

History of Economic Thought I



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Chapter One

1 Introduction to History of Economic Thought

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

1.1 Defining 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.

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.

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) 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 globalized era of the twenty first.

1.2 The interaction between Economic history and 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.

1.3 Scope and Significance of History of thought

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

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, 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.

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.

Benefits to be gained from the study of the history of economic thought

A primary reason for studying the history of economic thought is to become a better economist. With few exceptions, the important economists of past and present have been well acquainted with the theoretical history of their discipline. Reading the history of economic thought strengthens theoretical and logical skills by providing opportunities to relate assumptions to conclusions: one learns to work through the logic of systems that are different from one's own. Social scientists also need to be aware of their methodologies. An effective means of achieving this awareness is to study historical controversies—such as those between the deductive and inductive approaches, or between the advocates of rigorous abstract theoretical models and advocates of a more historical, descriptive approach and to note the gains and losses to be realized by using each methodology. The history of economic theory can also teach us humility. When we see great minds make important theoretical errors or fail to examine or pursue what appear from historical hindsight to be obvious paths, we realize that our own theoretical paradigms may be faulty in ways that are difficult for us to perceive, because we are blinded by our preconceptions.

Yet another reason for studying old ideas is to foster new ones. Study of past economic theory is often the source of inspiration for a new idea. Theories sometimes get lost in the past and are not carried forward to the future, or they may become linked to specific applications. A good example of this is the development around 1815 of the concept of diminishing returns and rent. Until about 1890, when their applicability to factors of production was finally recognized, returns and rent were applied only to land. Also, fruitful ideas may be discarded along with an outworn or otherwise objectionable ideology to which they are linked. Orthodox theory largely ignored the work of Marx until the Great Depression of the 1930s necessitated a search through past economic theory for an explanation of the causes of depression in a capitalist system.

With this background, we shall proceed to a study of the history of economic thought, tracing the emergence of modern orthodox economics while still taking into account the deviations from orthodoxy that have helped to shape the content of present-day economics.

In addition to the scope and content of theory, we shall note major methodological issues and the relationships between the development of a theory and the economic conditions at the time of its development. Where the internal workings of particular theories provide insights, we shall explain them. From time to time we shall indicate the general significance of particular ideas in the development of theory and the broader implications of theory as a basis for the formulation of economic and social policy.

1.4 Nature of Economic Thought

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

1.5 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.

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:

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

1.6 Five major questions that we need to bear in mind in considering the various schools of thought

Dear students! The following major questions shall be noted for your consideration at the end of each school. Then you can also trace the Ethiopian historical situation during the time. These are:



What was the historical background of the school? Or the pushing factors behind



What were the basic tenets of the school? Who were the forerunners? Whom did the school benefit? Or seek to benefit?



How was the school valid, useful, or correct in its time?



Which tenet of the school becomes long lasting contribution?

What was the historical situation in Ethiopia when these ideas were developed elsewhere?

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.

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?

Chapter Two

2 Methodological Issues

Overview

In thinking about the history of the discipline, one is naturally led to ask, “What do economists know and how do they know that they know it?” Such questions belong broadly to epistemology, the study of human knowledge; in the philosophy of science they are included in the subject “methodology.”

Objective of the chapter:

After completion of this chapter you are expected to;



Define certain methodological terms.



Identify methodology significantly influences what economists do.



Consider the evolution of methodological thinking and its influence on economic thought.

2.1 Methodological Controversies in Economic and Evolution of Various Methodologies

Dear student! Do you know how methodology influences science/truth? Please try your own ideas. _____

Well done! It is sometimes said that discussions of methodology should be left to those senior members of the profession who are ready for retirement. Quite the contrary. Before you can begin to study economic issues, you must decide what you will study and what approach you will take; you must make methodological decisions. Thus, methodological questions are more relevant to young than to old economists.

We present a few methodological issues that have arisen in the philosophy of science from the ancient Greeks to modern-day thinkers.

2.1.1 Economics as an Art and as a Science

Perhaps the most important distinctions in economic thought are those between the art of economics, positive economics, and normative economics.

Positive economic concerns the forces that govern economic activity. It asks such questions as: How does the economy work? What are the forces that determine the distribution of income? The sole

purpose of these inquiries is to obtain understanding for the sake of understanding. (About the facts ‘what is’).

Normative economics explicitly concerns questions of what should be. It is the philosophical branch of economics that integrates economics with ethics. Normative judgments should enter into the analysis as little as possible.

The art of economics concerns questions of policy. It relates the science of economics to normative economics and asks questions such as: if these are one’s normative goals, and if this is the way the economy works, then how can one best achieve these goals?

The distinction is important because positive economics and the art of economics have quite different methodologies. The methodology of positive economics is formal and abstract; it tries to separate economic forces from political and social forces. The methodology of the art of economics is more complex because it concerns policy and must address interrelationships among politics, social forces, and economic forces.

Whether positive economics or the art of economics should be the primary focus of economics has prompted unending debate in the history of economic thought.

The German historical school and the English Marshallian School have advocated that primary attention be given to the art of economics. They draw strength in this advocacy from the work of Adam Smith. Modern orthodox economists focus on positive economics and find support for this position in the writings of David Ricardo. Consistent with that view, most modern methodological writing has centered on positive economics, and our methodological discussion in this chapter will follow that focus. We will, however, return to the many interesting issues surrounding the art of economics when we examine the economic policies put forward by various economists.

2.1.2 The Importance of Empirical Verification

How we go about answering the questions “What do we know?” and “How do we know that what we know is right?” depends on the answer to the question “Is there an ultimate truth that scientists are in the process of revealing (an absolutist view), or is there no underlying truth (a relativist position)?” If there is ultimate truth, how do we find it? If there is none, are some propositions more truthful than others? Methodologists past and present have failed to reach consensus on these problems but have generated an enormous amount of material on the subject. Believing that an

ultimate truth exists leaves one with the problem of deciding when one has discovered it.

The means by which the growing scientific world strove to discover the truth involved trained empirical observation as exemplified in the scientific method. This entailed the integration of reason with empirical observation. Although this subject is far too complicated for us to elaborate, verification is discussed in detail in the writings of Kant, Hume, Descartes, and other seventeenth- and eighteenth- century philosophers. We will simply define three terms that have played an important role in the discussion, inductive, deductive, and abductive.

The first two terms are well known. Inductive reasoning is empirical, proceeding from sensory perceptions to general concepts; deductive reasoning (logic) applies certain clear and distinct general ideas to particular instances. Because most philosophers believe that knowledge derives from a mix of these, the debate usually centers on the nature of the optimal mix.

“Abductive” is the name pragmatic philosopher Charles Peirce gave to a particular mix of the inductive and deductive approaches. The abductive concept is important for economics and other studies of complex systems. Abductive reasoning uses both deduction and induction to tell a reasonable story of what happened. It combines history, institutions, and empirical study to gain insight; however, it does not claim to provide a definitive theory, because, when we are dealing with a complex system, definitive theories are beyond our grasp. Methodological issues have played major roles in the development of economic thinking, but they quickly become complicated. In the appendix to this chapter we provide a brief overview of the development of present-day methodology in economics.

2.2 The Evolution of Methodological Thought

In the chapter we mentioned the concepts of induction, deduction, and abduction as an introduction to methodology. Let us now consider the evolution of methodological thinking and how it influenced economics.

2.2.1 The Rise of Logical Positivism

The methodology of science moved into the twentieth century with the development of logical positivism, which provided the scientific method with philosophical foundations. It established a working methodology expressing the empirical and non-empirical, or rational, aspects. Logical positivism linked with deductive reasoning a positivist desire to let the facts speak for themselves. It originated with a group known as the Vienna Circle, which attempted to formalize the methods of scientists by describing the methods scientists actually followed.

The logical positivists argued that scientists develop a deductive structure (a logical theory) that leads to empirically testable propositions. A deductive theory is accepted as true, however, only after it has been empirically tested and verified. The role of the scientist, they said, is to develop these logical theories and then to test them. Although there was debate among the logical positivists as to what constituted truth, all concurred that it would be discovered through empirical observation.

Logical positivism reigned in the philosophy of science only from the 1920s through the 1930s, but its influence in economics continued much longer. It was logical positivism that formalized the distinction between normative and positive economics, first made by Nassau Senior in 1836 and later by J. S. Mill and John Neville Keynes. This distinction is still retained in most introductory textbooks, which describe economics as a positive science whose goal is to devise theories that can be empirically validated. Normative discussions were purged from economics as unscientific.

2.2.2 From Logical Positivism to Falsificationism - Karl Popper and Its Critics

Logical positivism represented a culmination of the belief that the purpose of science is to establish “truth.” The methodology of science has since progressively removed itself from that view. The first departure resulted from a concern about the “verification” aspect of logical positivist theory. This concern is best expressed in the writings of Karl Popper, who argued in the 1930s that empirical tests do not establish the truth of a theory, only its falsity which is why Popper’s approach is sometimes called falsificationism. According to Popper, it is never possible to “verify” a theory, since one cannot perform all possible tests of the theory. For example, assume that a theory predicts that when the money supply increases, prices will increase by an equal percentage. Then assume that in an appropriate experiment the predicted result does in fact occur. According to Popper, this indicates only that the theory has not yet been proved false. The theory may or may not be true, since the next experiment may produce a result that is not consistent with the theory’s prediction.

Popper asserts, therefore, that the goal of science should be to develop theories with empirically testable hypotheses and then to try to falsify them, discarding those that prove false. The progression of science, according to Popper, depends upon the continuing falsification of theories. The reigning theory will be the one that explains the widest range of empirical observations and that has not yet been falsified.

2.2.3 From Falsificationism to Paradigms - Thomas Kuhn

It would be nice if methodological problems could be resolved as neatly as Popper's approach suggests, but methodological debates are anything but neat. More recent developments have moved methodology progressively away from such neat distinctions. The modern rejection of Popper's theory is not without grounds: falsificationism has several serious problems.

