inputs because their aim is to accumulate bullions, and import leads to a decrease of bullions.

Mercantilism proper: are the later period mercantilists. They improved international trade in that if there is no input in the home, they have to import.

✓ Mercantilists' views world resources are limited. They do not understand the development of technology. This is a static approach. They argued that we can get prosperous and the expense of others. They did not think mutual benefit (advantage).

→ Since their theory hadn't universal application, we could not consider them as economic thinkers (pure economists). T*hey are more practical people.*

4.9. CHAPTER SUMMARY

- Mercantilism was a revolt against the medieval ways of life. Basically, mercantilism doesn't represent a period of time in history as in case of middle age. But mercantilist was dominant between 15th c – 18th c, from end of middle age to the first half of 18th.
- The social, economic, political cultural and scientific conditions and the changes that were taking place during the 13th & 14th C in Europe were the main factors that gave rise to mercantilism.
- Because of their influence on the political environment, mercantilism is regarded as an economic equivalent of Machlarelli and Badin.
- The main principles of mercantilism includes: consideration of gold and silver as the most desirable form of wealth' advocacy to nationalism, consideration of foreign trade as the only means for acquiring gold and silver, advocacy to regulation of business, protectionism, advocacy to colonization and monopolization, preference to strong central government, large and hard working population, recommendation to multiple tax system, and distinction between intrinsic and extrinsic value.
- Mercantilism has been known by different names in different countries. In France, it was known as Colbertism; in Germany it was known as Cameralism.
- Broadly, Mercantilists are grouped in to Bullionists and Mercantilism Proper.

4.10. SELF TEST EXERCISE

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of the Mercantilism. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1. Why are mercantilist sometimes referred to as bullionists?
2. Why did mercantilist favor large populations and low wages? How does the mercantilist position in this issue relate to income and substitution effects of a wage rate increase?
3. What advantage did Petty ascribe to large populations?
4. What does the term fear of goods as it relates to international good?

5. In what respect did Petty's economic analysis extend beyond the typical mercantilist views?
6. Compare and contrast modern arguments for protectionism with those of the mercantilist era?
7. Who did the mercantilism benefited or seek to benefit?
8. Which tenet of mercantilism becoming lasting contribution?
9. Critically evaluate the significance of each of the following mercantilist to the development of modern economic thought:
    a. N. Machiavelli
    b. Jean Bodin
    c. Philip. W. van Hornigk
    d. Antonoi Serra
    e. Thomas Mun
    f. J. B. Colbert
    g. Sir William Patty

CHAPTER FIVE: THE PHYSIOCRATIC SCHOOL

5.1. INTRODUCTION

- **Overview:**

Dear student! In the previous chapter we have discussed the economic thoughts of the mercantilist period. As you may recall, mercantilists largely favored positive balance of trade and the only form of wealth is gold and silver. In this chapter, I will introduce you with a new school of thought called Physiocracy. Physiocracy is the collective name of those economic principles and policies which developed during the 18th c. Economic thinkers who contributed to the growth & development of Physiocracy have been designated as physiocrats. After presenting an overview of the school, we will examine the economic contributions of the most prominent physiocrats.

- **Chapter Objective:**

Dear Student! Upon successful completion of this chapter you will be able to

- Understand the economic thought of the physiocratic school;
- Point out the major tents of the physiocratic school;
- Compare and contrast the economic thought of different physiocrats
- Compare and contrast the economic thought of the physiocratic school with the recent thoughts;
- Evaluate the relevance of physiocratic economic thoughts to the modern thoughts;
- Appreciate the depth of economic thoughts of the physiocratic school.

- **Chapter Content:**

The remaining part of this chapter is organized as follows:

- Historical background Physiocracy
- Factors responsible for the rise of Physiocracy
- Major tenets of the physiocratic school
- Representatives of the physiocratic school
- Evaluation of the physiocratic school
- Chapter Summary
- Self Test Exercise

5.2. HISTORICAL BACKGROUND OF PHYSIOCRACY

Dear student! When did this new economic thought emerge? And when did it end? Please, write your idea on the space provided below.

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Good! Physiocrats appeared in France during the end of the Mercantilist epoch. Adam Smith refers to this system as the agricultural system in contrast with the mercantilist system[8]. This term emphasizes the fact that while to the mercantilists the primary source of national wealth was international trade to the Physiocrats it was essentially agriculture. While to the mercantilists a surplus balance of trade and the state power was the end objective, to the Physiocrats, agriculture was only an important plank which provided the source of surplus.

The beginning of this school can be dated at 1756 when Quesnay published his first article on Economics in the *Grand encyclopedia*. The school may be said to have ended in 1776 with the

[8] The Physiocrats preferred to be (or called themselves) Economists. But posterity has agreed to call them Physiocrats. Physiocracy was marked the rise of first school of economic thought (although some writer wrote mercantilist as a school. In reality it was not a school because it has no universal applicability).

publications of Smith's *Wealth of Nations* and the downfall of Turgot from his high office. (Turgot himself was a physiorat).

Dear student, is Physiocracy a continuation of mercantilism? Not really! Physiocracy was not just a furthering and refinement (or continuation) of the mercantilist doctrine nor a modification of it. It was basically a reaction against mercantilism and was offering an alternative political and social system. Mercantilism was characterized by all sorts of restriction, controls and regulations. In contrast to that physiocrats were claiming to be a natural system based up on belief that there existed natural laws based up on a belief that there existed natural laws which ought to be followed for stability and all round benefits. Mercantilism could not claim to be coherent and integrated system. It was fragmentary and emphasized on foreign trade; Physiocracy, on the other hand, was a complete system in spite of its emphasis on agriculture as the source of 'surplus.' Their interest was in a complete system and its healthy working.

5.3. FACTORS GIVING RISE TO PHYSIOCRACY

Dear student! How did the new economic thought emerge? What were the then socio-economic conditions? Please write your answer on the space provided below.

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Good! Physiocracy had its root in the then existing socio economic conditions of France which were chiefly the result of mercantilist policies. In reality, Mercantilism did not provide any practical solution for the practical problem aroused. That was the base for the foundation of Physiocrats. Although it longs shorter, Physiocracy had won great acceptance since it gave new idea which they think is to be applied all over the world. A number of factors were responsible for its origin. These include:

i. The stagnation of French economy

The forces of regulation which had been adopted under Colbertism had exhausted their resourcefulness and there was a need to rejuvenate the economy. Despite its being predominant source of income in the country under the set of restrictions trade and industry had somewhat

gained upper hand at the expense of agriculture. Agriculture was in a state of stagnation as compared with its increasing usefulness and profitability in England.

In general, agriculture was in wretched (miserable) condition and the agricultural workers bore a heavy burden of tax. Accordingly, the then new thinking (Physiocracy) was being increasingly focused on the revival of the economy. It is claimed that just as mercantilism was reflecting the aspirations and interest of the growing commercial capitalists in France, it was the emergence of capitalist agriculture which provided the basis of the new philosophy.

ii. The Degeneration of the court

France experienced a degenerated and corrupt court life. The king was the center about which everything in the state revolved. He believed in the authoritarian maxim '*I am the state*' and himself led an extremely luxuries life. The life of the political administrators from the king down wards was very luxurious and corrupt. Public expenditure was extravagant and wasteful. Loans and taxes were the two chief sources of revenues. But the money was used to the service of few people belonging to the upper most strata of society.

- ✓ Physiocracy was the direct outcome of the *miserable condition in France* which was also responsible to the rise of French revolution.

iii. Heavy taxes

The result of the very extravagant and wasteful public expenditure was an increasing indebtedness of the government and the need to levy extra taxes to finance the public expenditure (or to replenish state treasure).

But the taxes were inequitable and unjust. The nobility and clergy owned about two third of the countries land, but they were hardly paying any taxes, while the poor peasants were being crushed under heavy tax. Taxes were regressive in character. Besides, the tax was being imposed arbitrarily and irrationally. There were several types of taxes but none of them were rational in modern sense of taxation principle. Furthermore, the manner of collecting these taxes was the worst feature. Under the law the farmers were required to pay taxes at fixed price, but these 'farmers of the revenues' as they were called collected over and above that amount and pocketed (two third of it) themselves.

5.4. MAJOR TENETS OF THE PHYSIOCRATIC SCHOOL

Dear student! What do you think are the main concept of the Physiocratic school? Please write your answer on the space provided below?

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Great! The concept of the Physiocratic school may be summarized as follows

Natural Order: The physiocrats introduced the idea of natural order to economic thinking. The term physiocrat itself means 'rule of nature'. According to this idea, laws of nature govern human societies such as those discovered by Newton govern the physical world. All human activities, therefore, should be brought into harmony with these natural laws. The objective of all scientific study was to discover the laws to which all the phenomenon of the universe were subject. In the economic sphere, the laws of nature conferred to individuals the natural right to enjoy the fruits of their own labor, provided that such enjoyment was consistent with the rights of others.

According to physiocrats, human society is thus subject to two kinds of laws: the natural laws (*Lois naturales*) and the positive laws (*Lois Positives*). *The Natural Law* has been defined by the physiocrats as the providential order decreed by God for the welfare of mankind. It is a universal and unchangeable. *Positive laws* are of human origin. They are essentially subordinate and should only be introduced in so far as they are in conformity with the natural law.
According to the Physiocrats, the natural order reveals itself through the principles of private property and individual liberty. The institution of private property, according to the Physiocrats, is the fundamental institution on which all other institution of the society depends. The most important natural right is the right to provide private property.

Laissez-faire, Laissez-passer: This phrase, credited to Vincent de Gournay (1715-1756), in effect means 'let people do as they please without government interference.' Governments should never extend their interference in economic affairs beyond the minimum absolutely essential to protect life and property and to maintain freedom of contract. The physiocrats were

opposed almost to all feudal, mercantilist and government restrictions, favoring freedom of business enterprise at home and free trade abroad.

Emphasis on agriculture: The physiocratic thought that industry, trade and the professions were useful but sterile, simply reproducing the value consumed in the form of raw materials and subsistence for the workers. Only agriculture (and possibly mining) was productive, because it produced a surplus, a net product above the value of the resources used in production.

Surplus product as source of wealth: Physiocrats differed from the mercantilists on the *form and source* of wealth. For the Physiocrats, a product was not the creation of utility; it was surplus making. Though it appears that the realization of net product was somehow connected with the market valuation of the produce, to the physiocrats surplus meant primarily a material surplus. To them the origin of wealth lay in agriculture and this wealth consisted of real produce. *Net product is defined as the excess of wealth produced over and above what is required to product it*. In the Physiocratic system, *agriculture was considered as the only sector which yields net products or surplus produce*.

In commerce, nothing is produced but only transfers the already produced commodities from one hand to another. In industry too, the artisans simply combine or modify the raw materials and produce no surplus wealth. *In industry and commerce, wealth produced exactly equals wealth consumed.* Consequently, the physiatrists finally believed in the idea that "Labor applied anywhere except to land is absolutely sterile, for man is not a creator".

In Physiocrats thought, it is not clear whether the quality of producing surplus applied also to extractive industries or not. It appears that the physiocrats themselves were not sure of their ground here. From agriculture and fisheries there could result repeated surplus with each operation but the same could not be said in a very definitive manner with regard to mines and there were very few but contradicting references to the same. According, to Turgot, mines could not yield a net product, because while land produces repeatedly, from a mine we only take up something which is already stored there.

Taxation of the land owner: Physiocrats thought that because only agriculture produced a surplus, which the landowner received in the form of rent, only the landowner should be taxed.

All taxes imposed on others would be passed on to the landowners anyway. A direct tax on landowner was preferable to indirect taxes, which increased as they were passed along to others.

Interrelatedness of the economy: Quesnay in particular and the physiocrats in general, analyzed the circular flow of goods and money within the economy.

5.5. REPRESENTATIVES OF THE PHYSIOCRATIC SCHOOL

Dear student! We shall now introduce you with some important physiocrats and their contribution to economic thought. Who do you think are these individuals? Please put you answer on the space provided below.

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Good! Of course, there are many physiocrats but below are some of the most influential writers of the physiocrats.

i. Francois Quesnay (1964-1774)

Quesnay, the son of a land proprietor, was the founder and leader of the physiocratic school. Trained to be physician, he made a fortune through his skill in medicine and surgery. Quesnay rose to be the court physician of Louis XV and Madame de Pompadour. In 1750, he met Gournay and soon become more interested in economics than in medicine.

The most important contribution of Quesnay to Economic science is his development of the concept of the general circulation of wealth in an economy. In this regard, Physiocracy is the first School of Economics that analyzed, in a systematic way, the general circulation of wealth in an economy.

The credit of putting the whole idea in a very systematic and coherent form goes to *Quesnay*.

To Quesnay, society was analogous to the physical organism. The circulation of wealth and goods in the economy was like the circulation of blood in the body. Both could be confirmed to the natural order and both could be understood through a thoughtful analysis. Quesnay presented this circular flow of wealth in the ***Tableau Economique*** in 1758. It immediately

caused an unprecedented applause and was hailed as the biggest land mark in the development of economics.

The Tableau Economique

Quesnay's Tableau Economique began with distinguishing between three important social classes of the society: the proprietors, the cultivators, and the sterile class.

The proprietors of land: They account for less than a quarter of the population. This includes: the landowners, the king & his councilors, the nobility & the clergy, and other landed properties of the realm. Thus, this class includes not only the landed proprietors proper but also anyone who had any title or feudal right. These landed people were parasites who lived on the net product arising from agriculture. Under the production relations assumed by the Physiocrats, the peasants had to surrender whatever surplus they got to these people in the form of rent.

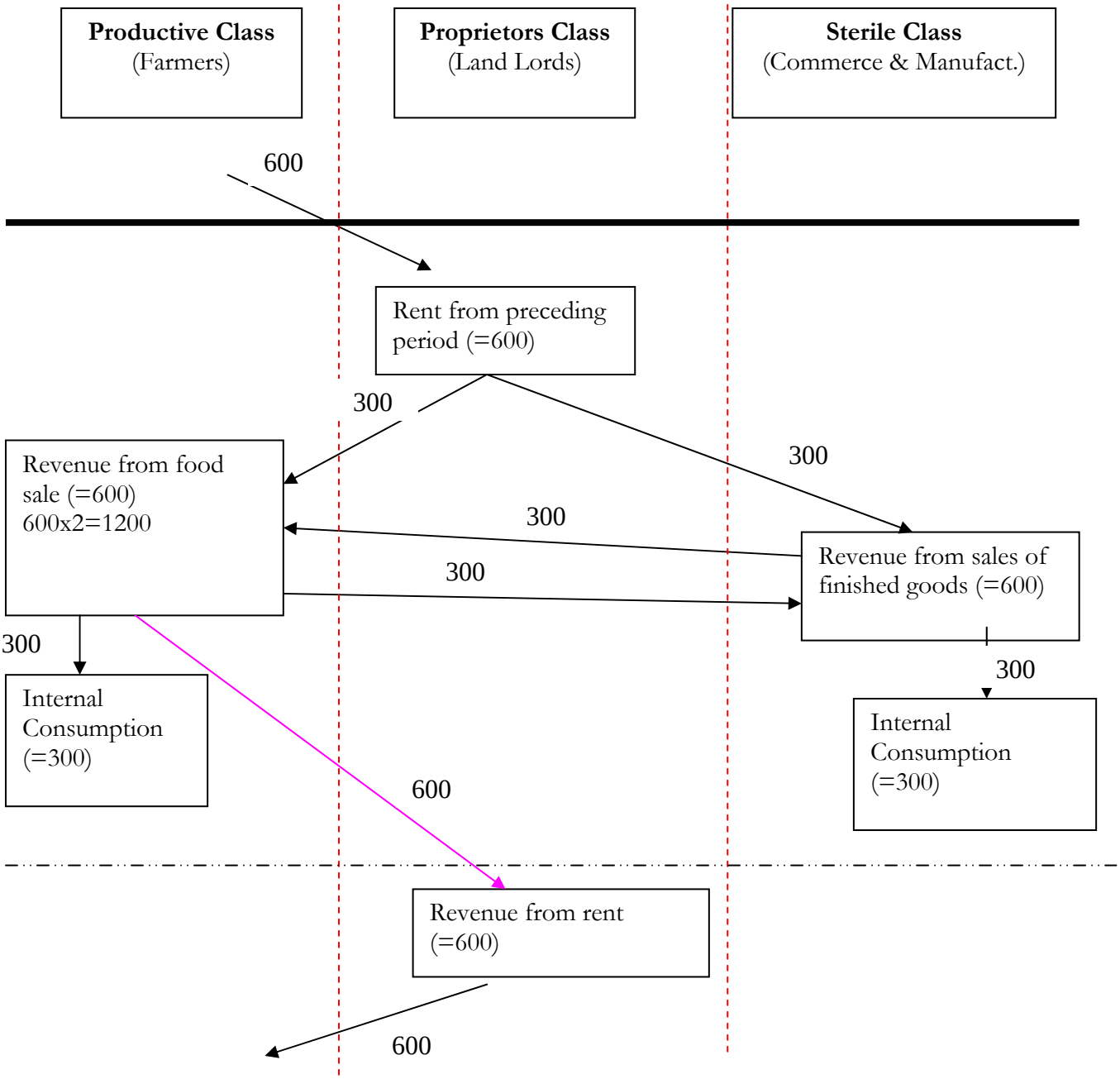
The cultivators: They were just the farmers and the laborers. They do not own the land but they form about half of the population. This category was the only one which was productive in the sense of getting surplus over and above the inputs in their operation. (But we don't know whether this category includes fishery and mining or not).

The sterile class: This includes artisans, manufactures and merchants, craftsman, shopkeeper and traffickers.

The general idea conveyed by the Tableau Economique is that the proprietors of land contribute to production by expenses on improvement of land and by advanced to maintain the cultivators. The cultivators, in turn, are able to produce a surplus over and above all these expenses. This is the net product which goes to the landowners by way of rent. Of these receipts, the land owners may and should make fresh annual advances to the cultivators which would enable them to produce a similar net product next year also. It is obvious that if the landowners fail to return these annual advances, agricultural production will fall and there will be a reduction in the net income also. The landowners divide their rent income by spending it on industrial goods and agricultural produce (or food). The industry similarly divides its expenditure on food and raw materials from agriculture and up on the expenditure within the industrial sector. Agricultural sector supplies food to the land owners, and raw material to the industry, and obtains finished industrial goods from industry. In this way year after year the circular flow is maintained.

Since the Table runs in terms of financial flows, it would be helpful to recount the argument in terms of the figures given in the Table itself. (See Table-1 below)

Table 1: Quesnay's Tableau Economique



Note: the figures in the table refer to the society that has 3 million families of four people each. The standard monetary unit in France was 'livre' and the figures are in million

The Summary end picture may be presented as follows.

1) ***Landowners*** :

   Receipt: 600 million livres in the form of rent

   Expenditure: - on food 300 million livres

   - on industrial goods 300 million livres

2) ***Industry*** :

   Receipt: -from agriculture on account of sales of finished good -300 million livres

   - from land owners on account of sales of finished goods 300 Million livres

   Expenditure: - on food & raw materials from agriculture -300 million Livres

   - within the industrial sector itself -300 million

3) ***Agricultural sector*** :

   Receipt; - from landowners for sale of food. 300 million livres

   - within the industrial sector it self – 300 million livres

   Expenditure: - payment to Land owners in the form of rent – 600 million livres

   - payment to industrial sector for finished goods-300 million livres

   - food consumption-300 million livres

Evaluation of the Theory of Circulation:

Dear student! What are the weaknesses and strengthes of the Tableau Economique? Please write your answer on the space provided below.

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Good! As you might have said, the tableau has many strengths and weaknesses. Below are the main conclusions of the evaluation of the Tableau Economique.

1. The Physiocratic treatment of the circulation of wealth is based up on a particular type of society and cannot be said to be a theory of universal application. It has a feudal setup in which the land owners and cultivators are two clear cut classes. Thus, their reasoning would not apply to another society in which the cultivator themselves own the land.
   - ⇨ They were assuming a capitalist agriculture in which the land owners were interested in securing the maximum possible of land and subjected the cultivators to only a

subsistence living. Thus, the Physiocrats were assuming a social setup which need not be adopted by every society

2. The Physiocrats are not able to justify the grounds up on which the landowners appropriate the net product instead of the cultivations doing so. (Accepting the existence of private property is one thing allowing the appropriation of the net product is another). Landowners receive 40% of national income.

   Quesnay made injustice saying manufacturers sterile (but not to Land lords) despite their effort in producing goods and services. Furthermore, the Physiocrats, instead of criticizing the existence and unethical exploitation of land-owners, praise them; i. e the title of sterile class applied to the manufacturing class is not extended to them in a direct manner.
3. The whole treatment is in a static setup where everything churns round year after year and the same facts are repeated every time. Eventualities like – the failure of crops, the failure of landowners in providing the annual advances, changes in market prices, changes in natural calamities, etc were not considered.
4. Their assumption that labor was not the creator of wealth is not a realistic assumption. Quesnay said, it is not labor that produce surplus but nature. With this, he tries to prove that of natural order. From the table, it is evident that surplus always goes to the land lords. This is because the surplus comes from land and this surplus should go to the land lords.
5. Quesney argued that tax should be collected only from the land lords because the surplus has gone to them through rent. Furthermore, the Tableau is telling the government not to take more rent than the surplus produced by farmers; i.e. rent should equal to surplus
6. The scheme of circulation of wealth covers only three classes, namely the landowners, the farmers and the industrial and trading classes. It leaves out a government sector. Although the government follows a *laissez faire* poly, still it has some functions to perform & need tax revenue for its performance.

Despite all these limitations, Physiocratic theory of circulation of wealth made a solid contribution to the development of economic thought. It must be remembered that it was the first ever attempt of a comprehensive description of the whole economy and in which the interdependence of different sectors was clearly demonstrated.

ii. *Jacques Turgot* (1721- 1781)

Anne Robert Jacques Turgot was born of a noble family of Normandy that for several generations had furnished the state with able administrative officials. He was the financial advisor for Louis XIV as Quesnay was court physician. Turgot rose in the ranks of government service until he became the Finance Minister in 1774; this had been Colbert's office one hundred years ago.

Immediately after two years of his ministerial office, Turgot introduced several new measures: freedom of internal grain trade was introduced; guilds and privileged trading; corporations were abolished; a tax that all landowners had to pay was enacted; etc. Finally, the king dismissed Turgot because of the protests of the court and other powerful people who were losing privileges following his policies.

Turgot, like other physiocrats, believed in an enlightened absolutism, and he looked to the king to carry through all reforms. Obviously, Turgot and the other physiocrats had their roots in the old feudalistic regime of France; they were reformers rather than revolutionaries. But the reactionary French regime could not tolerate their reforms.

In his 'Reflection on the Formation and Distribution of theRriches' written in 1766, Turgot, developed a theory of wages in which he held that competition among workers lowers the wage to the minimum subsistence level. This was an early statement of what was latter called the 'iron law of wage'. He was an advocate of free trade and direct tax on landowners.

Turgot's economic contribution in the realm of economic thought was in correctly presenting the law of diminishing returns. *It never can be imagined,* he said that, *a doubling of expenditure in agriculture will double the product.*

5.6. EVALUATION OF PHYSIOCRATS

Dear student! From the discussions held above about the physiocratic school, what lesson did you take? How do you evaluate the contribution of this school to the development of economic thought? Please, write your answer on the space provided below.

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Good! Please compare your own evaluation with the summary of the evaluation of the physiocratic school given below.

1. The Physiocrats are credited for their famous doctrine of "***laissez fair-laissez passer***" which was principally directed to attack the protectionist principle of mercantilists. It was also an attack on the greater government action of mercantilists. (laissez faire, laissez-passer means let everything go on its way and let everything pass/flow)

   The first man who utters this principle was Vincent de Gournay (1712-1959). He was a Physiocrat. The Physiocrats underlined that the positive law should not go beyond the point of protection against invasion and of routine administration. =>positive law should have a limit.
2. The search for the natural order led the Physiocrats to the adoration of agriculture. For the Physiocrats, agriculture alone produces the wealth of a nation. In contrast to the mercantilists view that wealth is only that of gold & silver, for Physiocrats, agriculture is the productive activity while all other occupations, although necessary, are unproductive and sterile.

   "Agriculture," Quesnay said, "is the source of all the wealth of the state and the wealth of all the citizens". "Everything that is disadvantageous to agriculture is prejudicial to the nation, and everything that favors agriculture is profitable to the state and the nation" The Physiocratic accentuation of the importance of agriculture was a reflection of the needs of France at the time, and a reaction against mercantilism which stressed the importance of commerce and manufacturing. Mercantilists were bitterly affected by Physiocrats.
3. Quesnay has developed his famous "Tableau Economique" where he showed the circular flow of goods in an economy. The Tableau Economique they present was the first systematic analysis of the flow of wealth on what later come to be called a microeconomic

basis. Economists such as Smith, Marx and Keynes who favored the description of economic activities in terms of large aggregate paid tribute to Quesnay for originating this approach. The attitude of physiatrist towards Quinsy's masterpiece (i.e. his Tableau Economique) is one of the extravagant adoration. In the eyes of Marquis and Mirabeau, Tableau Economique is one of the three great discoveries of our planet. These were:

1. *invention of writings*- which alone gives human nature the power of transmitting laws, its counteracts, its annals and its discoveries
2. *invention of money* –which binds together all the relation between civilized societies
3. *Economic tableau* – which completes them both by perfecting their object

To this effect Mirabu said 'it is the great discovery of our age, but of which our posterity will reap the benefits.'

4. They distinguished between wealth and money. For them wealth is not equivalent to money. It consists of real production. This is an improvement over the mercantilist's position. To mercantilism, the objective of the country's economic policy was to have a surplus of trade balance; to the Physiocrats, it was the creation of the net product and its efficient circulation. But it was a half truth to say that only land yielded wealth. These wrong premises led them to advocate a single direct tax on net product of land. The reasoning of this conclusion (namely, tax will finally come out of only some surplus) was correct but being based up on wrong premises led to the erroneous prescription that there should only be a single tax. Industry trades were considered necessary but not productive.
5. Physiocrats viewed the economic system in its totality. They were able to demonstrate the interaction between different sectors of the economy. The health of one sector could not be guaranteed without the corresponding health of the other. This approach was a major advancement in the field of macroeconomics. It also provided a basis for the input-output analysis.
6. Their philosophy of natural order and laissez faire pointed towards obsolescence of mercantilists' restriction and the response of economic thinking to the changing economic restrictions.
7. In the process of offering an alternative economic system, they laid the foundation for a systematic economic thought. Above all, we find that the Physiocrats put economics on scientific footings. In spite of some contradictions here & there, their methods of analysis were scientific and they succeeded in separating the science of economics from other

disciplines. To them production was not the creation of utility but appeared to be a find of "creation" of matter.

8. They were not able to make substantial contributions towards the theories of value and price, or money and interest.
9. Their reverences for the institution of private property and the feudal set-up puts them in the category of those who would be indifferent to the welfare of the common mass and who would justify an exploitation by the renter class of the working class.

5.7. CHAPTER SUMMARY

- The term Physiocracy emphasizes the fact that while to the mercantilists the primary source of national wealth was international trade, to the Physiocrats, it was essentially agriculture. While to the mercantilists a surplus balance of trade and the state power was the end objective, to the Physiocrats, agriculture was only an important plank which provided the source of surplus. The beginning of this school can be dated at 1756 when Quesnay published his *Tableau Economique* and ended in 1776 with the publications of Smith's *Wealth of Nations*.
- Physiocracy was not just a furthering and refinements (or continuation) of the mercantilist doctrine nor a modification of it. It was basically a reaction against mercantilism and was offering an alternative political and social system.
- A number of factors were responsible for its origin. These include: The stagnation of French economy, the degeneration of the court, and imposition of heavy taxes on poor peasants
- The physiocrats introduced the idea of natural order to economic thinking. The term physiocrat itself means 'rule of nature'. They were opposed almost to all feudal, mercantilist and government restrictions, favoring freedom of business enterprise at home and free trade abroad-Laissez faire-Laissez passer . To them the origin of wealth lay in agriculture and this wealth consisted of real produce. Net product is defined as the excess of wealth produced over and above what is required to product it. In the Physiocratic system, agriculture was considered as the only sector which yields net products or surplus produce.
- Physiocrats thought that because only agriculture produced a surplus, which the landowner received in the form of rent, only the landowner should be taxed.

- Quesnay was the founder and leader of the physiocratic school. The most important contribution of Quesnay to Economic science is his development of the concept of the general circulation of wealth in an economy.
- Quesnay's Tableau Economique began with distinguishing between three important social classes of the society: the proprietors, the cultivators, and the sterile class.

5.8. SELF TEST EXERCISE

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of the Physiocratic school. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1. When did the physiocratic school begin? When did it end? Why was the school short-lived?
2. In what respects was the physiocratic school a reaction to mercantilism? Why did it develop in France?
3. Briefly summarize the key elements of Quesnay's *Tableau Economique*?
4. What sector of the economy did physiocrats favor? Why? What was the implication for the tax policy?
5. Discuss the major shortcomings and contributions of physiocratic thought?
6. Compare and contrast the doctrines of physiocrats with those of mercantilists.
7. Explain the physiocratic concept of *Net product*.

CHAPTER SIX: CLASSICAL SCHOOL

6.1. INTRODUCTION

- **Overview:**

Dear student! In our discussion so far, we have seen the major tenets of two schools of thoughts: Mercantilism and Physiocracy. As you may realize soon, these are the stepping-stones to the preparation of the work which in scope and content became the point of departure for all who followed. The body of doctrines which held sway in England during 100 years after the decline of Physiocracy is named as Classicism. In this chapter we introduce you with a very organized and scientific school of economic thought known as Classical School. We first provide you with an overview of the school and then introduce with the major representatives of the school.

- **Chapter Objective:**

Dear Student! Up on successful completion of this chapter you will be able to:

- Understand the background of the classical school.
- Understand causes of classicism
- Know the main arguments of the school
- Distinguish between the forerunners, founders and decendents of the classical school.
- Be exposed to the economic thoughts of the major representatives of the school.
- Evaluate the lasting contribution of the school to the contemporary economic thought

- **Chapter Content:**

Dear Reader! The remaining part of this chapter is organized as follows.

- Background of the school
- Period of classicism
- Factors giving rise to classicism
- Forerunners of the classical school
- Founders of the classical school.
- Other representatives of the classical school
- Chapter Summary
- Self Test Exercise

6.2. BACKGROUND OF THE SCHOOL

Dear student! Do you know the historical background of the classical school? Please write your answer on the space provided below.

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Great! Classical economics is widely regarded as the first modern school of economic thought. Classical economists attempted and partially succeeded to explain economic growth and development. They produced their "magnificent dynamics" during a period in which capitalism was emerging from a past feudal society and in which the industrial revolution was leading to vast changes in society. These changes also raised the question of how a society could be organized around a system in which every individual sought his or her own (monetary) gain. Classical economists reoriented economics away from an analysis of the ruler's personal interests to a class-based interest.

6.3. PERIOD OF CLASSICISM

Dear student! When do you think was the classical doctrine so dominant? Please write your answer on the space provided below.

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Great! When did it begin and end? The term classical economics was applied to a school of economic thought that began with Adam Smith's writing of *The Wealth of Nations* in 1776. More specifically, it refers to the economic writings of the period from Adam Smith to John Stuart Mill, which is roughly from 1750 to 1850. Interestingly enough, the creator of the term was Marx, and it was further perpetuated by John Maynard Keynes in his General Theory. The classical school of economic thought was the dominant school of thought until the time of the great depression. The school was active into the mid-19th century and was followed by neoclassical economics in Britain beginning around 1870.

6.4. FACTORS GIVING RISE TO CLASSICISM

Dear student! What were the factors that gave rise to the classical school? Please write your answer on the space provided below.

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Great! Two 'revolutions', one relatively mature and the other just beginning, were of particular significance to classical economic thought.

i. **The Scientific Revolution:** in the last quarter of 17th c, Isaac Newton (1642-1727) greatly advanced Kepler's earlier scientific laws of planetary motion and Galileo's mathematical laws of the movement of bodies on earth. This revolution in science, associated particularly to Newton, popularized the already existing idea that the universe is governed by natural laws. This had its own impact on the ideas of the classical school. According to the classicists, the lingering feudal institutions and the restrictive controls of mercantilism were no longer necessary. For them Newtonian science furnished a nature fully as effective as the earlier will

of God. If the Divine will had created a mechanism that worked harmoniously and automatically without interference, then Laissez-faire was the highest form of wisdom in social affairs. Natural laws would guide the economic system and the action of people.

These ideas were revolutionary in their time. No longer would people unquestioningly accept ancient truths, such as that interest is sinful or people inherited their station in life.

ii. **The Industrial Revolution:** In the same quarter, industrial revolution is just beginning, but it intensified over the period in which the latter classical economists wrote. Both the industrial revolution and classical political economy developed first in England. In 17th c, England trailed Holland in commerce but lagged behind France in manufacturing. But, by the middle of 18th c, England gained supremacy in both commerce and industry. England stood to benefit from international trade. As English entrepreneurs became stronger, they no longer had to rely on government subsidies, monopoly privileges, and tariff protections. As a result, many mercantilist practices were breaking down under the upsurge of business activities that were spreading in every direction. This growth of industry led to increased emphasis on the industrial aspect of economic life on current thinking.

6.5. MAJOR TENETS OF CLASSICISM

Dear student! What do you think are the main point of the classical school? Please write your answer on the space provided below.

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Good! Please, compare your answer with the explanation given below.

