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Midterm Review Assignment

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Theories/Arguments

1. Gluts and Recession
2. Labor Theory of Value
3. Utility Theory of Value
4. Laisse Faire
5. Conflict vs Harmony
6. Theory of Value? (***explains what determined the exchange value or price of the goods/services sold in markets)***
7. Production vs. exchange perspectives
   1. Exchange point of view is that you never go inside a factory and actually see what is happening. You see people exchanging factors. Also if government does not get involved, then competition will guarantee that people will get paid what they are worth.
   2. Production view says you have to look at different modes of production. Smith says in capitalism that once land lands in particular hands, a small group owns the means of production…Everybody else has to go and get jobs. If this is the case, workers will always take the best they can get…In that setting, there will be other workers who will say, “hey I will work for that.”
8. Class vs individual as the unit of analysis

Possible questions:

Why do people earn what they earn?

Explain arguments and evolution of these arguments.

**Labor Theory of Value**

The labor theory of value that the exchange value of a commodity is determined by the amount of labor embodied in that commodity, plus the relative allocation at different points in time of indirect labor and direct labor used in production. Smith argued that labor was the only original creator of value. He insisted that the necessary prerequisite for any commodity to have value was that it be the product of human labor. Advances in human productivity have been associated with the labor processes that have resulted in the creation of new tools. Some economists argued that the tools produced are the reason behind subsequent production. Smith however, recognized that tools are simply the products of labor and their contribution is really the contribution of the creators of these tools. It was by labor which all the wealth in the world was originally purchased. Smith saw labor as the determinant of exchange value in precapitalist economies. To further explain his arguments on labor value, Smith used a deer vs. beaver market example. In this example, he explains that among the nation of hunters, it usually costs twice as much labor to kill a beaver than to kill a deer. It is therefore reasonable to conclude that one beaver should naturally exchange for or be the worth or two deer. Although Smith never presented a consistent labor theory of value, his ideas where later used by Ricardo in order to present his LVT. Like Smith, Ricardo also advocated that labor reflected the prices of commodities; more importantly, freely reproducible commodities. Ricardo strengthened the LVT principle by dismissing a few objections. Unlike Smith, he believed that the beaver vs. deer argument was also relevant in a capitalist society. *Talk about the objections made and how he dismissed those 2 objections (page 100).*

**Gluts/Depressions**

Malthus’ theory of gluts or depressions is his most important and lasting contribution to economic theory. Malthus’ exchange viewpoint was most likely a factor that led him to investigate the circulation of money and commodities. Malthus explained that the general cause of a general glut of commodities was the periodic insufficiency of effectual demand. In order for effectual demand to equal the value of all commodities produced, all three classes had to be willing and able to spend all of their collective income on the commodities produced in each production period. The issue was that laborers of necessity spent all of their incomes on their subsistence and capitalists were driven by a passion to accumulate capital and had neither the inclination nor the time to spend much of their profits on consumption or personal services. Landlords, however, were gentleman of leisure. Their continual income from rents, allowed them to spend their income on comfortable surroundings, servants, and patronizing the arts, universities, and other institutions of culture. They spent their income on consumer goods. Malthus pursued policies that would alter the distribution of income, leaving the capitalists with lower profits and some other call with more income to spend on consumption! Jeremy Bentham shared a similar concern with Malthus. In a laisse faire government, Bentham came to see that saving might not always be matched by new investment. In this event, production, profits, investment and prices would decrease, unemployment would be created, and the free market would not function in the best interest of the public. It is therefore reasonable to say that Bentham’s concern ties in with Malthus’ arguments on gluts.

**Conflict vs Harmony (61, 79,)**

Much of Smith’s and Ricardo’s analysis flowed from their labor theory perspective. In terms of the issue of class conflict versus social harmony, the labor theory of value view class conflict to be of fundamental importance in understanding capitalism. Smith’s system of natural liberty was envisioned as an economic system in which harmony prevailed. Smith was aware that selfish and acquisitive motives led to individual and class conflicts. The invisible hand, according to Smith, would resolve superficial or apparent conflicts in a manner most conducive to human happiness. It was only as Smith abandoned the labor theory of value however, that he was able to argue for the invisible hand argument and social harmony.