- ✓ First, empirical predictions of some theories cannot be tested because the technology to test them does not exist. What should one do with such theories?
- ✓ Second, it is difficult to determine when a theory has or has not been falsified. For example, if an empirical test does not produce the expected results, the researcher can and often does attribute the failure to shortcomings in the testing procedure or to some exogenous factor. Therefore, one negative empirical test often will not invalidate the theory.
- ✓ A third problem arises from the mindset of researchers, who may fail to test the implications of an established theory, assuming them to be true. Such a mindset can block the path to acceptance of new and possibly more tenable theories.

Partly in response to these problems, Thomas Kuhn, in *The Structure of Scientific Revolutions* (1962), moved methodology away from falsificationism by introducing the concept of the paradigm into the debate. A paradigm, as Kuhn uses the word, is a given approach and body of knowledge built into researchers' analyses that conforms to the accepted textbook presentation of mainstream scientific thought at any given time. Kuhn argued that most scientific work is normal science, in which researchers try to solve puzzles posed within the framework of the existing paradigm. This work often leads to the discovery of anomalies that the paradigm fails to account for, but the existence of such anomalies is not sufficient to overthrow the reigning paradigm—only an alternative paradigm that is better able to deal with the anomalies can do so. Once such a superior paradigm is developed, a scientific revolution becomes possible.

In revolutionary science, first the existing paradigm is rejected by part of the scientific community, and then the old and the new paradigms begin to compete and communication between researchers in the opposing camps becomes difficult. Ultimately, if the revolution is successful, new questions will be posed within the new framework and a new normal science will develop. Whereas in Popper's view "truth" (or the closest we can get to truth) will win out, in Kuhn's view a superior theory might exist but not be adopted because of the inertia favoring the existing paradigm. Hence the reigning theory is not necessarily the best.

Those who disagreed with mainstream theory quickly adopted Kuhn's analysis, because it suggested that the paradigm they preferred might prove to be superior to, and thus able to supplant, the mainstream view. Moreover, Kuhn's work suggested that changes occur by revolutions; it offered hope that change, when it came, would come quickly. Although Kuhn focused on the natural sciences, he had a significant influence on the social sciences, such as economics. Methodological discussions throughout the 1970s and 1980s were peppered with the term paradigm.

2.3 Recent developments in the Methodology of Economics

2.3.1 From Paradigms to Research Programs

The view that the existing theory might not embody the truth was extended by Imre Lakatos during the late 1960s and 1970s. He tried to grasp and articulate the procedures good scientists were actually following; he observed that scientists are engaged in the development of competing research programs, each of which involves analyzing and attempting to falsify a set of data but also involves unquestionably accepting a set of hard-core logical postulates. Each study derives a set of peripheral implications from the hard core and then attempts to falsify them. Falsification of a single peripheral implication will not require rejection of the theory but will occasion a reconsideration of the logical structure and, perhaps, an ad hoc adjustment. Only if "sufficient" peripheral implications are falsified will the hard-core assumptions be reconsidered. Lakatos called research programs progressive if the process of falsifying the peripheral implications was proceeding, degenerative if it was not.

Lakatos's work has two significant features:

- ✓ It recognizes the complexity of the process whereby a theory is falsified; and
- ✓ whereas earlier analyses required that one theory predominate, Lakatos provides for the simultaneous existence of multiple workable theories whose relative merits are not easily discernible.

2.3.2 From Research Programs to Sociological and Rhetorical Approaches

In one way, the developments we have just outlined move progressively away from logical positivism, but in another way they are refinements of it that recognize the limitations of empirical

testing. A much more radical departure from previous methodology can be found in Paul Feyerabend's *Against Method: An Outline of an Anarchistic Theory of Knowledge* (1975). Feyerabend argues that the acceptance of any method limits creativity in problem solving and that the best science is therefore to be confined to no method—in other words, anything goes. Though his radical argument at first seems crazy, he has provided some new perspectives on knowledge that throw light on the rhetorical and sociological approaches that have influenced recent developments in the methodology of economics. Although earlier approaches acknowledged the difficulty of discovering truth, they did not question the Platonic vision of truth as absolute.

The rhetorical and sociological approaches do just that. Since they refuse to assume the existence of an ultimate and inviolable truth, they search out other reasons to explain why people believe what they believe. The rhetorical approach to methodology emphasizes the persuasiveness of language, contending that a theory may be accepted not because it is inherently true but because its advocates succeed in convincing others of its value by means of their superior rhetoric. The sociological approach examines the social and institutional constraints influencing the acceptability of a theory. Funding, jobs, and control of the journals may have as much influence on which theory is accepted as the theory's ability to accurately explain phenomena. Those who adhere to the sociological approach contend that most researchers are interested less in whether the theories they advance are correct than in whether they are publishable. What these two theories most notably share is skepticism about one's ability to discover truth, or even whether truth exists at all. According to these approaches, a theory has not necessarily evolved because it is the closest to the truth; it may have evolved for a variety of reasons, of which truth if it exists is only one.

2.3.3 Post rhetorical Methodology

Where does this leave us with respect to methodology? In a somewhat muddled state, but being muddled is not unusual for methodology. Following the progress of epistemology through the past few decades, we have seen the answers to questions about how and what we know become progressively vaguer until methodology is all but annihilated: the most persuasive researchers win out regardless of the value of their work. Fortunately, however, we need not accept such a view as total reality. Although such extreme viewpoints provide interesting insights, they clearly need to be tempered by common sense. Even admitting the social and rhetorical influences on the direction of science, one need not accept that Feyerabend's "anything goes" attitude necessarily follows. Methodology, moreover, is not going to end here. A post rhetorical methodology will probably

combine insights such as Feyerabend's with more workable approaches and emphasize abduction rather than deduction or induction.

Although researchers may never know with certainty whether a given theory is true or false, they must accept the most promising ideas as tentatively true working hypotheses. They may revert to certain elements of logical positivist and falsificationist methodology to do this. They may even accept all the arguments of the rhetorical and sociological schools and still behave as they always have toward the truth or falsity of their research. The difference will be in perspective: post rhetorical economists will be more skeptical of their knowledge, less likely to dismiss an argument as false before they have closely considered it, and more likely to "let 1,000 flowers bloom." A post rhetorical economist will scrutinize the incentives of researchers to study particular theories and will view with skepticism the results of studies that coincide with the researcher's own interests or preconceived beliefs. Finally, a post rhetorical economist will be much more likely than a logical positivist or a falsificationist to follow Bayesian, rather than classical, statistics.

Bayesians believe one can discover higher or lower degrees of truth in statements, but not ultimate truth. The Bayesian influence will engender a reinterpretation of classical statistical tests, rendering them less exact, less persuasive, and not independently representative of a specific confidence level. In the methodology of the future, information about the researcher as well as the research will probably be a necessary component of statistical reporting.

For both the Bayesian and the rhetorical economists, understanding ultimately rests on faith. Recognizing that, one must proceed cautiously in the search for understanding, realizing that too skeptical a mindset stymies creativity. Thus, rhetorical methodology should provide only a Meta methodology that, once accepted, little affects the day-to-day work of economists. They do what they do.

Methodological Conclusions

Methodological arguments in economics have generally lagged far behind those in epistemology and the philosophy of science. According to most economics textbooks, the reigning methodology in economics is still logical positivism, which was long ago declared dead in other fields, as well as in the methodologically oriented economics journals. But occasionally the economics profession goes through a methodological spasm, looking inward and asking, "Is this what we should be doing?" It never fully answers this question but goes on as before, though equipped with slightly updated methodological views. Even though methodology is seldom discussed, ultimately it is

methodology that accounts for many of the differences among economists. Formalists are more likely to use a logical positivist or falsificationist methodology and believe in an absolutist approach; no formalists are more likely to use a sociological or rhetorical approach and believe in a relativist approach.

Self-Test Exercise

- 1) Is economics a science or art?
- 2) What is normative vs positive economics? Analyze it.
- 3) Why mythological consideration is important economics science? Briefly discuss it.
- 4) Paul Feyerabend argued that it was fruitless to try to formalize 'the scientific method' as a well-defined procedure. What does he mean? Discuss it.
- 5) Mention the two sub approaches of Against Method philosophy and critically discuss on their basic points.

Chapter Three

3 Ancient Ideas of Economic Thought or Pre-Classical Economics

Introduction

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.

3.1 Hebrew, Greek- Plato, Aristotle, Xenophon

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? 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:

- i. **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.
- ii. **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.
- iii. **Agriculture and Industry:** the Hebrews held agriculture and tilling of land in high esteem while they looked down upon 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.
- iv. **Labor:** the Hebrews regarded all kinds of labor dignified, but the pride of place was given to the agricultural labor.
- v. **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.
 - a. **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.
 - b. **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.
- vi. **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.
- vii. **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.
- viii. **Interest and Money:** while money serves as a medium of exchange it cannot be regarded as productive.

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?

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?

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.

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.

- i. **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"
- ii. **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.

- iii. **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. 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 everyone is paid & work according to their needs and abilities.
- iv. **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.
- v. **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.
- vi. **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.'

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 on economic problems.

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

- i. **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.

- ii. **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.

- iii. **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.

- a. **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.
- b. **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.

- c. **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).

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:

- i. **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 possessions on who excessive claims rest. The implication of Xenophon'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 richer.
- ii. **On Agriculture:** Xenophon 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 landmen and mariners perish." This is to say that the base of an economy is agriculture.
- iii. **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'.
- iv. **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.
- v. **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.
- vi. **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.
- vii. **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.

- viii. **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 these 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.

3.2 The Romans, Synchronism, Stoicism, Epicurism

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?

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?

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.

Impediment to Economic Enquiry

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?

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:

- 1) **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 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.
- 2) **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.

- 3) **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.