Classical doctrine is frequently called economic liberalism. Its bases are personal liberty, private property, individual initiative, private enterprise, and minimal government interference. The term *liberalism* should be considered in its historical context: Classical ideas were liberal in contrast to feudal and mercantilist restrictions on choice of occupations, land transfers, trade, and so forth. It is a testament to historical change that today we might call a person who advocates economic liberalism a "conservative."

The major features of this body of thought can be summarized as follows. A fuller development of these notions appears throughout the next several sub-topics.

Minimal government involvement: The first principle of the classical school was that the best government governs the least. The forces of the free, competitive market would guide production, exchange, and distribution. The economy was held to be self-adjusting and tending toward full employment without government intervention. Government activity should be confined to enforcing property rights, providing for the national defense, and providing public education.

Self-interested economic behavior: The classical economists assumed that self-interested behavior is basic to human nature. Producers and merchants provided goods and services out of a desire to make profits; workers offered their labor services to obtain wages, and consumers purchased products as a way to satisfy their wants.

Harmony of interests: With the important exception of Ricardo, the classicists emphasized the natural harmony of interest in a market economy. By pursuing their own individual interests, people served the best interests of society.

Importance of all economic resources and activities: The classicists pointed out that all economic resources (such as land, labor, capital, and entrepreneurial ability) as well as all economic activities (such as agriculture, commerce, production, and international exchange) contribute to a nation's wealth. The mercantilists had said that wealth was derived from commerce; the physiocrats had viewed land and agriculture as the source of all wealth.

Economic laws: The classical school made tremendous contributions to economics by focusing its analysis upon explicit economic theories or "laws." Examples include the law of comparative advantage, the law of diminishing returns, the Malthusian theory of population, the law of markets (Say's law), the Ricardian theory of rent, the quantity theory of money, and the labor theory of value. The classicists believed that the laws of economics are universal and immutable.

6.6. FORERUNNERS/PRECURSORS OF THE CLASSICAL SCHOOLS

Dear student! Who do you think are the first people that gave the first insight to the doctrine of the classical school? Please, write your answer on the space provided below.

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Great! As you might have said, there were many people who directly and indirectly contribute to the rise of classism. But a remarkable contribution is made by the following two great thinkers of the 17th c.

i. Richard Cantilon (1680-1734)

His Biography:

Richard Cantillon (1680?-1734) was born in Ireland. He spent many years in Paris, becoming a wealthy banker and a successful speculator in stocks and foreign currencies. In 1734 Cantillon was robbed and murdered and his house was set a fire, probably by a cook he had dismissed ten days earlier.

Richard Cantillon, acknowledged by many historians as the first great economic "theorist", is an obscure character. His only book, *Essai sur la 'Nature du Commerce en General,* was written between 1730 and 1734 and published in French in 1755. Cantillon himself may have translated it from his English manuscript, which was never found. Although his work was well-known to the Physiocrats and the French school, Cantillon fell into obscurity in the English-speaking world until resurrected and popularized by William Stanley Jevons in the 1880s.

Indeed, the origins of economic theory itself can be traced to CantilIon. William Stanley Jevons, one of the cofounders of the marginalist revolution, and the economist who is generally credited with rediscovering Cantillon, called the *Essai"* a systematic and connected treatise, going over in a concise manner nearly the whole field of economics.

His Economic Ideas:

Cantitlon predated the physiocrats in two ways. First, he used the term *entrepreneur* and emphasized the role of this figure in economic life. Business people, Cantillon said, commit themselves to definite payments in expectation of uncertain receipts; this risk taking is remunerated by profit, which competition tends to reduce to the normal value of the entrepreneurs' services. Second, writing a generation before Quesnay constructed his *Tableau Economique.* Cantillon stated:

Cash is therefore necessary, not only for the Rent of the Landlord . . . but also for the City merchandise consumed in the Country. . . . The circulation of this money takes place when the Landlords spend in detail in the City the rents which the Farmers have paid them in lump sums, and when the Entrepreneurs of the Cities, Butchers, Bakers, Brewers, etc. collect little by little this same money to buy from the Farmers in lump sums Cattle, Wheat, Barley, etc.

Cantillon developed a theory of value and price. His emphasis on the role of land and labor, on supply and demand, and on the fluctuations of price around intrinsic value makes him a direct forerunner of classical economics.

Cantillon anticipated classical economic thought in several other ways. For example, he stated, "Men multiply like Mice in a barn if they have unlimited means of subsistence." The classical economist Thomas Malthus held a similar view. Also, Cantillon analyzed interest as a reward for the risk taken in lending, based on profits that the entrepreneurs can make by borrowing and investing.

In addition, Cantillon focused on the productivity of a nation's resources. He regretted that both nobles and monks did not work to produce goods. Furthermore, Cantillon said, in Catholic countries there are too many holydays, "which diminish the labor of the People by about an eight part of the year."

With one foot in the mercantilist camp, Cantillon opted for a surplus of exports is being good for business. But he did not believe that gold and silver mined at home would serve the same purpose. His emphasis was on the production of goods and their sale abroad, so that business

would flourish. But he believed that an export surplus could not be maintained indefinitely; subsequent events would wipe it out. Cantillon's analysis of the forces that prevent a perpetual export surplus and his emphasis on the sale of goods rather than on the accumulation of gold came close to classical thinking.

Cantillon held that the discovery and exploitation of rich mines of gold and silver would raise domestic prices, rents, and wages. These increased costs would in turn promote imports to the detriment of domestic workers and manufacturers because money would now out of the country. *"The great circulation of Money, which was general at the beginning, ceases; poverty and misery follow and the labour of the Mines appears to be only to the advantage of those employed upon them and the Foreigners who profit thereby."* But if the increase in money comes from a surplus of exports of goods, it enriches merchants and entrepreneurs and gives employment to workers. However, as money flows into the country and business prospers, consumption and prices rise, spending on imported luxury items grows, and the export surplus dwindles. The state begins to lose some branches of its profitable trade, and workers leave the country.

Cantillon was perhaps the first to define long-run equilibrium as the balance of *flows of income*, thus setting the foundations both for Physiocracy as well as Classical Political Economy. Cantillon's system was clear and simple and absolutely path-breaking. He developed a two-sector general equilibrium system from which he obtained a theory of price (determined by costs of production) and a theory of output (determined by factor inputs and technology).

Cantillon's careful description of a supply-and-demand mechanism for the determination of short-run market price (albeit not long-run natural price) also stand him as a progenitor of the Marginalist Revolution[9]. In particular, his insightful notes on entrepreneurship (as a type of arbitrage) have made him a darling of the modern Austrian School[10]. Cantillon was also one of the first (and among the clearest) articulators of the Quantity Theory of Money and attempted to provide much of the reasoning behind it.

Finally, one of the consequences of his theory was that he arrived at a quasi-Mercantilist policy conclusion for a favorable balance of trade but with a twist: Cantillon recommended the

[9] To be discussed in chapter 8
[10] To be discussed in chapter 8

importation of "land-based products" and the exporting of "non-land-based" products as a way of increasing national wealth.

Generally, The *Essai* is considered influential for the development of both the Physiocrats and the classical economists and Cantillon was one of the very few people mentioned by Adam Smith in the *Wealth of Nations*.

Unfortunately, Smith misrepresented Cantillon's work. Both Cantillon and his *Essai* were largely forgotten during the period of classical economics. The true significance of the *Essai* was gleaned by the French economists A.R.J. Turgot and J.B. Say, who were important precursors to the modern Austrian School. Since his rediscovery during the marginalist revolution, a substantial body of literature has grown up in appreciation of Cantillon and a number of mysteries surrounding him and the *Essai* have been solved. Most importantly, the Scottish philosopher and tax collector Adam Smith should no longer be considered the father of economics. That title now belongs to the Irish entrepreneur and Austrian economist, Richard Cantillon.

Notice that there is no reliance on natural law or the automatic reestablishment of equilibrium here! It is David Hume who takes this line of reasoning a step further.

ii. David Hume (1711-1776)

His Biography:

David Hume (1711-1776) was born in Scotland twelve years before his fellow national and friend, Adam Smith. Hume entered the University of Edinburgh at the age of twelve and left at fifteen without taking a degree. Later, eminent as a philosopher, Hume was twice refused a chair in philosophy at Edinburgh because of his skeptical spirit and unorthodox thinking.

Hume was one of the most prominent figures of the Scottish Enlightenment and a close friend of Adam Smith. In fact Adam Smith was once nearly expelled from Oxford University because a copy of Hume's '*A Treatise of Human Nature*' was found in his room.

Hume was one of the greatest philosophers in Western history, as well as an accomplished historian, economist, perennial skeptic and delightful fellow. His fame as a historian derived from his multivolume *History of England,* which went through numerous editions; his reputation as an economist was established by his economic essays in *Political Discourses,* published in 1752. Of all the forerunners of classical economics, Hume came closest to the ideas of Smith. Had he written a complete and systematic treatise on economics, he would have ranked near the top as one of the founders of the science.

His Economic Ideas:

Hume's contributions to economics are found mostly in his '*Political Discourses* (1752),' which were later incorporated into his *Essays* (1758).

On wealth: Hume was a virulent anti-Mercantilist. He was adamant that wealth was measured by the stock of commodities of a nation, not its stock of money.

On theory of Money: He was also one of the better articulators of the Quantity Theory and the neutrality of money ("It is none of the wheels of trade: it is the oil which renders the motion of the wheels more smooth and easy", *Of Money*, 1752). Contrary to the Mercantilists, Hume related low interest rates not to abundant money, but to booming commerce. He was one of the first to spell out the "loanable funds" theory of interest, arguing that interest rates are determined by the demand for loans and the supply of saving. Low interest rates are thus symptoms of a booming, commercial economy, where thrift and the desire for gain and accumulation take hold. However, he admitted that *in the short-run* (and only the short-run), a rising supply of money could have a beneficial effect on industry.

On International Trade: Hume's most famous contributions are in international trade. In "Of the Jealousy of Trade" (1758), Hume disputed the mercantilist concept that trading states are rivals, with one gaining only at the expense of the other. In the parlance of modern game theory, Hume argued that international trade is a positive sum game, one in which the payoffs sum to a positive number. This is to be contrasted to the zero-sum of the mercantilists, where the gain to one party is exactly offset by the loss of the other.

On Equilibrium Price: Hume's greatest contribution as an economist was in presenting what has since been called the *price specie-flow mechanism*. Of course he is the one who have introduced the automatic "price-specie flow" mechanism and the "reflux principle". Its basic argument was to deny the old Mercantilist policy proposition that the inflow of gold specie into a nation could be accomplished by manipulating the external trade balance. The mercantilists wanted to promote a surplus of exports in order to accumulate specie. In the somber view of Cantillon, this tactic was self-defeating because if more specie were available, prices would go up and imports would increase. But, to pay for the imports, money would be shipped abroad, leaving poverty and bankruptcy behind; therefore, the government should prevent an excess of money. The physiocrats were basically unconcerned with foreign trade, except that they wished to permit the free flow of grain abroad. But Hume, who like Cantillon accepted John Locke's quantity' theory of money (the price level is determined by the quantity of money available, given the velocity and quantity of output), argued that the inflow of specie would, lead to a rise in domestic prices, thereby changing the terms of trade against the recipient nation. The demand for its exports abroad would consequently decline, and its own demand for foreign imports would increase, thereby reversing the external trade balance so that specie now would flow back out. Hume also used this logic to deny the idea that rises in prices can be blamed on rising wages. Specifically, if there was a wage-induced rise in the price level in England, the terms of trade between England and other nations would change in a manner detrimental to English exports and favorable to the imports from other nations. This would thereby induce an outflow of money from England , and thus a reduction in England's money stock which would bring the price level in England back down.

Hume analyzed the mechanism of international equilibrium that would operate without government intervention and conclude that Laissez-faire could prevail with happy results.

On Natural Laws: Hume's automatic flow mechanism of international trade lent credence to the idea that there was a "natural balance" of trade between nations with deliberate policy moves could not contradict. But Hume was not a believer of the "natural law" or "social contract" theories popular with contemporary political and social philosophers. He was a thorough empiricist in both his political and philosophical work.

Hume did not believe these price-level adjustments (either upward or downward) would occur instantaneously. He argued that price-level changes initially would lag behind the changes in money. For a time an increase in money would boost spending, production, and employment. But eventually the influx of money would be fully absorbed as an increase in the price level. Likewise a decrease in the supply of money would first depress spending, output, and employment before it lowered the price level.

On exchange rate: Hume explicitly states the effect of imports and exports on the domestic currency exchange rate. If a nation, say England, imports more than it exports, eventually it will experience a decline in the value of its currency relative to others. Why is this so? The reason for the depreciation in the pound relative to the currencies of other nations is that England needs more foreign currency to finance its imports than it is earning through its sales abroad. This shortage of foreign currencies will drive up their prices; that is, the pound price of foreign currencies will rise. This means that the pound depreciates while other world currencies appreciate. British goods therefore are cheaper to other nations, and consequently British exports rise. And because foreign goods are now more expensive (a pound will buy less of them), England reduces its imports. The initial net import surplus in England vanishes.

On the concept of Price Elasticity: Hume showed an awareness of the concept of price elasticity of demand, which was not formally incorporated in to economic analysis until far later. You may recall that this idea concerns the responsiveness of buyers of a product to changes in price. Hume said that if duties on wine are lowered, the government will collect *more* revenue, apparently assuming that the increase in revenue from greater sales abroad will exceed the loss of revenue from the lower price per unit.

On taxes: In a letter to Turgot in 1766, Hume opposed the physiocratic idea that taxes imposed on workers get passed on to the landowner in the form of higher wages and reduced rent. Wages of labor depend, he said, on the supply of and demand for labor, not on taxes. When a tax is laid on the products that workers consume, the immediate consequence is that these people consume less or work more; the tax is not simply passed on to *the* landowner.

6.7. MAJOR REPRESENTATIVES/ FOUNDERS OF THE CLASSICAL SCHOOL

Dear student! Who do you think are the founders of the classical school? Please, write your answer on the space provided below.

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Great! Again there were dozens of great philosophers that contributed to the development of the classical school. But a remarkable contribution is made by the following three great thinkers of the time.

i. Adam Smith (1723-1790)

His Biography:

Adam Smith, the kindly, brilliant founder of the classical school, was born in the sea port and manufacturing town of Kirkcaldy, Scotland. His father, comptroller of customs in the town, died before his son was born. Margaret Douglas Smith provided a home for her son until her death in 1784 in her ninetieth year. Young Smith attended Glasgow College at fourteen years of age; he later studied moral and political science and languages at Balliol College, Oxford. He then returned to his mother's home to continue independent study for two years. After that Smith moved to Edinburgh, where he gave lectures on rhetoric and literature. He was elected professor of logic at Glasgow College in 1751, and in the following year he was given the chair of moral philosophy, which he held for nearly twelve years. In 1759 he published *The Theory of Moral Sentiments,* after which his lectures concentrated less on ethical doctrines and more on Jurisprudence and political economy.

Smith spent more than two years with his charge in France, where he established close personal friendships with the physiocrats, including Quesnay and Turgot. In 1776 Smith published *An Inquiry into the Nature and Causes of the Wealth of Nations,* which he had begun in France ten years earlier. Its fame was immediate, and it established Smith's reputation forever.

After the publication of his book. Smith spent two years in London, where he mingled with the leading intellectuals of the day. Then, on being appointed commissioner of customs in Scotland, he went to live in Edinburgh with his mother. Shortly before he died in 1790 most of his unpublished manuscripts were destroyed according to his wish and without explanation.

Important Influences:

Dear student! What do you think were the major influences that shaped Smith's thought? Please write your answer on the space provided below.

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Well! There were several key influences on Smith's thinking. First and perhaps foremost was the general intellectual climate of his time. This was the period known as the *Enlightenment*. This intellectual movement was built upon two pillars: people's reasoning ability and the concept of the natural order. (Please, recall the two important revolutions that took place in the last quarter of 18th c.)

Second, Smith was influenced by the physiocrats, particularly Quesnay and Turgot. He praised the physiocratic system 'with all its imperfections' as 'perhaps the nearest approximation to the truth that has yet been published on the subject of Political Economy.' The physiocrats' attack on mercantilism and their proposals to remove trade barriers won his admiration. From these thinkers he drew the theme of wealth as 'the consumable goods annually reproduced by the labor of society', the desirability of minimal government interference in the economy, and the concept of the circular process of production and distribution. He had planned to dedicate his *Wealth of Nations* to Quesnay, had the latter lived until the book was completed.

Third, Smith was influenced by his instructor at Glasgow College-Francis Hutcheson. Hutcheson felt that people themselves could discover what is ethically good-the will of God-by discovering the actions that serve the good of humankind.

Finally, Smith was influenced by his friend David Hume, who through his letters and personal conversations contributed to Smith's intellectual development and economic ideas.

His Major Works:

His two main works are *The Theory of Moral Sentiments* and *An Inquiry Into the Nature and Causes of the Wealth of Nations*. Adam Smith's chief contribution was to build a coherent and logical theory of how the economy works. The elements of Smith's theory were mostly already available in the writings of earlier writers. However, in these writings good ideas co-existed alongside numerous other useless theories. Somebody had to figure out which theories were useful and which were useless and combine the useful theories into a consistent and persuasive overall theory that we can reliably use to think about society. This is what Smith did. For this he is called the father of economics.

Theory of Moral Sentiments. This work was an argument against the views of writers such as Hobbes and Rousseau who argued that the pursuit of self-interest, an important human instinct, inevitably leads to a cruel and nightmarish society. Smith argued that as people are able to imagine what others are going through, they are able to empathize with the sufferings of others. When the experiences of others are felt as our own experience, our instinctive pursuit of self-interest can lead us to pursue the interests of those others. So, it is perfectly consistent to believe that human beings pursue self-interest *and* are generous towards others.

Sometimes our *passions* cause us to do bad things. And our instinctive tendency to defend ourselves even when we do bad things leads to a *bias* that prevents us from seeing that we did something wrong. This problem is partially corrected by the wide acceptance of *moral rules* in a society. When the moral rules are clear-cut, a misdeed may so clearly violate a moral rule that it might be impossible even for the perpetrator to deny the misdeed.

Of course, even moral rules may not be enough, in which case laws and the enforcement of those laws would be necessary to keep society together. However, unlike Hobbes and Rousseau, Smith did not believe that without a structure of laws society would inevitable descend to chaos.

Moreover, apart from the human ability to empathize with the sorrows of others, the sheer practicality of peace-the fact that we realize that it is necessary for prosperity-may be enough to encourage the good.

The Wealth of Nations: Smith's 900-page economic treatise, *An Inquiry into the Nature and Causes of the Wealth of Nations,* appeared in 1776, the year of the American Revolution. This was the book that established him as one of the premier economic thinkers in the history of economic thought. The whole of smith's economic thought is found in this book. The insights contained in the therefore require careful scrutiny.

The Theory of Moral Sentiments was published seventeen years before *Wealth of Nations*. It went through six editions during Smith's lifetime, the last in the final year of his life, so it cannot be said that this book represented only his earlier ideas and *Wealth of Nations* his later ideas. The books stand side by side, presenting different but complementary facets of his thinking. *Moral Sentiments* discussed the moral forces that restrain selfishness and bind people together in a workable society; *Wealth of Nations* assumed the existence of a just society and showed how the individual is guided and limited by economic forces.

Both *Moral Sentiments* and *Wealth of Nations* reconcile the individual with the social interest through the principle of the invisible hand, or natural harmony, and the principle of natural liberty of the individual, or the right to justice. In *Moral Sentiments,* sympathy and benevolence restrain selfishness; in *Wealth of Nations,* competition channels economic self-interest toward the social good.

His Economic Ideas:

On Division of Labor: The first chapter of *Wealth of Nations is* titled 'Of the Division of Labor', an unfamiliar phrase in Smith's time. The first sentence reads as follows: 'The greatest improvement in the productive powers of labor, and the greater part of the skill, dexterity, and judgment with which it is any where directed or applied, seem to have been the effects of the division of labor.'

The division of labor, said Smith, increases the quantity of output produced for three reasons. First, each worker develops increased dexterity in performing a single task repeatedly. Second, time is saved if the worker need not go from one kind of work to another. Third, machinery can be invented to increase productivity once tasks have been simplified and made routine through the division of labor.

Dear student! Do you remember the main concern of mercantilist and physiocrats? Please, write it precisely on the space provided below.

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Great! They are concerned mainly with the exchange of goods and on agricultural output, respectively. By beginning his book with a discussion of how the same number of workers could produce substantially more output by dividing their labor, Smith immediately made it clear that *Wealth of' Nations* was a break from the prominent economic notions then in existence.

On Invisible Hand: Smith pointed out that participants in the economy tend to pursue their own personal interests. The person of business pursues profit: *'It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.'* The consumer looks to find the lowest price for a good, given its quality. The worker tries to find the highest pay, given the non-wage aspects of the job. But hidden within the apparent chaos of economic activity is a natural order. There is an invisible hand that channels self-interested behavior in such a way that the social good emerges.

The key to understanding Smith's invisible hand is the concept of competition. The action of each producer or merchant who is attempting to earn profit is restrained by the other producers or merchants who are likewise attempting to make money. Competition drives down the prices of goods and in so doing reduces the profit received by each seller. In situations in which there is initially only a single seller, extraordinary profit attracts new competitors who increase supply and erase the excessive profit. In an analogous way, employers compete with one another for the best workers, workers compete with each other for the best jobs, and consumers compete with one another for the right to consume products. Stated in contemporary economic terms, the result is that resources get allocated to their highest valued uses; economic efficiency prevails. Furthermore, because businesspersons save and invest-again out of their self-interest, capital accumulates and the economy grows. The pursuit of self-interest, restrained by competition, thus tends to produce Smith's social good (maximum output and economic growth.)

On the Role of Government: This harmony of interests implies that interference by government into the economy is unneeded and undesirable. According to Smith, governments are wasteful, corrupt, inefficient, and the grantors of monopoly privileges to the detriment of the society as a whole. Smith extended his belief in the harmony of interest and laissez-faire to international trade: *'The wealth of neighboring nation--- is certainly advantage in trade.'*

It is tempting to label Smith as an advocate of laissez-faire; we have seen his dislike for government involvement in the economy. But unlike some of the more extreme advocates of that view, Smith did see a significant, albeit limited, role for the state. Specifically, he saw three major functions of government: (1) to protect society from foreign attack, (2) to establish the administration of Justice, and (3) to erect and maintain the public works and institutions that private entrepreneurs cannot undertake profitably.

On Taxes: To finance the aforementioned government activities, Smith recommended taxation. His four maxims for good taxes are as follows: First, taxes should be proportional to the revenue enjoyed under the protection of the state. This was a drastic departure from the regressive taxes prevalent at the time. Second, taxes should be predictable and uniform as to the time of payment, the manner of payment, and the amount to be paid. Third, taxes should be levied at the time and in the manner most convenient to the contributor. Finally, taxes should be collected at minimum cost to the government.

In International Trade: Smith pointed out how foreign trade can promote greater division of labor by overcoming the narrowness of the home market. Exports also remove surplus products for which there is no demand at home and bring back products for which there is domestic demand. Smith also condemned bounties(subsidies) on export.

In a direct attack on mercantilism, Smith argued that government should not interfere in international trade. Nations like individuals and private firms, should specialize in producing goods for which they have an advantage and trade for goods for which other nations have an advantage.

For Smith, international trade was based on differences in absolute cost, everybody buying in the cheapest market. Smith's absolute cost difference can be illustrated as follows:

Let both England and Portugal are producing wine and cloth. The costs of production in the two countries are given below.

Table: Hours of labor necessary to produce a unit of wealth			
Country	**Wine**	**Cloth**	**Domestic Barter Rate**
Portugal	100	50	1W:2C
England	50	100	2C:1W

For Adam Smith, trade between two countries will occur only if each country has an absolute cost advantage over the other in at least one commodity. In the above example, England has an absolute cost advantage in wine and Portugal in cloth. Hence, England will specialize in wine and export it to Portugal because Portugal is willing to pay a price greater than what it costs in England. Similarly, Portugal will specialize in cloth and export it to England because England can pay a higher price than Portugal's domestic barter rate.

On Value: In a statement in which he poses the "water-diamond paradox," Smith observed that there are two kinds of value: the one may be called "value in use," the other, "value in exchange." He said:

> *The things which have the greatest value in use have frequently little or no value in exchange; those which have the greatest value in exchange have frequently little or no use value. Nothing is more useful than water: but it will purchase scarce anything; scarce anything can be had in exchange for it. A diamond, on the contrary, has scarce any value in use; but a very great quantity of other goods may frequently be had in exchange for it.*

Smith did not solve the paradox of value. Smith directed his attention toward exchange value, the power that the possession of a commodity provides to purchase other goods. This, according to Smith, is its "natural" price. The question of what determines the exchange value of a good, or simply its relative price, has been one of the central interests of economists since the market economy developed. Posed differently by later economists, "Do goods have value because people dive for them, or do people dive for goods because goods have value?" Smith basically answered that goods have value because people need to dive to get them; that is, that the costs of production determine a good's exchange value or relative price.

Smith examined the problem of value in a primitive and an advanced economy. He defined the former as "an early and rude'" state in which labor is the only scarce resource (capital and land are either non-existent or are free goods) and the latter as a state in which capital had accumulated (in which both capital and land commanded a positive price.)

Labor theory of value in a primitive society: Smith argued that in a society in which labor was the only resource, the relative value of a good would be determined by the amount of labor necessary to produce it. This is an elaboration of the "labor cost theory of value" first presented by Petty. On the other hand, again according to Smith, the value of any commodity to a person who possesses it, *if he wishes to exchange it for other commodities,* "is equal to the quantity of labor which it enables him to purchase or command. Labor, therefore, is the real measure of the exchangeable value of all commodities." This version of Smith's value theory sometimes is referred to as his "labor commanded theory of value." In a primitive economy, according to Smith, labor is both the source (labor cost theory) and the measure (labor commanded theory) of exchange value.

Value theory in an advanced economy. Smith realized that the growth of capital would invalidate a simple labor cost theory of value. In a society where capital Investments and land resources become important, said Smith, goods will normally be exchanged for other goods, for money, or for labor at a figure high enough to cover wages, rent, and profits. Moreover, profits will depend on the whole value of the capital advanced by the employer. The real value of commodities can no longer be measured by the labor contained in them. They still, however, can be measured by "the quantity of labor which they can, each of them, purchase or command." The quantity of labor that a commodity can buy exceeds the quantity of labor embodied in its production by the total profits and rents.

Demand, according to Smith, does not influence the value of commodities; the cost of production -wages, rent, and profits - are the only determinants of value in the long run.

On Market Price: Like Cantillon, Smith distinguished between the intrinsic or natural price of a good and its short-run market price.

N*atural price* is the long-run price below which the entrepreneurs no longer would continue to sell their goods. According to Smith, there are ordinary, or average, rates of wages, rent, and profit in every society or neighborhood. He called these the natural rates of each. When a

commodity is sold for its natural price, there will be exactly enough revenue to pay these natural rates of wages, rent, and profit. In a desperate situation they would sell goods more cheaply, but this would not continue. They could always go out of business or enter another line of production.

Market price is the actual price at which any commodity is sold. It may be above, below, or exactly the same as its natural price. The market price depends on the aberrations of short-run supply and demand, and it will tend to fluctuate around the natural price. Restated, short-run supply and demand are not fundamental determinants of prices (exchange values), but instead simply cause fluctuations in market prices around the natural prices or values of commodities.
Smith also distinguished between the real price of a product and its money, or nominal price. Here he was simply echoing Hume and others by pointing out that increases in the stock of money in the society can cause the money price of products and resources to rise.

On Wage: Smith addressed three facets of wages: the aggregate level of wages, the growth of wages over time, and the wage structure. With respect to the first two, he employed *the wages fund theory*. The wages fund idea implies that there is a stock of circulating capital out of which present wages are paid. This stock consists of the savings of the capitalists and is dependent on the revenue from previous production and sales. Consequently this fund is fixed in the short run, but it can be increased from one year to the next.

$$Average\,annual\,wage = \frac{Wages\ fund}{Number\,of\ laborers}$$

As seen in equation above, the average annual wage depends on the size of the wages fund in relation to the number of laborers.
The minimum rate of wages must be that which will enable a worker with a family to survive and perpetuate the labor supply. But when the demand for labor rises, wages will rise above this minimum. The rate of increase of national wealth determines the demand for labor and the wage by influencing the size of the wages fund. This explains Smith's emphasis on capital accumulation and economic growth. Smith commended the rise of wages that accompanied economic growth, thus opposing the *low wage doctrine* of mercantilism. According to smith *no society can surely be nourishing and happy, of which the far greater part of the members are poor and miserable.*

Furthermore, Smith said that high wages increase the health and strength of the workers, animating them to do their best work because high wages give hope for an improved life. In contemporary terms, this concept is known as *economies of high wages,* or *efficiency wages.*

Smith also recognized that bargaining plays a role in the process through which wages are determined. He also argued that the advantages and disadvantages of every type of employment would be equal or tend towards equality. Under this theory of "equalizing differences," or what contemporary economists call *compensating wage differentials,* actual wage rates for different jobs-the wage structure-would vary according to five factors: *agreeableness of the occupation, cost of acquiring the necessary skills and knowledge, regularity of employment, level of trust and responsibility, probability or improbability of success.*

On Profit: According to Smith, because every investment is exposed to the risk of loss, the lowest rate of profit must be high enough to compensate for such losses and still leave a surplus for the entrepreneur. The gross profit includes compensation for any loss *and* the surplus. Net or clear profit is the surplus alone or the net revenue of the business.

Classical economists generally did not treat interest as a separate distributive share; it was handled simply as a deduction from profit. The lowest rate of interest must be a little higher than the losses that sometimes occur through lending. The interest that the borrower can afford to pay is proportional to the net or clear profit only, and the rate must generally be lower than the rate of profit in order to induce borrowing. As profits rise, borrowers seek more money, and interest rates rise, and as profits fall, interest rates decline along with them.

On Rent: Smith presents several theories of rent, none of which is complete or entirely accurate. But in some parts of his book, Smith adhered to Petty's (and Hume's) perspective that prices of agricultural produce determine the rent that the landlord can charge. Rent, said Smith, "is the price paid for the use of land." It is the highest price the tenant can afford to pay after deducting wages, the wear and tear of capital, average profits, and other expenses of production. Rent, therefore, is a surplus or a residual. High prices of produce yield high rents, and low prices yield low rents.

Taken together, Smith's views on wages, profits, and rents constitute an attempt to formulate a theory of the functional (factor share) distribution of income. Although incomplete, Smith's analysis certainly was far superior to the distribution theories presented by the Physiocrats.

On Money: According to smith, money is vital as a means of payment, to be sure, because without it, business would be shackled with a barter system. But money itself does not add to the output or the wealth of a society. It facilitates the circulation of goods, but the production of the latter is what constitutes the wealth.

Smith's views on money clearly were in opposition to the Mercantilists. If money's function is to serve as a medium of exchange, then paper money would do equally well as gold and silver and would require less effort to produce. Gold and silver, said Smith, are like a highway that enables goods to be brought to market without being itself productive. Banking would save the labor of producing gold by providing paper money, just as a highway through die air would save land that might be used for other things.

On Public Debt: Smith criticized the growth of public debt and the taxes required to pay interest on it. The view among many contemporary economists that an internally held debt is of little economic consequence because we owe it to ourselves was voiced in Smith's time. He answered that *'This apology is founded altogether in the sophistry of the mercantile system.'*

Smith was afraid that the heavy taxes needed to pay the interest on the debt would induce merchants and manufacturers to invest their capital abroad to the detriment of the home country. Smith felt that government debt and interest charges represented resources that might have been used productively by private individuals if government had not diverted them to its own purpose. With militaristic, corrupt, and wasteful governments far removed from *the* people and partial to special interests, such a diversion of resources would not serve society. The assumption behind smith's argument is full employment but in modern time even deficit spending is widely practiced to counteract recessions.

On Economic Development: Smith viewed the economy as a whole and emphasized growth and economic development. Smith viewed the division of labor and the accumulation of capital as the primary factors that promote a growing stock of the nation's wealth.

Smith contended that the division of labor spurs capital accumulation and that both work together to increase labor productivity. The rise in labor productivity increases national output which widens the market and justifies further division of labor and capital accumulation. As a result of the capital accumulation, the wage fund increases and wages rise. Higher wages motivate further productivity growth which, in turn, results in increased national output. The rise in national output increases the goods available for consumption, which for Smith constitutes the wealth of nations.

On Distribution of Employment: Smith spoke of one additional factor that might give rise to increased productivity and growth. That was 'a more proper distribution of employment.' Here Smith made a distinction between productive labor, which adds value to a product, and unproductive tabor, which does not.

Productive Labor stores up labor in a tangible commodity that has market value. According to Smith, among the productive workers are 'artificers, manufacturers and merchants'

Unproductive labor is that invested in offering services; it does not result in tangible goods available in the marketplace. According to Smith, unproductive laborers include kings, soldiers, churchmen, lawyers, doctors, writers, players, buffoons, musicians, opera singers, dancers, and so forth.

In modern national income accounting, say, those payments to servants, military personnel, advertisers, and physicians are additions to our national income. To Smith this would have seemed strange. He would have considered such expenditures as deductions.

