

ECON 400: History of Economic Thought

Lecture Slides 3

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Sabanci University, Spring 2024

Classical Economists

- David Hume (1711–1776)
- Adam Smith (1723–1790)
- Jeremy Bentham (1748–1832)
- Thomas Robert Malthus (1766–1834)
- David Ricardo (1772–1823)
- Jean-Baptiste Say (1767–1832)
- James Mill (1773–1836)
- John Stuart Mill (1806–1873)
- Karl Marx (1818–1883)

Classical School

- More accurately, English Classical Political Economy, dominant school of economic thought until late 19th century
- Unified against Mercantilism, collectively envisioned a capitalist market economy and tasked the government with promoting the market economy.
- Dominantly against the British Corn Laws, an end-product of Physiocratic thinking, that led to high agricultural prices and land rents.
 - Shifted the focus away from land and the landlords and towards capitalist firms.
- Laws of population, diminishing returns and profits painted a grim picture which earned economics the popular name “the dismal science”.

Classical School

David Hume (1711–1776)

- A Scottish Enlightenment philosopher and a friend of Adam Smith
- **Key aspect:** Contributed to Quantity Theory of Money by arguing money is “sterile”.
- Argued against Mercantilist views that focused on nation’s stock 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.*
- Articulated an international specie flow system that argues:
 - Even if there is a gold specie inflow, it will be temporary: Gold stocks ↑
Domestic prices

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Classical School

Adam Smith (1723-1790)

- A Scottish philosopher who taught social philosophy at University of Glasgow
- Founder of the “Classical School” and touted as “the father of economics”
- Argued against restrictions of Mercantilism which he viewed as interfering with “the natural law”.
- His works include *The Theory of Moral Sentiments* and *The Wealth of Nations*
- **Key aspect:** Developed the concept of division of labor, distinguished between short-run and long-run prices, built a labor theory of value.

Classical School

Adam Smith (1723-1790)

- Invisible hand (Moral Sentiments)
- Division of labor (WN Book I Ch I-III)
- Theory of value (WN Book I Ch IV-IX)
- Theory of growth (Book II will discuss this later)

Adam Smith (1723-1790)

Invisible hand

- In his *Theory of Moral Sentiments*, to show his distaste for the land-centered economy, argued that the poor live on the scraps from the rich who accumulate more goods than they can consume under the influence of an “invisible hand”:
 - ...*The rich only select from the heap what is most precious and agreeable. They consume little more than the poor, and in spite of their natural selfishness and rapacity, though they mean only their own convenience, though the sole end which they propose from the labors of all the thousands whom they employ, be the gratification of their own vain and insatiable desires, they divide with the poor the produce of all their improvements... They are led by an **invisible hand** to make nearly the same distribution of the necessities of life, which would have been made, had the earth been divided into equal portions among all its inhabitants, and thus without intending it, without knowing it, advance the interest of the society, and afford means to the multiplication of the species.*
- Argued that without any interference, hedonistic nature of humankind leads to an efficient allocation of wealth.

Adam Smith (1723-1790)

Invisible hand

- In his *Wealth of Nations* a moral philosophy professor, Adam Smith, took up the idea that the nature, left alone, would take care of itself.
- Akin to Mandeville's view, argued that self-seeking motives were the best sorting-out machine:
 - *Every individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command. It is his own advantage, indeed, not that of society, which he has in view. But the study of his own advantage naturally, or rather necessarily leads him to prefer that employment which is most advantageous to society... He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it... and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part his intention.*

Adam Smith (1723-1790)

Invisible hand

- With this optimal sorting, went against Mercantilist trade restrictions promoting the idea that the absolute advantage would solve the trade problem:
 - *What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way which we have some advantage.*

Adam Smith (1723-1790)

Division of labor

- If people are so good at sorting, what does this tell us about their occupations?
- Borrowed from Diderot, he used the “pin factory” example to point out the efficiency that task division brings to a firm.
 - He had seen ten men can produce 48,000 pins per day.
- Iterating this idea, argued that there must also be a division of labor, a specialization where everyone does what (1) they do best (least costly or at highest gains) (2) is in their self-interest.
 - *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.*
- Without outside interference, division of labor can be achieved with the highest labor productivity, which is the basis of “wealth of nations”.

Adam Smith (1723-1790)

Division of labor

- At its core, division of labor builds upon exchange.
- What someone does best must also be of economic value (in their self-interest).
 - There would be no university professors if there was no demand for higher education.
- Therefore, division of labor is actually constrained by *the extent of the market*.
 - Supply is driven by the demand.