The **Cynics** were missionaries, and their message was/ that life could be lived on any terms the age could impose. It is particularly easy for the modern observer to see only the grotesque aspect of Cynicism, and to miss its real significance. This is partly due to the fact that Cynicism is usually presented to us in histories of Greek philosophy, where it forms an interlude of semi-comic relief between Socrates and Plato, or between Plato and the Stoics. But a most important reason is that the Cynics represented a standard with which we are unfamiliar that of the minimum. Through long exposure to statistics, we can readily grasp any conception that involves a norm the cost of living, the real wage of the working man, and so on but in the modern world no one voluntarily lives, as did the Cynics, at subsistence level.

More than 2000 years ago, in the Greek world, many philosophers occupied themselves with the question, what makes our lives happy? Most of these antique philosophies, like the systems of Plato, Aristotle and the Stoa, not only produced theory on this subject, but also promised happiness to those who were willing to accept their viewpoints. Among these great philosophical systems Epicurus' philosophy stands out because it is a view that identifies happiness with pleasure and is the one among the ancient versions of hedonism that is best known and to which attention is still paid.

Epicurus' philosophy, formulated in the third century B.C., gave its followers the prospect of personal happiness and took almost religious proportions; the adherents lived in small communities and the founder of this school was worshipped as a deity. His life was considered exemplary. There are some indications that Epicurus was successful in living his own philosophy, and he gave clear, understandable advice on

how to achieve personal happiness. Moreover, he claimed to have founded his philosophy on empirical facts. His philosophy about the good life brought Epicurus fame that has lasted till the present day. **Epicureanism** is a name for a specific lifestyle that seeks refined sensual pleasure, although this stance does not follow logically from the philosophy. Epicurus warned explicitly against the pursuit of luxury. Indulgence would increase desires and make a person dependent on the whims of fortune. Epicurus' though. Epicurus warned explicitly against the pursuit of luxury. Indulgence would increase desires and make a person dependent on the whims of fortune.

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.



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 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 and the attitude towards want satisfaction.

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?

3.3 Medieval Economics and Feudalism– St. Thomas Aquinas & Nicholas Oresme

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.

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.

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 molded 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.

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.

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.

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. In general, it can be said that St. Thomas' view on all economic matters were highly influenced by Aristotle & Christianity.

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 cannot be treated as a science because for it did not aim at explaining the cause and effect of economic phenomenon.

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

- i. nature and function of money
- ii. the inequity of money, and
- iii. 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. 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:

3.3.1 Just price, Usury, Guild, Manor

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.

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.

Prohibition of usury: 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. 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.

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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 used 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 in admittance 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.

Usury was so offending during the medieval period 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.

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
- 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**.

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.

3.3.2 Economic functions of the State

The kind of economic activity we see today in the industrialized areas of the world did not exist to any significant degree during the Middle Ages. In particular, although the production of goods for sale in a market increased throughout the period, it did not play a dominant role in everyday life. The *feudal economy* consisted of subsistence agriculture in a society bound together not by a market but by tradition, custom, and authority. The society was divided into four groups: serfs, landlords, royalty, and the church. All land was fundamentally owned by the Roman Catholic Church or the king. Use of the land owned by the king was given to the lords or nobles, who in exchange had certain obligations to the central authority. These obligations, based not on contracts (as in the modern market economy) but on tradition and custom, consisted of supplying services and goods. The right of land use, with its corresponding obligations, was passed by birthright from father to son. Since the secular central authority was never very strong during the Middle Ages, the lord was, for the most part, master of his domain.

The relationship between lord and serf was also dictated by custom, tradition, and authority. The serf was tied to the land by tradition and paid the lord for use of the land with labor, crops, and sometimes money. In return, the lord protected the serf from outsiders during times of war. Each manor or estate was a virtually complete economic and political unit. It usually had its own church, built by the lord and partly managed under the influence of the lord, since he nominated the pastor. As the largest landholder in Western Europe, the church had significant secular influence. In general, its estates were better managed than those of the feudal lords, partly because churchmen were the only class proficient in reading and writing.

Most individuals accepted their place in feudal society without much question. There were scattered examples of serfs revolting against their lords, but these were unusual occurrences. All land belonged to God, who had put it in the custody either of a man who was king by divine right or of the church. Not to accept the authority of one's superiors was to oppose the will of God, who had given them authority, and to endanger one's salvation in the next life. In such a system, land, labor, and capital were not commodities bought and sold in a market as they are today, and there was very little production of goods for sale in the market.

Although there were strong elements in the feudal society that reinforced tradition and were hostile to

change, other factors began to erode feudalism's foundations. Most economic historians regard changing technology as the major cause of the decline of feudalism. Changes in agricultural technology had disruptive influences on the manor. Manufacturing began, which was based on the replacement of human and animal power by mechanical power from water and wind. Thus, in the course of the Middle Ages and especially during the five hundred years prior to 1450, society was transformed.

The scholastic writers were educated monks who tried to provide religious guidelines to be applied to secular activities. Their aim was not so much to analyze what little economic activity was taking place as to prescribe rules of economic conduct compatible with religious dogma. The most important of the scholastic writers was St. Thomas Aquinas.

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*.

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.

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.

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 upon 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.

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 prohibition 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*, *Poenam 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.

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?

3.4 Mercantilism

Dear student! In the preceding lessons, 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*.

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

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, warrior 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.

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.

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.

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 Catholicism 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 sea 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. He 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 Bodin.

Major Tenets of Mercantilism:

The main principles of mercantilism can be summarized as follows.



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



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.



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).



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.



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.



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.



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.



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 cheap 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.



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.



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.

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 royal 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.

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.

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.

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:



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.



Commodities have to be manufactured in the country. Recommendation to industrialize the economy.



Population is to be encouraged and people turned from idleness. They should be trained in various skills and activities.



Gold and Silver, once in the country, are under no circumstances to be hoarded but are to remain in circulation.



The inhabitants should get along with their own domestic products and do without forcing products as far as possible. Consumption of imported goods (especially luxury) should be avoided.



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.



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.

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.



either a country has its own mines or



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.

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.

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.

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). They are more practical people.

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 Machiavelli and Bodin.



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.

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. Antonoι Serra
 - e. Thomas Mun
 - f. J. B. Colbert
 - g. Sir William Patty

3.5 The Physiocratic School of Economic Thought

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.

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 system⁸. 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 publications of Smith's Wealth of Nations and the downfall of Turgot from his high office. (Turgot himself was a physiocrat).

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).

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.

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.

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:



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.



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.



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.

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?

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 naturelles) 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 produce 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 physiocrats 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.

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 your answer on the space provided below.

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

Francois Quesnay (1694-1774)

Quesnay, the son of a land proprietor, was the founder and leader of the physiocratic school. Trained to be a 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 became 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 landmark 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.

A simplified account of Quesnay's Tableau Economique is presented below. Quesnay assumed that the land is owned by landlords but is cultivated by tenant farmers, who are therefore the only really productive class. The product that the tenant farmers create has to satisfy not only their own needs but also the needs of the landowners (including the king, the church, the public servants, and others who depend on the income of the land owners). In addition, the output of the farmers provides for the needs of the sterile class (manufacturers and merchants). The tableau shows, how the Net Product circulates among the three classes and how it is reproduced each year.

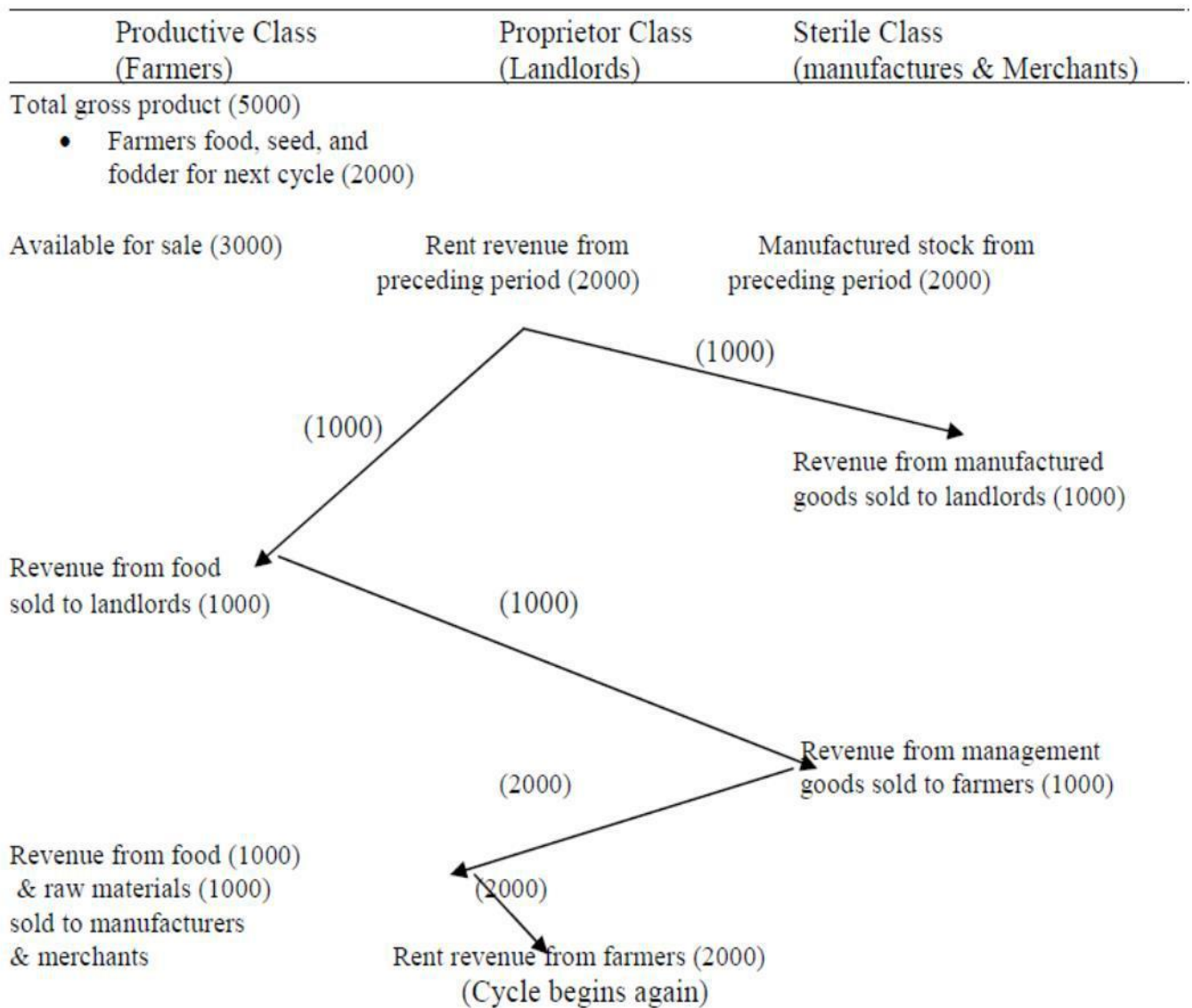
The farmers start with an annual gross product of 5000 million livres (or dollars). Of this, 2000 million dollars are immediately deducted as necessary expenses of production to provide food, seed, and fodder for the farmers themselves. The landlords start with 2000 million dollars in rent paid by the farmers during the preceding cycle. The manufacturers and merchants start with 2000 million dollars worth of goods manufactured during the preceding cycle.