But to understand Smith, we should look at the problem through his approach to capital accumulation and economic growth. For him, material goods can be accumulated and, therefore, are a potential means of increasing wealth. Even consumer goods produced today can be used to support workers in the future, thereby enabling them to work and produce goods. But services are of the moment only; they vanish in the simultaneous acts of production and consumption, and they cannot be accumulated. From this point of view they are unproductive, although they indeed are useful. Nevertheless, in the modern meaning of the term *productive,* Smith obviously was in error.

ii. Thomas Robert Malthus (1766-1834)

His Biography:

Thomas Robert Malthus, was born to Daniel and Henrietta Malthus on 13th February, 1766, and become the sixth of seven children. They were a prosperous family, his father being a personal friend of the philosopher David Hume and had an acquaintance of Jean-Jacques Rousseau. The young Malthus was educated at home until his admission to Jesus College, Cambridge in 1784. There he studied many subjects and took prizes in English declamation, Latin and Greek, but his principal subject was mathematics. He earned a masters degree in 1791 and was elected a fellow of Jesus College two years later.

Malthus married his first cousin once removed Harriet Eckersall, on April 12th, 1804 and had three children, Henry, Emily and Lucy. In 1805 he became Britain's first professor in political economy at the East India Company College. Finally, he died on 29th December, 1834 and buried at Bath Abbey in England. Malthus was a well known demographer and political economist. His major works were *An essay on the principle of Population* (1798) and *Principles of Political Economy* (1820). But he is best known for his highly influential views on population growth.

Important Influences:

Dear student! What do you think were the major influences that shaped Malthus' thought? Please write your answer on the space provided below.

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Well! Among the factors that influence Malthus's thinking the 'Poor Law' and the 'Corn Law' that were passed in England. *Poor law* is the law that dictates the poor should have minimal income irrespective of their earnings. The law linked family income to the price of bread , and if earning fell below the prescribed level, allowances would be granted to make up the difference.

Corn Laws were the laws that placed tariffs on imported grains and effectively placed a minimum price on grain imported to England from abroad. However the most important factor that influences Malthus's thinking was the optimistic belief of his father in perfectibility of man and society. The faith of his father was based on the works of Godwin and Condorcet.

William Godwin (1756-1836) published a book in 1793 that formulated the philosophy of anarchism. According to Godwin, human race is perfectible through a continuous advance toward higher rationality and increased wellbeing. The major obstacle to progress, he said, are private property, economic and political inequality and the coercive state. Population growth, he believed is not a problem. When a population limit is reached, humanity will refuse to propagate itself further.

Marquis de Condorcet (1743-1794) favored a universal suffrage of men and women. He had an idea of social progress based on three fundamental principles: equality among nations, equality of individuals within a nation, and perfectibility of mankind. Equality would overcome the social evils of the day and lead to perfections. It abolishes war 'as the greatest of plague and as the greatest of crimes.' These increase population but the food supply increases more rapidly. If the problem of subsistence could eventually no longer be solved in this way, Condorcet favored birth control to limit the population.

These were the ideas against which the young Malthus rebelled. The vice and misery that plague society are due, he said, not to evil human institutions but rather to the prolific fertility of human race. The abolition of war for which Condorcet dreamed would merely remove one of the essential remedies of overpopulation. Condorcet's welfare programs would only counter a second factor limiting population-hunger. Godwin's egalitarian, communistic society, Malthus said, would mean more food for the mass and, therefore, a more rapid growth of population.

His Population Theory:

Malthus presented his famous law of population as follows:

> *Population, when unchecked, increases geometrically; subsistence increases at best only arithmetically. That is, population tends to increase at the rate of 1, 2,4, 8,16, 32., and so forth, whereas the rate of increase of subsistence is at best only 1, 2, 3, 4, 5, 6.*

Therefore, it may be safely asserted that, Malthus said, population, when unchecked, increases in a geometrical progression of such a nature as to double itself every twenty-five years

Malthus identified two types of checks to population growth: those he called "preventive checks" and those he called "positive checks."

Preventive Checks: these are those that reduce the *birth* rate. The preventive check of which Malthus approved was termed moral restraint. People who could not afford children should either postpone marriage or never marry; conduct before marriage should be strictly moral. The preventive check of which Malthus disapproved he called vice. This included prostitution and birth control, both of which reduced the birth rate.

Positive Checks: these are those that increase the *death* rate. These were famine, misery, plague, and war. Malthus elevated these to the position of natural phenomena or laws; they were unfortunate evils required to limit the population. These positive checks represented punishments for people who had not practiced moral restraint. If the positive checks could somehow be overcome, people would face starvation because a rapidly growing population would press upon a food supply that at best would grow slowly

According to Malthus, then, poverty and misery are the natural punishment for the failure by the 'lower classes' to restrain their reproduction. From this view followed a highly significant policy conclusion: There must be no government relief for the poor. To give them aid would cause more children to survive, thereby ultimately worsening the problem of hunger.

His Theory of Market Gluts:

In his principle of principle of political economy, Malthus developed his theory general over production. Here Malthus explained that there would be a possibility of inadequate effective demand to maintain full employment. As a result, there will be a general glut of commodities in the market. This has been known as *'Malthus theory of Gluts'*

For Malthus effective demand is that which establishes a price high enough not only to cover costs but also yield a profit at the current rate. Production is sustained only if it is profitable and that profitability depends on effective demand. Overproduction is, therefore, the result of effective demand. The workers, he said, are unable to purchase all the commodities in the market; capitalist, on the other hand, prefer to save rather than to spend. So who will purchase the extra output?

As a solution to this problem, Malthus favored unproductive consumption by landlords. Rent, said Malthus, is a surplus based on the difference between the price of agricultural produce and the costs of production (wages, interest, and profits). Its expenditure, therefore, adds to effective demand without adding to the cost of production. The other forms of income- wages, interest, and profit-increase purchasing power but also raise production costs, and costs must be kept down if a nation is to maintain its competitive position in world markets.

Although Malthus favored unproductive consumption by landlords, including the hiring of large numbers of menial servants, he opposed excessive unproductive consumption financed by the government. Government officials, soldiers, sailors, etc necessitate higher taxes, which might impede the increase of wealth. For times of acute economic distress, Malthus recommended government spending on public works. He had also the view that war offered another stimulus that could eliminate gluts.

iii. David Ricardo (1772-1823)

His Biography:

Born in London, on 18th April, 1772, Ricardo was the third of seventeen children in a Sephardic Jewish family (from Portugal) that emigrated from the Netherlands to Great Britain just prior to his birth. At age 14, after a brief schooling in Holland, Ricardo joined his father at the London Stock Exchange, where he began to learn about the workings of finance. This beginning set the stage for Ricardo's later success in the stock market and real estate. At twenty-one he married a Quaker woman and left the Jewish faith to become a Unitarian. As a result of this act, his father disowned him, although they later reconciled.

Ricardo became interested in economics after reading Smith's *The Wealth of Nations* in 1799 on a vacation to the English resort of Bath. This was Ricardo's first contact with economics. He wrote his first economics article at age 37 and within another ten years he reached the height of his fame. Ricardo was a close friend of James Mill, who encouraged him in his political ambitions and writings about economics. Other notable friends included Jeremy Bentham and Thomas Malthus, with whom Ricardo had a considerable debate (in correspondence) over such things as the role of land owners in a society.

Ricardo's work with the stock exchange made him quite wealthy, which allowed him to retire from business in 1814 at the age of 42. In 1819, Ricardo took a seat in the House of Commons as the member of the parliament. He held the seat until his death 11th September, 1823.

He is often credited with systematizing economics, and was one of the most influential of the classical economists, along with Thomas Malthus and Adam Smith. Although Smith was the founder of the classical school and set its dominant tone, David Ricardo, a contemporary of Malthus, was the leading figure in further developing the ideas of the school. Ricardo demonstrated the possibilities of using the abstract method of reasoning to formulate economic theories. He also extended the scope of economic inquiry to the distribution of income. He was an outstanding example of a deductive thinker. He began with basic premises and then used logic to deduce generalizations. Ricardo called his broad generalizations on economic laws, and he considered their operation to be as valid in economics as are the laws of physics in the natural sciences.

His Theory of Diminishing Return and Rent

Ricardo's law of diminishing returns and theory of rent developed in response to the debate over the Corn Laws. Recall that the concept of diminishing return in agriculture dates back to Turgot, the physiocrat. But it was Ricardo who developed the notion most clear and complete. In using this concept to develop his theory of rent, Ricardo became the first economist to formulate a marginal principle in economic analysis. His theory of rent, therefore, is seminal to the later rise of the Marginal school.

Rent, said Ricardo, is the proportion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil. it includes the return on the long run capital investments that are amalgamated with the land and increase its productivity.

Ricardo's theory of rent assumes the operation of two principles: the *differential principle* and the *marginal principle*. The first explains the differential nature of rent while the later gives the measure of rent.

1. *The Differential principle*: implies that an equal amount of labor and capital may produce different amounts of output. In agriculture, equal quantities of capital and labor produce different quantities of output in two ways:
   - Under *extensive cultivation*, the output differs when equal quantities of labor and capital are employed on lands with different qualities. More fertile land yields more output and hence more rent and vice versa.
   - Under *intensive cultivation*, the output differs when equal quantities of labor and capital are employed successively on the same land due to the law of diminishing return.
2. The Marginal principle: this implies that the price of the produce is determined by the cost of production of the marginal producer. Marginal producer is the one who produces under the most unfavorable circumstances. When we apply the marginal principle to agriculture, equal quantities of capital and labor produce different rent in two ways:
   - Under *extensive cultivation*, the price of output will cover cost of production on the marginal land
   - Under *intensive cultivation*, the price of output will cover the cost of the marginal doze of inputs required.

The implication of the above analysis is that the marginal land and the marginal doze of capital and labor does not generate any rent because revenues just cover their cost of production. All the intra-marginal land and intra-marginal units of capital and labor gets rent because they operate under more favorable cost conditions than those at the margins of production.

Let us illustrate Ricardo's theory of rent with the help of the following table.

Dose of Capital & Labor	**Marginal product from different grades of land (quintals of Corn)**				**Total Product**
	A	**B**	**C**	**D**	
1	80	70	60	50	260
2	70	60	50	_	180
3	60	50	_	_	110
4	50	_	_	_	50
Total Product	260	180	110	50	600

Assume the price of corn is $1, and the price of a dose of labor and capital is $50.

Under extensive cultivation, D grade land is marginal land because the cost of one unit of capital and labor employed ($50) is just equal to the value of its product ($50). When one unit of capital and labor is employed, on A, B, C, and D grades of land, A gets a rent worth $30 (=80-50), B gets a rent worth $20(=70-50), C gets $10(=60-50) and D gets no rent(=30-50).

Under intensive cultivation, on A grade land the fourth dose of capital and labor is the marginal or no rent dose because its cost ($50) is just equal to the return from it. ($50). The first, the second and the third doses (intra-marginal doses) get a rent worth $30, $20, $10 respectively.

Dear student, under intensive cultivation, what is the rent of B grade land when the second dose of labor and capital is employed? Please write your answer on the space provided below.

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His Theory of Exchange Value and Relative Prices

Exchange Value: Ricardo wrote that for a commodity to have exchange value, it must have use value. Utility (subjective want satisfying power) is not the measure of exchangeable value, although it is essential to it. Possessing utility, or use value, commodities derive their exchange value from two sources: (1) their scarcity and (2) the quantity of labor required to obtain them.

The value of *non-reproducible* commodities, such as rare works of art, classic books, and old coins, is determined by their scarcity alone. For these items, supply is fixed, and, therefore, demand will be the primary factor in determining exchange value. But most commodities are *reproducible,* and Ricardo assumed that they are produced without restraint under conditions of competition. It was these goods to which Ricardo applied his labor theory of value.

Recall that Smith stated a labor theory of value for a primitive society and developed a "labor commanded" theory for advanced economies. Unlike Smith, Ricardo applied his labor theory of value to an advanced economy. In fact, he felt that Smith's distinction between the two types of economies was artificial. According to Ricardo, the exchange value of a commodity depends on the labor time necessary to produce it. The labor rime includes not only the work done in making the commodity itself but also the work embodied in the raw materials and capital goods used up in the process of production.

Relative Prices: Although labor is the foundation of the value of commodities, market prices deviate from value or natural price because of accidental or temporary fluctuations of supply and demand. If the market price rises above the natural price, profits rise, and more capital is used to produce the commodity. If the market price falls, capital flows out of the industry. The actions of individuals seeking maximum advantage tend to equalize the rates of profit and to keep market prices proportional to values. Short-run prices depend on supply and demand, but long-run values depend on the real costs of production, and the relative real costs of production of two commodities are nearly proportional to the total quantity of labor required for the entire production process.

His Distribution of Income:

Ricardo employed his analytical engine to explain the distributive shares of land, labor and capital, and their behavior overtime. Ricardo conducted his analysis in macro terms. But he did not directly deal with the distribution of national income. Instead, he analyzed the distribution of the produce of a single firm and applied the conclusion of the micro analysis to the economy as a whole. Thus, Ricardo's macro analysis was simply a generalized micro analysis.

Unlike Adam Smith, who focused on the causes of wealth, Ricardo emphasized that the focus of political economy should be the distribution of wealth. In a letter to his friend Malthus in 1820, Ricardo stated "Political economy you think is an enquiry into the nature and causes of wealth-I think it should rather be called an enquiry into the laws which determine the division of the produce of industry amongst the classes who concur in its formation. No law can be laid down respecting quantity, but a tolerably correct one can be laid down respecting proportions."
Ricardo's reference is to factor shares or what today we call the *functional distribution of income*. His concern was for understanding the forces that determine the shares of the national income accruing as wages, profits, and rents (interest was combined with profits). Let us examine his thinking on each share.

Wages: Labor, said Ricardo, like all other things that are bought and sold, has its natural price and its market price. The *natural* price of labor is that price that, given the habits and customs of the people, enables workers to subsist and to perpetuate themselves without a change in their numbers. The natural price of labor depends on the price of the necessities of life required by the laborers and their families. The *market* price of labor depends on supply & demand and fluctuates around the natural price. In the long run, both the natural price of labor and nominal wages tend to rise, said Ricardo, because of the increased difficulty and cost of producing food for growing number of people. Ricardo's idea that in the long run the worker gets only a minimum wage came to be known as *the iron law of wages*. When the market price of labor rises above the natural price, a worker can rear a large and healthy family. As population increases, wages fall to their natural price or even below. When the market price of labor is below the natural price, misery reduces the working population and wages rise. The long-run tendency is, therefore, for workers to receive the subsistence minimum.

Profits: Ricardo felt that the rates of profit in different fields of enterprise within a country tend to equalize. If the rate of profit is higher in industry than in the farming of marginal land, capital will flow from agriculture to industry, and a better grade of land will become the new marginal land. If agriculture is more profitable than industry, capital will flow towards agriculture, and the next worse grade of land will become the marginal land cultivated.

Recall that Ricardo emphasized that profits and wages vary inversely; one increases at the expense of the other. Why must higher wages come out of profits instead of being passed on in higher prices? The answer lies in the equation of exchange and in the international balance of payments. If wages fall, prices will not fall. If they do, gold will flow into the country, and prices will rise again. Therefore, a fall in wages will result in a rise in profits.
And what will be the long-run trend for the profit rate and the profit share of national income? Recall that Adam Smith thought that the rate of profit would fall because of growing competition among entrepreneurs, and he welcomed this development. Ricardo thought that the rate of profit would fall because of the increasing difficulty of growing food for an expanding population.

Rents: As stated in the previous section, Ricardo saw a conflict between the interests of workers and capitalists. An even more basic conflict exists, he said, between landlords and the rest of society. As population increases, the increased demand for food will raise its price. We know from our previous discussions that this will bring poorer land into cultivation and will cause better land to be worked more intensively. Rents, therefore, will rise. Nominal wages, we have seen, will also rise to maintain the natural, or subsistence, wage. Thus, profit rates and the profit share of the national income will fall.

Policy implications: Ricardo drew several important conclusions from his analysis of the components of the national income.
First, he felt that wages should not be regulated, nor should relief be given to the indigent. It is naturally regulated by the cost of means of subsistence.
Second, Ricardo concluded (as had the Physiocrats) that a tax on rent would affect only rent. Such a tax would fall wholly on landlords and could not be shifted to anyone else. The landlords

could not raise rents to pay for the tax, because marginal land would pay no rent and, therefore, no tax.

Finally, disagreeing with Malthus, Ricardo strongly opposed the corn laws. Why? The answer, of course, follows from his distribution theory. Lower grain prices will reduce rent and increase profits, thereby increasing capital accumulation, bolstering the wages fund, and delaying the arrival of a stationary state.

His Theory of Comparative Costs

Dear student! Do you remember Smith's theory of international trade? What was the bas, according to Smith, for two countries to engage in trading? Please write your answer on the space provided below.

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Good! According to Smith, two countries will engage in international trade only if one country has absolute cost advantage over the other in producing one commodity and the other country has similar advantage on the other good.

Ricardo made a strong argument for free trade based on the efficiency gains that it confers. Smith advocated foreign trade without impediments in order to widen markets and remove surpluses; trade was based on differences in absolute costs. Ricardo made a brilliant and lasting contribution to economic thought by showing that even if one country is more efficient than another in producing all commodities, trade between the two nevertheless can be of mutual benefit. His theory of comparative costs is now known as the *law of comparative advantage*.

Ricardo *explicitly* assumed in his theoretical proof of the gains from trade that capital and labor did not flow between countries. He *implicitly* assumed that cost remained constant as output increased. Otherwise, specialization would not be carried on to its fullest extent. All costs were measured in terms of labor hours, an approach consistent with the labor theory of value.

Ricardo based his explanation of the law of comparative costs on the number of units of labor necessary to produce a specific quantity of cloth and wine in two countries; England and

Portugal. To say that it takes a certain amount of labor to produce each unit of cloth or wine is also to say that a certain quantity of wine or cloth can be produced with each unit of labor. That is, if it takes, say, *two* units of labor to produce each unit of output, then obviously each unit of labor can produce one-half unit of output. We will employ this later terminology to illustrate Ricardo's law of comparative advantage.

Table: Hours of labor necessary to produce a unit of wealth			
Country	**Wine**	**Cloth**	**Domestic Barter Rate**
Portugal	80	90	1W:0.8C
England	120	100	1W:1.2C

The above table shows that Portugal has an absolute cost advantage over England in producing both wine and cloth. Would Portugal be better off foregoing trade with England? Ricardo answered with an emphatic 'No.' Each nation should produce the product for which it has a relative advantage; that is, the product for which it has the lowest domestic opportunity cost. Portugal's opportunity cost of producing one unit of wine is 1.125 units of cloth (90/80). England's opportunity cost of producing one unit of wine is 0.833 units of cloth (100/120). It is relatively less costly for Portugal to specialize in producing wine. Alternatively, Portugal's opportunity cost of producing one unit of clothing is 0.888 unit of wine *(80/90);* England's is 1.2 unit of wine. England should therefore specialize in clothing because it has a lower opportunity cost than Portugal.

International trade based on comparative cost doctrine shows an overall reduction of production cost. Before trade, England requires 220 hours (120 + 100) of labor to produce one unit of wine and cloth each. Portugal requires 170 hours (80 + 90) of labor to produce one unit of wine and cloth each. After trade Portugal produces two unit of wine using 160 (80 + 80) labor hours and England produces two units of cloth using 200 (100 + 100) labor hours. The total labor hours required to produce two units of wine and cloth each before trade was 390 which gets reduced to 360 (160 + 200) after trade, a reduction of 30 labor hours.

Ricardo did not specify clearly how the gains shown in the above table would get divided between England and Portugal. Although his theory defines the limits within which the ratios of exchange between internationally traded commodities could fluctuate, it does not attempt to explain what determines the ratios. According to Ricardo, if Portugal's wine is exchanged for English cloth at a rate of 1W:1.2C, then all the gains of trade will go to Portugal. But if Portugal's wine is exchanged for English cloth at a rate of 1W:1.0.8C, then all the gains of trade will go to England. These are the two limits in which the actual terms of trade will be determined.

6.8. OTHER CONTRIBUTORS TO CLASSICAL SCHOOL (DESCENDANTS)

Dear student! Are these the only representatives of classicism? Is Ricardo the last writer of the classical school? No! Several important thinkers in addition to Smith, Malthus, and Ricardo contributed to classical economic analysis. We examine four of them in next section of this chapter.

i. Jeremy Bentham (1748-1832)

Not only was Bentham an enthusiastic adherent of the Classical school, but also made some original contributions to its philosophy and economics. Bentham boasted, "I was the spiritual father of [James] Mill, and Mill was the spiritual father of Ricardo: so that Ricardo was my spiritual grandson."

In accordance with his wishes, Bentham 's body was dissected for the benefit of science. He left his entire estate to University College, London, with the stipulation that his remains be present at all meetings of its board. His skeleton, padded and dressed, is on public display in a glass case. The skeleton is seated in a chair, with cane in gloved hand. The head of the body is wax, but Bentham's actual head, preserved in the manner of South American headhunters, rests on a plate between his feet.

His Utilitarianism:

The central theme of Bentham's thought has been called utilitarianism, or the principle of the greatest happiness. Its underlying philosophy-hedonism-dates back to the Greeks of antiquity. This notion is that people pursue things that provide pleasure and avoid things that produce pain; all individuals seek to maximize their total pleasure. Utilitarianism superimposed on hedonism the ethical doctrine that conduct should be directed toward promoting the greatest happiness of the greatest number of people. Thus, by recognizing a positive role for society, utilitarianism tempered the extremely individualistic outlook of hedonism. If an individual pursues only personal pleasure, will this action promote the general happiness? Not necessarily, thought Bentham. Society, however, has its own methods of compelling individuals to promote the general happiness. The rule of law establishes sanctions to punish individuals who in their own pursuit of pleasure harm others excessively. Moral or social sanctions also exist, of which ostracism is an example. Even theological sanctions, such as fear of punishment in the hereafter, would help reconcile the individualistic self-interest of hedonism with the utilitarian principle of the greatest happiness for the greatest number of people.

Diminishing Marginal Utility

In *The Philosophy of' Economic Science,* Bentham argued that wealth *is* a measure of happiness but that wealth has diminishing marginal utility as it increases. Here, Bentham introduced the idea of the marginal utility of money, just as Ricardo introduced the idea of marginal productivity in his theory of rent.

Implication of His Ideas:

The following are the main implications of Bentham's economic and philosophical ideas

1. Government intervention is justified if enhances the happiness of a community more than it diminishes it. If something adds to a commoner's pleasure more than it detracts from the pleasure of an aristocrat, it is commendable; the intervention is
2. Most existing state controls and regulations were harmful and unnecessary. Individuals themselves, not government, are generally the best judge of what most effectively promotes their own well-being. His slogan for government was "Be quiet," but he did not worship laissez-faire as a principle to be accepted blindly.

3. Utility is measured cardinally and its unit of measurement is money.
4. Money has a diminishing marginal utility. If government takes income from someone who has an income of $10,000 per year and gives it to someone who earns only Sl,000 per year, more happiness will be gained by the poor person than will be lost by the wealthy one. But Bentham did not suggest that this theory be put into practice. Equalizing incomes, he thought, would destroy happiness by alarming the rich and depriving them of a feeling of security, by taking away their enjoyment of the fruits of their work, and by destroying the incentive to work. When security and equality are in opposition, said Bentham, equality should give way.

ii. Jean-Baptist Say (1767-1832)

Jean-Baptist Say was a Frenchman who popularized Adam Smith's ideas on the continental Europe. His major work, *A Treatise on Political Economy,* was published in 1803.

His Economic View:

On theory of value: Say opposed the labor theory of value of the classical school, replacing it with supply and demand, which in turn are regulated by costs of production and utility. Thus, in some respects, his analysis was more advanced than that of Ricardo.

On monopoly cost: Say pointed out that monopolists not only create what today we call *efficiency losses* (or *deadweight losses*} but also use scarce resources in their competition to obtain and protect their monopoly positions.

On entrepreneurship: Say contributed to economic thought by emphasizing entrepreneurship as a fourth factor of production along with the more traditional ones of land, labor, and capital. Dear student do you know the first economic thinker who have used the term *entrepreneur* for the first time? It is Richard Cantillon

Say's Law of Markets:

Say's chief claim to fame rests on his theory that general overproduction is impossible. As indicated in the previous chapter, this came to be known as Say's law.

The earliest statement of this idea can be found in the writings of Francis Hutcheson (Smith's instructor), Adam Smith, and James Mill. But Say also expressed this idea, and Keynes later attributed it to him. As a result, it became Say's law, as opposed to the Smith-Mill law.
This theory of market is based on the concept that exchange between two parties involves both a purchase and a sale. Say denied that there could ever be a general glut of commodities. The interpretation of Say's law which has become popular is that *supply creates demand*. Prices are assumed to be such that the value of commodities produced is just equal to the value of expenditure on commodities as a whole.

Although challenged by Malthus, Sismondi, and Marx, Say's law continued to dominate economic thinking until Keynes highlighted its weaknesses in 1936. Uncritical acceptance of this law of markets appears to have delayed the study of business cycles for many decades.

iii. Nassau William Senior (1790-1864)

Senior was the oldest son of a country clergyman who had ten children. In 1825 Senior became the first professor of political economy at Oxford. In his economic thinking he departed significantly from classical economics and moved toward the neoclassical position that triumphed after 1870.

His Positive Economics:

Senior wished to separate the science of political economy from all value judgments, all policy pronouncements, and all efforts to promote welfare. Today we refer to this suggested type of analysis as *positive economics,* in contrast to *normative economics,* which concerns itself with the 'ought to be' and uses economics to champion public policies. According to Senior, economists should concern themselves with analyzing the production and distribution of wealth, not the promotion of happiness.

Senior did not heed his own prescription that economists should never offer a single syllable of advice. In his long career in public life, he made numerous pronouncements on policy issues, never explaining whether his recommendations were offered with all the weight of his economic theories behind them or not

His Four Propositions:

Senior stated four principles of economics that he felt are empirically verifiable and from which an integrated theory of economics could be deduced.

(1) That man desires to obtain additional wealth with as little sacrifice as possible. *[Principle of income or utility maximization]*

(2) That the population of the world is limited only by moral or physical evil, or by fear of a deficiency of those articles of wealth which the habits of each class of its inhabitants lead them to require. *[Principle of population]*

(3) That the powers of labor and of the other instruments which produce wealth, may be indefinitely increased by using their products as means of further production. *[Principle of capital accumulation]*

(4) That agricultural skill remaining the same, additional Labor employed on the land within a given district produces a less proportionate return. *[Principle of diminishing returns]*

His Abstinence:

According to Senior, the exchange value of goods depends on demand and supply. Underlying demand is the concept of the diminishing marginal utility of goods as more units are acquired. This was an important insight that later was expanded by the marginalists. Supply depends on the costs of production. But cost, said Senior, is *subjective*-the sum of sacrifices required in order to use nature's agents to produce useful goods. The costs of production are the labor of the workers and the abstinence of the capitalists. *Abstinence* was a new term that Senior contributed to the lexicon of political economy. It implied a value judgment about the sacrifices undertaken by the capitalist in postponing (or foregoing forever) the consumption of wealth.

His Productive Labor:

Senior disagreed with Smith, who thought that the producers of services are all unproductive. Lawyers, doctors, and teachers, Senior said, are productive because they promote the increase of wealth. Where a soldier must protect the farmers, both are productive.

To Senior, the proper distinction was not between productive and unproductive labor but rather between productive and unproductive consumption. The latter category includes consumption of jewelry, tobacco, gin, and beer, all of which diminish the mass of commodities without adding to the workers' capacity to produce.

iv. John Stuart Mill (1806-1873)

John Stuart Mill was the last great economist of the Classical school, undoubtedly the greatest since Ricardo's death. Mill made some significant original contributions, and he systematized and popularized the whole body of economic thought of his predecessors. The Classical school was already in decline during Mill's mature years, and he departed from some of the key concepts built into the classical structure by Smith and Ricardo. Mill's great *Principles of Political Economy,* first published in 1848 and reprinted in the United States as late as 1920, was one of the most widely read of all books on economics in the period. As Adam Smith's *Wealth of Nations* had during an earlier period, Mill's *Principles* dominated economics teaching. was the leading textbook in the field, at least until the publication of Alfred Marshall's *Principles of Economics* in 1890. In the case of Oxford University it was the standard text until 1919.

His Biography:

John Stuart Mill was born on 20th May 1806 in the Pentonville area of London, United Kingdom. He is the eldest son of the Scottish philosopher and historian James Mill. John Stuart was educated by his father, with the advice and assistance of Jeremy Bentham and Francis Place. He was given an extremely rigorous, some would say harsh, upbringing, and was deliberately shielded from association with children of his own age other than his siblings. His father, a follower of Bentham and an adherent of associationism, had as his explicit aim to create a genius intellect that would carry on the cause of utilitarianism and its implementation after he and Bentham were dead. The boy began to learn Greek at three. He mastered algebra and elementary geometry and began to study differential calculus by the time he was twelve; At nineteen he was publishing original scholarly articles. This intensive study however had injurious effects on Mill's mental health, and state of mind. At the age of 21 he suffered a nervous breakdown.

Mill refused to study at Oxford University or Cambridge University, because he refused to take Anglican orders from the "white devil" Instead he followed his father to work for the British East India Company until 1858. Between the years 1865-1868 he served as Lord Rector of the University of St. Andrews, where he gave an inaugural speech on the value of culture.

In 1851, Mill married Harriet Taylor after 21 years of an intimate friendship. Taylor died in 1858 after developing severe lung congestion, only seven years into her marriage to Mill. Mill died in Avignon, France in 1873, and is buried alongside his wife.

The main ideas of J.S. Mill are summarized as follows:

On utilitarianism: Mill's famous formulation of Utilitarianism is known as the "greatest happiness principle." It holds that one must always act so as to produce the greatest happiness for the greatest number of people. One of Mill's major contributions to Utilitarianism is his argument for the qualitative separation of pleasures. Bentham treats all forms of happiness as equal, whereas Mill argues that intellectual and moral pleasures are superior to more physical forms of pleasure.

Mill defines the difference between higher and lower forms of happiness on the principle that those who have experienced both tend to prefer one over the other. This is, perhaps, in direct opposition to Bentham's statement that "Cinema is as good as beach," that if a going to beach causes more pleasure to more people than a night at cinema, it is more imperative upon a society to devote more resources to develop beaches than running cinema houses.

Production: Mill recognized and analyzed three productive factors: land, labor, and capital. Wealth is defined as including all useful things that possess exchange value. Productive labor includes only those kinds of exertions that produce directly or indirectly, utilities embodied in material objects. Unproductive labor is that which does not end in or contribute to the creation of material wealth. For example, saving a friend's life is unproductive unless the friend is a productive laborer of greater production than consumption.

What are the obstacles to increasing production? Lack of labor and capital are not the reasons, said Mill. The limited extent of land and its limited productiveness are the real barriers to increases of production. Mill recognized *increasing* returns to scale in manufacturing; *decreasing* returns to scale in agriculture.

On the laws of production and Distribution: Mill distinguished between the laws of production and the laws of distribution

Laws of production are universal and cannot be changed by changing social systems. These include laws of population, laws of capital accumulation, law of diminishing returns.

Laws of distribution are man-made and can be changed when necessary. These include the laws of profit, the laws of rent, the laws of wages.

Mill failed to recognize that production and distribution are interrelated and that interference with one involves interference with the other.

On the wage fund: Mill, like Senior, Ricardo, Mill, and Smith before him, accepted the wages fund notion. Wages, he said, depend mainly upon labor demand and supply. The demand for labor depends on that part of the capital set aside for the payments of wages. The supply of labor depends on the number of people seeking work. Under the rule of competition, wages cannot be affected by anything but the relative amounts of capital and population. Wage rates cannot rise except by an increase of the aggregate funds employed in hiring laborers or by a decrease in the number of workers employed. Nor can wage rates fall except by a decline of the funds devoted to paying for labor or by an increase in the number of laborers to be paid. This theory presupposes a *unitary* elasticity of demand for labor; no matter what the wage rate, the same sum is expended for labor.

It follows then, according to Mill, that government cannot increase total wage payments by fixing a minimum wage above the equilibrium level. Given a wages fund of a fixed size, the higher wage income that some workers would receive would be offset entirely by the lost wage income of those who became unemployed.

On Exchange: The value of a commodity cannot rise higher than its estimated use value to the buyer. *Effectual demand*-desire plus purchasing ability-is therefore one determinant of value. But differing quantities are demanded at different values. If demand depends partly on value and value depends on demand, is this not a contradiction, asked Mill. He resolved it by introducing the concept of a demand *schedule* (a relationship between price and the quantity demanded), and by so doing greatly advanced value theory. The quantity demanded is what varies according to the value (or price). The market value gets determined through the interaction of supply and demand, and once this value is established, the quantity demanded gets determined.

Mill had a definite understanding of supply and demand schedules, elasticity of supply and demand, and their influence on prices.

On international Trade: Mill endorsed Ricardo's advocacy of free international trade based on the law of comparative costs. But to this law, Mill added a law of international values, one of his important original contributions to economic analysis. Here again the elasticity of demand for goods entered into his theory.

Dear student! Do you recall that Ricardo's international trade theory was incomplete? If yes, why it is incomplete? Please write your answer on the space provided below.

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Good! As you might have said, it failed to show how the gain from trade is divided among the trading countries. Mill showed that the actual barter terms of trade depend not only on domestic costs but also on the pattern of demand. More specifically, the terms of international exchange depend on the strength and elasticity of demand for each product in the foreign country.

On Government: In the final book, *On the Influence of Government*, Mill defended the concept of minimal government.

Dear student! Do you remember what laissez faire-laissez passer mean? Please write your answer on the space provided below.