Adam Smith (1723-1790)

Theory of value: Water-Diamond Paradox

- Starts with a value paradox between water and diamond to differentiate between *value in use* and *value in exchange*
 - What is the origin of value? Is the value in object's use? Or is it in its exchange?
 - Water has use but no exchange value and the opposite is true for diamond.
- Raises the question on how to determine the value in exchange if it does not depend on the use.

Adam Smith (1723-1790)

Theory of value: Nominal vs real price

- Distinguishes between *the nominal* and *real price*. The nominal is defined to be the price paid in gold and silver. Real price, however, is not the price of a good expressed in terms of other goods. Instead:
 - *The real price of every thing, what every thing really costs to the man who wants to acquire it, is the toil and trouble of acquiring it.*
- Known as “labor embodied in production”, the value hinges upon the optimal division of labor (the invisible hand):
 - *If among a nation of hunters, for example, it usually costs twice the labour to kill a beaver which it does to kill a deer, one beaver should naturally exchange for or be worth two deer.*

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 - **Question:** What happens if this ratio does not hold?

Adam Smith (1723-1790)

Theory of value: Labor embodied vs labor commanded

- Normalization of prices takes place by comparing “labor embodied”.
- However, creating much confusion, switches to another value definition, “labor commanded” where he states the real value of a good is:
 - *the quantity of labour which it can enable them to purchase or command.*

Adam Smith (1723-1790)

Theory of value: Labor embodied vs labor commanded

- **Example:** Assume that a bushel of corn sells for \$2 and a pair of shoes sells for \$8. Now assume that it takes 4 hours to make shoes and 1 hours to produce a bushel of grain.
 - ① What is the labor-embodied value of corn relative to shoes?
 - ② Assume that hourly wage is \$2. What is the labor-commanded value of corn relative to shoes?
- **Answer:**
 - ① Labor-embodied value of corn against shoes is $4\text{hr}/1\text{hr}=4$.

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- **Answer:**
 - ① Labor-embodied value of corn against shoes is $4\text{hr}/1\text{hr}=4$.
 - ② If $w = \$2$, then labor-commanded value of corn against to shoes is $(\$8/\$2)/(\$2/\$2) = 4$.

Adam Smith (1723-1790)

Theory of value: Labor embodied vs labor commanded

- Argued that labor is the anchor while dollar value changes:
 - *Labour, therefore, it appears evidently, is the only universal, as well as the **only accurate measure of value**, or the only standard by which we can compare the values of different commodities at all times and at all places.*
- That being said, preferred labor-commanded definition over labor-embodied:
 - *From century to century, corn is a better measure than silver, because, from century to century, equal quantities of corn will **command** the same quantity of labour more nearly than equal quantities of silver.*
- Apparently, labor-commanded value of corn changes when hourly wages go up or down so it is not stable at all.

Adam Smith (1723-1790)

Theory of value: Natural vs Market Prices

- Realizing that labor-commanded value changes with wages, switched back to labor-embodied value again.
- Argued that although market prices we see can change from today to tomorrow what prevails in the long run is the natural price while hinting at the invisible hand:
 - The **natural price**, therefore, is, as it were, the central price, to which the prices of all commodities are continually gravitating. Different accidents may sometimes keep them suspended a good deal above it, and sometimes force them down even somewhat below it. But whatever may be the obstacles which hinder them from settling in this center of repose and continuance, they are **constantly tending towards** it.

Adam Smith (1723-1790)

Theory of value: Labor Theory of Value

- Here he again upholds the labor-embodied value as the natural value that embedded in its production:
 - *It is natural that what is usually the produce of two days' or two hours' labour, should be worth double of what is usually the produce of one day's or one hour's labour.*
- Two justifications for his labor theory of value:
 - It would be *just* to set prices based on hours of labor required in their production.
 - If prices do not reflect labor-embodied ratio, then in their self-interested, people would switch tasks (e.g. hunting beaver-deer)
- This re-organization of labor in response to prices may work in the *early and rude* state but not in a modern society.
 - At the extreme, laborers cannot get angry about land rents and switch to being a landlord.