The landlord class uses its 2000 million livres to buy 1000 million in food from the farmers and 1000 million in manufactured goods from the sterile class. The farmers use the 1000 million revenue received from the landlords to buy that amount of manufactured goods from the sterile class. This group has now sold its stock of manufactured goods for 2000 million livres, which it uses to buy food (1000 million) and raw materials (1000 million) from the farmers. At the end of the cycle the farmers have 2000 million livres in food, seed, and fodder, and 1000 million worth of manufactured goods which they will use to produce 5000 million livres' worth of farm products in the next year; the landlords have food, manufactured goods, and a claim for 2000 million in rent from the farmer's next harvest; and the sterile class have raw materials, which it will use to produce 2000 million livres' worth of manufactured goods.

Apparently the manufacturing class is left with no manufactured goods for its own consumption. Ronald L. Meek (in his book *The Economics of Physiocracy*, 1963) has a solution to this problem - a solution that he says is implied in the physiocratic writings. The number of people in the sterile class is one-half that in the productive class, and therefore their total personal consumption must be one half that of the productive class. The productive class consumes 1000 million livres worth of food and 1000 million livres 'worth of manufactured goods. The sterile class must therefore consume 500 million livres' worth of each. Since it possesses 1000 million livres' worth of food, it can export half of it to pay for imported manufactured goods.

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)

Quesnay's Tableau Economique



Criticisms of the Theory of Circulation (Tableau Economique)

Below are the main conclusions of the weaknesses of the Tableau Economique.

1. The Physiocratic treatment of the circulation of wealth was 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. 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.

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 was 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 was 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. Quesnay argued that tax should be collected only from the land lords because the surplus has gone to them through rent.

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 policy, 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.

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 The Riches’ 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 later 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.

Evaluation of Physiocrats

The summary of the evaluation of the physiocratic school given below.



The Physiocrats are credited for their famous doctrine of "laissez fair" which was principally directed to attack the protectionist principle of mercantilists. It was also an attack on the greater government action of mercantilists. The first man who utters this principle was Vincent de Gournay (1712-1759). He was a Physiocrat.



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 was 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”



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 macroeconomic 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.



They distinguished between wealth and money. For them wealth was not equivalent to money. It consists of real production. This was 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.



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.



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.

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..

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 Four

4 The Classical School

4.1 Over view of the classical school

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

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.

Period of Classicism

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

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.

4.2. Factors for the Emergence of the Classical School

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

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

- 1. 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.
- 2. 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.

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.

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 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.

4.2 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.

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.

Richard Cantillon (1680-1734)

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 Cantillon. 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:

Cantillon 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 Revolution⁹. In particular, his insightful notes on entrepreneurship (as a type of arbitrage) have made him a darling of the modern Austrian School¹⁰. 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 importation of "land-based products" and the exporting of "non-land-based" products as a way of increasing national wealth.

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.

David Hume (1711-1776)

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 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.

4.3 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.

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.

Adam Smith (1723-1790)

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.

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.

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 value them, or do people value goods because goods have value?" Smith basically answered that goods have value because people need to have 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.

Natural 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.

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.

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 the 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 labor, 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.

David Ricardo (1772-1823)

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.



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.



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 dose 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.

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

Doses of Capital and Labour	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	260	180	110	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 ($=50-50$).

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.

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 time 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.

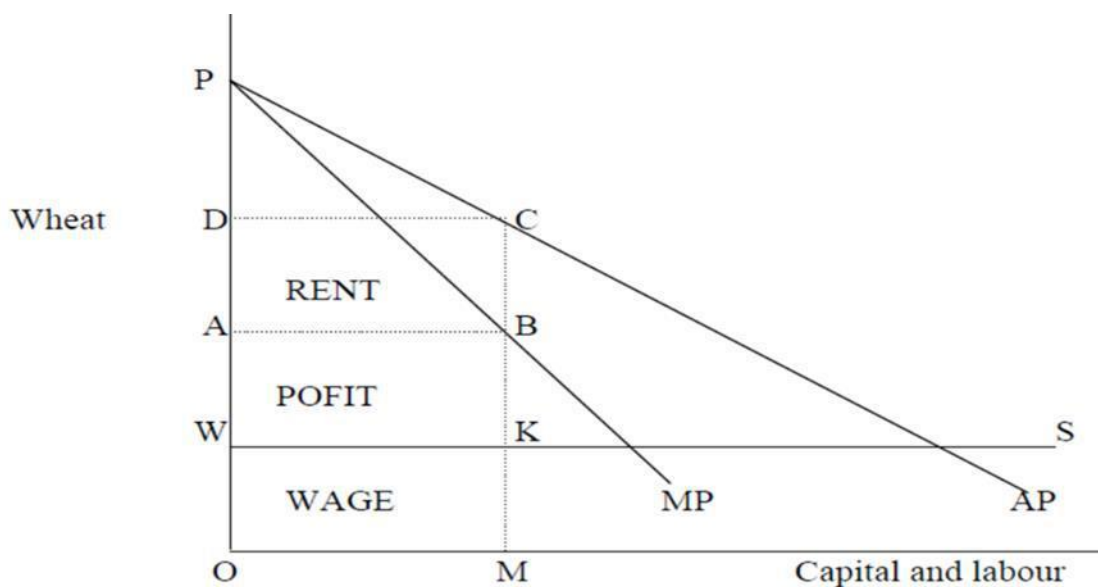
Wages: Labor, said Ricardo, like all other things that are bought and sold, has its natural price and its market price. The natural price of labor is that price that, given the habits and customs of the people, enables workers to subsist and to perpetuate themselves without a change in their numbers. 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.



When OM units of the variable input is employed, total product is equal to $OMCD$ (i.e., units of variable input times average product). According to the marginal principle, the variable input receives its marginal product and the fixed input gets the surplus (as determined by the gap between the average and the marginal product).

Rent is equal to the total product ($OMCD$) minus the marginal product of the variable input (BM) multiplied by the units employed (OM), which will give $OMBA$. Hence, rent is equal to $ABCD$ (or PAB), (the intra marginal surplus).

The share of labour, i.e., wages, is determined by the SUBSISTENCE THEORY OF WAGES. WS shows the subsistence wage rate (i.e., OW). The wage bill is equal to $OMKW$.

Profits are the residue equal to the total product-less-rent minus the wage bill. That is profits = $OMBA - OMKW = WKBA$.

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.

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 4.2: Hours of labor necessary to produce a unit of wealth

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.

4.4 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.

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



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.



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.

Utility is measured cardinally and its unit of measurement is money.

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 \$ 1, 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.

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.

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.

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.

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.

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, and 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.

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.

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.

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 Cantillon 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 dose of capital and labor does not generate any rent because revenues just cover their cost of production.



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.

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. Expand the following statement; the names Colbert, Turgot, and Say reflect the changing pattern of economic thought in France between 1650 and 1825.
3. How Smith did criticize mercantilists?
4. How Smith does defined the wealth of nations? What factors interact to cause increases in the nation's wealth?
5. How did Senior and Mill modify Malthus's theory of population?
6. How, according to Smith, can the social good result from the pursuit of individual self- interest?
7. 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?
8. Is Smith's natural price determined by supply, demand or both? Explain carefully.
9. Compare and contrast the implication for wages of the theory of population presented by Thomas Malthus with the wage theory provided by Adam Smith
10. 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?
11. Compare and contrast the views of Ricardo and Malthus on each of the following topics:
(a)Corn Law (b) subsistence wage, and (c) market gluts.
12. 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?
13. How did Ricardo's labor theory for an advanced economy differ from Smith's?

Chapter Five

5 Immediate Reactions against the Classical School

Introduction

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 THE

5.1 German Historical School: Frederic List

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.

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.

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.

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 France; 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 the 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.

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.

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 phases: the older school and the younger school.

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.

To summarize 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.

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:

- 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.
- 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.

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.

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

- a. **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.
- b. **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.

- c. **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 are 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."
- d. **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.

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.

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, and 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 Classical did

not realize the importance of other motives. The fact is that they did not give sufficient importance to motives other than self-interest.

Furthermore, 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.

5.2 The Rise of Socialism

5.2.1 Pre Marxian Socialist thinkers

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 19thc, 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.

The Historical Background of Socialism

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

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.

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.

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.

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.

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.

i. 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.