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Good! It means no government intervention. Mill introduced enough exceptions to the idea of laissez-faire. He pointed out that individuals operating in a market economy are not necessarily the best judges of how much education society should provide. Child labor should be regulated. Government should also do those things that serve the general interests of all people but that are not profitable to individuals, such as undertaking geographic or scientific exploration.

6.9. CHAPTER SUMMARY

- The term classical economics was applied to a school of economic thought that began with Adam Smith's writing of the *Wealth of Nations* in 1776. Scientific and industrial revolutions were of particular significance to classical economic thought.
- The major features of this body of thought are their lasting contribution in their analysis of and argument on minimal government involvement, Self-interested economic behavior, Harmony of interests, Importance of all economic resources and activities, and Economic laws. Richard Cantilon and david Hume are the forerunners of these school while Adam smith, Thomas R. Malthus and David Ricardo are the real architect of the classical school.
- Adam Smith is a brilliant founder of the classical school. The whole of smith's economic thought is found in his book-The Wealth of Nations. In this book Smith covered a wide range of economic issues and concepts such as the division of labor, the invisible hand, the role of government, taxes, international trade (theory of absolute advantage), theories of value, price, wage, profit rent, money, public debt, economic development, distribution of employment, etc.
- The real contribution of Malthus on the other hand is his theory of Population and theory of market glut. In his theory of population Malthus argued population, when unchecked, increases in a geometrical progression while food supply increases at geometric rate. Malthus identified two types of checks to population growth: those he called "preventive checks" and those he called "positive checks." His theory of market glut refers to possibility of general over production. Due to lack of inadequate effective demand to maintain full employment. As a result, there will be a general glut of commodities in the market.
- Although Smith was the founder of the classical school and set its dominant tone, David Ricardo, a contemporary of Malthus, was the leading figure in further developing the ideas of the school. His lasting contribution to economic thought are his theory of Diminishing Return and Rent and theory of comparative costs.
- In his theory of diminishing return, Ricardo argued that that the marginal land and the marginal doze of capital and labor does not generate any rent because revenues just

cover their cost of production. In his theory of comparative cost, Ricardo made a brilliant and lasting contribution to economic thought by showing that even if one country is more efficient than another in producing all commodities, trade between the two nevertheless can be of mutual benefit. Ricardo has also made an important contribution on explaining exchange value and relative prices and distribution of income.

- Jeremy Bentham, Jean-Baptist Say, and Nassau William Senior are the later age classical economists. But John Stuart Mill was the last great economist of the classical school, undoubtedly the greatest since Ricardo's death. Mill made some significant original contributions, and he systematized and popularized the whole body of economic thought of his predecessors.

6.10. SELF TEST EXERCISE

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of the Classical School. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1. Critically evaluate Ricardo's theory of rent.
2. Do you agree with Bentham that the interest of the community is simply the sum of the interests of the several members who compose it? If so, is it then accurate to say that whenever someone adds to his or her net pleasure, the interest of the community rises by that amount?
3. Expand the following statement; The names Colbert, Turgot, and Say reflect the changing pattern of economic thought in France between 1650 and 1825.
4. How did Smith criticized mercantilists?
5. How Smith does defined the wealth of nations? What factors interact to cause increases in the nation's wealth?
6. How did Senior and Mill modify Malthus's theory of population?
7. How, according to Smith, can the social good result from the pursuit of individual self-interest?

8. What, according to Smith, determine exchange value in a primitive economy? What determines exchange value in a primitive economy? Why did Smith use 'labor command' rather than simply 'money command' as the measure of the values of a goods?
9. Is Smith's natural price determined by supply, demand or both? Explain carefully.
10. Compare and contrast the implication for wages of the theory of population presented by Thomas Malthus with the wage theory provided by Adam Smith
11. What, according to Malthus, are market gluts? How and why do they come about? How can they be avoided? What is the significance of the corn laws to all of this?
12. Compare and contrast the views of Ricardo and Malthus on each of the following topics: (a) corn laws, (b) subsistence wage, and (c) market gluts.
13. Use the following data to determine which nation should specialize in the production of shoes and which in the production of wheat. If both countries agree to engage in production of according to their comparative advantage, by how many units will labor time be saved?
14. How did Ricardo's labor theory for an advanced economy differ from Smith's?

CHAPTER SEVEN: IMMEDIATE REACTIONS AGAINST THE CLASSICAL SCHOOL

7.1. INTRODUCTION

- **Overview**

Dear student! As you may recall, classical economists had established a well organized body of economic doctrine. The tenets and policy pronouncements of classical political economy, however, drew criticism from several diverse groups of thinkers. Specially, socialists and historical economists were generally critical of classical economics. Of course, almost all of the subsequent schools of thought are developed as a reaction either against or in favor of the classical school. We focus on the ideas of these groups in the following chapters.

This chapter provides the reaction of the German historical school to the classical school's ideas and an overview of socialism and examines the views of several early socialist critics of capitalism.

- **Chapter Objective:**

Dear student! Upon successful completion of this chapter you will be able to

- Understand the causes of the oppositions to the classical doctrines
- Factors that contributed to the rise of historical and socialist schools
- Distinguish between historical school and socialism
- Distinguish between different types of socialism
- Understand the major tenets of historical school
- Evaluate the contribution of historical school and socialism
- Understand the main concept and arguments of historical school and socialism
- Distinguish between the main representatives of historical school and socialism

- **Chapter Content**

The remaining part of this chapter is organized as follows;

- The Historical school
  - Background of the school
  - Phases of the historical school
  - Major tenets of the historical school
  - Evaluation of the German Historical School
- The Rise of Socialism
  - Historical background of socialism
  - Concepts of socialism
  - Types of socialism
- Karl Marx
- Chapter Summary
- Self Test Exercise

7.2. THE HISTORICAL SCHOOL

Dear student! What does the Historical School refer to? What is the difference and similarity of the Classical School and the Historical School? Please, write your answer on the space provided below.

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Great! The use of deductive method of reasoning by the Classical School gave rise to a class of critics known as the *Historical critics*. The critics who attacked Ricardo and his followers for the use of deductive method have often been put together and named as the ***Historical School***. They were neither theorists nor their aim was to propound a theory. They refuse to accept the generalization made and to recognize the boundaries of the science determined by the classicists. The Historical school asserted that economic problems should be studied with reference to the past as well as to the present and hence they want to rebuild and formulate the science accordingly.

The reaction against the classical doctrines was most vigorous and prominent in Germany, and even the emergence of historical school may be ascribed to German. That is why some literature regards the school as the ***German Historical School***.

7.2.1. Background of the Historical School

Dear student! What factors do you think contribute to the rise of historical school? Please, write your answer on the space provided below.

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Good! The peace treaty after the Napoleonic wars left Germany divided into thirty-nine separate states, most of them monarchical, almost all of them undemocratic. The victorious Great Powers of Europe manipulated Germany to promote their own ulterior purposes. Austria wanted to keep Germany weak and divided; Britain wished to see a strong Prussia to thwart a future resurgent trance; Russia desired for itself the parts of Poland not yet seized by Germany or Austria.

The German struggle against Napoleon had aroused patriotic and nationalistic emotions. Prussia, the largest, richest, most militaristic, and most powerful state in Germany, dominated the country. It dominated the German government and armed forces. A series of successful wars further strengthened nationalism under Prussian hegemony. Because certain key economic institutions of nineteenth-century Germany differed substantially from those of Britain, it is not surprising that a different economic ideology arose.

Mercantilist regulations persisted in Germany at least until the formation of the empire in 1871, long after they had disappeared from the British scene. Competition and freedom of enterprise, which the classicists took for granted in their economic analysis, were severely restricted in Germany. British theories were obviously inapplicable to the German situation. The historical

school defended and rationalized the German way of life by questioning the historical relevance of the British classical economic doctrines.

The Germany that gave birth to tile historical school was divided, weak, and primarily agricultural. Nationalism, patriotism, militarism, paternalism, devotion to duty and hard work, and massive government intervention all combined to change the pattern and promote industrial growth. Because Germany of the mid-nineteenth century was far behind England in the development of industry, its economists reasoned that government assistance was required for it to catch up.

In a nut shell, although the German enthusiasts readily accepted the English political economy, at the close of the 18th c after the Napoleonic war, it was detected that the German problems cannot be tackled with the help of Classical's doctrines. In fact the doctrines were unsuitable for the conditions prevailing in Germany during those days. The Ricardian theories apparently were the result of the conditions existing in England, resulting from industrialization, Private enterprise & free trade. This cannot be made to apply to Germany where economic problems were chiefly the concern of administration.

Among the many factors which contributed to the rise of Historicism in Germany, the most important were the Hegelian Philosophy and the works of Savigny.

- ***Hegel:*** *(Philosopher & delivered lecture on philosophy in the University of Berlin from 1818 - 1731). He* attached great importance to the state as an institution and to historical studies.
- ***Savigny:*** emphasized that legal system and institutions were the product of the social conditions and necessarily of relative validity. He argued that institutions which are important for the present may become outmoded at a later date. Hence economics should be studied with the help of comparative method.

7.2.2. Phases of the Historical School

Dear student! What were the phases through which the Historical School evolved? Please, write your answer on the space provided below.

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Great! The members of the historical school caught all the points and attempted to formulate them in a broad scientific manner concentrating chiefly on the problem of method.

The German historical school passed through two pleases: the older school and the younger school.

a) The Older Historical school

The school was primarily represented by Roscher, Hildebrand & Knies. (All were professors in various universities of Germany).

This phase is characterized by the negative or destructive approach in the sense that here the deductive method of classical economics was criticized and a historical inductive method was advocated but the laws of classical economics were not replaced by another set of laws. Even efforts were not made to discover these laws. Actually, in some cases, the very existence of economic laws doubted.

Wilhelm Roscher ***(1817-1894)***, by giving a vivid account wants to prove that general principles or laws were essentially incomplete. He held that only the national economy belonging to a particular period and particular people was of importance.

Burno Hildebrand ***(1812-1871)*** rejected the method used in political economy and expressed his belief in the historical method. He also questioned Roscher's attitude in recognizing the existence of natural laws. According to him, there were three stages of economic development: *natural economy, money economy, and credit economy*. In this regard, he said that economic science need not attempt to find unchangeable, identical laws amid the multiplicity of economic phenomena. Its task is to show how humanity has progressed despite all the transformation of economic life and how economic life has contributed to the perfection of mankind.

Summary: they argue that the classical laws could not be universal and perpetual because they had been derived on an abstract basis. Instead, they favored inductive logic. They wanted that the basis of analysis be shifted from the individual as such to the whole society and that the motive of actions be not economic rationality but the totality of the society. In other words, they wanted to widen the scope of economics and brought in a fresh approach.

b) The younger Historical school

The younger group, while following the path laid down by their predecessors, made some positive contribution. It differed from the older group in so far as it denied the existence of *non-empirical laws* in economies. The younger school tried to build up a new system of economics by pointing out that the existence of economic laws could not be taken for granted. *Firstly*, through extensive historical studies and collection of data, it was to be found whether there did exist economic laws; and *secondly*, if they did, then to formulate them.

The older historical school was devoted to criticizing the classical school for their deductive reasoning. They merely laid down the principles whose application was left to the younger historical school. The younger group started with the determination to apply the historical method in more thoroughgoing way than their predecessors.

The younger historical school had two distinctive characteristics:

i) They gave up the fruitless controversy regarding economic laws which was engendered by Hildebrand & Knies. They did not deny the existence of natural social laws or uniformities, and held that the chief purpose of science of economics was the search for these laws.

ii) The younger group was not only satisfied with advocating the use of historical method but also attempted to put it in to practice.

Gustav von Schomoller (1838- 1917)

Schomoller doubted if laws of society could at all be discovered. He argued economic laws did exist but could be discovered only after the ground work of unearthing all the historical data had been completed.

It goes to his credit that in search of the facts, he was not against the use of deduction wherever needed, though mostly it would have to be induction; i.e. he was convinced that the use of both the inductive and deductive methods were necessary for formulating economic theory.

7.2.3. Major Tenets of the Historical School

Dear student! What were the major doctrines of the historical school? Please, write your answer on the space provided below.

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Great! Four principles were basic in the thinking of the German historical economists:

Evolutionary approach to economics. The historical school applied a dynamic, evolutionary perspective in its study of society. It concentrated on cumulative development and growth. An analogy was sometimes drawn to Darwin's evolutionism in biology: The social organism is born, develops and grows, and finally decays and dies. Society is constantly changing. Therefore, what is relevant economic doctrine for one country at a particular rime may be irrelevant for another country or another age. This relativistic approach was especially useful in attacking classical economics as being unsuitable for Germany.

Emphasis on the positive role of government. The Historical School was nationalistic, whereas classical economics was individualistic and cosmopolitan. If the social organism is the center of study, if it is the force for dynamic movement, then society and the state, rather than the individual, occupy the center of the stage. In Germany it was the state that fostered industry, transportation, and economic growth. In the process of defending a unified economy, it was easy to develop an ardent nationalistic glorification of the state. The historical school gave great prominence to the need for state intervention in economic affairs and emphasized that the community has interests of its own that are quite distinct from those of the individual.

Inductive/historical approach. The economists of the Historical School emphasized the importance of studying the economy historically, as part of an integrated whole. Because economic and other social phenomena arc interdependent, political economy cannot be treated adequately except in combination with other branches of social science. The historical school

criticized the abstract, deductive, static, unrealistic, unhistorical qualities of Classical and Marginalist methodology. It undertook massive inductive studies, using primary source material and studying changing social institutions. The school claimed that its historical method allowed it to study *all* the forces of an economic phenomenon, *all* the facets of economic behavior, not merely their economic logic. Some of the historical economists opposed nearly all forms of theorizing. They denied that there are any valid economic laws, with one exception: They believed that patterns of development are discernible in history and can be generalized into "laws of development."

Advocacy of conservative reform. Political economy, said the historical economists, must not merely analyze motives that prompt economic activity but must weigh and compare the moral merit of these actions and their outcomes. It must determine a standard of the proper production and distribution of wealth so that the demands of justice and morality are satisfied. The historical economists thought the German state should be entrusted with the amelioration of conditions for "the common man."" This would strengthen loyalty to the state while it safeguarded the health, well-being, and efficiency of the factory workers. Reforms, they hoped, would also divert the working class from socialistic ideology. The advocates of moderate social changes were dubbed "Socialists of the Chair," a reference to the academic positions they held.

7.2.4. Evaluation of the German Historical School

Dear student! From the discussion held above, how do you evaluate the contribution of the historical school? Please, write your answer on the space provided below.

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Well! The general, idea as regarded the impact it made up on the development of economic thought, can be formulated as follows:

Firstly, the differentia specific of historical school is not to be found in the use of the historical material; i.e. the use of such a material has not been its monopoly. The classical economists also used historical material, but only to substantiate the conclusion which they had already drawn. What distinguishes the historical school really is its use of the historical material for the search of relevant laws and generalization, if any.

Secondly, the basic distinction of the historical school lies in its assigning the historical and descriptive work the foremost place at the cost of the basic conception considered prerequisite for a social science. However all these should not be taken to underestimate the real impact which the historical school made up on economic thought and its tools and techniques of analysis. The historical school becomes instrumental in driving home the importance of the truth that there has to be a proper balance between facts and logic. The two must supplement each other. Theory has no meaning unless it can be substantiated by facts and a collection of facts is useless without our being able to drive certain conclusion from them.

Broadly speaking, we find two types of ideas in the Historical school writings namely, critical and positive

Critical Ideas: The historical school criticized the classical economists chiefly on three points namely (i) universality of their doctrines,(ii) their philosophy and principles, and (iii) the use of the deductive method.

- According to the historians the great defect in the writings of Smith and his followers was their belief that the laws formulated by them were applicable in all circumstance and at all places. On the contrary the historians believe that such universality was never possible. Economic laws formed at one time and for one country cannot be suitable for another time in the same county and for another country at any time and place. And it was the duty of the statesman to adapt legislation to meet different situations.

Again the historians believed that economic laws had only a relative value. The classicists also never denied the relativity of their own conclusions.

- The historical school further pointed that the classical doctrines were based upon narrow and crude psychological assumptions. Almost all of them had in view the man who was motivated by self-interest and who was absorbed in the pursuit of pain. The historians, on the other hand, say that self-interest is not the only motive by which a man is governed. There are other motives like prestige, pleasure, sense of duty, vanity, pity, benevolence, customs etc, which also influence man's behavior.

As against these criticisms some individuals like Wagner and Hajela argued that the only motive which is found common is that of self-interest. Similarly, they added, it is not correct to say that the Classicals did not realize the importance of other motives. The fact is that they did not give sufficient importance to motives other than self interest.

Further more, the Classical School was criticized for using abstract or deductive method. According to historians, the classical writers found it easier and simple to deduce economic laws from generally accepted fundamental principles. But the multiplicity of motives found in operation in this world well proves the inefficiency of this method. It is only by patient observation that one can arrive at conclusions real to this world, at the same time, taking full account of the complexity of economic phenomena. The Historians were quite optimistic about the usefulness of the inductive method.

It will have to be recognized that the analysis provided by the classical writers has been incomplete, and their generalizations were hasty and sometimes even ambiguous. But this does not disprove the legitimacy of the deductive method. In social sciences where experiment is *will-nigh* impossible, abstraction is the only means of escape from these other influences which complicate the problem so much.

Several schools and individuals (even including the members of the historical school) gave comment on the argument between the Classical & the Historical methods. Pareto has remarked that "*discussion of method is a pure waste of time. The aim of the science is to discover economic uniformities and it is always right to follow or pursue any method that is likely to lead to that end.*"
Schmoller (from historical school) says "*induction and deduction are both necessary for the science, just as the right and left foot are needed for walking.*"

Positive Ideas: The positive ideas of historians are more important than their critical ones because they provided a clue to an entirely different point of view which we are daily coming in to contact in the study of economic principles. Economic phenomena may be studied from two points of view: ***mechanical and organic.*** In the mechanical approach, the thinkers are more concerned with *reducing the complexity of the economic phenomena to few formulae and generalizations*, while in the organic approach they *keep in view the changing facts and thus present a more real and correct picture*.

According to the historical school, the classical economists belong to the first category. They have tried to explain all the aspects of economic phenomena with the help of simple mechanical principles. Consequently, their vision was narrow and limited. Most of the interesting and important economic phenomena (such as banks & exchanges, trade unions, employer unions, merchant *vs* consumers, peasant *vs* landlords etc) were left out by the classical writers, and cannot be analyzed with the help of mechanical principles. The mechanical view is evidently inadequate if we wish to delineate concrete economic life in its manifold economic activity. The chief weakness of the mechanical conception is that it studies man and his activities as an isolated individual, completely neglecting his environment. With a view to having a correct understanding of all the different aspects of economic life, one must take in to consideration the environment which influences the economic activities. This is what the Historians emphasized.

7.3. THE RISE OF SOCIALISM

Dear student! Socialism is another influential reaction against the classical economic thought. Although socialistic ideas have been known to people since the existence of man on earth, socialism proper is essentially the product of the 19th c. The 19th c socialist ideas, chiefly emerged out of the confusion and disorder created by the principles enunciated and policies advocated by the classical economists. In the latter half of the 18th c and in the beginning of the 19th c, there appeared in France and England a host of writers who cried hoarse against the existing social order. In general socialism was essentially the product of their social order.

7.3.1. The Historical Background of Socialism

Dear student! What are the factors giving rise to socialism? Please, write your answer on the space provided below.

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Great! With the advent of large factories, the industrial revolution shattered the security of the old agricultural-village-handicraft economy. Around these factories sprang up crowded slums, where vice, crime, disease, hunger, and misery were a way of life. Industrial accidents brought scant or no compensation for the families of the maimed and the killed. Political rights for wage earners did not exist, and unions were illegal. Every ill wind that reduced production and employment compounded the misery of the workers, and every new triumph of industrialization - although ultimately creating more new jobs than it destroyed - threw tens of thousands of handicraft workers onto the labor market. The poverty of the masses seemed increasingly oppressive as great fortunes multiplied.

From this backdrop came calls for economic reform. But most owners of capital, often citing the pronouncements of Smith and the other classicists, held stubbornly to the concept that the best government is the one that interferes least in the economy. Some historians conclude that the rise of Marxian socialism was given additional force by the failure of earlier, more moderate socialists to persuade industrialists to join in humanitarian movements.

7.3.2. The Concept of Socialism

Socialism (or socialist movement) is a reaction or a protest against capitalist system and, therefore, they are against the Classical School because classical economists assume that capitalism is a perfect system. But socialists said that this system is unjust and inefficient

Dear student, do you remember why classicists prefer capitalism? Please attempt on the following space.

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Good! As you have said, the classical economists believed capitalism to be in *ideal*/perfect system because of two reasons:

i) It abolishes unnecessary government regulation and restrictions and restores individual liberty.

ii) Individuals guided by self-interests and acting under competitive conditions , can work most efficiently and produce maximum wealth.

The socialists, on the other hand, saw the other side of the picture and found capitalism as an unjust and inefficient system and not for humanity because all the working burdens are carried by the laborers and the prosperity was taken by few individuals (lords) and hence it makes the laborers to live in poor condition.

The socialist movement was developed in two phases: In the early phase, the workers combined to form a *common front against the employers* and demand the abolition of various factory evils (including long hours of work). This explains how *trade unions* movement begins.

In the later phase, this working class movement was impregnated with the broad socialist objective. Now, the socialist revolted against the capitalist system as a whole along with its foundation of *competition and private property* and demanded its replacement with a new and better social order; i.e. *later they want not only to reform but also to change the system as a whole.*

7.3.3. Types of socialism

Dear student! Do you think that socialism is all the same? If not what are their difference? Please, write your answer on the space provided below.

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Great! Those who advocated socialism often disagreed vehemently on the type of socialism to be sought. It is, therefore, imperative to delineate the several types of socialism before attempting the more difficult task of sorting out the common ideas. The major types of socialism include the following.

A. Utopian socialism.

Utopian socialism dates back to the beginning of the 19th C with Henri Comte de saint Simon, Charles Faurier, and Robert Own as the forerunners. They developed their ideas at a time when the industrial workers were still weak and unorganized, demoralized by the rapid changes of the industrial revolution, deprived of the franchise, and not yet aware of their latent power. The Utopian socialists regarded the competitive market economy as unjust and irrational. According to these writers, all the evils were the outcome of competition which had destroyed individual liberty. Individual liberty was an extremely valuable possession to them. In their opinion, competition, on the other hand, made the employers crazy for earning more and more profits, and on the other compelled the workers to agitate for more and more wages. The natural results have been the establishment of *monopolies* and the *loss of individual liberty*. They, therefore, advocated the replacement of competition with association. That is why Utopian socialists are also known as ***associationists***, *pinned their faith on the voluntary association of workers*, for the amelioration of their conditions.

The basic idea of these socialists was that no man/woman was by birth, good or bad. He/she was what his/her environment was made him/her. Consequently, they want to change him by changing his environment. They believed that individual liberty and personality can never flourish unless the environment is changed. These people believe that by organizing people in to small groups, through voluntary cooperation and thereby establishing a community with perfect political and social system- *an Utopia*- they could achieve the ultimate happiness.

They worked out concepts of perfect social arrangements and then appealed to the whole world to adopt them. They preached universal togetherness rather than class struggle and looked to the capitalists to cooperate with and even finance their schemes. Imaginary model cooperative communities were elaborated, and some were actually tried, usually unsuccessfully.

By and large, the utopian socialists regarded the competitive capitalist market economy as unjust and irrational. They worked out concepts of perfect social arrangements and then appealed to the whole world to adopt them. They preached universal brotherly love rather than class struggle and looked to the capitalist to cooperate with and even finance their schemes. Of course some imaginary modeled cooperative communities were elaborated and some were actually tried, usually unsuccessfully[11].

B. State socialism.

This involves government ownership and operation of all or specific sectors of the economy for purposes of achieving overall social objectives rather than profit. The former Soviet Union is an example of a nation in which all of the major sectors were, until recently, state owned and operated. But state socialism also can occur within a capitalist framework. Examples within the United States are the federal Social Security system, and the postal service. Historically, the state socialist considered the state to be an impartial power that could be influenced to favor the working class if the vote were extended and the workers educated and organized. Then, the state could take over enterprises and become the employer; or it could foster and subsidize cooperatives (workers or consumers as owners). Louis Blanc was the chief early proponent of state socialism.

C. Christian socialism.

This version of socialism developed in England and Germany after 1848, with Charles Kingsley being its leading advocate in England. It arose after the defeat of radical movements in both countries. The workers were offered the solace of religion to assuage their pain and to provide hope. The Bible was to form the manual of the government leader, the employer, and the worker; God's order was mutual love and fellowship. Property owned by the rich was to be held

[11] V.I Hajala, p: 256-7

in trust for the benefit of everybody. This movement, repudiating violence and class struggle, advocated sanitary reform, education, factory legislation, and cooperatives.

D. Anarchism.

Anarchism held all forms of government as oppressive and hence should be abolished. One of its early proponents of Anarchism was Pierre Joseph Proudhon (1809-1865).
Anarchists did not advocate that society have no order but rather that society's order arise out of self-governing groups through voluntary or associate effort. Human nature, they contended, is essentially good if not corrupted by the state and its institutions. Private property .should be replaced by collective ownership of capital by cooperating groups.

He opposed socialists because of their utopian schemes. The use of property brings abuses since the owner can exploit others through it. Proudhon, therefore, attacked not the use of property but the exploitation through it in the form of rent, discount, money interest etc. *His program called for retention of private property but without the right of exploitation and escheat.* Proudhon did not believe the existence of state as necessary. Once such individual gets a right to free use of the means of production, there could be voluntary and mutually beneficial arrangements for production and distribution and the need for government would vanish. He did not believe in communism for in communism, the strong get exploited by the poor. He wanted to harmonize property and community through liberty.

Another anarchist, Mikhail Bakunin, said *the state is the root of evil.* But this does not mean that Anarchism is an orderless system. *Anarchism did not advocate a society without order but rather that societies order arise out of self-governing groups, through voluntary and associative effort. Human nature, they said, is essentially good if not corrupted by state and its institutions.*

Anarchists envisioned communities engaging in production and carrying on trade with other communities, with associations of producers controlling agricultural, industrial, and even intellectual and artistic production. Associations of consumers were expected to coordinate housing, lighting, health, food, and sanitation. Mutual understanding, cooperation, and complete liberty would characterize anarchist society. Individual initiative would be encouraged, and every tendency to uniformity and centralized authority would be effectively checked. Although the

methods of achieving their goals differed, the ideal community of the anarchists resembled that of the Utopian socialists.

E. Marxian socialism.

Karl Marx and Fredric Engles were the outstanding leaders of the School. The huge thinking capability of Marx dwarfed the fame (reputation) of Engles although he made indisposed contribution to the system. Marx described his socialism as scientific socialism because he attempted to give scientific proof of the inevitability of the replacement of capitalism by socialism. Marxian, or "scientific socialism," is based on a labor theory of value and a theory of exploitation of the wage earners by the capitalists. Although Marx and Engels passionately despised capitalism, they paid tribute to the great increase in productivity and production that it unleashed. But capitalism faced class struggles and contradictions that inevitably would lead to its being overthrown and replaced by socialism. The capitalist state oppresses the workers. The working class, in overthrowing the bourgeois state, will establish its own dictatorship of the proletariat to destroy the bourgeois class. Under the resulting socialism, private property- in consumer goods is permitted, but the capital and land is publicly owned by the central government. Production is planned, as is the rate of investment, with the profit motive and the free market eliminated as the major guiding forces for the economy.

F. Communism.

According to Marx, communism is the stage of society that eventually supersedes socialism. Under socialism, the slogan is "From each according to his ability, to each according to his work." Under communism the slogan becomes 'from each according to his ability, to each according to his need." This presupposes a superabundance of goods relative to wants, the elimination of money payments based on work performed, and a devotion to society as selfless as a person's loyalty to his or her family. The state will wither away when antagonistic classes dis-appear, and government over people will be replaced by administration over things, such as large railway systems and coal-iron-machinery complexes. The so-called communist countries today have actually established state socialism or are in the process of establishing it. Communism exists nowhere at present.

G. Revisionism.

In Germany revisionism was advocated by Eduard Bernstein (1850-1932). In England the Fabian socialists led by Sidney and Beatrice Webb (1859-1947; 1858-1943) were revisionists. Revisionism abjured the class struggle; denied that the state is necessarily an instrument of the wealthy class; and pinned its hope on education, electioneering, and gaining control of government through the ballot. The government was to regulate monopolies, control working conditions in factories, take over some public utilities, and gradually extend its ownership of capital. Because the revisionists, especially the Fabian branch, favored municipal ownership of public utilities, revisionism has sometimes been called "gas and water socialism."

H. Syndicalism.

Georges Sorel (1847-1922) promoted and popularized this form of socialism in labor circles in the Latin countries of Europe. Syndicalists were antiparliamentarian and antimilitarist. They believed that socialism deteriorates into bourgeois beliefs when it engages in political and parliamentary activity. If represented in parliament, the movement will degenerate into opportunism to gain political influence. What the workers require is one big union that will not play the bourgeois game of seeking social reform and the amelioration of conditions. The union calls for a general strike that will overthrow capitalism; each industry will then be organized as an autonomous unit managed by the workers, and these units will be combined in a federation that will become the administrative center. The syndicalists expected coercive government to disappear. Syndicalism differed from anarchism in that the former relied exclusively on revolutionary unionism and the general strike for the overthrow of government. But both favored the abolition of private property and extinction of political government.

I. Guild socialism

G. D, H. Cole (1889-1959), a professor of economics at Oxford University, was the major advocate of this type of socialism. The guild socialists accepted the state as a necessary institution for expression of the general interests of citizens as consumers. The actual management of industries was to be entrusted to the employees (the producers), organized in their industrial guilds, rather than to the government. But the government was to develop overall

economic policy for the whole community, not merely for the workers. Every worker would be a partner in the enterprise for which he or she worked; this was the essence of the "industrial democracy" that guild socialists favored. The nation would no longer be divided into opposing camps of capital and labor; instead, it would be divided into producers and consumers, with each having its national association-the guild and the government. Thus producers and consumers would form a partnership of equals.

7.3.4. Commonalities of Socialism

Dear student! Recall that each of them, as we saw above have some basic differences. But what is their similarity? Please write your answer on the space provided below.

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Good! The various strands of socialism had several features in common. First, they all repudiated the classicist notion of the harmony of interests. Instead, they viewed society as being composed of distinct classes whose interests were often opposed to one another. Second, and following from the first, the socialists all opposed the concept of laissez-faire. With the exception of the anarchists, socialists viewed government as being potentially a progressive representative of the interests of the working class. Third, these people rejected Say's law of markets, claiming, instead, that capitalism is given to either periodic crisis or to general stagnation. Fourth, the socialists denied the concept of humanity upon which classical thought was erected, instead believing in the perfectibility of people. Capitalism produced self-interested behavior through its emphasis on making profits and accumulating wealth; with the proper environment, the nobler human virtues such as sharing with others would emerge. Fifth, each of the various socialist ideologies advocated collective action and public ownership of enterprise to ameliorate conditions of the masses. This ownership could be undertaken by the central government, local governments, or cooperative enterprises.

In general, we have many types of socialism. But one thing is common with all the socialist: *they show dissatisfaction with the working of capitalists system and aim at its transformation.*

7.4. KARL MARX *(1818-1883)*

7.4.1. Life and Works:

Karl Heinrich Marx (Son of an upper-middle class lawyer) was born in Treves, Germany on May 5, 1818. His parents were of Jewish faith but gave up after birth of Marx - changed to Christian. Marx was educated at universities of Bonn & Berlin. At 17 he entered the University of Bonn to study law but transferred after a year to the University of Berlin where his interest become directed primarily to Philosophy & History. He got his PhD at the age of 23. Although his father want him to adopt academic or official carriers, Marx found them unsuitable for him and want to journalism because he want to take part in political activities of Germany

In 1843, he published Introduction to Critique of Hegel Philosophy of Rights. Then he left Germany & move to Paris (France) where he took over the editorship (of a news letter?). Again he wrote on the critique of the Hegelina philosophy of law which contains one of the clearest expositions of his theory of the *history of class struggle* and of the spirit of revolution which is found throughout his writings. He also expelled from Paris and then move to Brussels (Belgium) in 1845. At the mean time two important events took place: *the creation of his interest in political economy, and his acquaintance with his life- long friend and collaborator Friedrich Engels (who was also his financial Supporter).*

In collaboration with Engels he wrote the Communist manifest which contained theory & program of the communist League formed in 1847. In 1848 Marx left Brussels and returned to Germany to take an active part in the revolution.

Marx was exiled to London in 1849. Except for brief visits to the Continent, he lived the rest of his life in England, where he spent days and years in the reading room of the British Museum exploring "the confounded ramifications of Political Economy." Tormented by illness, extreme poverty, and the death of three of his children in infancy, Marx continued to study, write, and organize. He wrote many articles for the *New York Tribune,* whose payments helped him subsist. He organized and led the International Working Men's Association, the "First International," which lasted from 1864 to 1876. In 1867 he published the first volume of his magnum opus

(master piece), *Das Kapital (Capital)*. He died on March 14, 1883. After Marx death, Engels edited his manuscripts and published Vol. II (1885) and Vol. III (1894) of Marx's work. After Engels died, the remaining manuscripts were left to the leading Marxian of the time, Karl Kautsky, who published another three volumes under the title *Theory of Surplus Value.*

Marx was the man who gets the greatest support following Mohammed Prophet in this world. Marx spent most of his time in the British Museum reading and writing and it is told that he died of hunger with all his families.