* Smith says LTV in capitalism will not hold but then flounders on a theory of other things. Abandoned LTV accepted “adding up theory”
  + Views property ownership and bargain power… has the production view. But then he said in capitalism LTV wont reflect price.
  + Ricardo says…
* Malthus spent a lot his time against the LTV.

The reason the exchange vantage point generally supports a view of social harmony is that it takes for granted existing laws of **ownership** and the existing **distribution of property right**s. The production vantage point (or labor theory of value) on the contrary, considers these as elements of the economy to be explained by the theory and generally sees them as the legal manifestation of class division.

(exchange view)

Furthermore, when the laws of ownership and distribution of property rights are taken for granted, then every exchange can be seen as mutually beneficial to both parties involved. The laborer who has nothing to sell but labor power is better off if he or she can find a buyer—no matter how low the wage—than if he or she starves. Therefore, all exchange is beneficial to capitalist and laborer alike, particularly if one accepts the inevitability of a class of proprietors and a class of laborers.

The invisible hand is a term used by Adam Smith to describe the unintended social benefits of individual self-interested actions. The phrase was employed by Smith with respect to income distribution (1759) and production (1776). The exact phrase is used just three times in Smith's writings, but has come to capture his notion that individuals' efforts to pursue their own interest may frequently benefit society more than if their actions were directly intending to benefit society.

**Government intervention**

Smith emphasized that Laissez-faire capitalism was the best possible economic system. It was therefore important to have limited government intervention it allowed the forces of competition and the free interplay of supply and demand to regulate the economy. If government did not encourage the investment of capital in any sector, then the capitalists’ selfish quest for maximum profits would cause economic development to take place in accordance to his natural and socially beneficial order. If there was limited government intervention Smith argued, “most men will choose to employ their capitals rather in the improvement and cultivation of land, than either manufacturers in foreign trade.” Smith concluded that government intervention, regulations and grants of monopoly, and subsidies all tended to misdirect capital and to diminish its contribution to economic welfare.

Opposition:

Late Bentham argued for government intervention because he had two concerns. His first concern was that saving would not always lead to investment. Sitting on money would decrease prices, production, profits and investment; unemployment would be created, and the free market would not function according to the interest of the public. Bentham’s second reason to have government interference was to reduce the socially harmful effects of great inequalities and wealth and income.

*Talk about how government interference would fix these two issues… (mention aggregate utility)*

**Rent**

Malthus and Ricardo both had different views on rent. According Malthus rent was, “the natural result of a most inestimable quality in the soil, which God has bestowed on Man—the quality of being able to maintain more persons than are necessary to work it.” Rent existed because of the difference of fertility in the soil (83). Ricardo’s definition of land differed from Malthus’; he defined rent as, “that portion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil.” According to Ricardo, determination of rent was based on two assumptions. The first assumption was that land differed in fertility and all lands could be put on a spectrum from most fertile to least fertile. The second assumption was that competition always equalized the rate of profit among the capitalist farmers who rented land from the landlords. It was this second assumption that Ricardo based his arguments against high rents and corn laws. As a defender of the landlord class, Malthus believed that high rents were both the result of and the best single indicator of general economic prosperity. Malthus argued that because the landlord class was the only class that spent income on commodities produced and consumer goods in each production period, they helped prevent gluts or depressions. Ricardo on the other hand was a defender of the Capitalist class. Ricardo argued that corn laws forced us to cultivate more land. Cultivating more land reduced profit and increased rent. To increase profits and decrease rents, Ricardo supported the idea of importing goods.

**Production vs Exchange**

**Theory of Value**

"Theory of value" is a generic term which encompasses all the theories within economics that attempt to explain the exchange value or price of goods and services. Key questions in economic theory include why goods and services are priced as they are, how the value of goods and services comes about, and—for normative value theories—how to calculate the correct price of goods and services (if such a value exists).