Charles Fourier (1772-1837) - aspired to change human societies to a better system by practical example rather than by preaching. Unlike Saint-Simon he advocated decentralisation in place of central planning; instead of industrialisation a movement back to the land; instead of managerial direction the spontaneous self-assertion of individuals. Saint-Simon worshipped production and work, idols that Fourier refused to revere unless they had qualities gratifying certain innate propensities in men. Fourier attracted much

attention from his contemporaries, but has had little influence on subsequent thought. Like those thinkers of the pre-Revolutionary epoch, he believed that nature was altogether good and that evil was the result of human control and influence. He wanted to organize society in a manner that would be conducive to social harmony and at the same time permit gratification of fundamental psychological needs arising from immutable nature of man and stifled in the commercial society of his time.

Jean Joseph Louis Blanc (1811-1882) - was the son of an Inspector General of Finance. He was educated in Paris and, at an early age, became a prominent figure in the socialist movement of France. He is regarded as the father state socialism³⁰⁸ because he put the burden of reform upon the state. He set his ideas in his organizational *de travail* first published in 1841. The central point in his thought is a desire for a broad and perfect development of each man's personality.

Proceeding from the idea of the brotherhood of man, he advocated payment not according to service or productivity, but according to needs and wants. Thus, he postulated the principle of from each according to his ability, to each according to his needs. His system, therefore, is not based upon a demand for the whole produce of labour but upon the more philanthropic idea of a right to subsistence. He called for the recognition of the right to work, and proposed to implement these principles by means of National workshops, producer cooperatives, which would be established with the financial assistance of the government and would in time take the place of competitive private enterprise.

The Saint-Simonians of the 1830s heavily influenced Blanc. Though he was more practical than the socialist dreamers of his epoch in that he directly appealed to the workers, and sought the immediate intervention of the state to improve their lots, his schemes were characterized by a good deal of vagueness and sentimentalism.

Robert Owen (1771-1858), the son of a prosperous farmer and merchant, was born in North Wales in 1771. He left school at the age of only nine years to continue self-education through reading. At the age of nineteen, after borrowing some money from his father, he set up his own business in cotton spinning and became a successful manufacturer. He was the first British textile-mill owner to use American long-staple cotton. Before reaching the age of thirty, he owned the New Lanark mills near Glasgow in which two thousand workers were employed. His success as an industrialist was due to his outstanding capacity as a manager; to his employment of the latest machinery and method; and to the efficiency obtained by the introduction of improvements in the working conditions in his mills.

His career shows three well-marked phases: an early phase from 1799-1824 when he was a respectable owner of a new type of cotton mill in Lanark, Scotland, accompanied by cheap housing for his workers

and a school for their children, and struggled to convince the rich and the powerful of the wisdom and practicality of his plans for a new social order; a phase of unsuccessful community building in Indiana, USA, which lasted from 1824-29; and from 1829 onwards, when he was increasingly drawn into British working-class politics, culminating in the formation of the Grand National Consolidated Trades Union in 1833, the first attempt anywhere in the world to form a national federation of trade unions. When this failed within a year, Owen went back to community experiments, in Britain this time. The Rochdale cooperative movement, which flourished in Britain in the 1840s, was undoubtedly inspired by Owenite ideals but the Rochdale cooperatives were consumer not producer cooperatives and thus fell short of Owen's own vision of social redemption. Owen lived until the age of 87, a venerated but nevertheless disillusioned man.

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.

ii. 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.

iii. 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 in trust for the benefit of everybody. This movement,

repudiating violence and class struggle, advocated sanitary reform, education, factory legislation, and cooperatives.

iv. Anarchism

Pierre-Joseph Proudhon (1809-1865), son of a small brewer, spent his early years in an environment of small peasant proprietors. He became a printer for a while and his unquenchable thirst for knowledge made him dedicate his time entirely to continuous reading and study of the social problems of his times. From an early age he was interested in social problems and became the leading anarchist of his days. He was greatly influenced by the writings of the political philosophers of the period after the French Revolution, particularly by Fourier. The latter's opposition to centralisation and compulsion by the government made him a forerunner of the anarchists, who proposed to abolish organised government all together. In both these respects – voluntarism and transition to anarchism Fourier's position resembled that of Proudhon.

Proudhon was in fact the first social reformer to call himself an anarchist. He cherished the family and the neighbourly ties within the local community but beyond these limits he had no use for authority and condemned coercion in all forms, be it practised by the government or by associations of the Fourierist type. He thus came to reject Representative Jean Charles Leonard Simonde de Sismondi, originating from an Italian aristocratic stock, was trained as a historian, and he acquired practical experience in business and finance in France while he was very young. Anarchism held all forms of government as oppressive and hence should be abolished.

Later on, Sismondi went to Italy, where he settled and devoted his life to scholarship and writing. Though he wrote widely on economics his fame, as a writer, rests chiefly on his work in history. His economic ideas are contained in his two books published in 1803 and 1819, respectively.

In contrast to the utopian socialists of the time, he stands eminent among the economic protestants of classicism in the early period of the eighteenth century. He became one of the first and foremost critics of the classical economic theory and method in the nineteenth century. In so doing, he laid much ground-work for the method of analysis later advanced by the German historical school. His disagreement with the classical economics was based less on theoretical than on its method, aims, and conclusions. Sismondi viewed economics as a science of government, thus he was willing to replace the government by industrial administration. As a moral science, the physical wellbeing of man, insofar as it can be the work of his government, is the object of political economy. A science that concerns itself solely with the means of increasing wealth without studying the purpose of such wealth was, in Sismondi's view a false science.

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 order less 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.

5.3 Marxian Economics

v. 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.

vi. 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 disappear, 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.

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.

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.

Economic Ideas:

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 newsletter?). 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.

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.

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 succeed 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.

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.

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 spirit (idea) is the driving force. Spirit 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 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 Capital, 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 on 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.

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 phases: the older school and the younger school. The older historical school was devoted to criticizing the classical school for their deductive reasoning.



Four principles were basic in the thinking 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.

6. 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.

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 important in a history of economic thought textbook.
3. 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.
4. 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.
5. In what respect did the views of the older and younger historical schools differ regarding classical economics?
6. Cite possible reasons the historical school evolved mainly in Germany as opposed to other areas of Europe.
7. Distinguish between bourgeois socialism and working class socialism. Which one belongs to Marxian socialism
8. 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?

Chapter Six

6 The Marginal Revolution

Introduction

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.

6.1 Overview of the Marginalist School-the Maximization Principle

The marginalist school of economic thought was founded in the 1870s by William S. Jevons, Karl Menger, Leon Walras, and Knut Wicksell. By the turn of the century, the marginalists had more fully explored the process of rational decision making on both sides of the market—the demand side and the supply side. Economic decisions, the marginalists argued, were typically made at the margin. In economics, “margin” refers to the next unit or the additional unit. The groundbreaking work of the marginalists soon dominated supply and demand analyses, the theory of value, and other topics related to decision making by market participants.

On the demand side of the market, the marginalists developed the concept of utility and how changes in utility effect the price people are willing to pay for goods or services. Utility refers to

the usefulness or satisfaction a consumer derives from the consumption of an item. In the early 1870s, marginalists developed the law of diminishing marginal utility. This economic law states that as a consumer purchases additional units of the same item in a given period of time, the marginal utility falls. This observation is core to rational consumer decision making and to pricing decisions by businesses.

On the supply side of the market, the marginalists built on earlier work by the classical economists to more fully examine the value of resources used in production. The supply side of the market deals with the behaviors and actions of the producer. In the 1890s, Swedish economist Knut Wicksell developed the marginal productivity theory. According to this theory, firms should employ additional resources in production only when the additional (marginal) revenues were equal to or greater than the additional (marginal) costs that they had to pay for these resources. After all, if the marginal costs were greater than the marginal revenues, the firm would lose money. Meanwhile in Austria, Karl Menger developed the concept of derived demand, which stated the demand for resources was derived from the demand for the goods that these resources produced. In other words, resources—including human labor—have value only when they can be used to produce goods that people are willing to buy.

6.2 Forerunners of Marginalism

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 employer sin 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.

Classical economics did not become neoclassical economics overnight; the recasting of perspectives and theoretical structure occurred gradually. For example, the idea of utility had existed in economic literature for a long time. Aristotle had used the concept of use value some two thousand years earlier, and Jeremy Bentham had used the concept of utility in utilitarian philosophy in the latter part of the eighteenth century.

In the nineteenth century, a host of minor writers had had a clear conception of the principle that as an increasing quantity of a good is consumed, the good will yield diminishing marginal utility to the consumer. None of these writers, however, had been able to elaborate in full the concept of diminishing marginal utility or to apply it to the solution of economic problems. In retrospect, and with nearly perfect hindsight, one can see marginal analysis emerging as early as 1834, when Samuel Mountifort Longfield (*Lectures on Political Economy*), in being critical of the labor theory of value, developed a marginal productivity theory. W F. Lloyd in his *Lecture on the Notion of Value* (1837), Jules Dupuit in an article titled "On the Measurement of the Utility of Public Works" (1844), Hermann Heinrich Gossen in *Development of the Laws of Human Relationships* (1854).

The marginalist revolution occurred between 1870 and 1890: it was opened by Menger, Jevons, and Walras, was continued by Edgeworth, Wieser, Bohm-Bawerk, Pantaleoni, and Clark, and closed by Fisher and Marshall. It is important to note that there were major differences in approach, among the marginalist writers themselves, which caused bitter controversies.

These were so widespread that still today it is difficult to recognize a homogeneous school of thought in the early marginalist approaches. Their way of seeing the world, in any case, seemed new and unfamiliar to many theorists and this caused a great deal of resistance. It was only in the 1890s that a new 'classical situation' was established, and a new feeling of repose spread among the economists. In fact, it was only towards the end of the century that the fundamental

homogeneity of the various versions of marginalist theory was perceived by the historians of economic thought.