7.4.2. His Scientific Socialism:

Dear student! Do you remember what scientific socialism is? And what is its difference from other forms of socialism? Please write your answer on the space provided below.

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Good! The socialist critics of classical economics preached dramatic reform; their objection to capitalism and its alleged evils was moral. Karl Heinrich Marx (1818-1883), the leading theoretician of "scientific socialism," dismissed that approach. He sought to show that capitalism had internal contradictions that would ensure its eventual demise. Marx believed that social revolution was inevitable within advanced capitalist countries, and he and his compatriot Friedrich Engels (1820-1895) advocated that the workers of the world unite to hasten this event.

The earlier socialists could not succeeded in formulating a body of economic theory different from that already in existence. They could not succeed in establishing what they want simply because they appealed to sentiments to prove the desirability of the aesthetics beauty of socialism. They never endeavored "to prove by economic reasoning, the inevitability of socialism." Their socialism can be labeled as "middle class socialism" or "bourgeois socialism" and not as "*working class socialism.*"

It was only with Karl Marx that socialism entered the main current of economic doctrine. It becomes a body of doctrines based on the support of economic arguments. Marx clearly interpreted the recent & current economic phenomena and foretold the future.

7.4.3. Influences Shaping His Ideas

Dear student! What were the factors that influenced Marx's idea? Please, write your answer on the space provided below.

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Good! Marx was essentially a product of his environment – the economic and political conditions of Germany He draw inspiration from the experience of English Industrialism & trade unionism as well as from the French post revolutionary political struggle.

Besides Engels, several other intellectuals influenced Marx. Chief among them were Ricardo, the early socialists, Darwin, Hegel, and Feuerbach.

The Ricardian influence. Marx studied the works of both Smith and Ricardo and was intrigued in particular by Ricardo's labor theory of value. He felt that Ricardo's theory had several shortcomings and proceeded to sketch his own labor theory-one that had revolutionary implications.

The role of the socialists. Marx was well aware of the pronouncements of several of the socialists discussed in the previous chapter. He shared their moral outrage against contemporary capitalism, their sharp criticism of classical political economy, and their socialist vision of future society. Marx felt, however, that socialism would not be forthcoming until die conditions of the working class deteriorated to die point of open rebellion. He sought to show why this deterioration was inevitable under capitalism.

The Darwinian connection. Charles Robert Darwin (1809-1882) was inspired by Malthus, and his own monumental work impressed Marx. Darwin stated that while reading Malthus on population, it suddenly occurred to him that in the struggle for existence that he had observed everywhere, favorable variations tended to be preserved and unfavorable ones destroyed. Marx read Darwin's book(*On the Origin of Species by Means of Natural Selection-1859)*in 1860 and saw parallels in it with his own thinking on political economy. To Marx, the present organizational relationships in the economy, like present biological organisms, were consequences of past change and antecedents of changes still to come. Darwin thus influenced Marx by *reinforcing Marx's* perspective that dynamic, as opposed to static, analysis is the route to true understanding.

The Hegelian influence. Of far greater significance to Marx's thinking was the dialectical process developed by Georg Hegel (1770-1831). According to this eminent German philosopher, historical knowledge and progress occur through a process of conflict of opposing ideas. An existing idea, or *thesis,* gets confronted by an opposing idea, or *antithesis.* The ensuing struggle between the ideas transforms each into a new idea, or *synthesis,* which then becomes the new thesis. The process then begins again. Marx modified Hegel's notion of the dialectical process, using it to formulate his own theory of historical materialism.

Feuerbach's materialism. In common usage, the term *materialism* refers to the tendency of a person or society to overemphasize the pursuit of consumer goods. But this is not the definition of the term as used in the context of our discussion of Marx. Instead, philosophical "materialism" refers to an emphasis on "matter," "real things," or "the world of reality," as contrasted to "the realm of Ideas" (idealism). Although Marx accepted Hegel's notion of a dialectical process within history, he replaced Hegel's idealism with a modified version of Ludwig Feuerbach's concept of philosophical materialism. More important, like Feuerbach, Marx emphasized materialism-the importance of material realities-as opposed to Hegel's idealism.

From Quesnay he derived the fundamental conception of the economic process

7.4.4. Marx as a Father of International socialism

Broadly speaking, there are many claimants of this title, but it is only Marx who is the true claimant[12]. Marx gave to socialism a new form and content. His socialism was meant for all those who were "***have nots"*** and it was a revolution against those who were the "*haves*" The indubitable fact is that all subsequent schools have been dominated by Marx and that even when subsequent schools have disowned him, they have owned their existence to a reaction from Marx. Marx's analysis, his deep study of economic problems, his styles, his clarity of ideas, his logic, his scholarship and his passion to reach the bottom of every mater, all have made him an important figure in the world of economic ideas. By and large, his socialism was scientific socialism and he was the father of the world socialist movement in the true sense of the term.

[12] For the list of the claimants see Hajela P. 267

7.4.5. Main Ideas of Marxism

Dear student! What do you think are the main ideas of Marxism? Please, write your answer on the space provided below.

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Great! Below are the summary of the ideas of Marxism.

1. Philosophy: Marx's philosophy is known as 'dialectical materialism'. According to this philosophy, matter and not sprit (idea) is the driving force. Sprit is just a reflection of matter. This is contrary to Hegel's philosophy. For Hegel, the idea was paramount and would eventually influence society; to Marx, the mode of production of the material means of existence conditioned the whole process of social, political and intellectual life.

2. Materialistic conception of history: The materialistic conception of history underlines that the dominating and determinant factor in all history is economic character. [Everything is governed by economic benefit. Material benefits/ interests are at the center of everything.] This materialistic conception of history finds its expression in un intermittent (continuous) class struggle. [In pursuing their economic interest people join an endless class struggle.]
History according to Marx is merely a record of class struggle; as soon as one is resolved, another is engendered (born).

3. Theory of value: Marx accepted Ricardo's theory of Labor value and developed it. In his C*apital,* Marx started his economic with his analysis of commodity.
For Marx, a commodity has got two characteristics: use value and exchange value.

> ***Use value***: is a capability to satisfy human wants directly (as a means of subsistence) or indirectly (as a means of production).
>
> ***Exchange value***: is a capability to be exchanged with others.

For Marx the (exchange) ***value*** *of a commodity is determined by the amount of labor time embodied (contained) in the quantity*. By Labor time Marx mean the *socially necessary* labor time. The socially necessary Labor time, on the other hand, is the average time needed by all workers. This socially necessary Labor time includes the direct labor in producing the commodity as well as the labor

embodied in the machinery and raw material that are used up an the value transferred to the commodity during the process of production; i.e. not all the values embodied in the production of the machine that is added to the socially necessary Labor time but only that part of machines labor time to produce the commodity or technically the depreciating part.

While he thought that all values derived from labor, Marx, like Smith and Ricardo before, aware that labor is not homogeneous but it is some times more proficient because of natural ability or superior training. That is way by labor time he did not mean the time spent by any particular individual, but the socially necessary labor time. By socially necessary labor time he meant the labor time necessary to produce any use value with the given normal conditions of social production and the social average degree of skill and intensity of labor. In a given time and under given conditions, highly skilled labor will produced commodities of a higher exchange value than the less skilled laborers. The fact that more labor time is lavished on a commodity does not necessary give it higher value. Only socially necessary labor time contributes to value.
Marx's instance that an object can have an exchange value only if it represents embodied labor led him to distinguish between value and price. An object like uncultivated land may command price but devoid of exchange value because there is no labor congealed in it.

4. **Theory of surplus value:** According to Marx, ***labor power*** has unique characteristics of being capable of producing more than its own value when it is put in its productive use. For Marx, all commodities sell at their value (exchange value). The capitalist receives profit by purchasing the commodity that can create a value greater than its own; i.e. labor power.
It is appropriate to distinguish between Marx's concept of labor time and labor power. Labor power refers to a man's ability to work; labor time is the actual process and duration of work. Labor power is a commodity bought and sold in the market while labor time is the ingredient that gives all commodities (including labor) their value.
The value labor time is determined by socially necessary labor time required to produce the necessity of life the worker and his family consume. If these necessities could be produced in 4hrs per day the value of the commodity labor power would be 4 hrs per day even if the labor time worked per day is 8hrs. The excess of value produced by labor power over its own value is known as ***surplus value***. The surplus value is pocketed by the capitalist and constitutes ***exploitation of labor.***

5. The Industrial Reserve Army: The uncontrollable thirst of capitalist to increase the surplus value in every possible way leads to increasing misery and degradation of the working class and to the formation of an increasingly large industrial reserve army of unemployed and underemployed. [He is criticizing the capitalist because the capitalist need more surplus; not welfare of the worker.]

Marx criticizes Malthusian theory of population as the serving the interest of the ruling class against the worker by saying that the poor themselves are responsible for their poverty. According to Marx, the explanation of over population and poverty lies in capitalist mode of production and not in the biological capacity of man to produce as Malthus believed. Under capitalism the demand for labor increases less rapidly than the supply of Labor. The result is the increase in the industrial reserve army (unemployment). For Marx, the problem of unemployment arises not because there is excess supply of labor but because there is inadequate demand for labor.

6. The Law of Capt. Accumulation: The large capitalist devours (destroy) the smaller so that means of production become concentrated in ever few hands. Society becomes increasingly affected by commercial crises until the favorable movement. Wealthy expropriators will be expropriated and the proletariat will enter into a new system based on public ownership of the means of production and dictatorship of the proletariat.

7.5. CHAPTER SUMMARY

- The use of deductive Method of reasoning by the classical School gave rise to a class of critics known as the Historical critics. The German historical school passed through two pleases: the older school and the younger school. The older historical school was devoted to criticizing the classical school for their deductive reasoning. They merely laid down the principles whose application was left to the younger historical school. The younger group started with the determination to apply the historical method in more thoroughgoing way than their predecessors.

- Four principles were basic in the dunking of the German historical economists: evolutionary approach to economics, emphasis on the positive role of government, inductive/historical approach, advocacy of conservative reform. The historical school criticized the classical economists chiefly on three points namely (i) universality of their doctrines,(ii) their philosophy and principles and (iii) the use of the deductive method.
- Socialism (or socialist movement) is a reaction or a protest against capitalist system and therefore, they are against the classical school because classical economists assume that capitalism is a perfect system. But socialists said that this system is unjust and inefficient
- Those who advocated socialism often disagreed vehemently on the type of socialism to be sought. It is therefore imperative to delineate the several types of socialism before attempting the more difficult task of sorting out the common ideas. The major types of socialism include: Utopian socialism, State socialism, Christian socialism, Anarchism, Marxian socialism, Communism, Revisionism, Syndicalism, Guild socialism. Although we have many types of socialism, one thing is common with all the socialist: *they show dissatisfaction with the working of capitalists system and aim at its transformation.*
- Karl Heinrich Marx (1818-1883), the leading theoretician of "scientific socialism," sought to show that capitalism had internal contradictions that would ensure its eventual demise. Marx believed that social revolution was inevitable within advanced capitalist countries, and he and his compatriot Friedrich Engels (1820-1895) advocated that the workers of the world unite to hasten this event.

7.6. SELF TEST EXERCISE

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of the major reactions against the Classical School. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1. Briefly identify and state the significance of each of the following to the history of economic thought: Utopian socialism, state socialism, Christian socialism, and anarchism
2. Discuss: The contributions of the early socialists to economic analysis are at best minor; it is questionable whether these people are of sufficient importance to deserve mention

in a history of economic thought textbook.

3. What are the contrasts between syndicalism and anarchism? Between Christian socialism and Marxian socialism?
4. Refer to the list of major tenets of the classical school in chapter six and indicate which of these principles the historical economists would reject. Explain.
5. In what respect is most of the empirical research done by contemporary economists "historical"? Is this the type of research that the more extreme historical economists had in mind? Explain.
6. In what respect did the views of the older and younger historical schools differ regarding classical economics?
7. Cite possible reasons the historical school evolved mainly in Germany as opposed to other areas of Europe.
8. Distinguish between *bourgeois socialism* and *working class socialism*. Which one belongs to Marxian socialism
9. If workers are paid the value of their labor power, as Marx contended, then in what sense are they exploited?
10. Suppose that 3 hours of socially necessary labor time are embodied in the commodities that typical workers and their families must consume each day-Assume also that the capitalists employ these workers for 12 hours a day. What is the rate of surplus value? The rate of profit?
11. Discuss the weakness in Marx's contention that the introduction of new machinery and new techniques of production would cause a growing reserve, army of the technologically unemployed.

CHAPTER EIGHT: THE RISE OF SUBJECTIVISM OR MARGINALIZM

8.1. INTRODUCTION

- **Overview:**

Dear student! In chapter six of this module we have discussed about the classicism which is dubbed by some as the objectivism. The sharp criticism against this school of thought was raised by the marginalist school which is also known as the subjective school. The beginning of the marginalist school is dated at 1871, the year Jevons and Menger published their influential books on marginal utility theory. In this chapter we develop an overview of the Marginalist School and discuss the ideas of the most important representatives of the school.

- **Chapter Objective:**

Dear student! Up on successful completion of this chapter, you will be able to:

- Examine the essence of subjectivism
- Understand the historical background of marginalism
- Distinguish between classicism and marginalism
- Distinguish between different kinds of marginalism
- Know the representatives of marginalism and their contributions to economic thought.

- **Chapter Content:**

The subsequent part of this chapter is organized as follows:

- The Historical Background of the School
- Subjectivism as Reaction to Classicism
- Main Points of Marginalizm
- Types of Subjectivism
- The Austrian School
- The mathematical School
- Chapter Summary
- Self Test Exercise

8.2. THE HISTORICAL BACKGROUND OF THE SUBJECTIVISM

Dear student! What factors do you think were responsible for the rise of subjectivism? Please, write your answer on the space provided below.

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Great! Compare your answer with the explanation given below.

Serious economic and social problems remained unsolved even a hundred years after the beginning of the industrial revolution. Poverty was widespread, although productivity was increasing dramatically. The extremely uneven distribution of wealth and income created much dissatisfaction even though the general standard of living was rising. Long hours of labor, dangerous and unhealthy working conditions, the preponderant economic power of employers in bargaining with workers, the rise of monopolistic enterprises, and insecurity in old age were among the many problems that caused people to seek solutions beyond the narrow confines of classical economic thinking.

The trend of the 19th c in Europe was to develop three approaches of attack on pressing social problems, and all three flouted classical economic precepts. These approaches were to promote socialism; to bolster trade unionism; or to demand government action to ameliorate conditions by regulating the economy, eliminating abuses, and redistributing income. The marginalists opposed all three "solutions." They theorized with seemingly Olympian impartiality and concluded that, although the value and distribution theories of the classical economists were inaccurate, their policy views were correct. The marginalists defended market allocation and distribution, deplored government intervention, denounced socialism, and sought to discourage labor unionism as either ineffective or pernicious.

8.3. SUBJECTIVISM AS REACTION TO CLASSICISM

Dear student! Is subjectivism a reaction or extension of classical school? Please, write your answer on the space provided below.

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Great! Compare your answer with the explanation given below.

The influence of reputation of classical economics had started waning owing to its narrowness, dogmatisms and lack of adjustability to times and places. The classical economists were dubbed as materialists since they laid undue emphasis on objective considerations and on the objective side of value, excluding the subjective factors. There emerged a trail of critics, some emphasizing the importance of utility while others stressing the significance of manmade institutions. While the Historical school criticized the abstract absolutism of the exchange value economics the socialists started the movement for ending the capitalist system. Both these schools were extremists and hence a reaction from their theories was natural, leading to the formulation of new doctrines and the development of the science. In this regard, subjectivism can be considered as reaction against the objectivism of the classical writers.

Furthermore, early marginalists believed that classical value and distribution theories erred in seemingly concluding that land rent is an unearned income and that exchange value is based on the labor time involved in the production process. The first idea was seized and expanded by the American economist Henry George, the second by Karl Marx.

8.4. MAIN POINTS OF SUBJECTIVISM /MARGINALIZM

Dear student! What do you think are the tenets of subjectivism? Please, write your answer on the space provided below.

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Great! Compare your answer with the explanation given below.

1. The subjectivists, like the classicists, used deductive method of analysis;
2. Marginal utility becomes the primary force in determination of Value. They were opposed to the use of averages and that is why they made use of marginal utilities. The marginalists' theory of value is often known as the *utility theory of value*. The marginalist theory of value can be put briefly as follows:
   i. Marginalists hold that value essentially springs from utility.
   ii. Successive portion of a good have diminishing marginal utility and value is determined at the margin. i.e. the crucial utility which determine value is the least important use to which the good can be used.
   iii. Value is reflected back from things consumed to the agent which produces the commodity. i.e. value sanction cost and is not caused by cost.
3. Like the classicists their object of study was an "economic man." It is the man whose economic activities are primarily motivated by self-interest (for Classical's) and/or pleasure (for Marginalists). The Marginalists assumed that men are rational in balancing pleasures and pains, in measuring marginal utility of different goods and in balancing present against future needs. Their approach was hedonistic for they assumed that the dominant derives among men are to maximize pleasures and to minimize pain. So they differ from the Classicals in that the subjective economists substituted the word *self-interest* with *pleasure*. They also measured disutility/ displeasure / dissatisfaction /pain involved in exchange transaction.
4. Like the Classicals, the Marginalists defended *laissez faire* as the most desirable power. They believe that there should be no interference with natural economic laws if maximum social benefits are to be realized. Their method of analysis was abstract and deductive as was the method of the classical school.
5. Like the classical economists, the subjective economists believed in perfect competition since they thought that man can get maximum satisfaction only under conditions of absolute free competition.
6. The Marginalists believed that economic forces generally tend toward equilibrium. Whenever disturbances cause dislocations new movements toward equilibrium occur.
7. Marginalists do not agree with the classical's thought regarding doctrine of demand and supply. The classical economists held that price was determined by demand & supply and price and demand moved in direct proportion while supply and price moved in

inverse proportion. As against this, the subjective economists pointed out that demand and supply were as much a function of price as price was the function of demand and supply.

8. The Marginalists are also known for extensive use of mathematics. The marginal reasoning gave mathematics a prominent place in economic analysis. Economic functions are assumed to be differentiable continuous.

8.5. TYPES OF SUBJECTIVISM

Dear student! Is subjectivism all the same? Do subjective economists agree on all matters? Please write your answer on the space provided below.

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Good! Please compare your answer with the explanation given below.

Those economists who emphasize the importance of the subject (or the ego) are known as the subjective economists. Although these economist agree on several issues, we observe slight differences between subjective economists. Their difference is significant especially on two issues:

i. *on the use of mathematics*- in this aspect we found two groups:

   The first group made large use of mathematics and stressed that economic phenomenon subject to independent variations and capable of quantitative expressions. The others made use of mathematics only for purpose of illustration. They are purely deductionists and try to analyze the causes of the problem more directly.

ii. *On the use of cost in determining value*- in this aspect we have three groups:

   Some consider cost as a problem/pain/displeasure and treated it at par with utility and hence coordinated the study of both. Some others considered costs as the secondary and subordinate. There are also other groups which did not assign any place to cost.

For convenience sake, we shall divide the above mentioned class of subjective economists in to two broad groups:

a. the Austrian School, and
b. the Mathematical school.

8.6. THE AUSTRIAN SCHOOL

Dear student! What is the contribution of Austrian School? And who are the architect of this school? Please write your answer on the space provided below.

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Good! Please compare your answer with the explanation given below.

The Austrian school is among the influential school of thought. The Austrians were very instrumental in sharpening the tool of the margin and popularizing its tool. But even within marginalism they deserve to be called a school for various reasons. The Austrians worked in such a well defined framework that in spite of their differences they can be easily recognized as a well knit group. Their primary aim was to uncover the ultimate and unified principle of value. And in this connection they adapted a hedonistic or pain and pleasure approach.

Karl Menger (1840-1921), Friedrich Wieser (1851- 1926), and Eugene von Bohm Bawerk (1851-1914) were the most important members of the school. These members of the Austrian school emphasize the importance of subjective elements in the determination of value and were successful in developing full-fledged utility theory value. According to the Austrian school, it was value that determines cost of production and not vice versa.

8.7. THE MATHEMATICAL SCHOOL

Dear student! What do you think is the role of mathematics in the development of economic thought? How did the school emerge? And who are the architect of this school? Please write your answer on the space provided below.

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Good! Please compare your answer with the explanation given below.

The use of mathematics in economic enquiries was made as early as 1838 by Cournot, the French economist. But, it is only in the field of exchange that the use of mathematical formula has been made. Little use has been made of members and algebraic formula whereas geometric figures and diagrams have been brought in to constant use.

The most celebrated members of the Mathematical School are Cournot, Gossen, Jevones, Walras, Pareto, Cassel, and Hicks. Among the forerunners of the mathematical school may be mentioned the name of Condillac and Bentham.

- ☞ Condillac, a French writer was the first to state clearly that value depends up on *intensity of wants*. While refuting the cost of production theory of value, he declared that "a thing does not have a value because of its costs, but it costs because it has a value."
- ☞ Bentham suggested the idea of marginal utility and the law of diminishing utility when he said "the greater the quantity of the matter of property a man is already in possession of , the less is the quantity of happiness he receives by the addition of another quantity of the matter property to a given amount.

Dear student! What are the major components of the Mathematical School? And who are the founders of this school? Please write your answer on the space provided below.

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Good! Please compare your answer with the explanation given below.

There are two slightly differentiated groups of writers (or schools) in the mathematical school.

i. The Marginalist School
   - Introduces the theory of marginal analysis

ii. The Lausanne School
   - Introduces the theory of General equilibrium

These two introductions constitute the two main achievements of the mathematical school.

8.7.1. The Marginalist School

The year 1871 marks a turning point in the history of economic thought. It witnessed the rise of a new school and the end of the classical school as the dominant school. Marginalism is still dominant in the field of microeconomics. The characteristic feature of the Marginalist school was the introduction of marginal analysis. The most important members are H.H. Gossen (forerunner) and W. S. Jevones

William Stanley Jevons (1885 1882)

William Stanley Jevons is given the credit of independently (and simultaneously with the Austrian school) discovering the marginal utility theory and originating the marginal school. He come to know Gossen's discovery and gracefully acknowledged him in the second edition of his theory of political Economy.

His Biography:

Jevons, a son of iron merchant, was brought up in Liverpool and attended University College of London from 1851-1854. His main interest, then, was exact sciences especially chemistry. He also studied mathematics, Latin and Greek. Before completing his degree course, he got an offer of an assayer (the job of testing the purity quality of precious metals, ores, etc) in the mint in Sydney (Austria) and went there. He planned to save out of his earrings for future study. Having saved requisite amount during five Years of service, he returned to England and completed his study for the B.A and MA degree in the fields of logic and political economy. He was a professor of political economy at Owens college, Manchester, and later (in1876) he became a professor at the University College, London , but has to resign his post after 4 years on account of ill health.

Jevons was a great lover of loneliness because it helped, he thought, in raising his thought above the ordinary level of others. He was much interested in pursuing independence. At forty seven, this active and versatile man drowned while swimming.

Jevons called Ricardo "that able but wrongheaded man who shunted the car of economics science on to a wrong line." Mill he felt, pushed the car further toward confusion. Malthus and Senior were much more to Jevons' taste.

His Theory of Value:

Jevons has put his central doctrine in the forefront of his "Theory of political Economy" in the following way. "Repeated reflection and inquiry have led me to the somewhat novel opinion that *Value depends entirely up on utility*.

- Jevons distinguishes between total utility and marginal utility (he calls' the latter *the final degree of utility*)

  The final degree of utility is defined by him as a ratio of the increase in total utility (caused by the addition to the stock of good under consideration) to the increase in stock of the good itself.
- Jevons also gives us the law of diminishing marginal utility in very clear-cut terms . "The final degree of utility varies with the quantity of commodity and ultimately decreases as that quantity increases"
- Jevons' law of diminishing marginal utility solved the paradox of water and diamonds.

  For instance, Adam smith believed that utility has nothing to do with the magnitude of exchange value because water was more useful than diamonds but diamond were more valuable than water.

  The principle of diminishing marginal utility reveals that while the total utility of diamonds is less than the total utility of water, the marginal utility of diamonds is far greater than the marginal utility water. Jevons said that "water up to a certain quantity is indispensable, that further quantities will have various degree of utility but beyond a certain point, the utility appears to cease."

Thus, it is only when we compare the marginal utilities of objects and consider them in relation to the relative scarcity of those objects that the real solution to the paradox can be found.

His Theory of Exchange:

With the help of the law of diminishing marginal utility, Jevons arrived at the equation of exchange, expressing the conditions of equilibrium and thus forming the basis of his theory of exchange.

Jevons puts his theory of exchange as follows: "The ratio of exchange of any two commodities will be the reciprocal of the ratio of the final degrees of utility of the quantities of commodity available for consumption after the exchange is completed."

In simple language, the equation of exchange requires that in equilibrium the ratios at which the two commodities are exchanged must be inversely proportional to the final degree utility.

This condition of exchange can be put symbolically as follows in away familiar to students of micro economics,

$$\frac{MUA}{MUB} = \frac{PB}{PA}$$

To conclude, Jevons dismissed the labor theory of value as something that cannot stand for a moment. He held that labor is essentially variable and its value must be determined by the value of the producer, not the value of the produce by that of labor.

8.7.2. The Lausanne School

Basically they are Marginalists. The major achievement of this school (and that of Warlas in particular) is the theory of general equilibrium. Another feature of this school is the use of mathematics. The most important members are Leon Walras and Vilfredo Pareto

i. Leon Walras (1834-1910)

Leon Walras, Francch economist**,** was the son of the distinguished Auguste Walras and remembered for his exposition of the early principle of value related to scarcity. It was a turning point in Leon Walra's career when he got in 1870 the professorship of political economy in the Faculty of Law at Lausanne a post he held till his resignation in 1892. Walras contributed to marginal utility revolution in economics using calculus techniques but found that much of his work has been anticipated by others. It was in the field of general equilibrium that he was to make his mark and main contributions. Thus, Walras' greatest contribution to economic science is to provide a new method of analysis-the general equilibrium method. Walras' general equilibrium analysis which considers the interrelationships among the many variables in the economy is often compared with Alfred Marshal's partial equilibrium analysis which takes the most important variable and considers other variables as given. The partial equilibrium method is also known as the ceteris paribus method. Walras viewed the economic system as unified system in which all the markets are inter-linked and the prices in different markets are determined simultaneously. According to the general equilibrium approach, the economic system as a whole is in equilibrium and the valuation problem is solved only when all demands in the economy became equal to all supplies in the economy as a whole.

ii. Vilfredo Pareto (1848-1923)

Pareto read and reread Walras and was impressed by the concept of general equilibrium. In 1893 he was appointed professor- extraordinary at Lausanne on the recommendation of Walras and in 1894 he was made professor. He held this post until resignation in 1909.

In addition to extending the general equilibrium system Pareto shares the credit for an independent innovation of indifference curves with the Englishman Francs Edgeworth (1845-1926). The aim of the idea of the indifference curves was to avoid measuring utility quantitatively. They advocate ordinal rather than cardinal measure of utility.

Pareto's idea on distribution helped in the development of welfare economics. He mentioned that if through redistribution total wellbeing of the members of the community increased, it implied an advantageous redistribution. This meant that such a step should increase the wellbeing of every one or increase the wellbeing of the sum without reducing that of the others. His optimality (now known as Pareto optimality) was the situation from where we could not increase the welfare of sum without reducing that of the others. He is also credited for the use of mathematics.

Conclusion: Marginalism/subjectivism had developed in several countries through the efforts of different people working independently of each other at first. The treo who have formally established Marginalism/subjectivism were

1. William Stanly Jevons (1835-1882) of England
2. Karl Menger (1840-1921) of Austria
3. Leon Walras (1834-1910) of Switzerland.

Note that

- Jevons's *Theory of Political Economy* was published in 1871.
- Menger's *Principle of Economics* appeared in 1871 in Austria.
- Walras *Elements of Pure Economics* published in 1874 in Switzerland (Lausanne) [13]

[13] The surprising fact is that the books, especially the first two, were written by different people at different places but with the same message

Although these are generally considered to have formally established Marginalism, the first reasonably complete statement of Marginalism was given by Herman Heinrich Gossen (1810-1858) in his work "Development of the Laws of Exchange Among Men and the Consequent Rules of Human Transaction's" published in 1854.

The history of this book is one of the curiosities of economic literature. Though Gossen believed to have made a stunning discovery, his book was entirely neglected on its publication. The book was not sold at that time because of its complex mathematical application. Disappointed by this, Gossen ordered a destruction of the unsold copies which must have been the whole stock, shortly before his death 1858. However, one copy of it was found by professor Adamson of Manchester in 1878. It was reprinted in Germen in 1889.[14]

8.8. CHAPTER SUMMARY

- Those economists who emphasize the importance of the subject (or the ego) are known as the subjective economists. The classical economists laid undue emphasis on objective considerations and on the objective side of value, excluding the subjective factors. Marginalism or subjectivism can be considered as reaction against the objectivism of the classical writers. In marginalist school, marginal utility becomes the primary force in determination of Value. Marginalists do not agree with the classical's thought regarding doctrine of demand and supply. The Marginalists are also known for extensive use of mathematics.
- However, the classicists and marginalists have several points in common. The subjectivists, like the classicists, used deductive method of analysis, defended laissez faire as the most desirable power, point of study is an economic man, believed in perfect competition, believed that economic forces generally tend toward equilibrium
- There are several classification of subjectivism and their difference is mainly on *the use of mathematics and on the use of cost in determining value*. Accordingly we have three slightly differentiated schools in subjectivism: the Austrian school, the Marginalist School, the Lausanne School. The latter two are collectively known as the mathematical school. The

[14] Still the important base of this school is Bantam's theory of Pain & Pleasure though he didn't push foreword.

Marginalist School introduces the theory of marginal analysis where as the Lausanne School introduces the theory of General equilibrium.

- Subjectivism had developed in several countries through the efforts of different people working independently of each other at first. The treo who have formally established subjectivism were William Stanly Jevons Karl Menger and Leon Walras. Although these are generally considered to have formally established subjectivism, the first reasonably complete statement of subjectivism was given by Herman Heinrich Gossen

8.9. SELF TEST EXERCISE

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of the subjectivism. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1. Briefly explain subjectivism and Identify the major causes for the rise of subjectivism
2. What is the difference between marginalism and classicism? And what is their similarity?
3. Compare and contrast the economic view of Jevons, Menger and Walras.
4. What is the difference between the Lausanne school and the Austria School?
5. What is the water diamond Paradox and how did the marginalist try to solve it?
6. Which of the major tents of marginalist school apply to Jevons?
7. Bring out clearly the contribution of the Austrian school in the development of economic thought.
8. Assess the positive contribution of the mathematical school to the development economic theories.
9. Give an estimate of pareto'e contribution to economic thought.
10. Leon Warlas is regarded by some as the greatest economists of the world. On what contribution of his to economic thought is this claim based?

CHAPTER NINE: THE NEOCLASSICAL SCHOOL

9.1. INTRODUCTION

- **Overview**

Hello Students! In the previous chapter we have discussed the main tenets of the Marginalist School and the contribution of some thinkers to the school. Here, we embark on a new school called Neoclassical School. Because *neo* means "new,'" *neoclassicism* implies a new form of classicism. The neoclassical economists were "marginalists" in the crucial sense that they emphasized decision making and price determination at the margin. Nevertheless, one of the differences between the earlier marginalists and later neoclassical economists is that neoclassical thought stressed both demand *and* supply in determining the market prices of goods, services, and resources, whereas the earlier marginalists tended to stress demand alone. In this chapter, we will learn the main points of the neoclassical school via the works of the greatest figure in the neoclassical school, Alfred Marshall (1842-1924)

- **Chapter Objective**

Dear student! Up on successful completion of this chapter you will be able to:

- Grasp the historical background of Neoclassicism
- Explain the essence of Neoclassicism
- Distinguish between the figures of Neoclassical school
- Understand the main contribution of Alfred Marshal to Economic Thought.

- **Chapter Content**

The remaining part of this chapter is organized as follows:

- Historical Background of Neoclassicism
- Representatives of Neoclassicism
- Alfred Marshal
- Monetary Economics
- John G. K. Wicksell
- Chapter Summary
- Self Test Exercise

9.2. HISTORICAL BACKGROUND NEOCLASSICISM

Dear student! How do you think did Neoclassicism emerge? And who do you think is the founder? Please write your answer on the space provided below.

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Good! The period between the passing away of Mill and the advent of Marshall was full of implications in so far as the development of economic science is concerned. Forces were let loose to bring the science into disrepute. First, attempts were made to broaden the scope of economic analysis by recognizing the inter-relationship of economic and ethical factors. Economics, thus, became more affected with a humanitarian interest. This change in outlook may be largely attributed to the labor movement which developed during the latter half of the nineteenth century and which was responsible for the downfall of the *wage-fund* doctrine.

The criticisms of the Historical School were also responsible for shaking the foundations of the classical economics. The German thought, actually speaking, had started gaining in strength in England. The development of the biological sciences and the idea of evolution further accentuated this change. The theoretical criticisms emerging chiefly from within found in the works of Cairnes, Jevons, Marshall and Hobson, had also gone a long way in influencing the English thought. All these developments led to the overthrow of the classical economics. Economics, although only for the time being, was thrown into the background. It was only in 1885, when Prof. Marshall took the Chair at Cambridge and established the "Cambridge School" that Economics started regaining its hold.