Adam Smith agreed with certain aspects of ***labor theory of value***, but believed it did not fully explain price and profit. Instead, he proposed an ‘Adding-up Theory’ (or cost-of-production theory, to later develop into exchange value theory) that explained value was determined by several different factors, including wages and rents. This theory of value, according to Smith, best explained the natural prices in the market. While an underdeveloped theory at the time, it did offer an alternative to another popular value theory of the time.

The ***utility theory of value*** was the belief that price and value were solely based on how much “use” an individual received from a commodity. However, this theory is rejected in Smith’s work The Wealth of Nations. The famous “water-diamond” paradox questions this by examining the use in comparison to price of these goods. Water, while necessary for life, is far less expensive than diamonds, which have basically no use. Which value theory holds true divides economic thinkers, and is the base for many socioeconomic and political beliefs.

The labor theory of value asserts that the economic value of a good or service is determined by the total amount of socially necessary labor required to produce it. When speaking in terms of a labor theory of value, value without any qualifying adjective theoretically refers to the amount of labor necessary for the production of a marketable commodity, including the labor necessary for the development of any capital used in the production process. Both David Ricardo and Karl Marx attempted to quantify and embody all labor components in order to develop a theory of the real, or natural, price of a commodity.

In either case, what is being addressed are general prices—i.e., prices in the aggregate, not a specific price of a particular good or service in a given circumstance. Theories in either class allow for deviations when a particular price is struck in a real-world market transactions, or when a price is set in some price fixing regime.

**Utility Theory of Value**

The ***utility theory of value*** was the belief that price and value were solely based on how much “use” an individual received from a commodity. However, this theory is rejected in Smith’s work The Wealth of Nations. The famous “water-diamond” paradox questions this by examining the use in comparison to price of these goods. Water, while necessary for life, is far less expensive than diamonds, which have basically no use. Which value theory holds true divides economic thinkers, and is the base for many socioeconomic and political beliefs.

**A)** Explain the general argument Bentham, Say and Senior made about the determinants of income distribution in capitalism. **B)** Explain how this argument can apply equally to both an owner and a worker in a particular firm. **C)** Explain the general type of policy that would be sensible and/or appealing if you accept this general argument about the distribution of income and you want to reduce income inequality. **D)** Explain why. **E)** Finally, briefly explain Adam Smith’s general argument about the determinants of income distribution in capitalism and, if you’re able, describe policies that might reduce inequality if that was the goal.

1. Bentham, Say and Senior had a particular and direct argument on the distribution of wealth. The argument ultimately came down to income being determined by the amount of utility on produces with his activity, to the community. So, a worker can only give the utility of his labor, compared to the capitalist that saves and buys factory. And second, income is determined by the sacrifice one made, as well as the contribution to the production process. Again, a capitalist has the means to “sacrifice”, which is invest and save where a worker gives up free time. A capitalist just sacrificed more and created more utility that goes to the community.
2. A higher capitalist ‘sacrificed’ more and contributed more to production. More utility, compared to the worker that only has his labor (just a given – ignored). In a firm, the CEO, or the boss might have had a big influence on the company because of his investments or “sacrifices”. The worker on the other hand, only does his job, thus not making a significant contribution to be the boss.
3. If one accepts this argument and want to change it and fix inequality, then certain policies would be placed such as:
   1. Creating more utility; more training for workers; more educational opportunities, any certain program that can give workers these “skills” that they are lacking.
4. If the problem is that they can’t make the same contributions as capitalists, then policies should aim to get them closer to having the same skills or knowledge as capitalists. Once they have the skills and knowledge, then they can contribute more and have better opportunities in higher paying jobs.
5. Adam Smith believed that wages were determined by an economic, social and political struggle between the classes. People are rich because they have the means of production which the average working class does not, or cannot have. It comes down to bargaining power. To reduce inequality, one might give workers more bargaining power.