Cournot was the first scholar to be interested in the firm as such, to study its behaviour in different market situations and to pose the problem of the determination of the scale of production. It is not surprising, therefore, that his great work received no attention for several decades (which induced him to abandon economic research). In *Researches into the Mathematical Principles of the Theory of Wealth* (1838), he made the first rigorous formulation of a demand function; a function which he used to determine the price and quantity produced under monopoly.

It is the theory still found today in microeconomic textbooks. The monopolist faces a demand function of the type $D = f(p)$, where p is the price of the good. By multiplying the demand by the price, the total revenue, $R = pf(p)$ is obtained; and from this, Cournot proved that the monopolist's profit, given by the difference between revenue and costs, is at its maximum when the marginal revenue is equal to the marginal cost.

In 1838, A. Cournot (1801-1877) made an enormous advance in formalizing the interrelatedness of the economy while analyzing certain microeconomic problems. He was able to express some of the problems of the theory of the firm in mathematical form, and he used calculus to prove that profits are maximized when marginal cost is equal to marginal revenue. In doing so, he did for the theory of the firm what Jevons and Menger did for choice theory: he formulated it in marginal terms. In addition, Cournot went beyond Jevons and Menger, whose heuristic and arithmetical expositions had limited their insights. Cournot's abstract mathematical orientation assisted him considerably in comprehending relationships within the economy and helped him to anticipate Walras. Cournot correctly concluded that "for a complete and rigorous solution of the problems relative to some parts of the economic system, it [is] indispensable to take the entire system into consideration. Cournot felt, however, that mathematical analysis was not sufficiently developed to permit the formulation of a general equilibrium model. J. H. von Thünen (1783-1850) also applied calculus to the solution of problems in economic theory; and as with Cournot, this mathematical orientation led him to see the possibility of presenting a general equilibrium model as a system of simultaneous equations.

The solution was reached by Hermann Heinrich Gossen in 1854. He argued that 'absolute value' does not exist, and that value depends on a relationship between a subject and an object. This relationship is based on utility. Gossen worked on the presupposition that the goal of an economic

agent is to obtain maximum pleasure. He also formulated two laws that still today form the basis of the neoclassical theory of consumer behaviour. The first law establishes the principle of decreasing marginal utility: the pleasure obtained from good decreases as the amount consumed increases until, eventually, satiety is reached. The second law is more important. In fact, it is a theorem derived from the assumption of maximizing behaviour and from the law of decreasing marginal utility. It states that the individual will choose to demand the various goods in such proportions that the satisfactions per unit of value they give him are equal at the moment at which he stops consuming them; or, rather, that the individual will continue to exchange two goods until the values of the last units he possesses of them become equal.

In chapter four 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.

(1) Antoine Augustin Cournot

The idea of a demand function itself was proposed by Charles D'Avenant (1699), who even attempted to estimate one for wheat (on the basis of data allegedly provided by Gregory King (1696)). The first concrete expression of a demand function was accomplished by Pietro Verri (1760). Thereafter silence reigned until the enormous leap of Augustin Cournot (1838). Cournot did not bother with the niceties of utility; his concern was focused on demand functions directly which he considered to be deductible from empirical fact. He was the first to express the demand function in algebraic form as $D = F(p)$ and the first to draw demand-and-supply functions in price-quantity space. This, of course, was not all: in addition to demand functions, Cournot introduced the concepts of marginal revenue, marginal cost, the concept of the profit-maximizing firm, monopoly, duopoly, perfect competition and, of course, his famous "reaction functions". But marginal utility was nowhere in sight. As he argued, the "accessory ideas of utility, scarcity, and

suitability to the needs and enjoyments of mankind...are variable and by nature indeterminate, and consequently ill-suited for the foundation of a scientific theory".

(2) Jules Dupuit

The first successful connection between marginal utility and demand was accomplished by the French engineer Jules Dupuit (1844). His remarkable effort at developing a cost-benefit analysis of public works led him to draw the demand curve in price-quantity space. Unlike Cournot, Dupuit did not rest his demand curve on empirical intuition but rather identified the demand curve *as* the marginal utility curve itself. Dupuit's basic idea was this: as quantity rises, the marginal utility of the good declines. Consequently, one should also say that as the quantity rises, the willingness of a person to pay for that good decline. Thus, the concept of diminishing marginal utility should translate itself into a downward-sloping demand function.

Of course, Dupuit's logic was suspect in at least one place: marginal utility is particular to an individual, while market demand is an aggregate, so something must be said about the interpersonal comparability of utility in order to proceed with the connection. Dupuit skimmed on this. Nonetheless, the important point was that the connection was made between demand and utility. Dupuit, however, did not draw a supply curve and thus did not get price-determination into his story.

Dupuit went on to define "relative utility" (what later became known as Marshall's "consumer surplus") as the area under the demand/marginal utility curve above the price and used it as a measure of the welfare effects of different prices -- yielding his famous conclusion that public welfare is maximized when the price (in his case, the toll rate on a bridge) is zero.

(3) Hermann Heinrich Gossen

The final step came from Hermann Heinrich Gossen (1854). Unlike Dupuit, Gossen clearly distinguished the marginal utility curve from the demand curve. Gossen posited that demand is derived from the utility-maximizing choices of the consumer. Gossen's "Three Laws" can be stated as follows:

(a) the amount of utility derived from the consumption of a good declines with each additional unit of that commodity (i.e. diminishing marginal utility, or, to use Gossen's term, "diminishing worth of the last atom".)

(b) a person maximizes his utility when he distributes his income among various goods so that he obtains the same amount of satisfaction from the last unit of each good or, if money is being used, he obtains the same amount of satisfaction from the last unit of money spent upon each commodity (i.e. equality of the ratio of marginal utilities to the ratio of prices, i.e. $MU_i/p_i = MU_j/p_j$ for any two goods i, j).

(c) a good has value only when the demand for it exceeds supply (i.e. subjective scarcity is source of value).

Of Gossen's three laws, the second is perhaps the most remarkable. The idea that, at the margin, the consumer substitutes between goods so that he obtains the same marginal utility (in terms of money) across goods yields the downward-sloping demand curve for each of the goods. To see this, merely note that when the price of a good rises, the marginal utility in terms of money (MU_i/p_i) declines and thus, by Gossen's first law (diminishing marginal utility), less of that good will be bought. The foundations of the Marginalist Revolution were thus in place.

Subjectivism as Reaction to Classicism

The influence of reputation of classical economics had started waning owing to its narrowness, dogmatism 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, and second by Karl Marx.

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.

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 Classical's 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 Classical, 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.

6.3 First - Generation Marginalists

Those economists who emphasize the importance of the subject (or the ego) are known as the subjective economists. Although these economists agree on several issues, we observe slight differences between subjective economists. Their difference is significant especially on two issues: *on the use of mathematics* and *on the use of cost in determining value*. For convenience sake, we shall divide the subjective economists in to two broad groups:

- A. The Austrian School, and
- B. The Mathematical School.

The Austrian School

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.

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.

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.

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

- a. ***The Marginalist School:*** Introduces the theory of marginal analysis
- b. ***The Lausanne School:*** Introduces the theory of General equilibrium

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

a. 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. Jevons.

William Stanley Jevons (1855 -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 came to know Gossen's discovery and gracefully acknowledged him in the second edition of his theory of political Economy. Jevons, a son of an 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. He was a professor of political economy at Owens College, Manchester, and later (in 1876) he became a professor at the University College, London, but had to resign his post after 4 years on account of ill health. 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.

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 diamonds 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 of 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 a way familiar to students of micro economics,

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.

b. The Lausanne School

Basically they are Marginalists. The major achievement of this school (and that of Walras 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, French 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 Walras'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 Marshall'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 become 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 Francis 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.

6.4 Second - Generation Marginalists

Gustav Cassel (1866-1945) - a Swedish engineer turned economist, contributed in the field of monetary theory (rather pure economics in the sense that he did not think it worthwhile to explore the phenomenon of value). He contributed to the exposition of the general equilibrium in his own restricted way, which was devoid of the utility, and the valuation derived from it. Cassel rejected the marginal utility and its role. Instead he brings in the concept of scarcity of goods which give rise to the phenomenon of prices.

To Cassel marginal utility cannot be measured, there is no way to estimate utility except to consider its manifestations in terms of money prices. Accordingly the task of the economist is not to probe the formation of values but only to analyze the determination of prices. The fact that values manifest themselves in terms of prices implies that we are to deal with the theory of prices instead of the theory of value.

Cassel seeks to explain economic phenomenon by a single principle of scarcity. With unlimited wants and limited supply, there is a need to exchange and price formation comes in to balance the demand and supply. And it is on this basis that he gives us his general theory of equilibrium. He assumes perfect competition and static economy. Cassel had also discussed the theory of interest with the distinction between single and durable goods; the problem of balance of payments by putting forth the purchasing power parity theory as an explanation of the determination of the equilibrium rate of exchange.

John Bates Clark (1847-1835) - Clark was born in Providence, Rhode Island (U.S.A.) and was educated at Brown and Amherst and then went to do his graduate studies at Heidelberg and Zurich Universities. He returned and began teaching political science in 1877, and by 1895 he was appointed a professor of political science at Columbia University where he remained until his retirement in 1923. The contributions, which made him famous, fall into two parts: the marginal productivity theory and the capital theory. His first book, *The Philosophy of Wealth* (1885) was a work of protest against so-called Ricardianism, with its premise of economic man, and its concentration on competition when really that form of economic organisation had disappeared. The book called for arbitration in labour disputes, profit sharing, and producers' cooperatives.

His second book, *This of Distribution of Wealth* (1899), was completely different. For one thing, it was designed to show that the existing system of property rights provides a fair distribution of income in the sense that each man gets what he produced, that is, he gets his marginal product. This he demonstrated by being as abstract as Ricardo, focusing on the static state and holding constant factors which account for dynamic change in the real world: changes in population, capital, technology, consumers' wants, and the elimination of inefficient business. Other assumptions are full employment and competition. Finally, there is the crucial law of diminishing returns, which, is held to be universal phenomenon, applicable to all factors of production.