9.3. REPRESENTATIVES OF NEOCLASSICISM

Dear student! Who do you think are the major representatives of neoclassicism? Please write your answer on the space provided below.

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Good! As you have tried to mention them, there are a host of scholars who contribute to the birth and growth of neoclassism. The list includes Alfred Marshall, John. G. h. Wicksell, Irving Fisher, Ralph G. Hawtrey, Piero Sraffa, Edward H. Chamberlin and John Robinson. But the most pressing contribution toward the development of neoclassicism was made by Alfred Marshall and John G. K. Wicksell. Marshall founded what in some literature said the Cambridge School and Wicksell found what is sometimes called the Stockholm School. Both schools, of course, belong to the Neoclassical School.

9.4. ALFRED MARSHALL *(1842-1924)*

His Biography:

Marshall was the son of a cashier in the Bank of England. His father was a rather tyrannical gentleman, author of a tract called *Man's Rights and Woman's Duties*. He overworked Alfred at his studies, made him promise never to play chess because it was a waste of time, and tried to banish mathematics from the boy's life because it was irrelevant to the ministry, which the father had picked for his son's career. Young Marshall, however, rejected a scholarship at Oxford that would have led to the church, rejected the ministry, and rejected the study of "dead languages." Instead, he attended Cambridge, where he devoted himself to mathematics, physics, and later on, to economics. He was aided by a well-to-do-uncle, his father simply being too poor to pay for his tuition when he gave up the Oxford scholarship.

His position in Economic Science

Dear student! What is the role of Marshall in economic science and wahat was his major achievement? Please write your answer on the space provided below.

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Good! As already stated, Marshall appeared at a time when the classical school was under heavy-fire and when economics was passing through a crisis and was dubbed as a 'dismal science'. His *Principles* was an important landmark in the development of economic thought. He presented a synthesis of the classical doctrines and the marginal utility analysis of subjectivists, hence producing "neoclassical" economics.. His aim was to reconstruct economic science in the light

of the new developments and in the context of the changed conditions. He himself said of his *Principles* that "the present treatise is an attempt to present a modern version of old doctrines with the aid of the new work and with reference to the new problems of our age." The subjectivists and the marginalists also sought to reconstruct the science, but like them, Marshall did not demolish the existing structure of economics, but chiseled it out, modified it, supplemented it and made it up-to-date.

Truly speaking, in relation to economics his position was similar to that of Mill. Like Mill he was inspired by the desire to improve the conditions of the workers. "His primary interest in all his writings and studies on economic subjects was to make the science a useful instrument of social amelioration and progress. Economic theory and principles were to him means to practical ends and not ends in themselves." Both Marshall and Mill built up economics on classical foundations and in this respect Marshall did for Mill what Mill had done to Ricardo. Despite these similarities both had a different background and both were trained in different environments. Mill did not attend any school or university whereas Marshall received his education in London and Cambridge. Marshall was a teacher while Mill was a businessman. Quite unlike Mill, Marshall was deeply religious, but strangely enough, both had set for themselves the task which was alike in nature and both of them accomplished it with equal success.

Marshall popularized the modern diagrammatic approach to economics-the bane of beginning students-that helped elucidate certain fundamental principles. Although he was an expert mathematician who liberally placed mathematics in footnotes and appendixes, he was skeptical of the overall value of mathematics in economic analysis.

Marshall defined his subject as follows: "Political Economy or Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing." Economists, he said, like other scientists, collect, arrange, interpret, and draw inferences from facts. They seek knowledge of the interdependence of economic phenomena, of cause-and-effect relationships. Every cause tends to produce a definite result if nothing occurs to hinder it. Economics is not a body of concrete truth, but rather an engine for the discovery of concrete truth.

His Utility and Demand

On Marginal Utility: According to Marshall, demand is based on the law of diminishing marginal utility. "The marginal utility of a thing to anyone diminishes with every increase in the amount of it he already has." Marshall introduced two important conditions for the law to apply. First, the period is just a moment in time, which is too short an interval to consider any changes in character and tastes of a particular person. Second, those consumer goods must be *indivisible.*

On Measurement of Utility: The utility approach of the Marshallian system dealt with pleasures and pains, desires and aspirations, and incentives to action. How can we measure the utility of such intangibles? Marshall boldly said, "with money." The earlier marginalists said that the strength of a person's preferences determines the amount of money the person is willing to spend to acquire some product or the amount of labor the person is willing to sacrifice to achieve some goal. Marshall, however, turned the relationship around so as to measure preferences according to the financial scale of payments. The earlier marginalists would say that if shoes are twice as useful to you as a hat, you are willing to pay twice as much for shoes—for example, $40 versus $20. Marshall would say that because you are willing to pay twice as much for shoes as far the hat, we can conclude that the shoes yield twice as much utility to you.

On Law of Demand: Marshall's law of demand follows directly from his notions of diminishing marginal utility and rational consumer choice. Suppose that a consumer's expenditures are in equilibrium such that the last dollar spent on each of several products yields identical marginal utility'. That is, suppose that $MU_x/P_x = MU_y/P_y = \ldots = MU_n/P_n$. How will this consumer react if the price of product X falls while the prices of the other goods remain constant? Marshall reasoned that the rational consumer would buy more of product X. Why is this so? The answer is that, following the decline in the price of X, the ratio MU_x/P_x will exceed the MU/P ratios for the other goods. To restore a balance of expenditures, the consumer will substitute more of X for less of Y, Z, and the like. As this substitution occurs, the marginal utility of X will fall, and the marginal utility of the other goods will rise. At some point the now-lower marginal utility of X, in relation to the lower price of X, will yield a ratio equal to the MU_y/P_y, and the MU_Z/P_Z. Thus, equilibrium will be restored. Therefore, in Marshall's words: "the amount demanded increases with a fall in price, and diminishes with a rise in price." This is the now-familiar law of downward sloping demand.

Marshall illustrated the law of demand with both a table and a demand curve. He drew his demand curve by assuming that the period of time is sufficiently short to justify a *ceteris paribus* assumption. We have already observed that he held tastes or preferences constant. Other variables that he held constant were the person's wealth, the purchasing power of money, and the price of substitute commodities. Today such "other things equal" constitute what we call the determinants of demand. In the long run these determinants can change, and when they do, the entire demand curve shifts either leftward or rightward. Thus, Marshall had a clear conception of differences between changes in the quantity demanded (measured along the horizontal axis) and changes in demand (shift of the entire curve).

Consumer's Surplus: Unlike the Austrians, Marshall asserted that the total utility of a good is the sum of the successive marginal utilities of each added unit. Therefore, the price a person pays for a good never exceeds, and seldom equals, that which he or she would be willing to pay rather than go without the desired object. Only at the margin will price generally match a person's willingness to pay. Thus, the total satisfaction a person gets from purchasing successive units of a good exceeds the sacrifices required to pay for the good. Recall that this excess of utility over expenditure is called consumer surplus. Although Dupuit was the one who first noted this concept Marshall is credited for naming the concept "consumer's surplus" and systematically exploring it.

Elasticity of Demand: Marshall was far superior to his predecessors in handling elasticity of demand, analyzing the subject verbally, diagrammatically, and mathematically. The only universal law pertaining to a person's desire for more of a commodity, Marshall said, is that, other things being equal, it diminishes with every increase in his supply of that commodity. It follows, therefore, that the lower the price, the more the consumer will buy. That is why the demand curve slopes downward to the right. Elasticity of demand tells us whether the diminution of desire (marginal utility) is slow or rapid as the quantity increases. It relates the percentage drop in price to the percentage increase in quantity demanded, which, of course, is based on diminishing marginal utility of the good.

Marshall also discussed what we now call the determinants of the elasticity of demand. Elasticity of market demand tends to be great when a good has a high price relative to the size of the buyers' incomes. Marshall said that a lowering of the price results in many more buyers being

able to afford the product. On the other hand, when the price of a product is low relative to people's incomes, a similar percentage change in price will not result in much of an increase in purchases.

His Theory on Supply

Supply, said Marshall, is governed by cost of production. Marshall conceived of supply not as a point or single amount but rather as a curve. Supply is a whole series of quantities that would be forthcoming at a whole series of prices. For purposes of exposition, Marshall divided time into three periods: (1) the immediate present, (2) the short run, and (3) the long run.

Dear student! Do you remember what does immediate present, short run, and long run mean? Please write your answer on the space provided below.

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Good! According to marshal the difference between immediate present, short run, and long run is explained as follows.

Immediate Present: Market prices refer to the *present,* with no time allowed for adaptation of the quantity supplied to changes in demand. The corresponding market period which may be as short as one day, is defined as that period during which the quantity supplied cannot be increased in response to a suddenly increased demand. Nor can the quantity supplied be decreased immediately in response to a decline of demand, because it takes time for production to be curtailed and inventories reduced.

Short Run: To analyze the period that Marshall referred to as the short run, he divided costs into two types, which he called *supplementary costs* and *prime costs*. Supplementary costs are now known as *fixed costs;* prime costs are known as *variable costs*. Fixed costs, or overhead costs, such as top executive salaries and plant depreciation, are constant; they cannot be changed in the short run. In fact, the short run is defined as that period during which tile variable inputs can be increased or decreased, but the fixed plant costs cannot be changed. The short-run supply curve

slopes upward and to the right—the higher the product price, the larger is the quantity' supplied. Modern economics views the short-run supply curve as a marginal cost curve. Therefore, higher market prices enable firms to profitably expand their output.

Long Run: In the long run, all costs are variable, and they must all be covered if the firm is to continue in business. If the price rises such that total revenue exceeds total cost of production, capital will enter the industry, typically through new firms, and market supply will increase. The entire supply curve will shift rightward. If the price falls below the average cost of production, capital will withdraw, probably by die exit of firms. Consequently, the market supply will decline (die supply curve will shift leftward).

His Theory on Equilibrium Price and Quantity

Dear student! What determines market price? Please write your answer on the space provided below.

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Good! The classical economists said, "Cost of production," meaning objective labor-time cost, and the sacrifice of abstinence. "Demand," said the early marginalists. Marshall, the great synthesizer, said, *"Both* supply *and* demand." Behind supply lie both financial and subjective costs. Behind demand lie utility and diminishing marginal utility. In the words of Marshall: *We might as reasonably dispute whether it is the upper or the under blade of a pair of scissors that cuts a piece of paper, as whether value is governed by utility or cost of production. It is true that when one blade is held still, and the cutting is effected by moving the other, we may say with careless brevity that the cutting is done by the second; but the statement is not strictly accurate, and is to be excused only so long as it claims to be merely a popular and not a strictly scientific account of what happens.* Marshall illustrated the idea of equilibrium competitive market price and quantity with both a table and a graph.

His Theory on Distribution of Income

The distribution of income in a competitive economy is determined by the pricing of factors of production. Businesspeople, said Marshall, must constantly compare the relative efficiency of every agent of production they employ. They also must consider the possibilities of substituting one agent for another. Horsepower replaced handpower, and steampower replaced horsepower. At the margin of indifference between two substitutable factors of production, their prices must be proportionate to the money value they add to the total product. The most striking advantage of economic freedom is manifest when a businessperson experiments at his own risk to find the combination of factor inputs that will yield the lowest costs in producing the output. Entrepreneurs must estimate how much an extra unit of any one factor of production will add to the value of their total product. They will employ each agent up to that margin at which its net product would no longer exceed the price they would have to pay for it. Marshall based this analysis on the diminishing returns that result from the "disproportionate use of any agent of production."

His Theory on Increasing & Decreasing Cost Industries

A key analytic device for Marshall was his concept of the "representative firm.,'" which for him was the typical 19th c sole proprietorship. This abstraction served, at least, three major purposes in his analysis. First, in speaking of the normal cost of producing a commodity, he referred to the expenses of a representative producer who is neither the most efficient nor the least efficient in the industry. Second, this analytic device showed that an industry can be in long-period equilibrium even though some firms are growing and others declining; they simply neutralize each other. Third, even though the representative firm may not be increasing its internal efficiency, it can experience falling costs of production as the industry expands.

On Internal versus External Economies: *Internal economies,* said Marshall, are the efficiencies or cost savings introduced by the growth in size of the individual firm. As the firm grows larger, it can enjoy more specialization and mass production, using more and better machines to lower the cost of production. Buying and selling also become more economical as a firm's size increases. Larger firms can secure credit on easier terms, and they can use high-grade managerial ability more effectively.

On the other hand, *external economies come* from outside the firm; they depend on the general development of the industry, As the industry grows, suppliers of materials build plants nearby to serve the expanding industry; these supplies become cheaper both because transport costs are reduced and because they are "lass produced in firms that are growing. Perhaps, in addition, providers of transportation services emerge to meet the special needs of the burgeoning industry, thus reducing the cost of delivering products to customers.

Marshall thought that an increased volume of production in an industry will *usually* increase the size and therefore the internal economies possessed by a representative firm; it will *always* increase the external economies to which the firm has access. Therefore, he said, die cost of production in terms of labor and sacrifice will fall if the volume of output expands.

External economics are available to all firms in an industry. However, if internal economies grow with the size of the tirm, how can competition be maintained? If as a firm becomes larger it becomes more efficient, will this not mean that eventually there will be only a single firm in the industry (natural monopoly)? Marshall's concept of the representative firm provided the answer. The decline and death of the entrepreneur will lead to the decline and death of the firm. Individual businesses, Marshall thought, will typically not last long enough to realize all the benefits of an ever-increasing scale of production. New entrepreneurs will elbow their way into the business arena and renew the process of increasing the size and efficiency of their firms.

On Increasing and Decreasing Returns to Scale: If all factors of production used in an industry expand, will the cost per unit of output rise or fall? Marshall thought that we generally have increasing returns to scale in industry; as labor and capital expand, organization and efficiency improve. Only when we rely heavily on nature, as in agriculture, do we have decreasing returns. Where the actions of the laws of increasing and decreasing returns to scale are balanced, we have the law of constant returns: Expanded output is obtained through a proportionate expansion of both labor and the sacrifice of waiting.

Welfare Effects of Taxes and Subsidies: Marshall's analysis of constant, increasing, and decreasing cost industries led him to the following novel policy conclusions: (1) Either a tax or a subsidy will reduce net consumer utility in a constant cost industry; (2) a tax may add to net consumer

9.5. THE MONETARY ECONOMICS

Dear student! What is monetary economics? And who are the architect of this school? Please write your answer on the space provided below.

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Good! Please compare your answer with the explanation given below.

Of course, there is no separate school of monetary economics as such, although some contemporary economists are called "monetarists" and some economic schools emphasize monetary phenomena more than others. Therefore, we see in the Time Scale of Economic Ideas that a white arrow emanates from the neoclassical school to monetary economics and from the latter back to the neoclassical school.

The classical and Marxist schools and the early Marginalists regarded money merely as a veil that has to be pulled aside to examine the real world; they felt that money and prices are subordinate to more basic economic factors. Others, such as Wicksell and Keynes, combined monetary analysis with their study of fundamental economic processes. Money in economic theory was destined to increase in importance over the years with the growth of banking, credit, and economic fluctuations as well as the increasingly important monetary policies of central banks and governments.

Marshall devoted some attention to monetary analysis. Specifically, he stated a version of the equation of exchange called the *Cambridge equation*. This version is $M= kPT$, where M *is* the stock of money, k is the fraction of income that people collectively wish to hold in the form of cash balances. P is the general price level, and T is either the volume of trade or real income. Marshall's k is nothing more than the reciprocal of the velocity of circulation, V, *in* the more familiar equation of exchange, $MV= PT$. So, even though certain aspects of the theories presented by Wicksell, Fisher, and Hawtrey are more closely associated with macroeconomics than microeconomics, these economists are within the overall Marshallian neoclassical tradition.

Collectively, Wicksell, Fisher, and Hawtrey made a two-fold contribution to economics. First, they explored an area that had been neglected but was growing in importance and, therefore, required emphasis. Second, they helped integrate monetary analysis into general economic theory. It is important to note, however, that they may have exaggerated the role of money; it is easy to overcompensate for past shortcomings by allowing the pendulum to swing too far in the opposite direction.

As we have suggested, the monetary economists of the neoclassical school differed noticeably from the non-monetarists in the same school because the monetary theorists had to deal with aggregative analysis, such as total demand, total money supply, total saving, and total investment. A split within the neoclassical tradition ensued. The non-monetary branch looked at the individual person's or firm's real sacrifices, income, consumption, saving, and investment. The monetary branch aggregated these categories for the whole economy, emphasizing monetary factors along with real factors. It remained for later economists to synthesize monetary and non-monetary economics, although credit is due Wicksell as an important forerunner of these later economists.

John G. K. Wicksell (1851-1926)

His Biography:

John Gustav Knut Wicksell was born in Stockholm, Sweden, in a middle-class family. After studying mathematics, languages, literature, and philosophy as an undergraduate at the University of Uppsala, he took advanced degrees in mathematics and physics there. He was elected president of the student body of the University and became increasingly active in the philosophical, political, and literary debates and activities of student circles. As a popular lecturer and pamphleteer he explored such social questions as the population problem, birth control, emigration, prostitution, the need for direct progressive income taxes, etc. Wicksell's interest in social problems and reform led him to a study of economics. From 1885 to 1890 he studied at universities in England, France, Germany, and Austria. His most memorable experience in the study of economic theory was his discovery in a Berlin bookshop of von Bohm-Bawerk's book on capital theory soon after its publication in 1888. This book had a profound influence on his own economic thinking.

His Economic Ideas:

Wicksell made several major contributions to economics. First, he was one of the earliest economists to suggest that the typical firm will first experience increasing returns, then constant returns, and finally decreasing returns as it expands its size. Second, he anticipated the theory of monopolistic competition that was worked out later by Chambcrlin and Robinson in the 1930s. But, Wicksell's chief claim to fame lies in his contributions to monetary economics. These advancements include: (1) an analysis of the role of interest rates in achieving an equilibrium price level or in generating cumulative inflationary or deflationary movements; (2) recognition of the potential contribution of the government and the central bank in retarding or promoting price stability; and (3) an early statement of the saving-investment approach to macroeconomic equilibrium. This last contribution established Wicksell as the father of the so-called Stockholm school of economics. In addition, his work became one of the sources of Keynesian economics; Keynes himself complimented Wicksell as an important precursor of his own ideas. Wicksell's overall objective was to synthesize monetary theory, business-cycle theory, public finance, and price theory into one system. Although he was not totally successful, he advanced the state of economic thinking in this area.

On Price Level Changes: To Wicksell, monetary theory turned on one main question; Why do prices collectively rise or fall? To answer this question, he turned to an analysis of interest rates. Here he distinguished between the normal or natural rate of interest and the bank rate.

The *normal or natural rate* of interest, he said, depends on supply and demand for real capital that is not yet invested. The supply of capital flows from those who postpone consuming part of their income and thereby accumulate wealth. The demand for capital depends on the profit that can be realized from its use, or its marginal productivity. The interaction of supply and demand determines the natural interest rate:

The normal or natural rate of interest applies only to credit between individuals. Banks, however, complicate matters, because unlike private persons, they are not restricted to their own funds in their tending or even to the funds placed at their disposal by savers. Because banks create credit, they can extend loans even at very low rates of interest. On the other hand, they need not lend out all of the funds placed at their disposal by savers. Hence, the bank rate of interest may be either less than or greater than the normal or natural rate of interest. When

either of these two situations occur, the price level will eventually change. More specifically, if banks lend money at materially lower rates than the normal or natural rate as defined in the previous quotation, saving will be discouraged, and the demand for consumption goods and services will rise. Anticipations of price increases will cause prices to rise even more. Equilibrium is disturbed, and a cumulative upward price movement begins. The fundamental cause is a bank or market rate of interest below the normal or natural rate that would bring into balance real saving and real investment at constant prices. Prices will rise without limit so long as the bank rate of interest is less than the natural rate.

Conversely, if the bank rate of interest is above the natural or normal rate, prices will fall. The reason? Saving will increase, and investment spending will decline. The decline in investment spending will reduce national income, which, in turn, will cause the prices of consumer goods to decline. With the prices of both capital and consumer goods tailing the general price level will obviously decline; that is, deflation will occur. Expecting further price declines, buyers will reduce their present expenditures even further; thus, aggravating the deflation.

On Imperfect Competition: Wicksell recognized the inadequacy of the purely competitive model in retail markets; thus, anticipating by several decades the theory of monopolistic or imperfect competition proposed by Edward Chamberlin and Joan Robinson. It is remarkable that thirty-two years passed between Wicksell's statement of the problem and its further systematic development, but the idea of pure competition was central to much of the marginalist thinking, and its revision required overwhelming evidence of monopolistic tendencies in the economy. In 1901 Wicksell wrote that retailers usually have a fixed circle of customers, and this enables them to have fixed rather than fluctuating prices. While retail prices do respond to changes in wholesale prices, they do so only after a time lag and in modified form:

With respect to a complete monopoly, Wicksell followed the lead of Cournot and others by indicating that the volume of sales is artificially restricted to the point that yields maximum profits. Every rise in price reduces the quantity of goods demanded. "But, so long as the falling-off in demand [quantity demanded] is less than proportionate to the increased profit per unit of the commodity resulting from the higher price, the total net profit…will increase." Conversely, when the decrease in sales is more than proportionate to the increased profit per unit, further price increases are disadvantageous. It is important to note, said Wicksell, that fixed, or overhead

costs have no influence whatever in determining the most profitable monopoly price; only variable costs (marginal costs) are to be considered.

9.6. CHAPTER SUMMARY

- *Neoclassicism* implies a new form of classicism. But they were "marginalists" in the crucial sense that they emphasized decision making and price determination at the margin. While the neoclassical thought stressed both demand *and* supply in determining the market prices, the earlier marginalists tended to stress demand alone. The most pressing contribution toward the development of neoclassicism was made by Alfred Marshall and John G. K. Wicksell.
- Marshall presented a synthesis of the classical doctrines and the marginal utility analysis of subjectivists, hence producing "neoclassical" economics.. His aim was to reconstruct economic science in the light of the new developments and in the context of the changed conditions.
- According to Marshall, demand is based on the law of diminishing marginal utility. For the earlier marginalists, a preference determines the amount of money the person is willing to spend to acquire some product. But for Marshall it is the financial scale of payments that measure preferences.
- Marshall's developed the now-familiar law of downward sloping demand that says the amount demanded increases with a fall in price, and diminishes with a rise in price. For the classical economists, it is the cost of production and for the marginalists, it is demand that determines value. But Marshall, the great synthesizer, said, "Both supply and demand" determines value.
- Wicksell made several major contributions to economics. His theory of returns to scale, theory of monopolistic competition, his contributions to monetary economics are among the money that led him to great fame.

9.7. SELF TEST EXERCISE:

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of the Neoclassical School. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1. Briefly identify and state the significance of each of the following to the history of economic thought: neoclassical thought, law of demand, consumer's surplus, elasticity' coefficient, supplementary costs, prime costs, equilibrium price, rules of derived demand, quasi-rent, constant, increasing, and decreasing cost industry, internal economies, and external economies.
2. Is the standard neoclassical assumption of rational economic behavior valid?
3. What is Marshall's law of demand? How does it relate to (a) the equimarginal rule, (b) the law of diminishing marginal utility, and (c) consumer surplus?
4. Speculate on how you think Marshall would respond to the following question: Do pearls have value because people dive for them, or do people dive for pearls because pearls have value?
5. Contrast Marshall's distinctions between: (a) supplementary and prime costs; (b) immediate present, short run, and long run; (c) increasing and decreasing cost industries; and (d) internal and external economies.
6. Explain this statement: In the short run, a profitable firm focuses solely on its prime costs (variable costs) in deciding how much to produce. Supplementary costs (fixed costs) are irrelevant to this decision.
7. Briefly identify and state the significance of each of the following to the history of economic thought: Wicksell, normal or natural rate of interest, bank rate of interest.
8. Suppose that the natural rate of interest just equals the bank rate of interest. Will either inflation or deflation occur, according to Wicksell? Explain, relating your answer to investment and saving.
9. Discuss the following statement: Wicksell felt that the focus of monetary policy should be on the interest rate.

CHAPTER TEN: THE INSTITUTIONALIST SCHOOL

10.1. INTRODUCTION

- **Overview:**

Dear student! So far we have seen several schools of thought. We have also noted that the birth of most schools was attributed to either a reaction or an advancement of Classical School. The Classical School, which gave birth to later school of thoughts, was mainly the product of Britain and was the reflection of British economy. The role of America, the most influential country in the world today, towards the development of economic thought had been almost nil until the beginning of 20th century.

The Institutionalist School, an American contribution to economic thought, began around early 20th c and continues to the present. By 1900 its founder, Thorstein Veblen, had published his first book as well as many articles and book reviews. In this chapter, we provide an overview of the institutionalist school, and then discuss Veblen, who critically dissected orthodox thinking and provided the theoretical approach of institutionalist economics.

- **Chapter Objective:**

Dear Student! Upon successful completion of this chapter, you will be able to

- Know the historical background of institutionalism
- Understand what institutionalism means
- Grasp the main points of institutionalism
- Identify the icons of the institutional school
- Understand the economic ideas of T. Veblen

- **Chapter Content:**

Dear Student! The remaining parts of this chapter are organized as follows:

- The historical background of the school
- The Development of Institutionalism
- Major tents of institutionalism
- Representatives of Institutionalism
- Thorstein Bunde Veblen
- Chapter Summary
- Self Test Exercise

10.2. THE HISTORICAL BACKGROUND OF THE INSTITUTIONALIST SCHOOL

Dear student! How do you think did Institutionalism emerge? And who do you think is the founder? Please write your answer on the space provided below.

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Good! In the period between the Civil War and World War I, the achievements of American capitalism were impressive. Rapid growth made the United States the biggest and most powerful industrial system in the world. The improvements in living conditions of many wage earners, however, fell far short of their aspirations and of the possibilities created by the general rise in national income. Hours of labor were long; housing often was inadequate; security in times of sickness, unemployment, and old age was negligible; higher education was inaccessible for most workers' children; job security was virtually nonexistent; and health and safety regulations were inadequate. Frequently, employers organized company towns and dominated the workers, even in their personal lives; large-scale immigration tended to undermine wage rates; taxation was regressive; usury was widespread; and recurring recessions were devastating to those who lost their jobs.

The age of monopoly may be said to have begun in the 1870s, and this movement accelerated around the turn of the century. Conservative voices predominated in the schools, in the press, in the pulpits, and in government. The state and federal governments, which proclaimed laissez-

faire with respect to workers' interests, were quick to use the police and militia against labor in industrial disputes. They were also generous in establishing tariff protection for business and in granting large subsidies to railroads.

The American political and economic environment of the late 19th c led many economists to question the assumptions and conclusions of the neo-classical school. The doctrine that minimal government interference produces the maximum social well-being increasingly seemed untenable. There was much concern about monopoly, poverty, depression, and waste. The movement for social control and reform was gathering momentum, and it was in this milieu that institutional economics grew.

At the time two major methods of achieving social change were recognized (1) reorganize society along socialist lines; and (2) undertake social reform, that ameliorated conditions through government intervention in the economy. The object of this second approach was to save capitalism by improving the conditions of the masses. Veblen was critical of social movements and favored a radical reconstruction of society. Nevertheless, the institutionalist school he founded reflected the reformist approach. The changes wrought by the New Deal in the 1930s, for example, were greatly influenced by institutionalism.

The influence of the German historical school on American institutionalism is quite visible. Most of the leaders of the American Economic Association which was founded in 1885, were familiar and friendly toward the German movement and its methodology. Some of Veblen's illustrious teachers had studied in Germany. We should note, however, that despite certain similarities in methodology between the German historical school and American institutionalism, the latter was not nationalistic, and it was more liberal and democratic in its outlook.

10.3. DEVELOPMENT OF INSTITUTIONALISM

Dear student! How did institutionalism develop? Please write your answer on the space provided below.

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Good! Please compare your answer with the explanation given below.

The institutional approach to economic theory is not in any way new, but as a system of thought it could be developed only at the hands of the American economists during the 20th c. The foundation of the new system was laid by Veblen through his 'The Theory of the Leisure Class' and 'Instinct of Workmanship'. The development and growth of sociological ideas added further strength to it. The great depression of the 1930s provided an extremely favorable atmosphere for the development of institutionalism as a movement in academic thought and as a tool of public policy. The institutionalists criticized the rational self-interest approach of the classical economists and emphasized the importance of human instincts and habits in moulding economic activities. Therefore, the stress is on man-made institutions and institutional environment.

Dear student! Who do you think are the founders of this school? Please write your answer on the space provided below.

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Good! Please compare your answer with the explanation given below.

Veblen, Common and Mitchell formed the Older institutional school, while a host of writers of the younger generation, namely W.E Atkins, Tyson, S.H Slitcher, W.H Hamilton, A.B Wolfe, R.G Tugwell, etc. comprise the younger school. The older school is chiefly concerned with the description of economic life institutions and instincts pointing out the maladjustments which they may found. They do not set any goals and would like the social evolution to take its own course. Their approach is essentially critical and negative. On the other hand, the approach of the younger school is positive. Their chief objective is to direct social evolution in such a way

that social institutions and human activities may move simultaneously. They also seek to replace old economics with new economics. They carried out important researches in the field of sociology, history, and statistics; and succeeded in arousing a permanent interest in social reform.

10.4. MAJOR TENETS OF THE INSTITUTIONALIST SCHOOL

Dear student! What do you think are the essences of institutionalism? Please write your answer on the space provided below.

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Good! The following describe seven key ideas of this school:

- **Holistic, broad perspective**. The economy must be examined as a whole, rather than examined as small parts or separate entities isolated from tile whole. A complex organism cannot be understood if each segment is treated as if it were unrelated to the larger entity. Economic activity is not merely the sum of the activities of persons motivated individually and mechanically by the desire for maximum monetary gain. In economic activity there are also patterns of collective action that are greater than the sum of the parts. A union, for example, develops a character, an ideology, and a method of operation of its own. Its features cannot be deduced from the study of the individual members who belong to it.

  Even the concept of economic activity is too narrow in the institutionalists' view. Economics, they assert, is intertwined with politics, sociology, law, custom, ideology, tradition, and other areas of human belief and experience. Institutional economics deals with social processes, social relationships, and society in all its facets.

- **Focus on institutions.** This school emphasized the role of institutions in economic life. An institution is not merely an organization or establishment for the promotion of a particular objective, like a school, a prison, a union, or a federal reserve bank. It is also an organized pattern of group behavior, well-established and accepted as a fundamental part of the culture. It includes customs, social habits, laws, modes of thinking, and ways of living. For instance, slavery and a belief in slavery were institutions. Other examples are the

beliefs in laissez-faire, or unionism, or a government social security system. Going out on new year's eve to raise a din and clatter is an institution. So was communist ideology in the Soviet Union and anticommunism in the United States. Economic life, said the institutionalists, is regulated by economic institutions, not by economic laws. Group social behavior and the thought patterns that influence it are more germane/relevant to economic analysis than is the individualism emphasized in marginalist theory. The institutionalists were especially interested in analyzing and reforming the institutions of credit, monopoly, absentee ownership, labor-management relations, social security, and the distribution of income. They advocated economic planning and the mitigation of the swings of the business cycle.

- **Darwinian, evolutionary approach.** The evolutionary approach should be used in economic analysis, because society and its institutions are constantly changing. The institutionalists disagreed with the static viewpoint that sought to discover eternal economic truths without regard for differences of time and place, without concern for changes that were occurring constantly. Instead of asking "What is?" the institutionalists asked "How did we get here, and where are we going?" The evolution and functioning of economic institutions should be the central theme in economics. This approach requires knowledge not only of economics but also of history, cultural anthropology, political science, sociology, philosophy, and psychology.
- **Rejection of the idea of normal equilibrium.** Rather than the idea of equilibrium, institutionalists emphasized the principle of circular causation, or cumulative changes that may be either salutary or harmful in seeking economic and social goals. Maladjustments in economic life are not departures from normal equilibrium but rather are themselves normal. Before World War II the outstanding maladjustment was the business slump. Then, the problems of economic development became the center of attention. In the late 1970s the problem became stagflation, the simultaneous occurrence of inflation and unemployment, whereas in the mid-1980s, problems of trade deficits and federal budget deficits arose. The institutionalists are convinced that collective controls through government are necessary to continually correct and overcome deficiencies and maladjustments in economic life.

- **Clashes of interest.** Instead of the harmony of interests that most of their contemporaries and predecessors deduced from their theories, the institutionalists recognized serious differences of interests. People, said the institurionalists, are cooperative, collective creatures. They organize themselves into groups for the members mutual self-interest, which becomes the common interest of the group. There are, however, clashes of interests between groups, such as big business against small business, consumers against producers, farmers against urban dwellers, employers against workers, importers against domestic producers, and the makers of goods against the lenders of money. Here, again, a representative and impartial government must reconcile or override clashing interests for the common good and for the efficient working of the economic system.
- **Liberal, democratic reform.** The institutionalists espoused reforms in order to bring about the more equitable distribution of wealth and income. They denied that market prices are adequate indices of individual and social welfare and that unregulated markets lead to the efficient allocation of resources and a just distribution of income. The institutionalists invariably condemned laissez-faire and favored a larger role for government in economic and social affairs.
- **Rejection of pleasure-pain psychology.** The institutionalists repudiated the Benthamite underpinnings of economic analysis. They reached out instead for a better psychology, and some of them incorporated Freudian and behaviorist ideas into their thinking.

10.5. REPRESENTATIVES OF THE INSTITUTIONALIST SCHOOL

Dear student! Who do you think are the major representatives of institutionalism? Please write your answer on the space provided below.