Adam Smith (1723-1790)

Theory of value: Value-Added Theory of Value

- Smith adapted his theory of value to conform to the fact that there are barriers to switching between inputs of production:
 - *When the price of any commodity is neither more nor less than what is sufficient to pay the **rent** of the land, the **wages** of the labour, and the **profits** of the stock employed in raising, preparing, and bringing it to market, according to their natural rates, the commodity is then sold for what may be called its **natural price**.*
 - So now it is about labor-commanded value and not the labor-embodied!
- Then, attempted to pin down (and failed) natural level of each component:
 - *The natural price itself varies with the natural rate of each of its component parts, of wages, profit, and rent; and in every society this rate varies according to their circumstances, according to their riches or poverty, their advancing, stationary, or declining condition. I shall, in the four following chapters, endeavour to explain, as fully and distinctly as I can, the causes of those different variations.*

Adam Smith (1723-1790)

Theory of value: Natural Wages

- **Spoiler alert:** Smith did not pin down the natural wages.
- First, argued that wages may settle down at the subsistence level (remember from Cantillon), possibly the easiest answer as they can't go below.
 - This gap will be later on filled by Malthus's Law of Population.
- Similar to other Classical writers, adopted **wage fund** idea where wages are assumed to be paid by a fixed capital fund that is equal to last year's profits.

Adam Smith (1723-1790)

Theory of value: Natural Wages

- Concluded that fixed capital fund and subsistence-level wages can pin down employment level → if wages were to go up, employment would go down.
- Wages would go above the subsistence level only in a “growing” economy where wage fund is freed up by contemporary inflow of new capital.
 - *Though the wealth of a country should be very great, yet if it has been long stationary, we must not expect to find the wages of labour very high in it. The funds destined for the payment of wages, the revenue and stock of its inhabitants, may be of the greatest extent; but if they have continued for several centuries of the same, or very nearly of the same extent, the number of labourers employed every year could easily supply, and even more than supply, the number wanted the following year.*

Classical School

Jeremy Bentham (1748–1832)

- An English philosopher regarded as the one of the founding figures of utilitarianism.
- **Key aspect:** Defined the utility in a modern sense where it is measurable, divisible, and summable.
 - *By utility is meant that property in any object, whereby it tends to produce benefit, advantage, pleasure, good, or happiness,... or to prevent the happening of mischief, pain, evil, or unhappiness to the party whose interest is considered.*
- Laid out the Felicific (Hedonic) calculus which aims to model the utility as measurable based on intensity, duration, purity, and the extent (its reach).
 - Gave a peculiar example on calculating the level of minimum penalty to prevent a crime.

Classical School

Thomas Robert Malthus (1766–1834)

- An English reverend and scholar who wrote on economics and population dynamics
- Major works include *An Essay on the Principle of Population*, which will be discussed today, and *Principles of Political Economy*, which will show up later on “General Glut” debate.
- **Key aspects:** Developed a population hypothesis that still influences debates in economics of population growth and development.

Thomas Robert Malthus (1766–1834)

Malthus's Population Trap

- Alluded to Cantillon's subsistence-level wage argument:
 - *Men multiply like mice in a barn if they have unlimited Means of Subsistence.*
- Argued that left *unchecked* humans would procreate faster than the growth of their economic means:
 - *I say, that the power of population is indefinitely greater than the power in the earth to produce subsistence for man.*
 - *Population, when unchecked, increases in a geometrical ratio. Subsistence increases only in an arithmetical ratio. A slight acquaintance with numbers will shew the immensity of the first power in comparison of the second.*
- Conjuring up his famous “trap”, argued that two forces are set to be equal by the nature:
 - *By that law of our nature which makes food necessary to the life of man, the effects of these two unequal powers must be kept equal... This implies a strong and constantly operating check on population from the difficulty of subsistence. This difficulty must fall somewhere and must necessarily be severely felt by a large portion of mankind.*

Thomas Robert Malthus (1766–1834)

Two checks on population: Misery and Vice

- Positive check where necessities erase the “surplus” of procreation:
 - *Among plants and animals the view of the subject is simple. They are all impelled by a powerful instinct to the increase of their species, and this instinct is interrupted by no reasoning or doubts about providing for their offspring. Wherever therefore there is liberty, the power of increase is exerted, and the superabundant effects are repressed afterwards by want of room and nourishment, which is common to animals and plants, and among animals by becoming the prey of others.*