Clark's fame, however, rests on his attempt to apply the marginal theory not only to market and production but also to distribution of income. The executive of a business, according to Clark's analysis, combined land and natural resources, capital and labour to produce a marketable product. He maintained that the remuneration which the executive would pay for each factor contributing to production would depend on their relative marginal productivity, that is, the last unit of each which he believed desirable to pay for, determined its price. If a farmer, for example, found it worthwhile to employ more labour on a given plot of land, he would keep on hiring until the marginal labour unit was reached. If farm wages, on the other hand, were high and land was cheap, Clark held that it might pay the farmer better to use more land and less labour, cultivating less intensively. A manufacturer would; likewise, substitute machinery for labour if the marginal value of the product he could obtain by employing machinery was greater than that of the labour, which

it permitted him to eliminate. Similarly, low wages might deter technological improvement by making it more expensive to buy a machine than to pay wages for manual work.

Clark made a clear distinction between static and dynamic economic conditions in his economic analysis insisting that the laws operative in a static economy must not be confounded with the laws governing conditions of continuous changes and adjustments. His theory states that given static conditions and assuming pure competition, natural law would operate so as to give to each factor of production an income reward exactly equal to the factor's contribution in the productive process.

Francis Y. Edgeworth (1825-1926) - was born in Ireland, and he studied languages before he was awarded a scholarship to study at Oxford in 1867 graduating in 1869. He had been called to the Bar in 1877 and three years later he was lecturing in logic at King's College, London. In 1888 he was appointed Professor of Political Economics at King's College, London and two years later he was appointed to the Tooke chair of Economic Science. Later, he was appointed Drummond Professor of Political Economy at Oxford from 1891 to 1922, occupying the chair first held by Nassau Senior.

His original work on contract curves, indifference curves, and statistics was done in London, before his appointment at Oxford. In 1881, he became editor of the *Economics Journal* of the Royal Economic Society, a position he held until his death. Edgeworth did not develop his ideas in economics into larger, more systematic statements. In 1881, he published *Mathematical Physics: An Essay on the Application of Mathematics to the Moral Sciences*. This work, really on economics, looks at the Economical Calculus and the Utilitarian Calculus. He formulated mathematically a capacity for happiness and capacity for work.

His conclusions that women have less capacity for pleasure and for work than do men would not be popular in the 1990s. In 1885 he published *Methods of Statistics*, which presented an exposition of the application and interpretation of significance tests for the comparison of means. In 1892, Edgeworth examined correlation and methods of estimating correlation coefficients in a series of papers. The first of these papers was *Correlated Averages*. Edgeworth has made greater use of mathematics and this led his reasoning to a higher degree of abstraction. Edgeworth proceeds on the assumption that the utility, which one derives from consumption or possession of a good, is not dependent upon that good only, but also on the quantities possessed and consumed of other

goods. In other words, utility is related to the consumer's entire consumption. This led him to develop the indifference Curves.

Friedrich von Wieser (1851-1926) was twenty years old when Menger published his *Principles* in 1871. He was a student of Menger, along with Eugen von Böhm-Bawerk (1851-1914), and later took Menger's chair at the University of Vienna in 1903. Böhm-Bawerk also taught at that university. Not only did they continue to expand on and improve some of Menger's original ideas, they had as students Ludwig von Mises (1881-1973) and Joseph Schumpeter (1883-1950). Mises spawned still another generation of economists. The influence of Menger and the University of Vienna has led historians of thought to refer to an *Austrian school*, which we will examine in this and some of the following chapters.

Wieser, like Menger, did not use any mathematics and developed his arguments by using abstract Robinson Crusoe verbal models. He was the first to use the term marginal utility, which became the accepted expression among economists. Wieser's seminal work concerned costs and factors of production; he demonstrated how inputs or factors of production receive their value from final goods through a process of *imputation*. Value causation ran in a single line from the marginal utility of the marginal or final consumer good back through to the various inputs that had produced the consumer well. The classicals had maintained that factors of production were price-determining. Wieser concluded that they were price-determined. His failure to use any but the simplest mathematics as examples prevented him from pursuing his important insights into the cost side and from developing marginal productivity analysis.

Eugen von Böhm-Bawerk (1851-1914), Böhm-Bawerk and Wieser were the same age; both were students of Menger, and they were friends and brothers-in-law. Wieser was influential largely in Austria and Germany, whereas Böhm-Bawerk became much better known in England and the United States. Following the publication of his first book, Böhm-Bawerk acquired a disciple in England, William Smart, who translated his *Capital and Interest* in 1890 and *The Positive Theory of Capital* in 1891. One reason for the lesser influence of Menger in English-speaking countries is that his *Principles* was not translated until 1950. Böhm-Bawerk was a profound scholar whose work in the area of capital and interest was published in three volumes. The first, *Capital and Interest: A Critical History of Economic Theory*, covers more than 150 writers from as far back as the Greeks. It took him some twenty years to finish the trilogy, during

much of which time he was an important figure in the Austrian government. His contributions to economics included his book on Marx; his lucid exposition and extension of Menger's ideas on marginal utility; and his development of a theory of capital and interest. Like his teacher Menger, and his colleague and friend Wieser, Böhm-Bawerk used no mathematics. He expounded his views on value or price formation with a monocausal line of reasoning and saw none of the mutual determination pointed out by Walras and Marshall, which has become an important building block in modern economic thought.

Johann Gustav Knut Wicksell (1851-1926)- the great Swedish economist, not only became recognized as the founder of a 'school' of economic theory, but he has also exercised such great influence on the other economists that one may say, without him economics would be different. Wicksell studied philosophy and mathematics, and obtained his degree in 1885. Thereafter, he took up economics, studying in France, Germany, Austria and England. Returning to Sweden, he was made assistant professor at Lund in 1900, and there he occupied the chair of economics from 1904 to 1916.

He wrote many articles for Swedish publications and some German and English journals. His major works, however, were written in the German language between 1893 and 1906. They are concentrated under five volumes: Value, Capital and Rent. Wicksell's thought was greatly influenced by the long decline in prices and discount rates during the period 187-1895, and the discussions, which accompanied them. Thus he dwelt upon price secular and cyclical, and tended to emphasise the part played by credit. He is a pioneer in coordinating theories of price and of interest with a theory of value of money.

During his years as a wandering scholar, Wicksell became acquainted with the various approaches to economics then in vogue in different European countries – the historical economics of the Germans, the pure theory in its Austrian and Walrasian variants, and the more realistic analysis of Marshall.

Wicksell deals with economic life in terms of marginal utility, and he makes large use of mathematical equations upon which Walras depended. He sought to synthesise the marginal productivity analysis of the Austrian school and the general price equilibrium theory of the Lausanne school –the theory that all prices are so mutually interdependent that a mathematical process of simultaneous equations can solve the price Problems. Wicksell correlates his theories

of value and of distribution, so that it may be said that marginal productivity occupies the centre of his system. He applied his general marginal-productivity theory under the employment all factors of production making economies from a larger-scale of production impossible. Here he considers only economically productive employment, and so avoids the problem of equilibrium at less than full employment.

In its broad outline what Wicksell attempted was a fusion of Austrian and Walrasian thought, in which a version of Bohm-Bawerk's capital theory, modified in line with the marginal productivity theory, was to be fitted into the general equilibrium system. In the pursuit of this attempt, Wicksell introduced numerous refinements and corrections, some of which paralleled contemporary work by other scholars, for example, his marginal productivity theory, developed one year ahead of Wicksteed, and his transformation of utility into demand functions. Wicksell, however, was virtually the only economist of note to criticise the view, advanced by some of the architects of the marginal revolution, that competitive prices denote a special optimum. Instead he pointed out that in the presence of pronounced inequalities of income an exchange between the rich and the poor might yield a larger total utility when affected at a price suitably fixed than at a competitive price, and he cautiously expanded the argument to apply to minimum wages and maximum hours of work established by legislation or by trade unions.

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 Marginalist School introduces the theory of marginal analysis whereas 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 three who have formally established subjectivism were William Stanley 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.

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's 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?

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Assignment Questions Maximum points (30%)**Part I: Read the following questions carefully and choose the best answer (20 pts)**

- 1) One of the following statements is **Not True** about characteristics of “Economic Thought”?
 - A) Economic thought is not a fixed set of theories & techniques of analysis.
 - B) Economic thought is the product of time.
 - C) Anybody of economic doctrine/theory has limited validity.
 - D) History of economic thought is not basically a history of ideas.
 - E) None of the above.

- 2) All of the following are reasons for departure of scholars in economic ideas, *except*?
 - A) Lack of controlled experiments in the method.
 - B) Divergence of opinion on account of the attitudes of the economists.
 - C) Economic investigation is being undertaken based on individual’s purposes.
 - D) Unanimity among economists in the assessment of facts.
 - E) B & C

- 3) Which one of the following statement is **Not True**?
 - A) Normative economics is value based while positive economics is fact based.
 - B) Positive economics are subjective while normative economics objective.
 - C) Positive statements can often be broken down into a cause and an effect.
 - D) The validity of normative statements can never be tested.
 - E) B & D

- 4) All of the following statements are examples of positive economics, *except*?
 - A) A reduction in income tax will improve the incentives of the unemployed to find work.
 - B) Resources are best allocated by allowing the market mechanism to work freely.
 - C) Cut-price alcohol has increased the demand for alcohol among teenagers.
 - D) Higher interest rates will reduce house prices.
 - E) None of the above.

- 5) Identify **False** statement about Logical Positivists
 - A) Verification-a criterion of demarcation between scientific & non-scientific statements.
 - B) Verification- a proof of meaningful and meaningless statements.
 - C) Unscientific if a statement is empirically unverifiable.
 - D) Scientific only if they are provable through observation and experimentation.
 - E) None of the above.