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Good! As you have mentioned many economists provided the theoretical approach of institutionalist economics; but the major ones are John K. Galbraith, Wesley C. Mitchell. In this section, we only discuss the economic idea of Thorstein Veblen, who critically dissected orthodox thinking and provided the theoretical approach of institutionalist economics.

THORSTEIN BUNDE VEBLEN(1857-1929)

His Biography:

Thorstein Bunde Veblen, the son of Norwegian immigrants was born on a frontier farm in Wisconsin and raised in rural Minnesota. He completed his undergraduate college education at Carleton College, Minnesota, where he was a student of J. B. Clark. His graduate work was done at Johns Hopkins, where he failed to obtain a scholarship, and at Yale, where he received a doctorate in philosophy. No academic position was available to him, however, largely because he held agnostic views at a time when a divinity degree was considered a desirable prerequisite for teaching philosophy.

Veblen received fellowships at Cornell and at the University of Chicago for postdoctoral work. He became the editor of the *Journal of Political Economy* at Chicago. Veblen never reached the rank of full professor, despite his eleven books and his lasting world reputation. In 1918 he worked briefly for the Food Administration in Washington, D.C., and served as an editor of the journal *The Dial*. A former student aided him financially in his later years. He died in August 1929, a few months before the great stock market crash and the beginning of the depression he had been predicting. Veblen was a bitter, skeptical, pessimistic, and lonely man. His books, though written somewhat ponderously and obscurely, are replete with wit, wisdom, and sardonic attacks on middle-class virtues.

Dear student! What do you think are the main economic ideas of Veblen? Please write your answer on the space provided below.

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Good! Below are the main contributions of Veblen to economic thought.

His theory of the Leisure Class

Veblen's first and most popular book was *The Theory of the Leisure Class,* published in 1899. The leisure class is characterized by conspicuous consumption, a propensity to avoid useful work, and conservatism.

Conspicuous consumption. Veblen held that the leisure class is engaged in the predatory seizure of goods without working for them. Those who accumulate wealth do so not merely to take care of their physical wants, or even their spiritual esthetic, and intellectual wants. Rather, they wish to consume in a way that displays their wealth, because a show of wealth indicates power, prestige, honor and success in our pecuniary (monetary) culture. To be reputable, such consumption must be wasteful. Poorer people must work in order to subsist, but even their pattern of spending includes an clement of wasteful conspicuous consumption. Their outlook on life is imposed by the dominant leisure class.

Propensity to avoid useful work. Members of the leisure class must avoid useful, productive work. They must indulge only in wasteful or useless tasks if they are to remain reputable. Force and fraud arc present today, Veblen said, as they were among barbarian peoples. We find them in modern warfare, in business, and in sports and games:

Conservatism. Veblen asserted that the evolution of social structure has been a
process of natural selection of institutions. Progress can be attributed to the survival of the fittest habits of thought and the enforced adaptation of individuals to a changing environment. Institutions must change with changing circumstances. The development of these institutions represents the development of society. Unfortunately there is a conflict between current beliefs (ceremonial institutions) and current requirements (dynamic technological institutions) because of the cultural lag in the process of change:

A portion or class of society that is sheltered from environmental forces will adapt its views more slowly to the altered general situation and will, therefore, retard the process of social change. The wealthy leisure class is in just such a sheltered position with respect to economic forces that make for change or readjustment. The characteristic attitude of this class is indicated in the maxim that, "Whatever is, is right." But the law of natural selection, as applied to human

institutions, asserts that, "Whatever is, is wrong." That is, current institutions are wrong to some extent, from the evolutionary standpoint, because they do not change quickly enough to be in tune with the times.

His Attacks on Neoclassical Economics

Dear student! Which doctrines of the neoclassical school did Veblen attack? Please write your answer on the space provided below.

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Good! Please compare your answer with the explanation given below.

Veblen's theory of the leisure class constituted an attack on neoclassical economics, which assumed that consumers are sovereign. Through their "dollar votes" consumers determine the composition of commodities produced and therefore the allocation of society's resources that will maximize welfare. But if large portions of consumption are undertaken mainly to impress neighbors, who strive to retaliate by purchasing similar items to maintain their relative status, then government might be able to enhance overall well-being by restricting "wasteful" consumption by everyone. As pointed out by Breit and Ransom, "Thus, Veblen, in making economic man into social man, upset the [laissez-faire] policy implications of neoclassical consumption theory."

Veblen also accused the neoclassicists of supporting the present scheme of the distribution of wealth and income. Standard theory, he thought, is not truly a theory of anything, but merely folklore or theology used to justify private property and property incomes. Business economics has been developed to defend the business community, and the questions it asks and seeks to answer are not relevant to the population as a whole. Veblen was concerned with social economics instead of the business economics of price, profit, and ownership.

Finally, it is interesting to note that Veblen attacked the notion of perfect competition, which then dominated standard economic theory. He recognized that most businessmen had some monopolistic control over the prices they charged and that they used advertising to strengthen

their market positions. This analysis, published in 1904, foreshadowed the rise of the theory of monopolistic competition in 1933.

His Instinct for Workmanship

Veblen believed that work is not generally irksome, or else the survival of the human race would be jeopardized. Humanity's greatest triumph over other species in the struggle for survival has been a superior ability to control the forces of environment. It is not people's proclivity for *effort* but for *achievement* that really matters. When not harassed by overwork, people have not an aversion to work, but instead an instinct for workmanship that conduces to the material well-being of the race and its biological success. People inherently want to do work and to do it well. They deprecate waste. Allied with the equally important instinct for parenthood, the instinct for workmanship impels the current generation to improve life for posterity. Basically we try to avoid greed and indolence, we educate and train our children, we improve technology, and we conserve our resources-all because of our instinct for workmanship and our wish to provide for our descendants. Tills instinct conflicts with the conventional antipathy to useful effort, but it is the dominant force, especially among the great mass of artisans, farmers, and technological experts.

His Credit and Business Cycles

According to Veblen, credit plays a special role in modern business. Borrowing money can increase profits as long as the current rate of business earnings exceeds the rate of interest. Under competitive conditions, what is profitable for one businessperson to undertake becomes compulsory for all competitors. Those who take advantage of the opportunities afforded by credit are in a position to undersell those who do not. The recourse to credit, therefore, becomes widespread and typical. The competitive earning capacity of an enterprise comes to rest on the basis of the initial capital plus such borrowed hinds as this capital will support. The competitive use of credit in extending business operations gives an enterprise a differential advantage against other competitors, but the credit expansion has no aggregate effect on earnings or on total industrial output. In fact, aggregate net profits from industry are reduced by the amount of interest that has to be paid to creditors outside the industrial process.

Veblen's views on credit led him directly into his business-cycle theory. The extension of credit enables competing businesspeople to bid up the prices of the material capital goods used in

industry. As their dollar value increases, these goods serve as collateral for the further extension of credit. The extension of loans on collateral such as shares of stock or real property has a cumulative character. Credit expands even more with the organization of monopolies, because the expected increase in the profits of monopolies and the imputed goodwill of the new corporations also are capitalized in the prices of the securities issued.

This cumulative extension of credit rests on a shaky foundation. Sooner or later a discrepancy will arise between the money value of the collateral and the capitalized value of the property computed on expected earnings. In other words, the rise in earnings will not keep pace with the rise of the nominal value of capital (capital plus loans). When this discrepancy becomes obvious, a period of liquidation begins. Along with liquidation, the industrial crisis is accompanied by credit cancellations, high discount rates, falling prices, forced sales, shrinkage of capitalization, and reduced output. The creditors take over business properties, thereby further consolidating ownership and control into fewer hands.

Workers benefit during prosperity not through higher rates of pay but through fuller employment. As the general price level rises, the increased cost of living reduces real rates of wages. Slowly money wages rise in response to increasing prices of goods, and this helps bring prosperity to an end, because profit margins shrink and capital values fall.

Veblen thought that the discrepancy between capitalization and earning capacity is chronic so long as no extraneous circumstances enter temporarily to set aside the trend of business affairs. Therefore, chronic depression, more or less pronounced, is normal under the fully developed regime of machine industry. Depressions are temporarily overcome, however, by speculative increases of prices, new discoveries of precious metals, and credit expansion. The deliberate promotion of monopoly can restore the profitability of business by restricting output and raising prices, thereby bringing the accepted capitalization in line with the actual earning capacity. If successful, the monopoly will neutralize the cheapening of goods and services affected by current industrial progress.

The decline of profits and chronic depression can be remedied by an increase in the wasteful and unproductive consumption of goods as well as through monopoly. But private wasteful expenditure on a scale adequate to offset the surplus productivity of modern industry is nearly out of the question.

10.6. CHAPTER SUMMARY

- The Institutionalist School is the first American contribution to economic thought. The American political and economic environment of the late nineteenth century- monopoly, poverty, depression, and waste-led many economists to question the doctrine that says minimal government interference produces the maximum social well-being. The great depression of the 1930s provided and extremely favorable atmosphere for the development of institutionalism
- The Institutionalists criticized the rational self-interest approach of the classical economists and emphasized the importance of human instincts and habits in moulding economic activities. Therefore, the stress is on man-made institutions and institutional environment.
- The key ideas of this school are: their Holistic/broad perspective in examining an economy, their focus on institutions, their evolutionary approach in economic analysis, rejection of the idea of normal equilibrium, prevalence of clashes rather than harmony of interest between society, espouse of liberal/democratic reform, and rejection of pleasure-pain psychology.
- John K. Galbraith, Wesley C. Mitchell are among the money who provided the theoretical approach of institutionalist economics.

10.7. SELF TEST EXERCISE

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of the Institutionalism. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1. Identify and briefly state the significance of each of the following to the history of economic thought; institutionalism, Veblen, *The Theory of the Leisure Class,* conspicuous consumption, instinct for workmanship,
2. Compare and contrast the characteristics of the German historical school with those of the institutionalise school.

3. As the classical school is to Isaac Newton, the institutionalist school is to whom? Explain.
4. Use Veblen's idea of conspicuous consumption to explain why a significant decline in the price of a particular product might lead to a reduction in the quantity demanded. How does this differ from a so-called Giffen good?
5. What is Veblen's distinction between making money and making goods?
6. What necessitates the rise of institutionalism?

CHAPTER ELEVEN: WELFARE ECONOMICS

11.1. INTRODUCTION

- **Overview:**

Dear student! As you may recall, we have gone through several schools of thoughts and saw the different arguments provided on a given economic problem. Now, we are on the stage where analysis is being made toward the goal of social welfare. The welfare economists addressed such heterogeneous topics as rules for achieving maximum welfare, the problem of external costs and benefits, income inequality, the potential for achieving maximum welfare under socialism, difficulties associated with majority voting, and decision-making in the public sector.

This chapter explores the contributions of the following two theorists: Pareto and Pigou. As you will see in the subsequent section of this chapter, this does not, however, mean Pareto and Pigou are the only welfare economists; but, we made short owing to several constraints.

- **Chapter Objective**

Dear student! Up on successful completion of this chapter you will be able to:

  - Define welfare economics
  - Distinguish between welfare economists
  - Study the contribution of different theorists to welfare economics

- **Chapter Content**

Dear reader, the remaining part of this chapter is organized as follows:

  - What is Welfare Economics
  - Representatives of Welfare Economists
  - Vilfredo Pareto
  - Arthur Cecil Pigou
  - Chapter Summary
  - Self Test Exercise

11.2. WHAT IS WELFARE ECONOMICS

Dear student! What does welfare economics mean and what is the concern of welfare economics? Please write your answer on the space provided below.

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Good! Welfare Economics was a direct refutation of classical economics, especially the laissez-faire doctrine. As against the objectives of maximization of production and wealth, pursued by the classical economists, the welfare economists emphasize 'welfare', to be the direct objective of all economic thought and policies. Whereas the classical economists emphasized production, supply and costs, the welfare economists lay stress on consumption, utility and demand. This emphasis of welfare economists was not new but it received fillip only after the World War I, mainly because of the existence of poverty amidst plenty.

Welfare economics is the branch of economic analysis concerned with discovering principles for maximizing social well-being. It has been described as a tendency to modify the classical doctrines and to make economics deal with social policies, directed towards achieving the goal of social welfare. According to Reder, welfare economics is 'the branch of economic science that attempts to establish and apply criteria of propriety to economic policies.' Welfare Economics is not a distinct and unified system of ideas.

Economics itself is often defined as the study of how society chooses to use its limited resources to achieve maximum satisfaction. Nearly every aspect of economics, therefore, has a welfare dimension. Nevertheless, several important contributors to economics have focused specifically on either or both of the following: defining welfare optimality and analyzing how maximum welfare can be achieved; identifying factors that impede the achievement of maximum well-being and suggesting ways that the impediments might be removed. We refer to these individuals as welfare economists.

11.3. REPRESENTATIVES OF WELFARE ECONOMISTS

Dear Student! Who do you think are the main figures of Welfare Economics? Please write your answer on the space provided below.

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Good! Professor Alfred Marshall has been regarded as the founder of welfare economics. It has been developed further by a host of writers including Henry Clay, R.G Hawtrey, A.C Pigou, Vilfredo Pareto, von Mises, Lange, Arrow, Edgeworth, Hobson, and Buchanan.

i. VILFREDO PARETO (1848-1923)

Welfare economics dates back to the classical economic ideas of Smith and Bentham. Several subsequent economists dealt with welfare considerations, including Marshall, who examined the welfare effects of taxes and subsidies in increasing and decreasing cost industries. Historians of economic thought, however, view Vilfredo Pareto (1848-1923) as the originator of the "new'" welfare economics, which is rooted in Walras' principles of general equilibrium. Pareto was born in Paris to Italian parents, studied at the University of Turin in Italy, and later accepted the chair of economics at the University of Lausanne, Switzerland. There he continued and expanded the mathematical tradition established by his immediate predecessor, Walras. Pareto set forth his major ideas in his *Manual of Political Economy,* published in 1906.

Pareto Optimality

Of particular relevance to the topic at hand, Pareto refined Walras' analysis of general equilibrium and set forth the conditions for what we now call *Pareto optimality,* or maximum welfare. Other economists then established the more rigorous mathematical proof that perfectly competitive product and resource markets achieve Pareto optimality.

Maximum welfare, said Pareto, occurs where there are no longer any changes that will make someone better-off while making no one worse-off. This implies that society cannot rearrange the allocation of resources or the distribution of goods and services in such a way that it aids someone without harming someone else. The Pareto optimum thus implies (1) an optimal

distribution of goods among consumers, (2) an optimal technical allocation of resources, and (3) optimal quantities of outputs. person's well-being while not reducing someone else's welfare.

Evaluation

Pareto's welfare theory is a significant contribution to economics. He did much to help economists better understand the conditions for, and the welfare significance of, economic efficiency. However, the central Pareto criterion, "Does a change make someone better-off while making no one worse-off?" is not always well suited for evaluating public policies.

Of the several criticisms of the Pareto standard, four seem particularly germane. First, some economists argue that it fails to address the important issue of distributive justice, or the fair distribution of income in society. Instead, it simply establishes the efficiency conditions for any *existing* distribution.

Second, and closely related, many public policies that increase national output and overall welfare also redistribute income as a by-product of the policy. For example, although a policy of free foreign trade normally boosts a nation's total output and welfare, it may also injure specific individuals who lose their jobs because of imports. A strict interpretation of the Pareto criteria would block the enactment of such a policy. Similarly, under most circumstances, immigration of skilled workers increases total output in the destination nation. However, the increased supply of labor may depress the wages received by native workers in the skilled labor markets. Should government legislate such policies as free trade and open immigration, even if such compensating payments are not actually made?

A third objection to the Pareto criteria is that they are based on a static view of efficiency. Short-run movements away from Pareto optimality conceivably could increase long-run or dynamic efficiency. For example, some contemporary economists contend that by focusing on static efficiency some of the provisions of antitrust laws may impede private actions-such as joint development of new technologies-that would increase the nation's long-run growth of output and welfare.

Finally, the moral judgments that the Pareto criteria purposely exclude are often legitimate and dominant factors in policy formulation. Some private transactions-for example, prostitution, the sale of babies, and the purchase of drugs-that may be Pareto optimal may also conflict with society's moral values. Such values often dwarf considerations of economic efficiency in debates on public policy.

ii. ARTHUR CECIL PIGOU (1877-1959)

Arthur Cecil Pigou succeeded Marshall in the chair of political economy at Cambridge University in 1908 and held this position until his retirement in 1943. He was the leading neoclassical economist after the death of his predecessor, and like Marshall, he expressed humanitarian impulses toward the poor, hoping that economic science would lead to social improvement. In his own cautious way, Pigou was willing to go further than Marshall in allowing a role for the government in ameliorating certain undesirable features of society.

In his *The Economics of Welfare,* written in 1920, Pigou hoped to provide the theoretical basis for government to enact measures that promoted welfare. As an economist, he was concerned with *economic* welfare, defined as "that part of social welfare that can be brought directly or indirectly into relation with the measuring-rod of money." Unlike Pareto, who cast his theories in terms of general economic equilibrium, Pigou continued in the "old welfare" tradition of Smith, Bentham, and Marshall, relying mainly on partial equilibrium analysis. His contributions to welfare economics include his observations on income redistribution and the divergence between private and social costs.

Income Redistribution

Basing himself on Jevons and Marshall's principle that the marginal utility of money diminishes as more is acquired, Pigou asserted that greater equality of incomes under certain conditions could increase economic welfare. Pigou insisted that interpersonal comparisons of satisfaction can properly be made when dealing with people of the same background raised in tile same environment. In this sense he was more of a reformer than those "purely scientific" economists who fastidiously avoided value judgments and proclaimed the impossibility of comparing satisfactions among different people.

Divergence Between Private and Social Costs and Benefits

Pigou's most significant deviation from orthodox theory lay in his focus on the divergence between social and private marginal costs and benefits. The idea that such a divergence could occur was not original with Pigou. Henry Sidgwick (1838-1900), writing in 1883, discussed the same general topic, but in a less concise way. The private marginal cost of a commodity or service is the expense the *producer incurs* in making one more unit; the social marginal cost is the expense or damage to *society* as the consequence of producing that unit of product. Likewise, the private marginal benefit of a commodity is measured by the extra satisfaction it provides the *buyer;* social marginal benefit is the extra satisfaction *society* gets from the production of the added unit.

These distinctions are significant because the acts of production and consumption may impose costs or benefits on parties other than the producer and consumer. These external costs and benefits, or externalities, spillover to other parties and are sometimes referred to as "spillover effects." For example, said Pigou, sparks from railway engines may do damage to surrounding woods or crops without their owners being compensated for the damage. Social costs (internal plus external), therefore, are greater than the private costs (internal) to the railway; the net private marginal product exceeds the social net product. Similarly, an entrepreneur who builds a factory in a residential district destroys much of the value of other people's property. The increased sale of intoxicating beverages is profitable to the distiller and the brewer, said Pigou, but external costs are incurred when more police and prisons become necessary.

There are opposite cases, Pigou said, in which some benefits of private actions spillover to society's benefit, but for which the person who renders the benefit is not compensated. Thus, the social marginal net product exceeds the private marginal net product. For example, the expansion of one firm in an industry may give rise to external economies in the industry as a whole that will reduce the costs of production of other firms. Private investment in planting forests will benefit surrounding property owners. Preventing smoke from pouring out of factory chimneys will benefit the community at large much more that it will benefit the factory owner. Scientific research is generally of greater value to society than to the researcher and inventor, although the patent laws aim at creating a closer match between private and social marginal net products.

Pigou derived an important welfare implication from his analysis: Not all competitive markets produce levels of output that maximize society's total welfare. Sidgwickian-Pigouvian analysis of social costs and benefits, thus, challenged the widely held perspective that we can always and everywhere rely on competitive markets to maximize society's economic welfare (produce Pareto optimality). According to Pigou, the welfare task of government is to equalize (1) private and social marginal costs and (2) private and social marginal benefits. It can do this through the use of taxes, subsidies, or legal regulation. There is a greater role for government in the economy, said Pigou, than that envisioned by advocates of laissez-faire.

Other Contributions

Several other theories presented by Pigou have had lasting relevance.

On Saving: His stress on the desirability of increasing savings in the economy found favor with many economists and government policy makers in the 1980s and 1990s.

On Present Satisfaction: Pigou contended that people prefer present rather than future satisfaction of equal magnitude because the human telescopic faculty is defective; we, therefore, see future pleasure on a diminished scale. The bias contributes to far-reaching economic disharmony, because people distribute their resources between the present, the near future, and the remote future on the basis of a somewhat irrational preference. Consequently, efforts directed towards the remote future are sacrificed for those directed to the near future, while these, in turn, are given up to enhance present consumption. The creation of new capital is checked, and people are encouraged to use up existing capital to such a degree that larger future advantages are sacrificed for smaller present ones. Natural resources are consumed more quickly and wastefully because future satisfactions are underrated.

On Government Intervention: Pigou concluded that economic welfare is diminished by government intervention that strengthens the tendency of people to devote too much of their resources to present use and too little to future use. Government should, thus, avoid any tax on saving, including property taxes, death duties, and progressive income taxes if it wants to maximize economic welfare. Heavy taxes on consumption are preferable because they encourage saving, but such taxes have the disadvantage of hurting low-income people disproportionately.

On Price Discrimination: A final contribution of note is Pigou's discussion of price discrimination. It was he who classified price discrimination into three types: first degree, second degree, and third degree. First-degree price discrimination occurs when the monopolist charges each consumer the exact amount she or he would be willing to pay rather than go without the commodity. The monopolist, therefore, takes all of the consumer's surplus as revenue. Second-degree price discrimination is a cruder form of first-degree discrimination. The seller charges one price for each unit within an initial block of units and then charges lower prices for units within subsequent blocks. Electrical utilities commonly used this type of quantity discounting prior to the rate reforms of the 1970s and 1980s. Third-degree price discrimination involves separating groups of consumers into different classes and charging different prices based on the elasticity of demand for each group. One of many possible examples would be charging students and professors less than the general public for business newspapers and magazines.

11.4. CHAPTER SUMMARY:

- Welfare economics is the branch of economic analysis concerned with discovering principles for maximizing social well-being. It was a direct refutation of classical economics, especially the laissez-faire doctrine. Whereas the classical economists emphasized production, supply and costs, the welfare economists lay stress on consumption, utility and demand.
- Although Marshall has been regarded as the founder of the welfare economics, Pareto and others has further developed it. The most notable contribution of Pareto is his theory of optimality, the conditions for what we now call *Pareto optimality*. Maximum welfare, said Pareto, occurs where there are no longer any changes that will make someone better off while making no one worse off.
- Pigou was the leading neoclassical economist after the death of his predecessor-Marshall. His contributions to welfare economics include his observations on income redistribution and the divergence between private and social costs.
- Pigou asserted that greater equality of incomes under certain conditions could increase economic welfare. He also derived an important welfare implication that not all

competitive markets produce levels of output that maximize society's total welfare. Pigou has also made important contributions on saving, on present satisfaction, on government intervention, on price discrimination.

11.5. SELF TEST EXERCISE

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of the Welfare Economics. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1. Identify and briefly state the significance of each of the following to the history of economic thought: welfare economics; Pareto; Pareto optimality; marginal rate of substitution; marginal rate of technical substitution; marginal rate of transformation; Pigou; externality; first-, second-, and third-degree price discrimination
2. Explain the following statements: Pareto's welfare analysis is in the tradition of Walras, whereas Pigou's welfare analysis is in the tradition of Marshall.
3. Explain why a negative externality in production results in too much of the good being produced from society's perspective, whereas a positive externality results in too little being produced. How, according to Pigou, might such over and under allocations of resources be corrected?

CHAPTER TWELVE: KEYNESIAN ECONOMICS

12.1. INTRODUCTION

- **Overview:**

Dear student! So far we have gone through eleven chapters introducing you with the main tenets of each school of thought and representatives of the schools. By now we get on the last chapter of this module called Keynesian Economics.

As can be implied from its name, John Maynard Keynes is the chief representative and the founder of this school of thought. The basic idea of the Keynesian economics was contained in his book shortly known as "The General Theory". To grasp the cream of this school, looking at the works of J.M. Keynes is sufficient. Hence, in this chapter we provide a brief overview of the Keynesian school and discuss Keynes's major ideas.

- **Chapter Objective:**

Dear student! Upon successful completion of this chapter you will be able to:

- Understand the main tents of Keynesian Economics;
- Know the contribution of John Maynard Keynes to economic thought;
- Compare and contrast Keynesian economics with other schools of economic thought

- **Chapter Content:**

The remaining parts of this chapter are organized as follows:

- Historical Background of Keynesian Economics
- Major tenets of Keynesian Economics
- John Maynard Keynes
- Keynesian Economies: An appraisal
- Chapter Summary
- Self Test Exercise

12.2. WHAT IS KEYNESIAN ECONOMICS

Dear student! What do you know about Keynesian Economics? What is Keynesianism? Please write your response on the space provided below.

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Good! Keynesian Economics is a term used to describe macroeconomic theories of the level of economic activity using the techniques developed by John Maynard Keynes. The Keynesian system of ideas is one of the most significant schools of economic thought. The school began with the publication of Keynes's *The General Theory of Employment, Interest and Money* in 1936 and remains a major presence in orthodox economics today. It arose out of the neoclassical school, Keynes himself being steeped in the Marshallian tradition. Although Keynes sharply criticized certain aspects of neoclassical economics, which he lumped together with Ricardian doctrines under the heading of "classical economics," he used many of its postulates and methods[15]. His system was based on a subjective psychological approach, and it was permeated with marginalist concepts, including static equilibrium economics. Keynes disassociated himself from attacks on the neoclassical theory of value and distribution.

12.3. THE HISTORICAL BACKGROUND OF THE KEYNESIAN SCHOOL

Keynes' ideas were given added impetus by the Great Depression of the 1930s, the worst the Western world had ever known. Yet the roots of his ideas can be traced back to before 1929. The work of many economists, including that of Mitchell and his associates in the National Bureau of Economic Research, was within the framework of aggregate economics, or macroeconomics, rather than the microeconomics of the neoclassical school. Keynes also adopted this macro-economic approach. World War I and the economic controls enacted required an overall view of the economy. The growth of large-scale industrial production and trade made the economy more susceptible to statistical measurement and control, making the inductive, aggregate approach more feasible than in the past. In fact, his approach was

[15] It was Keynes who gave the name classical economics to the economic ideas of Adam Smith and its proponents.

increasingly necessary as the public became more eager for the government to deal actively with unemployment.

Keynesian thinking also had its roots in the spreading concern about secular stagnation, or a declining rate of growth. The mature private-enterprise economies the Western world were less vigorous after World War I than before it. The rate of population growth was declining; most of the world had already been colonized; there seemed to be no room for further geographic expansion; production appeared to outrun consumption as incomes and savings rose; and there were no new inventions like the steam engine, the railroad, electricity, and the automobile to stimulate new and vast capital investments. Also, the decline of vigorous price competition reduced the rate of replacement of old machinery with new and better machines, and the economy was dragged downward when the growing accumulated of depreciation funds from past investments were not spent quickly enough. These observations about secular stagnation, which became particularly important after 1929, were based in part on the works of Marx, John A. Hobson (1858-1940), Veblen, and others, and in part on actual observations and historical studies.

After the Great Depression began in the early 1930s, many economists in the United States advocated policies that later would be called Keynesian. It is interesting to note that these policies were presented before the publication of Keynes' *General Theory*. Leading figures both inside and outside of the economics profession were urging public work programs, deficit budgets for the federal government, and the easing of credit by the Federal Reserve System. Many economists were aware of the multiplier effect that increased government spending could have on total spending and income. Some theorized that as the national income increased, consumption expenditures rose less rapidly than total income, and saving increased more rapidly. Wages were recognized as a source of demand for goods as well as a cost of production, and cutting wages was frequently opposed as providing no real remedy for unemployment; this was macroeconomic thinking. People derived these ideas independently of Keynes and widely discussed them in the United States. But it was Keynes who provided the analytical framework that integrated these ideas and touched off the "Keynesian revolution'" in economics.

12.4. MAJOR TENETS OF THE KEYNESIAN SCHOOL

Dear student! What do you think are the major tenets of Keynesian economics? Please write your answer on the space provided below?

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Good! The major characteristics and principles of Keynesian economics are listed next.

- **Macroeconomic emphasis**. Keynes and his followers concerned themselves with the determinants of the *total* or *aggregate* amounts of consumption, saving, income, output, and employment. They were less interested, for example, in how an individual firm decides on its profit-maximizing level of employment than in the relationship between total spending in the economy and the aggregate of such employment decisions.
- **Demand orientation**. Keynesian economists stressed the importance of *effective demand* (now called aggregate expenditures) as the immediate determinant of national income, output, and employment. Aggregate expenditures, said these economists, consist of the sum of consumption, investment, government, and net export spending. Firms collectively produce a level of real output that they expect to sell. But sometimes aggregate expenditures are insufficient to buy all the output produced. As unsold goods accumulate, firms lay off workers and cut back output. That is, effective demand establishes the economy's *actual output,* which in some cases is less than the level of output that would exist if there were full employment {*potential output).*
- **Instability in the economy**. According to Keynesians, the economy is given to recurring booms and busts because the level of planned investment spending is erratic. Changes in investment plans cause national income and output to change by amounts greater than the initial changes in investment. Equilibrium levels of investment and saving—those that exist after all adjustments have occurred—are achieved through changes in national income, as opposed to changes in the rate of interest. Investment spending is determined jointly by the rate of interest and the *marginal efficiency of capital,* or the expected rate of return above the cost on new investments. The interest rate depends on people's preferences for liquidity and the quantity of money. The marginal efficiency of capital

depends on the expectation of future profits and the supply price of capital. The expected rate of profit from new investment is unstable, and, therefore, one of the most important causes of business fluctuations.

- **Wage and price rigidity**. Keynesians pointed out that wages tend to be inflexible downward because of such institutional factors as union contracts, minimum wage laws, and implicit contracts (understandings between employers and their workers that wages will not be cut during downturns judged to be temporary). In periods of slack aggregate demand for goods and services, firms respond to lower sales by reducing production and discharging or laying off workers, not by insisting on wage cuts. Prices also are sticky downward; declines in effective demand initially cause reductions in output and employment rather than declines in the price level. Deflation occurs only under conditions of extremely severe depression.
- **Active fiscal and monetary policies**. Keynesian economists advocated that the government should intervene actively through appropriate fiscal and monetary policies to promote full employment, price stability, and economic growth. To combat recession or depression, government should either increase its spending or reduce taxes, the latter increasing private consumption spending. It also should increase the money supply to drive down interest rates in the hope that this will bolster investment spending. To counter inflation caused by excessive aggregate expenditures, government should reduce its own spending, increase taxes to reduce private consumption spending, or reduce the money supply to raise interest rates, which will dampen excessive investment spending.

12.5. JOHN MAYNARD KEYNES *(1883 - 1946)*

His Biography

Keynes was born in Cambridge, England, to Florence Ada Keynes and John Neville Keynes on June 5, 1883. He was lucky of having an educated family. His father was a distinguished economist who thought political economy and logic and was also a Registrar of Cambridge University for many years. His mother was also a very able woman who was once a Mayer of Cambridge. Young Keynes graduated from Cambridge in 1905 in the Mathematical Tripos and

was deeply influenced by Marshall & Sidgewick. From 1906-1908, he served in the Indiana office. In 1909, he started teaching economics in Marshallian Tradition at King's College.

Keynes was an important figure both in the world of practical affairs and academic life. He was chairman of the board of a life insurance company, he served as director of other companies, and he was a member of the governing body of the Bank of England. In addition to being a financier, he was a high government official, the author of many scholarly theoretical works, a journalist, a connoisseur/expert and supporter of the arts, and a teacher at Cambridge University.

Keynes was the principal representative of the British Treasury at the peace conference after World War I, with power to speak for the chancellor of the exchequer. He was his country's chief negotiator in organizing the International Monetary Fund and the International Bank for Reconstruction and Development and in obtaining the United States' postwar loan to Britain. He became a baron in 1942, and to those of his friends who criticized his accepting the title, his joking defense was "I had to do it in order to get servants." In 1912, he was chosen editor of the Economic Journal and shouldered this responsibility till near his death. In 1926 Keynes published a brief book entitled *The End of Laissez-faire,* in which he stated that the evils of the day were the fruits of risk, uncertainty, and ignorance. Big business is often a lottery in which some individuals are able to take advantage of ignorance and uncertainty. The consequences are great inequalities of wealth, unemployment, disappointment of reasonable business expectations, and impairment of efficiency and production. In 1946, he was appointed as the Governor of the IMF and the International Bank for Reconstruction and Development. Finally, he died on April 21, 1946.

His Works

Keynes was a prolific writer, and he published more than a dozen of books. However, the master piece of Keynes which immortalized his name was his "*The General Theory of Employment, Interest and money*" (shortly The General Theory) which came out in 1936 and caused what is known as *"Keynesian Revolution."* Of course *The General Theory* is a monumental work and can easily be grouped with Smith's *Wealth of Nations*. To strength this idea it was once written that "If a stranger from Mars should undertake to read the literature on economics from, say, 1700 to

the present day, he would be struck, particularly, by the new direction and outlook injected by the publications of a) The Wealth of Nations, b) the works of Jevon, the Austrians, and Walras and c) Keynes' General Theory. However, Keynes's General Theory did not have an instantaneous acceptance in academics circles. These were basically due to

1. The book avoids the usual value & price treatment of economics. It tries to analyze the determination of the overall level of output & employment in the economy.
2. The book was badly written & not suitable for class room teaching
3. Even, for quite some time, it was not exactly understood what the General Theory was trying to convey.