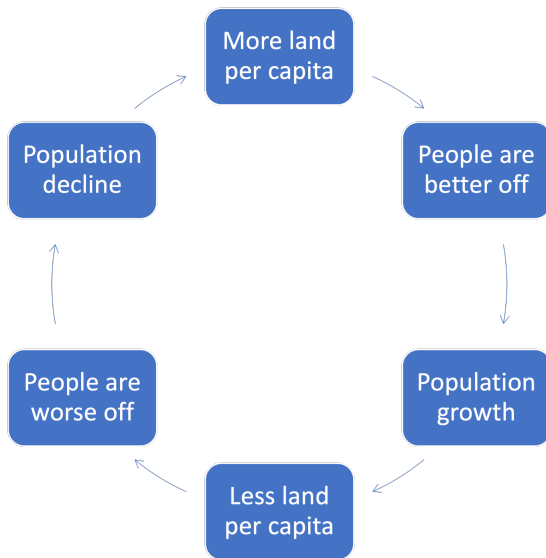
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- For humans, there is also a preventive check:
 - *Impelled to the increase of his species by an equally powerful instinct, reason interrupts his career and asks him whether he may not bring beings into the world for whom he cannot provide the means of subsistence... Will he not lower his rank in life? Will he not subject himself to greater difficulties than he at present feels? Will he not be obliged to labour harder? And if he has a large family, will his utmost exertions enable him to support them? May he not see his offspring in rags and misery, and clamouring for bread that he cannot give them? And may he not be reduced to the grating necessity of forfeiting his independence, and of being obliged to the sparing hand of charity for support?*

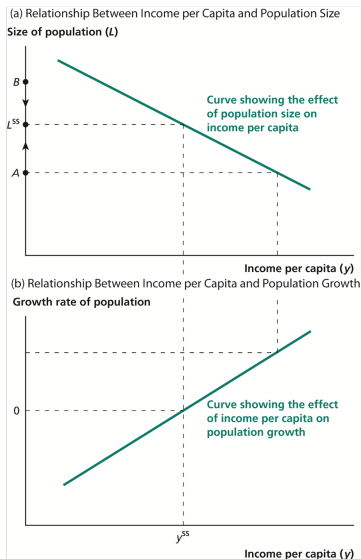
Thomas Robert Malthus (1766–1834)

Malthusian Logic



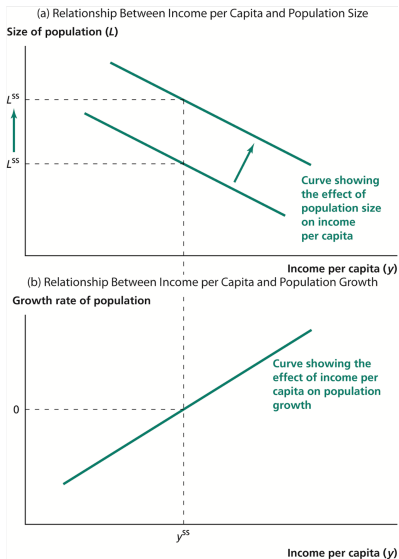
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Malthus's Population Trap



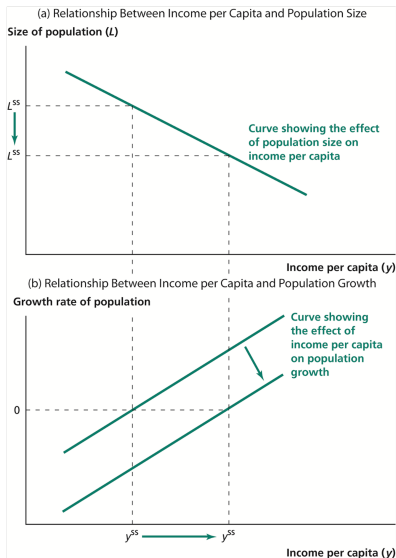
Thomas Robert Malthus (1766–1834)

Ineffectiveness of improving land productivity



Thomas Robert Malthus (1766–1834)

Effect of Moral Restraint



Thomas Robert Malthus (1766–1834)

Empirical examination of Malthus's hypothesis

- The case of Ireland supported his hypothesis:
 - With the arrival of potato, population of Ireland increased from 2 millions to 8 millions in less than 50 years, which followed by the Great Famine, caused by potato blight, reducing it to 4 millions through starvation and migration.
- However, after his death, the case of Britain during the second half of 19th century proved him wrong:
 - Population growth rate declined in spite of declining death rates but more importantly, this happened in a time where the output (and productivity) had increased greatly.
 - His hypothesis argued to be falsified because this change was not due to a deliberate work of moral restraint – humans were simply no longer responding to productivity increases as described.