- 6) **True** statement about Sir Karl Popper, *except*?
- A) Developed the theory of Falsification.
 - B) He pointed out that a theory may be meaningful without being scientific.
 - C) If a statement, hypothesis, or theory is not falsifiable then it is not scientific.
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- 7) He argued that it was fruitless to try to formalize 'the scientific method' as a well- defined procedure,
- A) Paul Feyerabend
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 - C) Karl Popper
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 - E) None of the above
- 8) One of the following is *Not* among the major impediments that hinder the emergence of economic enquiry in ancient times?
- A) The dominance of the State
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- 9) St. Thomas Aquinas was influenced by Aristotle's view of, except
- A) Nature and function of money
 - B) The inequity of money
 - C) The principles which should govern exchange
 - D) Communism
 - E) None of the above
- 10) Not true about *Stoicism*:
- A) It is the prevailing philosophy, which transferred Greek philosophy to the Romans.
 - B) It is a philosophy on rational, systematic universe governed by the law of nature.
 - C) Individual happiness is achieved by conforming to inevitable law of nature.
 - D) The system of thought that combined the teaching of Christianity and the philosophy of Aristotle.
 - E) All of the above.
- 11) The two cardinal economic doctrines of the middle ages are found in the notion of
- A) Just price and the Prohibition of usury
 - B) Public Finance and Joint Stock
 - C) Division of Labor and Law of Returns
 - D) Money and Interest
 - E) All of the above

- 12) One of the following is **Not** among the major tenets of Classicism?
- A) Minimal government involvement
 - B) Self-interested economic behavior
 - C) Importance of selected economic resources and activities
 - D) Universal and immutable laws of economics
 - E) None of the above
- 13) **Not true** about David Hume's contributions to economics?
- A) Wealth was measured by the stock of commodities of a nation, not its stock of money.
 - B) International trade is a positive sum game, not the zero-sum.
 - C) Introduction of the automatic "price-specie flow" mechanism.
 - D) Introduction of the concept of price elasticity of demand.
 - E) None of the above.
- 14) Which one of the following is **Odd** to Adam Smith's view, which one?
- A) Economic and social order was achieved in which the 'invisible hand' was given a free hand to operate.
 - B) He agreed that taxes should entirely be fallen upon the rent of land.
 - C) His major preoccupation was the nature and causes of wealth.
 - D) For him the capitalist collects profit because he is a supplier of capital.
 - E) Only B & C are odd to his view.
- 15) One of the following statements is **Not True** about Ricardo's theory of distribution.
- A) National income received by capitalists, landlords, and laborers.
 - B) Long run subsistence wage would not be equal to the iron law of wages.
 - C) Profits are a residue equal to total product-less-rent minus wages.
 - D) Profits would be high or low in proportion as wages were low or high.
 - E) Wage is determined by the subsistence theory of wages.

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	1C:2W

- 16) Given the above table, which one of the following statements is **incorrect** according to Adam Smith's concept on international trade?

- A. Trade between two countries will occur only if each country has an absolute cost advantage.
 - B. England has an absolute cost advantage in wine and Portugal in cloth, hence, England shall specialize in wine.
 - C. Portugal has an absolute cost advantage in wine and England in cloth, hence, Portugal shall specialize in wine.
 - D. Portugal shall specialize in cloth and export it to England because England can pay a higher price than Portugal's domestic barter rate.
 - E. None of the above.
- 17) The founders and leading theoreticians of 'scientific,' socialism were?
- A. Karl Heinrich Mark and Friedrich Engles
 - B. Pierre-Joseph Proudhon and Mikhail Bakunin
 - C. Henry Comte de Saint-Simon and Charles Fourier
 - D. Wilhelm Roscher and Gustav Schmoller
 - E. None of the above
- 18) The basic ideas of Marginalism can be summarized as follows, **except?**
- A. Marginal Utility became the primary force in the determination of value.
 - B. The marginalists continued the classical school's idea of 'laissez fair' as the most desirable policy.
 - C. The marginalist analysis focused on an economic system based on pure monopoly.
 - D. The marginalists are also known for their extensive use of mathematics.
 - E. The marginalists believed that economic forces generally tend towards equilibrium.
- 19) One of the following is **not true** about Jevons's formulation of value?
- A. Cost of production determines supply.
 - B. Supply determines final degree of utility.
 - C. Final degree of utility determines value.
 - D. The value of labor must be determined by the value of the produce.
 - E. None of the above.
- 20) What makes Warlas different from his predecessors like Jevons, Menger and others is his use of_____
- A. the notion of equilibrium
 - B. the case of sectional equilibrium
 - C. the general equilibrium method
 - D. the partial equilibrium analysis
 - E. none of the above

Part II: Give Short and Precise Answers for the Following Questions (10 pts)

1. Whether positive economics or the art of economics should be the primary focus of economics has prompted unending debate in the history of economic thought. Identify the two major groups & their respective advocacy?
2. Mention the two sub approaches of Against Method philosophy and write on their basic points.
3. Explain St. Aquinas's contribution on concept of Private property. How he defined and distinguished?
4. To Smith, the state must adhere to the philosophy of laissez-faire. But unlike some of the more extreme advocates of that view, Smith did see a significant, role for the state. Discuss.
5. Briefly discuss on Malthusian "Theory of Gluts" contrast against Say's *Market Law*.
6. The central theme of Bentham's thought has been called Utilitarianism, or the principle of the greatest happiness. Briefly discuss on it.
7. Briefly summarize on the essence of the Garman Historical School, what is their root cause against classical school.

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- A) Just price and the Prohibition of usury
 - B) Public Finance and Joint Stock
 - C) Division of Labor and Law of Returns
 - D) Money and Interest
 - E) All of the above

- 12) One of the following is **Not** among the major tenets of Classicism?
- A) Minimal government involvement
 - B) Self-interested economic behavior
 - C) Importance of selected economic resources and activities
 - D) Universal and immutable laws of economics
 - E) None of the above
- 13) **Not true** about David Hume's contributions to economics?
- A) Wealth was measured by the stock of commodities of a nation, not its stock of money.
 - B) International trade is a positive sum game, not the zero-sum.
 - C) Introduction of the automatic "price-specie flow" mechanism.
 - D) Introduction of the concept of price elasticity of demand.
 - E) None of the above.
- 14) Which one of the following is **Odd** to Adam Smith's view, which one?
- A) Economic and social order was achieved in which the 'invisible hand' was given a free hand to operate.
 - B) He agreed that taxes should entirely be fallen upon the rent of land.
 - C) His major preoccupation was the nature and causes of wealth.
 - D) For him the capitalist collects profit because he is a supplier of capital.
 - E) Only B & C are odd to his view.
- 15) One of the following statements is **Not True** about Ricardo's theory of distribution.
- A) National income received by capitalists, landlords, and laborers.
 - B) Long run subsistence wage would not be equal to the iron law of wages.
 - C) Profits are a residue equal to total product-less-rent minus wages.
 - D) Profits would be high or low in proportion as wages were low or high.
 - E) Wage is determined by the subsistence theory of wages.

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	1C:2W

- 16) Given the above table, which one of the following statements is **incorrect** according to Adam Smith's concept on international trade?
- A. Trade between two countries will occur only if each country has an absolute cost advantage.

- B. England has an absolute cost advantage in wine and Portugal in cloth, hence, England shall specialize in wine.
 - C. Portugal has an absolute cost advantage in wine and England in cloth, hence, Portugal shall specialize in wine.
 - D. Portugal shall specialize in cloth and export it to England because England can pay a higher price than Portugal's domestic barter rate.
 - E. None of the above.
- 17) The founders and leading theoreticians of 'scientific,' socialism were?
- A. Karl Heinrich Mark and Friedrich Engles
 - B. Pierre-Joseph Proudhon and Mikhail Bakunin
 - C. Henry Comte de Saint-Simon and Charles Fourier
 - D. Wilhelm Roscher and Gustav Schmoller
 - E. None of the above
- 18) The basic ideas of Marginalism can be summarized as follows, **except**?
- A. Marginal Utility became the primary force in the determination of value.
 - B. The marginalists continued the classical school's idea of 'laissez fair' as the most desirable policy.
 - C. The marginalist analysis focused on an economic system based on pure monopoly.
 - D. The marginalists are also known for their extensive use of mathematics.
 - E. The marginalists believed that economic forces generally tend towards equilibrium.
- 19) One of the following is **not true** about Jevons's formulation of value?
- A. Cost of production determines supply.
 - B. Supply determines final degree of utility.
 - C. Final degree of utility determines value.
 - D. The value of labor must be determined by the value of the produce.
 - E. None of the above.
- 20) What makes Warlas different from his predecessors like Jevons, Menger and others is his use of _____
- A. the notion of equilibrium
 - B. the case of sectional equilibrium
 - C. the general equilibrium method
 - D. the partial equilibrium analysis
 - E. none of the above

Part II: Give Short and Precise Answers for the Following Questions (10 pts)

1. Whether positive economics or the art of economics should be the primary focus of economics has prompted unending debate in the history of economic thought. Identify the two major groups & their respective advocacy?
2. Mention the two sub approaches of Against Method philosophy and write on their basic points.
3. Explain St. Aquinas's contribution on concept of Private property. How he defined and distinguished?
4. To Smith, the state must adhere to the philosophy of laissez-faire. But unlike some of the more extreme advocates of that view, Smith did see a significant, role for the state. Discuss.
5. Briefly discuss on Malthusian "Theory of Gluts" contrast against Say's *Market Law*.
6. The central theme of Bentham's thought has been called Utilitarianism, or the principle of the greatest happiness. Briefly discuss on it.
7. Briefly summarize on the essence of the Garman Historical School, what is their root cause against classical school.