This was why Samuelson once said "it is a badly written book, poorly organized and laymen who beguiled by the authors previous reputation bought the book cheated of his 5 shillings, it is not well suited for classroom use". After a moment, in spite of certain ambiguities and other deficiencies of the book, the message was found to be of profound importance, both for theory & policy.

Keynes started his work by distinguishing his own system from what he calls the *Classical Economics*. He has tried to impress upon his readers that the book is not an extension or a modification of the received doctrines, but a theory entirely different from the classical theory. The methodology of Keynesian economics may be distinguished from neoclassical economics by its concern with aggregate behavior, especially the income generating effect of total expenditure and the emphasis placed on the investment component in determining the level of activity. The development of Keynesian theory has centered around three related topics:

1. the stability of a market system and particularly its ability to maintain full employment
2. the role of money in such a system and
3. the long term dynamics of the market economy

The Main Points of Keynes' Work

Dear student! What is the main economic idea of J. M. Keynes? What are his lasting contributions? Please, write your answer on the space provided below.

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Good! Below are the summary of Keynes' work.

1. Theory of Employment

Keynes was dissatisfied with the classical theory which ran in terms of say's law and in which there was an automatic adjustment towards full employment. They, thus, believed that there would not be any unemployment in the economy owing to the operation of the forces of competition. And, whatever persons refused to work at a reduced wage, they thought that they were not involuntary unemployed. They considered such behaviors as irrational and did not allow their theory to be affected by it. In this classical system frictional & voluntary unemployment could exist but no involuntary unemployment. But Keynes argues that in the modern capitalist society, no economy is capable to operate at full employment consistently or to have an automatic tendency to secure full employment. According to Keynes, involuntary unemployed person include those who would not be willing to work at a lower money wage.

It is recalled from the thoughts of the Classical School that the economy is always at equilibrium and operates at full employment. For the Classicists, unemployment (or operation of an economy at less than full employment) is the consequence of disequilibrium which will come to full employment automatically when the market becomes at equilibrium. The greatest contribution of Keynes lies in the statement that *unemployment is possible even when the economy is at equilibrium*. It is found that in terms of Keynesian framework there will be an inherent tendency for level of income to settle at less than full employment.

From this analysis we get at two conclusions.

- First, in its own, the type of economy which Keynes is considering will not attain full employment of income and even if it does, it would tend to slide down to a less than full employment level.
- Second, this level of employment can be pushed up by increasing the effective demand, through operating on the aggregate demand function. This operation, if it is to be on the side of consumption, may be coursed through a redistribution of income in favor of those sections of the community who have a higher marginal propensity to consume (*mpc)*, or it may be implemented through various welfare schemes whereby added purchasing power come in to those hands which would spend it away.

2. Theory of Wage

Keynes did not agree with classical economists thought that employment will increase owing to wage reductions. The classical economists like Pigou claimed that the employers were ready to offer more employment if the workers were ready to accept lower wages. If there were unemployment, according to Classicists, it was only voluntary in the sense that workers were not ready to accept lower wages, which correspond to their marginal productivity.

Keynes, however, maintained that Pigou's argument was faulty in that it ignored the fact of aggregate income. Note that both Keynes and Pogou agreed that the means to increase labor employment was to reduce the real wage level and make it worthwhile for the employers to offer for employment. But they differed as to the mechanism by which it could be done. The classical economists believed that a single employer would offer more employment to workers if they agreed to accept lower money wages. And they generalized to the whole economy and asserted that a general lowering of money would be able to increase employment in the economy. Keynes pointed out that the argument ignored the fact that when money wages were reduced throughout the economy, there would be a reduction in aggregate demand also. This would reduce effective demand and the workers would be left with the same amount of employment.

According to Keynes, wage reduction implies reduction of marginal cost which influences prices to fall. Hence, real wage of the workers may not decrease. For Keynes employment can only increase when there is a fall in the real wage of the workers, especially in the field of consumption goods.

3. Theory of Consumption Function (Propensity to Consume)

Keynes's formulation of the consumption function is considered as an epoch making contribution to the tools of economic analysis (analogous to, but even more important than Marshall's discovery of the demand function). According to Keynes, the consumption function is the ratio of consumption to income. This function taken for granted, the level of income is determined by volume of investment, of course, without taking the time lags in to account. Consumption determines demand which in its turn, leads to the production of commodities as well as capital. It is the lack of "effective demand" or lagging consumption that creates crises and generate depression.

Keynes has asserted that the total income and the total expenditure of a nation are closely related. i.e. the amount which the community would like to consume depends up on the expected income for the period under consideration. At very low expected income the amount which the community would like to consume would exceed that income. [Keynes confines himself to short period only in which the change in consumption is bound to lag behind the change in income]. However as expected income rises, the planned consumption also rises, but not as fast as income. In other words, the marginal propensity to consume (which is defined as the ratio of increase in planned consumption to the increase in expected income) would be less than one; i.e. due to the psychological tendency of people, when income increases expenditure on consumption goods doesn't increase proportionately

On the basis of this assumption, Keynes takes up the analysis of the factors governing output and employment. The economy which Keynes has in mind is a capitalist developed one but it is a closed economy. According to Keynes, total income (Y) is comprised of the income earned through consumption Goods(c) and the income earned through investment goods (I).

i.e. $Y = C + I$

On the other hand, of the total income (Y) ,a part will be used for consumption (C) and the rest for saving (S)

i.e. $Y = C + S$

Hence, $Y = C + I$, or $Y - C = I$

$Y = C + S$, or $Y - C = S$

$I = S$

Thus, it is clear that during any period of time, saving and investment consist of the flow of income which the receiving people are not spending on consumer goods.

4. Theory of Investment

Investment here refers to new investment or current investment. Recall that Keynes has assumed that Consumption depends primarily on real income. In other words, what Keynes called the propensity to consume depends on income except under abnormal conditions like war, earth quakes, strikes, revolutions etc. Given the propensity to consume, the level of output is dependent on the inducement to invest, which in turn, determines the volume of investment $Y = f(\text{Inv.}, \bar{c})$. The inducement to invest depends upon the relation of the current rate of

investment to the marginal efficiency of capital; i.e., current investment is a function of marginal efficiency of capital and interest rate.

The *marginal efficiency of capital (MEC) has been defined as the ratio of the expected yield of additional capital assets over a period of time to the supply price of the asset*; i. e. MEC is a measure of expected rate of return or profitability on new investment. The inducement to invest will be strong if the value of an additional unit of capital exceeds its cost. The value of an additional unit of capital depends on the marginal efficiency of capital and on the rate of interest at which these expected annual reforms are discounted.

Apart from the marginal efficiency of capital, the disposition of investors is also affected by the current rate of interest at which they obtain capital. In Keynesian terminology, *the rate of interest is the price paid for parting with cash or liquidity and using it for investment in assets.* Interest, thus, is determined by the liquidity preferences (that is, the preference of an individual or group of individuals for cash to assets).

Dear Student! What is the rationale for liquidity preference? Please write your answer on the space provided below.

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Good! According to Keynes, the individuals' preference for liquid assets, or liquidity preference, is mainly: a) for daily transaction (transaction motive) b) for meeting contingent needs (contingency motive) and c) for meeting business needs (or the speculative motive). The rate of interest is, thus, the price paid to an individual for parting with his liquidity preference. Obviously, the higher the liquidity preference, the higher will be the rate of interest and vice versa. Similarly, the fall in the quantity of money, the rate of interest would rise and with an increase of it the rate of interest will decrease.

One important comment, here, is the existence of *liquidity trap* a phenomenon which develops when the rate of interest falls and touches the normal floor limit; i.e., the lower limit below which it is not expected by the market to fall. This phenomenon of liquidity trap implies that after the rate of interest has fallen to a certain level, liquidity preference may become virtually

absolute in the sense that almost everyone prefers cash to holding a debt which yields so low rate of interest.

5. The Theory of Multiplier.

Dear student! From your macroeconomics lesson, what do you remember about multiplier? Please, explain the concept of multiplier very shortly on the space provided below.

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Good! Keynes became famous for the development of the theory of multiplier which is so intimately connected with the marginal propensity to consume. But Keynes has never claimed for the originality of this concept of multiplier in to economic theory. From the previous discussions it is evident that the aggregate income of the community is determined by the rate of investment together with the propensity to consume. The basic idea of multiplier is that just as in a river the creation of one wave gives rise to a number of waves. Similarly, in an economy each injection of money gives rise to a series of new money. *The multiplier means that with a given consumption function, if net investment is increased (say by government or some other public authority), a multiplier process will be introduced which will cause an increase in income which will be a multiple of the initial net investment which started the process.*

The value of this multiple by which the income increases (or the ratio of the increase in income to the initial increase in net investment causing that investment) is called by Keynes as multiplier. If an investment of $1million causes an increase in the total income by $3million, the multiplier is 3, in case the increased income amounts to $2milliom, the multiplier is 2. The multiplier is, thus, a number by which the increase in investment must be multiplied in order to give the resulting increase in income. Or, it is a numerical coefficient indicating how great an increase in income results from each increase in investment. The value of this multiplier obviously would depend up on the value of the mpc.

The question is how and why the increase in the total income is more than incorporation to the increase in the investment? The reason is that with each investment, the resultant expansion in production and national income is much more than the primary investment. Apart from this,

increased income will be spent by the wage earners and by the recipients of profits and interest leading to increased income to others in the economy. This increased income will go on repeating like this. [In case, with an increase in income, there is no increase in consumption, the multiplier effect will be zero. Thus, the amount of the multiplier is determined by the relative proportions of spending and saving, out of increased income].

If for every dollar of additional income, three-fourth is spent and one-fourth is saved, then the aggregate addition to income is 1+3/4 + 9/6 + 27/64 and so on. That is, initially \$ 1 is spent, the first individual save ¼ of it and spend ¾ of it. This ¾ is income for the 2nd individual. The 2nd individual will spend only ¾ of 3/4 $\left(=\frac{9}{6}\right)$ which will be income of 3rd individual. The 3rd individual will spend only ¾ of $\left(\frac{9}{6}\right)$ $\left(=\frac{27}{64}\right)$ which will be income of 4th etc. The process will go on. It can be observed that this creates a serious of geometric progression with a common ratio of ¾. The total income generated due to the first dollar investment will be the sum of this geometric progression. From our little knowledge of Algebra, we can compute the total income generated from this process using the formula

$$S_n = \frac{G_1(r^n - 1)}{r - 1}$$

Where S_n = sum of the first n terms

G_1 = the first term

r = common ratio.

But, in our case, n cannot be determined and hence we will use the formula for sum of infinite serious. For $|r| < 1$, when n increases continuously, $G_1\, r^n$ is close to zero. Accordingly S_n = $\frac{G_1 r^n}{r-1} + \frac{G_1}{1-r}$ is close to the number $\frac{G_1}{1-r}$ and we say that the series S_n converges to $\frac{G_1}{1-r}$.

Hence, for G_1 = \$1, r = ¾ the sum of income series is $S_n = \frac{1}{1-3/4} = \frac{1}{2/4} = 4$

i.e., the ratio of the increment in total income to the volume of investment is 4:1 and therefore the multiplier is 4. Multiplier depends upon the propensity to consume which, in turn, determines the proportion of savings out of each increment. Whatever the multiplier, the total savings during all the turnovers will necessarily be equal to the original investment. It would, thus, be observed that investment will result in an increase in income up to the point at which

the saving would be equal to it. More technically, the multiplier is just the reciprocal of marginal propensity to save.

i.e, $m = \frac{1}{s} = \frac{1}{1-c}$.

This implies that the stronger the propensity to save, the smaller will be the increase in income and vice versa. On the other hand, the higher the consumption function (or the propensity to consume) or the higher the spending the greater will be the multiplier.

If $c = 2/3$, $m = 3$

If $c = 1/3$, $m = 2$

If $c = 3/4$, $m = 4$

6. Theory of Prices.

In his analysis of price, Keynes agreed with the orthodox/classical view that increase in the quantity of money in circulation leads to an increase in the price level. The basic difference between Keynesian analysis & this classical analysis is regarding the process through which this effect is caused (i.e., on the transmission mechanism). As a matter of fact, the classical quantity theory of money failed to analyze the process through which the price would be affected. Keynes tried to fill in the gap. The transmission mechanism according to Keynes is as follows.

Increase in the supply of money is likely to increase the availability of funds. This increase in money supply tends to lower the rate of interest and increase the demand for investment which ultimately leads to an increase in income employment and output. This increased output can only be possible at an increasing cost, beyond a certain point, price will accordingly rise. It would just be observed that Keynes has established the relation between quantity of money and the price through output.

12.6. KEYNESIAN ECONOMIES: AN APPRAISAL

Dear Student! From the discussions made above, what do you think are the difference between Classical Economics and Keynesian Economics? What are the strengths and weaknesses of the Keynesian Economics? Please, write your answer on the space provided below.

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Good! Compare your answer with the following explanations.

1. **Departures from the Classical Economics:**

1) The analysis of wages and employment, the attack on savings, and the emphasis on spending are the revolutionary elements in Keynesian economics.
2) Keynesian Economics leads to a set of questions which involve the possibility of equilibrium at different levels of employment (and in which full-employment is a possibility but under-full employment a greater possibility) the neutrality of money, and also the stability of price level. Now in Keynes, full employment is not attained because of rigidity of real wages. And even if wages are assumed flexible in the Keynesian system full employment may not be achieved on account of two further possibilities; the possible interest in elasticity of consumption and investment function, and the phenomenon of liquidity trap.
3) Keynesian economics is more practical and effective than the classical economics. It is institutional in the sense that it gives due importance to institutional factors explaining high rates of interest, inadequate supplies of money, over-saving, uncertainties, rigidity etc.
4) Keynes regards laissez faire as a lost force. According to Keynes, the chief result of laissez-fair policy were deficit demand, unemployment, waste of resources, etc. He rejected the laissez-faire philosophy because the classical economists were interested in the distribution of the product and not in the employment of economic resources of the country. Classicists assumed that all incomes earned in production of commodities would be used for purchasing them. Hence, Keynes felt that adequate attention was not given to effective demand and its relation to supply function. Keynes found that the failure to spend current

income on consumption and investment goods was the chief cause of unemployment. Hence, he pleaded for controlling consumption, savings and investment.

5) It would be interesting to observe that Keynes was not against capitalism as such but he was critical of its parasitic elements (such as excess savings, high rate of interest).
6) Keynes has also criticized classical theory regarding rising wage rate and its relation to unemployment. For Keynes, level of employment is determined by effective demand and that a stimulation in effective demand comes through changes in the marginal propensity to consume
7) Keynesian theories were one of the most influential one in the formulation of public policies. Of course, no other economist had so large influence on public policy particularly in so short time as Keynes. In the domain of fiscal measures, Keynesian concept of deficit spending has been the most popular. Keynes suggested that a sound policy of public finance must aim (a) keeping the rate of interest as low as possible so as to force capital to undertake investment risks in order to earn profits (b) supplementing a private investments by government spending (c) adopting a progressive tax system which would adversely affect savings and thus help in maintaining the level of consumption in the country.

2. Points of Strength

- It was Keynesian achievement to show the inherent weakness of the classical economics which assumed self adjusting mechanism of the economy for attaining full employment.
- Keynes provided a complete theory in which both monetary & fiscal aspects of the economy were properly integrated and influenced each other
- Keynes was able to counteract a number of preventing myths in economic theory & policy prescriptions. Among the then prevailing challenges up on which Keynes shed a light of hope are
    - The relationship between employment & wage rate. For Keynes it is only when real wages declines (not monetary wage) that employment increases.
    - To avert economic crises, interest rate should be lowered so that investment will be encouraged
    - Saving will end up with less saving via curtailment in effective demand and employment.

- Keynes also shed new light on the motives for holding money by referring to the liquidity attributes of money which made it desirable asset in comparison with other assets.

3. Points of Weakness

- His General Theory (the book that immortalized his name) was severely criticized for its bad style. This creates a friction for Keynes' thought to be understood & accepted by his fellow. Keynes can also be legitimately criticized for assuming that the businessman would be facing definite and stable demand & supply function. In other words, Keynes made only a limited use of expectations and did not extend the treatment by the element of uncertainty. For example, his marginal efficiency of capital is based on the assumption that future flows of expenditure and receipts can be estimated with certainty.
- Keynes rejected the orthodox stand that both saving and investment were interest elastic and equal. Having rejected the interest elasticity of savings he could show that savings, and investment could be continuously unequal ex-ante but Keynes was not able to bring about a fuller treatment of the theory of interest.
- Keynes may also be criticized for ignoring the portions of value and distribution. He is also accused of confining his analysis to those cases where the money markets are fully developed. He also chose to concentrate chiefly up on the working of the economy before full employment and left out the actual process of adjustment while discussing the interactions between various determining variables.
- Keynes's short-run static thinking fed him to exaggerate the trend toward secular stagnation. Like many economists before him, he thought that the profitability of new investment would decline as the most profitable projects were undertaken first, leaving less attractive projects for later exploitation. In saying so, Keynes underestimated the possibilities of technological change and the new capital investments it would stimulate.
- Keynes was narrowly provincial with respect to both space and time. He seemed to think that unemployment might have become a problem in ancient Egypt and in the Middle Ages had it not been for the building of pyramids and cathedrals. His analysis of mercantilism strongly implied that the problems of 1636 were the same as those of 1936: "There has been a chronic tendency throughout human history for the propensity to save to be stronger than the inducement to invest." He thought that throughout history the weakness of the inducement to invest had been the key to the economic problem.

- Keynes also can be criticized for his too-ready acceptance of wasteful government spending. To be sure, he preferred that the state finance useful, rather than useless, projects. But he recognized that the business community might condemn useful public works if they competed with private enterprise. In such a situation wasteful spending was preferable to serviceable projects and was much better than doing nothing at all.
- Keynes was sympathetic toward private-wasteful-consumption spending as well as public waste. He defended Bernard de Mandeville's *The Fable of the Bees: or, Private Vices., Publick Benefits* (1705), which told of the appalling/awful plight of a prosperous community that suddenly abandoned luxurious living and amusements in the interest of saving.

12.7. CHAPTER SUMMARY

- Keynesian Economics is a term used to describe macroeconomic theories of the level of economic activity using the techniques developed by J. M. Keynes. Keynes is the chief representative and the founder of this school of thought. the Great Depression of the 1930s magnified the dominance of the school.
- The major characteristics and principles of Keynesian economics are: macroeconomic emphasis, demand orientation, instability in the economy, wage and price rigidity, active fiscal and monetary policies. Keynes's major contribution include his theory of employment, theory of wage, theory of price, theory of investment, theory of consumption, theory of multiplier.
- Keynes agreed with the orthodox/classical views that increase in the quantity of money in circulation leads to an increase in the price level.
- Keynes rejected the laissez-faire philosophy because the classical economists were interested in the distribution of the product and not in the employment of economic resources of the country. For Keynes, level of employment is determined by effective demand and that a stimulation in effective demand comes through changes in the marginal propensity to consume
- Keynesian economics is institutional in the sense that it gives due importance to institutional factors explaining high rates of interest, inadequate supplies of money, over-saving, uncertainties, rigidity etc.

- Keynes became famous for the development of the theory of multiplier which is so intimately connected with the marginal propensity to consume. The multiplier is a numerical coefficient indicating how great an increase in income results from each increase in investment. The value of this multiplier obviously would depend up on the value of the marginal propensity to consume.
- According to Keynes the rate of interest is the price paid to an individual for parting with his liquidity preference. The individual's preference for liquid assets, or liquidity preference, is mainly for three reasons: for daily transaction (transaction motive), for meeting contingent needs (contingency motive) and for meeting business needs (or the speculative motive).

12.8. SELF TEST EXERCISE

Dear student! Now it is your turn to discuss on important issues presented above. Please, attempt all of the following question. They are meant to evaluate the extent to which you understood the essence of the Keynesian economics. If you encounter challenges in answering them, you are strongly advised to refer back to the note provided in this chapter.

1. Identify and briefly state the significance of each of the following to the history of economic thought: John Maynard Keynes; *The General Theory of Employment; Interest and Money;* consumption function; marginal propensity to consume; marginal propensity to save; marginal efficiency of capital; liquidity preference; equilibrium income and employment.
2. Clearly explain Keynesian economics in not more than fifty words.
3. What caused the emergency of Keynesian school? Why? How do you distinguish from the classical thoughts?
4. According to Keynes, an economy can be at equilibrium only if it is at full employment level. True or False? Explain.
5. Distinguish between Keynes' voluntary and involuntary unemployment.
6. What is the mathematical relationship between marginal propensity to consume and marginal propensity to save? Prove it.
7. Compare and contrast Classical's and Keynes's view on wage, price, and interest.
8. What is marginal efficiency of capital?

9. 'A bird in hand worth two in bush'. Which rationale of liquidity preference does this saying explain?
10. Explain the concept of multiplier.
11. Contrast the major tenets of the Keynesian school with those of the marginalist school.
12. Use the information in the table to answer the following questions. Assume initially that no government spending or taxes occur in this hypothetical economy.

	CONSUMPTION (C)	SAVINGS (S)	INVESTMENT (I)
$000	$020	$-20	$40
100	100	00	40
200	180	20	40
300	260	40	40
400	340	60	40

a) What is the marginal propensity to consume in this economy? What is the marginal propensity to save?

b) What is the equilibrium level of income? Explain

c) Suppose investment spending declined by $20. What would be the new equilibrium income and the new level of consumption? What is the size of the multiplier? Why would it be reasonable to assume that an increase in the unemployment rate would be associated with the decline in national income?

d) What actions, according to Keynes, could the government take to restore the equilibrium level of income that you determined in part (b)?

13. Explain, using Keynes's concept of the marginal efficiency of capital, how it is possible for investment spending to decline, even though the market rate of interest remains unchanged.
14. If the marginal propensity to consume in a certain economy is 2/3, what will be the government multiplier of $1 investment in the economy?

CONCLUDING REMARKS

Dear student! Thank you for accompanying me throughout the long journey of explaining the evolution of economic thought. I hope you have grasped an important lesson from the ride. But what conclusions, if any, can we draw from our study of the history of economic thought? Different observers will likely draw varying conclusions. Below are the conclusions made by Brue & Grant (2007).

1. **Economics is a dynamic discipline.**

Our understanding of the principles of economics and the working of the economy has progressed over the years and is still emerging. New ideas and developments in the field have tended to be followed by yet other ideas and developments. Some of the subsequent thinking has extended, amplified, and improved the existing base of knowledge; other theories and studies have challenged the new ideas. This expansion and competition of ideas has not always produced "truth" in the scientific sense of that word, but they have generated a widespread, nearly universally accepted body of basic principles of economics. Such principles are still emerging in the field.

2. **Neither current events nor increased professionalization alone explains the development of economic theory.**

In some instances, it has been the critical issues of the day that have stimulated new developments in economic theory. In other cases, current events and problems have turned the profession's and the public's attention to theories - long before advanced - that suddenly have new relevance. But in still other situations, the advancement of new theories came quite independently of the current issues. Increased professionalism among economists, along with the heightened interest in understanding unresolved paradoxes and improving existing theories, has been a major factor in the advance of the discipline. A prime example is the development of general equilibrium analysis.

3. **Individual economists have "mattered."**

Economic thinkers do economic thought. We have seen that individual economists have made a difference in the history of economic theory and method. Smith, Ricardo, Marx, Marshall,

Walras, and Keynes, to name but a few, are to economics as Newton and Einstein are to physics and Darwin is to biology. This obviously is not meant to imply that the development of economics owes fully to those we have discussed in this module. For every economist studied there have been hundreds of others who have contributed greatly to the development of the discipline. Each book and journal article written on the subject adds directly or indirectly to the development of economic thought.

4. New ideas seldom lead to the total abandonment of the existing heritage.

New scholarship in economics normally is connected to a previous body of thought, and although it may alter or transform the older tradition, it rarely replaces it. Keynes, for example, drew heavily from the neoclassical scholarship and methodology. As revolutionary as they were, the Keynesian ideas did not supplant the neoclassical tradition. Recall that Keynes himself had no major quarrel with the main body of Marshall's microeconomic theory. As stated by Stigler, "One of the prominent lessons of the history of human thought is that new ideas do not lead to the abandonment of the previous heritage; the new ideas are swallowed up by the existing corpus, which is thereafter a little different.

5. Economics has become increasingly specialized.

As the general body of economic knowledge has increased, individual economists have found it increasingly necessary and useful to specialize in a single or limited number of fields of the discipline. This specialization has become particularly noticeable in the last several decades. Not only is there specialization within economics (international economics, welfare economics, economic growth and development, labor economics, and so forth), but also there are specializations within the fields of economics (human capital theory and mobility & migration, both within labor economics).

6. Both positive & normative economic thoughts have been important in economics.

Over the centuries, the discipline of economics has moved away from "political economy," with its emphasis on advocacy and "what ought to be," toward "positive economics," which eschews value judgments and focuses on discovering and stating uniformities among economic phenomena ("what is"). Examples of positive economics are value or price theory, theories of the firm, principles of the gains from specialization and trade, theories of the consumption

function, and so forth. But our study likewise reveals that "political economy," or normative economics, has contributed to the public awareness of economic principles and has helped advance the discipline of economics itself.

7. **Economics increasingly has incorporated mathematics & statistics into its basic methodology.**

Several important economists such as Walras, and Pareto were self-described mathematical economists. Others such as Jevons and Wicksell used mathematics extensively. Within the past few decades, econometrics has become standard fare within the neoclassical and Keynesian traditions.

8. **Future developments in economics & the economy are difficult to predict.**

At any single point, it would have been nearly impossible to predict with any certainty the course of subsequent events and developments both in economics and in the economy. It should be remembered that there is activity today on several fronts by groups of economists dissatisfied with the current orthodoxy. These include the neo-Austrians, who reject the mathematical orientation of the discipline and the static definition of efficiency that pervades much of mainstream thought. There also are the supply-side economists, who advocate policies to increase production and stimulate productivity growth and who reject strict monetarism. There are traditional institutionalists and socialists, now on the defensive, but still working to formalize and popularize their ideas. There are the "post-Keynesians," who are working to develop models in which prices and wages are "fixed" through the exercise of power, as opposed to being determined freely in the marketplace. One simply cannot predict which, if any, of these lines of reasoning will result in scholarship of sufficient importance to dictate its inclusion in the next chapter of the history of economic thought. But our review of the historical record demonstrates one thing clearly: *New developments in economics will occur. What we know today about economics will not be enough to last us our lifetimes. Somewhat ironically, the study of the past in economics teaches us the importance of staying current. It also implores us to keep an open, yet discerning, mind.*

NOBEL PRIZE IN ECONOMICS

The **Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel** is a prize awarded each year for outstanding intellectual contributions in the field of economics. The award was instituted by the Bank of Sweden (the world's oldest central bank) at its 300th anniversary in 1968. Although it was not one of the awards established in the will of Alfred Nobel, the economics laureates receive their diploma and gold medal from the Swedish monarch at the same December 10 ceremony in Stockholm as the Nobel laureates in physics, chemistry, physiology or medicine, and literature. The amount of money awarded to the economics laureates is also equal to that of the other prizes.

The prestige of the prize derives in part from its association with the awards created by Alfred Nobel's will, an association which has often been a source of controversy. The prize is commonly referred to as the **Nobel Prize in Economics** or, more correctly, as the **Nobel Memorial Prize in Economics**.

In February 1995, it was decided that the economics prize be essentially defined as a prize in social sciences, opening the Nobel Prize to great contributions in fields like political science, psychology, and sociology. Also, the Economics Prize Committee was changed to require two non-economists to decide the prize each year, whereas previously the prize committee had consisted of five economists.

Award process

The economics laureates, like the Nobel laureates in chemistry and physics, are chosen by the Royal Swedish Academy of Sciences. Nominations of about one hundred living persons are made each year by qualified nominators and are received by a five to eight member committee, which then submits its choice of winners to the Nobel Assembly for its final approval. No more than three people can share the prize for a given year. The final award is made in Stockholm, and is accompanied by a prize (10 million Kronor, or roughly 1 million Euros as of 2006).

Nobel Prize Winners in Economics

1960s

Year	Name	Topics
1969	Ragnar Anton Kittil Frisch (Norway), Jan Tinbergen (Netherlands)	- for having developed and applied dynamic models for the analysis of economic processes

1970s

Year	Name	Topics
1970	Paul Samuelson (United States)	- for the scientific work through which he has developed static and dynamic economic theory and actively contributed to raising the level of analysis in economic science
1971	Simon Kuznets (USA)	- for his empirically founded interpretation of economic growth which has led to new and deepened insight into the economic and social structure and process of development
1972	John Hicks (United Kingdom), Kenneth Arrow (USA)	- for their pioneering contributions to general economic equilibrium theory and welfare theory
1973	Wassily Leontief (Russia)	- for the development of the input-output method and for its application to important economic problems.
1974	Gunnar Myrdal (Sweden), Friedrich Hayek (Austria)	- for their pioneering work in the theory of money and economic fluctuations and for their penetrating analysis of the interdependence of economic, social and institutional phenomena
1975	Leonid Kantorovich (Soviet Union), Tjalling Koopmans (Netherlands)	- for their contributions to the theory of optimum allocation of resources
1976	Milton Friedman (USA)	- for his achievements in the fields of consumption

		analysis, monetary history and theory and for his demonstration of the complexity of stabilization policy
1977	Bertil Ohlin (Sweden), James Meade (UK)	- for their path breaking contribution to the theory of international trade and international capital movements
1978	Herbert Simon (USA)	- for his pioneering research into the decision-making process within economic organizations
1979	Theodore Schultz (USA), Arthur Lewis (Saint-Lucia)	- for their pioneering research into economic development research with particular consideration of the problems of developing countries

1980s

Year	Name	Topics
1980	Lawrence Klein (USA)	- for the creation of econometric models and the application to the analysis of economic fluctuations and economic policies
1981	James Tobin (USA)	- for his analysis of financial markets and their relations to expenditure decisions, employment, production and prices
1982	George Stigler (USA)	- for his seminal studies of industrial structures, functioning of markets and causes and effects of public regulation
1983	Gerard Debreu (France)	- for having incorporated new analytical methods into economic theory and for his rigorous reformulation of the theory of general equilibrium
1984	Richard Stone (UK)	- for having made fundamental contributions to the development of systems of national accounts and hence greatly improved the basis for empirical economic analysis

1985	Franco Modigliani (USA)	- for his pioneering analyses of saving and of financial markets
1986	James Buchanan Jr. (USA)	- for his development of the contractual and constitutional bases for the theory of economic and political decision-making
1987	Robert Solow (USA)	- for his contributions to the theory of economic growth
1988	Maurice Allais (France)	- for his pioneering contributions to the theory of markets and efficient utilization of resources
1989	Trygve Haavelmo (Norway)	- for his clarification of the probability theory foundations of econometrics and his analyses of simultaneous economic structures

1990s

Year	Name	Topics
1990	Harry Markowitz (USA), Merton Miller (USA), William Sharpe (USA)	- for their pioneering work in the theory of financial economics
1991	Ronald Coase (UK)	- for his discovery and clarification of the significance of transaction costs and property rights for the institutional structure and functioning of the economy
1992	Gary Becker (USA)	- for having extended the domain of microeconomic analysis to a wide range of human behaviour and interaction, including nonmarket behaviour
1993	Robert Fogel (USA), Douglass North (USA)	- for having renewed research in economic history by applying economic theory and quantitative methods in order to explain economic and institutional change
1994	John Harsanyi (USA), John Forbes Nash (USA), Reinhard Selten (Germany)	- for their pioneering analysis of equilibria in the theory of non-cooperative games

1995	Robert Lucas Jr. (USA)	- for having developed and applied the hypothesis of rational expectations, and thereby having transformed macroeconomic analysis and deepened our understanding of economic policy
1996	James Mirrlees (UK), William Vickrey (USA)	- for their fundamental contributions to the economic theory of incentives under asymmetric information
1997	Robert C. Merton (USA), Myron Scholes (Canada)	- for a new method to determine the value of derivatives
1998	Amartya Sen (India)	- for his contributions to welfare economics
1999	Robert Mundell (Canada)	- for his analysis of monetary and fiscal policy under different exchange rate regimes and his analysis of optimum currency areas

2000s

Year	Name	Topics
2000	- James Heckman (USA), - Daniel McFadden (USA)	- for his development of theory and methods for analyzing selective samples - for his development of theory and methods for analyzing discrete choice
2001	George A. Akerlof (USA), Michael Spence (USA), Joseph E. Stiglitz (USA)	- for their analyses of markets with asymmetric information.
2002	Daniel Kahneman (Israel/USA), Vernon L. Smith (USA)	- for having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty - for having established laboratory experiments as a tool in empirical economic analysis, especially in the

		study of alternative market mechanisms
2003	Robert F. Engle (USA), Clive W. J. Granger (UK)	- for methods of analyzing economic time series with time-varying volatility or common trends
2004	Finn E. Kydland (Norway), Edward C. Prescott (USA)	- for their contributions to dynamic macroeconomics: the time consistency of economic policy and the driving forces behind business cycles
2005	Robert J. Aumann (Israel/USA), Thomas Schelling (USA)	- for having enhanced our understanding of conflict and cooperation through game-theory analysis
2006	Paul Krugman	- for his analysis of trade patterns and location of economic activity.
2007	Leonid Hurwicz , Eric S. Maskin , and Roger B. Myerson	- for having laid the foundations of mechanism design theory.
2008	Edmund S. Phelps	- for his analysis of intertemporal tradeoffs in macroeconomic policy.

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